



**FOREST GOVERNANCE, MARKETS AND TRADE:
IMPLICATIONS FOR SUSTAINABILITY AND LIVELIHOODS**

**ADDING VALUE: CAN FLEGT
VOLUNTARY PARTNERSHIP
AGREEMENTS LEAD TO
INCREASED INVESTMENT
AND TRADE FOR PARTNER
COUNTRIES?**

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COORDINATING INSTITUTIONS

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While the Department for International Development has provided financial support for this publication, the findings and views presented do not necessarily reflect UK government policy.

ADDING VALUE: CAN FLEGT VOLUNTARY PARTNERSHIP AGREEMENTS LEAD TO INCREASED INVESTMENT AND TRADE FOR PARTNER COUNTRIES?

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April 2009



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ACKNOWLEDGEMENTS

The author would like to thank the many experts from around the world who have contributed to this report. Kerstin Canby was an important contributor and editor, and Hugh Speechly provided guidance throughout. Mark Campanale provided important insights into the latest developments in investment markets. In addition, the author would like to thank the numerous peer reviewers: Matthias Rhein, John Bazil, Neil Bird, Clare Brogan, David W. Brown, Duncan Macqueen, James Mayers, Moray McLeish, John Palmer, Michael Richards, Andy Roby, Saskia Ozinga and Emile Jurgens.

INTRODUCTION

In May 2003, the European Union published its proposal for a Forest Law Enforcement, Governance and Trade (FLEGT) Action Plan which sets out a range of measures that aim to tackle the global problem of illegal logging and associated trade, including financial and technical support to achieve improved forest governance in developing timber-producing countries. It also provides for Voluntary Partnership Agreements (VPAs) between these countries and the European Union. Under these agreements, Partner Countries will implement an agreed licensing scheme that assures that their timber exports to the EU have been legally produced. In return, EU border control agencies will only allow shipments of timber products from Partner Countries entry to the single market if they are covered by these FLEGT timber legality assurance systems (TLAS). VPAs therefore tackle both the supply and demand side of the trade, combining border controls with measures and capacity building in partner countries to implement timber legality assurance systems. This arrangement aims to boost the confidence of buyers in increasingly sensitive EU markets that they are not purchasing illegal timber, thereby enhancing the reputation of exports originating from Partner Countries.

This note discusses the potential of VPAs¹, by strengthening forest governance, to assist partner countries to improve their business climates for investment, giving a boost to local jobs and growth, and providing incentives for improved forest management. While it is acknowledged that VPAs can create additional challenges for forest-based enterprises (both large and small) due to the cost of implementing TLAS as well as changes in market or trade structures caused by the VPA itself, these costs may be outweighed by the benefits:

1. *The creation of a stable platform for governance reform and bringing down sector risk*, resulting in Partner Countries' increased ability to attract increased international capital investment.
2. *Improved profitability for enterprises based on legal forest management* if:
 - (a) the TLAS results in the removal of illegal timber from the system, thus leveling the playing field for legal operators who cannot currently compete in distorted markets;
 - (b) Partner Countries are able to gain additional market access to environmentally sensitive markets once they apply FLEGT licensing to all their exports and therefore gain a positive reputation for 'always legal' timber.
3. *Laying the foundation for ecosystem payment schemes*. To the extent that a successful VPA process demonstrates commitment to improved resource governance and law enforcement, Partner Countries may gain credibility as a reliable marketplace for payment for environmental services such as those emerging for forest carbon (e.g. under the voluntary carbon market or an emerging REDD scheme).

¹ At the time of writing (February 2009) none of the VPAs in negotiation have yet been completed. While some VPA impact studies have been referenced, this paper takes a theoretical approach and attempts to speculate how the VPAs may best be designed, negotiated and implemented with a view to enhancing investment and trade.

