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## ECPRS Report # 2

# Hype or Reality: Can the CDM trigger FDI?

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## Hype or Reality: Can the CDM trigger FDI?<sup>1</sup>

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### Summary & Conclusions

Inherent in the CDM concept was the expectation that the Clean Development Mechanism might broaden the traditional economic determinants of foreign direct investment flows. Such an additional investment opportunity would act as an economic driver and direct Foreign Direct Investment (FDI) towards environmentally supportive investments and subsequently would expand access to new markets for climate-friendly technologies or services.

It is generally accepted that the CDM has underperformed and that this situation is likely to continue. Problems identified are related to CDM governance, its objectives, the eligibility of projects, or the functioning of emissions markets. It is hoped that once these issues are settled, the CDM could live up to its expectations to direct FDI towards greener technologies.

This report analyses the relation between Foreign Direct Investment and the CDM. It describes various CDM transaction types, provides current CDM project data, presents general FDI flows presented to main destinations of FDI and finally examines the possible links between FDI and CDM potential.

The author of this report however cautions against over-simplification and concludes that CDM financial flows are not correlated with FDI flows at present and that ways to make CDM more attractive to trans-national companies would deserve further exploration. Further research is needed to determine how developing country entities can attract CDM investment or enhance their ability to export CERs. This will require more detailed analysis of:

- the sources of demand (countries; government vs. private; sectors and their CDM preferences),
- the dynamics of evolving carbon markets,
- the different CDM transaction models (equity investment in CDM projects vs. *ex ante* CER purchase agreements vs. secondary market CER trades), and
- the national determinants of CDM financial flows.

Discussion of this paper should identify policy implications and recommendations.

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<sup>1</sup> This article is part of ECPRS's policy analysis aiming to identify a strategy to improve the functioning of the CDM. Concretely, this paper will focus on the potential link between FDI and CDM and whether FDI and CDM could be made more synergistic in order to strengthen the current CDM. ECPRS paper # 1 on the state of the CDM describes all major initiatives that have been launched recently and lists both the diagnosis and the prescriptions that have been put forward.

<sup>2</sup> This article is based on a recent publication titled "Exploring the relationship between FDI flows and CDM potential" (April 2005), Transnational Corporations (UNCTAD, Geneva), pp 1-45 by Anne Arquit and the author. Raymond Saner is co-founder of the Centre for Socio-Eco-Nomic Development (CSEND) in Geneva ([saner@csend.org](mailto:saner@csend.org)).

## 1. Generic CDM transaction types

The following analysis is based on an understanding of CDM as a bilateral undertaking between a host country (developing country) and an investor country (industrialised country). Recent literature have brought to the foreground possibilities of unilateral CDM (Jahn, Michaelowa, Raubenheimer & Liptow, 2004; Laseur, 2005). While the potential for unilateral CDM exists, no unilateral CDM based credits have been sold so far (IETA/CF, 2005: 22) and hence unilateral CDM is not part of this paper's scope.

The financial contribution of industrialised country entities (e.g., governments, private companies, market intermediaries) to CDM projects can take a number of forms. The basic CDM transaction models from the perspective of the Annex I (developed country) entity are:

- Investment in CDM projects: equity investment, i.e., direct via joint venture companies/wholly owned subsidiaries or indirect (portfolio) investments via purchase of securities. Such equity based investment provide equity for co-financing of projects that generate CER credits (investor receives profit/ROI<sup>3</sup> and CERs).
- Purchase of yet-to-be-generated CERs: forward contract (e.g., in the form of a carbon purchase agreement) or call option to purchase a specified amount of CERs generated by a CDM project upon delivery, perhaps with some up-front payment;
- CER trade in secondary markets: spot or options transactions in existing CERs.

