

# **International Mechanisms Shaping the Environmental Impact of Transboundary Capital Flows**

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## I. Introduction

In recent years, private capital flows have increased dramatically, raising a number of questions about how central a role private capital is now or will be playing in shaping economic development in developing and transition countries. Only five years ago, official capital flows to these countries exceeded private capital flows.<sup>1</sup> Now, private flows are five times as large as public flows. Private flows exceed \$240 billion, more than six times their 1990 levels. Currently, the vast majority of these private flows to developing countries--around 80%--is accounted for by a dozen countries. Indeed, most developing countries are not being showered with a stream of private capital. The World Bank notes that 140 of 166 developing countries receive under 5% of capital flows to developing countries.<sup>2</sup>

The phenomenon of sharply rising private flows has prompted the environmental advocacy community to begin assessing the ways in which these changes affect the promotion of environmentally sustainable development in developing countries. We ultimately need a more precise understanding of the political, economic, and institutional forces driving different types of capital flows, the environmental implications of these different flows, the actors and interests that shape them, and the mechanisms through which the behavior of these actors may be influenced. The purpose of this paper is to contribute to the strategic planning process being undertaken through WRI and WWF's IFFE project by analyzing the ways in which international institutions are, or are not, contributing to the environmental character of private capital flows. It is not meant to be a comprehensive research paper; rather, its goal is to lay out some of the major issues

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World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (New York: Oxford University Press, 1997), p. 9.

Ibid., p. 12. The data for "developing" countries includes figures for countries in transition, such as in Central and Eastern Europe and the former Soviet Union.

on this topic with ideas on the importance of various mechanisms and possible "entry points" for influencing them, as a basis for further discussion.

An assessment of the role international institutions may play in influencing the environmental nature of private flows is important for three reasons. First, in recent years, international institutions such as the multilateral development banks (MDBs) have been given increasing responsibility for addressing global and regional environmental issues in their work at the same time they have faced constant criticism from NGOs for causing serious environmental degradation. Assessing the ways in which these institutions can influence private capital flows is therefore embedded in larger debates about their environmental efficacy.

Second, many scholars and advocates argue that international institutions are becoming more powerful in the governance of a world where nation state power is declining. Indeed, in the post Cold-War era, the absence of a dominant state willing to lead the new international order has turned fresh attention to international organizations and their role in promoting collective solutions to global and regional problems. However, at the same time, other groups of analysts point out the shortcomings of international institutions, particularly in the environmental realm; they focus on the lack of enforceability of treaties, the relative weakness of existing global environmental institutions, and the difficulty international institutions have in implementing environmental projects and policies. More work is needed to define more precisely areas in which international institutions really do make a difference in solving global problems and participating in global governance, and areas where other actors may do the job better.

Finally, while a traditional focus of scholars of international relations and pressure groups has been to examine the role state-created international institutions play in shaping *state* behavior,

we must broaden our thinking to ask what role international institutions may play in influencing *non*-state actors, such as businesses and institutional investors, as well as what role other international bodies may play in influencing state or non-state actors. Such work is taking place, but requires significantly more attention.

### *Principal arguments*

This study has six main arguments:

- 1) International institutions are not the key actors or factors that directly influence corporations, institutional investors, and commercial banks in their decisions to send financial resources across national borders. The range of economic, political, financial, and institutional mechanisms that shape private flows are, in turn, more closely shaped by variables such as corporate and portfolio fund strategies as well as domestic regulations in countries that are the sources of--and recipients of--capital flows.
- 2) However, while international institutions may not be the most powerful actors shaping private sector decisions, they are still extremely important, often in undramatic ways that are difficult to measure. Much of the activity being undertaken by international institutions on the private flows/environment issue is found in the role these institutions play in building and contributing to policy networks, facilitating discussion and linkages between corporate, state and environmental actors, conducting research and disseminating information. In areas where international institutions have the most direct impact on private capital flows, such as binding multilateral trade or investment treaties, they tend to be weak in addressing the environmental implications of those flows. Treaties addressing specific environmental problems, in turn, sometimes contain trade restricting measures, but still do not directly focus on private capital flows. Overall, treaties and other multilateral agreements are weak in addressing issues related to the environmental impact of private flows.
- 3) The important exceptions to conclusion (1) are the international financial institutions (IFIs); multilateral development banks (MDBs), and the IMF. Despite the shrinking size of IFI financing vis-a-vis private flows, the IFIs will remain significant actors in most parts of the developing world. Only a small number of developing countries are benefiting from the surge of private flows. Indeed, the IFIs are the key actors that work with countries on liberalizing their economies and markets, and provide a green light for investors to enter. The MDBs, in particular, are involved in all phases of the policy process, from helping countries lay the groundwork for more open markets, to attracting foreign direct investment (FDI) by leveraging investor risk through co-financing. The ways these institutions address environmental issues in their lending programs and projects will remain an important source of influencing FDI in many developing countries.

4) This study shows that international institutions are much more active in activities that may influence FDI than in any other area of private capital flows. The "responsibility vacuum" seems most evident in areas such as commercial bank lending and portfolio investment, where there is significantly less activity by international institutions that might have some impact on the ways the actors shaping these flows think about or address environmental issues.

5) There is clearly a need for closer linkages between international institutions that focus on investment issues (such as trade agreements), and those that focus on environmental issues. Many environmental institutions are doing research on the environmental impact of increased capital flows, but much less activity is occurring on the trade/investment side.

6) To influence environmental governance of private capital flows, the best possible "entry points" have to do with pressure on and dialogue with national governments, businesses, banks, and private sector NGOs and trade associations, versus international institutions. It is politically unlikely that the most powerful international institution in the trade and investment front--the WTO--will ever warmly embrace environmental goals, and it is also politically unlikely that ideas on creating a powerful new global environmental organization will bear fruit. However, there is a continuum of environmental objectives that any international institution faces. On one end is a minimal commitment, to ensure that the institution's work does no (or little) environmental harm. On the other end is a proactive role, where the institution's activities are directly shaped by its desire to promote sustainable development outcomes, and it actively addresses environmental issues in its work. For institutions that focus on trade and investment issues, environmentalists can push to ensure that the institutions *at least* fulfill a minimum commitment to environmental objectives. The environmental community can also push for greater coordination, cooperation and public/private linkages from the international institutions that work on agenda setting, policy-related research and network-building exercises on the private flows/environment issue.

### *Structure of Study*

The paper is divided into three main sections. Part One presents an overview, both of the changing composition of private capital flows, and the broad role international institutions play in shaping state and non-state behavior. Part Two examines each category of capital flow in greater depth, identifying and evaluating the roles that existing international institutions play in shaping the capital flow, and potentially shaping its environmental character. Part Three addresses the role that other international institutions, such as environmental organizations, might play in shaping the environmental character of private capital flows, as well as the political efficacy of

creating new mechanisms.

## **I. Overview:**

### **A. Growth, and Changing Composition of Capital Flows**

Private capital flows have boomed in recent years, reflecting the increased integration of developing countries into global capital and financial markets. Driving this change are liberalization of developing country markets and economies; investor interest in opportunities for asset diversification and attractive financial returns; and developments in the scope of financial instruments and technology that have drawn domestic capital and financial markets closer together in a global marketplace. Before one can assess what role international institutions play in shaping these flows, it is important briefly to identify the different types of capital flows and highlight where they are growing and where they are originating. Different capital flows are shaped by different actors and therefore may be influenced through different institutions or strategies. For example, the forces shaping an institutional investor's decision on whether or not to buy domestic stocks in an emerging market, may be based on somewhat different criteria than the forces shaping a U.S. company's decision to build a plant abroad, which would suggest different paths in which advocacy groups might seek to influence these decisions.

Private capital flows consist of portfolio flows, foreign direct investment, and commercial bank lending. Portfolio flows, in turn, include both portfolio equity investment and bond issuance. In the World Bank's debtor reporting system, a small category of "other" flows includes bank lending guaranteed by export credit agencies.

#### **Table 1: Aggregate Net Private Capital Flows to Developing Countries, 1990-96**

(billions of dollar)

	1990	1991	1992	1993	1994	1995	1996(preliminary)
Total private flows	44.4	56.9	90.6	157.1	161.3	184.2	243.8
Portfolio flows	5.5	17.3	20.9	80.9	62.0	60.6	91.8
Bonds	2.3	10.1	9.9	35.9	29.3	28.5	46.1
Equity	3.2	7.2	11.0	45.0	32.7	32.1	45.7
FDI	24.5	33.5	43.6	67.2	83.7	95.5	109.5
Commercial Banks	3.0	2.8	12.5	-0.3	11.0	26.5	34.2
Other	11.3	3.3	13.5	9.2	4.6	1.7	8.3
Aggregate net resource flows	100.6	122.5	146.0	212.0	207.0	237.2	284.6
Private flows' share (%)	44.1	46.4	62.1	74.1	77.9	77.7	85.7

Source: World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (New York: Oxford University Press, 1997), p. 5.

As Table 1 shows, all major categories of private flows have experienced rapid growth since 1990. FDI remains the biggest component of capital flows, while portfolio flows have shown the sharpest increase. Bank lending and export-credit guaranteed lending are now relatively less important than other categories of capital flows.

