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How the RBI Shaped India's Multi-Pronged Reforms (1997-2008)

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The fifth volume of the history of the Reserve Bank of India helps us understand how the economic reforms and policies during 1997-2008 were shaped in India's complex political and social setting. This is more than a banking and monetary history, it covers the larger economic history of the period.

There are two broad approaches to write histories of institutions like central banks. The first way is to divide the period under the review into mini periods and then analyse how the organisation journeyed through the period. The second is to divide the organisation across various departments and functions and analyse how the various departments and functions traversed through the period. For the first, you ideally need a long period - only then can you analyse the history through mini periods. For the second, you need enough departments and functions to chronicle the history.

Each of the first four volumes on the history of the Reserve Bank of India (RBI) from its founding in 1935 onwards followed one or the other approach. The fifth volume, covering the period 1997-2008, has adopted the second approach, dividing the history across RBI's functions into chapters: macroeconomic context, monetary management, financial markets, foreign exchange management, regulation and supervision of financial system, rural credit, organisational changes and so on.

This review of the fifth volume of RBI's history offers an overview of the working of the RBI as detailed in individual chapters. (Ashutosh Raravikar provides a snapshot of all five volumes.)

Macroeconomic context

The fifth volume's period starts with the Southeast Asian crisis in 1997 (chapter 1, 'The Macroeconomic Context'). The crisis acted as a red herring for countries wishing to liberalise too quickly, especially in the financial sector. The crisis was followed by the nuclear tests at Pokhran in 1998, which posed macroeconomic challenges in the wake of sanctions.

Post these two stiff challenges, the Indian economy saw "robust growth." The average growth rate in the first half of the period (to 2002) was 5.3% and in the second half (2002-07) it touched 8.8%. In general, average growth rates were higher across regions (barring advanced economies) in the second half of the period.

> This stability in finance ministership and RBI governorship laid the foundations for a stable and high growth macroeconomic environment as well.

It is remarkable that India grew at higher rates despite frequent changes in the government. There were four short-lived governments between 1996-99, followed by two stable governments which completed their terms. The volume notes that despite volatile political environments, the finance ministry was headed mainly by just three finance ministers: P. Chidambaram, Yashwant Sinha, and Jaswant Singh. Likewise, there were three RBI governors in the period: C. Rangarajan (December 1992 to November 1997), Bimal Jalan (November 1997 to September 2003) and Y.V. Reddy (September 2003 to September 2008).

This stability in finance ministership and RBI governorship laid the foundations for a stable and high growth macroeconomic environment as well. Apart from growth, most of India's macroeconomic indicators improved significantly during 1997-2007.

A multiple indicators approach

Monetary policy went through significant changes in the period in all aspects: objectives, instruments, and processes of policymaking (chapter 2, 'Monetary Management').

The RBI, which had historically focused on inflation and ensuring credit flow to the economy, added a third objective: financial stability. This was mainly in response to the multiple crises during that period.

The central bank shifted to new instruments for achieving these objectives. For its credit objective, the central bank moved from administered interest rates to market interest rates. For price stability, it shifted from using instruments from the cash reserve ratio (CRR) and the bank rate, to the liquidity adjustment facility (LAF). The introduction of the LAF in 2000 was a major turning point in RBI's monetary policy as it could manage markets by infusing or withdrawing liquidity. For financial stability, the central bank monitored volatility in bond and foreign exchange markets along with limiting exposure of banks to foreign inflows.

The process of monetary policy making also changed from monetary targeting to a multiple indicator approach. The central bank had started targeting money supply (M3) as an anchor for price stability following the recommendations of the Chakravarty Report (1985). Many countries had adopted monetary targeting and failed. India went through a similar experience as well. The monetary target was achieved only four times during 1985-1998. In 1998, RBI shifted its approach from monetary targeting to using a Multiple Indicator Approach (MIA). Under MIA, the central bank tracked multiple economic indicators from quantity variables such as money, credit, and output, to rate indicators such as inflation and different interest rates.

The central bank based its monetary policy decision based on all these multiple indicators. The monetary policy decision was announced in terms of two interest rates under the LAF: repo rate for infusing liquidity and reverse repo rate for absorbing liquidity.

More autonomy

The RBI gained more autonomy during 1997-2008 due to three distinct policy changes.

