

# Chasing Shadows

## Re-imagining Finance for Development





# Contents

---

<b>SUMMARY</b>		
<b>OVERVIEW – A short history of development and finance</b>		
Investing in security	2	<b>Part II – Taming the Bull?</b>
Reconnecting a disjointed world	4	Making private capital work for developing countries
Looking forward or repeating the mistakes of the past?	4	FDI and the local multiplier effect
Economics for human dignity	4	The weaknesses of voluntary codes and standards for 'corporate responsibility'
<i>Box: The Millennium Development Goals</i>	5	Lack of enforcement mechanisms
<b>PART I – Switching off the vacuum cleaner</b>	6	Competing standards and codes
Reform of global finance and the need for domestic resource mobilisation	6	Opportunities for "corporate spin" and selective application
Increasing inflows – not enough to promote development	7	Lack of stakeholder rights
Switching off the vacuum cleaner	9	Taming the Bull: making foreign investment work for developing countries
Debt cancellation under an international insolvency process	8	<b>Part III – A world turned upside down</b>
Democratising capital flows – domestic and international regulation	8	Ecological debt, finance and development
Plugging the leaks – making foreign finance work harder	9	Ecological finance – a macro-economic framework for the 'real', real world
The alternative – generating local finance for local development needs	10	New finance and the scale of the challenge
	10	Foreign debt versus carbon debt – the HIPC initiative and the Kyoto Protocol
	11	<b>Conclusion</b>
		<b>References</b>
		<b>Additional reading</b>

# Summary

*Chasing Shadows* starts from the premise that finance is not about money. It is about the relationships between people, states, markets and the natural environment. It is also a tool to achieve the fundamental goals of human fulfilment, dignity and quality of life that lie behind the notion of economic development.

Somewhere, however, this simple idea has become corrupted. Finance has been transformed from the means to an end, to an end in itself. Vast sums of money now circulate the globe without ever touching the ground or being harnessed for productive purposes. While millions throughout the world cannot meet their basic needs, the financial resources which could allow them to fulfil these needs dance ephemerally, weaving an arcane path through the intricacies of global hedge funds, capital markets and off-shore bank accounts.

At the same time, nations desperate to create a stable economic climate for their citizens are dictated by unelected, unaccountable agencies. They are told to borrow money to buy another countries' goods, and then to pay it all back with interest. When this strategy fails, the agencies step in again and order the country to downsize public spending; routing financial resources away from the communities where it is most needed. To complete matters, the soil, atmosphere, marine life, forests and fauna – the living capital of a nation that allows its people to live, eat and breath – are being steadily drained from the debtors by their creditors. Never before has there been so much finance, and so little human development.

Looked at afresh, the absurdity of this situation becomes clear. Yet the business leaders, economists and political leaders that drive this upside-down notion of development refuse to admit that the game is up. Like the Wizard of Oz, the magnificent world they have built around themselves is a sham; based on little more than smoke, mirrors and shadows generated by a complex machine that is under increasing strain to make it all work. The situation would be almost comical, if it didn't have such serious consequences for the future security of humanity.

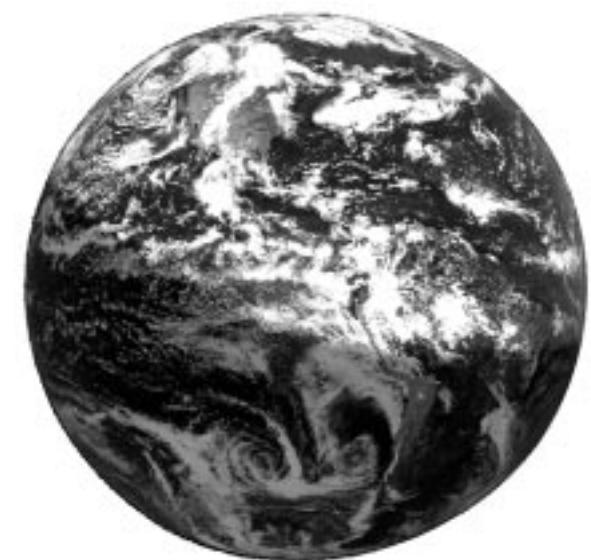
This is the tragedy of the United Nations Financing for Development initiative. In the uncertain political climate post-September 11th, what could and should have been a real opportunity for a new vision of global security – one in which finance and markets are once again subordinated to the people they theoretically serve – has been lost. As with so many attempts before it, the noble goal of bringing finance back into line with the objectives of ensuring basic human rights, national development and environmental sustainability is being undermined by the same hollow principles of maintaining open

markets, drawing in unrestrained foreign direct investment and ignoring ecological debt. Like children chasing shadows, the world's leaders are bent on the reckless pursuit of ideologies that lack substance in the real world.

However, there is the potential to realise an alternative vision. In this report, the New Economics Foundation maps out some of the key features of a world in which there would be *real* finance for development. The structure of the report is simple.

- The overview examines the artificial divide that has been created in the modern world between human and environmental relations on one hand, and abstract free markets on the other; and traces the implications of this divide in the expression of power within international institutions. It warns that global security will not be achieved until this imbalance is addressed.
- Part I delves into international financial structures and processes. It likens the current global financial system to a giant vacuum cleaner, with capital being sucked from the South to North through debt servicing and capital flight. It also notes that foreign investment often does little to contribute to local economic development, which in the absence of adequate capital controls see money drain away like water from a leaky bucket. The authors propose a new 'Jubilee Framework' that would reassert democratic control over national and international financial institutions and encourage greater economic self-reliance.
- Part II moves onto the role of private finance and the role of corporations in foreign direct investment. It observes that the majority of FDI currently fails to generate a local multiplier effect, with most going straight back to the country where the investor is based rather than benefiting the host community. It also notes that developing countries generally lack the incentives or capacity to monitor and enforce good corporate behaviour. The responsibility therefore falls on Northern governments to take the lead by introducing legislation that would require companies to implement a strategy for corporate social responsibility (CSR), and to report on performance in this area through their annual reports. The authors suggest the need for greater stakeholder participation in company boardrooms, to ensure that host communities have an input into the business plans and activities of multi-national enterprises.
- In Part III, the report looks at the most neglected aspect of financial flows: that of ecological debt. It argues the South is, in

"*Chasing Shadows* starts from the premise that finance is not about money. It is about the relationships between people, states, markets and the natural environment."



# OVERVIEW – A short history of development and finance

## Investing in security

The United Nations Conference on Financing for Development (FfD) in Monterrey, Mexico, March 2002, has been much anticipated, especially by the poorest countries. It represents a historic turning point for the UN. In the context of post-September 11th reflections on the future direction of global geo-politics, it also seemed an auspicious, even providential moment for world leaders to tackle global insecurity.

Western leaders in particular have been given a mandate to achieve greater stability and security for their people. Yet, rather than devising visionary strategies to build a more stable and cohesive world, their reaction has been to pursue a military response. Mobilising unprecedented sums of money, they have turned to the world's great arms manufacturers for comfort and safety. The \$798 billion<sup>1</sup> allocated annually to *world* military expenditure (\$139 per capita) is now considered insufficient to guarantee global security. In the United States alone, President Bush proposes to dramatically increase spending on defence and homeland security by \$76 billion.<sup>2</sup>

While Western leaders are massively expanding military expenditure, their representatives at the UN were preparing for Monterrey by quietly burying much less costly, and more rational, proposals for promoting global insecurity. Bowing to pressure from the US government, they voted down proposals made by ex-Mexican President Zedillo to double the flow of international development aid from a paltry \$50 billion each year (\$9.80 for each person in the developing world), to \$100 billion.

As a minimum, \$100 billion is needed each year to secure the fundamental basic needs and human rights for millions of the world's deprived, bitter and disillusioned people. This would do a great deal more to secure the peace and security that Americans and the rest of the world crave than would the \$800 billion spent each year on war, and weapons of destruction.

But leaders and their ambassadors at the UN seem to lack the mettle and nerve to tackle the underlying causes of global insecurity and environmental vulnerability. Instead, uneasy and alarmed, and much like their predecessors in the 1920s, they invest frantically in military solutions. Monterrey is therefore likely to disappoint those in the poorest countries who looked to this UN Conference as a source of hope – for peace, security and stability.

## Reconnecting a disjointed world

While Monterrey is likely to fall short of expectations, it will nonetheless be a historic occasion for other reasons. For the first time in more than fifty years of existence, the UN will encroach on a sphere – global finance – long dominated by the Bretton Woods Institutions (BWIs) – the IMF and World Bank. This development is hugely welcome, and, in spurring new ideas and mind-sets, could potentially set the framework for a more open and democratic system of global economic governance.

The transformation of our world into one artificially divided between abstract free market relations on the one hand; and human and environmental relations on the other, has led to major economic and environmental dislocation and degradation. It has also sharply divided the work of international institutions. The IMF, World Bank and WTO actively promote de-regulated markets in capital, goods and services. They are thus situated on one side of the great divide.

On the other side sits the UN, which through its various agencies and conventions, defends the interests of states; protects the fundamental human rights of all of the world's people; ensures their right to peace and democratic development; and promotes environmental sustainability. However, in the new market-oriented dispensation, the UN finds itself on the 'wrong' side of the divide. Riding the wave of an ideology that elevates markets over human and environmental rights; and the rights of capital over the rights of nations; the BWIs have a much higher status than the UN. The proliferation of UN institutions and initiatives designed to protect human rights, the environment and the rights of sovereign states have therefore been subordinated to the narrowly defined economic objectives of freeing capital movement and liberalising trade and investment rules.

It is therefore from a position of weakness that the UN will endeavour at Monterrey to reconnect the BWIs, with their narrow conception of economics as being just about markets, to the task of human development. There will be valiant attempts to integrate, and perhaps even subordinate, markets to human rights and to the environment. To do so, the UN and its supporters will have to overturn a dominant, if utopian, neo-liberal ideology that believes all human, political and environmental relations are best managed by subjecting them to the discipline and efficiencies of the price mechanism and the market.