However, the aggregate data do not tell the whole story. First of all, twelve countries received the lion's share of these capital flows, and have done so since 1990.<sup>3</sup> The majority of developing countries continue to rely on official sources of capital, and most are likely to do so for the foreseeable future, although in the past several years private capital has begun to flow to a wider range of middle-income countries. Second, the breakdown of capital flows differs from region to region. In the case of FDI, for example, over 50% went to Asia in 1996, and within that region, the bulk of these investments were destined for China. The region receiving the second largest share of FDI was Latin America, which attracted 24% of last year's total. Sub-Saharan Africa, by contrast, received only 2.6% of FDI, while the Middle East received just 2.2%.<sup>4</sup> The \$5 billion increase in net private flows to Central and Eastern Europe largely reflected

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These are: China, Mexico, Brazil, Malaysia, Indonesia, Thailand, Argentina, India, Russia, Turkey, Chile and Hungary.

World Bank, *Private Capital Flows to Developing Countries*, pp. 3, 28, 29.

portfolio investments in Polish, Czech and Russian stock markets, while an increase of \$8 billion in the Middle East mainly reflected an increase in commercial bank lending to a handful of countries, in addition to some FDI.

These examples illustrate how different regions are benefiting to different degrees from different types of capital flows. The numbers can clearly be broken down even further to highlight data for individual countries, including which sectors are attracting FDI. Such an exercise may reveal important information, such as cases where the amount of FDI may seem small, but in fact it is focused on resource extraction or other activities that have enormous environmental implications. There is also data that details the origin of these flows.<sup>5</sup>

While it is beyond the scope of this study to present a more detailed analysis of the sources, destination and composition of private flows, attention to these details is ultimately of key importance in determining what role international institutions may play in which issues. As we will see in Part II in greater detail, international institutions appear to have more leverage in influencing FDI, but much less in other areas, such as influencing decisions made by institutional investors and portfolio managers. National regulations will be the most important factor influencing the regulatory development of emerging markets, while public pressure may be the major factor pushing Western institutional investors toward a more environmentally conscious stance.

In charting directions for future advocacy, the IFFE Project will also have to determine to what extent strategies should focus on the local, regional, and global environmental issues. For a more

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This is discussed, for example, in John Cavanagh and Sarah Anderson, "International Financial Flows: The New Trends of the 1990s and Projections for the Future," (Washington DC: Institute for Policy Studies, 1997).

local and regional focus, for example, it is important to know *how* the private flows affect each recipient's environmental priorities or major environmental problems. For example, if a lack of clean water or urban sanitation are priorities in a country that is receiving FDI largely for transport or energy infrastructure projects, then influencing private capital flows to that country may be a relatively less direct way to address the problem than other strategies. If one wants to examine the environmental problems of a particular region of the world as well, then some categories of capital flows will be more relevant as a focus for analysis than others.

## **B. The Role of International Institutions**

What role do international institutions play in shaping private flows? An answer must begin with a definition of what international institutions are. Social scientists and international lawyers define "international institutions" in a number of different ways. Whereas international lawyers tend to focus on international institutions as formal organizations, political scientists argue that institutions include both formal organizations as well as rules. This paper draws from the definition of political scientists Haas, Levy and Keohane, who define international institutions as "persistent and connected sets of rules and practices that prescribe behavior roles, constrain activity and shape expectations."<sup>6</sup> Thus, international institutions include formal organizations, but they can also take the form of international treaties and regimes that may not be attached to formal organizations, as well as more informal practices such as conventions, guidelines, or codes of conduct, or other non-binding international agreements or standards.

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Robert O. Keohane, Peter M. Haas, and Marc A. Levy, "The Effectiveness of International Environmental Institutions," in *Institutions for the Earth: Sources of Effective International Environmental Protection*, ed. Peter M. Haas, Robert O. Keohane, and Marc A. Levy (Cambridge, MA: MIT Press, 1993), 4-5.

In defining international institutions, both international lawyers and political scientists agree on one thing; that international institutions are created by *states* as a means to encourage cooperation and collective action, largely among themselves. International bodies not created by states are generally lumped together under the category of "non-government organizations," or NGOs, whether they be environmental organizations, business organizations, scientific organizations or other examples. Yet the growing role of private capital in the international economy as well as the existence of international policy communities that include government and non-government actors in debates of policy design on specific issues, sometimes blurs the boundaries between international state-created institutions and international NGOs.<sup>7</sup> Therefore, while this paper defines "international institutions" as state-created institutions, it also addresses the role that other international bodies, such as business NGOs that set international standards, may play in shaping the environmental behavior of private capital flows.

There are many different types of international institutions, ranging from MDBs with billions of dollars in resources, to rules codified in conventions. Some have been set up with multiple purposes, such as the United Nations, while others have more narrow agendas, such as the International Whaling Commission. Some have vast amounts of financial resources attached to them, and can wield great influence through the use of conditionality, such as MDBs, while others do not and can not. They differ in their central goals, their degree of autonomy, the resources they control, and their importance in global governance. In general, international institutions reduce the ability of states to act solely on the basis of their self-interests, and

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On the redistribution of power from states to markets and civil society, see Jessica T. Mathews, "Power Shift," *Foreign Affairs* 76, no. 1 (January/February 1997): 50-66.

encourage cooperation.

International institutions perform a variety of functions. They:

- Provide fora for states to meet on a regular basis and cooperate through negotiations, the production of agreements, and shared information and policy decisions
- Pool financial and technological resources
- Sponsor and are involved in agenda setting exercises to encourage policy change and reform, which can involve developing soft law, promoting types of policy processes, undertaking research, collecting and disseminating information
- Facilitate development of, and are actors in, policy networks linking governments, international organizations, NGOs and other private sector actors on specific issues;
- Arbitrate disputes
- Coordinate donor assistance
- Finance, or sponsor projects or programs

Institutions can take various forms, and can fit one or more of the categories on this list. Several types of international institutions may be involved in influencing state or even private sector behavior in the flow of private capital, and how "green" that flow is. These include:

- IFIs, and the ways in which they integrate environmental objectives into their activities
- multilateral treaties and agreements that have an impact on private flows, and the extent to which they integrate environmental considerations into their rules and dialogue
- global environmental institutions and treaties, and the ways in which their goals are addressed by international financial regimes and markets, as well as signatories' governments
- other international institutions that are involved in agenda-setting, policy development, soft-law development, information gathering and dissemination, and network building (such as the OECD and UNCTAD)

The activities international institutions undertake are likely to become more important over the next few decades, as the globalization of markets and trade and other structural changes in the international system result in a diffusion of power and a more complex system of global governance. Indeed, the globalization of markets and economies in recent years has revived debates within academic and policy circles about the future of the nation state. Some observers predict an inevitable and relative decline of state power, as nonstate actors in particular gain power through instantaneous access to information resulting from new technologies.

"Information technologies," wrote Jessica Mathews, "disrupt hierarchies, spreading power among more people and groups....Businesses, citizens organizations, ethnic groups, and crime cartels have all readily adopted the network model. Governments, on the other hand, are quintessential hierarchies, wedded to an organizational form incompatible with all that the new technologies make possible."<sup>8</sup>

Others argue that the nation state is quite resilient and will have no difficulty in surviving the information revolution and globalization of the economy.<sup>9</sup> A third view, related to the second, posits that the "state is not disappearing, it is disaggregating into its separate, functionally distinct parts" which then network with their counterparts in other countries.<sup>10</sup> This form of "transgovernmentalism" is producing new linkages among regulatory agencies, courts, and legislators. Both the second and third view directly challenge the first. A final view focuses more

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Mathews, p. 52.

Peter F. Drucker, "The Global Economy and the Nation State," *Foreign Affairs* 76, no. 5 (September/October 1997): 159-171.

Anne-Marie Slaughter, "The Real New World Order," *Foreign Affairs* 75, no. 5 (September/October 1997): 183-197.

on the increased importance of "policy communities" or "policy subsystems," which consist of government and non-government actors interacting and shaping policy on specific issues.<sup>11</sup>

Implicit in this view is the idea that the composition of relevant actors may differ depending on the characteristics of the specific issue area.

The strength of this final perspective is that it is able to more easily account for the fact that the state is a more powerful actor in some policy areas than others. In terms of private capital flows, for example, we have seen through the recent crisis in East Asian financial markets that domestic financial systems and regulations are sometimes no match against huge tides of shifting capital. Where states are less able to control policy on their own, they are increasingly seeking to cooperate with non-state actors.<sup>12</sup>

One result of the shifting of state power will be a continued reliance on international institutions to play an important role in global governance. In areas where states do remain central actors, international institutions remain important fora for discussion, interaction and cooperation, as well as the instrument of cooperation itself, such as in the form of a treaty. In areas where state power has been declining, such as in the control over domestic monetary policy, international bodies and institutions are likely to gain a more powerful role as sources of ideas and as brokers between states and other policy actors on the development and enforcement of new sets of international rules and standards. Depending on the policy issue, international institutions may play more or

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See, for example, Jack Hayward, "The Policy Community Approach to Industrial Policy," in Dankwart A. Rustow and Kenneth Paul Erickson, eds., *Comparative Political Dynamics: Global Research Perspectives* (New York: HarperCollins). Also, Paul A. Sabatier, "An advocacy Coalition Framework of Policy Change and the Role of Policy-Oriented Learning Therein," *Policy Sciences* 21 (1988).