First, the government and the RBI signed an agreement to discontinue issuance of ad-hoc treasury bills. In the early 1950s, the government started issuing treasury bills to the central bank in return for funds to bridge its deficits. This facility, which was supposed to at best be temporary, became permanent for the next four decades. Each time the government needed funds, it issued these bills in an ad-hoc manner to the central bank, a practice known as deficit financing. This meant that monetary policy always played second fiddle to fiscal policy.

> In 1997, the government and RBI signed an agreement that stopped this practice of deficit financing.

As part of the 1991 reforms, the government and RBI decided to stop this financing arrangement. The government agreed to start financing its deficit from the market by issuing bonds. This meant a market for government bonds had to be developed, which took a few years. In 1997, the government and RBI signed an agreement that stopped this practice of deficit financing.

Second, the enactment of the Fiscal Responsibility and Management (FRBM) Act put a ceiling on government's deficits (fiscal deficit at 3% of GDP and revenue deficit at 0%). It also prohibited the RBI from participating in purchasing government securities in the primary market.

Third, the RBI Act (1934) was amended. Earlier the CRR could not be lower than 3% or higher than 20%. The new amendments gave RBI operational independence to set CRR at any level. Further, a new section was added to the RBI Act that gave clarity on central bank's regulatory powers over money and foreign exchange derivative markets.

The period also saw RBI forming an informal advisory group named as the Technical Advisory Committee on Monetary Policy (TACMP). The TACMP comprised experts and economists who advised the governor on monetary policy. This added to the autonomy of central bank in taking monetary policy decisions.

Market interfaces

Earlier, monetary policy was an internal affair, with the major changes announced in form of circulars. As monetary policy became more market oriented, it was imperative that the central bank change its communications policy.

The RBI started issuing monetary policy statements and putting them on its website for wider dissemination. It also increased the frequency of its monetary policy meetings to quarterly from biannually. The top management started giving more speeches explaining the stance of monetary policy and many other developments. The central bank also became more open towards getting feedback from different stakeholders: banks, industry bodies, trade associations, and economists.

One of the highlights of the fifth volume is an attempt to understand how different kinds of financial markets develop (chapter 6, 'Financial Markets'). When we say financial markets, we mean money markets and government securities markets (bond markets). These

markets had started functioning earlier but were perfunctory as interest rates were administered. Post the 1991 reforms, interest rates were deregulated, automatic monetisation of deficits was stopped, and the statutory liquidity ratio (SLR) was reduced.

Money and bond markets needed to adapt to these huge policy changes, leading to a complete transformation of money and bond markets. The call money market became a highly popular source for uncollateralised interbank funding. The central bank also developed new collateralised funding markets such as market repo and collateralised lending and borrowing operations (CBLO) for providing a stable source of inter-bank funding. Certificates of deposit became a popular source for banks to raise money. Corporates increasingly began to tap funds via commercial papers.

> A key institutional intervention was the establishment of the Clearing Corporation of India Limited … in 2002 ,which played a stellar role in development of money and bond markets.

In the bond market, the government shifted its borrowing to the market players. It began to issue treasury bills of different maturities (14, 91, 182, and 364 days) and bonds of different maturities. In 1994, the RBI had started the primary dealer system to enable buying and selling of government securities. The primary dealing activity picked up steam with the development of money and government bond markets. The period also saw the introduction of new bond instruments such as floating rate bonds and strips, and new ways of trading such as "when issued" trading and "short-selling".

A key institutional intervention was the establishment of the Clearing Corporation of India Limited (CCIL) in 2002 to act as a central counterparty for all trades involving government securities and foreign exchange and guarantee their settlement. The CCIL was instrumental in developing CBLO and NDS-OM (negotiated dealing system-order matching) which acted as an anonymous platform for trading in government securities.

Capital account convertibility

One of the contentious policy issues during the period was the pace of liberalisation of the capital account of the balance of payments (chapter 4, 'Foreign Exchange Market and Management of the Capital Account'). India had broadly liberalised the current account (export and import of goods and services) by 1994 but had decided to go slow on capital account convertibility (CAC) (inflow and outflow of foreign capital).

