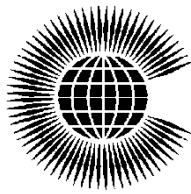


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**Reform in the Bretton Woods Institutions:
A Commonwealth Perspective**

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Reform of the Bretton Woods Institutions – A Commonwealth Perspective

Executive Summary – Issues for Discussion

Ministers are asked to comment on whether they would wish to see any of the following issues pursued within the Commonwealth:

- Using the good offices and convening power of the Commonwealth to examine the issues of IMF governance and feed into the ongoing process of consideration in the Fund.
- The promotion of multilateral cooperation might best be promoted through the auspices of the Fund.
- Monitoring experience of Commonwealth members with the recently reformed instruments of the International Financial Institutions to collate experience and identify the scope for future improvements to these facilities.
- Greater flexibility in the eligibility criteria for multilateral resources through the inclusion of measures of vulnerability amongst the criteria in their use and in supporting members' efforts to increase the pace of financial disbursement.
- Scope for Commonwealth exploring the scope for a practical scheme of reallocation of SDRs from developed to developing countries.
- Innovative approaches to addressing the increasing demand for global goods and for managing the issues raised by the financing of sustainable development for the international institutional system.

In addition, Ministers may wish to comment on general developments in the Bretton Woods Institutions. In particular, they may comment on whether:

- Reform of financing instruments and the low income country Debt Sustainability Framework for use at the Bank and Fund have fully addressed concerns previously expressed by Ministers; and
- The current economic crisis raises additional new needs, particularly in the low-income countries most significantly affected by the crisis.
- The resources of the Institutions are adequate or should be augmented further?

The past year has seen extraordinary developments in the global economy which – partly as a direct consequence – have been mirrored by rapid change within the Bretton Woods Institutions. Before this acceleration of reform in the World Bank and the IMF, Commonwealth Heads of Government, and subsequently Commonwealth Finance Ministers, had identified modernisation of the International Financial Institutions as a priority. The financial and economic crisis has made that need more widely accepted.

2. This paper examines developments in this area over the past year. The first part of the paper sets out the progress in taking forward the views expressed by members of the Commonwealth collectively in the process of reform. The second section examines more closely the specifics of reform. There is a focus on the extent to which changes in the Bretton Woods Institutions have been consistent with the principles and objectives expressed by Commonwealth Ministers and leaders. The paper also looks forward, identifying policy proposals where the Commonwealth may have a commonality of interest and invites Ministers to consider further Commonwealth activity in these areas.

Commonwealth Engagement with Reform

3. In their 2007 statement, Commonwealth Heads of Government said that they judged that *‘the current architecture of international institutions, which was largely designed in the immediate aftermath of the Second World War, does not reflect the challenges in the world of the 21st Century’*¹. They asked that the Secretary General of the Commonwealth establish a representative group in order to identify what the Commonwealth might do to address this concern.

4. This representative group met in London in June 2008 and set out a number of principles to guide reform in international institutions. In the view of the group, international institutions should be:

- Legitimate in the eyes of member states to command confidence and commitment of members to the institution’s goals.
- Characterised by fair representation for all countries.
- Responsive to the needs of all members, especially the smallest and poorest.
- Flexible in responding to new challenges, national priorities and the specific circumstances of member states, and changing global realities.
- Transparent and accountable to the entire membership and the wider public.
- Effective through being capable of addressing today’s global challenges.

5. The group also identified three specific areas where Commonwealth advocacy might be valuable. Reform of the International Financial Institutions was one of these areas. A subsequent meeting of Heads of Government in September 2008 tasked Commonwealth Finance Ministers with developing this initiative further.

6. At their meeting in St Lucia in October 2008, Commonwealth Finance Ministers endorsed the principles set out in the Marlborough House Statement, emphasised their desire that the Commonwealth should play a role in the reform of the IFIs and agreed to conduct a consultative process to identify areas of agreement and difference amongst the membership².

¹ See paragraph 54 of the Commonwealth Heads of Government Statement, Kampala 2007

² See paragraph 11 of the Commonwealth Finance Ministers Communiqué, St Lucia, 2008.

Ministers also stressed the need to complement the existing reform processes in the institutions.