At present, the most common form of transaction is forward contracts to purchase CERs (Lecocq and Capoor, 2003: 18), which limits the risk to the buyer. And – contrary to initial expectations – governments and hybrid entities (e.g., public-private partnerships, such as the funds offered by the World Bank's Carbon Finance practice), rather than private entities, have been the main buyers. In 2002-03, the Government of the Netherlands accounted for 30% and the World Bank Prototype Carbon Fund for 26%<sup>4</sup> of the project-based emission reduction market in volume terms (Lecocq and Capoor, 2003: 12). These two points are important to keep in mind when exploring the relationship between foreign direct investment and CDM flows.

From the perspective of an Annex I country entity, cross-border sourcing of greenhouse gas emission reductions can take two basic forms: arms-length trade (CER imports) and direct production of CERs through FDI (or other forms of equity investment) in CDM projects. Under the prevailing CER forward purchase (trade) model, transactions will likely be governed by traditional factors of comparative trade advantage, such as initial endowments (in particular, capital and labour). In addition, countries' initial endowments of cheap greenhouse gas emission reduction potentials will be an important factor. The relationship between international trade flows and potential CDM flows is not the subject of this report, but would warrant further consideration, given the prevalence of CDM transactions in the form of CER trade.

## 2. The wishful scenario

Inherent in the CDM concept was the expectation that the Clean Development Mechanism might broaden the traditional economic determinants of foreign direct investment flows, as multinational companies (MNC) perceive new CDM-related business opportunities, such as the production of Certified Emission Reductions by foreign affiliates and their subsequent internal use or sale. The assumption here being that production of CERs would also give the subsidiary or affiliate of a MNC a competitive advantage (e.g. energy efficiency improvements). On the other

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<sup>3</sup> Rate on Investment

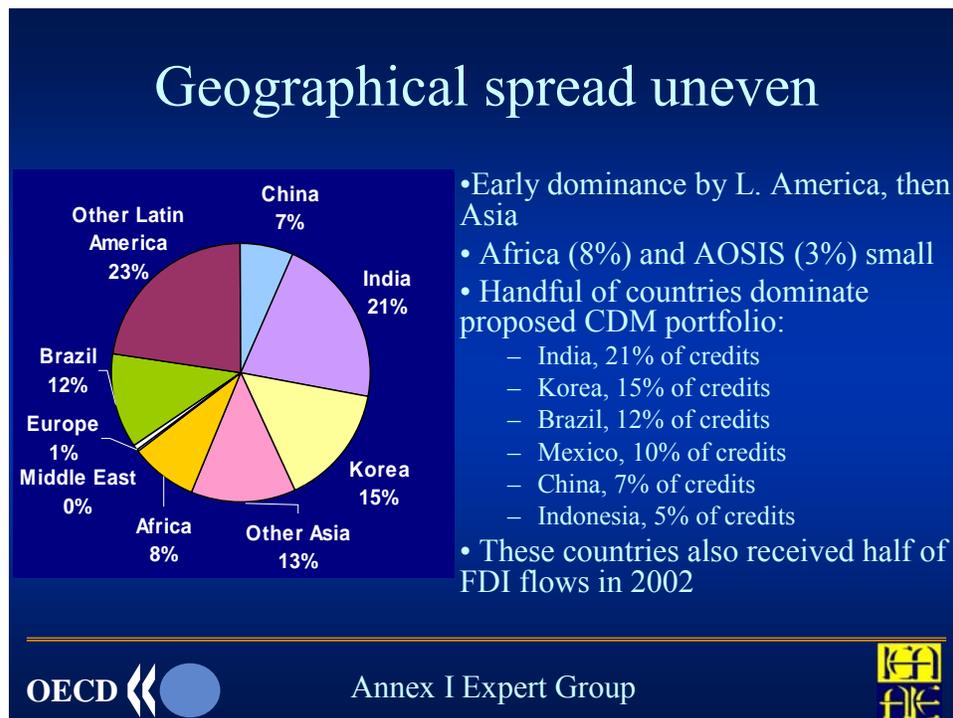
<sup>4</sup> [Figures to be updated]

hand, such an additional investment opportunity might act as an economic driver and direct FDI towards environmentally supportive investments, such as access to new markets for climate-friendly technologies or services.

