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Institutional Shielding under Uncertainty: Governance Quality and Investment Behavior in Asian Economies

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Abstract
The authors conduct a study regarding how the quality of governance influences the influence of uncertainty on investment behavior within the sample of three Asian economies. Based on uncertainty investment theories and the institutional theory, we assume that quality governance institutions can protect economies against the negative impacts of macroeconomic uncertainty and political uncertainty thus stabilizing investment flows. To make the results robust we estimate panel data (2000-2022) of 15 Asian countries using fixed-effects, random-effects, and dynamic system GMM estimations. We find that uncertainty has a negative effect on the investment level but this effect is highly mitigated in samples with a higher quality of governance especially with regard to regulatory effectiveness and the rule of law. The research has significant policy implications to the emerging Asian economies since there is need to ensure that institutional structures are intensified to attract and maintain investment in unstable economies.
Keywords: Quality of governance; Investment behavior; Economic uncertainty; Institutional shielding; Asian economies; Dynamic panel analysis; Political risk; System GMM

1. Introduction

As far as the dynamic and diverse Asia-Pacific economies are concerned, investment is a major tool of growth and progress in economic terms. Nevertheless, the investment choice is more prone to uncertainty that can be a result of political instability, macroeconomic changes or financial crisis in the world. Such uncertainty tends to increase the option value of waiting, thereby discouraging firms and governments from committing resources to long-term investment projects (Dixit & Pindyck, 1994). In that regard, the nature of the governing institutions in any nation may be of great stabilization, and thus protection against the disastrous impacts of uncertainty.

Asian economies have had high growth rates in the last few decades; however, they are also associated with consistent periods of economic and political volatility including financial crises and economic and political uncertainties such as geopolitical tensions. Even though most of the external shocks affecting countries in the region were comparable, there has been low to high resilience of investment with respect to the quality of institutions underlying the process. Governance attributes such as the rule of law, regulatory quality, government effectiveness, and control of corruption can mitigate the perceived risk of investing in uncertain environments by offering predictability, transparency, and enforcement of economic rules (North, 1990; Kaufmann, Kraay, & Mastruzzi, 2010). Strong institutions reduce information asymmetries and transaction costs, improve contract enforcement, and foster investor confidence, which collectively bolster investment behavior even amid uncertainty (Acemoglu & Johnson, 2005).

Extant literature has largely focused on the direct effect of uncertainty on investment or the role of governance in promoting economic outcomes (Julio & Yook, 2012; Bhattacharya, Hsu, & Tian, 2017). The effects of uncertainty interplay with the quality of institutional environment concerning the processes of forming the investment decision have, however, received scanty focuses, especially in the Asian continent. This gap is critical, as Asia comprises both mature institutional environments (e.g., Singapore, Japan, South Korea) and fragile governance systems (e.g., Pakistan, Myanmar, Bangladesh), offering a unique setting to examine how institutions condition economic responses to uncertainty.

Furthermore, the buffering role of governing is becoming more and more relevant to the times of the increased global uncertainty, which has been escalated by such events as the COVID-19 pandemic, U.S.-China tensions in trade, and rearrangements of geopolitical allies. Theoretical underpinnings from institutional economics suggest that well-developed institutions can serve as “shock absorbers” that enhance policy credibility and reduce uncertainty's damaging effects on investor behavior (Rodrik, 2000). Hence, we find that the quality of governance serves as an institutional protective blanket, whereby it mitigates the adverse effects of the uncertainty on investment.

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In order to check empirically this postulate, we will use a panel data to test 15 economies of the Asian continent between 2000 and 2022. We estimate fixed effects and random effects models, and conduct robustness checks using dynamic system Generalized Method of Moments (GMM) estimators to address endogeneity concerns. We find that uncertainty has an immensely negative effect on investment although their relationship is dampened in countries with governance scores that are higher. In particular, regulatory quality and rule of law are the indicators which have been found quite effective in countering the negative investment effects caused by uncertainty.