IMPROVING MARKET REACH AND PROFITABILITY FOR ENTERPRISES BASED ON LEGAL FOREST MANAGEMENT

ENSURING ACCESS TO GLOBAL MARKETS FOR LEGAL TIMBER

European Public Procurement Policies: Several countries, including at least seven EU countries as of the end of 2008, have already adopted public procurement policies requiring government departments to purchase legal timber, with an additional preference given to timber from sustainably managed sources. In many cases, credible demonstration of legality, such as a FLEGT license, is becoming a minimum requirement of doing business. Some EU governments already require that sources are both legal and sustainable, others are moving quickly in that direction. About one fifth of wood products consumed in the EU are used by or for public agencies, so these requirements are powerful drivers of change in supplier systems.

Although only applicable to civil works financed by central government departments, these policies are having a much wider influence. Contractors hired for private construction projects are also adopting the same policies on a voluntary basis. This is partly because these contractors do not want to manage two separate streams of timber – those from legal and/or sustainable sources and then those from unconfirmed or possibly illegal sources – which would require physical separation of timber in storage and processing, as well as separate documentation.

Meeting New Legislative Requirements: Recent legislative acts related to due diligence in the sourcing of wood materials are further examples of the global trend towards eliminating illegal timber from major markets.

The recent amendment to the US Lacey Act in 2008 makes it a federal offence to import and trade in illegally-sourced timber products.² While not a guarantee against prosecution, importing goods covered under a FLEGT license is likely to be considered as having provided at least some form of due diligence, which may have a positive bearing on any investigation into the legality of, and any criminal liability related to, wood products imported into the United States. Countries that apply legality assurance systems to all their exports could thus obtain a structural advantage over non-VPA countries in accessing the US market.

In the EU, a proposal for new legislation now under consideration will require traders to assess the risk of handling illegally-produced timber products and to implement systems to ensure they do not place such products on member states' markets, and may impose penalties on anyone putting illegally sourced wood products on the market.

Continued and Increasing Retailer Preference for Legally Verified or Certified Wood Products: Since the mid-1990s, major retail organizations such as B&Q in the UK and Home Depot in the United States have developed purchasing policies which give preferences to sustainably certified wood products. Many, faced with limited supply of certified wood products, eventually had to adopt “step-wise approaches” by which they accepted a minimal level of transparency and due diligence for wood products such as proof of origin or legality, with the understanding that the supplier would be working over the

² Gregg, R.J. and Porges, A. (2008) Amendment to the U.S. Lacey Act: Implications for Chinese forest products exporters, Forest Trends, Washington D.C.

course of 3-5 years towards full certification. In 2008, the world's largest retailer, WalMart, began conducting training with its buyers and suppliers, strengthening its internal supplier documentation requirements and implementing procedures related to the US Lacey Act declaration requirements. Providers of third-party services who help companies clean up their supply chains and track their wood products report that inquiries from both domestic and foreign businesses are increasing. Twenty nine timber trade associations from 18 countries and 20 global forest companies came together on October 29-30, 2008 in Geneva for the International Timber Trade Federation Day, to discuss how industry can best respond to new international demands to prevent trade in illegally logged timber.

Over time, the FLEGT license may become more widely accepted globally. As a large diverse trading bloc, the EU is adept at the formulation and monitoring of standards that protect consumers, or project EU social and environmental values.³ Businesses that wish to trade with the EU have found that early adoption of these standards can have competitive advantages (see Box 1). Although the EU market may not be the largest export partner for many VPA candidate countries (for instance the EU represents 11% of Indonesia's total forest products exports⁴), the FLEGT approach to timber legality assurance has the potential to become one of the reference standards for legal timber. This will not only extend the scheme's influence, but also increase the likelihood that more producing countries will seek partnership agreements. As the scheme expands, the volume of trade associated with displacement of illegal timber though non-partner country markets may diminish.

