



Capital Flows and Environment

by Hilary French, Worldwatch Institute

In the wake of the Asian economic crisis, the international capital that had been pouring into that region since the beginning of the decade reversed course as investors raced for the exit. Suddenly commentators who just months earlier were extolling the virtues of global economic integration were urgently warning that international financial flows had outgrown existing financial regulatory structures. But few people are paying attention to another critical issue: the extent to which this decade's massive international financial flows to the developing world have undermined the ecological foundations of emerging economies. Urban air pollution levels in many Asian and Latin American cities are among the worst in the world, and natural resources such as forests and fisheries are badly depleted on both continents.

Policy reforms are needed to steer private capital flows in a more environmentally sound direction. But the levers of change are shifting: the influence wielded by public aid agencies is waning while private sector clout is on the rise. The amount of private capital flowing into the "emerging markets" of the developing world exploded in the early 1990s, rising from \$42 billion at the beginning of the decade to an all-time high of \$256 billion in 1997, according to World Bank estimates. Meanwhile, spending on official development assistance fell by nearly a quarter over this period in the face of large government budget deficits in donor countries and declining political support for aid. This shrinking public presence coupled with expanding private flows dramatically changed the complexion of North-South development finance. Whereas in 1990 only 43% of the international capital moving into the developing world came from private sources, by 1997 this share had risen to 85% (see figure).

This shift in the sources of capital poses a policy challenge as the private sector is less accountable to the public interest than are government agencies. But the challenge is not insurmountable: a growing array of "green" international investment strategies are taking shape in hopes of shifting private capital out of environmentally damaging activities and into enterprises that sustain the natural world rather than degrade it. These initiatives must be launched quickly and on a large scale if they are to turn around a global economy that pumps 17 million tons of climate-warming carbon from fossil fuel burning into the atmosphere every day and extinguishes thousands of plant and animal species annually.

Key Points

- The environmental implications of this decade's massive movements of money into the developing world, while enormous, are also complex and somewhat contradictory.
- Investors are often drawn to places endowed with bountiful natural resources but handicapped by weak or ineffective environmental laws.
- Policy reforms are needed to steer private capital flows in a more environmentally sound direction.

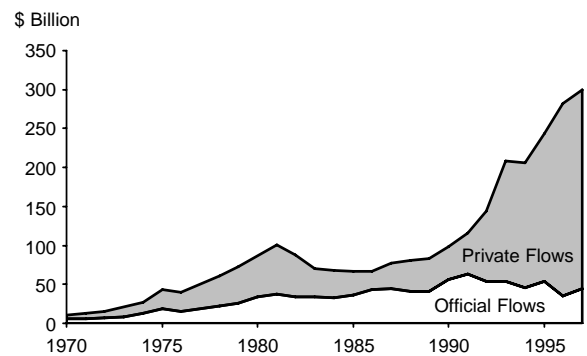
Understanding the role of private capital flows in all of this is no simple matter. The environmental implications of this decade's massive movements of money into the developing world, while enormous, are also complex and somewhat contradictory.

As investors search the globe for the highest return, they are often drawn to places endowed with bountiful natural resources but handicapped by weak or ineffective environmental laws. Many people and communities are harmed as the environment that sustains them is damaged

or destroyed—villagers are displaced by large construction projects, for example, and indigenous peoples watch their homelands disappear as timber companies level old-growth forests. Foreign investment-fed growth also promotes western-style consumerism, boosting car ownership, paper use, and Big Mac consumption rates toward the untenable levels found in the United States—with grave potential consequences for the health of the natural world, the stability of the earth's climate, and the security of food supplies.

Yet international capital can bring environmental benefits as well, such as access to cutting-edge technologies that minimize waste generation and energy use. These new processes can help developing countries leapfrog over the most damaging phases of industrialization and avoid the kind of costly cleanup bills that many industrial countries are now saddled with.