7. The Commonwealth Finance Ministers Meeting in 2008 took place as the financial crisis in the global economy was at its most intense. Dealing with the fallout from that event - and the subsequent economic crisis – has been the primary focus of every Commonwealth Finance Minister. In parallel, the crisis made the work of recasting International Financial Institutions an immediate task. As a result, the opportunity and appetite for extensive intra-Commonwealth debate was reduced.

8. In consultation with the Prime Minister of St Lucia, the Chair of the 2008 CFMM, a twin track approach was pursued to respond to evolving events. First, an online consultation was established seeking the views of members on reform. Regrettably, the response rate to this was too low to allow a collective opinion of the membership to be developed. Secondly, the Secretary General was tasked with ensuring that the Commonwealth principles agreed by Finance Ministers were fed into the IFI reform process both within and outside the Bretton Woods Institutions. To this end, the Secretary General has held discussions with representatives of the institutions and has worked to ensure that the Commonwealth's views were widely understood in the international community. This has influenced the approach to reform in international fora such as the G20 and the UN. In addition, the members of the Commonwealth have been able to apply the principles in their own consideration of reform proposals. Finally, the Commonwealth, through the Secretary-General, has advocated strongly the need for reform to recognise the views of all countries, not just the largest or most powerful.

9. The Commonwealth has been one of many voices seeking to influence reform of the International Financial Institutions. However, it was amongst the first both to call for fundamental reform of the International Financial Institutions, before the crisis reached its height, and to set out a coherent set of principles for reform. Many of those principles, especially those of effectiveness, legitimacy, accountability and inclusiveness are now common currency.

Reform – Progress and Next Steps

10. The second part of this paper considers reform of each of the IFIs in a number of dimensions with a particular focus on the issues which have been highlighted in previous Finance Ministers discussions. It provides some view on how far Commonwealth principles are reflected in the reforms which have been undertaken and provides some indication of potential next steps within the Commonwealth.

Governance

11. Since their establishment in 1944, the governance structures of the IMF and World Bank have tended to evolve slowly. The result has been that changes to the voting shares of members and the distribution of national representation on the Executive Boards of the two institutions have lagged changes both in the global economy and in the function of the institutions themselves. Similarly, the overall framework of responsibility and accountability within the institutions has drifted progressively away from best practice in corporate governance in either the private or public sectors.

12. These outmoded governance structures and procedures have risked undermining the legitimacy and effectiveness of both the Bretton Woods Institutions. The Commonwealth

principles show that reform of governance should have the aim of reinforcing the legitimacy and effectiveness of the institution through ensuring fair representation and voice for all countries. They also attach importance to improving accountability. This section considers the reform of governance in the institutions from this perspective taking the issues of votes, procedures and accountability in turn.

Votes and Boards

13. The recognition that changes are needed to the distribution of voting shares in both the World Bank and the IMF to strengthen legitimacy and effectiveness predates the crisis. However, the imperative for change has been heightened by it. In the past, the structures of governance in each of the institutions have mirrored each other closely. The establishment of a third seat for Africa in the World Bank in 2008 has broken that symmetry and opens the opportunity for a progressive divergence of the governance structures allowing them to reflect fully the different natures and purposes of the institutions. Breaking this link opens the opportunity for well designed, and tailored, reform in each institution.

At the World Bank

14. By the time Commonwealth Finance Ministers meet, negotiations on proposals for change to voting shares in the World Bank to be taken to the Annual Meetings in Istanbul will be concluded. This reform will show the extent to which the new opportunities for divergence in the nature of voting shares can be exploited. In particular, the reform has the opportunity to set an overall vision for how the governance of the World Bank should operate. From a Commonwealth perspective this and future reforms should be judged by their ability to support the objectives set out by Ministers previously. To promote the effectiveness of the World Bank, this points to a greater voting share for all borrowing members. This would bring the World Bank more into line with other Multilateral Development Banks where the balance between creditor and borrowing members is more closely balanced. In achieving this rebalancing, the Commonwealth has a particular concern for the needs of the poorest and the smallest countries. Some means of strengthening the voice of both of these groups independent of voting shares are discussed later in this section. Nevertheless, there is a strong case for an increase in the voting share of each of these groups since the Bank is a disproportionately important source of finance for these countries. At a minimum, it is important to ensure that the voting shares are not eroded through the accommodation of the desire of larger countries for greater voting share.

