No. 134, October 2010

C.D. Howe Institute
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BACKGROUNDER

MONETARY POLICY

Faceoff:

Should the Bank of Canada Release its Projections of the Interest Rate Path? —The Cases For and Against.

Pierre Siklos and Andrew Spence

In this issue...

Two views on whether the Bank of Canada should publish a conditional interest rate forecast.

The Study in Brief

Whether the Bank of Canada should release its projections of the interest rate path is a hotly contested issue with potential implications for the Bank's transparency, accountability and credibility. In this Backgrounder, two leading monetary policy thinkers take opposite sides in the debate.

Pierre Siklos argues in favour of the Bank publishing a conditional interest rate forecast. This would represent, he says, the clearest statement possible that the central bank is committed to transparency. The benefits of such openness, he argues, are the following: (i) the forward track can produce realistic expectations and facilitate efficient asset pricing; (ii) making forward track projections public would improve policy coherence; (iii) enhancing the clarity of central bank communication via the release of a conditional forecast would improve perceptions about discussions inside the policy-making body.

Andrew Spence argues the opposite side. Given the conditional nature of forecasts, he says, and given that they are generated by complex macro-models, releasing the forecasted interest rate path would be a poor substitute for ongoing communication about the Bank's interest rate intentions, whether implicit or explicit. Financial markets would likely respond to the public information by turning their attention to the model generating the forecast, potentially broadening the array of relevant variables to consider and for the central bank to explain subsequently.

In Spence's view, it is not clear that releasing the interest rate path forecast would result in better monetary policy communications and outcomes than the use of existing communication techniques. Indeed, the experience of the few central banks that do release an interest rate forecast suggests that a public forecast and changes to that forecast can create as many communication problems as they solve.

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$12.00
ISBN 978-0-88806-818-7
ISSN 0824-8001 (print);
ISSN 1703-0765 (online)

Living Up to Accountability: Conditional Commitments and the Right Kind of Transparency

By Pierre L. Siklos

In the of April 2009 edition of its *Monetary Policy Report*, the Bank of Canada introduced a conditional commitment to hold the policy rate at the effective lower bound (ELB), or ¼ percent, until July 2010.[1] Less attention was paid to the accompanying quote from Governor Mark Carney. It is worth reproducing. He said:

> There is a plan to restore confidence and growth, we are implementing it, and it will work. The impact of these policies will build over time and will be significant. For maximum effect, it is critical that measures be grounded in robust and principled frameworks: the objectives should be transparent; indicators of success clear; and entry and exit criteria well articulated. Citizens must be able to hold policy-makers accountable. Policy-makers must rise to the occasion.

It is with accountability in mind that this paper argues in favour of the Bank publishing a conditional interest rate forecast. This would represent the clearest statement possible that the central bank is committed to transparency.[2]

The Reserve Bank of New Zealand (RBNZ), Sweden's Riksbank and Norway's Norges Bank provide forward interest rate tracks. All three central banks target inflation. They recognize that, in the interest of consistency, providing inflation and output growth (or output gap) forecasts have implications for future expected interest rates.[3] Given the Governor's clear statement, it is natural to ask why a conditional interest rate forecast is a feature expressly reserved for the ELB? The answer is that it should not be, and the debate over whether this kind of information represents transparency gone too far, as some critics contend (e.g., Mishkin 2004, and Spence below), underappreciates the role of accountability. An obvious way to assess the central bank's performance is through the publication of the policy rate forecast, conditional on a set of assumptions that naturally change over time. By providing guidance only during exceptional times, the central bank is being overly tactical. It is easy to see, then, why markets might focus on the commitment part and ignore the conditionality.[4]

If inflation-targeting central banks have managed to explain why inflation occasionally falls outside the target range, they should be able to explain why a forecasted interest rate path is subject to change. The objections to central banks making public their inflation forecast used to be trotted out before these same institutions adopted

Comments on a previous draft by Phil Bergevin, Paul Jenkins, Thor Koeppl, David Laidler, Michael Parkin, Chris Ragan and Nick Rowe are gratefully acknowledged.