## Looking forward or repeating the mistakes of the past?

The world's leaders are in the grip of this ideological mindset, and seem unable to associate its consequences with the current crisis of human insecurity. In the words of G.K Chesterton "It isn't that they can't see the solution. It is that they can't see the problem."<sup>3</sup>

But it was not always thus. In 1944, amid the destruction and terrible loss of life of World War II, the leaders of the west met in Bretton Woods to agree a new world order; one very different from that which had existed pre-1914 and pre-1929. In developing this new world order, they were concerned above all else about human insecurity. In the midst of a catastrophic war, they sought to build a new, more stable, and less volatile world economic order.

A major pre-condition for future security and stability, they reasoned, was the wresting of control for economic and human development from unaccountable capital markets.<sup>4</sup> At the Bretton Woods meeting, they agreed to a) impose controls on international capital movements and b) abandon 'self-regulating' market mechanisms like the gold standard, which had removed government control over key economic policies, including interest and exchange rates.

The IMF, World Bank and UN were designed to reflect this new world order, under which human development needs would be prioritised over the interests of capital markets. Leaders who had lived through the horrors of war, drew back from a system which in the 1920s had subjected human development to self-regulating and unaccountable markets; which had led to a prolonged and destructive depression; and which had weakened the power of governments to intervene in the economy. Indeed, much of the paralysis of governments in the face of the crises of the 1920s and 30s was due to the assumption that they should not intervene and regulate 'free' markets.

Under the Bretton Woods framework, this economic doctrine was dramatically recast. Financial markets were once again brought under control by the imposition of capital controls; and states were once again granted the right to policy autonomy. The IMF and World Bank were given a mandate to reverse the major imbalances and disorder caused by financial liberalisation on the one hand, and the deflationary policies of the gold standard, on the other. In the political arena, the UN was mandated to protect and defend the fundamental rights of all human beings; and of states, large and small. Insofar as the BWIs were members of the UN family, they were accountable to the UN General Assembly. (To this day the President of the World Bank and the Managing Director of the IMF regularly report to the Economic and Social Committee of the UN (ECOSOC).)

Now, as we prepare for the Monterrey Conference, almost 60 years later, the BWIs preside over a very different world order; one ironically similar to that which prevailed in the 1920s and 1930s. Capital markets have been freed from constraints on their mobility. And the BWIs preside over deflationary policies as bad as those of the 1920s, disguised as 'macroeconomic stabilisation' programmes or even 'poverty reduction and growth' programmes. Every economics student knows that inflationary policies transfer assets from lenders to borrowers. Deflationary policies, in contrast, transfer assets from borrowers to lenders – which is why they are favoured by creditors, and promoted by the IMF. As the famous economist John Maynard Keynes noted:

*"Deflation...involves a transference of wealth from the rest of the community to the rentier class and to all holders of titles to money; just as inflation involves the opposite. In particular it involves a transference from all borrowers, that is to say from traders, manufacturers, and farmers, to lenders, from the active to the inactive."<sup>5</sup>*

Today, instead of the gold standard, 'dollarisation' prevails, under which poor countries have their interest rates determined by a few remote and unaccountable individuals at the United States Federal Reserve. The price of their currency is fixed by the fluctuating value of the US dollar, over which they have no control. In this way vital economic levers are removed from nation states and transferred to unaccountable institutions in the US.

Today's dollarisation and deflationary economic policies favour international bankers, creditors and investors; helping to transfer and uphold the value of assets and investments in these countries just as they did in the 1920s. But they deprive states of control over key economic levers. The result has been periodic economic and political crises, such as swept through Southeast Asia and Russia in the late 1990s, and as recently witnessed in Argentina.

Around the world – and not just in poor countries - democratically elected governments are punished by capital markets if they fail to act in the interest of international creditors and investors. As a result, states and governments are once again, as in the 1920s, losing the right to policy autonomy; to control over key levers of the economy; and are obliged to implement deflationary policies.

The consequences are everywhere to be seen: levels of poverty, unemployment, inequality and environmental degradation that, in global terms, eclipse the statistics of the 1920s, 1930s and 1940s. Just as in the 1920s, it is these deteriorating conditions that are fuelling global insecurity.

Free market ideologues have succeeded in weakening well-intentioned institutions like the UN and the Red Cross; as well as undermining the capacity of states and governments to provide a secure social, economic and political climate for their citizens. They have made politics and politicians look distasteful and self-serving. They have denigrated the diversion of resources to human development, as 'wasteful' and 'inefficient'. They argue that only the price mechanism can determine the ultimate value of a good, public or otherwise.

Gerhard Schroeder's recent decision to defy the European Union's stability pact and exceed the target for budget deficits so as to pay unemployment and pension benefits would have been viewed by leaders in 1944 as a reasonable, accountable and democratic response to a long-term external shock (re-unification) and to an economic downturn. Given Germany's history, they would have applauded the democratic instincts of Chancellor Schroeder.

But in a world more reminiscent of 1924 than 1944, Schroeder's defiance of the bankers and international capital markets – and his government's accountability to the electorate, is treated sceptically. How long, ask the commentators, will his government's defiance last, in the face of financial dealers determined to attack the Euro and re-assert the rights of money markets over the human and democratic rights of the German people?

### **Economics for human dignity**

Meeting human needs is the basis for the Millennium Development Goals set out at the United Nations Development Summit in September 2000. The goals present a broad consensus on which needs are universal (see box overleaf). In convening the Financing for Development Conference, the United Nations has taken a significant step towards striving to meet these goals. The FfD initiative is attempting to bridge the gulf between the intentions of those who designed the post-war world economic order; and the reality of today's economic order. It is also looking to close the gulf that has grown up between the international institutions.

In Monterrey, UN officials, supported by a few far-sighted world leaders, will call for increased aid for the poor; and will attempt to consciously integrate policies on debt, aid, trade and finance. In the context of so-called 'free' markets in trade and finance; declining aid levels and increased militarisation, those will be important challenges to the dominant worldview.

However, while edging forward at Monterrey, the UN cannot be expected to overturn the dominance of the worldview that currently

holds sway. This will take the mobilisation and spread of new ideas; a new mindset to replace the existing ideology. For, as Whitney Griswold once argued, "the only sure weapon against bad ideas is better ideas".<sup>6</sup>

That is what this report from the New Economics Foundation provides. In the following pages, we lay out a range of ideas for tackling human insecurity, economic instability and environmental vulnerability, which go beyond the confines of the current neo-liberal paradigm. We hope that these ideas will begin the long process of transforming the global economy into one in which market relations are once again embedded in social, political and environmental relations. In sum; a global economy in which peace, stability and human development once again take priority over the interests of 'impersonal' and unregulated capital markets.

### *The Millennium Development Goals*

1. Eradicate extreme poverty and hunger
  - Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day
  - Halve, between 1990 and 2015, the proportion of people who suffer from hunger
2. Achieve Universal Primary Education
  - Ensure that, by 2015, children everywhere, girls and boys alike, will be able to complete a full course of primary schooling
3. Promote gender equality and empower women
  - Eliminate the gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015
4. Reduce child mortality
  - Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate
5. Improve maternal health
  - Reduce by three quarters, between 1990 and 2015, the maternal mortality ratio
6. Combat HIV/AIDS, malaria and other diseases
  - a. Have halted, and begun to reverse, the spread of HIV/AIDS
  - b. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases
7. Ensure Environmental Stability
  - a. Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources
  - b. Halve by 2015, the proportion of people without sustainable access to safe drinking water
  - c. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers
8. Develop a Global Partnership for Development

# PART I – Switching off the vacuum cleaner

## Reform of global finance and the need for domestic resource mobilisation

'Finance' and 'Development' are terms that should sit easily together. It seems self-evident that poor countries need investment in order to grow, and that subsistence incomes and low levels of savings severely limit the scope for investment to come from domestic sources. It is an unquestioned tenet of macro-economic theory that foreign investment brings the capital, skills, technology and employment needed to stimulate economic development.

This interpretation conveniently fits with the demands of global capital and its rich country owners. Investors seek ever-higher returns, beyond those that can be expected from the established industries of the 'developed' world. According to the neo-classical model of the global economy, investment flows from the capital rich North to the capital poor South, increasing the returns for Northern investors while making financial resources available where they are most needed. Where poor countries cannot attract sufficient private capital, development aid is injected into the gap, until the country is 'developed' enough for private foreign investors to step in.

This theoretical worldview does not, unfortunately, correspond with the reality faced by poor countries. After three decades of foreign borrowing, dozens of countries in the South are still crippled by debt service payments. Rapid capital account liberalisation in 'emerging markets' has led to crises in Mexico, Thailand, Malaysia, Indonesia, Brazil and Russia. Argentina is the latest victim, and the country has become virtually ungovernable after defaulting on \$150 billion of external debt last December.

The reality, therefore, is that global capital markets operate like a metaphorical vacuum, operated by the financial institutions of the North. Capital can flow from North to South, but as soon as it does so, the vacuum cleaner switches on, greedily sucking it back. The vacuum is so powerful that some capital is pulled back almost before it leaves – for example, when aid money is used to pay off multilateral loans or for procurement in the donor country. Even when capital reaches the South and is – at least in theory – used for productive expenditures, the force of the Hoover is strong. Bank loans must be repaid at usurious interest rates, bilateral and multilateral loans serviced, profits on FDI channelled back to the investor's country of origin.

The power of the metaphorical Hoover is such that even the domestic resources of Southern countries are extracted, through capital flight. In Argentina, total Capital Flight has been estimated at \$130 billion – almost equal to her total public debt<sup>7</sup>. Capital flight from the heavily indebted poor countries of Sub-Saharan Africa constitutes nearly half of the estimated external resource requirements of these countries<sup>8</sup>.