The period saw constitution of several committees, task forces, and internal working groups to suggest a roadmap for CAC. The two committees with S.S. Tarapore (a former deputy governor of RBI) as chairpersons led to intense discussions. The Tarapore I Committee Report of 1997 recommended CAC over a three-year period beginning 1997-98. Soon after the release of the first report, the Southeast Asian crisis broke out. One key lesson learnt was to be very cautious about CAC.

The Tarapore II Committee in 2006 noted that RBI had been muted on some of the recommendations of 1997 committee such as on liberalisation of resident capital outflows. However, on some of the recommendations the RBI had made progress beyond what was suggested in the 1997 committee such as outflows by corporates. By the time of the second report, there was a broad thinking that India should move towards a fuller CAC. This was yet again stalled due to the 2008 global financial crisis. The gradualist approach has stood the test of time because of the lessons learnt from the both the 1997 and 2008 crises.

> The government and the central bank worked out a policy named the Market Stabilisation Scheme … under which the government issued bonds to absorb extra liquidity arising from the capital inflows.

Apart from discussions on CAC, the major policy change in this period was the shift from the Foreign Exchange Regulation Act (FERA) of 1973 to the more liberal Foreign Exchange Management Act (FEMA) 1998. CAC liberalisation, albeit gradual, and the shift to FEMA led to a surfeit of capital flows. Net capital flows as a percentage of GDP increased to 8.6% from 2.3%.

By the mid-2000s, the economy was dealing with the different problem of surplus capital flows and appreciation of the rupee. The government and the central bank worked out a policy named the market stabilisation scheme(MSS) under which the government issued bonds to absorb extra liquidity arising from the capital inflows. Foreign exchange reserves increased to $309.7 billion in 2007-08 (equivalent to import cover of 14 months) from $29.3 billion in 1997-98 (import cover of 7 months).

The central bank used the reserves for intervening in foreign exchange markets during times of high volatility. The reserves also acted as a buffer during crises, a key lesson learnt from the 1997 Southeast Asian crisis. The volume has a useful discussion on how the central bank managed foreign exchange reserves and dealt with 'the impossible trinity' (a fixed exchange rate, free capital inflows and an independent monetary policy). Towards the end of the period, there was a debate between the government and the RBI on using a part of foreign exchange reserves for infrastructure development.

Regulating the financial system

This history of the RBI devotes three chapters (parts I and II of chapters 10 and chapter 11) to regulation and supervision of the different kinds of banks in India: commercial banks, cooperative banks, and regional rural banks. If one includes rural credit and financial inclusion (chapters 12 and 13), there are five chapters, which is one third of the entire volume.

The period 1997-2008 saw banks becoming financial conglomerates offering multiple financial services through subsidiaries: investment banking, mutual funds, and insurance. It was also highly eventful for regulation and supervision of financial system.

In an earlier period, the a committee headed by M. Narasimham (a former RBI governor) in 1991 had suggested a roadmap for reforming the financial system. The RBI constituted another committee under Narasimham in 1998 to review the banking reforms and strengthen financial institutions. The period saw the constitution of more committees and working groups to review different aspects of the complex financial system.

The reforms in banking sector become more difficult as the government was a major owner of the banking system via public sector banks (PSBs). The PSBs remained dominant due to implicit government protection but government interference also hindered their progress. On the other hand, the new private sector banks gradually began to chip away the share of PSBs because of fully computerised branches, better customer services, and innovative products. There was a discussion on allowing foreign banks to expand in India which led to a proposal to enable foreign banks to establish subsidiaries.

> The period saw the major failure of one private sector bank […] and one urban cooperative bank […] However, the volume discusses both the cases very sparsely which is disappointing.

Apart from detailing different kinds of banks, the volume comprehensively discusses how the prudential norms of banks were improved. Under the Basel-I norms, the banks were supposed to have a capital adequacy ratio (CAR) of 8%, which was achieved for most commercial banks. The RBI also went ahead to increase the minimum CAR to 9%.

The chapter on regulating non-banks discusses RBI's efforts to bring more transparency and governance to the myriad non-banking institutions. The central bank faced challenges to reform cooperative banks, which enjoyed political patronage from the state governments. The period saw the major failure of one private sector bank (Global Trust Bank) and one urban cooperative bank (Madhavpura Mercantile Cooperative Bank). However, the volume discusses both the cases very sparsely which is disappointing. The cases studies would have helped us understand lessons from failures of banks.

