Central European Review of Economics & Finance
Vol. 23, No. 1 (2018), pp. 35–49
DOI: 10.24136/ceref.2018.003
Received: 1 December 2017. Accepted: 16 January 2018

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SUSTAINABLE GROWTH OF INTERNATIONAL FINANCIAL MARKETS IN THE CONTEXT OF INTERNATIONAL CAPITAL FLOWS

In relation to financial markets sustainable growth is usually understood in a simplified and one-dimensional way as a share of financial market in the flow of investment resources from investors to projects that form part of broadly understood corporate social responsibility (CSR). Sustainable growth is usually described as an interconnection of three elements: economy, society, and environment. In such an approach the point of gravity clearly shifts towards the environmental dimension (natural resources) and the impact of economic growth upon the environment. However, if we assume that sustainable development per se goes beyond environmental and social aspects, we need to consider whether we could interpret the idea of „sustainable growth of the financial market" in relation to how economic system operates. In the paper the approach in the context of changes that take place in international financial markets and their impact upon stability of relations in international economy is proposed. The interest focuses especially on one of these elements, i.e., changes in the volume and structure of international capital flows. Hence, the goal of the paper is to analyse selected international aspects of capital flows against the background of challenges to sustainable growth of the global economy.

JEL Classification Codes: F21, F3, Q01.

Keywords: sustainable growth, international financial markets, international capital flows.

The notion of „green financial market" used in specialist literature refers directly to financing environment-friendly projects or to environment-friendly enterprises (e.g., renewable energy sources) or to enterprises, which have decided to include environment-

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friendly solutions (e.g., power stations, waste water treatment plants, manufacturing plants, etc.) (see Dziawgo 2010). Subjects connected with the „green financial market" cover also the emergence and growth of a relatively new group of financial intermediaries, such as, e.g., investment funds, which by definition invest in enterprises seeking to accomplish environmental goals. Expected rate of return on investment is not the top priority for these funds, whose investors are aware that the funds are looking for investment projects that would be attractive not just because of the ROE they offer but because they take account of environmental aspects in their operating strategies and growth prospects (see Huppé, Silva 2013; Janicka 2016).

Sustainable growth is usually described as an interconnection of three elements: economy, society, and environment (Kronenberg, Bergier 2010, p. 6). In such an approach the point of gravity clearly shifts towards the environmental dimension (natural resources) and the impact of economic growth upon the environment. The abovementioned idea of „green financial market" makes part of this framework. However, if we assume that sustainable development *per se* goes beyond environmental and social aspects, we need to consider whether we could interpret the idea of „sustainable growth of the financial market" in relation to how economic system operates. In the paper I would like to propose approaching the phenomenon in the context of changes that take place in international financial markets and their impact upon stability of relations in international economy. My interest focuses especially on one of these elements, i.e., changes in the volume and structure of international capital flows. Hence, the goal of the paper is to analyse selected international aspects of capital flows against the background of challenges to sustainable growth of the global economy.

1. Global financial system

Financial system is defined as an interconnected network of markets, actors, instruments, legal arrangements, etc. (Blake 1990, p. 3). At this point it is worth noting that definitions of a financial system and financial market sometimes overlap and intertwine. Financial market is a set of interdependent actors, instruments, regulations, etc. It makes part of the financial system, whose key role in the market economy consists in intermediating in the transfer of financial resources from actors running financial surpluses to those suffering from financial deficits. The task is accomplished by the financial market at national and global levels. Thus, international financial market can be seen as part of international financial system, which transfers financial resources from capital providers to capital recipients at a global scale.

Stability of the financial system is perceived primarily as its resilience to the impact of unexpected external events of various intensity. Yet, what is a stable growth of financial system about and has it got anything in common with sustainable growth? In order to answer the question we need to consider the role of financial system/market in contemporary economy. Usually we divide economy into two main areas: real economy and financial sector. In simple terms, real economy is concerned with actually producing goods and services while the financial sector provides financial services to the real economy. Theoretically, the growth of the financial sector should be linked directly with the growth of the real economy. If real economy starts growing at a faster rate (e.g, production dynamics increases) financial sector follows (e.g., supply of loan supply increases). Undoubtedly, there is a feedback loop between the growth of financial sector and the growth of real economy, however, the interdependence is expected to be asymmetrical. Financial sector serves the real economy meaning its growth should be correlated with that of the real economy. As we can read in the Financial Stability Report of the National Bank of Poland (NBP) „the stability of the financial system is a necessary condition for ensuring sustainable growth in the long term” (NBP 2017, p. 3).

Recent decades have witnessed an intensification of a phenomenon that distorts this dependence – financialization of the economy. The term reflects the increase in the significance of the financial sector in generating GDP of a given economy. Centre of gravity shifts from the real economy, which produces goods and services towards the financial sector, which not only intermediates in investment flows and settlements but also starts operating in favour of its own growth, independently of what is going on in the real economy. As suggested by P. Dembinski „over the period of 10 years, between 1995 and 2005 global financial assets (total stock market capitalisation, total of tradable bonds, and the balance total of banks and insurance companies) increased from 200% to 400% of global GDP, i.e. they doubled. Over the same period, the value of transactions (in the stock and bond markets, in Forex and derivative market) increased from 7-times global GDP to 26-times global GDP, i.e., almost four times”. (Dembiński 2012). In the light of the above data it is hard to maintain the thesis on the role of the financial sector as a service provider to the real economy; the world of finance got clearly alienated.

