



## **The EU response to the financial crisis: The development dimension**

### **CIDSE Recommendations**

**CIDSE** ([www.cidse.org](http://www.cidse.org)) is an international alliance of Catholic development agencies working together for global justice.

**Context:**

The ongoing financial crisis has dramatically illustrated the failure of current economic and financial policy and global economic governance to contribute to the common good and particularly the interests of the poorest and most vulnerable communities. As CIDSE is concerned that until now insufficient attention has been dedicated to the development dimension of the crisis and how this should be addressed it hereby presents its recommendations to the EU. CIDSE urges the EU to take its recommendations into consideration in determining EU action to tackle the crisis, beginning at the G20 summit on the 2<sup>nd</sup> of April 2009 in London.

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**Contact person:**

Denise Auclair ([auclair@cidse.org](mailto:auclair@cidse.org))

Jean Letitia Saldanha ([saldanha@cidse.org](mailto:saldanha@cidse.org))

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CIDSE is an alliance of 16 Catholic development agencies in Europe and North America working together for global justice, in partnership with development actors all over the world. As an organisation that draws its inspiration from Catholic Social Teaching, we have worked for many years to ensure that the common good, and particularly the interests of the poorest and most vulnerable communities, are central to global economic and financial policy making. Our objective is that global governance be directed towards sustainable, people-centred development, the eradication of poverty and upholding of human rights.

The ongoing financial crisis has dramatically illustrated the failure of current economic and financial policy and global economic governance to contribute to the common good. In Europe, economies from the Irish “Celtic tiger” to new EU member states are facing deep troubles. The developing world has seen investments drying up, remittances rolling back and falling export demand coupled with unmet liquidity needs. With national economies under pressure, vulnerable communities in the industrialised world and a far larger number of people in the developing world are finding it increasingly difficult to survive. The World Bank has estimated that 100 million people have already been pushed back into poverty as a result of the crisis.

We therefore welcome statements made by various European Heads of State, most recently reflected in the February Euro-G20 summit in Berlin, recognising that actions to address the impacts of the financial crisis include development concerns and a reform of global economic governance. Given this commitment, we urge you to take into consideration the following recommendations in determining EU action to tackle the crisis, beginning at the April G20 Summit in London:

- 1. Stepping up transparency and regulation**
- 2. Strengthened regional and sub-regional schemes for monetary cooperation**
- 3. Tackling currency speculation**
- 4. A new design for financial standard-setting bodies**
- 5. Reform of global economic governance**
- 6. A comprehensive and binding response to sovereign unsustainable debt**
- 7. Global action on the financial crisis must be holistic and coherent with action to tackle other global crises**

## **1. Stepping up transparency and regulation**

Secrecy jurisdictions undermine development by triggering a flight of resources from an economy, that should normally contribute to a governments' budget revenue. Developing countries lost an estimated \$858.6 billion to \$1.06 trillion in 2006 (Global Financial Integrity project, Center for International Policy, USA). In a situation where resources are becoming even scarcer in developing countries, losses of such a magnitude underline the urgency of ending secrecy jurisdictions.

In the context of the financial crisis, an equally significant characteristic of secrecy jurisdictions is their ability to undermine the application of other jurisdictions' legislation. New regulations are thus ineffective unless they also can be made to apply to such jurisdictions. Secrecy jurisdictions have created the conditions for, and contributed to the magnitude of, the current crisis. More fundamentally, secrecy jurisdictions have been central to the perpetuation of financial turmoil for deeper reasons: by ensuring secrecy and favouring complex financial arrangements, they allow the concealment of excessive risks taken by banks and companies and bring uncertainty to the financial markets.

### **(i) Renewed and broader black-listing of secrecy jurisdictions and international agreement on measures for non-cooperation**

We welcome the resolve of the EU Finance Ministers meeting in Berlin towards developing a new list of tax havens which do not cooperate with foreign judicial and tax authorities. Renewed black listing efforts should combine the rationale behind OECD, FATF and FSF work in this regard, rather than stick to a narrow view on the issue. It should include all states and territories unwilling to agree to the automatic exchange of tax and judicial information, to abandon strict banking secrecy and to register trusts' beneficial owners. Major financial centres should also be included.