1 The conditional commitment said: "Conditional on the outlook for inflation, the target overnight rate can be expected to remain at its current level until the end of the second quarter of 2010 in order to achieve the inflation target, the Bank will continue to provide guidance in its scheduled interest rate announcements as long as the overnight rate is at the effective lower bound."MPR (2009, p. 2). The April 2009 MPR suggests that the Bank would offer guidance temporarily because the policy rate was at its effective lower bound. "At the ELB, there are added benefits to increasing transparency through the use of an explicitly conditional policy statement tied to the inflation outlook" (op.cit., p. 25).

2 Parkin and Melino (2010) also call for the publication of a conditional policy rate forecast in part because their calculations, based on published Bank of Canada data, indicate that the range of plausible estimates for the future path of the overnight rate is very large.

3 It is interesting that in the paper that follows Spence, who uses the New Zealand case to argue against the publication of conditional interest rate forecasts, neglects to mention that the RBNZ's forecast is not for its policy rate, but for a related short-term rate (90-day bank bills) and that no confidence bands are published so that the likely range of possible future rates is unknown.

4 There are numerous other examples where central banks are being overly tactical, which may lead to markets focusing on the commitment rather than on the conditional aspect. The US Federal Reserve's open market committee has once before signalled that the fed funds rate would remain at some level for a "considerable period" or an "extended period," first between August 2003 and December 2005 and then again since March 2009. Meanwhile, the Bank of Japan during the period April 1999 to August 2000 and then again from March 2001 to July 2006 made a conditional commitment to keep the policy rate at the zero lower bound until deflationary expectations were no longer in evidence.

the transparency mantle.[5] Central bankers have been telling all who listen that monetary policy should not throw up unnecessary surprises to the markets. A credible central bank should offer sufficient guidance and this, therefore, ought to include interest rate forecasts.

Central banks once believed, in the words of Bank of England Governor Mervyn King (2000), that monetary policy should be "boring." However, the global financial crisis has introduced additional complications for the monetary authorities. As a result, central banks can no longer afford to be as boring as they used to be.

One way to keep markets alert to an upcoming tightening or loosening of the central bank's policy stance is to publish its conditional interest rate forecasts. Moreover, governments around the world introduced massive amounts of stimulus into their economies and have already put in place strategies for retrenchment. This may well have consequences for interest rates. One way a central bank can protect itself from being dragged into an interest rate dispute with the political authorities is by alerting markets, for example, to the consequences of fiscal tightening on future interest rate movements.[6]

When the Bank of Canada ended its conditional commitment on interest rates in April 2010, the implication was that it would revert to being less transparent (Erman 2010). Observers would once again have to rely on code words to divine how the central bank sees the way ahead for monetary policy. Unfortunately, this kind of approach to monetary policy can do more harm than good, as words can be taken out of context, misinterpreted or simply serve to confuse (Blinder et al. 2008).

It is worth, then, devoting some space to a review, and a rebuttal, of some of the main objections to the release of interest rate projections. The critics argue that:

- *The public might not understand conditionality*. Conditionality is a fact of life. All contracts are conditional in nature. According to media monitor Factiva, Canadian media articles between April 2009 and May 2010 concerning the Bank's interest rate policy reiterated each time the conditional nature of its commitment. This suggests that consumers of this information are aware of what conditionality implies.

- *If the central bank is forced to change its mind too often, conditionality becomes more difficult to communicate with a potential loss of central bank credibility*. Central banks do not respond to every wiggle in inflation, nor is there an expectation that they should. Instead, the source of the shock and its persistence are what matter. Central banks seem to have found a way of communicating this. There is no reason to believe that a conditional interest rate forecast is any more difficult to communicate than an inflation or real GDP growth forecast.[7]

