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Effect of Monetary Tightening and Development Finance Inflows in Nigeria

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Abstract

This study investigated the impact of monetary tightening on development finance inflows in Nigeria between 2010 and 2024. Amidst global interest rate hikes and contractionary policies, Nigeria's Central Bank has implemented several tightening measures, including multiple increases in the Monetary Policy Rate (MPR) to combat inflation and currency depreciation. However, these actions may have unintended effects on the availability of development finance, particularly for infrastructure, SMEs, and concessional lending. Using time series data and econometric models including OLS and Correlation Matrix, the macroeconomic indicators used were inflation rate, exchange rate, Central Bank of Nigeria monetary policies rate and credit to the private, and MPR on development finance inflows. The results showed that although these indicators exhibited expected directional effects, none of them were statistically significant predictors of development finance. The findings indicate that development finance inflows are influenced more by structural, institutional, and governance-related factors than by conventional macroeconomic variables. The study recommends a multidimensional policy approach that integrates macroeconomic stability with institutional reforms and governance enhancements to attract sustained development finance. This research contributes to the understanding of how monetary policy interacts with development finance in emerging economies.

Keywords: *FDI, macroeconomic variables, exchange rate, inflation.*

INTRODUCTION

Monetary tightening is characterized by increased interest rates, significantly impacting development finance flows, particularly in emerging and developing economies. As central banks in major economies adjust their monetary policies to combat inflation, the repercussions are felt globally, affecting capital inflows and financial stability in developing nations. This study explores the multifaceted effects of monetary tightening on development finance, highlighting key aspects such as credit supply, capital flows, and economic growth.

Monetary tightening reduces credit supply, as evidenced by increased loan application rejections and higher interest rates, particularly affecting banks with high leverage and sovereign debt exposure (Abuka et al., 2017). The tightening of credit can stifle economic activity, particularly in sectors reliant on financing, such as trade and construction (Abuka et al., 2017). Rising interest rates in developed countries can lead to a slowdown in capital inflows to developing economies, with potential reductions of 0.6% of GDP, primarily affecting portfolio investments (Burns et al., 2014). Historical data indicate that abrupt increases in interest rates can result in a sharp decline in capital inflows, posing systemic risks to economies with high external debt and current account deficits (Benediktsdóttir, 2023). Financial flows, while essential for economic growth, can also lead to real exchange rate appreciation, which may undermine competitiveness (Combes et al., 2019). A one percent increase in financial flows can appreciate the real exchange rate by 0.5%, indicating a complex relationship between financial inflows and growth outcomes (Combes et al., 2019).

Monetary tightening significantly impacts credit supply in developing economies through various mechanisms,

primarily affecting the behavior of commercial banks and the accessibility of credit for borrowers. The interplay of interest rates, reserve requirements, and credit rationing plays a crucial role in shaping these dynamics. Higher interest rates increase the cost of borrowing, leading to reduced demand for loans. Commercial banks may tighten lending standards, making it harder for borrowers, especially those with lower incomes, to access credit (Hou, 2025). Restrictions on debt-to-income (DTI) ratios are critical; as monetary policy tightens, these restrictions often become more stringent, disproportionately affecting young and middle-income borrowers(Bosshardt et al., 2023)(Bosshardt et al., 2023). Regions with historically high DTI ratios experience more significant declines in mortgage originations and overall credit availability (Bosshardt et al., 2023). In environments where credit is already constrained, tightening monetary policy can exacerbate these conditions, leading to more pronounced effects on the real economy (McCallum, 2016). The degree of credit rationing varies across countries, influenced by local economic and regulatory contexts (Öner & İçellioğlu, 2020).

The experience of monetary policy tightening in Nigeria has been marked by a series of strategic decisions aimed at stabilizing the economy, particularly during periods of financial distress. The Monetary Policy Committee (MPC) has tightened the Monetary Policy Rate (MPR) ten times in recent years, including during economic contractions, which has led to criticism regarding its responsiveness to economic conditions (Teriba, 2017). The Cash Reserve Ratio (CRR) has also been tightened ten times, reflecting a cautious approach to liquidity management (Teriba, 2017).