The International Monetary Fund should fulfil its responsibility for the monitoring and surveillance of financial centres. Reports on Observance of Standards and Codes should also report on compliance of jurisdictions that are financial centres handling assets on behalf of non-resident clients with standards of international financial transparency and effective exchange of information.

Gradual and strong retaliation measures should be put in place against uncooperative secrecy jurisdictions based on an international agreement. Such measures should target secrecy jurisdictions themselves, but above all they should target transnational companies, banks, rich individuals who use them, and their advisors. As a minimum, the benefit of national and multilateral rescue plans should be strictly conditioned to the full disclosure by banks and companies of their offshore activities and benefits. The recent UBS scandal in the US proves that a tax administration can obtain transparency regarding its citizens holding an offshore account, despite banking secrecy, by threatening to take away the bank's license.

Small, vulnerable economies that have turned into tax havens, many of which house poor communities who do not receive any advantage from the offshore status, need support and financial assistance to diversify their income and comply with standards to prevent money laundering.

### **(ii) Tackling tax evasion at the national level**

A report by France's Syndicat Unifié des Impôts estimated tax evasion in Europe at 2-2.5% of European GDP. According to media reports in 2008, Germany has lost as much as 30 billion euros in tax revenue annually as a result of tax evasion. Using all means at one's disposal to escape one's fiscal responsibilities undermines the common good. EU member states should make tax evasion a criminal offence and legally actionable in national courts. In this regard, financial intermediaries such as corporate directors, lawyers and accountants should also be made accountable. Tax evasion should be included under anti money-laundering legislation. The EU should support developing countries in

stepping up their anti-money laundering efforts as part of an international enhanced effort against anti money-laundering. The EU should also support strengthening regional Financial Action Task Forces by providing them with constraining power.

Corporate tax evasion reduces revenues available to developing countries to invest in development and to cushion the impact of economic shocks. Building upon recent work in the extractives sector, all transnational companies should be required to report on their accounts on a country by country basis, including tax payments to governments. Host country requirements such as local purchasing and trade-balancing requirements, currently forbidden by the TRIMs agreement, should be reallocated, given their potential to prevent unfair transfer pricing.

**(iii) Multilateral Cooperation starting within the EU**

Tax havens should be curbed by a multilateral common standard defining a tax basis to minimise tax avoidance and a race to the bottom. EU member states should harmonise tax bases and minimum rates of corporate taxation to eliminate destructive elements of tax competition. The crisis also exposes the flaws of banking supervision that relies on market-based incentives for risk management. The EU should urge the development of a new framework for cooperation on international banking supervision which provides greater space for local authorities' intervention in light of, inter alia, their assessments of systemic risks, and needs of countercyclical regulation of capital.

The impact on systemic risk of "shadow banking" can no longer be ignored by regulation. We support the call some European governments have made for a system to monitor and supervise risk management that encompasses all financial institutions with an impact on systemic risk. Credit rating agencies also share responsibility for backing the concealment of risks that led to the crisis. EU member states should take steps to regulate and monitor credit rating agencies that operate within their jurisdictions, including through independent expert assessments of their methods and models. Legal incentives to rely on credit rating agencies should be removed from EU and Member States' legislation unless the relevant enforcement authority is able to guarantee stepped-up supervision.

**2. Strengthened regional and sub-regional schemes for monetary cooperation**

Since the fall of the *par value* Bretton Woods system in the 1970s, instability and misalignments of currency exchange rates have become the norm. Increased levels of exchange rate volatility have a strong impact on trade performance through channels such as the levels of domestic investment, the variations of relative prices of export products (which in turn affect competitiveness of economies) and the price of access to finance for production. The value of market access concessions and price-based trade liberalisation measures that receive so much attention in trade negotiations has been at times dramatically reduced or become uncertain due to exchange rate variations. It is important to note that developing countries, who are usually the 'trend-takers' with regard to currency exchange markets, feel the adverse impact of these changes much more than developed countries.

The IMF is not in a position to regain its capacity to perform functions it lost in the fall of the Bretton Woods system in the 1970s. Its failed attempts over the last 10 years – first through the 'spill-over' assessment in Art. IV consultations and later through the 'multilateral consultations' on surveillance – provide sufficient evidence of this. There is an urgent need to establish alternative credible mechanisms for the multilateral management of exchange rates. While an institution that coordinates among hard currency issuers is desirable, problems would remain so long as the domestic currency of one country continues to be widely used as the main international trading and reserve currency.