Equally important is the extent to which the resources generated are encouraged (or even allowed) to circulate within the local economy. A weak local economy is like a leaky bucket, allowing resources to drain away. Poor countries need to find ways of plugging those leaks; for example, by encouraging local procurement and employment, and strengthening linkages with other parts of the domestic economy to create a 'multiplier effect'.

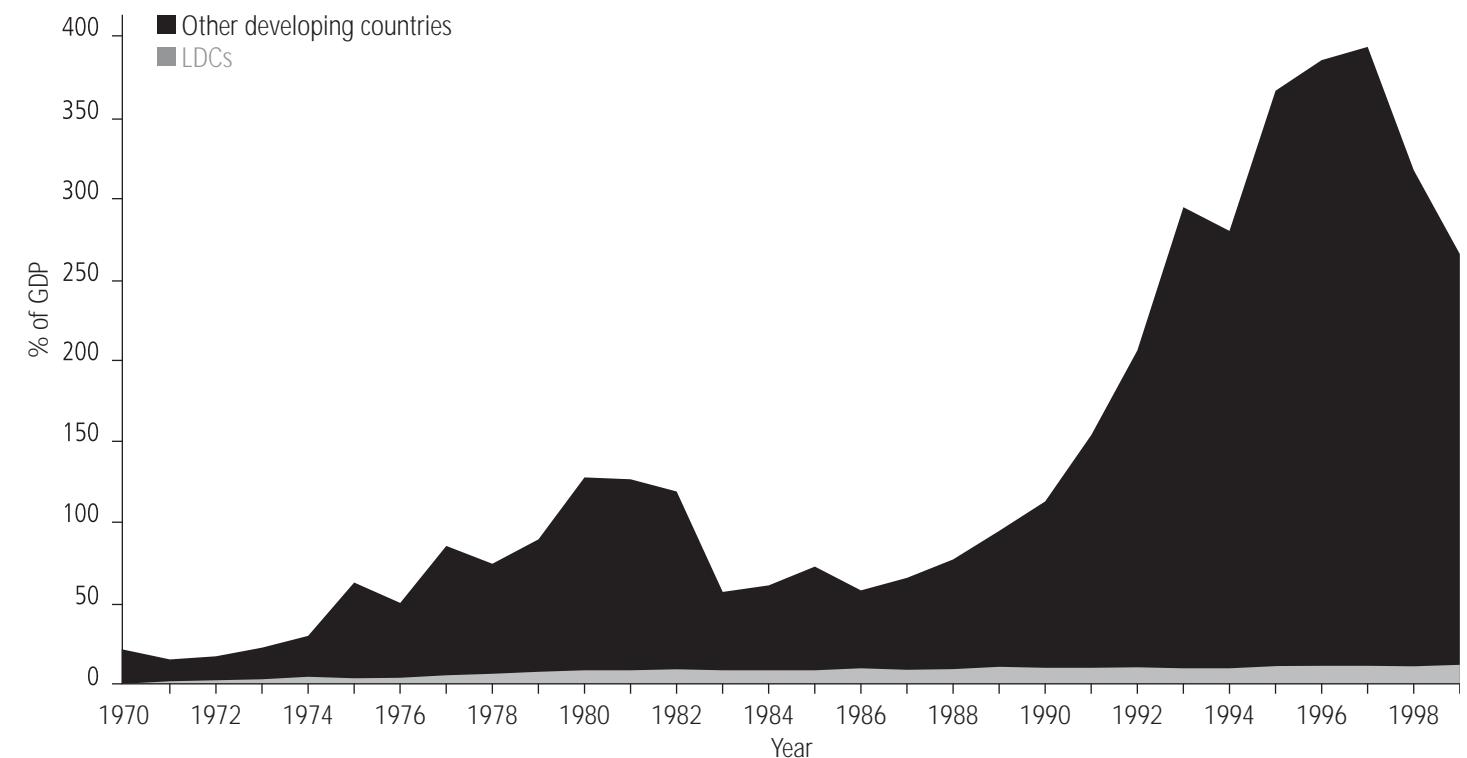
By focusing on only the inflows of foreign capital into Southern countries, the Financing for Development process is therefore only seeing part of the process. Here, our aim is to analyse inflows, outflows and the multiplier effects of foreign capital. We finish by arguing that countries need to increase their reliance on *domestic* forms of capital mobilisation and on plugging the leaks within their own economies to minimise the holes through which capital can leak out.

### Increasing Inflows – not enough to promote development

If the Millennium Development Goals (MDGs) are to be met, there is a need for substantial increases in aid to poor countries. Yet aid flows are in long-term decline, and only a handful of the OECD countries are even close to achieving the UN target of 0.7 per cent of GDP. A recent report by Jubilee Research at NEF showed that even with total debt cancellation, meeting the MDGs in the Highly Indebted Poor Countries (HIPC) alone would require an additional \$48 billion in aid.<sup>9</sup> But disappointingly, under pressure from the United States, the Draft Consensus for the Financing for Development Conference provides no firm commitments in this area.

The Financing for Development Conference also calls for increases in private capital flows to developing countries. At the moment, private capital flows to the world's poorest nations are in long-term decline. Of all foreign direct investment into developing countries, only 1.4 per cent is captured by the LDCs, down from 3.6 per cent two decades ago.<sup>10</sup> But even for those countries able to access private capital, rapid deregulation since the early 1970s has led to unexpected and destructive financial crises. Private capital is clearly not a panacea. Developing countries are either locked out of global capital markets, or are subject to large and volatile inflows and outflows, financial crises, and panics.

### Total capital flows to LDCs and other developing countries, 1970 – 1999



### Switching off the vacuum cleaner

In order to control the relentless flow of resources from South to North, the Hoover must be switched off. This means that reckless lending and borrowing must be brought under democratic control, through a combination of debt cancellation and an international bankruptcy procedure. We also need measures to control capital flows themselves – through a Tobin Tax, and increased use of capital control mechanisms.

### Debt cancellation under an international insolvency process

Successive debt relief initiatives on the part of creditor governments have failed. The latest of these, the Heavily Indebted Poor Countries (HIPC) initiative, is no exception. At the end of 2001 – a full year after the Millennium deadline set by the Jubilee 2000 campaign, and five years after the initiative was launched – only four heavily indebted nations had successfully passed through all the hoops of the HIPC initiative. Moreover, even when relief is provided, research by Jubilee Plus<sup>11</sup> has shown that debt burdens remain unsustainable.<sup>12</sup>

Debt service payments reroute badly needed financial resources out of the poorest regions on earth. In 1999, payments from 39 of the most heavily indebted countries stood at \$8.6 billion, almost double their combined spending on education.<sup>13</sup> According to recent findings by Jubilee Research at NEF, debt service payments are severely undermining the ability of the HICPs to meet the Millennium Development Goals. Meeting these goals will require total debt cancellation plus substantial increases in aid.<sup>14</sup>

Substantial debt cancellation, including 100 per cent of the debts of the poorest countries under an independent, transparent and just insolvency framework, is therefore a priority. While the IMF has proposed an alternative "Sovereign Debt Restructuring Mechanism" (SDRM), this plan falls down on several fronts. It would give greater power to the IMF, would not be overseen by a neutral judge, would give the IMF power to impose its own deflationary economic policies as a condition for entry into the Mechanism and would exclude the IMF's own debt from the debt restructuring process.<sup>15</sup>

"For those countries that saw dramatic growth in incomes between 1960 and 1995, domestic investment was almost entirely financed from domestic savings from about 1970 onwards."

We believe that the framework proposed by NEF, dubbed the Jubilee Framework would go much further towards introducing justice and democracy to international economic relations. The NEF Jubilee Framework, which includes the debts of both public and private creditors, would operate under the following guiding principles:

- **Accountability:** Resolving debt crises in a fair and equitable manner is clearly impossible when creditor governments and institutions act as judge, jury and plaintiff in their own cause. As the debt to be re-structured is public, not private, it is vital that the public within *debtor* nations are involved in the resolution of the crisis.
- **Transparency:** Citizens of the debtor nation must have access to publicly available information about the debt, and about those responsible, in order to hold decision-makers to account.
- **Democratic governance:** Citizens within debtor nations must be empowered to design economic, social and political conditionalities that would meet their fundamental human rights. Public surveillance of democratically determined conditions is the best way to discipline borrowers and lenders, and prevent a recurrence of debt crises.
- **Independence:** Any process or framework for a resolution of the crisis should be independent of both creditors and sovereign debtor. We propose that an ad-hoc court be appointed, along the lines of the arbitration courts that currently resolve territorial disputes between nations; and between corporations and states.

#### • Equal treatment of all creditors

#### Democratising capital flows – domestic and international regulation

Sovereign nations should be able to impose controls in order to retain foreign capital within a country and prevent capital flight. In fact, many of the countries that have enjoyed the most sustained economic growth over recent years have done just that. China, for example, has been one of the highest performing 'globalisers' of the last two decades, according to a recent World Bank study.<sup>16</sup> Yet China retains full control over capital by having an inconvertible currency, and as a result managed to escape the Asian crisis that toppled several of her neighbours.<sup>17</sup>

At the international level, there is also the need to support an international tax on currency transactions. Such a tax, first proposed by Nobel-prize winning economist James Tobin in the 1970s,<sup>18</sup> would put

'sand in the wheels of international finance'<sup>19</sup> and so reduce exchange rate volatility caused by sudden and unpredictable inflows and outflows of short term capital, or 'hot money.' In this way, the 'Tobin Tax' would make exchange rates more reflective of long run fundamentals rather than of short-term expectations and risk.<sup>20</sup>

#### Plugging the leaks – making foreign finance work harder

There is little point in countries taking in foreign investment unless the resources generated will circulate within the domestic economy. Of course, it is not always possible to determine which forms of foreign finance will leak most. This depends on the form that FDI will take, the use of aid and the stability of portfolio flows. Our point here is simply that governments must be able to make choices about the kind of foreign finance to accept, and be empowered to reject any foreign investment which does not have a minimum multiplier effect.