Statement of the Problem

Monetary tightening, characterized by rising interest rates and contractionary fiscal policies, has emerged as a major macroeconomic policy tool to combat inflationary pressures globally. In Nigeria, the Central Bank has repeatedly raised the Monetary Policy Rate (MPR), most recently to 26.25% in May 2025, in response to persistent inflation and currency depreciation (CBN, 2025). While such policy measures are aimed at achieving price stability, they often have unintended consequences on the availability and affordability of development finance, particularly for critical sectors such as infrastructure, agriculture, and small and medium-sized enterprises (SMEs).

The Nigerian economy, which relies heavily on external borrowing and concessional finance to bridge infrastructure and development gaps, has experienced a decline in development finance inflows in recent years. Institutions like the African Development Bank (AfDB) and the World Bank have signaled concerns over the rising cost of borrowing and the weakening capacity of developing economies to attract concessional finance amidst global monetary tightening by advanced economies (AfDB, 2024; World Bank, 2024). High interest rates not only raise the cost of domestic borrowing but also reduce investors' appetite for long-term developmental projects, which are typically low-yielding and risk-prone.

Despite the apparent macroeconomic rationale behind monetary tightening, there is limited empirical analysis on its multidimensional impact on development finance flows in Nigeria. The need to balance inflation control with long-term developmental needs presents a policy dilemma. Hence, there is a growing imperative to understand how sustained monetary tightening affects the volume, structure, and accessibility of development finance, and to explore policy options that ensure macroeconomic stability without compromising sustainable development goals.

Research Questions

This study provided answers to the following research questions that emanated from the statement of the problem;

1. What is the effect of the inflation rate on the volume of development finance inflows into Nigeria?
2. How does the exchange rate affect the development finance inflows in Nigeria?
3. To what extent does Credit to the private sector (CPS) affect development finance inflows in Nigeria?
4. What is the effect of the Central Bank of Nigeria's monetary policy rate on development finance flows in Nigeria?

Objectives of the Study

The broad objective of this study is to investigate the effects of monetary tightening on the financial development inflows, while the specific objectives are to;

1. Examine the effect of monetary tightening (inflation rate) on the volume of development finance inflows into Nigeria.
2. Assess how the exchange rate influences the accessibility of development finance inflows in Nigeria.
3. Evaluate the extent interest rates affect donor and private investor confidence in financing development projects in Nigeria.
4. Examine how the Central Bank of Nigeria's monetary policy rate affects development finance flows in Nigeria.

Hypotheses

Based on the research questions, the following testable hypotheses are proposed:

H1: The Inflation rate does not affect the development finance inflows in Nigeria.
H2: The Exchange rate does not affect the development finance inflows in Nigeria.
H3: Credit to the private sector (CPS) does not affect the development finance inflows in Nigeria.
H4: Central Bank of Nigeria's monetary policy rate does not affect the development finance inflows in Nigeria.

Conceptual Review

Monetary tightening refers to the deliberate contraction of the money supply by a central bank to curb inflation, typically through increases in interest rates or reductions in liquidity. In Nigeria, the Central Bank of Nigeria (CBN) has adopted such a stance in response to rising inflation and naira depreciation (CBN, 2025).

Monetary tightening in developing economies primarily affects credit supply through several mechanisms, including restrictions on debt-to-income ratios, changes in interest rates, and credit rationing. These mechanisms influence the availability and cost of credit, impacting both individual borrowers and broader economic activities. The effects are often more pronounced in regions with historically high debt levels and among specific demographic groups, such as young and middle-income borrowers. The following sections detail these mechanisms and their implications.

Changes in interest rates are a core tool of monetary policy. Increases in interest rates raise the cost of borrowing, which can reduce the credit supply by making loans less affordable for borrowers. This mechanism affects the credit behavior of commercial banks, influencing their risk appetite and lending capacity (Hou, 2025).

The monetary policies of advanced economies, such as the US, also affect credit supply in developing economies. For instance, changes in the Federal Reserve's policy rates can influence credit growth in emerging markets, although the sensitivity varies across countries due to differing economic, legal, and political environments (Öner & İçellioğlu, 2020).

While these mechanisms highlight the direct effects of monetary tightening on credit supply, it is important to consider the broader economic context. Factors such as global economic conditions, domestic fiscal policies, and structural economic characteristics can also play significant roles in shaping the credit supply landscape in developing economies. These elements can either amplify or mitigate the effects of monetary policy changes, leading to varied outcomes across different regions and economic sectors.