Drawing from the lessons it has learned with regard to the strength of a single Euro-zone in the current crisis, the EU should urge the replacement of the current system that relies on a single country's currency with strengthened regional and sub-regional schemes for monetary cooperation. In CIDSE's view, while being a more feasible form of multilateral exchange rate coordination, by supporting intra-regional trade it would also lead to diversifying products and markets, which would be particularly beneficial for developing country economies by deepening their resilience to external shocks such as the current crisis.

**As an ultimate goal, the EU should urge the creation of a more balanced system for multilateral management of exchange rates that builds upon and seeks to gradually coordinate South-South regional currencies and currency units.**

Such reforms would need a long time to come about. In the interim, some degree of currency exchange rate instability will presumably continue to exist, leaving non-reserve currency countries to disproportionately bear its impacts.

**As an immediate step, a regular and predictable mechanism should be put in place to ensure that developing countries can opt-out of their trade obligations to the extent required to counter the impacts of exchange-rate volatility on their economies. So long as there are no global institutions to manage exchange rates of *trend-makers*, the EU should make sure that *trend-takers* (most poor and undiversified economies) can enjoy the necessary space to manage their exchange rates.**

### **3. Tackling currency speculation**

While reducing exchange rate fluctuations is an important factor, a long-term vision of the global financial system that supports fairer trade and sustainable growth and development in general should also pay attention to curbing the speculative movements of capital that exacerbate the fluctuations of export-related incomes in developing countries. These magnify Dutch-disease dynamics and entrench an international division of labour that condemns a large number of countries to specialise in a decreasing number of low value-added exports.

A two-tier Currency Transactions Tax would enable international cooperation or even individual governments to better predict rapid speculative runs on currencies and moderate their effects. Of particular interest in these times of reducing ODA volumes and consequent finance shortfalls in reaching Millennium Development Goal targets, is its revenue-generating potential.

**It is very feasible for EU member states to adopt a simple stamp duty on foreign currency transactions such as a 'Currency Transaction Development Levy' at their national/ euro-zone level and encourage similar action by other countries. The EU should adopt (and advocate international support for) a policy that puts in place such a levy, while at the same time retaining the possibility of enforcing a full-fledged Currency Transactions Tax.**

Taking into consideration the rapid evolution of financial instruments, a more general Financial Transactions Tax (FTT) would make it possible to apply such a control on a whole range of financial transactions. The FTT could be applied on a step-by-step basis, starting with organised exchanges at key financial centres with an expansion to over-the-counter trading and broader geographical coverage in a next step. 'Normal' transactions between customers (private as well as corporate) would be exempted.

A FTT would have a regulatory effect, thereby stabilising excessive dynamic financial markets. As the tax base is the notional value of the respective transaction, this design implies that the tax burden relative to the cash invested grows as the leverage effect rises. Such a FTT would specifically hamper those transactions that involve high leverage, and therefore a high risk. A general FTT would make transactions more costly the shorter their time horizon, hence it would tend to dampen technical trading. It can be expected to reduce excessive liquidity stemming from short-term-oriented and potentially destabilising transactions. Moreover, a FTT could contribute to a small correction of the imbalanced taxes on 'real capital' and labour.

**Recognising the still early stages of the discussion of the feasibility of a more general FTT, the EU should encourage multilateral support for further exploration of its implementation at the political and technical levels.**

#### **4. A new design for financial standard-setting bodies**

The financial crisis has proven that problems in the design of financial standards have far-reaching implications for development and access to credit, for countries that have had no say in the design of such standards and are not represented in the bodies that design them, having even more dramatic consequences for less resilient and diversified economies. Fundamental principles of democracy and fairness underline the need for standards meant for universal application to be designed with universal participation. Key international standards such as accounting norms, which have a great impact on the ability of shareholders and citizens to monitor the activity of a company, are elaborated outside the scope of any public debate. For instance, the International Accounting Standards Board represents exclusively corporate interests.