Using a set of techniques generated through our work with local communities in the UK, NEF is developing tools to enable poor countries to evaluate the quality of FDI in terms of its economic multiplier impact. Ultimately, we would like to see criteria applied such that if FDI is perceived to be below a certain quality threshold in terms of economic impact, the host country could be empowered, through changes to existing legislation, to re-negotiate or ultimately reject such investment. Using this approach, countries would be able to present qualitative and quantitative data that shows when FDI is not Foreign Direct Investment, but Foreign Direct Extraction.

Foreign aid is especially prone to leak away. All too often it is used to promote the exports of the host country rather than improving the lives of the poor. In Australia, a major selling point for aid to taxpayers is that 80 per cent of the aid budget is spent inside Australia. In Djibouti, following the 1997 peace agreement, a reconstruction project was introduced to repair a bombed district of the capital. A French construction firm managed the project, importing most of the construction materials from abroad. The impact on the local economy, according to the ILO, was "absolutely zero."<sup>21</sup>

In order to 'plug' the leaky aid budgets, procurement must be localised and there must be greater use of local staff in place of expatriates. To this effect, recent moves by the UK and other major bilateral donors to 'untie' aid from procurement are welcome, and other donors should follow suit as a matter of urgency. The move towards budget support on the part of many donors should also go a long way towards reducing aid leakages.

#### The alternative – generating local finance for local development needs

*I sympathise, therefore, with those who would minimise, rather than with those who would maximise, economic entanglement between nations. Ideas, knowledge, art, hospitality, travel – these are the things which should of their nature be international. But let goods be homespun, whenever it is reasonably and conveniently possible; and above all, let finance be primarily national'*  
J.M.Keynes<sup>22</sup>

Standard models of economic development assume that poor countries have limited capacity to save, and should therefore rely on foreign borrowing to finance their investment needs. In the dominant discourse, the more open developing countries are to foreign finance, the better. Countries that aim to promote self-reliant development for local needs are condemned by development practitioners as autarkic, 'backward' states condemned to poverty and exclusion from the modern, 'globalising' economy.

But the evidence does not support this discourse. Consider the three graphs below. All three show average domestic savings and investment rates as a percentage of GDP for different groups of developing countries between 1960 and 1995. The first group are the exceptionally high performing countries, with real gains in per capita income of between 250 per cent and 700 per cent over the period. Next are the relatively poor performers, with total growth of between 4 and 50 per cent. Finally, we have the shocking group of 17 countries that have seen a *fall* in per capita incomes, in real terms, since 1960.

The graphs present an interesting picture. As we would expect, investment rates are higher for the countries that have seen the largest increases in per capita incomes over the period. But the most dramatic difference between the three groups of nations is in the relationship between *domestic savings* and *domestic investment*. For those countries that saw dramatic growth in incomes between 1960 and 1995, domestic investment was almost entirely financed from domestic savings from about 1970 onwards.<sup>23</sup> In the stagnant countries the gap between savings and investment widens in the late 1970s and 1980s and remains more or less constant up to the mid 1990s. The most dramatic trend can be seen in the negative growth countries, which see falling savings rates as from the early 1970s, reaching almost to zero by the early 1990s.

Of course, it can be argued that the trends in savings and investment are a consequence, rather than a cause, of the underlying growth trends – i.e. that countries which are growing a lot tend to save more

through higher incomes, and vice versa. But even if this were the case, we would still expect investment to be much more strongly related to growth than savings – while in fact, the converse appears to be true.

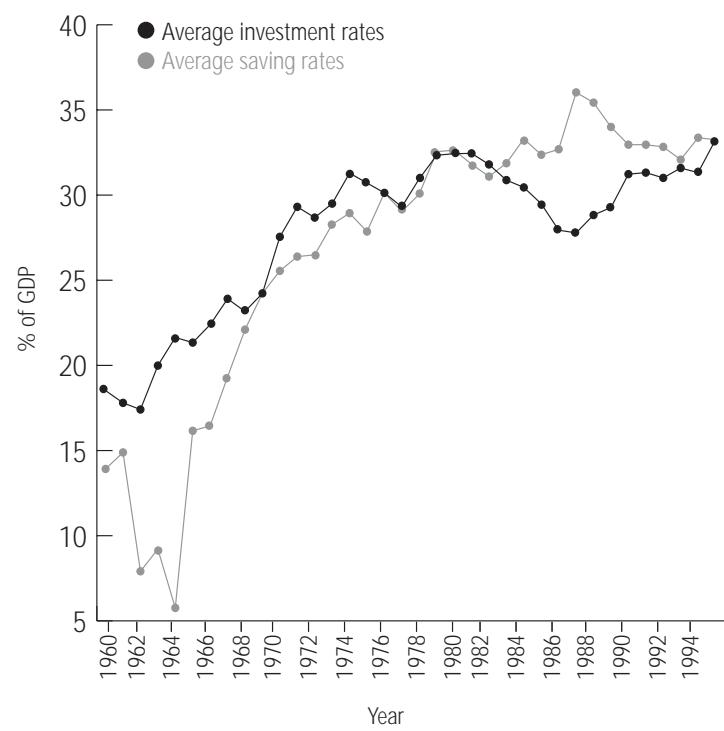
The renowned Harvard economist Dani Rodrik has said that "the critical factor [in growth transformations] is a set of targeted policy interventions that kindle the animal spirits of *domestic* investors."<sup>24</sup> Developing countries need to promote *domestic* sources of finance that can be used to meet local needs. Domestic finances are not immune to the force of the vacuum cleaner as the potential for capital flight remains. But if the local economy is strong, and capital controls are in place, domestic resources can have a much stronger local multiplier effect than foreign sources of finance.

All the grand statements of the UN bodies will come to nothing unless the fundamental trends operating within global finance are addressed. Put simply, the metaphorical vacuum cleaner needs to be switched off, and those standing guard over its power supply brought within democratic control. Without such changes – and without a shift towards domestic resource mobilisation within the developing world – 'development' will remain a chimera, and the millions who live in senseless poverty around the globe will continue to suffer.

## Part II – Taming the Bull?

### Making private capital work for developing countries

**Trends in savings and investment, exceptionally high growth countries, 1960 – 1995**



**Trends in savings and investment for stagnant countries, 1960 – 1995**



**Trends in savings and investment for negative growth countries, 1960 – 1995**



Investment per se does not guarantee that people and the environment benefit. Foreign investment is like a bull in a china shop. It can inadvertently leave broken systems in its wake: crushing, rather than strengthening the economies on which it lands. The problem is that investment's strings are pulled by self centred forces behind the scenes, rather than by the people whose lives will be affected on the ground.

The Toreador in Spain has a red cloth to tame and manage the bull's behaviour, but the international financial system has none. Everything is left to chance. Indeed, the international community relies on the good faith of the 'bull' to contain his temper and consider his impact on others.

Can we expect the bull to behave? It's unlikely. The incentives that make foreign investment work for developed economies don't necessarily work in the fragile economies of very poor countries. Profit-seeking motives have a tendency to reward investors above all. Most of those emanate from the North, and pay scant regard to the people who help deliver their riches.

Yet the United Nations' Finance for Development initiative focuses on both Foreign Direct Investment (FDI) and portfolio-based investments as a means to achieving long-term, sustainable development. It is like inviting the Bull into the china shop. FDI inflows to developing countries reached £240 billion in 2000, and have been overtaking grants as a source of finance in the past decade. In 1990, grants were 16 per cent higher than FDI flows; in 1999, they were 84 per cent lower.

The argument favoured by the mainstream development community is that foreign investment will bring job creation; much needed capital and technology transfer. This process leads, it is argued, to higher incomes amongst the middle classes, enabling them to buy more goods and services and thus spurring greater levels of employment and eventually income growth in other parts of the economy. The result? Reduced poverty, economic success and wealth creation. So the theory goes.

FDI in 2000, however for the 49 LDCs remained marginal at best, attracting only 0.3 per cent of world FDI inflows. The African share overall fell below the 1 per cent mark, while even middle-income regions, such as Latin America, attracted a smaller share, falling by a startling 22 per cent during 2000. These numbers precede any consideration of recent downturns in the global economy.

Consistent with the assumption that FDI will lead to the most progressive change, are the policies emerging from the multilateral agency and government partners involved in the FFD process, aimed at

promoting 'sound investment climates' and protecting the rights of international investors and shareholders. There is little consideration given to the way in which investment is delivered, or to measuring the true social, environmental and economic impacts of FDI on a wider group of stakeholders, including employees, communities and suppliers.

Investment, in and of itself, cannot guarantee positive impacts on development and the well-being of communities. While there are instances where the presence of a multinational has provided economic and social benefits to a local community, recent evidence has also shown some patchy results. From the high-impact extractive industries, to the garment sector, corporate leaders have, with few exceptions, yet to demonstrate a willingness to be concerned with their wider impacts. The FFD agenda has failed to take us any further in this regard.