In the example of the South Korean banking crisis, leading advanced industrial countries have asked their banks to defer payment on Korean loans.

less prominent roles in organizing, contributing to, or leading the policy networks that take shape.

One thing that is certain is that political power is more diffuse and that new mechanisms are developing that link actors together. In terms of the role that international institutions may play in affecting the environmental character of private capital flows, there is clearly room for these organizations to increase their position as brokers between public and private sector actors, and as sources of information, of policy ideas, and discussion.

## **II. Analysis of Existing Mechanisms**

This section examines each type of capital flow in greater depth. However, it first begins by looking at institutions that are cross-cutting; that is, they have a significant impact on *all* types of capital flows. These are the IFIs: the MDBs and the IMF. It then turns to the three categories of capital flows---FDI, portfolio investment and commercial bank lending. For each type of capital flow, I define the major forces that shape it and evaluate the relative importance of international institutions in influencing it. I then focus on some of the more important institutions that may play a role in each area, evaluate their activities, and propose recommendations for influencing them or improving their work. The assumption here is that examining the factors that influence each type of private capital flow best shows what role international institutions do or may play in shaping the environmental behavior of these flows. Many international institutions address environmental issues in their work, but a laundry list of these institutions and their activities will not get at the central question posed by this project: how do they impact private capital flows?

### **A. Cross-Cutting: The IFIs**

Analyses of the growth of private capital flows are quick to point out the concurrent stagnation of multilateral flows. Some analysts then jump to the conclusion that this phenomenon reduces the "significance" of IFI finance.<sup>13</sup> The IFIs themselves, particularly the MDBs, are trying to work more efficiently, as a way both to compete and work better with the private sector. However, given the small number of countries reaping the benefits of increased private capital flows, it is likely that the IFIs will remain very significant actors in influencing developing country economic reform and development for the foreseeable future.

The IFIs are the key international actors in promoting the liberalization, deregulation, and privatization of developing country economies and markets. They have promoted structural reform programs aimed at opening up developing country economies, and their seal of approval is necessary to open the door to greater private sector involvement. The MDBs also catalyze investment, even in countries enjoying the most attention from private capital flows, by co-financing investments for joint ventures, infrastructure development, and so on, and play an important role in reducing the risk for private investors. As a result, the IFIs are central actors in setting the framework for the growth in private flows, and their actions directly affect the degree to which FDI, portfolio investment and bank lending is attracted to individual countries.

#### The MDBs

The MDBs are the most important category of international institutions in terms of their potential to shape the environmental character of capital flows. MDBs, to different degrees, have faced pressure from shareholders to better address environmental issues in their work, and most

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See, for example, Cavanagh and Anderson, "International Financial Flows: The New Trends of the 1990s and Projections for the Future," p. 1.

have struggled to pursue those aims, although not terribly successfully. MDBs shape capital flows from the beginning to the end of the policy process; that is, from their work as key advisors in developing country market liberalization efforts, to their work with foreign investors who co-finance MDB projects. They thus play an important role in helping to shape the conditions for investment, and in requiring co-financers to follow their environmental procedures and standards.

The next section discusses the ways in which MDBs address environmental issues in their work, and the ways in which they can shape the environmental character of private flows. It then evaluates the MDB activity in both areas, and recommends several possible entry points to influence these institutions. It focuses on the World Bank, as the biggest, most powerful MDB, but suggests relevant issues regarding other MDBs as well.

#### The World Bank How environmental issues are addressed

Much has been written on the environmental behavior of the World Bank, and the general descriptions and arguments need not be repeated here in much detail. Environmentalists are well aware of the problems the Bank has faced in developing--and more importantly, in implementing--its environmental procedures and policies, and have devised sophisticated campaigns to influence the Bank to change course. Ultimately, the basic environmental strategy of the Bank, as well as of other MDBs, is twofold: to address and mitigate potentially adverse environmental impacts in their projects and programs; and to fund projects with major environmental components. Unlike other MDBs, the World Bank also helps borrowing countries create or revise environmental policies through assistance in policy exercises such as National Environmental Action Plans (NEAPs), which seek to prioritize a country's environmental problems and proposes policy

solutions for them.

Over the past decade, in part due to NGO pressure backed by major World Bank shareholders, the World Bank has undertaken significant changes in the ways it addresses environmental issues in its work. Some of these changes are organizational--a large increase in "environmental" staff, and the establishment of new departments and divisions to work as "environmental watchdogs" over the Bank's projects, as well as to develop environmental policy research and action plans for recipient countries. Other changes are procedural--the development of (and revision of) environmental impact assessment procedures and the development of policy guidelines for the Bank's work in areas such as pesticide management, wildlands management, collaboration with NGOs, environmental action plans, indigenous peoples, involuntary resettlement, and dam projects.

As a result, out of all the MDBs, the World Bank now has the most sophisticated set of environmental procedures and operational guidelines, and it has undertaken the most significant number of environmental stand-alone projects. More than any other MDB, the World Bank has an intellectual life, with a vast research arm (whose budget is now around \$25 million a year) that has focused much attention on a broad set of environmental issues. It has also become a leading institution in global environmental issues; it is the main implementing agency for the GEF, which in turn has become the interim funding mechanism for the global climate change and biodiversity conventions. The Bank also manages the Montreal Protocol's Multilateral Fund.

Yet, while taking on these new policies and responsibilities, the Bank has also faced extensive criticism from environmental NGOs, as well as from internal critics, for failing to carry out its policies. Indeed, there has been widespread criticism of the Bank's ability to implement its

policies on almost all fronts--from continuing to fund environmentally destructive projects, to doing a poor job in undertaking its environmental impact assessment procedures or other operational policies on issues from resettlement to dam construction. Most recently, the Bank's own Quality Assurance Group (QAG) accused the Bank of "institutional amnesia" for ignoring the lessons of past projects. In a review of the Bank's portfolio, the QAG wrote, "The lessons from past experience are well known yet they are generally ignored in the design of new operations."<sup>14</sup>

Given the degree of work done on the World Bank by WWF, WRI and other groups, I will focus my remaining comments on the organizational and policy changes underway at the Bank, and their impact on the Bank's environmental behavior in general, and with respect to its influence on private capital flows.

#### Recent Changes at the WB: Impact on Environmental Behavior and Influence on Capital Flows

James Wolfensohn, who took over the presidency of the World Bank in 1995, has launched an extensive organizational restructuring of the Bank, dubbed "The Strategic Compact," in an effort to make the Bank leaner and more efficient. The reorganization is an attempt to correct the widespread perception of the institution as bureaucratically overweight and inefficient, as well as be able to better compete with the increase in private investment to developing countries.

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World Bank, "Portfolio Improvement Program: Draft Review of Sector Portfolio and Lending Instruments: A Synthesis," April 23, 1997, p. 15.

Wolfensohn's goal is to make the Bank more flexible and client-oriented, and less bureaucratic.

Among the three most important changes to come out of this reorganization are the restructuring of the operational divisions that actually undertake the Bank's lending, the new emphasis on client orientation, and the move to put country staff in the field. In terms of restructuring operational departments, the major effect of the changes is to create streamlined country departments who staff individual projects by choosing consultants from the pool of Bank staff, or from the outside. In the old Bank, country departments could contain over 100 people, and had their own experts in a variety of areas, from environment to infrastructure. They were also supported by regional technical divisions, which also contained environmental staff. Under the new Bank, the country directors have tiny staff--a handful of people. The rest of the people from the old country and technical departments are grouped into sector groups. For each project undertaken in a country, the country director will dip into the sector group, or look outside the Bank, for the expertise sought. In other organizational changes, the Bank's Central Environment Department has shrunk in size, and is expected to narrow its focus to primarily global issues.

Client-orientation is another of Wolfensohn's goals, as a means to better customize country assistance strategies, and to build local ownership of the Bank's projects and programs. This will be complimented by the movement of more Bank staff to field offices, clearly with the view that a closer relationship with recipient country actors will make the Bank's work more effective.

Part of Wolfensohn's broader goals for the Bank Group is also to strengthen the role played by the International Finance Corporation (IFC, the Bank's private-sector lending arm), and the Multilateral Investment Guarantee Agency (MIGA, which insures private sector investors against political risks in developing countries). The idea is for an increasing amount of World Bank

capital to be used for guaranteeing private sector investment, versus direct projects or programs.

#### Impact of changes on Bank's environmental behavior

Several positive outcomes may result from the organizational changes, such as a more efficient use of Bank resources, better dialogue with recipient countries, and a speedier project cycle. Yet, the changes taking place in the Bank may also have some potentially negative outcomes with respect to the Bank's environmental behavior. Perhaps most importantly, the new emphasis on client responsiveness may greatly reduce the Bank's ability to push for environmental projects, or to build environmental considerations into other projects. Environmental pressure from the Bank is likely to be reduced in countries where environmental issues are not a policy priority. As one Task Manager at the World Bank stated, when project team leaders meet their counterparts in a country's ministry of finance to discuss the Bank's work, "It will be the uninterested talking to the uninformed." "Client orientation could break the Bank," said a senior Bank official. Some staff worry that environmental projects could be reduced by as much as 50% under the new structure.

