



Greening the International Financial Institutions (IFIs):

Finance for the next decade's
sustainable development

**Kirk Herbertson, World Resources Institute
For Stakeholder Forum**



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INTRODUCTION

In April 2010, diplomats from developing and developed countries gathered in a board room at the World Bank in Washington, DC. They voted unanimously, with five countries abstaining in silent protest, to approve a \$3.75 billion loan to South Africa to build one of the world's largest coal-fired power plants. The project was seen as a necessary emergency response to South Africa's electricity crisis that began two years earlier. Outside the World Bank, in meeting rooms on several continents, activists gathered to rethink their next steps after a year of campaigning against one of the most potentially destructive development projects in recent history.¹

Throughout the world, journalists and policymakers argued over whether it is more important to promote economic development or prevent climate change. The project's supporters argued that environmentalists were being anti-development, and that the power plant would bolster South Africa's economy and create jobs.² The project's opponents—climate change activists and local community leaders—argued that the project would triple the greenhouse gas emissions of South Africa's energy sector, contribute to South Africa's water scarcity crisis, and impose heavy costs on some of the country's most impoverished people.³ They argued that the water and land surrounding the power plant and its 40 coal mines would become heavily polluted. Nevertheless, the project is going forward, and the campaign against it continues.

In 2012, when government leaders gather in Rio de Janeiro, they will announce a new declaration that sets ambitious goals for achieving sustainable development. Whatever goals are agreed, the declaration will require large amounts of financing to implement. Where this financing comes from and how it is used will become important institutional questions. The international financial institutions (IFIs)—such as the World Bank—will play a key role in financing the new sustainable development agenda. Yet at the same time, the IFIs face constraints that limit their ability to promote sustainable development. This paper identifies some of the challenges that governments may need to consider as IFIs begin to support the implementation of the Rio+20 declaration.

¹ Smita Nakhooda, World Resources Institute, "The World Bank Eskom Support Program," 8 March 2010, <http://www.wri.org/stories/2010/03/world-bank-eskom-support-program>.

² World Bank Group, "Eskom Investment Support Project: Questions & Answers," 14 April 2010, http://siteresources.worldbank.org/INTSOUTHAFRICA/Resources/Q_A_Eskom_Investment_Support_Project_031810.pdf

³ David Hallows, Groundwork (2009), *The World Bank and Eskom: Banking on Climate Destruction*, <http://www.groundwork.org.za/Publications/worldbankeskom09.pdf>; Bobby Peek, GroundWork, 16 April 2010, <http://www.brettonwoodsproject.org/art-566122>; Bank Information Center, "World Bank approves \$3.75 billion loan to Eskom," 8 April 2010, <http://www.bicusa.org/en/Article.11838.aspx>.

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THE ROLE OF IFIs IN SUSTAINABLE DEVELOPMENT

IFIs exist throughout the world to provide financial support for development projects. They include government-owned banks, such as the World Bank,⁴ regional development banks,⁵ and export credit agencies.⁶ They also include numerous private sector banks that invest jointly with governments on projects.⁷ This paper focuses on the World Bank as an example of how IFIs operate.⁸

The World Bank is a UN agency, but acts separately—and sometimes at odds—with the UN.⁹ It operates as a bank, using the language of finance and development, rather than the language of environment and human rights. When governments first created the Bank in 1944, the World Bank was envisioned as one part of a system of international institutions. Whereas the UN would focus on political issues, the Bank would focus on economic growth, and Bank interference in political affairs was prohibited. Governments would appoint members of the Bank's board of directors, who would approve all investments and policy reforms, and vote by consensus.

Since 1944, our understanding of development has changed. The current approach to development recognizes that environmental and human rights protection is linked closely to economic growth and development. The 1992 Rio Declaration provides that “the right to development must be fulfilled so as to equitably meet developmental and environmental needs of present and future generations.” Over time, the World Bank has increasingly invested in activities that promote the environment and human rights, yet the legal mandate of the World Bank has not changed to reflect this broader understanding.

⁴ The World Bank Group consists of (1) the International Bank for Reconstruction and Development and (2) the International Development Association, which lend to governments (these two institutions are known collectively as the World Bank); (3) the International Finance Corporation (IFC), which lends to private companies; (4) the Multilateral Investment Guarantee Agency; and (5) the International Center for Settlement of Investment Disputes. This paper focuses on the World Bank and the IFC.

⁵ Examples of regional development banks include the Asian Development Bank, Inter-American Development Bank, European Bank for Reconstruction and Development, and African Development Bank.