#### FDI and the local multiplier effect

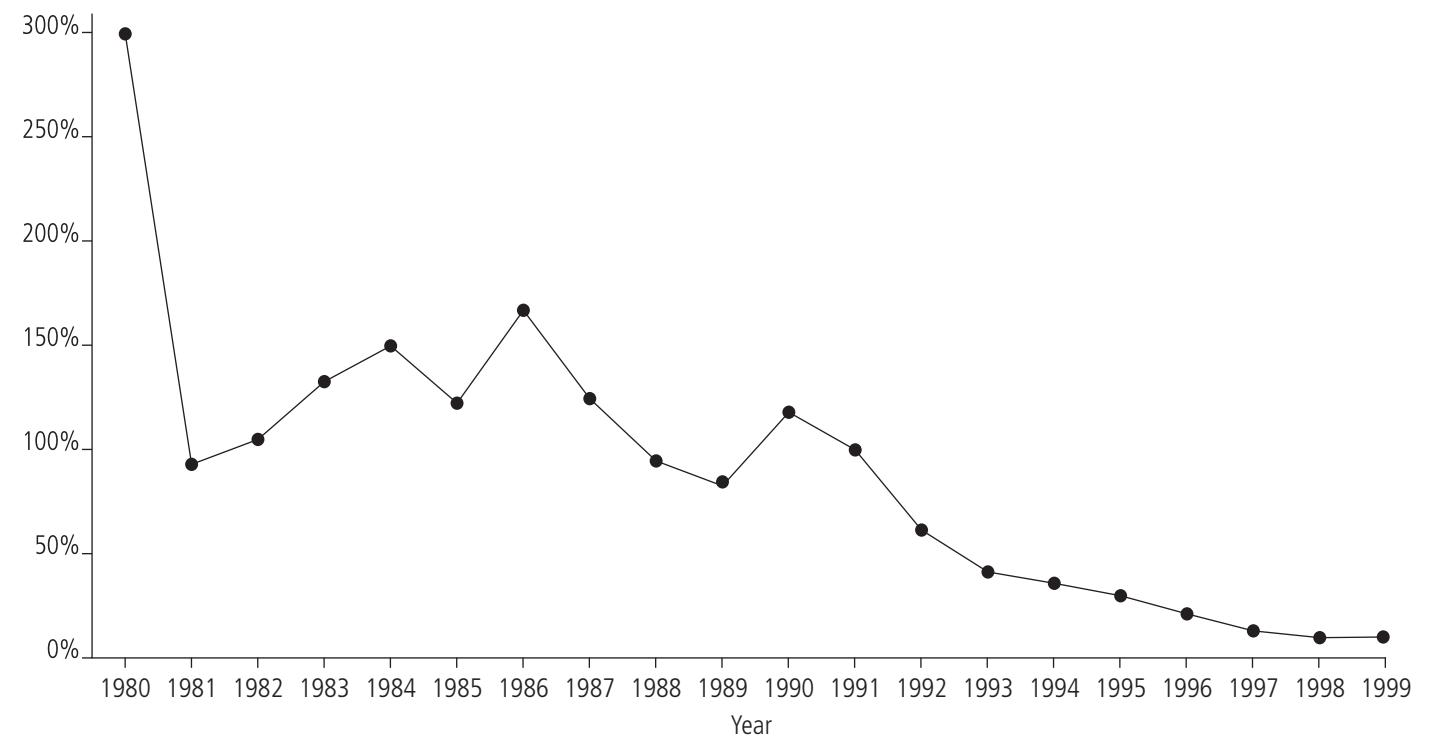
Most multilateral development institutions hold a false assumption that all FDI is good. By referring to macro-level economic studies rather than looking at the local picture, they are able to argue freely that all FDI contributes to development. The World Bank's proposed Private Sector Development Strategy makes no distinction between FDI that might extract resources from a local economy (mining and minerals, for example) vs. those that contribute more proactively to its development (i.e. knowledge based sector, such as IT). Most of the financial benefits of foreign investment accrue in the North, where the majority of MNEs are based, rather than the host region.

The UNCTAD World Investment Report 2001 *Promoting Linkages* argues that "a key factor determining the benefits host countries can derive from FDI are the linkages that foreign affiliates strike with domestically owned firms... whatever the current level of backward linkages, linkages can be increased or deepened further, with a view towards strengthening the capabilities and competitiveness of domestic firms." UNCTAD has proposed a series of strategies to enable FDI to promote linkages and gives many examples of how this has been successfully achieved. However, such proposals only tend to get more widely taken up if they are adopted by host countries and this requires clear monitoring criteria.

UNCTAD has provided a set of indicators that can be used to assess the quality of the backward linkages FDI creates in a host community. These indicators are useful, but they will not give an overall picture of the quality of an investment. An additional tool is needed to enable host countries to monitor how effective FDI is at linking with host firms. As discussed in Part I, private foreign investors should be required to

"Fine words and noble intentions are easy to write (and a delight to market), but monitoring, transparency and compliance are more painful and entail more far-reaching changes to corporate cultures and practices than most companies are prepared to countenance." <sup>25</sup>

Grants as a percentage of FDI, 1980 – 1999, all developing countries



measure the local economic impacts they have on a community; not only in terms of direct employment provision, but how they engage with local suppliers and generate a 'multiplier effect' in the community.

#### The weaknesses of voluntary codes and standards for 'corporate responsibility'

A plethora of voluntary codes and standards dot the map of the corporate responsibility landscape, from the OECD Guidelines on Multinational Enterprise to the UN Global Compact and the Global Reporting Initiative (GRI). Corporations and policymakers continue to endorse this less-than-firm approach, relying on the goodwill of companies to consider their external impacts; or the socially responsible investment (SRI) community to drive a risk-based management approach on behalf of shareholders. The European Union Green Paper on CSR advocated the continued promotion of voluntary standards, while the World Economic Forum in January 2002 reaffirmed the corporate sector's commitment to a vague notion of 'corporate citizenship', a principle reiterated in the FFD documentation (clause 23).

But this approach is fraught with weaknesses, putting unreasonable responsibility on the shoulder of corporations to perform what is the legitimate and necessary role of governments. As most MNEs are based in rich industrialised nations, it is particularly important for these countries to ensure that their companies operate to the highest standards across the world.

The voluntary approach to corporate responsibility has largely failed, and responsible investment will not occur without the appropriate institutional framework in place. There is an urgent requirement for governments to take leadership and provide a regulatory framework that will enable companies to behave responsibly.

The weaknesses of the voluntary approach to CSR can be summed up under four key headings: lack of enforcement mechanisms; competing standards and codes; lack of incentives; and limited stakeholder rights.

#### Lack of enforcement mechanisms

While international codes are promoting a range of bilateral and multilateral standards for corporate responsibility, they neglect to couple these with any viable means of enforcement. The UN Global Compact gives companies its seal of CSR approval by simply asking them to submit two case studies demonstrating how they have followed the Compact guidelines, without any monitoring or enforcement regime. The OECD Guidelines on Multinational Enterprise, the strongest of the global codes, provides for a National Contact Point that facilitates challenges but goes no further. Although two governments, the Netherlands and Finland, have responded to civil society critiques by linking the guidelines to export credit guarantee legislation, most efforts are vehemently fought by the majority of OECD members.<sup>26</sup>

Many of these codes allow companies to simply acknowledge that they agree to operate within the rule of law in all countries, thus mitigating any need for stronger international legal mechanisms to oversee corporate behaviour.<sup>27</sup> But even in countries with strong government, we see frequent violations of environmental and labour standards. It is extremely optimistic, therefore, to expect countries with limited capacity to provide adequate enforcement of the laws to uphold corporate responsibility. Furthermore, the financial power of MNCs means that business ultimately has the upper hand over the state. Companies regularly take advantage of poor working conditions and weak environmental standards where there is no legal pressure to do otherwise. At the national or regional level, states are forced to ensure that any form of regulation does not reduce 'competitive advantage.' Through corporate lobbying capacity, the state role is now limited to promoting safe investment climates and reducing any burden on business to generate wealth.<sup>28</sup>

Within this context, corporate citizenship, *i.e.* the voluntary adoption of approaches beyond legal requirements, seems a naive ideal.

#### Competing standards and codes

With the myriad of standards and codes now available, it is no wonder that business doesn't know how best to respond to the challenge of corporate responsibility. The market-driven approach has resulted in the proliferation of everything from the ISO standards (dealing with environmental management) to social labels, such as Fair Trade, to more basic codes such as the Global Sullivan Principles that offer loose commitments with regards to corporate behaviour. Other codes have been developed in such a way as to capitalise on corporate confusion, making a profit through their uptake.

The Global Reporting Initiative is close to providing a universal reporting standard that would go a considerable way towards ending the confusion surrounding expectations of transparency. Without transparency standards, companies can choose what information to include and what to exclude; making it virtually impossible for consumers, civil society or others to compare and benchmark information within a given sector. But at the same time, reporting itself remains voluntary, and it is unlikely that the situation will improve without some additional pressure. The SRI community has enabled more companies to provide information on their social and environmental impacts, but many of the companies who have high impacts in developing country regions, such as the extractive industries, are excluded from SRI funds entirely.

#### Opportunities for "corporate spin" and selective application

The 'business case for corporate responsibility' is the most commonly proffered argument by advocates of the voluntary approach to CSR. Arguing that the practice of corporate responsibility will mitigate risk for companies may be accurate. But risk for the company does not equate to positive development for a community. A recent observation by an ex-BP consultant was that stakeholder dialogue, a common tool of the CSR practitioner, was "a very subtle and intelligent management technique to evade criticism."

The business case further relies on consumer behaviour to reward corporate best practice. But recent studies in the UK have shown that while the majority of consumers intend to act ethically, few do so in practice due to a lack of information. And ethical businesses that are rewarded tend to be at niche ends of the market, ultimately providing little bearing on MNE activities in developing country economies.<sup>29</sup>

Perhaps the largest myth about the business case is that there are no mechanisms that require companies to pay for 'externalities' – the environment being the most common omission. Thus, to rely on the banner of 'corporate citizenship' to deliver on sustainable development objectives is simply not plausible, without significant guidance and leadership from government.