Box 1 – EU REACH standard

The Registration, Evaluation, Authorization and Restriction of Chemicals (REACH) initiative is an example of a prescriptive standards regime, driven by the precautionary principle rather than traditional cost benefit analysis. It was initially rejected by global companies as too rigid and expensive, but later accepted. American companies, under no obligation to follow REACH, discovered that it was in their best interest to conform to the highest standards available in the market. This raises the cost of entry to new market entrants, secures access to a major market and achieves cost efficiencies through the application of just one standard throughout the value chain.

Source: 'Brussels rules OK,' The Economist, September 20, 2007

INCREASING PROFITABILITY FOR LEGALLY COMPLIANT FOREST ENTERPRISES

Removing Distortions Caused by Illegally Sourced Timber in Markets: If implemented sector-wide (including all export and domestic markets), implementation of a TLAS will eventually result in the evaporation of the market in illegal timber. This will remove distortions that undercut those companies that fully comply with the law, yet must compete with illegal timber. One study calculates that the removal of illegal roundwood from global markets could lead to price increases of between 7 and 16 percent.⁵

³ Kelemen, R.D., 2007, Globalizing EU Environmental Regulation, Rutgers University, New Jersey

⁴ Blomkvist, L.G., et al. (2008) Analysis of the trade impact of the VPA for Indonesia, EC-Indonesia FLEGT Support Project, Jakarta

⁵ American Forest & Paper Association (2004), *Illegal Logging and Global Wood Markets: The Competitive Impacts on the U.S. Wood Products Industry*, Seneca Creek Associates, M Wood Resources International, LLC, Maryland

Most illegal timber requires less return to capital employed in silviculture, stand management and other overheads demanded by laws aimed at ensuring sustainable forestry. The impact on costs can be significant: a study in Indonesia has shown that the production cost of legal logs is 162 percent higher than for illegal timber.⁶ Through disbursing some of their excess rent on the bribes and unofficial payments to ensure official connivance, the illegal trade fuels higher transaction costs for all actors, including companies operating legally (as systemic corruption tends to affect all operators, regardless of their legality). If sector reform is successful in removing illegal wood from the market and introducing streamlined and transparent regulatory (including permit) regimes, legal timber producers will enjoy lower transaction costs, with significant benefits to their business. The impact of these changes will vary widely between Partner Countries, depending upon the current state of their forest industry and the extent to which fiscal instruments will accompany forest sector reform. For instance in the case of Ghana overall costs may rise,⁷ however, in Indonesia transaction costs are expected to fall by 43 percent⁸ (net of the additional costs of the TLAS and associated permits), reducing total production costs by over 5 percent. The dual benefit of lower transaction costs and higher sales prices will encourage entrepreneurs to make long-term capital investments that improve productivity (widening margins further), and will attract investors and creditors into the sector.

Reducing Transaction Costs to Buyers: Since FLEGT licenses will be issued on the basis of agreed assurance systems, timber products exported from Partner Countries will be effectively provided with a government-backed guarantee of legality. Partner Countries, especially those that apply FLEGT licensing to all their exports – both in terms of products and destination – will become associated with a brand: 'always legal' timber. Intermediaries will have the opportunity to both reduce their transaction costs and demand higher prices through association with the FLEGT 'brand'. Lower transaction costs will arise through removing the need to independently audit the supply chain to satisfy importers and retailers. The prospect of higher margins will give FLEGT licensed wood products a competitive advantage over similar products from non-partner countries that are not covered by internationally recognized certification schemes, such as the Forest Stewardship Council (FSC).