### 3. The current realities

The CDM Portfolio update presented by Jane Ellis of the OECD at the 2005 SB-meetings in Bonn offers causes for optimism and pessimism alike. On the positive side, CDM projects have increased to 5 registered CDM projects, 8 others are requested for registration by the CDM Executive Board of which 3 are under review and 110 CDM projects are under validation which could generate 16.9 Mt Co2-eq.<sup>5</sup>

Looking at the geographical spread, the picture is uneven with some developing countries dominating the CDM portfolio (see Figure 1 below).

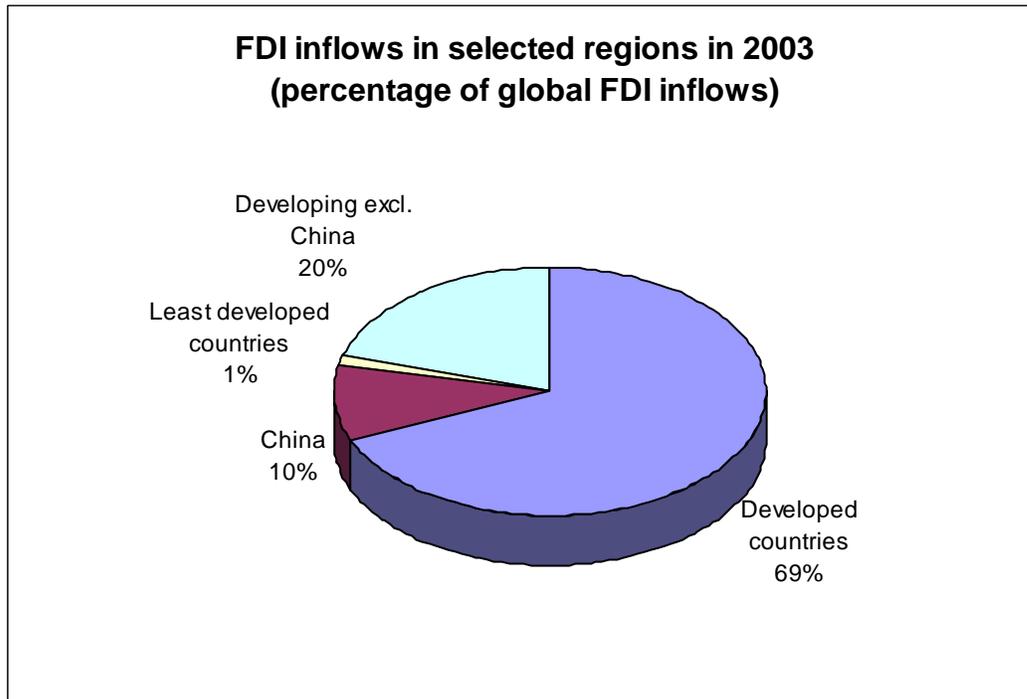


The main reasons that have been reported to cause such slowness are for instance barriers to greater CDM investment projects such as financial and institutional risk and uncertainty associated with delays in approving CDM project activities and methodologies or lack of sufficient capacity building in host countries to train validators (Ellis et al., 2004). While all these barriers are important with regard to getting CDM projects of the ground, the focus of this paper remains on the larger interaction issue of how FDI/CDM flows to developing countries.

Despite the slowly increasing investment flows into CDM opportunities, one should not forget that the main FDI flows do not go to CDM projects nor to developing countries. For the year 2003, by far the greatest recipients of FDI are the developed countries (69%), followed by developing countries without China (20%) then China (10%) and lastly the least developed countries (1%).

<sup>5</sup> See <http://www.oecd.org/env/cc>

Figure 2:



Source: Taffere Tesfachew & Karl P. Sauvant (2005)

The "big 3" non-OECD developing countries from a greenhouse gas emissions perspective are China, India and Brazil (see Table 1). According to a recent analysis of project-based pre-Kyoto compliance transactions (planned CDM and JI projects), 36 host countries entered into such contracts in 2003, with nearly two-thirds of transacted volumes hosted by Latin American countries, approximately 30% by Asian countries (including 10 projects in India) and less than 5% by countries in Sub-Saharan Africa (Lecocq and Capoor, 2003). The trend appears to be towards deals with large economies (e.g., India) or middle income countries (e.g., Brazil), and the role of China is therefore expected to increase from its current low level.