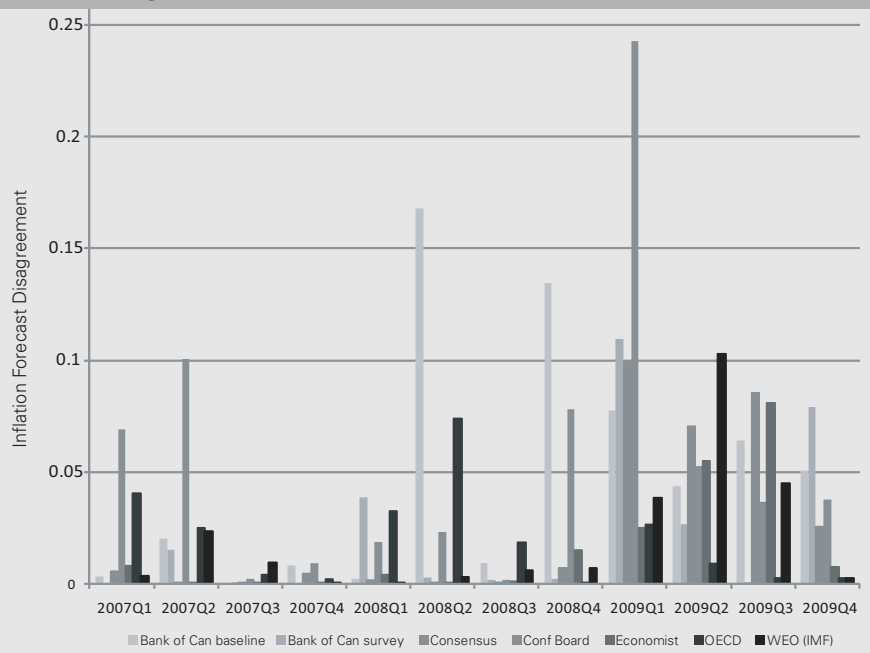
- *Financial markets will slavishly believe the central bank's forecast and become complacent*. This argument suggests that the public will come to rely almost exclusively on the central bank's forecast and become inattentive to other forecasts (Morris and Shin 2002, 2005). The hypothesis focuses on point forecasts, whereas a conditional forecast, by its nature, would highlight the uncertainties around the future path. Indeed, the central path of future policy rates is a tendency projection, not a firm promise of what the central bank will actually deliver. Figure 1 below shows the degree of dispersion across inflation forecasts. Clearly, forecasters disagree quite a lot about future inflation, in spite of the inflation forecasts appearing in the Bank's *Monetary Policy Reports*.

5 Publishing an inflation forecast has become a routine form of central bank communication around the world. The Bank of Canada publishes a so-called base-case projection in the MPR. It was not so long ago that the Bank argued against publicizing such forecasts (see Siklos 2003).

6 Worries over forecasts that are influenced by the stance of fiscal policy and could drag the central bank into unwanted territory are unwarranted. After all, the Bank's projection model incorporates an assumption about the level of the debt-to-GDP ratio. The Bank could simply use values projected by the finance department.

7 Indeed, the Norges Bank goes out of its way to explain the criteria necessary to properly communicate an interest rate path. See, for example, the March 2010 edition of its *Monetary Policy Report* at http://www.norges-bank.no/templates/reportroot____11459.aspx.

Figure 1: Forecast Disagreements in Canada, 2007-2009



Note: Dispersion in forecasts is evaluated as follows. Let d^j_{th} represent forecast disagreement at time *t*, for a forecast of horizon *h*, produced for economy *j*. Then, (1)

$$d^j_{th} = \frac{1}{N_j - 1}\sum_{i=1}^{N_j}(F^j_{ith} - \bar{F}^j_{\bullet th})^2$$

where *F* is the forecast for inflation, N_j is the number of forecasts, *i* identifies the forecast, while $\bar{F}^j$ represents the mean forecast value across forecasters in economy *j*. Forecast disagreement is first evaluated for each source (i.e., each i in equation [1]), and j= Canadian forecasts.

Source: Siklos (2010).

- *Reaching agreement on a future policy path may be difficult since monetary policy is decided by several individuals*. Responsibility for monetary policy rests with the Bank Governor who relies on advice from the Bank's governing council. This distinction is one that markets and the public understand and it serves to reinforce the conditionality of any forecast.[8] Based on England's experience since an independent decision-making body responsible for carrying out day to day monetary policy was created in the late 1990s, disagreement within its Bank Monetary Policy Committee over future policy does not seem to have hampered the ability of the Bank of England Governor to successfully conduct monetary policy.

Instead, this paper argues that publishing a forward interest-rate track meets public accountability demands through the provision of the right kind of transparency. Here are the benefits of such openness:

- *A forward track can produce realistic expectations and facilitate efficient asset pricing.* Financial markets, as we now know all too well, need not always be efficient. Bouts of irrational exuberance or excessive pessimism may well be mitigated by the publication of policy rate projections guided by a more dispassionate and realistic set of views about the future and, hence, assist in the stabilization of expectations.[9]

8 Spence, in his accompanying paper, is also concerned that an interest rate projection requires the central bank to communicate how the Bank's forecasts are generated and the sources of errors. The Bank already does some of this and requiring it to do more along these lines simply meets the test of accountability. In Norway, a team of independent experts, conducts an annual independent evaluation of monetary policy, including the Norges Bank's forecasts. The latest edition can be found at http://www.bi.no/en/Research/News/News-2010/The-Norges-Bank-Watchers-/.

