

11. Systemic Issues

i. Lessons from the past as a guide to the future

A number of lessons may be drawn from the recent past to help inform future policy. First, flexible exchange rates have been both volatile in the short run and subject to misalignment over the long run. These features carry with them potentially significant costs even in a world where hedging against exchange rate risks is available. Counter-trade may be encouraged, as also the inefficient allocation of resources worldwide. The associated uncertainties may lead to decision delays, with adverse implications for investment, growth and employment, and the danger of a ratchet effect on protectionism, with the consequences of currency overvaluation for protectionism not being symmetrically offset by the trade liberalising effects of undervaluation.

The lack of policy co-ordination fostered by flexible exchange rates has itself contributed to volatility and misalignment, and has allowed large fiscal imbalances to develop which have had destabilising global ramifications. Moreover, the costs of unco-ordinated policies have spilt over to developing countries. The consequences of unco-ordinated monetary contraction amongst G-7 countries at the beginning of the 1980s for global economic activity

and interest rates contributed significantly to the Third World debt crisis. And it may be no coincidence that the early 1990s, like the 1930s, were characterised by economic recession, rising unemployment and a slowdown in world trade.

Evidence for the superiority of market-based BoP financing is no more compelling. Private capital markets have exhibited pro-cyclical waves of feast and famine, have resulted in financial flows not clearly related to variations in the marginal productivities of capital across countries but to financial returns and expectations, and have incorporated strong regionalisation effects. The capital transfer patterns of the 1970s and 1980s do not, therefore, instil great confidence nor provide a satisfactory basis for the future. If private agents possessed the perfect foresight with which they are sometimes credited, the debt crisis would not have happened. Moreover, the market fails not only on *efficiency* grounds but in terms of *equity*, since the financing needs of many low-income countries are largely ignored by it.

The global environment in which the BWIs now function is hence very different from the one for which they were originally designed. There is greater interdependence between countries, via

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trade and finance and the globalisation of markets (not least via transnational corporations); hugely increased mobility of capital (following the removal or breakdown of capital controls); financial innovations in lending instruments; and the communications revolution. There is also the emergence of powerful new economies in South East Asia and, potentially even more important, the prospective emergence of others such as China; changing geopolitical allegiances, with a more complex mosaic emerging than in the days of the Cold War; the massive problems facing countries in transition; and some proliferation of international economic institutions, including the new World Trade Organisation (WTO).

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debate on
reform*

Another important change arises from the growing importance of developing countries both within the world economy and as members of the BWIs. Nearly 130 of the 178 members of the IMF are classified as 'developing countries' and the contribution of these to world output growth, when valued in purchasing power parity terms, rose from 32% to

37% during 1983-92. Moreover, the ability of some countries in Asia and the Western Hemisphere to achieve relatively rapid growth in the early 1990s despite a global slow-down suggests that developing countries have some independent growth and may be able to play a 'locomotive' role.

A final difference is that gaining agreement on international monetary arrangements is more difficult than in 1944, when a small number of like-minded intellectuals was able to push through policy reform. Subsequent attempts to induce fundamental reform have been unsuccessful. However,

because the Commonwealth includes within its membership large industrial countries as well as small and very poor developing countries, it straddles other inter-country groupings such as G-5, OECD, and G-24, and it therefore offers a useful forum in which reform may be debated, since a full range of country interests is represented.

In the remainder of Part II we concentrate on two related systemic issues. The first is policy co-ordination. This seeks to minimise the incidence of BoP disequilibria by eliminating macro-economic mismatches and by orchestrating responses to asymmetrical supply-side shocks. However, even at its most successful, co-ordination will not eliminate disequilibria altogether, so the second issue is how to deal with disequilibria when they arise. Here we examine the balance between adjustment and financing, and investigate ways of modifying the balance which has evolved in recent years. In the concluding Part IV we revert to systemic issues, to discuss questions of institutional change.