*Table 1. Emissions and FDI Data for Host Countries with Significant CDM Potential*

| Country           | Population 2000 (millions / % of world total) | Net GHG Emissions 2000 (Mt CO <sub>2</sub> e) | Emissions per Capita Ranking 2000 | Inward FDI 2002 (US\$ billion) | Inward FDI as a Fraction of Gross Fixed Capital Formation 2002 (%) | FDI Performance Index Ranking 1999-2001 <sup>o</sup> |
|-------------------|---|---|-----------------------------------|--------------------------------|--|--|
| China             | 1262 / 20.8                                   | 1356*   | 97                                | 52.7                           | 10.5   | 59   |
| Hong Kong (China) | incl. above                                   | incl. above                                   | incl. above                       | 13.7                           | 35.2   | 3  |
| India             | 1016 / 16.8                                   | 506*  | 140                               | 3.4                            | 3.2 <sup>□</sup>   | 120  |
| Brazil            | 170 / 2.8                                     | 230*  | 85                                | 16.6                           | 19.6   | 37   |

<sup>o</sup> The Index is an ordinal ranking of 140 economies, with the rank of 1 representing the economy with the best

\* First National Communication under the UNFCCC with official Government inventory data not yet available.

<sup>□</sup> Data for 2001.

Sources: Net GHG Emissions/Emissions per Capita, Climate Analysis Indicators Tool (CAIT) Version 1.5 (Washington, DC: World Resources Institute, 2003, available at: <http://cait.wri.org>); Inward FDI 2002, UNCTAD (2003: 249-252); Inward FDI as Fraction of Gross Fixed Capital Formation, UNCTAD (2003: 267-77); FDI Performance Index, UNCTAD (2003: 193-195).

#### **4. Overview of relevant FDI drivers and flows**

For CDM transactions that do involve private equity investment, FDI might serve as a useful, albeit incomplete, indicator of potential CDM flows (Fankhauser and Lavric, 2003). UNCTAD defines foreign direct investment<sup>6</sup> as "an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy in an enterprise resident in an economy other than that of the foreign direct investor" (UNCTAD, 2003a: 31). Although a minimally enabling FDI regulatory framework is a prerequisite for FDI, and business facilitation efforts can help attract investors, economic factors are the main determinants of FDI inflows and reflect the primary motivations of transnational corporations (TNCs, see first two columns of Table 2).

<sup>6</sup> In addition to non-equity forms of investment, FDI has three components: equity capital, reinvested earnings and intra-company loan or debt transactions (UNCTAD, 2003a: 31-32). The extent to which each of these components might be linked to CDM transactions may have been considered by individual MNCs with anticipated carbon liabilities, but this has not been the subject of academic analysis to date.