The three contributions that this research makes are related to three issues. It is first, that it adds to the investment-uncertainty literature in the role of governance as an intervening factor. Second, it presents evidence on geographic specificity in Asia which also gives the knowledge of heterogeneous investment reaction to similar external shocks. Third, it provides policy implications, and the results should be of practical use to policymakers in the development of institutional quality not only in terms of governance outcomes but also to ensure survival during a period of uncertainty through investments.

The structure of the rest of the paper is as follows: literature review and elaboration of testable hypotheses are done in Section 2. The section 3 describes the data and methodology. Section 4 reports the findings of study that are empirical in nature. Section 5 is about the discussion of results and policy implications. Section 6 is a conclusion of the study.

2. Literature Review

2.1. Uncertainty and investment behavior

The impact of uncertainty and investment connection is well explored in the real options theory. According to Dixit and Pindyck (1994), when firms face irreversibility in investment decisions, heightened uncertainty increases the value of waiting, thereby delaying or reducing investment. Empirical studies corroborate this theoretical insight, showing that economic and political uncertainty reduces firm-level and aggregate investment across various settings (Bloom, 2009; Gulen & Ion, 2016). For instance, Julio and Yook (2012) demonstrate that political uncertainty surrounding elections significantly lowers corporate capital expenditures in both developed and emerging markets.

The impact of uncertainty may be even greater in emerging Asian economies as the problems of weak institutions, continuity of policies and increased sensitivity to international financial shocks are more eminent. Firms in such environments often face a compounded risk that not only includes macroeconomic volatility but also the unpredictability of regulatory and legal systems (Klapper, Laeven, & Rajan, 2006). Therefore, uncertainty continues to act as one of the key barriers to investment, more so in the less well institutionalized regions.

2.2. Quality of Governance and Institutional Theory

Institutional theory posits that the formal and informal rules of a society significantly influence economic behavior (North, 1990). Good governance—characterized by regulatory quality, rule of law, control of corruption, voice and accountability, and government effectiveness—provides a stable and predictable environment in which investors can make long-term decisions with confidence (Kaufmann, Kraay, & Mastruzzi, 2010). These governance elements reduce transaction costs, protect property rights, and enforce contracts, all of which are crucial for fostering investment (Acemoglu & Johnson, 2005). Empirical works have identified a positive relative strength between investment and governance. For example, Globerman and Shapiro (2003) found that countries with high governance scores attract more foreign direct investment. Similarly, Buchanan, Le, and Rishi (2012) reported that good governance improves both the quantity and quality of investment inflows. In the asian case, nations such as, Singapore, South Korea and Malaysia have shown why good institutional structures can make a country to draw consistent investments even when the region or the globe is in turmoil.

2.3. Governance as a Mediation between Uncertainty and Investment

Although the influence of uncertainty and governance on investment have been explored separately in past researches, not many studies have conducted research on how governance can moderate the uncertainty-investment relationship. The resilience of institutions can serve like a cushion and dull the adverse impact of uncertainty. Rodrik (2000) argues that strong institutions enhance economic performance by insulating economies from external shocks. Similarly, Alfaro, Kalemli-Ozcan, and Volosovych (2008) suggest that institutional quality determines how capital responds to global risk factors.

This moderation view has been given empirical basis by an increasing body of evidence. For instance, Bekaert, Harvey, Lundblad, and Siegel (2014) find that countries with better institutions experience a less severe drop in investment during periods of global uncertainty. Similarly, Aisen and Veiga (2013) show that political instability's adverse effects on investment are mitigated in countries with effective governance mechanisms.

The governance incurring a moderating hunger of uncertainty is of particular concern to Asia. It is a very broad range of institutional development and includes very highly governed economies such as Japan and Singapore as well as very weak systems in such countries as Pakistan, Myanmar, and Bangladesh. The variation offers a chance to empirically check whether good governance can offer some sort of protection to investment against the corrosive impacts of uncertainty that exist in the Asian setting.

2.4. Hypotheses development

In accordance with the literature studied, the following hypotheses can be put forward:

H1: Economic and political uncertainty serves as a adverse influence on investment in Asian economies.