Improving Competition: A further benefit resulting from the removal of illegal wood from the system is the restructuring of local economies. Where the only local source of wood is illegal, trade is often mediated at the discretion of local elites (military, police, and officials) and not based on the proper functioning of the market. This, in effect, supports enterprises that may otherwise not be competitive and stifles the growth of potentially more vigorous and innovative businesses that could link the local economy to 'real' (i.e. undistorted) markets. Many of these businesses are small and medium forest enterprises (SMFEs), a sector that is burdened disproportionately by corruption and other unofficial transactions costs.⁹

⁶ Derived from data in Blomkvist, L.G., et al. (2008) Analysis of the trade impact of the VPA for Indonesia, EC-Indonesia FLEGT Support Project, Jakarta

⁷ Mayers, J., Birikorang, G., Danso, E.Y., Nketiah, K.S., Richards, M. (2008) Assessment of Potential Impacts in Ghana of a Voluntary Partnership Agreement with the EC on Forest Governance [DRAFT], IIED, London

⁸ Derived from data in Blomkvist, L.G., et al. (2008) Analysis of the trade impact of the VPA for Indonesia, EC-Indonesia FLEGT Support Project, Jakarta

⁹ This is partly because of their lack of political influence (through which they could counterbalance the local political bias towards illegal operators), but also due to the relative size of the charges in relation to the income of their business.

Most of the forest enterprises in developing countries are SMFEs,¹⁰ which are estimated to represent 50 percent of forest sector employment, generating US\$130 billion of gross value added.¹¹ The introduction of timber legality assurance systems, if combined with an improved enabling environment for business, could release the economic potential of SMFEs, attracting investment and credit to the sector.¹² This in turn could stabilize local political issues and underpin the sustainability of the legality assurance systems.

IMPROVING FOREST SECTOR INVESTMENT CLIMATE

Bringing Down Forest Sector Risk: A report commissioned by the UNFCCC Secretariat¹³ estimated that in 2006 more than US\$46 billion was invested in the forest sector of developing countries, of which less than 2 percent was official development assistance; the rest came from private sources – increasingly international capital markets. Hitherto, a large portion of this flow of capital has worked against sustainable forest management. This has been partly caused by the search for short-term returns, partly out of ignorance of the complexity of forest ecosystems, and partly out of greed. By definition, this situation is not sustainable since it has led to the depletion of forest resources. In addition, increased international awareness, the politics of climate change mitigation and discerning markets may no longer permit it.

It is likely, therefore, that future private capital investment in forestry-related enterprises will be influenced by new types of risk (e.g. loss of profit due to forfeiture of goods under the U.S. Lacey Act, or reputational risk arising from a global NGO campaign). Even adventurous investors that have previously been content to accept large risks to share price or reputation, perhaps operating in lightly-regulated regimes, will need some assurances of continued market demand (e.g. access to European markets) and sustainable supply before they commit capital. Furthermore, excessive and unevenly applied transaction costs introduce unpredictable risks. This may be less attributable to the complexity of the regulatory framework (though in some circumstances complexity encourages corruption), but rather the transparent and consistent application of the rules of the game. Thus, whilst strengthening governance and rule of law cannot wholly eliminate risk, it can make it more measurable and predictable. Effective implementation of VPAs, involving broader sector reform, should support these requirements.

Changing perceptions of risk in forestry investment: Capital investment in forestry and related industries may originate from traditional capital markets, emerging markets, or from international buyers of timber products motivated to make strategic investments in their value chain. In the future it may also be driven by two emerging trends in asset management: the quest for very long returns, and the growth of socially responsible investing (SRI).¹⁴ Timber investment has become a common asset class amongst some institutional investors. The long-term nature of sustainable forest management, rather than an

¹⁰ Defined as businesses employing up to 100 employees engaged in activities that extract or process timber or non-timber forest products

¹¹ Macqueen, D. (2008), Supporting Small Forest Enterprises – A cross-sectoral review of best practice. IIED, London

¹² Elson, D.M.M. (2008) Sharing the benefits: linking FLEGT Voluntary Partnership Agreements to jobs and growth, Forest Trends, Washington D.C.

¹³ Trines, E. (2007) Investment Flows and Finance Schemes in the Forestry Sector, with Particular Reference to Developing Countries' Needs, UNFCCC

¹⁴ IFC and DFID, (2008) In press, Forum for the Future and EnviroMarket: Forest-Backed Bonds – Proof of Concept Study. Forum for the Future and EnviroMarket Ltd, London

impediment to investment (as it tends to be seen by companies focused on short-term goals) is seen by some bond market analysts as a potential securitizable asset that can fill a gap in availability of 20 year-plus fixed income securities (see Box 2).