⁶ Many governments have established export credit agencies (ECAs) to help promote investments overseas. For example, the U.S. Export Import Bank is an arm of the U.S. government. Because of competitiveness concerns, many ECAs will not make reforms (including sustainability reforms) unless these reforms are agreed by all major ECAs. The OECD generally provides the platform for making these agreements. Increasingly, ECAs have raised concerns about the competitive advantage of the ECAs from governments such as China, India, and Brazil, which are not part of the OECD.

⁷ See e.g. the Equator Principles associations of private IFIs, <http://www.equator-principles.com>.

⁸ This paper focuses on the World Bank but recognizes that the world of development finance is complex. Other IFIs' efforts to promote sustainable development exceed the World Bank's in several respects. In the next ten years, trends among IFIs are likely to be shaped in large part by emerging actors—such as nationally owned financial institutions from emerging economies, which have expanded their overseas presence.

⁹ See e.g. Leonardo A. Crippa (2010), *Multilateral Development Banks and Human Rights Responsibility*, American University International Law Review, vol. 25, no. 3.

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Over time, the World Bank has evolved to become a “demand-driven” institution. After heavy criticism in the 1980s and 1990s for imposing economic reforms on countries, the Bank has reversed its approach. An important part of the Bank’s institutional culture, firmly engrained in staff members, is not to impose development on a government, but rather to allow the borrowing government to choose what is most appropriate for its people. Sometimes this is in line with sustainable development, as governments seek advice from the World Bank on tackling issues such as climate change and food insecurity. Other times, this approach is not in line with sustainable development, as governments seek funds to build projects that are environmentally destructive and violate human rights. These are the projects that often become the focus of civil society campaigns.

PROGRESS SINCE THE RIO DECLARATION

Despite a track record of controversies, the World Bank has undertaken a series of reforms over the past two decades to become a more environmentally and socially responsible investor.

In particular, the World Bank has adopted internal policies and institutional reforms to help ensure that its investments meet a minimum standard of acceptability. In 2006, for example, the Bank created its Sustainable Development Network, which is led by one of the Bank’s vice presidents. The network helps to develop the Bank’s sustainable development agenda, and to provide financial support on issues such as climate change, agriculture, and natural resource management.

Over time, the Bank has also strengthened its “safeguard” policies that set the minimum environmental and social requirements expected of borrowers. These policies were first developed in the 1980s and gradually updated. For example, borrowers must conduct an environmental impact assessment, and must consult with local communities as a condition of financing. In 2010, the Bank adopted a progressive “access to information” policy, which contains a presumption of disclosure for many Bank documents, and allows communities and civil society watchdogs to learn more about the Bank investments that might affect them. Since 1993, the World Bank’s Inspection Panel has provided a way for communities affected by Bank projects to bring complaints when the Bank’s policies are not followed.

Even though the World Bank’s legal mandate has not changed, its rhetoric focuses much more heavily on environmental and social issues. For example, in a January 2011 interview with *Newsweek*, World Bank Group president Robert Zoellick spoke about the Bank’s approach to climate change:

“We can make progress and learn lessons on the ground while others negotiate texts. We can build support for addressing greenhouse gases by more countries—developing and developed—by putting concepts into practice. We can assist smaller and less

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powerful states—such as small island countries, poor mountain states, and sub-Saharan Africa—that otherwise feel ignored, perhaps tempting some to obstruct negotiations that they think do not take account of their interests. We can use our new Climate Investment Funds to leverage other sources of public and private funding—we are raising about \$8 for every \$1 we invest—to help developing countries move toward low carbon growth and adaptation through practical projects. We can try to ensure that the 'perfect' isn't the enemy of the 'good.'¹⁰

Despite these reforms, the Bank has not measured its overall sustainable development footprint. The policies do not apply in all cases, and have not consistently prevented controversial investments from going forward.¹¹

CHANGING NATURE OF DEVELOPMENT FINANCE

Are IFIs prepared for the next decade of sustainable development? The ways that IFIs do business are changing, and in many cases, their approaches to environmental and human rights issues have not kept pace.

IFIs are now making investments in a wider variety of ways. Traditionally, the World Bank and other IFIs invested directly in projects—such as a dam or a road. Safeguard policies and other Bank approaches to sustainable development were designed with this type of investment in mind. Now, however, IFIs are providing finance and support in ways that are more difficult to monitor or track.