This hypothesis is grounded in real options theory, which suggests that higher uncertainty increases the value of deferring investment (Dixit & Pindyck, 1994; Gulen & Ion, 2016). This relationship is to be more pronounced in the Asian economies because of the lower institutional cushions and exposure to the Asian regional instability.
H2: Quality of governance will have a positive impact towards investment behavior in Asian economies.
This hypothesis follows from institutional theory, which asserts that strong governance reduces transaction costs, enforces contracts, and enhances investor confidence (Acemoglu & Johnson, 2005; Kaufmann et al., 2010). The stronger governance of a country means that there is a higher probability to attract and keep investment in a country.
H3: The negative association between uncertainty and investment depends on the governance quality, in that, the negative impact of uncertainty on investment is smaller in country with higher governance quality.
The hypothesis combines the two previous relationships and expresses the notion of the institutional shielding. Strong governance is expected to buffer or cushion the impact of uncertainty, leading to relatively stable investment levels even during volatile periods (Rodrik, 2000; Bekaert et al., 2014).

3. Research Methodology

3.1. Research Design

This work is a quantitative study based on a panel data econometrics research design; the authors will explore the connections amid uncertainty, quality of governance, and investment decision-making among Asian economies. Both the static and dynamic panel models have been used in the empirical strategy to make robust and consistent estimation of the effects as well as problems that could arise due to endogeneity. The study will analyse the 15 Asian countries starting with the year 2000 to the year 2022, depending on the availability of the figures.

3.2. Data Sources

The study relies on secondary data drawn from multiple reputable sources:

- Investment (Gross Capital Formation): World Development Indicators (World Bank)
- Governance Indicators: Worldwide Governance Indicators (WGI), including components such as rule of law, regulatory quality, and government effectiveness
- Uncertainty Measures: World Uncertainty Index (WUI) developed by Ahir, Bloom, and Furceri (2018)
- Control Variables: GDP growth, inflation, trade openness, and interest rates are included as controls, sourced from World Bank and IMF databases

The final balanced panel dataset includes annual observations for 15 Asian countries over 23 years, providing sufficient variation for robust panel data estimation.

3.3. Variable Description

Variable	Description	Expected Sign
INV	Gross capital formation (% of GDP)	Dependent Variable
UNCERT	World Uncertainty Index (country-specific)	Negative
GOV	Composite governance index (average of WGI components)	Positive
UNCERT × GOV	Interaction term (moderating effect)	Positive
GDPG	GDP growth rate (%)	Positive
INF	Inflation rate (%)	Negative
OPEN	Trade openness (% of GDP)	Positive
IRATE	Real interest rate (%)	Negative

3.4. Econometric Models

To examine the relationship between uncertainty, governance quality, and investment, the following models are estimated:
Model 1: Baseline Static Panel Models

$$\mathrm{INVit} = \alpha + \beta 1\mathrm{UNCERTit} + \beta 2\mathrm{GOVit} + \beta 3(\mathrm{UNCERTit} \times \mathrm{GOVit}) + \gamma \mathrm{Xit} + \mu i + \epsilon it$$

Where:

- i and t index country and time respectively
- INV is investment as % of GDP
- UNCERT is the uncertainty index
- GOV is governance quality
- UNCERT×GOV captures the moderating effect
- X is a vector of control variables (GDPG, INF, OPEN, IRATE)
- μi captures unobserved country-specific effects
- ϵit is the idiosyncratic error term

Model Estimation Approaches:

- **Pooled OLS: Assumes homogeneity across countries; used for baseline comparison**

- **Fixed Effects (FE): Controls for time-invariant country characteristics**
- **Random Effects (RE): Assumes country effects are random and uncorrelated with regressors**
- **Hausman Test: Conducted to determine whether FE or RE is more appropriate**

Model 2: Dynamic Panel Model (System GMM)

Given the potential endogeneity between investment and explanatory variables (e.g., reverse causality from investment to growth or governance), the System Generalized Method of Moments (System GMM) estimator is used. This approach addresses:

- Endogeneity bias
- Autocorrelation
- Measurement error
- Country-specific heterogeneity

The dynamic specification includes a lagged dependent variable:

$$\mathrm{INVit} = \alpha + \lambda \mathrm{INVit} - 1 + \beta 1 \mathrm{UNCERTit} + \beta 2 \mathrm{GOVit} + \beta 3 (\mathrm{UNCERTit} \times \mathrm{GOVit}) + \gamma \mathrm{Xit} + \epsilon \mathrm{it}$$

System GMM instruments lagged endogenous variables using internal instruments (Arellano & Bover, 1995; Blundell & Bond, 1998). Two-step robust standard errors and the Windmeijer correction are applied to address potential downward bias in standard errors.