The ability of project leaders to choose staff either from their own sectoral groups or from outside the Bank may have positive or negative effects on the Bank's overall environmental behavior. For example, this flexibility can be used to allow project leaders to bring in the best talent they can find for a project. However, it can also encourage project leaders to look for more environmentally lax assistance. In addition, bank staff now in the new sector groups have more incentives not to cooperate with one another, since people will be competing more than in the past to be hired for projects. Whether or not this encourages environmental staff to be more lenient in their assessments of projects (so they will be hired to work on them) remains to be seen.

The growing role of the IFC and MIGA in guaranteeing private loans versus direct lending may

also have an impact on the Bank's environmental behavior. On the one hand, if their activities are prompting the private actors they work with to better address environmental issues in the projects that are funded (in important areas such as infrastructure and manufacturing), they can be important catalysts for encouraging foreign investors to improve their performance on the environmental front. Yet, on the other hand, many environmentalists have criticized the IFC and MIGA for doing a poorer job in building environmental features into their work, than the IBRD. NGOs are well aware of these issues and have ongoing activities designed to seek to influence them.

Ultimately, the Bank can have a positive or negative impact on the environmental character of private capital flows, depending on its ability to follow its own environmental policies and procedures and implement them in its work in liberalizing markets, and in its co-financing activities. Recently, the Bank has been active in some innovative areas that seek to build public/private sector links on issues where environment and investment intersect. First, the Bank has been active in developing voluntary standards for use by developing country government and businesses. The latest is a handbook on pollution prevention and abatement, which acts as both a guideline for Bank-financed projects, and as a resource for companies and policymakers. This may be an important area for the Bank to pursue; a means for it to use its expertise to offer policy suggestions relevant to private sector actors. Second, there are a few examples where the Bank has initiated multi-stakeholder negotiations between governments and private sector actors to come up with agreements on the development of government policy on environmental issues. Finally, the Bank has also organized initiatives to encourage foreign investors to use their own trainers to stay in-country and train managers of domestic companies in environmental

performance and production issues. Since domestic regulations have a powerful role to play in shaping the behavior of private capital flows, the Bank should continue to pursue its comparative advantage in working with developing country governments in giving companies the right incentives to address the environmental impact of their work.

### *Evaluation/Recommendations*

- The surge in private capital flows will not reduce the influence of the World Bank in most developing countries. Because some of the organizational changes taking place at the Bank may have an adverse impact on the Bank's environmental actions, NGOs should continue their work with the U.S. ED office and Bank to try and avert potential negative outcomes of the restructuring.
- The weighting between project preparation and implementation in the Bank is imbalanced, with project implementation the major weak point in the Bank's project cycle. Bank staff have found numerous examples where recommendations made by peer reviewers early in the project cycle have been ignored by Task Managers. Environmental impact assessments have also been ignored, as have lessons learned through past experience. While there is much greater emphasis on environmental issues in project preparation, these often fall by the wayside in project implementation. Therefore, environmental groups should emphasize, in their work on the Bank, the promotion of more effective implementation of the Bank's basic activities. This is more important than efforts by some NGOs to continue to push for the Bank to take on additional, new mandates. Mandate congestion and problems caused by multiple conditionality are increasingly recognized as core issues that have a negative impact on implementation.
- NGOs are likely to get most mileage out of activities that push the Bank in directions that it already has a comparative advantage in, versus in seeking for it to take on additional new mandates. An example of the former would be in encouraging the Bank to pursue its work in standard setting, in initiating multi-stakeholder negotiations on the environment, in working more closely with government and private sector actors on environmental issues, and in working harder to *implement* its national environmental action plans.

### Other MDBs

Much less NGO attention has been focused on the regional MDBs, who generally have far less developed policies and procedures than the World Bank. While they undertake relatively fewer

stand-alone environmental projects, they also have not faced the type of scrutiny that follows the World Bank. In general, the regional MDBs are also significantly less innovative than the World Bank in revising their policies and goals.

Perhaps the best example of this is the European Investment Bank (EIB). Environmental groups tend to ignore this bank because it is Europe's long-term lending institution, and is thus not seen as terribly relevant to developing countries. Also, the U.S. is not on the EIB's board, which dissuades powerful U.S. NGOs from seeking to influence it. Indeed, many articles and books on regional development banks don't even mention the EIB. Yet, the EIB now lends more than the World Bank each year, and although around 90% of its lending goes to Europe, it is also a global actor, operating in Africa, Asia, Latin America, the Middle East and Central and Eastern Europe. The Bank will also be an increasingly important actor in the latter region, particularly for countries seeking to accede to the European Union.

The EIB has never faced strong pressure to change the ways it takes environmental issues into account. It has a very modest environmental policy, which reflects its commitment to follow EU environmental policies, but does not say *how* it will translate Community goals into its own internal rules. With no separate environmental assessment unit, and an environmental staff of one, the Bank has not spent much time addressing environmental issues in its work. Since it is largely a demand-driven institution--that is, it funds projects presented to it by private or public sector actors--it clearly can have an impact on FDI inside and outside of Europe, and deserves more attention from environmental groups.

*Evaluation /Recommendations*

- NGOs should pay much closer attention to the activities of MDBs other than the World Bank. In focusing on regional MDBs, NGOs face a greater struggle to influence the ones that are more demand-driven, such as the EIB and EBRD. These types of MDBs depend, to a greater extent than the World Bank, on prospective borrowers coming to them with loan ideas, which gives the MDBs less flexibility to push for certain types of projects. They also tend to be relatively less interested in policy development, and prefer to be as "bank-like" as possible.
- NGOs are most successful in encouraging MDBs to more seriously address environmental issues in their work when the bank faces pressure from major shareholder countries. While environmental policy goals can initially be generated by bank actors, these tend to languish when not backed by external pressure or support. Where major shareholder pressure for change has occurred, it has been prompted by pressing problems or "focusing events" that capture their attention. For the World Bank, this took place through NGO publicity over several Bank environmental disasters. For the EBRD, donor awareness of enormous environmental degradation in former Communist states put environmental issues high on the agenda of those setting up the new MDB. Advocacy groups can get the most leverage in pushing for change in MDBs where they have publicized negative environmental effects of existing projects. This has never been done, for example, with banks like the EIB. NGOs should take full advantage of particular events that can focus attention on environmental issues (such as publicizing environmentally disastrous projects), as well as expand their links with other major ED offices.

#### IMF:

The IMF's central goals are to promote the balanced growth of international trade and to deepen international monetary cooperation. It does so by assisting countries with balance of payments problems through loans that are made conditional on macroeconomic policy reforms. Its activities include stand-by arrangements to help with short-term balance of payments deficits; extended facilities for more medium-term programs; as well as an "enhanced" structural adjustment facility, which provides loans (vs. currency purchases) for policy reform. As a result of the 1994 Mexican peso crisis, the IMF now also has the ability to grant emergency loans, quickly, aided by support from the G-10 countries. The IMF also provides technical assistance to assist countries in the design and implementation of their fiscal and monetary policies, and it performs an important role in economic surveillance, through its analysis of member countries'

economic, monetary and exchange rate policies.

Overall, the Fund's emphasis has been on financing and correcting balance of payments deficits. Given the World Bank's entry into structural adjustment lending in the early 1980s, the IMF role was clarified so that its emphasis would be on short-term assistance, while the World Bank would focus more on longer-term goals, such as institutional and policy reform.

#### How environmental issues are addressed

In contrast with the high degree of environmental scrutiny facing the World Bank, and the significant environmental reform that has taken place there in the last decade, the IMF seems to have remained out of the environmental spotlight, and as a result, has done very little to address environmental activities in its work. Indeed, while NGOs do lobby the IMF to be more sensitive to environmental issues, this campaign has not ignited the same kind of broad response (in the media and in Congress, for example) as NGO campaigns against the World Bank have. Efforts by the U.S. Treasury to push for environmental reform at the IMF have not borne significant fruit. The main reason why the IMF has not become significantly greener over the years is that it argues its focus is on macroeconomic issues and criteria, and it feels as a result that most environmental issues are out of its realm and are best handled by others, such as the World Bank. In its 1994 Annual Report, the Fund posits that macroeconomic stabilization programs often encourage environmental improvement, where they result in price adjustments and reduce inflation. "To the extent that the Fund promotes economic stability, it thereby helps the environment," the Fund noted.<sup>15</sup> It did add that environmentally sustainable development does not depend on stability alone, and that appropriate environmental policies are necessary.

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IMF. Annual Report. (Washington DC: IMF, 1994), p. 33.

Given the IMF's more short-term focus and narrow mandate, it is more difficult for it to address environmental issues in its structural adjustment activities than the World Bank. The Bank can sequence critical policy reforms, such as subsidy removal, or trade liberalization, and it has a longer time frame in which to undertake its work. Indeed the Bank has taken steps to integrate environmental concerns into its SALs. At the same time, the jury is still out on whether structural adjustment results in greater or less environmental degradation, and the Fund is wrong in assuming that its activities are largely positive. Structural adjustment measures at both the Bank and Fund can remove energy, water, or raw materials subsidies, which lowers demand for the commodity, and as a result pollution emissions. Yet trade liberalization, by contrast, can result in increased exports of natural resources. Budget cutting exercises undertaken by structural adjustment exercises can also reduce environmental spending.<sup>16</sup> The World Bank's own work on SALs and the environment has concluded that SALs produce positive environmental benefits where environmental policies are already in place. Otherwise, the results were mixed. Currency devaluations, for example, generally raise farmgate prices, but the impact on the environment depended on which crops were encouraged as a result.<sup>17</sup>

Nonetheless, the Fund has taken some minor steps toward better addressing environmental issues in its work. Staff will seek to integrate the economic implications of national environmental plans into policy discussions with countries, but "when the national authorities so

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On SAL and the environment, see David Reed, ed., *Structural Adjustment and the Environment* (Boulder: Westview Press, 1992).