IFIs typically provide borrower governments with a menu of options, such as:

- **Invest directly in projects**, such as cleaner power plants, renewable energy, and access to clean water. However, numerous other IFIs exist to finance development activities, and often compete with the World Bank to provide cheaper loans with fewer environmental and social requirements.
- **Provide direct budget support to governments for policy reforms**, by injecting money directly into the government treasury. This leaves the government with almost full discretion on how to use this money. In these investments—which comprise over half of the Bank's portfolio—environmental and social safeguards do not apply.¹²

¹⁰ R.M. Schneiderman, "Davos: Robert Zoellick on the World's Challenges," Newsweek, 23 January 2011.

¹¹ For examples of recent controversial World Bank activities, please visit the websites of Bank Information Center, <http://www.bicusa.org>, and the Bretton Woods Project, <http://www.brettonwoodsproject.org>.

¹² Over half of the World Bank's funding is now channeled through "development policy loans." See Vince McElhinny, *World Bank and DPLs: What middle income countries want*, 4 February 2011, <http://www.bicusa.org/en/Article.12351.aspx>.

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- **Leverage further investments**, by managing climate change trust funds that attract other investors. In these cases, the World Bank faces the challenge of collaborating with UN and other intergovernmental institutions.
- **Share knowledge**, by providing expert advice to governments and companies on sustainable development best practices. However, recent studies question whether the IFIs provide consistent advice on sustainable development.¹³

IFIs also increasingly delegate responsibility to borrowers, in an effort to strengthen country ownership over development projects, and to build local capacity to sustain development. As such, IFIs now serve more as advisors to governments, and less as regulators who condition lending on specific reforms. At the same time, borrowers are being given a greater voice on the boards of directors that decide where money is channeled.¹⁴ All of these reforms are very much in line with the 2005 Paris Declaration on Aid Effectiveness, which calls for greater country ownership over development. Nevertheless, the implementation of these principles remains a challenge. How can IFIs shift greater responsibility to borrower governments, while ensuring accountability to donors and local communities?¹⁵ When IFIs face pressure to move loans quickly, they often face higher risks of corruption and weak capacity to protect the environment and human rights.

THE NEXT DECADE'S CHALLENGES: CLASH OF THE [INSTITUTIONAL] TITANS?

In the next decade, the World Bank and other IFIs will play an important role in financing sustainable development. They will bring valuable expertise in designing financial transactions and sharing knowledge across countries. Yet as the IFIs step further and further into global environmental and social initiatives, they find that they must increasingly collaborate with UN agencies.

Similarly, over 40 percent of the IFC's portfolio lends to financial intermediaries, which in turn lend on to other development projects. IFC's oversight of these investments remains limited. See Bretton Woods Project, "Out of sight, out of mind? IFC investment through banks, private equity firms and other financial intermediaries," 22 November 2010, <http://www.brettonwoodsproject.org/art-567190>.

¹³ Jonathan Lash & David Runnalls, "The World Bank, MDBs, and Low Carbon Development," 23 April 2010, <http://www.wri.org/stories/2010/04/world-bank-mdbs-and-low-carbon-development>; Smita Nakhooda & Athena Ballesteros (2010), *Investing in Sustainable Energy Futures: Multilateral Development Banks' Investments in Energy Policy* (Washington, DC: World Resources Institute), <http://www.wri.org/publication/investing-in-sustainable-energy-futures>.

¹⁴ At the World Bank, "voice and vote" reforms in 2010 gave greater voting power on the Board of Directors to emerging economies.

¹⁵ For a more detailed discussion of these challenges in the context of climate finance, see Athena Ballesteros et al. (2010), *Power, Responsibility, and Accountability: Re-Thinking the Legitimacy of Institutions for Climate Finance* (Washington, DC: World Resources Institute), <http://www.wri.org/publication/power-responsibility-accountability>.

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In many cases, collaboration between the UN and IFIs has raised tensions that date back to the founding of these institutions. The mandate of IFIs is to promote economic growth, while UN agencies promote reforms that do not always have a measurable economic return on investment. The culture of IFIs is to respond to the demands of borrowing governments, while UN agencies tend to focus on harmonizing global norms around human rights and the environment. IFIs approach environmental and social issues from a "risk management" perspective, justifying action when it threatens the return on investments, while UN agencies take a rights-based approach to development. As a result, IFIs are often willing to make tradeoffs on environmental and human rights issues. IFI staff members primarily measure success in terms of the volume of lending moved out the door, and how much it contributes to macroeconomic growth in a country. In the UN, success is measured by promoting and protecting human rights, and by mobilizing countries around common goals such as greenhouse gas emissions reductions.

The tensions between these two types of institutional cultures are common in several sustainable development initiatives underway.