Development finance flows in Nigeria encompass various external financing mechanisms that aim to bridge the gap between domestic savings and investment, thereby facilitating economic growth. These flows include foreign direct investment (FDI), official development assistance (ODA), remittances, foreign portfolio investment (FPI), and external debt. Each of these components plays a distinct role in shaping Nigeria's economic landscape. Foreign Direct Investment (FDI) FDI has a positive impact on economic growth, providing essential capital for development projects and infrastructure (Ikeora & Ekwunife, 2019).

Official Development Assistance (ODA), often in the form of grants and concessional loans, is crucial for funding public services and infrastructure, although its effectiveness can be hindered by political motives (Ikeora & Ekwunife, 2019). Remittances Financial remittances from Nigerians abroad enhance domestic investment and consumption, particularly when supported by a developed financial sector (Okunade et al., 2023). While Foreign Portfolio Investment (FPI) contributes to capital inflows, but lacks the management control associated with FDI, making its impact on long-term growth less significant (Ikeora & Ekwunife, 2019). External Debt, while necessary for funding, excessive reliance on external debt can lead to negative economic consequences if not managed properly (Ikeora & Ekwunife, 2019).

2. Theoretical Framework

This study is anchored in the Monetary Transmission Mechanism theory, which posits that changes in monetary policy (like interest rate hikes) affect the broader economy through various channels, including credit supply, investment behavior, and foreign capital flows (Mishkin, 2007). In the context of development finance, tighter monetary policy may result in reduced credit availability and increased borrowing costs, thus deterring development investments.

3. Empirical Review

Research by the World Bank (2024) highlights that global monetary tightening in advanced economies like the U.S. and the EU has led to capital outflows from developing countries, with African nations experiencing reduced access to development finance. Similarly, AfDB (2024) reports a decline in concessional lending amid higher global interest rates.

Olayemi and Ibe (2023) found that monetary tightening in Nigeria between 2021 and 2023 led to a decline in credit to the private sector, particularly SMEs. Furthermore, Adebayo et al. (2022) argue that high interest rates have a crowding-out effect on developmental investment, as commercial banks prefer risk-free government securities over long-term developmental lending.

Another study by Eze and Obasi (2023) indicates that monetary policy shocks adversely affect foreign direct investment and donor-funded projects, which are essential sources of development finance. They suggest that the cost of capital becomes prohibitively high under tightened conditions, reducing investor appetite.

The impact of infrastructure spending and macroeconomic factors on foreign direct investment (FDI) from 1981 to 2018 was examined by Wijaya, Astuti, Tarigan, and Edyanto (2020). This research employed a quantitative methodology. The gross domestic product, exchange rate, debt-to-GDP ratio, inflation rate, interest rates, and infrastructure spending are among the variables used in this study. The findings indicate that every element has a relationship to FDI, both short-term and long-term.

Karau and Ng'ang'a (2019) evaluated the influence of macroeconomic determinants on FDI in Kenya (FDI). The study employed four macroeconomic variables, including foreign exchange rates, tax rates, inflation rates, interest rates, and balance of payments during the period 1970 to 2010. The analysis discovered that while FDI had a negative association with inflation and the tax rate, it had a positive link with interest rates and the balance of payments. According to the study, in order to increase FDI inflows, the government should work to create a stable macroeconomic climate in the nation.

Using annual time series data from 1981 to 2018, Adebayo, Onyibor, and Akinsola (2021) investigated the relationships between FDI inflows and a few macroeconomic indices (gross capital creation, export, inflation, trade openness, and economic growth). The study employed the ARDL technique. The results obtained from the ARDL long-run estimate demonstrated that trade openness and exports had a favorable effect on FDI inflows. The ARDL results were consistent with the FMOLS and DOLS findings.

Research Design

This study adopts an ex post facto research design, which is suitable when the variables under investigation have already occurred and cannot be manipulated. The design is quantitative in nature and uses econometric analysis to assess the impact of monetary tightening on development finance flows in Nigeria between the period 2010 and 2024.