Capital Flows to Developing Countries
1970-1997



Source: World Bank

The first step in reorienting private capital flows is to track them better, a task made difficult by a paucity of publicly available data. Suppliers of official development assistance, such as the World Bank, publish detailed reports spelling out what the money is being spent on—whether it is dams, highways, and other infrastructure projects, social services such as health care and education, or environmental projects such as reforestation and pollution control. But private capital flows are something of a black box. We know they are growing fast, but the available statistics tell us little about what exactly is being financed. Nonetheless, a rough map can be sketched.

Most private funds have flowed to a relatively small group of countries: in the first half of the 1990s, just 12 nations received some three-quarters of all private inflows, with China alone accounting for a sizable share of the total. These 12 countries have an enormous impact on the health of the planet by virtue of their relatively large populations, economies, and land masses.

The quest for natural resources has historically drawn international investors into distant ventures in the developing world. This quest continues today, with international investment in resource extraction flowing rapidly into many countries that are richly endowed with natural assets such as primary forests, mineral and petroleum reserves, and biological diversity. In Chile, for example, commodities account for nearly 60% of foreign direct investment (FDI) stocks, most of it in copper mining. Diamond mining attracts most of the FDI that flows to Botswana, while in Tunisia, oil and gas development is a big draw.

Countries rich in natural wealth all too often squander this bounty by investing in ill-conceived projects that mine natural resources for the short-term economic gain of political elites at the expense of local peoples and future generations. A wiser long-term strategy would be to funnel capital into economic activities that preserve natural endowments, such as timber operations that are certified as sustainably managed, small-scale ecotourism enterprises, and “bioprospecting” ventures in which pharmaceutical companies pay for the rights to seek out commercially valuable species.

In recent decades, the manufacturing and services sectors have expanded rapidly in many developing countries, making them increasingly attractive targets for foreign investors. The World Bank estimates that manufacturing now accounts for just under half of all FDI flows to developing countries and that services—

including construction, electricity distribution, finance, retailing, and telecommunications—constitute more than a third, while the “primary” sector, which includes agriculture, forestry, and mining, now accounts for only some 20% of the total.

From an environmental point of view, the manufacturing takeoff is a double-edged sword. International investment in manufacturing sometimes helps developing countries adopt new technologies that produce less waste and use fewer raw materials than standard machinery, yet it can also bring highly polluting industries that jeopardize human and ecological health.

One of the most dramatic trends of the 1990s has been the rapid rate at which governments of developing countries have turned over many traditionally public infrastructure activities to the private sector. Private companies are now building power plants, telecommunications networks, water treatment plants, dams, and toll roads in many corners of the globe, and two-thirds of the financing comes from investors abroad.

The numerous power sector projects now in the pipeline have particularly serious implications for the environment—especially for the quality of the air and the stability of the climate. Over the next several decades, the bulk of new global investment in the power sector is projected to take place in developing countries. The world’s ability to avert a catastrophic warming of the atmosphere will depend in no small measure on what kind of power plants are built.

A sizable share of current international investment in the power sector is bankrolling multimillion-dollar coal- and oil-fired power plants that produce prodigious amounts of both local air pollutants and greenhouse gases. For instance, international investors are queuing up to participate in the construction of the more than 500 mid-sized power plants that China plans to erect by 2010—equivalent to more than double China’s current generating capacity. Many of these will be fueled by carbon-intensive coal.

Key Problems

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Foreign Policy in Focus is a joint project of the Interhemispheric Resource Center (IRC) and the Institute for Policy Studies (IPS). The project depends on sales and subscription income, individual donors, and grants from The John D. and Catherine T. MacArthur Foundation, General Service Foundation, and various church organizations. *In Focus* internships are available.

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The global nature of today's economy means that individual governments have less power than they once did to chart their own environmental courses. The buying preferences of consumers continents away can determine the fate of a country's rainforest, and concerns about international competitiveness are often used to block meaningful environmental reforms. Action at the international level is thus essential.

The rapid infusion of private capital into emerging markets led to some confusion regarding strategy on the part of those accustomed to operating in the more familiar world of aid-financed development. Yet new tactics that hold promise for shaping the developing world's environmental future are beginning to be employed in response to the changing international landscape.