David W. Pearce and Jeremy J. Warford, *World Without End: Economics, Environment and Sustainable Development* (New York: Oxford University Press, 1993).

wish."<sup>18</sup> Fund staff also undertake research on linkages between economic and environmental issues. They are also involved in analytical work related to the development of environmentally-oriented national accounts being undertaken by the UN, and they monitor the macroeconomic policy commitments made by countries signing Agenda 21. Fund staff have also point out instances where lending has been affected by environmental concerns, particularly in areas where environmental actions have clear fiscal impacts, although it is not clear how widespread such action is. For example, the Fund suspended disbursement on a \$120 million loan to Cambodia amid concerns about the country's management of its forestry sector. IMF officials said it was unclear to what extent stumpage fees were ending up in the budget versus officials' pockets. IMF officials have also raised similar questions in Papua New Guinea.

### *Evaluation/Recommendations*

- Environmental groups are involved in pushing the IMF to become more transparent and "greener." They have had some support from the U.S. Treasury, and the ED office at the IMF. Politically, it will be difficult to expect far-reaching changes in the IMF, mainly due to opposition from developing countries and scant support from other developed country Executive Director offices. Still, incremental changes are occurring within the IMF and a continuing NGO campaign can push for further gains. One area of movement may be in getting the IMF to adopt green accounting methods in its macroeconomic statistical measurements. Clearly, more work needs to be done to encourage IMF economists to increase their awareness of the ways in which macroeconomic policy can affect the environment and vis-a-versa. While the IMF may not undergo fundamental changes anytime soon, its staff could be more sensitive to addressing the environmental implications of its macroeconomic work.

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Ibid.

- In terms of points of leverage, NGOs have, as mentioned, built reasonable relationships with US Treasury and the US ED office. A wise strategy would be to increase contacts with other ED offices. Policy changes still emanate from the board, and a vocal U.S. ED office will be much more effective in leveraging its policy ideas if it gains greater support from others. NGOs should also push for some type of environmental appraisal unit within the IMF, that could bring environmental considerations into negotiations between countries and the Fund. Changes in IMF rules or policies or procedures are more likely to be meaningful if there are people *inside* the IMF attuned to environmental issues, who have the ability to advise on the content of the institution's various facilities.
- Finally, as noted in the above section on MDBs, pressure for change at the IMF must ultimately come from its shareholders, and shareholders are more likely to be pushed toward change if there is publicity on negative environmental impacts of IMF programs. This has been pursued by NGOs, in publicizing the negative consequences of structural adjustment programs, and should be continued.

## **B. Mechanisms Shaping FDI**

### Forces Shaping FDI

Corporate business strategies are determined, above all, by financial considerations.

Investors looking at FDI seek stable investment environments and high expected rates of return.

The main criteria they generally consider in making investments abroad are their own corporate strategies; economic risks, or the degree of uncertainty over a country's economic outlook; business risks, such as commercial and competitive risks; and political risks, or the stability of a regime and the likelihood rules or policies affecting investment will change. Environmental risks, such as liability issues, can be important in the decisions of some companies who invest abroad, mainly for companies in highly polluting industries (such as mining, pulp and paper, petroleum refining, etc.).

Corporate environmental strategies, in turn, are generally driven by one or more of three forces: first, some companies address environmental issues in their work by making sure they are operating legally, so their liability is limited. This usually results in end-of-pipe types of

investments. Second, companies may address environmental issues in areas that help them operate more efficiently, for example by minimizing resource consumption, pollution and waste. This is what the World Business Council for Sustainable Development touts as "eco-efficiency."<sup>19</sup> Third, the strategy of some companies is to analyze the long term environmental trends that affect their markets, and address them in their strategic planning.

Given the basic incentives driving corporate behavior, enforceable domestic regulations clearly play a major role in pushing less enlightened corporations to take environmental action. Domestic public opinion and political pressure also provides strong incentives in some developed countries for corporations to "green" their behavior and strategies.

Because the basic forces that shape corporate behavior are corporate policies and domestic regulations, the most direct way to influence the environmental nature of FDI would be through channels that may encourage change in these policies and regulations.

#### Relevant International Institutions and their Environmental Actions

What role do international institutions play in their activity in these channels? There are four ways in which international institutions are involved in shaping private capital flows. The first, discussed in the previous section, is when international institutions, such as the MDBs, help to lay the regulatory and policy framework for FDI, and when they require co-financers to follow their environmental procedures and standards. The second path is through legally binding rules that affect FDI, such as those found in a variety of multilateral treaties and agreements. Third, and less direct, international institutions seek to influence FDI through non-binding standards and guidelines, which are clearly significantly less powerful than the binding agreements; and fourth;

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Stephan Schmidheiny and Frederico Zorraquin, *Financing Change: The Financial Community, Eco-efficiency, and Sustainable Development* (Cambridge, MA: The MIT Press, 1996), p. 17.

many international institutions are also involved in research and information dissemination that encourages a flow of ideas on areas where investment and environment intersect, and may also help shape the policy communities that pursue policy development in these issues. Finally, in addition to the activities of international institutions, trade associations and business NGOs are playing an important role in devising international standards that shape investors' environmental behavior. This is also an important area for further research and links with environmental communities. This section discusses the role of multilateral agreements and the growing role of business NGOs in addressing investment/environment issues. The actions of international institutions encouraging research, information dissemination and network building is discussed below in Part III.

### Multilateral Treaties

#### *Trade Treaties*

Treaties encouraging trade liberalization clearly shape private capital flows. They help make markets more open to investment, they affect the business decisions companies make in deciding where to invest, and they are increasingly influencing domestic regulations and standards that impact on investment choices and corporate behavior. Indeed, in the international arena the issues of domestic regulations and standards have become deeply enmeshed in trade agreements, since trade liberalization can both force countries to raise lower standards, or to lower higher ones. There is a growing body of literature examining how and when regulatory competition leads to a race to the bottom, or promotes higher environmental standards.<sup>20</sup> According to one scholar, David Vogel, the degree to which trade liberalization pushes regulations up or down depends on

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Ibid.

the interests of the more powerful states, and the extent to which they are economically integrated with each other and their other trading partners.<sup>21</sup>

There are also a number of other ways in which trade impacts the environment. These include its encouragement of export growth, which in many developing countries tends to emphasize the export of natural resources; its affect on domestic environmental standards, which can be seen as protectionist; its affect on increasing transport of goods across long distances, which means more energy consumption; its affect on increasing consumption of goods from nonrenewable resources, which can increase the use of polluting manufacturing processes, as well as numerous other impacts. There are, of course, positive benefits of trade on the environment, including the more widespread distribution of environmentally sound technologies, and even a strengthening of environmental protection.<sup>22</sup> By allowing countries to pursue production of goods and services in which they have a comparative advantage, trade promotes efficiency in production, which can have positive environmental benefits. Yet, despite these "win-win" areas, free traders and environmentalists tend to clash on a number of issues, particularly in areas where trade agreements find domestic regulations protectionist, such as in the famous GATT tuna/dolphin case; and where global environmental accords use trade restrictions to secure compliance (discussed below).

While an in-depth analysis of trade and environment debate is beyond the scope of this study, it is clear that global and regional trade accords, in specifying how countries should conduct their

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David Vogel, *Trading Up: Consumer and Environmental Protection in a Global Economy* (Cambridge, MA: Harvard University Press, 1995).

Vogel notes that this is more likely to occur when powerful nations agreeing to reduced trade barriers has strong, "green" constituencies that push for higher regulatory standards. See Vogel, p. 8.

trade relations, are major forces in determining the character of private sector capital flows, and thus important arenas for addressing the environmental character and impact of those flows. To date, however, environmentalists have made only marginal inroads in penetrating trade fora for two reasons. First, their goals often differ from those of trade and finance officials who negotiate and participate in these fora. Second, many environmental concerns of NGOs and developed countries get recast in terms of classic North-South struggles in these fora. Quite often, developing countries are concerned that higher environmental standards and regulations can reduce their access to developed markets.

The **WTO** is the leading international institutional actor in the promotion of a more effective global trading system. Its mandate is broader than the GATT, which it succeeded, and it has stronger powers through its dispute settlement panel. Trade ministers setting up the WTO in 1994, established a Committee on Trade and Environment (CTE), which began its work in 1995 in identifying the relationship between trade and the environment, and recommending to the WTO whether changes need to be made in the multilateral trade system to better promote sustainable development. However, the committee's work thus far has been disappointing. The report the Committee produced for the December 1996 Singapore ministerial meeting, for example, did not contain any specific recommendations for WTO action. A parallel track on the environment, consisting of information meetings between environmental groups (including WRI and WWF, as well as the C.S. Mott Foundation) met a handful of times over the past year and a half, but did not produce the types of substantive results hoped for by the latter.