3.2 Nature and Sources of Data

The study relies on secondary time series data covering the period 2010–2024. Data will be obtained from the following reputable sources:

Table 1

Variable	Proxy/Measurement	Source
Monetary Tightening	Central Bank Policy Rate (MPR), CRR, and inflation rate	Central Bank of Nigeria (CBN), Statistical Bulletin
Development Finance Flows	Net Development Finance Inflows (total, concessional, sectoral)	World Bank Development Indicators, AfDB, DBN
Exchange Rate	Official Naira-Dollar Exchange Rate	CBN, IMF
GDP	Annual GDP Growth Rate	National Bureau of Statistics (NBS)
Credit to the Private Sector	Percentage of GDP	World Bank, CBN
Interest Rate Spread	Lending-Borrowing Rate Gap	IMF, CBN

Source: Author's compilation, 2025

3.3 Method of Data Analysis

The study will employ econometric techniques using Ordinary Least Squares (OLS) regression and Vector Error Correction Model (VECM) to assess both short-run and long-run impacts. The study carried out the following test: descriptive Statistics: to summarize the trends and patterns in monetary indicators and development finance flows, Stationarity Test: Augmented Dickey-Fuller (ADF) test was used to check for unit root, Cointegration Test: Johansen test was also used to assess long-run relationships, VECM or ARDL Models: it was used to analyzed the long-run and short-run impacts of monetary tightening on development finance flows, and finally Granger Causality Test was used to determine causality direction between key variables.

3.4 Model Specification

A basic functional form of the model is:

$$DFI_t = \beta_0+\beta_1 MPR_t+\beta_2 EXR_t+\beta_3 CPS_t+\beta_4 INF_t+\beta_5 GDP_t+\mu_t$$

Where:

DFI_t = Development Finance inflows at time t

MPR_t = Monetary Policy Rate

EXR_t = Exchange Rate

CPS_t = Credit to the Private Sector

INF_t = Inflation Rate

GDPt = Economic Growth
μt = Error Term

Descriptions of Variables

RESULT AND DISCUSSION

Descriptive Statistics

Table 2

DESCRIPTIVE STATISTIC

	DFI	CPS	EXR	GDPGR	INF	MPR
Mean	35.19259	13.680	34.2605	3.065	14.907	13.950
Median	30.64170	12.900	3.3300	3.250	12.500	13.000
Maximum	41.060	19.200	7.67540	7.810	33.200	27.500
Minimum	-18.790	8.000	1.5000	-1.790	8.000	6.000
Std. Dev.	2.4836	3.677	1.98784	2.594	6.704	4.643
Skewness	0.619	0.220	1.155	-0.277	1.510	1.521
Kurtosis	2.628	1.867	3.476	2.823	4.814	6.324
Jarque-Bera	1.043	0.923	3.476	0.212	7.753	12.691
Probability	0.594	0.630	0.176	0.899	0.021	0.002
Sum	52788.880	205.200	5139.080	45.980	223.610	209.250
Sum Sq. Dev.	86362594.000	189.284	553213.100	94.206	629.204	301.775
Observations	15	15	15	15	15	15

Source: Author's computation, 2025.

Table 1.3 provides a detailed overview of the descriptive statistics for the variables used in this study. The Development Finance Flow (DFI) shows a mean value of 35%, indicating that, on average, the SME brought the financial inflow of 35% into the Nigerian economy. The standard deviation of 2.48 suggests a considerable variation in financial inflow during the period examined.

The average DFI is 35.19, with a standard deviation of 30.64, signifying a considerable level of variability in development finance inflows across the years. The minimum and maximum values are 2.48 and 104.98, respectively, further emphasizing the wide range. The Jarque-Bera statistic is 0.594 with a corresponding p-value greater than 0.05, suggesting that the DFI variable is approximately normally distributed.

The CPS variable exhibits a mean of 13.68 and a standard deviation of 6.19, indicating significant variability. The distribution is highly positively skewed (2.628), indicating that most of the values are concentrated on the lower end with a few large outliers. The Jarque-Bera statistic of 205.20 and a very low p-value indicate that the CPS data significantly deviate from normality. The average exchange rate is 34.27, accompanied by a large standard deviation of 18.67, indicating significant variability in the exchange rate during the period. The data is moderately right-skewed (0.923) and has a low kurtosis of 0.630, indicating a flat distribution.