9 There is insufficient space here to delve into whether the Bank's conditional commitment of 2008/09 influenced interest rate expectations. A separate Appendix suggests, however, that the Bank was generally credible, and the early removal of the commitment did not unanchor expectations.

- *Making forward track projections public would improve policy coherence*. The Bank and federal government are jointly committed to maintaining a 2 percent inflation target. Implicitly, therefore, there must be a commitment to at least a range of future policy rates which, subject to uncertainties about future shocks and changes in other assumptions about key macroeconomic variables (e.g., the exchange rate), will be required to meet the target. The publication of such forecasts would improve the quality of monetary policy.

- *Enhancing the clarity of central bank communication via the release of a conditional forecast would improve perceptions about discussions inside the policymaking body*. A path for future policy rates, together with indications of the uncertainties around such a path, ought to foster debate about future economic policy. Indeed, since minutes of the Bank's governing council are not published, a conditional commitment on interest rates could be used to communicate subtle differences of views within the committee.

Even if there are challenges with the publication of conditional interest rate forecasts, there is little doubt that, on accountability grounds, such a transparency-enhancing move would burnish the Bank's reputation as a central bank that has got it right and position it for the hoped-for return to more normal times.

Appendix A

Market Expectations of Interest Rates in Canada 2007-2010

What was the impact of the Bank of Canada's historic conditional commitment? How did financial markets react and was the conditionality explicit in the Bank's commitment? Broadly speaking, as illustrated below, the Bank appears to have communicated its views in a credible manner, and the early removal of the commitment did not unduly upset financial markets. Overall, the evidence suggests that communicating the future course of interest rates need not represent transparency gone too far.

Figure A1 illustrates the differential between the three-month yield on bankers' acceptances (BA) and the overnight target, which can indicate stresses in financial markets. This spread began to rise sharply in the days before the October 8, 2008 announcement by the Bank of Canada and several of the world's leading central banks (viz., the U.S. Federal Reserve, the Bank of England , the European Central Bank, the Riksbank, and the Swiss National Bank), of a coordinated interest rate reduction. Thereafter, the spread between the BA yield and the overnight target remained fairly stable until early 2010 when it widened amid signs that the link between the two began to be severed, probably reflecting the markets' expectations that the Bank would abandon its conditional commitment, hence recognizing the conditional nature of that commitment. In fact, the spread returned to levels last seen just before its introduction.

Figure A2 shows the overnight target and a selection of yields on futures for bankers' acceptances ranging from three to 18 months. Before the period of the conditional commitment, there were frequent departures between the announced policy target and the futures market. Following the period of the conditional commitment, these departures persisted, although the futures market revised downward its expectations of futures short-term interest rates on the dates when the Bank reaffirmed its conditional commitment, suggesting that the Bank was credible in communicating its commitment.