*Table 2. Traditional and Potential CDM-Related Determinants of FDI Inflows*

| TNC Motive              | Selected Economic Determinants   | Additional CDM Drivers   | CDM relevance to TNCs  |
|-------------------------|--|--|--|
| Market-Seeking          | <ul style="list-style-type: none"> <li>• per capita income</li> <li>• market size</li> <li>• market growth</li> <li>• access to regional / global markets</li> </ul> | New/expanded markets for: <ul style="list-style-type: none"> <li>• climate friendly technologies in developing countries</li> <li>• CDM-related services</li> </ul>                              | <ul style="list-style-type: none"> <li>• TNC technology providers</li> <li>• TNC providers of CDM-related services (e.g., consulting, brokerage, certification)</li> </ul> |
| Resource/Asset-Seeking  | <ul style="list-style-type: none"> <li>• access to labour</li> <li>• access to raw materials</li> <li>• adequate infrastructure</li> </ul>                           | <ul style="list-style-type: none"> <li>• access to greenhouse gas reductions (CERs)</li> </ul>   | <ul style="list-style-type: none"> <li>• TNC emitters of greenhouse gases in regulated markets</li> <li>• Market intermediaries</li> </ul>                                 |
| Efficiency-Seeking      | <ul style="list-style-type: none"> <li>• differential comparative advantages</li> <li>• better deployment of global resources</li> </ul>                             | <ul style="list-style-type: none"> <li>• low-cost greenhouse gas reductions via CDM projects</li> <li>• investment in foreign affiliate technology upgrades compensated with CERs</li> </ul>     | <ul style="list-style-type: none"> <li>• TNCs emitters of greenhouse gases in regulated markets</li> <li>• TNCs without home country greenhouse gas liabilities</li> </ul> |
| Strategic Asset-Seeking | <ul style="list-style-type: none"> <li>• access to new competitive advantages</li> </ul>   | Access to complementary CDM assets possessed by foreign-based firms, e.g.: <ul style="list-style-type: none"> <li>• resources,</li> <li>• expertise/capabilities,</li> <li>• markets.</li> </ul> | <ul style="list-style-type: none"> <li>• TNC providers of CDM-related services (e.g., consulting, brokerage, certification)</li> <li>• Market intermediaries</li> </ul>    |

Source: Columns 1-2, UNCTAD (1998: 91), except Row 4, Dunning and McKaig-Berliner (2002: 8-9); Columns 3-4, this analysis.

The Kyoto mechanisms provide opportunities to technology providers to expand their market for state-of-the-art energy-efficient and climate-friendly technologies to developing countries, which, without CDM financing, may not be commercially viable in a developing country context. Yet a business model that would involve the direct engagement of such companies in Kyoto-motivated FDI transactions (e.g., up-front capital investment, loans or rebates in exchange for CERs generated using company technologies) has not received much attention to date<sup>7</sup>. Finally, TNCs that provide CDM-related services, such as legal services (advice on CDM contractual arrangements), CDM project validation and certification services, strategic consulting services (e.g., assessing potential CDM options/assets), or capacity building services have engaged in strategic asset seeking FDI (merger and acquisition activity or strategic alliances, see Table 2) to gain new competitive advantages.

In addition to these direct economic determinants, CDM-related motivations for FDI transactions might also include maintaining a positive public image and the license to operate in host countries of foreign affiliates by contributing to local sustainable development<sup>8</sup>; gaining a better understanding of company carbon liabilities, in-house mitigation potential/costs and CDM benefits; gaining experience to be in a position to influence policy; or management of corporate social responsibility obligations and related risks.

<sup>7</sup> Innovative approach proposed by Loayza F. and Kägi W (2001)

<sup>8</sup> For example of MNC investment in local economies see Saner, R. Yiu, L., Sondergaard, M. (2000), « Business diplomacy management : a core competency for global companies », *Academy of Management Executive*, Vol. 14, No.1, February 2000, pp. 80-92

## 5. Relationship between FDI flows and CDM potential

Research has confirmed that foreign investors for the most part do not simply avoid countries without rule-based governance systems (Li, 2004) and with a high pervasiveness and arbitrariness of corruption (Doh et al., 2003). Instead, they invest with different strategies: in poor governance environments, they tend to engage in foreign direct investment (rather than portfolio investment) in the form of joint ventures with local partners, which provides them with the greatest management control and thus better protection. Yet there seems to be a threshold of corruption beyond which FDI becomes relatively unattractive; this applies to countries such as India, Indonesia or Russia, that exhibit both a high pervasiveness and arbitrariness of corruption. In such settings, entry modes that allow investors to transfer ownership (build-own-transfer, non-equity forms of FDI such as management contracts) are more attractive and prevalent than equity FDI (Doh et al., 2003), which explains the low ranking of such countries with respect to the UNCTAD Inward FDI Performance Index (Russian Federation: 108, India: 120, Indonesia: 138, out of 140 economies ranked). Given the large scope for low-cost greenhouse gas reductions and the prevalence of non-FDI entry modalities in these countries, FDI, therefore, might not be a reliable indicator of potential Kyoto mechanism investment flows<sup>9</sup>.