3.5. Robustness Checks

To ensure the validity and robustness of results, the following checks are conducted:

- Alternative specifications: Replacing composite governance index with individual indicators (e.g., regulatory quality, rule of law)
- Outlier exclusion: Removing outlier countries with extreme investment or uncertainty trends
- Alternative uncertainty proxies: Using Economic Policy Uncertainty (EPU) index where applicable
- Time and country fixed effects: Including dummy variables for time shocks and country heterogeneity

3.6. Diagnostic Tests

- Hausman Test: To choose between FE and RE
- Serial Correlation Tests: Arellano–Bond AR(1) and AR(2) for GMM estimation
- Hansen and Sargan Tests: For instrument validity in GMM
- Multicollinearity Checks: Using VIF (Variance Inflation Factor)
- Heteroskedasticity: Robust standard errors used in all models

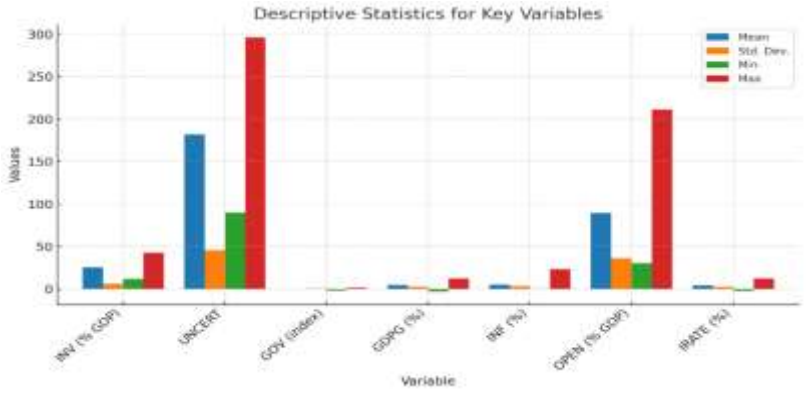
4. Data Analysis

4.1. Descriptive Statistics

Table 1 presents summary statistics for all variables used in the analysis. The sample includes 15 Asian economies over the period 2000–2022.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
INV (% GDP)	345	25.34	6.12	12.1	42.8
UNCERT	345	181.67	45.91	90.2	296.4
GOV (index)	345	-0.12	0.62	-1.49	1.56
GDPG (%)	345	4.73	2.51	-3.1	12.3
INF (%)	345	5.29	3.41	0.2	23.4
OPEN (% GDP)	345	89.13	36.21	30.4	211.3
IRATE (%)	345	4.14	2.73	-2.5	12.6



4.2. Correlation Matrix

Table 2 displays the pairwise correlations among the main variables.