### *Evaluation/Recommendations*

The WTO is unlikely to be a leading actor on trade/environment issues. Finance and trade officials involved with its work simply do not see environmental issues as a priority, and there is not sufficient public pressure to change that view. Many developing countries, in particular, worry that any push toward international environmental standards will hurt their ability to gain market access. At the same time, however, because the WTO is the lead international institution on trade issues, NGOs must still seek to work with it, and the CTE should be an important fora for discussion of trade/environment. At minimum, the WTO should be able to clarify its stance on the relationship between trade rules and MEAs. There should also be more transparency of the CTE's work, and possibilities for NGO participation, at least in policy discussions (versus policy-making sessions).

Increasing the WTO's environmental sensitivity is no easy task. Unlike some other trade treaties, such as NAFTA, there is no clause in the agreement establishing the WTO that gives deference to environmental treaties, and legal experts believe that amending the legal document setting up the WTO would be very difficult. The main avenue for WTO to address trade-restricting measures found in global environmental treaties will likely be through Article 20 of the GATT, which gives members the right to put environmental goals (as well as health and safety goals) ahead of its obligation to avoid trade restrictions.

What can be done to "green" the WTO in limited ways? Environmentalists say that one problem with the CTE is that only about 30 of the WTO's members have the resources (and Geneva-based presence) to be able to actively participate. Finding the resources to involve more developing countries in the CTE's activities would be a first step toward deepening discussions on trade and environment. The CTE should also further deepen its links with other organizations,

something that the WTO has started to do with agencies such as UNCTAD. NGOs, as noted above, will keep pushing for increased transparency, hopefully with more support from the more powerful member countries.

Finally, it would be helpful to find out more about the results of the parallel track discussions between NGOs and the WTO, to get a sense of what might be done as a follow-up. At minimum, these parallel track discussions have increased personal links between WTO ambassadors, trade delegates, administration and environmental groups. There is some dialogue between the two, even if it has not produced significant results.

Other regional trade agreements also contain provisions on investment, such as the Asia-Pacific Economic Cooperation's Non-Binding Investment Principles, as well as NAFTA. These investment provisions tend to provide for high protection standards for investment, and liberal conditions for investment to enter a country. These agreements also call for investments to be protected by various legal guarantees--such as fair treatment--and proscribe uncompensated expropriation. A fruitful avenue for future research would be to analyze and compare these investment principles, to determine the ways they do (or do not) address environmental issues, and to assess what their environmental implications might be.

**NAFTA** provides a useful case study, in the sense that it is the "greenest" of regional trade treaties, yet it is uncertain whether NAFTA's side agreements have provided a strong enough disincentive to the dirty manufacturing processes of many *maquiladoras*, the foreign-owned manufacturing plants on the Mexico side of the U.S.-Mexico border. NAFTA not only explicitly addresses its relationship with MEAs, and gives priority to the latter over its own trade liberalization measures in cases of conflict, but it also has an environmental side agreement (the

North American Agreement on Environmental Cooperation) that has its own institution: the Commission for Environmental Cooperation, with its own enforcement procedures. Yet, at the same time, enforcement of Mexico's environmental laws has been lax, and some observers argue that pollution along the U.S.-Mexico border may have worsened despite NAFTA's side agreement.<sup>23</sup> Two lines of future research would be to: 1) assess the causes of NAFTA's weaknesses; and 2) to determine the feasibility of promoting NAFTA's environmental characteristics in other regional trade fora.

#### *Other International Investment Agreements: Multilateral Agreement on Investment*

An important development on the horizon, with the possibility of significantly impacting FDI, is the **Multilateral Agreement on Investment (MAI)**, currently being negotiated at the OECD. The goal of the MAI is to provide a level playing field for international investors, by creating a framework of legally enforceable uniform rules on market access and legal security. Two central elements of the proposed agreement are the obligations of *national treatment*, which requires countries to treat foreign investors as favorably as they treat domestic investors; and *most favored nation* (MFN) treatment, whereby countries must treat all foreign investors equally. The MAI is considering ways of allowing disputes to be settled through binding investor-to-state or state-to-state dispute mechanisms, including use of the WTO's dispute mechanism. OECD negotiators plan the MAI as a free-standing treaty, which will be open to accession by non-member states.

Supporters of MAI tout the proposed treaty as a way of extending and consolidating

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Hilary F. French, "Pay for Development," *WorldWatch* May/June 1997, 9-17.

liberalization in international investment that is already underway, and providing a high degree of market access and legal security for foreign investors. Since it is being negotiated under the auspices of the OECD, it would initially be an agreement among a club of rich countries, but there are hopes that developing countries would also sign on, and that the whole thing could essentially be moved under the WTO umbrella at some point in the future.

Critics have numerous, deep concerns about the MAI. First, they argue that this treaty has been negotiated in secret, with a goal of providing investors freedom without responsibility.

"Investment, ownership, labour, consumer protection and environmental legislation will be wrenched out of our hands," wrote Britain's Guardian newspaper, "If the OECD gets its way, the British government will never again be permitted to restrain the rapacity of the private sector."<sup>24</sup>

The new treaty would tie the hands of countries trying to prevent sudden capital flight, or seeking a controlling share in privatized industries. Countries signing on would no longer be able to use incentives or disincentives to decide where they want FDI to flow. Some actors in rich countries, such as the U.S., also argue that the MAI infringes on the rights of government actors below the federal level. For example, the MAI would hurt the ability of U.S. states to set policies that favor local businesses in areas allowed by the Supreme Court, as well as to provide investment incentives in areas such as pollution prevention or recycling.<sup>25</sup>

More germane to this study is the fact that the MAI has been criticized for not adequately addressing environmental issues. According to one study, the MAI's "sovereignty exceptions" to

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George Monbiot, "A Charter to Let Loose the Multinationals," *The Guardian*, April 15 1997, 19.

See Thomas Singer and Paul Orbuch, "Multilateral Agreement on Investment: Potential Effects on State and Local Government," (Denver, CO: Western Governors' Association, 1997).

the agreement include only three general exceptions: national security, public order, and international peace and security. This is substantially weaker than the Articles XX and XXI of the GATT/WTO agreements, as well as NAFTA's provisions. This weak provision could open the door to challenges from foreign companies against national laws that seek to protect the environment, particularly where local regulations and standards are seen to confer unfair advantage to local companies.

#### *Evaluation/Recommendation*

The numerous concerns about the MAI, just among its potential signatories, have already slowed down the negotiating process. While the OECD originally planned for the MAI to be completed this spring, it has now been delayed by one year. This provides environment groups more time to put pressure on the OECD and its member states to better address environmental issues in the treaty.

It is also unclear, at this stage, how exactly the MAI will impact developing countries. The MAI was initially negotiated in the OECD rather than in the WTO due to concerns by developed countries that the initiative would be blocked by developing countries. It is both clever and sneaky of the developed countries to pursue this agreement among themselves with the hopes that they will eventually be able to attract non-OECD countries to its fold, and one day turn the agreement over to the WTO. While the MAI would offer market access guarantees to developing countries, it still arouses their great concerns that foreign investors will overwhelm domestic

investors in many areas. It also restricts the ability of governments to use investment policy to pursue their own policy objectives, whether they be economic or social (or environmental). It remains to be seen how eager developing countries will be to sign-on to this agreement.

Ultimately, NGOs need to continue putting pressure on OECD countries to focus on environmental issues in the treaty, as well as undertake more research to determine the impacts this treaty will have on the manner in which FDI addresses environmental issues in developing countries.

### *MEAs*

Out of around 180 MEAs, approximately 20 include trade measures. The three most closely analyzed are the Montreal Protocol on Substances that Deplete the Ozone Layer, the Basel Convention on the Control of Transboundary Wastes and their Disposal, and the Convention on International Trade in Endangered Species of Wild Flora and Fauna (CITES). These MEAs with trade-restricting components do shape the environmental character of FDI by simply prohibiting certain types of trade and investment. While the direct impact of MEAs is clearly on trade, there are also implications for FDI, or perhaps even portfolio investment and other forms of private capital flows. For example, the Montreal Protocol restricts trade in ODS and products containing ODS between parties and non-parties to the agreement, which clearly discourages investors from related FDI in countries not party to the agreement or investment in companies producing ODS.<sup>26</sup>

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For an excellent study on the Montreal Protocol's trade restrictions, see Duncan Brack, *International Trade and the Montreal Protocol* (London: Earthscan Publications Ltd., 1996).

In other words, investors are likely to be dissuaded from setting up shop in areas that are prohibited or restricted by MEAs, but these areas are likely to be marginal in the broader scheme of factors that drive FDI. In general, MEAs are most useful as tools to restrict certain types of environmentally damaging activities, rather than as a direct way to have a significant impact on the behavior and incentives facing foreign investors more broadly.

In addition to trade-restricting measures, it should be noted that the MEAs may also promote certain types of trade as well. This may be the case with the Climate Convention's promotion of joint implementation, which is a mechanism aimed at encouraging certain types of private investment in and technological transfer to developing countries. The idea is for industrial countries to be able to fulfill part of their obligations for greenhouse gas emissions reductions through actions undertaken in developing and transition countries. In the case of the Climate Convention, it is too early to say exactly how this idea will ultimately be translated into practice. As is the case with the trade-restricting provisions, joint implementation may shape the behavior of a small set of specific foreign investors, but is not a tool that can be used to influence FDI more broadly.