Box 2 – Shortage of long term fixed interest funds fuels interest in timber sector

At the time of writing, the global economic crisis has led to a fundamental re-assessment of the wisdom of certain types of financial transactions. However, such developments serve to reinforce the attraction of holding tangible assets, such as forestry, rather than esoteric intangible financial instruments that may be connected to a complex web of other intangible assets. Timberland investment is based on predictable biological growth, and is uncorrelated to any other assets, making it highly suitable for long-term risk-averse investment. Furthermore, the recent increase in government borrowing has been financed by short-term securities (5-10 years), making no impact in the shortage of long-dated securities required by pension funds. Thus the current financial crisis, insofar as its impact can be accurately assessed at this stage, may well lead to greater investment interest in forestry in the medium term.

Over the years prior to the economic downturn, a decline in the issue of longer-term bonds by central governments, combined with increasing demand for long term fixed income securities (20 – 50 years) from pension funds¹⁵, has led some investors to take an interest in less conventional assets. Basically, any asset that has the potential to produce a predictable income flow over a long period of time can be sold to an investor. In this sense the future income flow has been ‘securitized’. The advantage to the seller is that future income is brought forward to today, providing capital funds for activities such as afforestation. In return, the buyer of the security expects the risk to be commensurate with the rate of return (yield) offered, and for the nature of the underlying assets to be accurately described.

In an efficient market the yield on an investment is proportional to the risk. One would expect higher risk investments to pay a higher rate of return to the investor, as compensation for the possibility of a loss on the sum invested. In practice, the interest paid by asset-backed securities (which could be related to assets such as timber or even carbon) will to some extent depend upon the political stability and rule of law of the country in question. Better governance and a good enabling environment for business should mean lower risk, and thus securities associated with such a country will pay a lower interest rate to the investor, reducing the cost of capital for the business.

Short-term investors may not be so concerned with political risks; in fact in certain cases unstable political environments have attracted short-term investors who prefer opaque or malleable regulatory regimes. Long term investors, on the other hand, need to make predictions about a country’s long term governance performance in order to assess the underlying investment risk, and thus determine the appropriate price (or yield) for the security. Long-term investors are thus likely to perceive a country’s involvement in a VPA as a sign of stability, and sectoral reform - such as recognizing community resource rights - as an indicator of lower risk tenure arrangements. In any event, evidence of a legal and sustainable timber industry, with the governance strategy to support it, is a core requirement for a long-term investor in timber or carbon-based securities.

¹⁵ ODDO Securities, (2006) *The irresolvable \$2,000bn Pensions Conundrum*, Paris

However, for some time to come, capital flows into sustainable forestry are likely to be dwarfed by the huge flows into vertically integrated processing industries. As these businesses adjust to the changing market conditions and evolving investor requirements, they may find that their traditional business models, based on rapid liquidation of forests, needs revision. Evidence from studies of reduced-impact logging demonstrates that more careful management can be more profitable than quick liquidation over the long-term.¹⁶ This may lead to the breaking-up of vertically integrated industrial companies, that will sell their timberland assets (or assign the concession rights), as has occurred in mature northern markets, and is becoming more common in some developing countries such as Mexico.¹⁷ As wood processing companies reorganize their balance sheets to concentrate on core capital-intensive activities, they are likely to seek strategic alliances with forest management enterprises to secure raw material supplies. This new paradigm may result in comparative advantages for small and medium sized forest enterprises (SMFEs) in different forms of sustainable forestry, making them a potential area of interest for domestic investors and banks.