**ii. The international
co-ordination of macro-
economic policy**

The fundamental case for policy co-ordination is simple and appealing. In an inter-dependent world one country's actions have external effects on other countries. Ignoring these spill-overs results in sub-optimal decisions and the externalities need to be internalised into decision-making processes. Co-ordination involves modifying national policies to reflect international economic inter-dependencies and seeks to maximise joint welfare. Global problems of recession and unemployment may be best handled by globally co-ordinated policy since attempts to deal with such prob-

lems in isolation will encounter BoP constraints. At the same time, co-ordination highlights the potential unsustainability of some countries' policies, incompatibility between objectives (e.g. where all countries are simultaneously seeking to strengthen their BoP), the problems of 'global overkill' (where taken in aggregate, policies are excessive) and the 'fallacy of composition' (where a policy that may be effective when pursued in isolation will be ineffective, or less effective, when pursued simultaneously across countries).

Against this, critics argue that co-ordination impedes necessary exchange rate realignment, with adverse effects for financial markets, and diverts attention from the need to attend to domestic policy. Economic welfare, they suggest, is maximised when behaviour is competitive.

What does the evidence show? The BW system incorporated a form of rule-based co-ordination and that structure collapsed. However, the appropriate conclusion from this is that the *form* of co-ordination was too rudimentary, ignoring issues relating to the conduct of fiscal and monetary policy. A more recent failed experiment with policy co-ordination was the European Monetary System and its Exchange Rate Mechanism. Does the collapse of this in 1992/93 call into question the wisdom of co-ordination? Again, the answer is no. What it illustrates is the need, first, to identify carefully the exchange rates to be defended, since otherwise the commitment will lack credibility and, second, to allow rates to be realigned when there is a shock (e.g. German reunification) which creates fundamental disequilibria at the original rates. While policy co-ordination tries to minimise BoP disequilibria, any scheme for co-ordination must recognise that these will never be completely eliminated and incorporate a mechanism for dealing

with disequilibria when they arise.

Apart from the evidence from co-ordination experiments, various studies attempt to estimate the benefits and costs of co-ordination. Although some have identified only insignificant positive gains and some even losses, the models from which these results emerge are often based on quite restrictive (and unrealistic) assumptions. Where benefits are discovered, they are not limited to the industrial countries that undertake the co-ordination, but spill over to other country groups. Indeed, developing countries are sometimes apparently the principal beneficiaries from policy co-ordination amongst industrial economies. Of course, as noted above, North-South interaction is two way and the mutuality of interests as between North and South is significant. It is in the interests of industrial countries to encourage economic growth and development in poorer countries and policy co-ordination can play a significant role here.

Support for enhanced policy co-ordination came from Commonwealth Study Groups in 1983 and 1991 and the same principle has recently been endorsed by the Bretton Woods Commission chaired by Paul Volcker, which recommends that, 'the major industrial countries should give co-ordination a higher priority than they have' (1994, p.3). However, the crucial problem is in moving from general principles (where there appears to be little disagreement) to operational modalities. In the case of the Volcker Report, this problem is reflected by using elastic phraseology which talks about a 'broad improvement' and 'greater convergence' in national macroeconomic policies, as well as 'responding appropriately' to changes in international economic

The North and South have mutual interests in policy co-ordination

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conditions. The Report also suggests that '*in time*, this system could *possibly* involve flexible exchange rate bands' (italics added). A little more boldly, the Report proposes that industrial countries, 'should establish a more formal system of co-ordination involving firm and credible commitments to support policy improvements and avoid excessive misalignments and volatility' (p.5). However, when the details of more formal systems are proposed, disagreement invariably surfaces. For example, the Volcker Report has expressed admiration for the detailed proposals for policy co-ordination put forward by Williamson and Henning (1994) as an 'intellectual feat'

but dismissed them as 'too elaborate'.

The danger, then, is that policy co-ordination will be vulnerable to a Catch-22 syndrome: what is practical will be ineffective and what would be effective is impractical. The guidelines for policy co-ordination need to be sufficiently well-defined to be clear and effective, and at the same time avoid being too intrusive, thereby seeking to maximise the degree (or at least the illusion) of 'national sovereignty' retained by individual countries. Either way, it is preferable as a regime feature to have co-ordination based on guidelines (rules) rather than on discretion, although the latter will be required as an over-ride to the system to deal with unanticipated shocks.