In the area of supervision, the central bank enjoyed more autonomy in the regulation, making the task relatively easier. The bank failures led the central bank to sharpen its supervisory tools. The RBI, which was heavily reliant on online inspection, began to conduct active offline inspection. The central banks also shifted towards risk-based supervision, adapted to the risk profile of the supervised entity.

Financial inclusion

For the first time, the RBI history volume has a separate chapter on financial inclusion, customer protection and financial literacy (chapter 13, 'Financial Inclusion').

One key development, which drove the central bank towards financial inclusion was that data started showing a rising share of informal sources of lending. The focus of 1991 reforms was on cleaning the banking system. The inclusion agenda which started post bank nationalisation (even if not called financial inclusion) began to be ignored.

For spreading financial inclusion, the central bank introduced multiple initiatives. Banks were asked to open no-frills account, which required nil or very low balances. The banks could appoint banking correspondents as their agents in far flung areas to provide basic

services such as issuing small loans or collecting deposits. The two major innovations which started during the period were introduction of the Kisan Credit Card and the establishment of self-help groups to provide rural credit.

Another interesting nugget is that financial inclusion as a phrase and as a policy was initiated by the RBI (not discussed in the volume). Earlier, the policy focus and measurement was on financial exclusion which measured how many people were excluded from basic financial services. Governor Reddy shifted the locus to financial inclusion, which measured how many people were provided basic services. This was a more positive way of analysing and driving the agenda.

The central bank nudged banks to make banking easier for customers: simplify procedures, streamline banking charges and enhance customer experience. It also established a new customer service department to coordinate this important activity. The RBI had established a banking ombudsman scheme in 1996 to redress customer grievances. The central bank worked to make the scheme more effective in the reference period.

The RBI also realised (late though!) that financial literacy was the key to both customer protection and financial inclusion. Financial literacy was a huge challenge in India given its size, multiple languages, and high general illiteracy. Individual departments took their own initiatives to educate the public. For instance, the department of non-banking supervision released advertisements in 13 languages in 24 papers on depositing money with NBFCs. Given regional challenges, the several regional offices sprang into action. The New Delhi office decided to spread financial literacy using the comic book approach, fashioning the now-famous *Raju* series of comics.

The foundations for digital payments

Chapter 8, 'The Payment and Settlement System', is worth reading as it tells how the RBI, government, and other stakeholders laid the foundations for today's digital payments revolution.

The RBI had earlier introduced several changes: introduction of magnetic ink character recognition (MICR) for cheques, electronic fund transfer (EFT) and electronic clearing service (ECS). The RBI had also established the Institute for Development and Research in Banking Technology (IDRBT) and carved out a new department for information technology.

The central bank took several initiatives to develop the retail payment systems. A retail payment system deals with small value payments at large volumes in form of cheques, transfers, debits, or ATM withdrawals. Apart from cash, cheques were the dominant form of paper-based payments. Several initiatives were taken to improve the cheque settlement system: including computerising clearing houses and speed clearing for settlement of intercity cheques.

> Customers were beginning to use e-commerce and the internet for buying and selling, leading to rise in new payment services. The government also started using electronic payment systems to transfer payments to beneficiaries.

The electronic retail payment system started growing in the period for both debit (like auto-debit of utility payments and investments) and credit transactions (of salaries and pensions). For transferring funds on a one-to-one basis, the national electronic funds transfer (NEFT) system was implemented from 2003 onwards. The real-time gross settlements system or RTGS for large value payments was used for both retail and inter-bank purposes.

Card-based transactions, especially debit card transactions, registered high growth in the period. The number of ATMs increased more than 40 times to nearly 35,000 by 2008 from 800 in 1999. In parallel, customers were beginning to use e-commerce and the internet for buying and selling, leading to rise in new payment services. The government also started using electronic payment systems to transfer payments to beneficiaries.

The RBI's governing body formed an internal committee, the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS), for setting the broad vision for payments. The central bank formed the department for payments and settlement systems (DPSS) to rollout the BPSS's vision.