LINKS TO INVESTMENTS IN CARBON FORESTRY AND REDD PROGRAMS

Global investors are already showing increased interest in securitizing the payment for ecosystem services (PES) such as those that may be possible through emerging schemes under REDD, the World Bank's Forest Carbon Partnership Facility, or voluntary markets for forest carbon offsets. As these schemes rely upon the certainty that soil and canopy profiles will not be degraded over the very long term, their price will to a large extent be determined by the trust the buyer has in national resource governance and law enforcement. The installation of a timber legality assurance system by partner countries (and the likely governance reform process that accompanies it) may be interpreted by the market as evidence of better governance on the ground, and they may thus enjoy a better 'risk grade' rating for their carbon and PES projects, enhancing the income from such schemes.

As many of the policy processes called for by VPAs and REDD are similar, the two schemes should not be seen as competing, but mutually reinforcing, for instance:

- VPAs give policymakers experience in negotiating a national approach that does not undermine sovereignty and yet is still credible internationally
- The requirement to clarify tenure issues in production forests, and consult with a wide range of stakeholders in VPA preparation, enhances negotiating positions for subsequent REDD negotiations
- Data and processes developed for VPAs – such as definitions of legality, verification and monitoring systems – will install capacity that can later help create baseline data and monitoring protocols for REDD

¹⁶ Bull, G. (2003) Notes on global forest trends. University of British Columbia., quoted in Scherr et al, A New Agenda for Forest Conservation and Poverty Reduction: Making Markets Work for Low-Income Producers, Forest Trends, Washington D.C.

¹⁷ PROCYMAF (2000) Proyecto de conservación y manejo sustentable de recursos forestales en México. Informe y avance 1998-2000. Misión de evaluación de medio término. Mexico D.F., Mexico, Secretaria del Medio Ambiente, Recursos Naturales y Pesca (México, Secretariat of the Environment, Natural Resources and Fisheries).

- Proven ability to assure timber legality enhances the credibility of REDD schemes, thus underpinning their value to investors

Early examples of voluntary carbon markets based on expected future REDD models have often claimed they will deliver benefits to forest communities. This is partly because those investors interested in carbon markets tend to also be SRI investors (and thus seek an ethical dimension), but also because for REDD schemes to be meaningful they need to account for social and political realities as well as biophysical conditions. Indeed, it is hard to imagine how carbon valuation models can be deemed reliable long-term investments if they fail to take into account the complexity of local issues, such as land tenure claims and competing land use pressures. Such local factors will not only reveal the real usage profile of the forest – and thus its long-term carbon value – but also the range of claimants to any revenue. Through bringing about improved business conditions in and around the forests, the VPA should be able to anchor any forest carbon related investments to the social and environmental conditions on the ground that will ultimately determine their long-term viability.

CONCLUSION

The VPA process has the potential to alter global market conditions for illegal timber by setting new standards that are likely to have an influence on the timber trade far beyond the EU borders. Through removing illegal timber from local markets, the effective implementation of a country's legality assurance system can improve access to key markets, lower transaction costs and increase prices. Governance reform and a more transparent business environment will enable investors to measure political risk more effectively and make longer-term investments with confidence. A level playing field will also enhance the viability of capital investment in sustainable forestry, attracting investors that are seeking long term yields or socially and environmentally ethical outcomes.

A key driver of the trend towards legal timber production, and ultimately sustainable forest management, will be the desire by partner countries to maximise the opportunities presented by forest carbon payments (such as REDD) and similar markets for ecosystem services. Investors in carbon will heavily discount the price of credits backed by forest assets in countries that have opaque governance and a poor record of local democracy and conflict resolution. Entering a VPA and installing an effective legality assurance system may go some way to demonstrate to the market that positive changes are afoot, but facts on the ground will need to reflect these reforms.

This paper does not claim that strategic interests of investors alone will change the outlook for forests, but it does seem that the needs of investors are beginning to coincide with the needs of timber markets and forest communities, creating a nexus between legal and sustainable timber supplies, good governance, forest carbon programs such as REDD and community economic development. The VPA can be a valuable catalyst in this process.

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