The contradiction around climate change

IFIs, especially the World Bank, have had a significant presence at the UN climate change negotiations. Since 2008, the World Bank has managed the \$6.3 billion "climate investment funds," which have helped to finance climate related projects while governments negotiated a more permanent financing mechanism. In December 2010, governments signed the Cancun Agreement and created a Green Climate Fund as the central mechanism for financing the global response to climate change. Governments appointed the World Bank as an interim trustee of the fund. In the coming years, the Bank will play a leading role in directing finance to climate change efforts, and in setting the precedents for future financing. The Bank's performance will be crucial to the success of the UN climate change agreement.

At the same time, the World Bank has not committed to reduce its own climate change footprint.¹⁶ The Bank does not measure how its investments contribute to greenhouse gas emissions, and has not made significant progress on reducing the overall climate footprint of its lending portfolio. Indeed, the portfolio of fossil fuel-related projects has grown.¹⁷ In 2008,

¹⁶ The Asian Development Bank (ADB) has exceeded the World Bank in clean energy lending. In 2009, the ADB adopted a new energy policy that commits to measuring the carbon footprint of proposed project, providing technical support for countries to undertake low carbon strategies, and helping countries determine more energy efficient options. The ADB also committed to provide \$2 billion annually to clean energy project beginning in 2013, a doubling of such investments based on 2008 lending. ADB news release, 19 June 2009, "New ADB Policy Targets Secure, Clean Energy for Asia," <http://www.adb.org/media/Articles/2009/12917-asian-clean-energies-policies>.

¹⁷ See e.g., Janet Redman et al. (2008), *Dirty is the New Clean: A Critique of the World Bank's New Strategic Framework for Development and Climate Change* (Washington, DC: Friends of the Earth US), http://www.foe.org/Climate_Investment_Funds/DirtyIsNewCleanReport.pdf.

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research by the World Resources Institute revealed that 60% of the Bank's financing for the energy sector did not take climate change into account. In 2010, a follow-up survey showed that only a limited number of World Bank electricity sector loans support clean energy development.¹⁸ The Bank's recent investment in South Africa's coal-fired power plant illustrates the perception within the Bank that countries face a choice between clean energy and economic development, rather than considering these goals to be mutually reinforcing.

The contradiction between the World Bank's leadership role in the UN climate negotiations, and its unwillingness to manage its own climate footprint, raises questions about the overall legitimacy of IFIs' approach to climate change. Will the limited funds committed by donors at the UN climate negotiations be used in the most effective way? Will the fossil fuel projects that are made possible by World Bank investments contribute as many GHG emissions as the Green Climate Fund seeks to avoid? Or will the World Bank's new role in the Green Climate Fund create momentum to reconcile these tensions?

Conserving forests while ignoring forest dwellers

The climate change negotiations have also brought renewed interest to an old problem: forest conservation. Because forests help to take carbon dioxide out of the air, donors have begun to inject funds into initiatives that will support developing country governments' efforts to conserve forests. The first pilot initiatives—called Reduced Emissions from Deforestation and Forest Degradation (REDD)—have been led by the World Bank and the UN Development Programme.

One of the challenges of REDD is how governments can set aside land for forest conservation, when in many cases the forests are already occupied by local communities. Over 1.2 billion people depend on forests for their livelihoods, and several hundred million of these people rely on customary or informal rights to land.¹⁹ Many indigenous communities have lived on the same land for hundreds if not thousands of years, and their entire cultures and identities are tied to that specific area of land. Many developing country governments lack the capacity to simultaneously manage their forests, resolve existing land tenure conflicts, and manage vast amounts of international funding for REDD.

The World Bank and the UN take different approaches to this challenge. The World Bank manages two trust funds, and is still developing a way to address these risks, but has started to provide financing to governments before safeguards are in place. The UN REDD program, in contrast, takes a rights-based approach and requires the free, prior and informed consent of indigenous communities before a REDD project can go forward.

¹⁸ Athena Ballesteros, "Will Climate Finance Mean a New Path for the World Bank?," 17 May 2010, <http://www.wri.org/stories/2010/05/will-climate-finance-mean-new-path-world-bank>.

¹⁹ Beto Borges, Forest Trends, at Rights and Resources Initiative dialogue, 24 June 2010, Washington, DC.