Another difficulty in considering the relationship between FDI and potential CDM flows is that FDI is defined at the level of enterprises, whereas the CDM is a project-based activity. More research would be needed to determine under what conditions equity investments in foreign affiliates might be channelled into eligible CDM projects or why such FDI is or is not a good proxy for CDM project investment. In other words, investment in a company is not the same thing as investment in an individual climate change mitigation project. This is particularly true for FDI that flows to the service sector, which tends to have relatively low greenhouse gas intensity. In fact, 55-60% of FDI flows to developing countries from 1999-2001 went to the tertiary sector (UNCTAD, 2003a: 192), which may not correspond to the sectors with the highest potential for CDM investment. Further work might compare the greenhouse gas reduction potentials by sector of developing countries with their overall FDI performance and the distribution of inward FDI by sector.

From a global perspective, current trends in FDI flows give some indication of the preferences of capital. One element in common with the CDM is the quality of the general business environment<sup>10</sup>. FDI flows do not necessarily reflect CDM market potential, for a number of reasons:

- CDM demand comes from both governments and the private sector, which might have different motivations and preferences. And private sector demand is not all associated with TNCs that operate in developing markets.
- Conversely, not all TNCs have an interest in Kyoto compliance instruments such as CERs from CDM projects and therefore might not have a compelling incentive to make the required additional investment in climate mitigation.
- CDM transactions are predominantly in the form of CER trade, rather than equity investment in CDM projects, and not all equity investment in CDM projects will be in the form of FDI.
- FDI might flow to sectors/economies that do not represent large CDM potential and *vice versa*. India, for example, is expected to be a major supplier of CERs, but its inward FDI is low and non-equity FDI mainly flows to the telecom, IT and business services sectors, which do not have substantial CDM potential.

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<sup>9</sup> In an analysis of 13 economies in transition, an inverse relationship between the scope for JI and the general business environment was found (Fankhauser and Lavric, 2003).

<sup>10</sup> For further information on this topic, see Heller & Shukla (2003)

- FDI flows to companies do not guarantee investments in climate change mitigation efforts that meet CDM criteria, although technologies that are transferred to developing countries in connection with FDI generally tend to be more modern and environmentally "cleaner" than what is locally available (OECD, 2002).
- The necessary institutional prerequisites, specialized capacity and incentives to facilitate CDM investments and keep transaction costs low might be lacking in potential CDM host countries.

## **6. Overall investment climate and CDM considerations**

It is not obvious that the overall investment climate is a good proxy for the more specific CDM investment climate. Among FDI front-runners, a number of Latin American countries, such as Costa Rica, Chile or Mexico, have taken the initiative to promote CDM activities and have attracted a greater share of fledgling CDM transfers than the FDI giant China. The reason for this is that the Latin American countries have invested in the necessary domestic CDM capacity (e.g., CDM awareness and training programs, analysis of CDM potential, facilitation of project identification) and are committed to efficient institutional arrangements to promote and process CDM projects, which keeps transaction costs low. China on the other hand has only recently established the necessary institutional prerequisites for CDM.

Furthermore, contractual arrangements can minimize any country risk associated with CDM deals, assuming that these are in the form of carbon purchase agreements. India, for example, which remains an "FDI underachiever", has been the most active country in terms of submissions of projects for validation under the CDM. The projects have mostly been small-scale renewable projects, with the exception of some large, non-CO<sub>2</sub> projects. As mentioned in Section 2.2, unilateral CDM, implemented without the involvement of entities from a third party, is one way that countries with a poor investment climate are hoping to take advantage of the Kyoto mechanisms, although it remains unclear whether the CDM Executive Board will endorse the approach.