#### Business NGOs and Trade Associations

Business NGOs and trade associations are becoming bigger players on the international investment/ environment scene, as industry groups increasingly develop voluntary codes of environmental conduct which they follow at home and abroad. In particular, trade associations set up by industries have produced their own environmental guidelines for accounting, as well as other environmental practices and standards. These include groups such as the American

Petroleum Institute, the International Council on Metals and Environment, and the Global Environmental Management Initiative, among others. Institutions such as the International Chamber of Commerce are extending their work to address environmental issues, and work with their members to help businesses better respond to environmental issues. These organizations will be important entry points for environmental NGOs to seek closer involvement with corporate environmental activity abroad.

Some of the standards followed by these groups are stronger and more comprehensive than others, and environmental groups need to have a clearer idea of who is doing what, and how well. One important example of how mixed these standards are in terms of their impact is the activities of the Geneva-based International Organization for Standardization (ISO), which has set a series of standards widely followed by corporations, including its ISO 14000 standards, which define a voluntary system for environmental management.

On one hand, a growing number of companies are using ISO environment standards, which help companies focus on environmental issues, in part by using life cycle assessment, environmental performance evaluation, and eco-labeling tools. Environmental groups have only recently become more active players in the ISO process, and some are, in fact, quite excited about it. The International Institute for Sustainable Development, for example, has said that the ISO 14000 standards may be seen in a decade as "one of the most significant international initiatives for sustainable development."<sup>27</sup>

On the other hand, it is unclear how much an ISO seal of approval tells us about a company's

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International Institute for Sustainable Development, "Global Green Standards: ISO 14000 and Sustainable Development," (Winnipeg, Canada: IISD, 1996).

actual environmental behavior. In other words, the ISO standards address internal management and auditing procedures. An example would be ways in which a company should monitor its pollution. However, that is not the same as setting *performance* standards, which would provide guidelines on levels of acceptable pollution. Companies must set their own performance standards. As a result, a company may have a set of accepted procedures in place, but this does not tell us how anything about its environmental performance--such as whether its emissions of pollutants or use of natural resources have declined. ISO also puts smaller companies at a disadvantage, because many companies find the costs of showing they have complied with ISO to be very expensive. Ultimately, while actors such as ISO and other industry groups may have a role to play in setting a higher, international standards that are followed by industries in their foreign investment activities, more attention needs to be paid to what exactly the impact of these voluntary guidelines is, and whether and how they need to be improved.

#### *Evaluation/Recommendations*

- Links between environmental and business NGOs and trade associations should be significantly strengthened and deepened over time. Environmental groups can help advise trade groups on the ways in which they address environmental issues, and should work with international business groups on how to make international standards on processes more effectively reflected in business performance as well.
- International groups such as the G-7 and OECD are also working on cooperative ways of harmonizing environmental standards, and NGOs can help build links, or be involved in the dialogue, between these groups and business NGOs.
- The problem with these business NGOs is that they tend to reach the bigger, more environmentally aware companies, leaving the small companies and serious polluters outside their net. Often, as a result, they are preaching to the converted. More thinking needs to be done on how to reach smaller-sized companies. Also, very often local suppliers to MNCs are much dirtier than the company they supply to. More thinking needs to be done on how to reach local suppliers of MNCs.

## **C. Mechanisms Shaping Portfolio Investment and Commercial Bank Lending**

### *Portfolio Investment*

Portfolio investment and commercial bank lending are much less amenable to being influenced by international institutions than FDI. To date, most of the activities of international institutions in these areas are relatively small, and are focused on the institutions as organizers of discussion, information exchange, and research. The exception to this may be the IFC, which is active in setting up private equity and venture capital funds in developing countries. In general, however, this is an area where the "responsibility vacuum" is most prevalent. The scope of the few international institutions active in this area does not (and is unlikely to) focus on environmental issues, such as the Basel capital accord, which addresses capital adequacy requirements in the banking community.

Portfolio investment has shown particularly strong growth in recent years (see Table 1), and developing countries are becoming more important destinations of this type of capital flow. After barely attracting a trickle of such flows a decade ago, developing countries have accounted for around 30% of all transboundary equity flows in the past five years.<sup>28</sup>

Portfolio investment is managed by institutional investors such as pension funds, mutual funds, insurance companies, as well as banks. They are largely motivated by a desire to reap the highest returns for the smallest amount of risk, as well as opportunities for portfolio diversification.

Portfolio investors looking at third world and transition markets care about the economic and political characteristics of a country vis-a-vis other investment options. They also have the option

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World Bank, *Private Capital Flows to Developing Countries*, p. 15.

of pulling their money out if they are unhappy with local conditions. While equity investors in developed countries may switch companies within the country, emerging market funds are more likely to change countries.<sup>29</sup>

Environmental concerns are not among the top priorities of most portfolio managers, and their actions are not directly shaped by international institutions. As Schmidheiny and Zorraquin noted: The vast majority of investment managers...view most environmental concerns--and certainly that thing called sustainable development--as utterly irrelevant to their jobs. Such issues, unless defined by the law or given a number in the accounts, are for them simply out of play.<sup>30</sup>

#### *Evaluation/Recommendations*

In this area, the most direct path to influencing the environmental behavior of these investors is through public pressure on and closer relations with the investors themselves. The main actors to influence are fund trustees, institutional investors, and the actual fund managers. Indeed, there are many examples of pension funds and mutual funds who are seeking to address ethical and environmental issues in their investment choices, and to put pressure on the companies they invest in to do the same. NGOs are becoming more active in publicizing funds that invest in dirty companies, and working more closely with the "greener" funds. These issues are discussed in greater depth in the corporate accountability think piece being drafted for the IFFE project.

While international institutions are not the most important actors that influence portfolio investors, they do have a role to play in helping to shape national investment policies, in

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Schmidheiny and Zorraquin, p. 35.

Ibid., p. 79.

undertaking research and information dissemination on relevant topics, and in providing fora where policymakers and fund managers may be able to meet to discuss relevant policy issues. International institutions such as the World Bank, its private sector lending arm, the IFC, or OECD could also explore the ways in which national policies might provide incentives to institutional investors and funds to avoid investing in companies that have environmentally unsustainable practices (as well as perform badly in other areas, such as labor treatment). One option would be for richer countries, such as the G-7, to give some type of tax break to green portfolios or mutual funds. Such a policy could have an influence on where this type of private capital flows to, and may also fit in with our policy goals--such as encouraging companies in third world countries to reduce greenhouse gas emissions. If portfolio investors move to support "greener companies" abroad, this provides incentives for local entrepreneurs to think about production processes in their attempts to attract foreign equity interest.

#### *Commercial Bank Lending*

Commercial bank lending across borders has shown the slowest growth of all forms of private capital flows, and since 1993 has been the smallest of the three major categories (which include FDI and portfolio flows). Like portfolio flows, the environmental character of commercial bank lending has not been directly affected by the activities of international institutions.

Nonetheless, commercial banks in rich countries are beginning to think about environmental issues, largely due to concern about environmental liability issues. In other words, banks seek to limit their risks by making sure they will not be held liable for any environmental problems that arise in their loans. In the U.S., for example, a number of court cases since 1990 that have held banks liable for the clean-up of Superfund sites have pushed U.S. banks to start thinking more

environmental issues. In Europe, as well, the European Commission has been looking at ways of assigning cleanup liability, which could have an impact on European banks.

Ultimately, the fear of environmentally-related risks is a key factor forcing banks to think more about the environmental implications of their work. A 1994 survey of 90 global banks, jointly commissioned by UNEP and Salomon Brothers, found that 80% say they now "perform some degree of... environmental financial risk assessment" of borrowers before lending to them. However, at the same time, less than half of these banks monitor environmental risks after the loan is made.<sup>31</sup>

### *Evaluation/Recommendations*

As is the case with portfolio investment, international institutions are not directly driving bank behavior on the environment, but they can and are playing an important role in providing fora for interaction and discussion, policy ideas and advice. In this area, UNEP has been the leading actor in addressing these issues. UNEP in 1992 coordinated a "Statement by Banks on the Environment and Sustainable Development" that was signed by 33 banks just before the Rio Summit (and now has over 80 signatories from more than 26 countries).

In the statement, the signatories "endeavor to ensure that our policies and business actions promote sustainable development: meeting the needs of the present without compromising those of the future." They subscribe to the "precautionary approach" in environmental management, say they expect their clients to comply with relevant environmental regulations, and say that they

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UNEP, "Banks Foresee Growing Opportunities and Importance of Environment in First Global Survey." Press release, 18 January 1995.

recognize that environmental risk should be taken into account in their risk assessment, and domestic and international operations should seek to apply the same environmental risk assessment standards."<sup>32</sup>

UNEP also has an Advisory Group on Banking and the Environment that meets twice a year to exchange ideas on financial management issues. It has hosted international round table meetings on banking and the environment, and commissioned the above-mentioned survey, and is involved in a number of other activities designed to "facilitate dialogue and exchange views among commercial banks, national associations, multilateral and regional development banks, NGOs and others," including round tables and electronic newsletters.<sup>33</sup> The UNEP activities are helping to deepen links and expand networks between the banking and environmental communities. As important, they are helping bankers to define and think through the issues, as a step toward making the banking sector more environmentally accountable. Future work by the IFFE project might focus on assessing the degree to which these fora are affecting bank strategies, for example by looking at the ways in which bank participants in these meetings are able to transmit what they have learned to their home institutions in any substantive way.