The goals of standard-setting are also important considerations. Thinking of standards in the context of a politically agreed goal of full capital account liberalisation- an approach that has prevailed in standard-setting so far- is quite different from thinking of them in the context of a different goal. Each area of financial standards requires its own approach to setting goals and methods of participation to ensure adequate involvement by developing countries. The implications of the international agreed goal of at least halving poverty by 2015 should be taken into consideration as an important factor in determining the institutional composition and the national counterparts to which standard-setting bodies should relate in each country. For instance, it is likely that if the national counterparts are only central bankers, concerned with financial stability, the results will be quite different than if they involve trade unions, or small-and medium-size companies operating in the countries that will have to eventually implement the standards.

Problems arising out of a lack of participation in the design of financial standards are compounded by the pressure put on developing countries to adhere to them. The World Bank and the IMF- the main bodies assigned to pursue the implementation of particularly the 12 G7-endorsed standards and codes in developing countries- in most cases pursue their implementation through sanctions and incentives- a practice which calls into question the 'voluntary' nature of their implementation as agreed in the Monterrey Consensus (the global consensus reached at the first International Financing for Development Conference in 2002).

**Financial standard-setting bodies should add developing countries to their membership based on a clearly established time-line and be asked to report regularly on their compliance with this task. Guidelines should be established on the composition of these bodies and their goals. They should be required to ensure national members' contributions to these bodies come from a consensus among a diverse range of domestic constituencies. A UN-based**

**intergovernmental group of experts for addressing development-related questions arising from the design of financial standards should be established.**

## **5. Reform of global economic governance**

The crisis and the challenges it has revealed in present global economic governance calls for its overhaul. No body currently combines the legitimacy and the efficiency that are needed to tackle the economic turmoil. The G8 model that no longer reflects the actual distribution of economic power and industrial growth in the world today is becoming archaic. The G20, while representing a greater part of the world's people, still leaves out 172 countries. Member countries cannot really claim to represent others than themselves, as there is no mandate conferred on them by the larger community of countries, nor any mechanism for making them accountable to a larger constituency. The UN has the greatest legitimacy, but has been unable to efficiently govern on economic and social issues, with political priority being given to the International Financial Institutions. We welcome recent calls for a UN Economic and Social Security Council by German Chancellor Angela Merkel and European Commissioner Louis Michel. It is important that such a Council is built on an alternative model to the current Security Council with its outdated assignment of permanent seats and veto system.

**The EU should use the opportunity of this spring's ECOSOC High Level Dialogue with the IFIs, UNCTAD and WTO to introduce a discussion on a UN Economic and Social Security Council, and to decide on a roadmap to further develop the modalities of such a Council, including its implications for reform of the UN Charter. A strengthened Financing for Development follow-up process would provide a worthy venue for this discussion.**

Developing countries' reluctance to turn to the IMF to bail them out of the crisis reflects the distrust and caution with which these countries treat the institution. In Asia, Pakistan was the only country to turn to the IMF for finance after a period of great reflection. In Latin America so far only El Salvador has sought IMF assistance. Much of this feeling comes from a sense that the IMF does not adequately represent their interests. This in itself, along with a recognition of the inequity of the current system of representation, calls for a reassessment of the depth and extent of governance reform of the Bretton Woods Institutions. IMF reforms tabled so far, i.e. the reform of its voting structure at the Annual Meetings in 2006 and the Spring meetings in 2008 can only be described as piece-meal. The continued use of the existing formula – GDP openness, variability and reserves – continues to favour rich countries.

The measurement of GDP at market-based rates systematically underestimates the size of developing country economies. The current reform has accepted to measure GDP in terms of Purchasing Power Parity only to a limit of forty percent. The second variable, openness, is highly correlated to GDP measured in market-based rates, and therefore equally biased against developing countries. Moreover, the EU particularly should recognise that the inclusion of trade within an intra-currency union as international trade, substantially overestimates its weight. The third element, variability, is potentially a powerful variable to capture developing countries' need for the IMF, but as it is not measured as a ratio of GDP, will not work in that direction.

These issues need to be addressed now more than ever before, with global financial stability being recognised as a global public good. The growing call for the IMF to move away from financing roles towards surveillance and monitoring requires even-handedness to tackle advanced economies as much as, or even more than, developing countries' macroeconomic policy. The World Bank's mission of poverty eradication, that it has failed to achieve so far, underlines the need for it to undertake urgent reform.