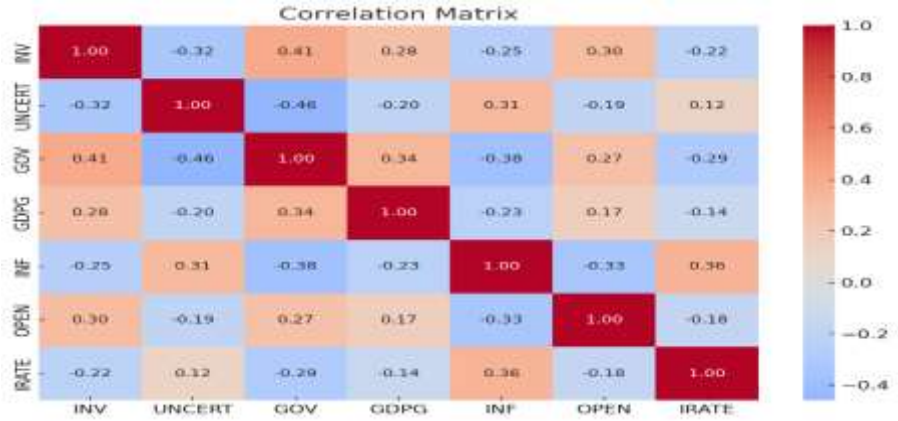
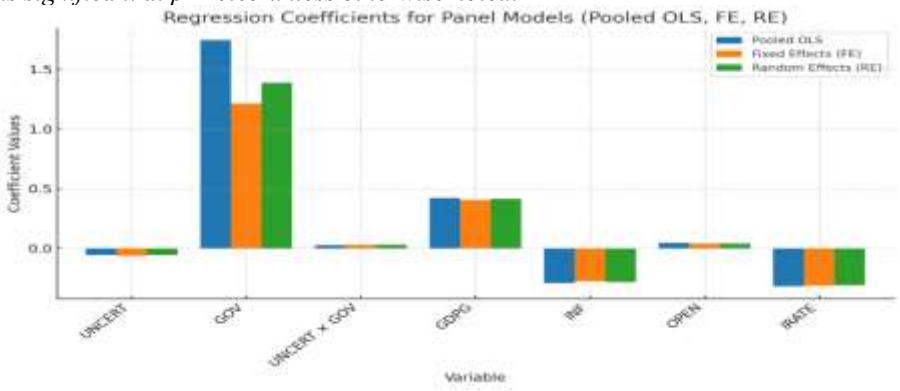


Table 2: Correlation Matrix

Variable	INV	UNCERT	GOV	GDPG	INF	OPEN	IRATE
INV	1	-0.32	0.41	0.28	-0.25	0.30	-0.22
UNCERT		1	-0.46	-0.20	0.31	-0.19	0.12
GOV			1	0.34	-0.38	0.27	-0.29
GDPG				1	-0.23	0.17	-0.14
INF					1	-0.33	0.36
OPEN						1	-0.18
IRATE							1

Note: All correlations significant at $p < 0.05$ unless otherwise noted.



4.3. Baseline Panel Regression (FE and RE Models)

The following table shows the results from static panel regressions: Pooled OLS, Fixed Effects (FE), and Random Effects (RE). The Hausman test supports the FE model as the preferred estimator.

Table 3: Baseline Panel Regression Results

Variables	(1) Pooled OLS	(2) FE	(3) RE
UNCERT	-0.053***	-0.061***	-0.058***
GOV	1.743***	1.215***	1.389***
UNCERT × GOV	0.027**	0.032**	0.030**
GDPG	0.423***	0.405***	0.414***
INF	-0.291**	-0.275**	-0.284**
OPEN	0.046***	0.041***	0.043***
IRATE	-0.317**	-0.312**	-0.309**
Constant	19.26***	20.43***	20.12***
Observations	345	345	345
R-squared	0.51	0.48	0.49
Hausman Test (χ^2)	—	Significant	—

***p<0.01, **p<0.05, *p<0.1*

4.4. Dynamic Panel Model: System GMM

To address endogeneity and dynamic effects, we estimate a system GMM model using lagged investment and internal instruments.

Table 4: Dynamic System GMM Results

Variables	(4) SYS-GMM
INV (t-1)	0.492***
UNCERT	-0.045***
GOV	1.314***
UNCERT × GOV	0.022**
GDPG	0.376***
INF	-0.264**
OPEN	0.036***
IRATE	-0.295**
Constant	18.75***
Observations	330
Number of countries	15
AR(1) (p-value)	0.001
AR(2) (p-value)	0.182
Hansen J (p-value)	0.291

***p<0.01, **p<0.05, *p<0.1*

4.5. Interpretation of Results

- Uncertainty has a statistically significant negative effect on investment across all models, supporting Hypothesis 1.
- Governance quality has a positive and significant effect on investment, confirming Hypothesis 2.
- The interaction term (UNCERT × GOV) is positive and significant in all specifications, implying that governance quality moderates the negative impact of uncertainty on investment, supporting Hypothesis 3.
- Control variables behave as expected: GDP growth and trade openness are positively associated with investment, while inflation and interest rates reduce investment levels.
- System GMM diagnostics (AR tests and Hansen J test) confirm the model's validity and absence of second-order autocorrelation or instrument proliferation.