One approach is to attach environmental conditions to bilateral and multilateral aid programs that support private investments, thereby using a limited amount of public money as an environmental lever to influence far larger pools of private capital. The U.S. Overseas Private

Investment Corporation (OPIC), for instance, provides political risk insurance for private investment. At the urging of environmental groups, OPIC is in the process of phasing in strengthened environmental guidelines that, among other things, require the agency to track and report on greenhouse gas emissions from its power projects and forbid it from underwriting projects in primary tropical forests or other ecologically fragile areas.

The U.S. Export-Import Bank (Eximbank), which provides

subsidized loans to other governments for the purchase of U.S. goods and services, has also taken steps to strengthen its environmental policies. In May 1996, Eximbank announced that its environmental guidelines prohibited it from extending export credit support for China's Three Gorges project—a blow to companies such as the heavy equipment manufacturer Caterpillar. But the bank's counterparts in Canada, France, Germany, Japan, and Switzerland stepped into the breach, undermining the effectiveness of the U.S. action. Stung by the Three Gorges experience, the U.S. is trying to persuade other donor countries to apply comparable environmental conditions to their bilateral export credit and investment promotion agencies.

At the multilateral level, significant potential clout over the private sector lies in the hands of the World Bank and its two affiliated organizations that underwrite private sector investments, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA). After a decade of pressure from nongovernmental organizations and determined efforts by committed insiders, the World Bank now has an extensive set of environmental and social policies. In

theory, all World Bank agencies (including the IFC and MIGA) are bound by these policies. Yet World Bank officials acknowledge that actual operating procedures have sometimes been different in private sector operations. And, by its own admission, the World Bank itself—let alone the IFC and MIGA—has not always followed its own rules.

The International Monetary Fund (IMF) is another economic institution that needs an injection of environmental sensitivity. The IMF's prominent role in the Asian economic crisis is demonstrating the organization's power while stirring controversy as to the wisdom of its financial advice. Little understood, however, are the profound effects that its economic recommendations have on the ecological health of recipient countries.

The IMF and the World Bank both make structural adjustment loans, in which recipient countries agree to a range of policy reforms in exchange for access to credit. Countries are often encouraged to boost exports in order to generate foreign exchange with which to repay debts. This creates pressure on them to liquidate natural assets in order to come up with the money. Structural adjustment loans also often require countries to cut government spending, which can mean that the budgets of already overburdened environment and natural resource management ministries are cut to bare-bones levels. Although many of the policy changes required under structural adjustment programs contribute to environmental destruction, the IMF and the World Bank could instead choose to use their influence to promote needed reforms, such as reducing environmentally harmful subsidies or implementing environmental taxes.

Environmental considerations also must be integrated into the official forums where the rules of international commerce are now being written, such as the World Trade Organization and the negotiations on the proposed Multilateral Agreement on Investment. And the UN could be charged with developing baseline environmental standards for industry comparable to those the International Labor Organization drafts on matters such as workplace safety and child labor. This effort would logically build on the World Bank's environmental policies and guidelines, which are already a common point of reference for private investors.

Around the world, public awareness of the damage that business-as-usual practices inflict on the planet is growing, and grassroots environmental groups are gaining strength. The Asian crisis, meanwhile, has drawn attention to the need to manage global economic integration better. As the process of devising international policies for a globalizing world commences, protecting the natural resource base that underpins the global economy merits a prominent place on the agenda.

Hilary French is Vice President for Research at the Worldwatch Institute in Washington, DC. She is the author of Worldwatch Paper 139, Investing in the Future: Harnessing Private Capital Flows for Environmentally Sustainable Development, upon which this brief is based.

Key Recommendations

- Use public aid money as an environmental lever to influence far larger pools of private capital.
 - Harness the World Bank and the International Monetary Fund's influence on behalf of needed reforms.
 - Integrate environmental considerations into the forums where the rules of international commerce are now being written.
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Sources for More Information

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