Figure A1: Interest Rate Developments in Canada

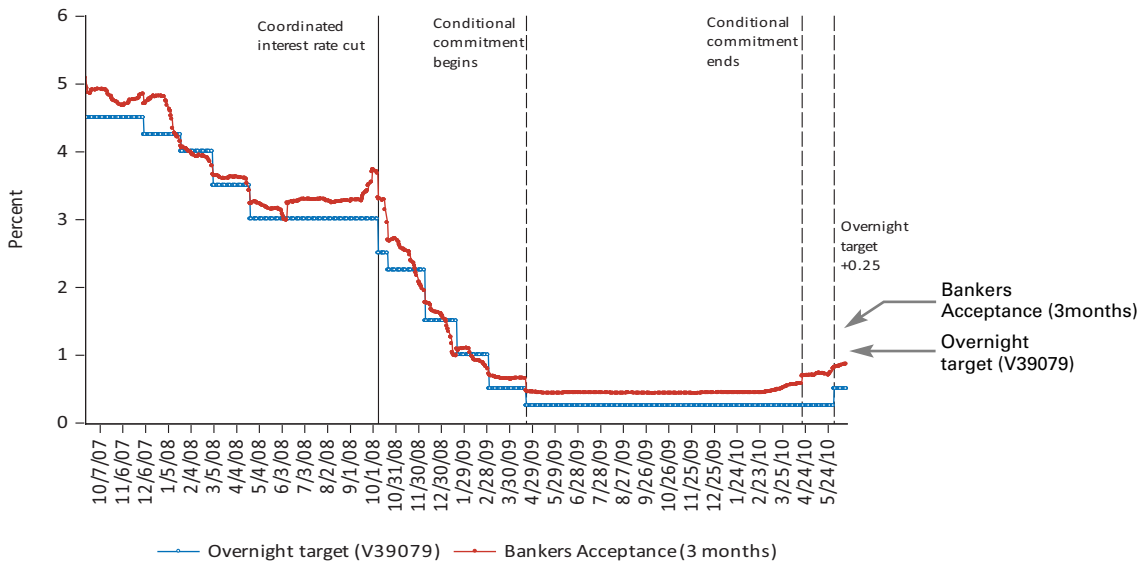
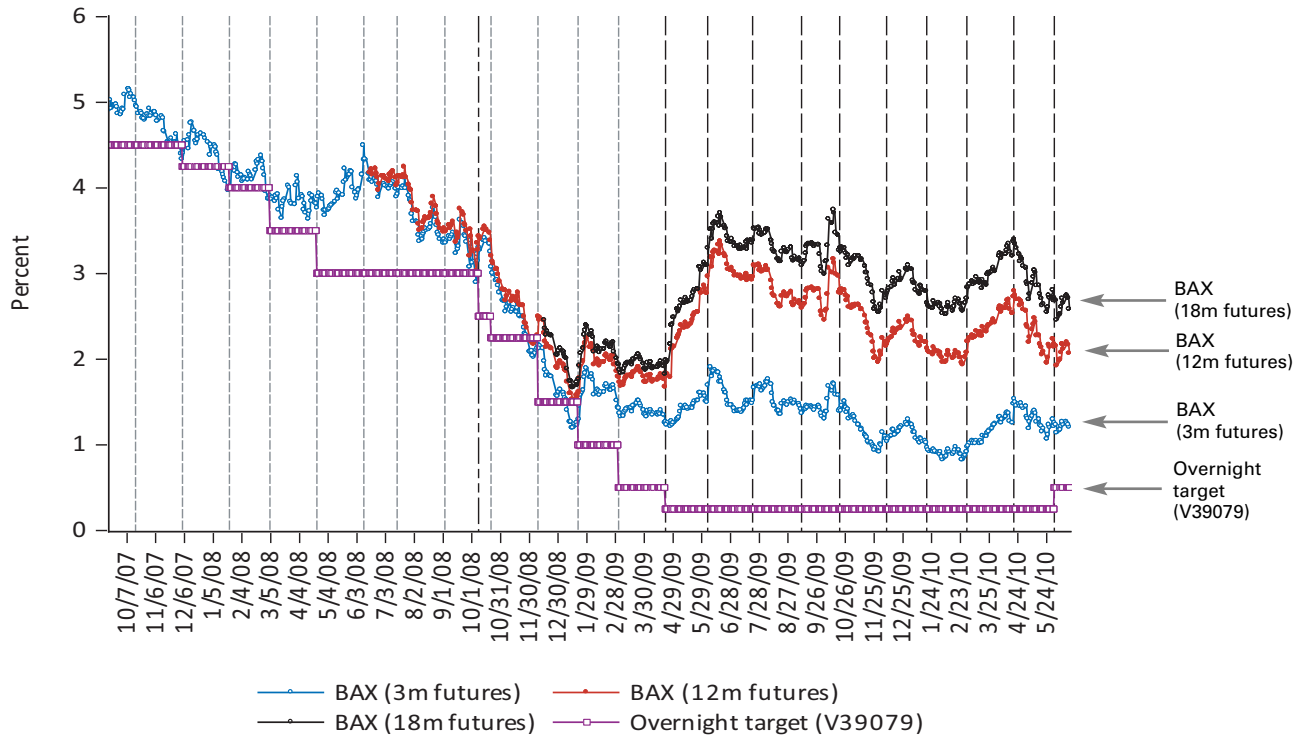


Figure A2: The Overnight Target Rate vs. BAX Futures



Notes: Data are from Bloomberg. BA refers to Bankers' Acceptances, which is an average yield for these types of instruments for nine Canadian banks. The data are daily. Yields on BA futures (BAX) are for the maturities shown in months. V39079 is the Bank of Canada's overnight target. The vertical lines are either Bank of Canada overnight target announcements or other announcements labelled separately. The period before the period of the conditional commitment is distinguished from the period when the commitment was in place by the type of vertical line drawn. Also shown separately is the joint interest rate action by several central banks announced on October 8, 2008.