A key design issue is whether target zones (or exchange rate bands) are vital in inducing convergence in macroeconomic policy. The current view within the Fund seems to be that, although there is a two-way relationship, it is the co-ordination of fiscal and monetary policy which is strategically the more

important. According to this view, problems with exchange rates arise largely from inadequate macroeconomic policies rather than from the nature of the exchange rate regime itself. An alternative view is that target zones which permit nominal rates to change in order to reflect changes in fundamental equilibrium rates none the less provide a focal point around which macroeconomic policies may be co-ordinated. However, suggestions that the ERM could, in effect, be globalised, at least amongst the world's three major monetary poles (the G-3), encounter the objection that a higher degree of collective determination is needed than exists now and is likely to exist in the foreseeable future.

A further important design feature relates to dealing with free-rider and time-inconsistency difficulties. How is compliance to be monitored and enforced? Peer pressure for the pursuit of appropriate policies may be insufficient. It has not in the past prevented countries from pursuing policies which have imposed external costs on others. Although more formal policy co-ordination would increase peer pressure, other mechanisms may be needed. In the case of surplus countries one idea would be to reactivate in one form or another, the almost forgotten 'scarce currency clause'. Through this mechanism the Fund could integrate its enhanced co-ordination role with the activities of the new WTO. In the case of those deficit countries which do not borrow directly from the Fund, additional pressures could be exerted via measures to interact more closely with private capital markets and to be more open in providing information (see below).

However, there are problems not only in the design of co-ordination but also in the modalities through which it takes place. These two aspects are connected by considering the *deepening* and

widening dimensions of co-ordination. Should it involve relatively few countries but go into depth or should it be less detailed but involve more countries? The answer to this question in turn connects economic and political elements, since co-ordination needs to be sufficiently detailed to make it work (loose commitments to 'co-operation' will be operationally meaningless) but at the same time has to carry sufficient international support for it not to be frustrated.

How many countries should be involved in the design of internationally co-ordinated policy? One principle involved is that negotiation becomes more difficult the larger the number of actors involved. This counsels limiting co-ordination to a small group of countries. A second principle suggests that governments will be more committed to guidelines restricting their policy freedom if they feel that they have been involved in the negotiating process, and will be suspicious of any process which excludes them (see Part III on 'ownership').

The nature of co-ordination is also significant, since if it were to be discretion-based and of a fire-fighting type it would almost certainly need to be limited in its coverage. Where it is rule-based, however (aiming to be preventive rather than curative), a wider constituency may be involved in its design. Co-ordination may need to be more complex and multi-layered than is implied above, however. Circumstances may exist, for example, where inflationary pressures amongst G-7 countries validate increasing interest rates. These clearly have effects on highly-indebted developing countries because the cost of servicing external debt will increase and capital outflows may be induced. Moreover, if rising interest rates slow the growth of the world economy this will weaken the export markets of developing countries. Part of co-ordination should

therefore be to insulate such countries from the consequences of damaging side-effects. Co-ordination of macroeconomic policy therefore has indirect implications for compensatory and contingency lending (see below).

Bearing in mind the twin principles introduced above, as well as the need for compensatory measures, there is a strong argument for policy co-ordination to be organised within the IMF; an *international* agency would then be orchestrating the *international* co-ordination of policy. This is also the conclusion reached by the Volcker Commission, which rejects the G-7 alternative on the grounds that 'the G-7 process is not an institution, a continuing body, or an executive entity.' The Commission also sees problems with the G-7's broad agenda, extending to political and security issues, and its relationship with non-G-7 countries. On the other hand, giving the tasks to the IMF 'whose major shareholders are the major industrial countries, that has the flexibility, the legitimate authority and much of the necessary expertise' would 'restore the original focus of the Fund' (p. 8). We agree.

But does the Fund's organisational structure lend itself to the task of co-ordinating policy? Williamson and Henning (1994) propose a Fourth Amendment to the IMF's Articles, a reconstitution of the Interim Committee into an International Monetary Council, and a new subcommittee of the Executive Board which would meet at least quarterly to exercise surveillance over countries' compliance with agreed guidelines. Others have suggested dismantling both the Interim and Development Committees altogether and replacing them with international

The case for enhancing the Fund's surveillance role

steering committees, based on G-3 members. However, although this suggestion complies with our first principle, it fails to meet the second. Given their growing importance in the world economy, developing countries must be fully involved in the policy co-ordination process.