The average inflation rate during the period is 14.91 with a standard deviation of 6.29. The distribution is moderately right with a standard deviation of 6.704 and a minimum and maximum of 8.00 and 33.2, respectively, which shows a normal distribution of the variables. The MPR has the lowest standard deviation among all the variables (2.21), reflecting relative stability in monetary policy rates over the years. The mean and median are closely aligned at 13.95 and 12.00, respectively.

Table 3 **CORRELATION MATRIX**

	DFI	CPS	EXR	GDPGR	INF	MPR
DFI	1	-0.5069	-0.67182	0.490454	-0.50413	-0.5392
CPS	-0.5069	1	0.186385	-0.59753	0.085609	0.140523
EXR	-0.67182	0.186385	1	-0.34294	0.916912	0.829174
GDPGR	0.490454	-0.59753	-0.34294	1	-0.17956	-0.21331
INF	-0.50413	0.085609	0.916912	-0.17956	1	0.831762
MPR	-0.5392	0.140523	0.829174	-0.21331	0.831762	1

Source: Author's computation, 2025.

The correlation matrix presented in Table 1.4 shows the nature and strength of linear relationships among the selected macroeconomic variables: Development Finance inflow (DFI), Credit to Private Sector (CPS), Exchange Rate (EXR), Inflation Rate (INF), Monetary Policy Rate (MPR), and GDP Growth Rate (GDPGR) as control variable.

The result reveals that DFI has a moderately strong negative correlation with CPS (-0.5069), EXR (-0.67182), INF (-0.50413), and MPR (-0.5392), while exhibiting a moderate positive correlation with GDPGR (0.490454). These result shows that an increase in inflation, exchange volatility, and tight monetary policy tends to adversely affect domestic financial investment. Conversely, economic growth appears to boost higher levels of investment.

The result shows that CPS displays a moderate negative correlation with GDPGR (-0.59753), suggesting that increased credit to the private sector does not necessarily translate to economic growth within the period under review. This may be as a result of inefficiencies in credit allocation or the presence of structural bottlenecks in the financial system. Additionally, CPS has weak positive correlations with EXR (0.1864), INF (0.085609), and MPR (0.140523), meaning a relatively limited direct influence from monetary indicators.

There is a very strong positive correlation between EXR and INF (0.916912), indicating that exchange rate depreciation is closely associated with rising inflation. This is consistent with cost-push inflation dynamics in an import-dependent economy like Nigeria. Similarly, EXR and MPR are strongly correlated (0.829174), reinforcing the notion that exchange rate fluctuations significantly influence central bank policy decisions.

As expected, INF and MPR also exhibit a strong positive relationship (0.831762), showing that the central bank often responds to inflationary pressures with tightening measures such as increases in the monetary policy rate. Conversely, GDPGR shows weak to moderate negative correlations with most monetary variables: EXR (-0.34294), INF (-0.17956), and MPR (-0.21331), further emphasizing the adverse effect of macroeconomic instability and tightening on growth.

Table 4

POOL OLS REGRESSION RESULT

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	8696.877	3263.731	2.664704	0.0258
CPS	-231.1377	167.8978	-1.376657	0.2019
EXR	-12.9424	7.273399	-1.779415	0.1089
INF	203.2508	206.9657	0.982051	0.3517
GDPGR	10.40986	260.1642	0.040013	0.969
MPR	-46.11885	201.3345	-0.229066	0.8239
R-squared	0.644603	Mean dependent var		3519.259
Adjusted R-squared	0.447161	S.D. dependent var		2483.698
S.E. of regression	1846.708	Akaike info criterion		18.16937
Sum squared resid	30692978	Schwarz criterion		18.45259
Log likelihood	-130.2703	Hannan-Quinn criter.		18.16635
F-statistic	3.264763	Durbin-Watson stat		2.214687
Prob(F-statistic)	0.058904			

Source: Author's computation, 2025.

The table presents the regression analysis results aimed at examining the effect of selected macroeconomic variables on Development Finance Inflows (DFI) in Nigeria from 2010 to 2024. The Ordinary Least Squares (OLS) method was employed, with DFI as the dependent variable and five explanatory variables: Credit to the Private Sector (CPS), Exchange Rate (EXR), Inflation Rate (INF), Gross Domestic Product Growth Rate (GDPGR), and Monetary Policy Rate (MPR). A total of 15 annual observations were included in the analysis.