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Taking the Path Most Travelled : Why the Bank of Canada Should Not Release its Interest Rate Projections

By Andrew Spence

The annals of communication history are littered with messages received that differ from those transmitted, often producing damaging confusion and misunderstanding. It is useful to remember this phenomenon when considering demands that the Bank of Canada release its forecasted interest rate path to achieve its 2 percent inflation target.

The main argument for making public the Bank's private interest rate forecast is that it will shape better financial market expectations about future monetary policy actions. This matters because the interest rates that people pay are priced off the yield curve, or the spread of interest rates across the maturity spectrum beyond the Bank's overnight interest rate. For its part, the Bank is reluctant to release its projected interest rate path in normal circumstances because financial markets are likely to view the projected path as a commitment, rather than as a projection conditional on existing information that is subject to change.

Given the conditional nature of forecasts, and given that they are generated by complex macro-models, releasing the forecasted interest rate path would be a poor substitute for ongoing communication about the Bank's interest rate intent, whether implicit or explicit. Financial markets would likely respond to the public information by turning their attention to the model generating the forecast, potentially broadening the array of relevant variables to consider and for the central bank to explain subsequently.

Practically, it is not clear that releasing the forecast for the interest rate path would result in better monetary policy communications and outcomes than the use of existing communication techniques. Indeed, the experience of the few central banks that do release an interest rate forecast suggests that a public forecast and changes to that forecast can create as many communication problems as they solve.

The Sharper the Lemon the More Bitter the Taste

Advocates of releasing the projected interest rate path assume that there is an information asymmetry between the central bank and the market, one that hinders formation of optimal expectations about future policy actions. While it is well known that asymmetric information leads to market inefficiencies, it is not clear that the central bank has a real information edge over the market beyond knowing – with a lead of three days – what its next policy action will be.

Without such an edge, the Bank of Canada is no more likely to achieve its forecasted interest rate path than if it had been forecast independently by a private sector agent that understands the Bank's inflation control process.[1] Both bank and agent would respond to the same publicly available data on the evolution of demand, output and inflation.

Routinely releasing forecasts would of course be another step along the road to more policy transparency, which in the past has unquestionably led to an improved understanding of central bank actions. Central bank watching is now much simpler than it was, financial market outcomes in the face of interest rate changes are much less tempestuous and the transmission of central bank interest rates changes is likely much more efficient than it once was.

Linked to transparency, however, is credibility. Transparency relates to what you say you will do, but credibility comes from doing what you say

1 The Bank generally understands that inflation is the result of prevailing excess demand or supply and inflation expectations. It explicitly forecasts the balances of excess supply or demand, but this requires it to forecast potential output, an unobservable variable to which much uncertainty is attached. The forward interest rate path that controls inflation is as uncertain as the estimate of potential output, so releasing this interest rate path projection risks conveying a sense of certainty that the Bank could not possibly hold.

you will do. Given the conditional nature of forecasts, and the very high likelihood that the central bank will often miss its forecast by a wide margin, making public its private predictions puts the Bank's credibility at risk at the very time when it needs it most: in the face of expectational surprises. Being so transparent is especially risky when there is a divergence of views between the Bank and the market over the Bank's interpretation of past and likely future economic events that could drive the Bank to abandon its commitment. In such a situation, the Bank risks its credibility and the usefulness of the public forecast.

The Devil is in the Details

The Bank of Canada's projected interest rate path is generated by the Bank's Terms-of-Trade Economic Model (ToTEM) forecasting model. Built into the model is a set of rules – or policy response functions – that seek to both achieve the inflation target and minimize the variability in actual inflation around the 2 percent target.

A rules-based policymaking process has the virtue of predictability – or so it is asserted. According to this theory, if the rules are robust and reliably implemented, the gap between actual inflation and inflation expectations narrows, leading to less policy intervention. The existence of predictable rules stabilizes expectations and reduces deviations of the actual interest rate path from the projected one. Surely this process would work better if we all knew the path? At least that's the idea.