Even outside the issue of co-ordination, the increasing membership of the Fund raises important questions of governance and democracy. At present, a few countries are able to dominate decision-making and frustrate the wishes of the majority of members. The increased economic importance of developing countries has received scant recognition in the decision-making of the BWIs, which appear increasingly undemocratic in their structures of governance. For example, Commonwealth countries comprise about 27% of the membership of the IMF and command just over 18% of the votes, only fractionally greater than the voting share of the United States which comprises a mere 0.56% of the Fund's membership and which exerts enormously greater influence.

At the same time, the increasing size of the Executive Board has been seen as diminishing its effectiveness and the establishment of smaller executive subcommittees as desirable. It will be important however that such changes are representative of the Fund's changing membership, with rotation having been suggested as one means through which this might be achieved.

The world economy in general benefits from stable economic growth, orderly foreign exchange and financial markets, liberal trade, full utilisation of capital and labour, and smooth adjustment to disequilibria. Since the collapse of the BW

system many of these objectives have been unrealised. It is in this context that policy co-ordination offers an opportunity for systemic improvement, as well as an opportunity for the Fund to reassert its pivotal role in global economic affairs. This general goal should unite Commonwealth countries, even though it may be expected that points of view will differ as to the detailed arrangements through which the goal may be best achieved.

iii. The adjustment– financing balance

The past two decades have witnessed a large shift in the balance between adjustment and financing as means of dealing with BoP deficits. In response to the first oil shock in 1973 the Fund established an Oil Facility to provide additional financial assistance to countries encountering oil-related deficits. It changed its mind as other shocks occurred, including the second oil shock of 1979 and the debt crisis of 1982-83, and opted for responses requiring much more adjustment. The Oil Facility was allowed to lapse, no new allocations of SDRs have been made since 1981, and the Compensatory Financing Facility was deliberalised from a low-conditionality to a high-conditionality facility. When modified in 1988 to include a contingency element and to become the Compensatory and Contingency Financing Facility (CCFF) its high conditionality status was retained, even strengthened; these changes also survived a subsequent review in 1993. Contingency planning has been taken by the Fund to require building up larger reserves in deficit countries through pursuit of still more contractionary adjustment policies, even though this could lead to real exchange appreciation. Despite recent efforts to

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strengthen the contingency-orientation of programmes, there has been a more general trend towards emphasis on adjustment and conditionality amongst lenders and donors.

There are clearly circumstances in which adjustment is essential: when disequilibria are non-transitory and related deficits are unsustainable in the long-term. In such cases postponing adjustment will make matters worse. However, where BoP deficits are temporary and self-correcting, adjustment is inappropriate as a policy response, except as a means of reducing vulnerability to temporary shocks, and external financing is superior. Developed country governments, including those of the United States and Britain, have used this logic to claim that their current account imbalances do not matter since they are ephemeral and can be financed by international borrowing because of strong credit worthiness.

But does the theory only apply to developed countries? Should developing countries faced with non-permanent shocks, such as harvest failures in Africa or hurricanes in the Caribbean, be expected to tighten macroeconomic policy in consequence? Either event would induce the temporary export shortfalls against which the CCFE was originally designed to insure. The only significant difference between the country groups relates to their creditworthiness. This is an area where the market fails. Systemically, the Fund as a BoP institution should provide compensatory and contingency finance to allow domestic policy to be implemented in a more stable and less disrupted way, while the World Bank should provide the longer term development assistance which allows exports to be diversified. It makes little sense for poor countries to protect themselves against unforeseen shocks by building up large stocks of unproductive international reserves. All this does is to make *certain* now the sacri-

fices that *may* have to be made in the future.

In any case, adjustment and financing are not pure substitutes. Any BoP programme will incorporate a package of adjustment and financing. Where the adjustment component focuses on supply enhancement and structural change, rather than on demand contraction, the process will take longer and in the interim more external finance will be required to support it. Of course, if as a result adjustment is more effective, the longer term need for BoP financing will be lowered; there is an intertemporal trade-off between financing now and in the future. Inadequate external finance may therefore damage the chances of effective adjustment, not least where it reduces the commitment of governments that have to implement the adjustment policies. In this sense external financing and effective adjustment are complementary.