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By putting forward different approaches to safeguards, the World Bank and UN have created a chaotic system, where governments and donors are unsure what safeguards to apply. This is increasingly a problem as REDD initiatives face pressure to demonstrate success by moving funds quickly out the door, often without forest governance reforms fully in place. For example, the Forest Peoples Programme, a civil society organization based in the UK, has raised concerns for several years that REDD funding in countries such as Guyana and Cameroon jeopardizes indigenous peoples' rights by moving forward before conflicts around forest land tenure are resolved.²⁰

Human rights, the World Bank way

Concerns over human rights arise frequently in the investments of the World Bank and other IFIs. If not carefully designed, development projects can displace people from their homes, create health risks, and cut off access to food and water for local people. Most governments acknowledge that World Bank investments can affect human rights, both positively and negatively. However, the Bank officially does not consider itself bound by international human rights treaties, and has adopted its own approach. The World Bank's approach is to treat human rights as one project risk that needs to be balanced with other considerations such as cost and efficiency. This differs from the rights-based approach used by the UN.²¹

Between 2009 and 2011, the International Finance Corporation—the private sector lending arm of the World Bank Group—updated its influential environmental and social performance standards. Hundreds of other IFIs and companies consider these standards to be best practice for foreign investment. The change in policy sparked a debate. In early 2011, several governments, civil society, and IFC staff raised concerns that language in the IFC's proposed policy misrepresents standards set forth in the UN Framework on Business and Human Rights. Most governments of the world, including China, India, Brazil, and Russia, have supported the UN Framework. Some have argued the IFC's proposed policy provides a weaker alternative that undermines the global consensus on the UN Framework.²² Can the IFC claim that it follows the UN Framework implicitly without actually referencing human rights? How can the language of human rights be translated into operational language that is useful for bankers, while remaining consistent with UN norms? The IFC is wrestling with these issues as it finalizes its policy.

²⁰ Forest Peoples Programme, "Guyana's forest and climate plans continue to generate controversy and sideline indigenous peoples," 7 December 2010, <http://www.forestpeoples.org/topics/redd-and-related-initiatives/news/2010/12/guyana-s-forest-and-climate-plans-continue-generate>; Emmanuel Freudenthal, Samuel Nnah and Justin Kenrick, Forest Peoples Programme (2011), *REDD and Rights In Cameroon: A review of the treatment of Indigenous Peoples and local communities in policies and projects*, <http://www.forestpeoples.org/sites/fpp/files/publication/2010/08/guyanaapawshopstatement-mar10.pdf>.

²¹ Kirk Herbertson, Kim Thompson & Robert Goodland (2010), *A Roadmap for Integrating Human Rights into the World Bank Group* (Washington, DC: World Resources Institute), <http://www.wri.org/publication/roadmap-for-integrating-human-rights-into-world-bank-group>.

²² Center for International Environmental Law et al. (2011), "Questions & Answers: Human Rights and IFC," http://www.business-humanrights.org/media/documents/ifc_and_human_rights_briefing_jan_2011_%282%29.pdf.

RECOMMENDATIONS FOR RIO+20

The IFIs' and UN's competing approaches to sustainable development have led to a piecemeal approach that sends mixed signals to those who look to these institutions for leadership. Rio+20 delegates may agree that it is important to promote economic development *and* protect the environment *and* respect human rights. But how can we move forward in practice?

First we need to link IFIs to broader global governance in a more coherent manner. Changing the mandates of IFIs into "green institutions" is unlikely, so governments and civil society should explore ways to reconcile IFIs' focus on economic growth with the role of other UN agencies in promoting environmental and human rights. At the international level, this will require UN agencies to take a greater, more proactive role in linking IFI policies to UN norms. It will require designing more meaningful ways for local communities to participate in global policy debates. And it will require the UN to help translate international environmental and human rights norms into standards that bankers can use.

Second, governments will need to reconsider their fiduciary responsibilities as members of the IFIs' boards of directors. Typically, a government's ministry of finance appoints officials to sit on the boards of the World Bank and other IFIs. In many cases, the ministries of finance do not communicate internally with other ministries that specialize in environmental and human rights issues. The result is a disconnect between what a government says and does at UN agencies, and how it acts at the IFIs. Often these same governments have ratified (or even championed) environmental and human rights agreements at the UN, but refuse to speak about these issues at the IFIs. Better internal communication is necessary for governments to approach sustainable development coherently.

CONCLUSION

The goals of Rio+20 should be forward-looking and ambitious, and should certainly rely on the IFIs for support. But any Rio+20 Declaration should carefully define a role for IFIs, and should take into account the complex cultures of these institutions. IFIs are notoriously difficult to reform. When calling for wider reforms, it will also be important for civil society and governments to engage the Bank on smaller (but still formidable) goals: holding IFIs accountable for their climate change performance, harmonizing global approaches to accountability and safeguards, and strengthening the links between human rights and the environment. In this way, even if we do not achieve full success in the next decade, we will be able to say that we took major steps forward.



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