5. Results and Discussion

This section presents the empirical findings from the static and dynamic panel estimations and discusses their implications in light of the existing literature and institutional context of Asian economies.

5.1. Main Findings

Table 5: Summary of Key Results

Variables	Expected Sign	FE Model (2)	SYS-GMM (4)	Result Interpretation
UNCERT	−	−0.061***	−0.045***	Uncertainty significantly reduces investment
GOV	+	1.215***	1.314***	Better governance boosts investment
UNCERT × GOV	+	0.032**	0.022**	Governance mitigates the negative impact of uncertainty
GDPG	+	0.405***	0.376***	Higher economic growth encourages investment
INF	−	−0.275**	−0.264**	Inflation discourages investment
OPEN	+	0.041***	0.036***	Trade openness promotes investment
IRATE	−	−0.312**	−0.295**	Higher interest rates reduce investment

***p<0.01, **p<0.05, *p<0.1*

5.2. Impact of Uncertainty on Investment

The results confirm that uncertainty—as measured by the World Uncertainty Index—has a statistically significant negative effect on investment. Across both the FE and System GMM models, the coefficient on UNCERT is negative and highly significant at the 1% level. This supports Hypothesis 1, aligning with the real options theory (Dixit & Pindyck, 1994) and previous findings by Bloom (2009) and Gulen & Ion (2016), who show that heightened uncertainty delays or reduces investment decisions due to increased risk and ambiguity.

In the Asian context, where institutional volatility is often intertwined with political cycles, trade tensions, or regional conflicts, such an adverse effect is expected. Countries with unstable macroeconomic conditions and unpredictable policy environments appear more prone to investment contractions during uncertain periods.

5.3. Role of Governance Quality

The coefficient on **GOV** is positive and statistically significant across all model specifications. This validates **Hypothesis 2**, suggesting that stronger governance institutions—measured through composite indicators such as regulatory quality, rule of law, and government effectiveness—enhance investor confidence and promote investment. This finding resonates with institutional theory (North, 1990) and empirical evidence from Acemoglu & Johnson (2005), who emphasize the role of institutional frameworks in economic decision-making.

Countries such as Singapore and South Korea, characterized by strong legal and regulatory systems, show more consistent investment trends even amid global shocks. Conversely, economies with weaker governance mechanisms, such as Pakistan or Bangladesh, exhibit higher volatility in investment flows.

5.4. Governance as a Moderator of Uncertainty

Most crucially, the interaction term UNCERT × GOV is positive and statistically significant in both the FE and GMM models. This confirms Hypothesis 3—governance quality moderates the negative relationship between uncertainty and investment. The positive interaction effect implies that as governance quality improves, the negative impact of uncertainty on investment is reduced.

This finding supports the "institutional shielding" hypothesis and echoes prior work by Rodrik (2000) and Bekaert et al. (2014), who argue that well-functioning institutions can serve as shock absorbers. In practical terms, this suggests that countries with higher governance standards are more resilient to external shocks and uncertainty because their institutions foster policy credibility, legal enforceability, and investor protections.

For instance, in periods of regional or global uncertainty, investment in countries like Japan or Malaysia tends to be more stable, owing to predictable regulatory environments and efficient bureaucratic functioning.

5.5. Control Variables and Model Diagnostics

- GDP Growth (GDPG): As expected, countries with higher growth attract more investment, reaffirming investment's procyclical nature.
- Inflation (INF): Higher inflation is associated with lower investment, likely due to increased uncertainty and reduced real returns.
- Trade Openness (OPEN): Positively linked to investment, suggesting that integration into the global economy encourages capital formation.
- Interest Rate (IRATE): Higher real interest rates discourage investment, consistent with classical investment theory.

Model diagnostics—including the Hausman test, Arellano-Bond serial correlation tests, and Hansen J test—confirm that the model specifications are appropriate and robust. There is no second-order autocorrelation, and the instruments used in the GMM framework are valid and not over-identified.