## **7. Implications of FDI flows for CDM additionality**

Technologies that are transferred to developing countries in connection with FDI generally tend to be more modern and environmentally friendly than what is locally available, perhaps lowering the business-as-usual emissions baseline. It has been shown that a significant fraction of TNCs self-regulate environmental aspects of their activities (e.g., OECD Guidelines for Multinational Enterprises, IFC Equator Principles, company policies), which is perceived to have a strong positive influence on the environmental performance of foreign affiliates; in fact, 30% of Asian foreign affiliates of TNCs involved in a recent study claim that foreign affiliates operate according to home country standards (Hansen, 2003). The International Finance Corporation – the private sector lending arm of the Bretton Woods Institutions – has detected a "huge interest in sustainability issues, coupled with the demand for innovative solutions" (Woicke, 2004). The typically better environmental performance of TNC investments might make it more difficult to demonstrate the additionality of climate protection projects in sectors/enterprises that attract a lot of FDI, although investment barriers are not the only ones conceivable, and it may be more expensive for TNCs to make additional CDM investments in their own plants. On the other hand, many companies have been surprised at the amount of no regret mitigation potential they have uncovered.

## **8. Rural Societies: Ignored by FDI, courted by CDM?**

In reviewing the available literature on determinants of inward FDI at the national level, Kumar (1996: 8-9) concluded that low income, agrarian economies with relatively poor availability of infrastructure have limited scope of attracting FDI inflows, regardless of whether their policies

are trade-friendly (e.g., liberalisation of trade policy regimes, investment incentives, protection of intellectual property rights). This conclusion is consistent with declining shares of low income countries in South Asia and Sub Saharan Africa in global FDI inflows, despite liberalization of trade and investment regimes (see figure 2). FDI flows have remained very modest, compared with other regions, such as Asia and Latin America, and multinational enterprises have not made as significant a contribution as elsewhere. According to the OECD (2003), FDI has been largely limited to investments in petroleum and other natural resources, and the TNCs have focused their activities on areas where returns are high enough to offset perceived risks of investing. In such cases, it might be difficult to argue convincingly that modest additional CDM financing is required to make a project commercially viable, but it is still conceivable that the CDM could help to overcome non-financial barriers to implementing some climate mitigation projects.

The backbone of the African private sector at present, however, is micro, small and medium-scale enterprises that often operate in the informal economy, yet most trade and investment promotion institutions do not reach them and channels for financial intermediation are ill-adapted to their needs (OECD, 2003). Efforts to attract more diverse FDI projects must go hand in hand with developing clusters of enterprises and sub-contracting or vendor programs to better link these enterprises to those operating in the modern economy. Similar efforts are needed to promote the development of carbon sequestration and small-scale rural energy supply or efficiency projects that are expected to be particularly important for CDM in many African countries. The World Bank's new Community Development Carbon Fund specifically targets small-scale projects in Least Developed Countries and the poorer regions of other developing countries. To date, large hydropower and waste-to-energy projects that involve methane emission reductions have attracted the greatest CDM investor interest (CDM Watch, 2004).

## **9. Implications and need for further research**

This paper suggests that the simplistic assumption that CDM financial flows will be correlated closely with FDI flows may not hold and warrants further analysis. More importantly, however, further research is needed to determine how developing country entities can attract CDM investment or enhance their ability to export CERs. This will require more detailed analysis of:

- the sources of demand (countries; government vs. private; sectors and their CDM preferences),
- the dynamics of evolving carbon markets,
- the different CDM transaction models (equity investment in CDM projects vs. *ex ante* CER purchase agreements vs. secondary market CER trades), and
- the national determinants of CDM financial flows,
- the possible links between trade flows, FDI and CDM

Transnational corporations should investigate their potential carbon liabilities and CDM opportunities to consider if and how they can take advantage of emerging carbon markets to enhance their bottom line, while contributing to the protection of the global climate system and the sustainable development of CDM host countries. The CDM will not offer the same incentives to all companies, but could be particularly attractive to companies operating in regulated markets, such as the EU, or which produce climate-friendly advanced technologies or have significant low-cost greenhouse gas reduction potential in their foreign affiliates. CDM host countries, in turn, should assess the linkages between trade, investment and environmental issues (OECD, 2001) and consider how they can leverage CDM financial flows in support of their development priorities.

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