The result revealed that CPS has a negative but statistically insignificant (coe -231.1377, p value 0.2019 > 0.05) effect on FDI. This implies that an increase in credit to the private sector is associated with a decrease in DFI, though not significant, hence, the null hypothesis that says credit to the private sector (CPS) has no significant effect on the development finance inflows in Nigeria is accepted. This finding aligned with the findings of Lee et al. (2024), Aromasodun (2022), Anyanwu & Yameago (2015).

There is a negative relationship between exchange rate and DFI, but the effect is not statistically significant (coef. -

12.9424, p-value 0.1089 > 0.05). This means that a unit increase in EXR will reduce DFI by 12.94, although the effect is not significant. Based on the above result, the null hypothesis that says the exchange rate has no significant effect on the development finance inflows in Nigeria is accepted. This result is consistent with the findings of Jaiblai & Shwnai (2019) and Eregha (2019).

Also, INF has a Positive but statistically insignificant (coe; 203.25: pv; 0.3517 > 0.05), which implies inflation does not significantly influence DFI during the period. An increase in the inflation rate will increase DFI by 203.25; this increase is not significant. The null hypothesis, which says the inflation rate has no significant effect on development finance inflows, is accepted. The finding was the same as the findings of Abahouth (2024), Ayinde et al. (2024), Phommouny et al. (2024), Dewi & Septriani (2023).

MPR has a very weak and insignificant negative (coe; -46.118, pv; 0.8239 > 0.05) impact of monetary rate on DFI. An increase in MPR will lead to 46.118 reductions in DFI, although the reduction is not significant, hence, the null hypothesis that the Central Bank of Nigeria has no significant effect on the development finance inflows is accepted. The result is consistent with the findings of Anochie (2022), Popovici & Calin (2021).

Overall, none of the independent variables exhibit a statistically significant impact on Development Finance Inflows at the 5% significance level, except for the constant term. The high standard errors and low t-statistics across the predictors point to potential limitations related to the sample size. The results indicate that macroeconomic variables such as CPS, EXR, INF, GDPGR, and MPR do not have statistically significant individual effects on DFI within the study period. However, the relatively high R-squared suggests the model has moderate explanatory power.

Summary of the Findings

This study investigated the impact of selected macroeconomic indicators, Credit to the Private Sector (CPS), Exchange Rate (EXR), Inflation Rate (INF), Gross Domestic Product Growth Rate (GDPGR), and Monetary Rate (MR) on Development Finance Inflows (DFI) in Nigeria between 2010 and 2024. Using the Ordinary Least Squares (OLS) regression technique, the analysis revealed several key insights. The model exhibited a moderately strong explanatory power, with an R-squared value of 0.6641, indicating that approximately 66.41% of the variability in DFI is explained by the independent variables. The F-statistic (3.2648) had a probability value of 0.0589, suggesting that the model is marginally statistically insignificant at the 5% significance level.

Conclusion

Based on the empirical findings, the study concludes that the selected macroeconomic indicators, namely CPS, EXR, INF, and MPR, do not individually serve as strong predictors of development finance inflows in Nigeria from 2010 to 2024. The weak statistical significance of these variables suggests that other factors, possibly institutional, political, or structural, may play more critical roles in influencing development finance inflow.

Although the model shows a moderate level of explanatory power, the marginal insignificance of the joint predictors highlights the need for a broader perspective in understanding what drives inflows of development finance in the Nigerian context.

Recommendations

In light of the study's findings, the following recommendations are proposed:

1. The policymakers should adopt inflation-targeting frameworks that balance price stability with economic growth to create a more favorable environment for long-term finance.
2. Expand the scope of analysis to include non-macroeconomic variables such as governance indicators, corruption indices, infrastructure quality, and institutional stability, which may have a stronger influence on development finance inflows.
3. Increase the sample size and frequency of observations (e.g., quarterly data) to improve the reliability and robustness of the model estimates.
4. Policymakers should not rely solely on macroeconomic indicators when formulating strategies to attract development finance. A multidimensional approach is required, incorporating policy reforms, transparency, and investment-friendly institutional frameworks.

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