The role of the BWIs in encouraging an optimal blend of financing and adjustment will vary given the diversity of country circumstances, such as those in the Commonwealth. For fully creditworthy countries the BWIs will not need to provide finance, and the IMF may seek to persuade them to place greater emphasis on adjustment through Article IV consultations. For middle-income developing countries on the margin of creditworthiness, the Fund's catalysing role could, in principle, be important, while co-financing and guarantees could be provided by the World Bank Group. Here the BWIs should attempt to support private capital markets and enhance the creditworthiness of borrowing countries.

Here too there are important links between financing and adjustment. The

Temporary shocks require compensatory financing, not adjustment

Volatile capital flows require two approaches

Fund's catalytic effect (which both theoretical and statistical analysis suggests is much less significant than is often claimed) could be strengthened by improving the effectiveness of Fund-backed adjustment programmes. Interaction with private capital markets could take place in other ways. Although private markets and the BWIs share many

interests, such as the pursuit of stable financial conditions and 'sound' economic policies, there has not always been a mutually supportive relationship between them. It has proved difficult for the Fund to influence, let alone regulate, private capital flows. Without resorting to capital controls (which, even if they were desirable, are probably impractical), two broad approaches exist.

The first is to design an international framework which seeks to stabilise private capital flows. This is the logic behind proposals that the Fund should more formally 'certify' market lending to developing countries or that countries should formally pre-commit themselves to accept Fund-backed programmes in the event of certain situations. It is also what lies behind the suggestion that the Fund should make available more detailed country information and enter into direct consultations with market participants. After the 1982/83 debt crisis the Fund attempted to exert more influence over private capital flows by briefing commercial bank steering committees and through a policy of concerted lending. But it has been reluctant to become systemically involved with private capital markets, even by way of offering general (non-country-specific) guidelines on country risk analysis. However, with private capital flows becoming increasingly important and given the potential and actual volatility of

market flows, now is an appropriate time to reassess this position. A second approach would be to compensate countries after the event for the volatility in capital flows which they experience. A specific proposal which advocates this approach is evaluated below.

For low-income countries, such as those in Sub-Saharan Africa, the BWIs need to stand in place of frequently absent private capital. Even the Volcker Commission, which urges the World Bank Group to focus much more on orchestrating private finance, recognises that the Bank's role needs to be substantially different in low-income countries, where increased highly-concessional finance is needed. While the problems faced by low-income countries are undoubtedly serious, it is wrong to assume that they are intractable and that it is beyond the scope of the BWIs to offer effective assistance. There is an array of policies that could usefully be adopted, including the reintroduction of quick-disbursing and low conditionality compensatory and contingency financing (via a modified CCFF), the wider use of subsidies to finance concessionary lending by the Fund across all its lending windows, the extension of debt relief to alleviate the problem of African debt, and new allocations of SDRs. These are not new ideas. Many of them (along with others) appeared as recommendations from the 1983 Commonwealth Study Group. Inaction reflects a past lack of political will rather than an absence of proposals. The mid-1990s, however, may offer a more conducive environment than the 1980s, when such forms of international economic intervention were out of step with the dominant economic and political paradigm. Moreover the prime global concern is now more with unemployment and recession than with inflation, and these are symptoms of deficient rather than excess liquidity.

As a specific example, the arguments assembled against an SDR-aid link when it was first proposed in the 1970s lack force in the 1990s. The inflationary consequences of SDR allocations are now accepted as insignificant and the dangers of damaging the SDR as an international reserve asset are no longer relevant. Concern over the fact that SDRs are exempt from Fund conditionality could be overcome by using SDR allocations to augment conventional Fund-backed programmes, where they would still alter the financing-adjustment balance in favour of short-term financing and longer term adjustment. Objections that the near-commercial rate of charge on the net use of SDRs eliminates the benefits to recipients are not persuasive, for many low-income countries have no access to commercial markets or can only borrow at considerably higher rates than carried by SDRs. In any case, the benefits to recipients can be raised by subsidising the charge they pay. Although the Interim Committee has deferred a decision on the Fund Managing Director's recent recommendation for a new SDR allocation, there remains a strong chance of eventual acceptance. While the consensus that is emerging focuses on a special SDR allocation for the former socialist countries, low-income countries should also receive new allocations, a substantial proportion of which would be to Commonwealth countries.

In addition to support from the BWIs, market-related opportunities also exist for reducing low-income countries' vulnerability to commodity instability. More aggressive use of futures and options markets could transfer some of the risk associated with export concentration. The BWIs could usefully provide technical advice on the scope for such self-help.