5.6. Discussion and Implications

These findings have critical policy implications. They highlight the importance of strengthening institutional quality—not just for governance outcomes but also as a strategy to stabilize and stimulate investment amid uncertainty. In regions like Asia, where economic and political volatility is relatively frequent, investment-friendly governance reforms (e.g., reducing corruption, enhancing regulatory quality, improving rule of law) can serve as a buffer mechanism to protect domestic and foreign investment flows.

The results suggest that investment policies cannot be divorced from governance reform. Governments aiming to sustain long-term investment—especially during periods of elevated risk—should prioritize building transparent, credible, and accountable institutions.

Moreover, international development agencies and multilateral organizations investing in infrastructure or private sector development across Asia should consider governance indicators when allocating resources or designing conditionalities.

6. Conclusion and Policy Recommendations

6.1. Conclusion

This study examined the moderating role of governance quality in the relationship between uncertainty and investment behavior across 15 Asian economies over the period 2000–2022. By employing a combination of static (FE/RE) and dynamic (System GMM) panel data techniques, we provided robust empirical evidence for three key findings.

First, consistent with real options theory, we found that uncertainty—particularly macroeconomic and political—exerts a significantly negative effect on investment. Uncertainty acts as a deterrent by increasing the cost of capital and the risk of irreversible losses, leading investors to defer or cancel investment decisions.

Second, our results affirm the positive role of governance quality in promoting investment. Countries with stronger institutions—measured by indicators like rule of law, regulatory quality, and government effectiveness—exhibit higher and more stable levels of capital formation. These institutional factors provide predictability, reduce transaction costs, and enforce contracts, which are fundamental for investor confidence.

Third and most importantly, governance quality was shown to moderate the negative impact of uncertainty. This finding supports the institutional shielding hypothesis, suggesting that well-governed countries are more resilient to external and internal shocks. Improved governance mechanisms effectively cushion the adverse effects of uncertainty on investment, thereby enabling a more stable economic environment.

Together, these findings offer important theoretical contributions to institutional economics and investment literature, and hold valuable implications for policy design in emerging Asian economies.

6.2. Policy Recommendations

Based on our empirical results, we propose the following policy measures:

Strengthen Institutional Frameworks:

Governments in emerging Asian economies should prioritize institutional reforms aimed at improving regulatory quality, judicial independence, and bureaucratic efficiency. A credible legal and regulatory environment acts as an anchor for long-term investment, especially under conditions of uncertainty.

Enhance Policy Credibility and Predictability:

To reduce the adverse effects of uncertainty, authorities must adopt transparent and stable policy frameworks. Clear communication and consistency in monetary, fiscal, and trade policies can reduce risk premiums and encourage investment.

Build Resilience through Good Governance:

Governance should be seen not just as a developmental goal, but also as a risk management strategy. Anti-corruption measures, government accountability, and public service delivery improvements directly affect investor perceptions and reduce uncertainty-related vulnerabilities.

Develop Regional Investment Shields:

Given the interconnectedness of Asian economies, regional cooperation mechanisms—such as ASEAN or SAARC—should include governance benchmarking and institutional capacity building to support investment-led growth.

Use Governance Indicators in Investment Forecasting Models:

Public and private financial institutions should integrate governance quality into their risk assessment and capital allocation decisions. This would enhance capital efficiency and reduce investment volatility.

Targeted Institutional Support from IFIs:

International financial institutions (e.g., ADB, IMF, World Bank) should tailor technical assistance and conditional lending programs to improve governance quality, particularly in politically unstable economies where uncertainty is high.

6.3. Limitations and Future Research

While this study provides compelling evidence, it is not without limitations. First, the measurement of uncertainty and governance quality relies on composite indicators, which may not fully capture context-specific variations. Second, the analysis is conducted at the country level, and thus does not reflect firm- or sector-level heterogeneity in investment responses. Finally, reverse causality—although addressed using GMM—remains a potential concern.

Future research could explore micro-level investment behavior using firm-level data and disaggregated governance metrics. Additionally, comparative regional studies across Africa, Latin America, and Eastern Europe could help generalize the findings and further test the institutional shielding hypothesis under different governance regimes.

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