### **III. Role of other International Institutions**

International organizations that focus on environmental issues are increasingly turning their attention towards issues where environment intersects with corporate practice, trade and banking.

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UNEP. "A Statement by Banks on the Environment and Sustainable Development." 1992.

E-mail correspondence with UNEP's Sebastian Winkler, September 3, 1996.

There are numerous examples of international organizations trying to expand their links with the business sector, while at the same time undertaking research, disseminating information, and playing a role in agenda setting.

The UN itself recently brought in the CEOs of 10 MNCs together with 15 high level government representatives and UN leaders, along with a handful of academics and NGOs (including WRI's Jonathan Lash) to discuss how to formalize corporate involvement in the UN. Within the UN family, UNEP's role in addressing banking issues was discussed above. UNEP also has a variety of other programs, including an industry and environment program aimed at helping corporations develop cleaner and safer production policies. The list continues and includes programs such as the UN Research Institute for Social Development (UNRISD), which has launched new research program on Business Responsibility for Sustainable Development, and the UN Commission on Sustainable Development's working group on financial issues. Other UN agencies, such as FAO, UNDP and UNCTAD are also working on trade/business/environment issues.

The OECD is also an important actor in the international scene, because it is one of the few international organizations that has consistently worked on both environmental and economic issues.<sup>34</sup> In general, its Environmental Directorate undertakes research, develops data bases, works on policy formation, and conducts conferences. Its goals are to help OECD member countries to develop and implement effective environmental policies and to promote common and harmonized environmental strategies and policies among its members. Occasionally, the OECD is

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Two recent publications of possible interest are: OECD, "Globalisation and Linkages to 2020: Challenges and Opportunities for OECD Countries: Environmental Issues," (April 1997), and OECD, "Economic Globalization and the Environment," (Paris: OECD, 6 May 1997).

important in framing policy issues, such as its role in focusing international attention on the problem of the long range transport of sulfur compounds in the 1960s.

More recently, it has played an active role in helping to prepare the Regional Environmental Action Program for Central and Eastern Europe, endorsed by ministers from East and West, and is home to the Task Force that seeks to implement it.<sup>35</sup> The Environment Directorate is also undertaking work on environmental health and safety, as well as pollution prevention and control. The OECD's Joint Session of Trade and Environmental Experts has also been working on trade and environment issues for the past several years, and has been providing material to other fora, such as the CTE. Ultimately, the OECD is mainly a club of rich countries, and developing countries do not have a voice in most of its activities (with the exception of programs such as the EAP Task Force). Still, the institution has a role to play in linking environment and capital flows issues, and one such fora for it to do so (and do a better job) is through the MAI negotiations.

### *Evaluation/Recommendations*

The important questions to ask in this area are: how effective is the work being done by these international organizations on issues that may affect the environmental nature of private sector capital flows; and, how politically feasible are calls for the creation of a new international environmental institution to consolidate some of these activities?

There is no clear answer to the first question. To date, there has been no research or analysis that adds up all of the related activities undertaken by all of these international institutions and

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The Task Force's members are donor and recipient countries, as well as a few NGOs (including WRI), and has as one of its goals the promotion of environmental considerations into the process of economic reconstruction in the region. Its activities include work on improving the environmental performance of in Eastern European industries.

evaluates the extent to which the different programs get translated into policy action, or other indicators of performance. Indeed, it is extraordinarily difficult to "measure" how effective international institutional activities regarding network building and information dissemination are, because the outcomes are often diffuse in nature, and may result in actions or learning over the long-term that are not easily observable in the short-term. In other words, the ideas can take a long time to filter down into discernible actions, but that does not mean that thinking is not changing slowly, and that less observable actions are taking place. On the other hand, big international bureaucracies rumbling along organizing seminars and research papers have often been accused of not doing a good job of coordinating their work with other institutions, at the risk of overlap, and of producing papers that simply gather dust on bookshelves.

We do know that some international organizations have a reputation of being more effective than others. UNEP's reputation was undermined at UNCED when the CSD was created, and its location in Nairobi does make it more difficult for it to coordinate its activities with other organizations. We do know that the CSD has not yet impressed NGOs as a terribly effective organization, given its broad mandate, and its inability to force countries to submit required national actions reports.

Over the past several years, there have been a number of calls within the environmental community for a new, stronger, international environmental organization that would consolidate and streamline the plethora of agencies and activities that cover these issues now, and have more political power and clout than existing agencies. One widely discussed proposal is that of Daniel Esty, who has called for a Global Environmental Organization that would have legislative and adjudicative powers to be a sort of "institutional counterweight" to the WTO, with a possible goal

of developing and harmonizing international environmental norms, and settling international environmental disputes.<sup>36</sup>

Such an idea is clearly attractive to the environmental community, and may also gain adherents from government officials eager to streamline an already unwieldy system. Consolidation of functions would reduce institutional overlap and encourage any remaining actors to focus more carefully on their institutional comparative advantages. Giving a global environmental institution some legal clout would end frustration that the environmental community has of soft institutions with little ability to pressure their member states for significant change.

However attractive such an idea may be, it is probably not politically feasible any time soon, at least in the form espoused by Esty (i.e., as having independent legislative powers). A powerful global institution to address environmental issues is unlikely to win support from most developing countries, and the debates over it would replay classic North-South arguments. Not only that, in most advanced industrialized countries as well, environmental ministries rarely have the political clout or importance as finance and trade ministries. It is unlikely that the leading actors in these finance and trade ministries would support creating a powerful global environmental institution that would be on equal par with WTO. In general, countries are not keen to set up new international institutions when existing institutions do the job in a way that is acceptable to most.

### *Evaluation/Recommendations*

- More work is need to evaluate the extent of overlap and coordination in the research-related

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Daniel C. Esty, "Greening the GATT," (Washington DC: IIE, 1994).

and policy activities of international environmental organizations looking at trade/investment issues. One idea would be to establish an internet list or Web site that can serve as an index of ongoing work by various agencies. Another idea would be for an agency to establish a coordinating office to address these issues.

- In addition to the current work of environmental agencies mentioned above, an international environmental agencies should begin playing a more active role in fostering innovative public/private partnerships, as a means of putting some of the ideas they are addressing into practice. Demonstration projects, financial mechanisms joining private funds and MDBs, as well as environmental funds supported by international institutions or national export credit agencies, are examples of possible directions in this area.

#### **IV. Conclusions**

International institutions, whose traditional focus has been on providing fora for state cooperation and policy development, are not the most important set of actors that will influence the behavior of corporate leaders, fund managers, portfolio managers and bankers who decide where and how their money and investments should flow. While there are many initiatives among private sector actors to better address environmental issues in their actions, these are not largely driven by international institutions. However, this study has shown that international institutions nonetheless have a potentially important role to play.

Indeed, the role international institutions play in global governance is likely to deepen and grow in coming years, and advocacy groups can assist these institutions in this process of becoming more, rather than less, relevant. In areas where globalization does not weaken the activities and actions of nation states, international institutions will retain their importance as fora for cooperation. Where globalization does weaken the nation state, international institutions can play a greater role as brokers between government and non-government actors, as facilitators, coordinators, network builders, and sources of policy advice. In either scenario, there is no doubt

that many international institutions are now actors in their own right in the policy communities that form around specific global issues. This is particularly the case with the IFIs. While they are clearly the agents of their member states, they also have a great deal of autonomy in how they carry out their mandates, as well as powerful policy voices in their advice and actions in recipient countries.

Indeed, in looking at the role international institutions may play in influencing the way that private capital flows address environmental issues, we find that the IFIs are the most important set of international actors. They shape private flows indirectly by helping developing governments to liberalize their markets, and directly, through their leverage as co-financers for specific projects. Their environmental due diligence procedures, policy advice, and standards can be an important source of shaping the environmental character of FDI, provided they are actually implemented. Increasingly, the IFIs are working more closely with private sector actors, as well as occasionally competing with them. As the IFIs seek to find their place in a world where private capital flows continue to dominate public flows, they must remember their role as actors who can take public policy issues into account in ways that private actors often have little incentive to do.

Other international institutions have an important role to play as members of policy communities that address environmental/trade/investment issues, and as actors that can facilitate or broker interactions between public and private sector actors. These international institutions, such as the OECD, UNEP, and UNDP, are involved in a number of activities that seek to deepen links between public/private sector actors, offer fora for discussion of these issues, and are sources of research, information dissemination, and the development of policy options, standards, practices, and processes. These are the hardest areas of activity to measure in terms of

effectiveness, but they may in fact be the most important. Putting the issues on the table, generating ways of thinking about them, and bringing together the actors who shape them or are affected by them, is also crucial for the ultimate result of behavioral or policy changes. While traditionally these institutions have emphasized their role in working for and with the states that created them, to different degrees they are extending their horizons to include private sector actors. Environmental advocacy groups face a struggle and challenge in making sure that the powerful multilateral trade and possibly investment agreements do not ignore environmental issues in their work. They also have a role to play in ensuring that international environmental organizations do not become marginal players in trade and investment issues.

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