#### Lack of stakeholder rights

The 'shareholder value' dictate means that business must operate in a way that delivers the most profits for shareholders. We have seen unprecedented growth and returns over the past three decades,

## Part III – A world turned upside down

### Ecological debt, finance and development

generously rewarding those who have invested until now. But demands of the stock market over this period, for year-on-year double-digit growth has meant that business decisions are not necessarily taken in the interests of the long-term sustainability of a company, nor its stakeholders. An exclusive emphasis on the bottom line can have negative implications, both for business and the society in which it is embedded.

The author Roger Cowe argues in favour of a stakeholder-operated company, which puts the needs of communities, staff, customers and the environment on an equal footing with shareholders, thus forcing companies to take their wider responsibilities more seriously.<sup>30</sup> The stakeholder corporation proposal has never been more relevant than for those living in the most marginalised economies, and companies should be required to act in favour of a range of stakeholder group interests – not just shareholders.

When communities are impacted negatively by corporate behaviour, the means by which to challenge them can be insurmountable. Thus far, many governments have been reluctant (indeed cowardly) in enforcing legal liability for the behaviour of companies registered in, but not operating within, their borders – leaving this to foreign governments and/or the market to oversee. Extra-territorial legislation is virtually non-existent, failing to give people the right to sue for bad behaviour. When they attempt to do so, the power of remote corporations means that stakeholders often don't live to see compensation. Litigation is still ongoing on the Union Carbide Bhopal disaster, which took place in 1984. And Union Carbide's recent metamorphosis under the Dow Chemical brand has added a further complication for victims of the disaster.

#### Taming the Bull: making foreign investment work for developing countries

The assumption of business acting 'responsibly' in the countries in which they operate is essentially taken for granted through the FFD process. There is no explicit reference to what corporate citizenship should mean, let alone a stronger commitment on behalf of government to ensure the adequate regulation of investment in these regions that meets the criteria of social and environmental sustainability. This is a missed opportunity, leaving the behaviour of the 'bull' to chance.

The New Economics Foundation has six recommendations that would strengthen foreign investment in developing countries and make it work better for the poor.

**1. Transparency and disclosure.** All companies should be required to report openly on their environmental and social impacts. Companies

operating in developing countries should make this information available in local languages and distribute it widely to the communities in which they operate. Furthermore, the delegations attending the Monterrey conference should adopt the GRI standard as a universal approach to reporting on social, environmental and economic issues.

**2. Strengthening the OECD guidelines on multinational enterprise.** Until there is an adequate international regime to police corporate behaviour, the OECD Guidelines on Multinational Enterprise should be incorporated into national law, as has been done in the Netherlands.

Non-OECD countries should also be encouraged to apply the guidelines. Donor governments could develop a fund that would support implementation, raise awareness amongst civil society stakeholders' and provide support to bring forward challenges under the regime.

**3. Enforcement mechanisms.** For any of the existing 'voluntary' codes, there must at a minimum be a viable means of enforcement. Local civil society groups may provide the most legitimate form of non-binding enforcement and should be given the resources to act as 'civil regulators'. Companies found not to be complying with codes should also face a challenge from their host state, with a threat to revoking their 'license to operate.'

Positive enforcement could also come in the form of tax incentives to help monitoring programmes for labour standards, as well as to enable the involvement of local civil society groups in the monitoring process.

**4. Government loans.** Publicly funded loans to private enterprise operating in developing countries should include basic corporate responsibility criteria before a loan is granted and there should be annual monitoring of social and environmental performance against these criteria.

**5. The stakeholder corporation.** Stakeholders should have some form of representation in the management of a company's social and environmental performance, either through local stakeholder councils, or representation at Board level.

**6. Measuring the local multiplier effect.** Host countries and multilateral institutions should measure the true local economic impact of FDI, through NEF's 'plugging the leaks' tool, to monitor how effective FDI is at making links with host firms and ensuring more money remains within the local economy rather than 'leaking out.'

'How to balance your desires with your needs,' says the advert in a glossy colour magazine. The answer is to spend £18,000 on a very powerful, sleek Italian sports car that also has four doors to make it practical.

If the average person living in Sub Saharan Africa wanted to balance their desires with their needs by purchasing this car, they would have to save their whole lifetime's income, and still borrow nearly another decades worth. In February 2002 life expectancy in the region fell to 43 years, its lowest level since records began. With an average per capita income of £350, saving everything for that car would take over 51 years.

Meeting human needs is the basis for the millennium development goals. The goals present a broad consensus on which needs are universal. But there is a problem discussing needs because the richest and poorest parts of the world speak a different language.

In countries that are the main providers of development finance the millennium development goals are either met or largely met. In these places, the word 'need' usually means meeting desires that are additional to having enough food, clothes, shelter, clean drinking water, education and access to health services.

This is the central irony of the debate on finance for development. As the rich world catastrophically and continually fails to meet its international commitments to finance real human needs, the poor world daily lends its environment to finance 'supersistent' (as opposed to subsistent) livelihoods for the rich.

This happens through the rich occupying disproportionate amounts of finite global environmental space. It is made visible in the flow of natural resources and cheap agricultural products from South to North. Poor countries also pay twice, for example, by bearing the costs of environmental crises like climate change. An accounting system that includes the *real* world turns upside-down the conventional relationship between rich and poor, North and South, creditor and debtor.

#### Ecological finance – a macro-economic framework for the 'real', real world

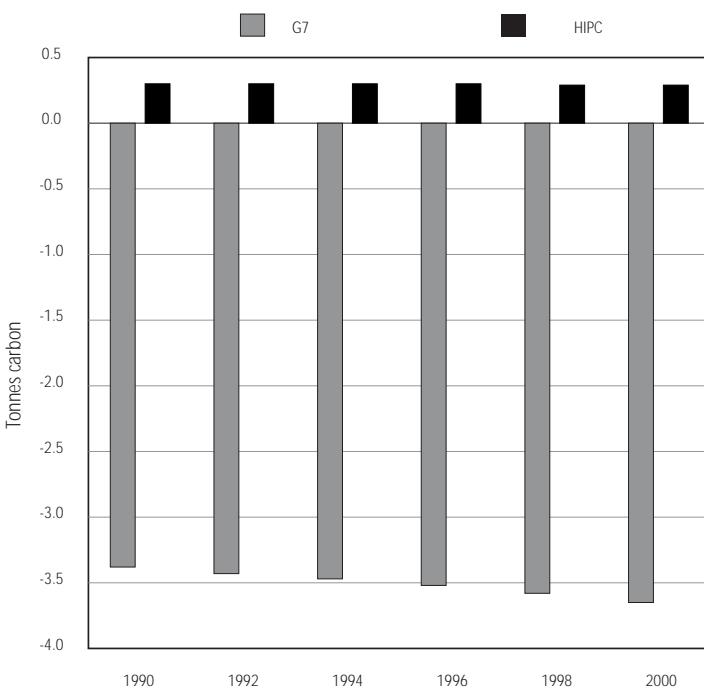
Orthodox economists lecture people about the need to live in the 'real world' of market forces. But there is another world that is more real still. The long-term management of the natural capital of the soil, seas and atmosphere is a pre-condition for all economic and social activity. No planet, no business. The scale of potential damages from climate change – due to the mismanagement of the atmosphere – are so great

that they threaten the end of development. Yet never before have financial markets been so disconnected from environmental realities that guarantee the conditions of life, or so disregarded most people's daily lives.

Perversely, many economic commentators leave the impression that the environment is a luxury, and one to be enjoyed only after the 'economic fundamentals' are correct. NEF argues that a new set of fundamentals must become the focus of economic planning. First among these is the management of our natural capital base. But, the infinite value of nature's life-support services is normally absent from national accounts.

At the Earth Summit in 1992, the Summit's secretariat said implementing Agenda 21 in low-income countries would need an extra \$125 billion per year from rich countries in the form of aid or other concessions. As a target it represents more than double total current aid flows. Official proposals put to the UN Finance for Development event, however, contain no references to environmental issues and their relationship with global finance or the international economy.

**G7 and HIPC nations shown per capita against the IPCC threshold for sustainable consumption of fossil fuels. The HICPs are in credit, while the G7's debit is clear**



(sources: CDIAC, UNFCCC, IPCC, GCI)

"Here is the central irony of the debate on finance for development. As the rich world fails to meet its international commitments to finance real human needs, the poor world daily lends its ecological capital to pay for the creature comforts of the global rich."



#### How to balance your desires with your needs.

From any angle, the services provided by ecosystems are bigger in value and more important than those of the formal economy. However, while precise valuation of what nature does for us is fraught with methodological problems, preliminary estimates are revealing.

One of the first attempts to provide a monetary value estimated the worth of ecosystems at \$33 trillion per year, nearly double global gross national product in the year measured.<sup>31</sup> Water and climate regulation alone were valued at \$4.1 trillion. Flood and storm protection were worth \$1.1 trillion. Coral reefs, which are particularly vulnerable to climate change, provided \$375 billion worth of goods and services. Far more of these environmental services are provided by the land, air space and territorial waters of developing, rather than industrialised, countries.

Take a snapshot of what powers the global economy today. Fossil fuels still provide over 80 per cent of commercial primary energy.<sup>32</sup> Wealth generation and the exploitation of fossil fuels are inextricably linked. Historical records show a hard-wired link between the growth of World Industrial Product and greenhouse gas emissions.

Today the relationship is no longer one-to-one. Yet, generally, for every extra dollar of global product, more greenhouse gasses are pumped into the atmosphere.<sup>33</sup> If we were to peel-off the proportion of the wealth of the Group of Seven industrialised countries that relies on the unsustainable consumption, per person, of fossil fuels it would add up to between \$13-15 trillion per year.<sup>34</sup> For every day that people in the rich world eat up fossil fuels over and above the threshold for sustainable consumption, they accumulate *de facto* an ecological or, more precisely carbon, debt.