At the IMF

15. The process of reform of voting shares in the IMF is working to a different timetable, which provides more opportunity for intra-Commonwealth discussion. The G20 has asked for the acceleration of the next review of Quotas to be concluded by the Spring Meetings of 2011. The IMFC has suggested that the `...upcoming review of quotas is expected to result in increases in the quota shares of dynamic economies, particularly in the share of emerging market and developing countries as a whole.' To achieve this, the IMFC expects that work on some elements of a new quota formula, will be taken forward before the Annual Meetings.

16. The concern with the IMF quota formula reveals the widespread dissatisfaction with the outcome of the technical discussions which guided the reform of quota shares in 2008 which resulted in a formula which was a compromise between a number of strongly held and diametrically different views. As a result there are a number of important technical issues to be resolved. These include: changing the definition of variability which currently tends to give too little weight to those most likely to use Fund resources; changing the definition and

the importance given to openness, which currently excludes financial openness; reconsidering the emphasis in the calculations given to the measurement of GDP at PPP exchange weights – which more accurately measure welfare in an economy – against market exchange rates – which capture the interactions of economies.

17. These debates are more important since there is a greater opportunity for fundamental change than in the past. The crisis has shown that there is a need for a significant increase in the Fund's financial resources. In the first instance, additional finance has been accessed from the membership through direct borrowing and through existing emergency facilities, suitably augmented. There is a strong case, consequently, for a substantial increase in the Fund's standing resources provided through the quota system. As a result, there is the scope for a closer alignment between actual quota shares and those calculated by any new formula. This opportunity will only be taken if there is wide acceptability of a new formula and the principles it embodies. In turn this requires political agreement on what the objectives of governance reform should be which will in turn guide the final outcome.

18. The Commonwealth's interest in this process is to ensure that any changes respect the principles outlined by Ministers. This interest is further defined by economic reality. The Commonwealth as a group has a greater share in world trade than in world GDP. As a result, it is more exposed to the risks of economic instability than other groups of countries, consequently strengthening governance in order to improve the effectiveness of the IMF matters disproportionately to Commonwealth members. In this context, the Commonwealth has a particular concern with sustaining the ability of the IMF to serve the entire membership including the both the poorest and smallest. This was emphasised by Commonwealth Heads of Government in their 2007 statement. With this background Commonwealth objectives for reform of voting shares and Board composition in the IMF could be:

- The acceptability of reform to all members to strengthen the legitimacy of the IMF;
- Voting shares of each low income country should be at least maintained in the reform to ensure that the voice of this group is not diminished;
- Voting shares of developing country small states should also be protected. Previous quota reforms have recognised the necessity of making special provision for small states to ensure fair representation and voice;
- The number of countries in each constituency should be made more equal through the elimination of all single country seats. This would have the effect of strengthening the voice of those members which are currently represented in particularly large constituencies, as well as diluting the voice of the largest members.
- A greater degree of automaticity in future changes to voting shares in the IMF (and the World Bank) to ensure that legitimacy, once enhanced, is maintained.

Procedures

19. Efficient governance requires more than an adequate distribution of voting power and seats at a Board table. Ministers have a declared aim of enhancing both the degree to which the voice of all countries is heard in the IFIs and strengthening accountability within the institutions. These issues are common to both the World Bank and the IMF. Steps which could be taken to achieve these Commonwealth aims for greater voice are:

- Increasing the number of decisions taken by double majority and raising the threshold for a blocking minority. This has the effect of increasing the need to build explicit coalitions for decision making within the institutions and removes the anomaly through which a single shareholder is able to prevent fundamental changes.
- Allowing countries to cast their votes individually rather than only as part of a constituency block vote. This is the practice in a number of Regional Development Banks and means that the voice of each country can – in principle – be directly heard on each issue.
- Creating institutional mechanisms such as Board sub-committees to ensure that issues of concern to those countries with smaller voting shares are fully considered.
- Making a reality of the merit based process of appointment. While there may be a general acceptance of the need for open selection of the Heads of the World Bank and the IMF, currently, the process of nomination too easily provides disincentives to credible candidates to stand.