The rationale for protecting adjustment programmes from the effects of 'outside' shocks does not only apply to

low-income countries. The experience of middle-income developing countries during the 1980s and 1990s reveals how domestic macroeconomic management may be disturbed by swings in the availability of private capital.

During the 1980s a number of proposals were put forward for schemes which would have effectively capped interest rates. More recent suggestions advocate devising a quick-disbursing credit mechanism to ameliorate sudden changes in private capital flows, especially when these are beyond the control of the countries concerned. The additional credit would supplement countries' own prudential reserve accumulations but would enable the cost of such provision to be shared between the countries themselves and the international financial institutions. The Fund would in this instance offer a second line of reserves. The principal proponents of such a facility see it as a low conditionality source of credit, but the Fund would only countenance the idea if it was linked to adjustment programmes.

A problem here is that providing 'second line' credit to better-off developing countries could crowd out 'first line' credit to low-income countries. If the BWIs have limited resources, it is important that they use them in ways that meet both efficiency and equity criteria. It would be preferable for the BWIs to instead explore ways in which they could dampen sudden changes in private capital flows. This might be achieved by strengthening the catalytic effect and making more information available (see above). It could also be achieved by the Fund taking on a larger role in regulating private financial markets and by the BWIs encouraging optimal matching between the financing needs of developing countries and the instruments through which finance is supplied by private capital markets. A stark mismatch in this respect

Use of futures and options

contributed to the debt crisis in the early 1980s, and the better match achieved in the early 1990s, when private capital has surged back into some Latin American economies, has led some observers to conclude that the new flows will be more stable – a conclusion which may, however, be premature.

Taking on additional financing commitments of course has implications for the BWIs' resources. Ways will have to be found either for targeting these, focusing a fixed lending capacity in a more concentrated fashion, or for raising the lending capacity of the institutions. The appropriate response may indeed differ between the BWIs. For the Fund, there is a strong case for making quota increases more automatic and for relating such increases to economic proxies for the size of the problems with which the Fund is attempting to deal (such as a sharp fall in the value of world trade). Although it remains appropriate to finance a public agency such as the Fund by subscriptions, borrowing from capital markets could also be used to supplement Fund resources. By acting as an intermediary between eventual borrowers and capital markets, the Fund could help stabilise the flow of private finance to developing countries. Dangers that Fund borrowing would crowd out World Bank borrowing have surely been overstated.

The need for additional resources would be minimised if the BWIs followed the principles of compensating for market failure implied in the above discussion. These would mean that they would underpin, stabilise and complement the role of private capital in the more creditworthy developing countries in ways that maximised private flows over time and minimised their own, but stand prepared to substitute for private capital in low-income countries, where, in absolute terms, the demand for finance is small.

As part of this reorientation, the past

proliferation of lending windows should be reversed. Streamlining access could be achieved by rationalising the range of Fund facilities. At present, these incorporate credit lines which are little used (the Buffer Stock Financing Facility and the CCFF) or have overlapping purposes (ESAF and the Extended Fund Facility). Proposals for yet more facilities are inappropriate on this criterion, although the Fund should retain the flexibility to introduce *ad hoc* initiatives in response to sudden crises, in the manner of the Oil Facility. For the facilities which exist at present, however, a better arrangement would be to consolidate them into three: stand-bys, extended arrangements, and compensatory and contingency lending (without any overall reduction in lending levels). Stand-bys could continue to rely on conventional stabilisation measures. Extended arrangements would focus on longer term structural adjustment packages (and have a permanent status, unlike ESAF) and be closely integrated with World Bank SAPs via Policy Framework Papers.

Compensatory and contingency lending would involve quick-disbursing low-conditionality finance, although possibly with a pre-commitment element to implement more far-reaching programmes if BoP problems do not improve. All Fund lending to low-income countries should then be provided on highly-concessional terms, which could be financed by subsidies or gold sales.

There would also be a case for the Bank to adopt, and have funded, a credit window offering terms intermediate between the present IBRD and IDA terms, for countries with a similarly intermediate creditworthiness. The present stark dichotomy between the near-commercial IBRD terms and the high-grant-element IDA terms is a poor fit to the spectrum of creditworthiness found in the developing (and ex-socialist) world.