In real terms that debt is counted in the accumulation of disruptive greenhouse gasses in the atmosphere. But, it also has a very real economic footprint. Already the economic damage attributable to climate-change-driven natural disasters has been put at over \$300 billion per year. The failure to properly capture costs in poor countries means that figure could easily be doubled.<sup>35</sup>

Using natural resource accounts, very poor countries therefore finance development in the rich world in several ways. They concede their environmental space and the economic opportunities it represents, and bear the environmental costs of development in rich countries through physical damage and the cost of adaptation.

Social upheaval generates still further costs yet to be accounted for. One authoritative study showed at least five small island states at risk due to global warming of ceasing to exist. Sea level rise in the range expected by the Intergovernmental Panel on Climate Change would devastate the Maldives. At the high end of estimates the entire 300,000 population would have to leave. And, as environmental refugees without international legal status, their future will be bleak. On the small South Pacific island of Tuvalu people are already leaving.<sup>36</sup>

Relatively few people live in small island states, although that is scant consolation to those that do. But the problem doesn't stop there. In Bangladesh, 20 million could be displaced, and up to 10 million more could be forced to flee in the Philippines. Millions more are at risk in Cambodia, Thailand, Egypt, China, across Latin America, and the list goes on.

Global financial and environmental instability come together in Indonesia. Following financial crashes there was pressure from the country's creditors to earn hard currency to repay debts. At the same time they were expected to sustainably manage the country's forest resources creating an irreconcilable conflict. And the forest lost. In 2001 the International Forum on Indonesian Development pointed out that Indonesia needed income to service its debts – estimated at between \$150–262 billion. Exporting timber and wood products like plywood and pulp was seen by the government as a good way to do it.<sup>37</sup> As in so many other countries, financial and environmental instability were locked together in a negative spiral.

#### New finance and the scale of the challenge

New sources of finance are being heavily promoted for developing countries in response to the challenges of climate change and sustainable development. But what do they amount to? During the decade since the Earth Summit aid declined in absolute terms on previous trends.<sup>38</sup>

The main conduit of funds dedicated to sustainable development is the Global Environment Facility (GEF) operated jointly by the World Bank, UNEP and UNDP. It administers three new funds under the climate Convention and Kyoto Protocol – a special climate change fund, a least developed countries fund and an adaptation fund. In the year 1999-2000 GEF funding for climate change was \$1.4 billion. Of this, only \$199 million was grant funding the rest was "leveraged through co-financing."<sup>39</sup>

At climate talks in Bonn, July 2001, rich countries made a pledge to provide \$0.4 billion per year by 2005 to help developing countries 'manage their emissions and adapt to climate change.'<sup>40</sup> Yet conservative estimates suggest that the OECD still spends around \$70-80 billion per year on subsidising fossil fuels and fossil fuel-based activities.<sup>41</sup> This figure is strikingly similar to one produced by UNICEF, which recently revealed that effective care for all the world's children between birth and the age of eight would require "a modest additional global expenditure of US \$70-80 billion each year".<sup>42</sup>

Meanwhile, the outstanding unpayable debts of the poorest countries still stand at around \$300 billion and continue to drain their resources even after several years of the international debt relief initiative, HIPC. The position of the indebted poor countries has worsened. One assessment by Jubilee Plus made in July 2001 predicted that all 23 countries qualifying for the HIPC initiative are in danger of their debts becoming 'unsustainable' even after relief.<sup>43</sup>

"The need to cut emissions therefore also creates a new obligation to share out the economic opportunities that go along with the use of fossil fuels."

## Foreign debt versus carbon debt – The HIPC initiative and the Kyoto Protocol

How the international community has managed these two great crises – climate change and poor country debt – shows how confused our priorities are. An old fashioned compare and contrast exercise reveals the bizarre tale of the carbon debt and poor country debt (under the HIPC Initiative).

### • Who pays the price?

**Carbon debt:** The poorest people in the poorest countries suffer overwhelmingly the worst impacts of climate change. By 2025 nearly half of people living in developing countries will be vulnerable to 'hydro-meteorological disasters', otherwise known as floods and storms.<sup>46</sup>

**HIPC debt:** The populations of the poorest countries pay for the debt through their taxes and through the loss of investment in schools and hospitals

### • Who is responsible for the debts?

**Carbon debt:** Historically, the industrialised countries of the rich world are almost entirely responsible for climate change

**HIPC debt:** The debts that weigh heavily on the shoulders of poor people are invariably the consequence of collusion between elites North and South. That said, the scale of outstanding unpayable debt for poor countries is oddly similar to the amount they lost in declining terms of trade in a single decade from the early 1980s.<sup>47</sup>

### • Who controls the process

**Carbon debt:** Rich countries drive the Kyoto Protocol and decide for themselves how much they should do to control climate change

**HIPC debt:** Rich countries and their appointed representatives in the financial institutions drive the HIPC initiative and decide how much poor countries should pay.

### • Are the targets adequate?

**Carbon debt:** The Kyoto Protocol proposes an average 5.2 per cent cut in CO<sub>2</sub> emissions for rich countries against 1995 levels. The scientific consensus is that cuts of 60-80 are necessary. Some, such as the head of UNEP, go further calling for cuts of 90 per cent or more. Britain's Secretary of State Margaret Beckett, said that current US policy could leave their emissions 25 per cent higher in 2010, compared to the 7 per cent cut that the US agreed to in Kyoto.<sup>48</sup>

**HIPC debt:** Notionally, HIPC will write-off around one third of the debts of 23 qualifying countries. Jubilee Research at NEF estimates that 39 of 42 countries need 100 per cent cancellation plus a doubling in aid to reach the millennium development goals.

### • How is stabilisation achieved?

**Carbon debt:** No official proposal in the international negotiations comes close to stabilising climate change

**HIPC debt:** A macro-economic plan that imposes measures for economic stabilisation is a pre-condition to qualifying for conventional debt relief

### • Is adjustment demanded?

**Carbon debt:** US Citizens lead one of the most fossil fuel intensive lifestyles in the world. Yet its administration dismisses as unacceptable any demand to change the American way of life in response to climate change.

**HIPC debt:** Agreeing to fundamental economic adjustment is a pre-condition to qualifying for conventional debt relief.

### • Who designs the stabilisation and adjustment?

**Carbon debt:** For what little there is, the rich countries

**HIPC debt:** Rich countries

### • Is it legal?

**Carbon debt:** Industrialised countries are setting up carbon trading regimes to help implement the Protocol. However, you cannot trade what you do not own. Consequently, before there is an agreed global basis for allocating emissions entitlements, any emissions trading is effectively trading in stolen goods.

**HIPC debt:** The Group of Eight industrialised countries control 49 per cent of votes on the board of the International Monetary Fund, and voting allocations are related to the size of financial contributions. In most electoral democracies paying for votes would be considered a criminal offence.

We stand at a crossroads on the path to financing development. One way leads towards greater human and environmental vulnerability. The other leads towards greater security for all.

Working within the tolerance limits of our natural resources is the ultimate macro-economic framework. Stray beyond those limits, for example in our abuse of the atmosphere, and economies and communities start to fall apart. The debate on Finance for Development is ready for a paradigm shift. Thinking in terms of environmental finance and how to balance our global ecological budget provides the tool for that shift.

The debt crisis has been pivotal in the development debate for many years. A comparison of orthodox foreign debt with carbon debt sheds new light. It exposes the glaring double standards employed by the major economic powers and their international financial institutions in the management of the global economy.

Ecological accounts reveal a world turned upside down. They show a world in which the poor are hugely financing the development of the rich, and the rich give virtually nothing in return. Whole new obligations emerge through the lens of ecological debt. Maintaining the pressure on poor countries to repay orthodox debts becomes untenable. The structural adjustment of rich country economies toward the sustainable use of natural resources becomes an urgent priority. New, substantial, and appropriate resource flows from rich to poor are demanded.

Importantly a new framework for reconciliation of the carbon debt needs to be brought forward. Its legacy can be recognised and dealt with by adopting a forward-looking plan on climate change. Developing countries can argue for a global deal that acknowledges their logical entitlement to equally share the global commons of the atmosphere, and the economic opportunities it represents. Against the historical expansion of greenhouse gas emissions, and divergence between the world's rich and poor, their needs to be a plan for both contraction and convergence.

This requires setting a maximum greenhouse gas concentration target for the atmosphere. After that, all countries can logically claim their right to share the 'emissions pie', achieving per person entitlements that become equal within an agreed period of time. This way, if rich countries want to continue taking up more than their fair share of the world's environmental space they will at least have to pay for the privilege, generating major resources for countries that need them.

Instability is anathema to development, yet it is increasing both financially and environmentally. Choices about the direction of the global economy now need to be seen through a new lens of risk reduction if they are to benefit poor countries. Every choice now needs to be cross-examined for whether it increases or decreases risk and vulnerability. Development that does not balance the ecological books, is not development at all.

# Conclusion

The United Nations represents a visionary goal – the coming together of countries under a single institution to build international peace and stability, and promote social and economic development. The UN potentially symbolises the highest form of global political organisation – one where all nations, large or small, are represented equally, and can represent their citizens' individual and collective long-term interests.

But the UN has fallen short of its ideals. The body fell beneath the wheels of two breakaway institutions, the World Bank and IMF. For the past fifty years, the Bank and the Fund have been the real power brokers of global governance, and have elevated the status of market relations above those of society and the environment. As a result, sovereign nation are at the mercy of global markets, finance and the largest corporations.

Now we must all face a world suffering greater financial, environmental and political instability. Rather than channelling capital into productive activities in those areas where this is most needed, a reckless and unstable global financial system actually extracts capital (both natural and financial) from the poorest regions of the world. This reverse Robin Hood effect is compounded by the global environmental impact of frenetic economic activity, for example in the effects of climate change on poor and vulnerable populations.