Accountability

20. As has been well documented, lines of accountability and responsibility in both the World Bank and the IMF are inadequately defined. The confusion of responsibilities between the Board, the Management of the respective institution and the Ministerial Committees – the Development Committee and the International Monetary and Financial Committee (IMFC), means that it is difficult to ensure accountability. In the IMF, proposals for clarifying this confusion have been developed, notably by the Committee of Eminent Persons chaired by Trevor Manuel which reported in March 2009. The proposals have been greeted cautiously, although at the heart of them lies a desire to strengthen the accountability of the Fund to its membership. This is a goal shared by all Commonwealth members. Two particular steps might be taken to reinforce accountability in the IMF:

- Putting in place a performance contract for the Managing Director through which clear benchmarks are specified and for which the Managing Director is held personally to account. This would allow for a reduction in the level of micro management from members of the Fund through the Board;
- Symbolically, discontinuing the practice of the Managing Director chairing the Board would also point to a clearer division of responsibilities.

21. Given the current state of the debate and the need for developing international consensus on the details of IMF governance reform:

Ministers may wish to consider whether there is value in using the good offices and convening power of the Commonwealth to examine the issues of IMF governance and feed into the ongoing process of consideration in the Fund.

IMF and Preventing Future Crises

22. The Fund's surveillance function exists to identify areas of potential instability in individual economies and in the global economy as a whole. A significant contributor to the conditions which fostered the crisis was fundamental inconsistency in macroeconomic policies within and between the largest economies. To the extent that these inconsistencies were unaddressed, the Fund's surveillance, either in analysis or influence, failed.

23. Rapid steps have been taken to address concerns about the technical elements of the surveillance process. This has seen an increase in the attention paid to the linkages between the financial sector and the real economy, although the continued publication of separate World Economic Outlooks and Global Financial Stability Reports suggests this process is not complete. At the institutional level this greater degree of integration has been complemented by closer working between the Fund and the newly created Financial Stability Board. This should increase the ability of the international system to identify and address emerging risks in the international system.

24. Importantly, this strengthened analysis on the linkages between the financial and real sectors has been complemented by a greater emphasis on the role of multilateral surveillance. As a result, the spillovers between economies and their potential impact on the global economy are now being more fully explored and more clearly explained. In addition, in the conduct of surveillance, the Fund's advice on the implementation of the 2007 Surveillance Decision has been helpful in stressing the need for judgements on economic policy to be fully rounded and not focussed exclusively on exchange rate regimes and levels. If applied fully it should remove some concerns about the lack of even handedness.

25. Delivery of economic and financial stability requires member countries of the Fund to take action in response to the risks to stability which are identified. Experience has shown that it is difficult to enforce multilateral cooperation even when desirable for long run global stability. Commonwealth members are particularly exposed to global economic instability. But the global economic stability needed by Commonwealth members can only be achieved through multilateral cooperation across the whole of the international community.

26. The open question is how this can be achieved. Institutional mechanisms have been proposed, including the establishment of an IMF Council to ensure that operational multilateral economic discussion takes place at the highest political level. In principle, this should lead to such discussions being fed directly into the domestic policy making process. A similar philosophy motivated the exercise of the Multilateral Consultation between the most significant deficit and surplus countries in 2006, yet failed to catalyse the needed multilateral action.

Ministers might consider the scope for a Commonwealth discussion over the coming year for how multilateral cooperation might best be promoted through the auspices of the Fund.

Global Public Goods and the World Bank

27. For the World Bank, in addition to its central aim of poverty reduction, repeated economic crises in developing countries and escalating development challenges have increased expectations that the Bank should supply global public goods. However, the provision of public goods by the World Bank raises fundamental questions. First, the interaction between the Bank's current objectives and approach and any role in providing Global Public Goods. The Bank currently has a clear poverty mandate and country focus in its work. A greater use of its skills, convening power and resources to deliver global public goods can dilute that focus.

28. Second, the question of funding sustainable development and especially finance for preventing and mitigating the impact of climate change present specific challenges.

Sustainable development is increasingly clearly fundamental to the ability of countries to fight poverty. Yet the international systems to address all the aspects of sustainable development are both fragmented and divorced from the institutions whose objectives are poverty reduction. This incoherence is a potential barrier to addressing either of these issues effectively. This is a much wider issue than reform of the World Bank on the one hand or of reform of the International Environmental Governance system on the other. Similarly, if the potential level of financial flows between developed and developing countries for addressing climate change are to be realised, the existing systems of ODA will need to be substantially adapted.