**The EU should support an amendment of the current formula to determine voting rights in the IMF and World Bank to include a consideration of ‘demand-oriented’ variables that favour developing countries as against ‘supply-oriented’ ones.**

The original Articles of Agreement of the IMF and the Bank ensured that only a few key decisions would be taken by special majorities. In the case of the IMF, the US share of 17% meant that in a number of these decisions, which could only be taken with a special majority of the votes (85%), the US would effectively have veto power. Over the years, however, the categories of decisions that require special majority have increased and so have the number of decisions subject to US veto.

For a number of decisions, the Charters of the institutions provide they require a certain proportion of voting power and a numerical majority of members (double majorities). Existing double majority provisions do not specify differences between developed and developing countries in terms of arriving at the numerical majority element. The introduction of a double majority requirement that would specifically include a separate majority of borrowing countries can increase the weight of developing countries in decision-making and encourage broader and more diverse coalitions across the membership - thereby ensuring more ownership - in support of policy decisions. Such a provision, requiring a majority of ‘regional members,’ is already in place in several Regional Development Banks.

**The EU should support the immediate introduction of the double-majority requirement for the IMF to take decisions related to its mandate to ensure global financial stability, as part of the broader effort to introduce this system of voting into policy decision-making in the IMF and World Bank.**

The current crisis and the extent to which poor countries are being affected also reflects the failure of the Bretton Wood Institutions’(BWIs) standardised approach to managing the economic problems of a country, regardless of its particular circumstances. Instruments such as the Country Policy and Institution Assessment (CPIA) and the Poverty Reduction Grant Facility (PRGF) remain far-removed from public discussion. There is a real or perceived fear in developing countries that they will not be provided with new loans or debt relief if countries dare to address their economic policies in a different way. The Boards of the Institutions have the ability to reject the macro-economic policies in the Poverty Reduction Strategy Paper (PRSP) by suspending the PRGF or Poverty Reduction Support Credit (PRSC)-supported programmes. All these factors remove the opportunity for real democratic control over IFI operations in developing countries while parliaments in developed countries have little oversight over the policy interventions being made by their countries’ Board representatives.

**The EU should urge that the BWIs make it mandatory for shareholders to certify that policy positions taken at the Board are regularly reviewed by a national Parliamentary Committee or another representative forum. Implications of financial commitments to the BWIs should similarly be reviewed by such fora. Low-income members’ governments should be held accountable by public representatives and civil society for the implications of loans contracted, as should the institution who gives the loans.**

The flawed nature of the current selection process for the leadership of the BWIs, based on an unwritten agreement between the USA and Europe coupled with weak attempts to open up the process, compounds a lack of confidence in the BWIs as legitimate institutions in the global economic architecture.

**The EU should take the lead by distancing itself from its customary prerogative of ‘nominating’ the head of the IMF and pave the way for the selection of the leadership of the**

**BWIs through open and transparent merit-based processes, an imperative acknowledged by the current head of the IMF, Dominique Strauss-Kahn himself.**

Finally the current discussion of the role of the BWIs in the financial crisis should also clarify its responsibilities in global governance. The UN Charter was conceived as a normative model to ensure that international policies, notably those in the monetary, financial and trade sectors, would be coherent and thereby provide solutions to international problems of an economic, social, cultural or humanitarian character, while promoting the respect of human rights for all. To this end, the system relied on two principles: specialisation and coordination. Within this scheme, the BWIs were specialised agencies of the UN. Ensuing events have distanced these institutions from this role.

**The EU should emphasise that as part of the UN system, the IFIs are accountable to international human rights law including the International Covenant on Economic, Social and Cultural Rights and the interpreting jurisprudence. The Relationship Agreements linking the IMF and World Bank respectively with the UN should be renegotiated, with an aim to enhance the responsibility of the BWIs to the UN, and to enhance the ability of the UN to ensure that IFIs fully respect the jurisdictions of other agencies, funds and bodies, particularly those with non-economic mandates. A permanent mechanism for solving jurisdictional disputes in a transparent way should be established.**

#### **6. A comprehensive and binding response to sovereign unsustainable debt**

Countries benefiting from multilateral and bilateral debt relief over the past years have been able to invest significantly more in development, and in the current situation have greater breathing room for their own fiscal stimulus responses. Yet, debt relief operations to date have remained restricted to a selected group of poor countries. In times where EU countries are finding it hard to fulfil their ODA commitments, making development flows more unpredictable than ever, there are strong political arguments for debt cancellation. Once committed, it is highly predictable. Writing off debts can also relieve the pressure on domestic borrowing, increasing the availability and reducing the cost of domestic credit, thereby spurring economic growth. By providing *de facto* budget support, debt cancellation can reduce the transaction costs of donors, and enhance local accountability and good governance.