Though there was a maze of regulations covering contracts, transactions, and information technology, none covered electronic transactions and fund transfers comprehensively. Even the RBI lacked powers to regulate electronic transactions. In its first meeting in 2005, the BPSS suggested a separate regulation for electronic fund transfers to give it legal backing. In 2007, the RBI and the government started working on a new act to give legal basis to all electronic payments and settlements.

The Payments and Settlement Systems Act and regulations came into being in August 2008, just after this volume's period ends. In the next volume, this theme will surely be the most prominent one, showing the transition of India's payments to the digital payment system.

Currency tweaks

The RBI discusses four activities related to banknotes (chapter 9, 'Currency Management'): improvement of supply, management of quality, detection of counterfeits and enhancement of security features. Earlier, the banknotes were printed at government presses in Nashik and Dewas. The central bank owned presses at Mysore and Salboni became fully operational during the reference period leading to improvement of supply. A clean note policy helped manage quality and detection of counterfeits. The central bank introduced new features under the Mahatma Gandhi series to deal with counterfeiting and improving the life of the notes.

The Rs 500 note was reintroduced in 1987-88 and the Rs 1000 note on 2000-01. We know that this Rs 1,000 note was demonetised 15 years later in 2016, along with the Rs 500 Mahatma Gandhi series note. Needless to say, the currency management of RBI has been very chaotic in the decade of 2010s which will (hopefully) be given due attention in the next volume.

Debt management

While the RBI gained and maintained autonomy for most part of the reference period, it started developing frictions with the government towards the end. There were frictions over quite a few issues, capital account convertibility, interest rate increases, exchange rate management etc. One such issue was that of a debt management office (Chapter 7, public debt management).

One of the RBI's functions is to manage the borrowing programme of the government. Once the government announces the borrowing for the given financial year, RBI designs the auction calendar of government securities, conducts auctions of securities and even conducts clearing and settlement of government securities.

> The 2013 economic slowdown and the 2020 pandemic also helped buttress RBI's views that it was better equipped to coordinate and manage the government debt.

In 2007, the then Finance Minister P. Chidambaram announced setting up a debt management office within the finance ministry. This practice of setting up a separate debt management office has been followed across developed countries such as the US and UK. The thought is that as central bank sets interest rates and also manages banking regulations, debt management acts as conflict of interest. The central bank would not be fully independent while setting interest rates as it would disrupt the borrowing programme.

The central bank disagreed with this proposal as it thought the government ownership of public sector banks leads to a larger conflict of interest as banks act as the major buyers of these bonds. Moreover, with the enactment of the FRBM Act in 2003, the conflict of interest at the central bank level had been mitigated. The government rejected RBI's view and went ahead with establishing a middle office in August 2008.

However, soon thereafter the global financial crisis hit and the government's proposal never took off. There were discussions in the later period but RBI thought it did a better job of managing the debt. The 2013 economic slowdown and the 2020 pandemic also helped buttress RBI's views that it was better equipped to coordinate and manage the government debt.

Leaner and fitter

The history of RBI usually focuses on the history of various policies of the central bank. However, history of RBI is also history of the RBI as an organisation (Chapter 15, 'Organisational Change'). The 1991 reforms forced companies to change but RBI made several changes thanks to its proactive leadership.

With the growth in computers, there was a decline in the "need for clerical work of posting, clerical computing, typing and manual passing of vouchers." The RBI all but stopped recruiting lower-rung staff. Between 1997 and 2008 overall staff strength declined to 21,000 from around 33,000. As a follow-up, the RBI took major steps to increase capabilities in computers and information technology both within the organisation and outside the organisation.

In tandem, the RBI moved towards recruiting more specialists with professional qualifications. It took measures to make the central bank a rewarding place to work by transitioning to a five-day week, providing high home loan limits, offsite retreats, medical facilities,

pensions and other perks.

To build human capital in the central bank, RBI took several measures. It started organising many workshops and seminars to train employees especially in the economic research division. The RBI started sending officers abroad for training. The RBI itself became a major training ground for officers of South Asian and African central banks. The RBI and IMF also started a joint training program in 2006 to impart macroeconomic and financial training to governments and central banks of South Asia and East African regions.

Apart from organisational changes, the chapter has interesting nuggets.

The first is of Customs and Central Excise sending notices to RBI to pay service tax on its services.