29. These are issues for the medium term to which a diverse group such as the Commonwealth can contribute discussion and thinking:

Ministers may consider the merit of a Commonwealth focus on innovative approaches to addressing the increasing demand for global public goods and for managing the issues raised by the financing of sustainable development for the international institutional system.

Reform of Instruments

30. Commonwealth Finance Ministers have had long standing concerns about the adequacy in coverage, availability and operation of the instruments in the Bretton Woods Institutions. They have felt that these instruments have not been sufficiently responsive to the needs of the membership in the face of the challenges of the global economy. These concerns are reflected in the importance attached by Ministers to flexibility and responsiveness as principles guiding reform of the IFIs. The economic crisis has created the opportunity for the institutions to demonstrate fully their adherence to each of these principles.

31. In the World Bank, the pattern created in the response to the global food crisis of creating dedicated funds using a mixture of existing and new money, has been continued in response to the wider crisis. A new Vulnerability Financing Fund has combined the existing Global Food Crisis Response Programme and new facilities – the Rapid Social Response Programme and the Infrastructure Recovery and Assets Platform. The IFC has taken a particular lead within the World Bank Group, reflecting the expertise of the institution in the private sector and its ability to attract capital flexibly. As a result a range of new facilities have been created in response to the needs revealed by the crisis to support bank recapitalisation, trade credit and infrastructure financing. In addition, IDA lending has also been accelerated to support national budgets, especially in the provision of social protection.

32. In this response, the World Bank has been attempting to simultaneously meet the immediate needs of government for fast disbursing money to deal with the crisis whilst addressing the long term development needs of the membership. It has also been used by the Bank as an opportunity to address pre-existing criticisms of World Bank facilities and policies, notably underinvestment in infrastructure and the productive sectors and a neglect of the interests of middle income countries.

33. In 2008, Commonwealth Ministers called for the IMF to review its instruments to re-establish their coherence and relevance. In the subsequent period there has been a comprehensive overhaul of the entirety of the Fund's financial instruments. These reforms respond to long term changes in global capital markets and the policy environment. For

emerging market economies and vulnerable developed economies the need for larger and more rapid access to emergency finance first exposed by the Asian crisis has finally been recognised in the Fund's facilities. For low income countries the driving force of the reordering of facilities has been the changing domestic policy environment and greater integration in the global economy. These changes have signalled the need for a more sophisticated set of tools for the Fund in the support of low income members for some time.

34. Flexibility in response to both economic circumstances and the needs of members has characterised this reform of facilities. The strongest examples of innovation have been:

- Greater emphasis on country ownership, especially in the design of the entry criteria for the Flexible Credit Line. This in turn has overcome nearly a decade of stalemate over the question of the Fund providing insurance facilities;
- A willingness to challenge existing presumptions about the volume of financial resources which the Fund should provide;
- The introduction of flexibility in the charging for low income country facilities to maintain concessionality over time, complemented by the decision to forgo interest payments until 2011;
- Steps towards generally lower conditionality in programmes in streamlining and downgrading structural reform criteria in all programmes.

35. This flexibility has extended to other policies of the IFIs. The Debt Sustainability Framework is due to be revised by the time of the Annual Meetings. The Commonwealth Ministerial Debt Sustainability Forum is feeding its views into the IFIs. Commonwealth Ministers have been concerned that the design and application of the framework has unrealistically constrained their ability to meet the development needs of their countries.

36. Overall, the reforms to instruments in the two institutions have gone a long way to responding to Commonwealth objectives, especially in increasing the coherence of IMF facilities. However, it is important that changes in design is followed by change on the ground for the membership as a whole. This is particularly true of the applicability of the new approach to structural conditionality and spending in the social sectors. Reportedly the initial reaction to the changes is positive. Further experience will show whether the application of these changes will enhance the overall effectiveness of the institutions in supporting the prosperity of borrowing members.

Ministers may wish to consider whether the reform of financing instruments at the Bank and Fund have fully addressed concerns previously expressed by Ministers; and whether the current economic crisis raises additional new needs, particularly in the low-income countries most significantly affected by the crisis.