So far debt relief operations have been unable to fulfil all of their potential benefits. Developing country external debt was calculated to be as high as US\$3.35 trillion in 2008. Even for countries who have successfully 'graduated' from debt relief operations, there is a real possibility of again defaulting on their debts as a result of the current crisis and recent endogenous and exogenous shocks. Many of the reasons for this go back to the ineffectiveness of the Debt Sustainability Framework (DSF) of the World Bank and the IMF. It is not applied universally by private and new official donors. It sanctions only the debtor for breaches in the debt ceiling it establishes per country although breaching a ceiling always needs a debtor and a creditor. At the same time new borrowing is in many instances the result of insufficient access to grants in the first place. Debtors are first left without alternative but to borrow and then punished for taking credits. The DSF does not address endogenous and exogenous shocks which many post-HIPC countries were hit by recently. The situation of several countries where external debt levels have apparently improved at the expense of generating new domestic debt is not considered.

**The EU should call for a new approach to comprehensively deal with the process of lending and sovereign borrowing, both in terms of quantity and quality. Responsible lending must be the cornerstone and can only be achieved by the adoption of a binding legal framework that ensures that all creditors engaging in irresponsible lending take responsibility for such**

lending, and that problems associated with irresponsible lending and borrowing are resolved on a predictable and equitable basis. Such a framework would take account of both the origin and impact of the debt and offer equal treatment to both debtors and creditors ultimately affecting the incentives not only for debtors, but also for lenders and prevent renewed indebtedness on a sustained basis. The framework could be in the form of an impartial and transparent process for resolving debt crises and disputes.

#### **7. Action on the financial crisis must be holistic and coherent with action to tackle other global crises**

The financial crisis, as dramatic as its implications may be, forms part of multiple crises the world is grappling with. The multiple crises of financial governance, climate, food and energy must provoke profound reflection on the inequity and unsustainable nature of current models of growth and the differential value placed on the various means of production and consumption.

The last 30 years have seen an unjust shift of resource investment from labour to the financial sector, contributing to an overestimation of the value of finance above all other productive resources. **The financial crisis underlines the need for a fundamentally new approach that emphasises a decent income for workers; the creation of stabilisation mechanisms for food prices which for a great part determine the income of peasants who form the majority of workers in developing countries; and mechanisms for a fairer distribution of income and wealth.**

The growth model of industrialised countries has been based so far on fossil-fuel exploitation, the main cause of climate change. The EU must acknowledge its substantial share of responsibility in creating the problem, by tackling its sources and paying for the solutions. Climate change is presenting additional challenges to developing countries striving to achieve poverty reduction in the face of an increasingly challenging trade and financial context. ODA flows to key sectors such as health and education must not be diverted because industrialised countries have created the additional burden of climate change to developing countries as a result of their own growth. So far the ambiguity of the EU's position in contributing to a post 2012 global climate change agreement has played a part in stalling the beginning of real negotiations, threatening the December 2009 deadline.

**The EU should commit to paying its fair share of the levels of financing necessary for climate action, by committing to financing mechanisms that will ensure secure, sufficient, accessible additional financing for climate action in developing countries, and by indicating concrete figures the EU will provide.**

#### **8. Conclusion**

We welcome the urgency and energy of the EU effort to address the current crisis in the context of the G20 Summit in April in London. At the same time, we underline that the G20 is but one forum of a limited number of countries, and cannot represent the global spectrum of needs and political interests concerned in designing an effective response to the impact of the current crises.

**We therefore emphasise the necessity for the EU to invest in the preparation, proceedings and follow-up of the June 2009 UN High-Level Conference on the global financial and economic crisis and its impacts on development, with the same level of energy and political investment that is going into preparations for the G20 summit.**

CIDSE policy paper references:

- *Upholding the Spirit of Monterrey: The Financing for Development agenda and its Unfinished Business*, June 2008.
- *Closing the gap: Addressing imbalances in global finance*, November 2008.

*(documents available on [www.cidse.org](http://www.cidse.org))*