The central bank protested that it was not a commercial enterprise and most of its services were statutory in nature and were like a public good. The central bank raised the issue with the finance minister, saying this was akin to the government taxing itself. The finance minister exempted the central bank from service tax but only prospectively. This meant the central bank has to pay service tax for the period 2001-06.

The second is of RBI deciding to promote certain deserving officers who could not be promoted in the normal due course. Perhaps being too adventurous, the RBI promoted Executive Director S.B Burman as the fifth deputy governor. Under the RBI Act (1934), the central bank could have only four deputy governors and all were to be appointed by the government. Needless to say, the government struck down the promotion. Barman remained an executive director but drew emoluments of a deputy governor.

Third, the RBI held shares in several organisations: State Bank of India, Securities Trading Corporation of India (STCI), Discount and Finance House of India (DFHI), Infrastructure Development Finance Company (IDFC) and so on. The RBI acted as a venture capitalist to all these companies With maturity in markets, there were suggestions that RBI sells its stake either in the market or to the government. The stakes in STCI and DFHI were sold to the other shareholders. As SBI was a public sector bank, the stakes were sold to the government. A former deputy governor, S.S. Tarapore, called it a "financial fudge" as government buying SBI stake was treated as capital expenditure, whereas RBI gains from the transaction was treated as a revenue receipt. The transaction kept the fiscal deficit unchanged but revenue deficits declined. The government always has a way around financial engineering.

Two governors

The years 1997-2008 cover a time when worldwide, central bankers begin to become more transparent, talk to media, give speeches and so on. The financial markets began to track every word by the central bank top management to gauge the policy stance and impact on financial markets. These changes would definitely put a spotlight on the RBI governor, the face of the organisation.

The volume does not pay much attention to the three governors who held office during during the period: C Rangarajan, Bimal Jalan and Y.V. Reddy. Rightly so, as this is a history of the RBI and not about the personalities of the governors. But given the period it is difficult not to talk about the leadership of the organisation.

Leaders are known for the institution they leave behind and both Jalan and Reddy did exceedingly well on this front. (Rangarajan was governor only for a brief part of the period covered in this volume hence the focus on the other two). Jalan handled RBI during the South East Asian crisis and later shaped RBI during this transition from a conservative central bank to a media savvy central bank.

> It is a pity that after the tenures of Jalan and Reddy ended, the government resorted to 3-year terms open to renewals leaving the whole thing uncertain and in hands of the government.

Reddy became governor when the idea of faster capital account liberalisation and financialisation of the economy was the global theme. Reddy, who was deputy governor first under Rangarajan and later under Jalan, learnt from both. He not only carried the legacy forward but also stamped his own impressions. He not just played devil's advocate by questioning the global theme but took measures to protect the economy from an eventual crisis. In his own words, he was seen as the worst central bank governor before the crisis and best after the crisis.

Both leaders also in a way contributed towards appointing women at the top leadership position of the central bank. Under these two governors, three women deputy governors were appointed: K.J. Udeshi, Shyamala Gopinath, and Usha Thorat. After these two governors, the RBI went back to a male-dominated top leadership.

One factor that helped Jalan and Reddy perform their roles in such an emphatic way was their long-term tenure. Jalan held office for 5.5 years and Reddy was given a straight five-year-term. It is a pity that after their tenures ended, the government resorted to three-year terms open to renewals, leaving the whole thing uncertain and in hands of the government.

Concluding thoughts

Overall, the fifth volume helps us understand how the reforms and policies were shaped in India's highly complex political and social setting. The writing is crisp, precise, and avoids over-explanation. It is no mean feat to summarise the highly eventful period in 650 pages.

Some areas where the volume could have added more is on the crises in the two banks that failed during the reference period. India saw a spate of similar banking failures in the 2013-19 period. The case of Yes Bank case can be compared to GTB and Punjab and Maharashtra Cooperative Bank can be compared to Madhavpura Cooperative Bank. The RBI history is one place where one can get detailed accounts of bank failures. For instance, the first volume had a detailed analysis of the failure of Travancore National Quilon Bank and the second one an analysis of the Palai Central Bank, both of which guide bank historians till date.

Ideally, RBI's history volumes should be required reading on courses on Indian economy. These volumes do not just cover the monetary and banking history but paint a much bigger canvas of India's economic and developmental history.

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