Ministers might also wish to consider whether there is a role for the Commonwealth in monitoring experience with revised instruments through collating the experience of member countries;

Other Multilateral Financing Challenges

37. There remain two long standing Commonwealth concerns which have been heightened by the economic crisis. The first is concern at the speed of disbursement of multilateral funds. Although procedures, especially in the World Bank, have been

streamlined with a view to accelerating disbursement there remain concerns from members that design and disbursement is not consistent with country needs.

38. The second is the nature of access to concessional finance within the international system as a whole. Commonwealth small states are especially affected by the lack of flexibility created by the use of income level alone to define access to concessional funds. This crisis has once again shown that regardless of income level, small states are uniquely vulnerable to the impact of exogenous shocks whether natural or economic. The crisis has also shown that building resilience to these shocks is a sound investment for the international community in preventing reduced living standards in the face of these shocks. Consequently there is a strong case for developing proposals for including measures of vulnerability to supplement income level in the allocation of concessional finance.

Ministers might also wish to consider whether there is a role for the Commonwealth in introducing greater flexibility in the eligibility criteria for multilateral resources through the inclusion of measures of vulnerability among the criteria used.

Resources

39. The crisis has reversed assumptions about the role of official finance provided by multilateral institutions in the global economy. In the period of abundant global liquidity and low global interest rates, it was widely presumed that the financing role of both the IMF and World Bank was likely to be permanently reduced. That is no longer the case. The crisis has created unprecedentedly high levels of demand for official resources. As a result, the World Bank has seen lending nearly triple to \$32.9 billion in the last financial year.

40. Due in part to the comfortable existing capital position of the Bank, it has had limited success in raising additional resources from donors. For example, the President of the World Bank's call for a contribution of 0.7 per cent of the value of the global rescue packages to development was not taken forward. In addition, new instruments have attracted limited new funding from donors and an acceleration of the replenishment of IDA to make up for the more rapid disbursement its funds has proved impractical. The role that the Bank is expected to play as a counter cyclical lender remains unresolved. The increase in Bank lending is a fraction of either the needs of developing countries or the fall in private sector flows to developing countries over the past two years. How far the Multilateral Development Banks should be equipped, both in skills and finance, with the ability to step into the breach is still an open question.

41. Countries have responded more fully to the calls for increased funding from the IMF. The depth of the crisis combined with the sharp increase in access limits for all countries has raised commitments of finance to \$157 billion by the middle of 2009, using the bulk of the Fund's lending capacity. The demand for increased IMF finance has been met in two ways. First, the existing resources of the Fund have been doubled through the use of additional finance both from the New Agreement to Borrow and the 'purchase of IMF notes' by countries who would prefer to lend formally to the Fund. Second, for low income countries, the Fund is aiming to support lending at higher levels with further capital for the PRGF Trust and additional subsidy resources. Part of the subsidy element will be provided by the profits from the sale of gold to fund the IMF's income; the remainder is expected to come from donors.

42. Indirectly, the IMF is in the process of increasing the financial resources of members through the distribution of \$250 billion of SDRs at the end of August. Commonwealth members will receive around \$45.2 billion with around \$6 billion going to Commonwealth Low Income Countries; nearly \$36 billion will go to members of the G20 and other developed Commonwealth countries and just over \$3 billion to Commonwealth small states. These resources provide some measure of security to members' reserve positions. In the past proposals have been made to redistribute SDRs from developed countries – who receive the most of the allocation, but arguably need it least – to developing countries. However, although there are currently suggestions for the use of SDRs to provide capital for the PRGF trust there are no plans for a wider scheme of redistribution of SDRs.

Ministers may wish to consider whether there is value in the Commonwealth exploring the scope for a practical scheme of reallocation of SDRs from developed to developing countries.

In addition, Ministers may wish to comment on:

- **Whether the resources in the institutions are adequate or should be augmented further?**
- **The counter cyclical role of multilateral official finance.**

Conclusion

Reform of the International Financial Institutions is a continuing exercise. The further improvement of the effectiveness of the World Bank and the IMF remains important to all members of the Commonwealth. This paper has outlined a number of possible ways in which Ministers may wish to use the comparative advantage of the Commonwealth as a 'safe space' in which ideas can be explored amongst a diverse group.