The trouble, however, is that ToTEM does not make the interest rate decisions; the Bank's governing council does. The actual policy path can therefore deviate significantly from the projected path because the council's decision-making process provides discretion to deviate from the rule.

There are some very good reasons for such permissiveness, mostly related to the limitations of formal macromodels. Models are simplifications of reality and seek to reduce complex economic relationships to a few behavioural equations, the parameters and relative variability of which are determined by history. They are notoriously subject to errors or shocks that drive a wedge between the actual interest rate path and the initial projection.

Given the scope for such deviation, the private-sector effort and resources saved by no longer having to guess the forward path would, if the projection were public, be diverted to getting a better understanding of the errors that might be embedded in the projection, with a necessary focus on the TOTEM model itself. To do so successfully demands rather specialized and rarefied skills.

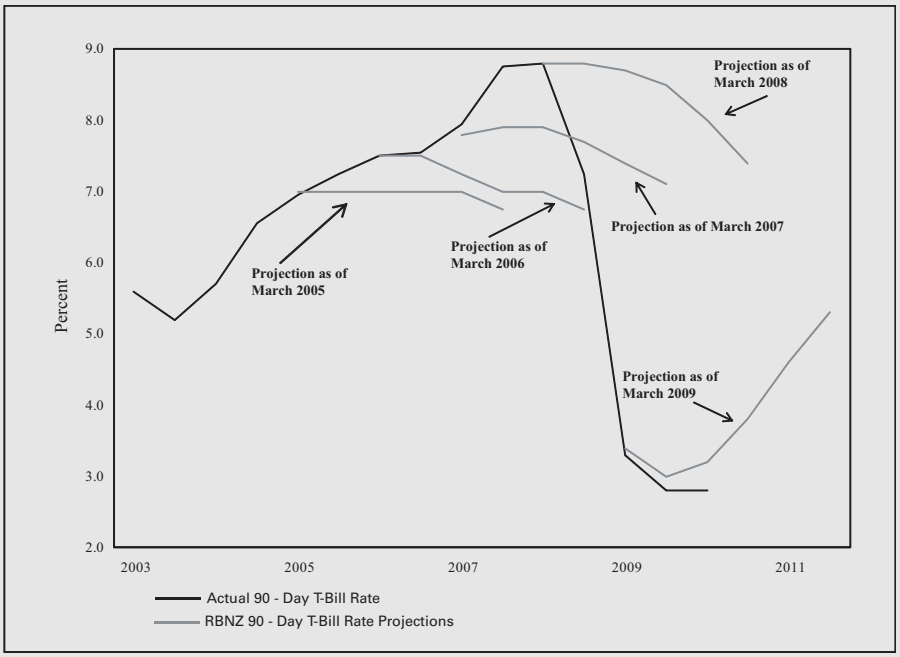
In other words, clarifying the conditional interest rate path may complicate the communication process because the Bank would come under pressure to explain its model, how the model generates projections and the sources of potential error.

Alternatively, the Bank could choose to release the governing council's interest rate forecasts, where the formal interest rate path model is just one of many inputs to the policy decision. In fact, the council's decisions are highly subjective and heuristic, and if its forecasts are made public, the market would ask about its data, assumptions and risk assessments, as well as the probabilities assigned to those risks.

Furthermore, observers would want to understand which council participant's forecast matters the most. Indeed, the council is not a democratic committee in the sense that one person has one vote and the majority view carries the day. Rather, it is what Blinder (2007) describes as an "autocratically collegial committee" where the authority rests with one decision maker, in this case the Bank Governor, with other committee members present to ensure that the single decision maker does not have an extreme preference.[2] In the absence of a change to the

2 See Blinder (2007) for a definition of such a committee.

Figure 1: Wide Scope for Error: The RBNZ Interest Rate Forecast



Source: Reserve Bank of New Zealand

Bank of Canada Act that would broaden responsibility for the interest-rate decision process, releasing the governing council's forecasts is unlikely to convey either the precision or conditionality of the Bank's policy intent.[3] As things stand now, the only council member's forecast that effectively matters is Mark Carney's.