Despite its initial promise, the UN's Financing for Development initiative now shows little signs of addressing this gross imbalance. For this reason, NEF believes that we need to re-imagine how terms like 'debt' and 'finance' are conceived. This should be done in light of the UN's Millennium Development Goals of reducing poverty and hunger, improving accessibility and effectiveness of health care and education, and ensuring environmental stability.

Individually, some of the ideas we advocate in this report may be familiar. However, when placed together, they form a logical sequence of proposals that collectively seek to reign in the power of footloose capital and bring markets into line with human development needs. To summarise, these include:

- A new insolvency process, in which debtor nations are involved in the resolution of the crisis and ordinary citizens can hold decision-makers to account.
- Increased democratic governance over aid and investment, including public surveillance of democratically determined conditions.

# References

<sup>1</sup> Stockholm International Peace Research Institute. See [http://projects.sipri.se/milex/mex\\_trends.html](http://projects.sipri.se/milex/mex_trends.html)

<sup>2</sup> "The cost of the war on terrorism and the cost of social security" by Dean Baker, at the Center for Economic and Policy Research, February, 2002. [www.cepr.net](http://www.cepr.net)

<sup>3</sup> G. K. Chesterton *The Scandal of Father Brown* (1935)

<sup>4</sup> For a detailed analysis of the Bretton Woods agreement, see Eric Helleiner 'States and the re-emergence of international financial markets'.

<sup>5</sup> From: A Tract on Monetary Reform, chapter IV, "Alternative Aims in Monetary Policy" (1923) published in Essays in Persuasion, Macmillan, 1972, page 166.

<sup>6</sup> The New York Times, Feb. 24, 1959.

<sup>7</sup> See Jubilee Plus Press Release, 14th January 2002 [www.jubileeplus.org/media/argentina\\_debt140102.htm](http://www.jubileeplus.org/media/argentina_debt140102.htm)

<sup>8</sup> Ajayi, (1997) and Amoako and Ali (1998), cited in Randidriamaro, Z (2000) 'Mobilising Domestic Financial Resources for Development' Third World Network Africa.

<sup>9</sup> 'The Unbreakable Link – Debt Relief and the Millennium Development Goals' by Jubilee Research at NEF, February 2002

<sup>10</sup> Source: UNCTAD, quoted in 'World Disasters Report 2001 Chapter 2.'

<sup>11</sup> Jubilee Plus is the former name for Jubilee Research at NEF.

<sup>12</sup> 'Flogging a Dead Process' Jubilee Plus Report September 2001.

<sup>13</sup> The Unbreakable Link: Debt Relief and the Millennium Development Goals. Report by Jubilee Research at NEF, February 2002

<sup>14</sup> The Unbreakable Link op.cit.

<sup>15</sup> For a detailed critique of the Sovereign Debt Restructuring Mechanism (SDRM), see 'Chapter 9/11? Resolving international debt crises – the Jubilee Framework for international insolvency' Report by Jubilee Research at NEF, January 2002

<sup>16</sup> 'Globalisation, Growth and Poverty' World Bank Policy Research Report, December 2001

<sup>17</sup> Henderson, H (1999) 'Beyond Globalisation: Shaping a Sustainable Global Economy'

<sup>18</sup> James Tobin, 'A proposal for international monetary reform' Eastern Economic Journal, 4, 1972

<sup>19</sup> Barry Eichengreen and Charles Wyplosz, Chapter 1 The Tobin Tax: Coping with Financial Volatility (ed. Mahbub ul Haq, Inge Kaul and Isabelle Grunberg.)

<sup>20</sup> 'The Robin Hood Tax' by New Economics Foundation and War on Want, 2001.

<sup>21</sup> World Disasters Report 2001, Chapter 2: The Ecology of Disaster Recovery by Andrew Simms

<sup>22</sup> The Collected Writing of John Maynard Keynes, vol 21. Edited by Donald Moggeridge. London: Macmillan Cambridge University Press

<sup>23</sup> The unstable trends in the high performing countries in the 1960s are most probably related to security issues in the South East Asian region during that period.

<sup>24</sup> Rodrik, D (2000) 'Global Trade as if Development Really Mattered.'

<sup>25</sup> Brett Parris, Foreign Direct Investment and Corporate Codes of Conduct in National Development Strategies: Costs, Benefits and Policy Options. OECD, November 2001

<sup>26</sup> Summary Report of the Chair of the meeting on the Activities of National Contact Points, 21 September 2001, OECD, Paris "While many NCPs underscored the desirability of coherence between the Guidelines and other policies, some were also concerned that such linkages, if not carefully designed, could undermine the voluntary nature of the Guidelines and break the thread of trust connecting the business community to the Guidelines process.

<sup>27</sup> See Competing Codes and Standards.

<sup>28</sup> The Bush Campaign received over \$13 million dollars from Exxon – not long after the election, Bush dropped the US commitment to the Kyoto protocol.

<sup>29</sup> Co-operative Bank, Who are the Ethical Consumers, October 2000 and Taking Flight: The rise of ethical consumer, New Economics Foundation, October 2001.

<sup>30</sup> Stakes not Shares: Curbing the power of the corporations, New Economics Foundation, 2000

<sup>31</sup> World Resources Institute, adapted from R. Costanza et al, "The value of the World's Ecosystem Services and Natural Capital," *Nature* Vol 387.

<sup>32</sup> International Atomic Energy Authority at [www.iaea.or.at](http://www.iaea.or.at)

<sup>33</sup> The poorest indebted countries are two times more efficient than the richest in turning fossil fuels into national product, kilogram for dollar. (ref: op cit *Who Owes Who?*)

<sup>34</sup> Christian Aid, *Who owes who? Climate change, debt equity and survival*, London 1999.

<sup>35</sup> International Federation of Red Cross and Red Crescent Societies, *World Disasters Report 2001*, Geneva.

<sup>36</sup> International Federation of Red Cross and Red Crescent Societies, *World Disasters Report 2002*, Geneva. (forthcoming, Geneva, 2002)

<sup>37</sup> *Down to Earth* No 49, May 2001. On [www.gn.apc.org/dte/](http://www.gn.apc.org/dte/)

<sup>38</sup> UNICEF, *The Progress of Nations*, July 2000.

<sup>39</sup> Overall, up to \$1,900 Billion a year are spent, of which, according to Norman Myers, about \$1,450 billion are perverse in environmental and/or social terms. Norman Myers: *Perverse Subsidies: Tax Dollars Undercutting Our Economics and Environment Alike* ISD, Winnipeg, Canada, 1998. Also papers from an IEA and UNEP Workshop, at [www.iea.org/workshop/sustain/challenge.htm](http://www.iea.org/workshop/sustain/challenge.htm)

<sup>40</sup> Andre de Moor & van Beers, *Subsidies and Climate Change*. Natural Resources Forum, May 2001.

<sup>41</sup> See Andre de Moor and Peter Calami, *Subsidizing Unsustainable Development: Undermining the Earth with Public Funds*. Institute for Research on Public Expenditure/Earth Council, 1997.

<sup>42</sup> OECD DAC (2000) *Development Cooperation 1999 Report*.

<sup>43</sup> UNFCCC, *Issues in the negotiating process – Financial Mechanism*.

<sup>44</sup> UNFCCC, *Bonn decisions promise to speed action on climate change*; 27 July 2001.

<sup>45</sup> Jubilee Plus (New Economics Foundation) "HIPC – flogging a dead process: the need for a new, independent and just debt workout for the poorest countries", July 2001.

<sup>46</sup> See International Federation of Red Cross and Red Crescent Societies (1999 & 2000) *World Disasters Report*.

<sup>47</sup> See *Paradigm Lost: critical voices on globalisation and the big hole in finances for development*, New Economics Foundation, 2000.

<sup>48</sup> US climate change plan does not alter UK's commitment to Kyoto, Statement by Rt Hon Margaret Beckett MP, 19 February 2002. ([www.Defra.gov.uk](http://www.Defra.gov.uk))

# Additional reading from the New Economics Foundation

---

**HIPC** – flogging a dead process

**It Takes Two to Tango** – creditor co-responsibility for Argentina's crisis

**Chapter 9/11** – the Jubilee Framework for international insolvency

**It's Democracy Stupid** – the trouble with the global economy

**Collision Course** – free trade's free ride on the global climate

**An Environmental War Economy** – the lessons of ecological debt and climate change

**Stakes not Shares** – curbing the power of the corporations

**Corporate Spin** – the troubled teenage years of social reporting



**Financing sustainable development suffers  
the whims of global investors.**

**Corporate capital can't work without new  
rules and better behaviour.**



**And, without balancing the ecological  
books, there will be no development at all.**



This report is written by  
Deborah Doane – Head of Corporate Accountability,  
Romilly Greenhill - Economist,  
Julian Oram – Senior Researcher,  
Ann Pettifor – Director of the Centre for International Finance  
and Governance,  
Andrew Simms – Policy Director  
Thanks to  
Jessica Bridges-Palmer, Noemi Emery, Sarah Foster, Bernie Ward  
Design – bwa

**The New Economics Foundation (NEF)**

NEF works to construct a new economy centred on people and the environment. Founded in 1986, it is now one of Britain's most creative and effective independent think tanks, combining research, policy, training and practical action. Now the UK home of the international Jubilee debt campaign, NEF has a wide programme of work on economic globalisation ranging from corporate accountability to climate change.

New Economics Foundation Cinnamon House, 6-8 Cole Street,  
London, SE1 4YH, United Kingdom,  
Tel: ++ 44 (0)20 7089 2800 Fax: ++ 44 (0)20 7407 6473  
[www.neweconomics.org](http://www.neweconomics.org)  
Registered charity number 1055254

March 2002

ISBN 1 899407 47 2