Another potential negative of releasing the Bank's conditional forecast is that it might crowd out competing private forecasts of the overnight rate. The market may well be tempted to substitute the Bank's forecast for its own, given the considerable resources the Bank devotes to this activity.

How well one performs as an investor, however, depends on how good one is as a return forecaster. The incentive to forecast accurately what the central bank is most likely to do, as opposed to what the central bank itself thinks it is most likely to do, is incentive enough to ensure that private investors will continue to forecast the most probable interest rate path. But, it is hard to imagine that private forecasts would not be affected by the public availability of the Bank's own interest rate forecast, and that this would not lower the quality of the information available to the central bank.

There is another important element to the discussion–the exchange rate. Given that Canada is a medium-sized, very open economy, large unanticipated adjustments in the exchange rate can invalidate any prior expected interest rate path. Therefore, to shape future policy expectations accurately, the Bank would also have to release its exchange rate forecast.[4]

3 Federal Reserve Chairman Bernanke expressed a similar concern about over-reliance on central bank statements intended to influence market expectations about the future policy rate path.

4 There are many competing forecasting models of the exchange rate, but the Bank of Canada's terms-of-trade model contains a very important role for commodity prices. To assess the Bank's interest rate forecast, the private sector would, therefore, have to also forecast commodity prices in order to forecast the exchange rate.

What I Do is more Important than What I Say

Financial markets do not like surprises. In recognition of this fact and to promote market efficiency, central banks give plenty of implicit and even explicit messages about future actions. The more confident the banks are of such future measures, the more explicit their guidance becomes. Yet, no matter how explicit the guidance, it must always be always conditional.

Conditionality matters. If financial markets take a projected interest rate path as more than an article of faith, and interest rate risk is hedged against that path, the first deviation will provoke all manner of intemperate invective condemning the Bank for not adhering to its commitment. Loss of trading profit rarely makes for a tranquil day. However, financial markets tend to view conditional commitments as literal commitment because a truly conditional commitment is really not much of a commitment at all.[5] Furthermore, the more often the Bank fails to conform to its projected path, the less useful its subsequent projections become.

Explicitly signalling intent also can have unintended consequences. Basically, when economic agents come to understand the Bank's model, they will adapt their behaviour to invalidate the model's predictions in a clear example of the Lucas critique. Take the case of New Zealand. The Reserve Bank of New Zealand (RBNZ) releases its interest rate and foreign exchange rate forecasts for the next two years. Before that it used a monetary conditions index to shape its inflation forecast and control process.[6] At first, the market paid close attention to the projections and ignored the lags between any change in policy intentions and its eventual impact on demand and inflation. When the RBNZ signalled it expected to ease monetary conditions to deliver a different level of the monetary conditions index (MCI) over a two-year period through a mixture of lower interest rates and a lower exchange rate, the market turned the forecast into immediate reality by taking the exchange rate down abruptly, which forced interest rates up. In other words, while the central bank rate forecast was mostly realized, it came at a price- too low an exchange rate and too high a rate of interest. In this example, an adverse mix of interest rates and the exchange rate can lead to a sub-optimal resource allocation challenging the assertion that publicly available central bank forecasts do little harm if they result in an economic imbalance.

The RBNZ no longer publishes a MCI forecast, and instead releases separate forecasts for each. However, as Figure 1 shows, the scope for error is significant. Small open economies such as New Zealand's can forecast the interest rate path with less confidence than large closed economies, especially net commodity exporters that are subject to large terms-of-trade shocks.

Having too Much of a Good Thing

The market can perhaps have too much information from the central bank in the absence of demonstrable information asymmetries. Instead of releasing the interest rate forecast and potentially complicating the communications challenge, the Bank should instead focus on communicating the logic of its monetary policy. In this way, both the Bank and the market can harmonize the interpretation of incoming information and better align expectations of future interest rate actions with those most likely to occur.

5 The Bank of Canada's experiment with the monetary conditions index in the mid to late 1990's floundered partially on a misunderstanding of what the bank's interest rate response to a move in the exchange rate would be. The market believed that the Bank would in all circumstances respond to a move in the exchange rate with an offsetting movement in interest rates based on a simple rule of thumb. While the bank had been at pains to explain how it would respond differently to the exchange rate in different economic and market conditions, market participants simply focused on an apparent policy rule.

6 A monetary conditions index takes the exchange rate and turns it into an interest rate equivalent to calibrate policy appropriately.

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