Alienation of finance means increased demand for the so called financial centres, specific enclaves on economic map of the world. These are locations, where financial services are offered on conditions much more favourable than in other regions of global economy. Besides financial centres there are tax havens, which ensure favourable taxation, secrecy, and easy procedures for those, who want to establish their businesses and operate there. While financial centres are perceived mainly as enclaves facilitating operations in international finance, tax havens aim exclusively at lowering taxes to private individuals and judicial persons. Besides, often financial centres are erroneously equated with tax havens although favourable taxation is only one among financial services they offer (for more see Karwowski 2010).

In response to the already asked question whether stability of the financial system and sustainable growth have got any common grounds I would clearly say yes. Stability of the financial system should not be boiled down to the quality of the market structure understood as the quality of its institutions and binding legal framework. It may also be perceived through the stability of the financial market meaning its demand and supply sides should grow harmoniously, emerging financial instruments should meet investors' needs instead of unduly increasing the risk of investment (justified from the point of view of financial entity that creates these instruments), actors in the financial market should have ready different market scenarios, from negative through neutral to positive. It is hard to resist thinking that in 2007 exactly the same elements failed in the US financial market: lack of synchronisation between demand and supply of money (over-liquidity of the banking sector which led to excessive growth of lending), generating non-transparent financial instruments, and excessive optimism of financial institutions (*too big too fail* approach). In this context, sustainable growth of financial markets means not only socially responsible investing (RSI) in corporate social responsibility (CSR) projects but also the taking account of threats to stable operations of the financial market resulting directly from its inherent attributes. Looking again at the real economy and financial sector, crisis in the real economy does not have to entail crisis in the financial sector while any crisis in the financial sector will immediately be reflected in the real economy. Under such approach, **sustainable growth of financial markets considers the needs of the real economy and safety thresholds identified based on available data, as well as factual and counterfactual scenarios of events taking place in global economy, in particular in the financial sector**. Such definition leaves no room for alienation of the world of finance, financial sector does not generate its own growth but acts as a structure complementary to the real economy.

2. International capital flows and increasing importance of financial centres

If we assume that modern financial markets are „transmission belts" between economic operators and countries with either surpluses or deficits of financial resources, we still need to explain the role of financial centres in global economy and in these flows. No doubt, financial centres facilitate financial operations at global scale, however, one may not forget that some operations (conducted in financial offshore centres) are covered by confidentiality clause when it comes to their amount and (often) parties involved. On top of that, due to very favourable tax rates they deprive governments of tax income they might legitimately expect.

Supporters of financial centres justify their emergence and growth with liberal approach to business often restricted by strongly etatist policies pursued by national governments. Nevertheless undoubtedly, such arguments are slightly demagogic if governments are to deliver on what society expects of them (and what nowadays goes far beyond functions exercised in the gold standard age, i.e., defence and judiciary) as they are not able to do that without adequate funds, which originate mainly from taxes.

Shortages in national budget restrict the government when it comes to investment in broadly understood infrastructure while its quality is one of the sine qua non conditions of social wellbeing. Looking at the issue from sustainable growth of financial markets viewpoint, there is a question of substantial financial resources of unknown value and origin deposited in financial centres, in particular in offshore financial centres, which may suddenly emerge in international financial markets and destabilise them. The situation is not only potentially crisis-generating but also hard to predict and control. Hence, we must distinguish between benefits and threats produced by financial centres to operators who use them and to the system of global economy where these actors operate. Table 1 lists values of foreign investment pools in global economy and the share of international financial centres.

Table 1. Foreign investment liabilities in global economy, 1995-2016 (bln USD)

	International financial centres (IFC)	Global economy (IFC excluded)	Total
1995	1	14	15
1996	1	18	19
1997	2	20	22
1998	2	23	25
1999	2	26	29
2000	3	28	31
2001	4	29	33
2002	6	32	38
2003	9	39	49
2004	11	48	59
2005	14	53	67
2006	18	65	82
2007	24	79	103
2008	22	70	92
2009	24	77	101
2010	25	83	108
2011	26	85	111
2012	29	91	121
2013	32	97	129
2014	33	97	130
2015	34	92	126
2016*	35	97	132

* estimates.

Source: author's research based on „The New Dynamics of Financial Globalization" McKinsey Global Institute, August 2017, p. 82.

Table 2. Foreign investment liabilities in global economy, 1995-2016 (in %)

	International financial centres (IFC)	Global economy (IFC excluded)	Total
1995	7	93	100
1996	5	95	100
1997	9	91	100
1998	8	92	100
1999	13	87	100
2000	10	90	100
2001	12	88	100
2002	15	84	100
2003	20	80	100
2004	19	81	100
2005	21	79	100
2006	21	79	100
2007	23	77	100
2008	24	76	100
2009	24	76	100
2010	23	77	100
2011	23	77	100
2012	25	75	100
2013	25	75	100
2014	25	75	100
2015	27	73	100
2016*	27	73	100

* preliminary data.

Source: author's calculations based on data from Table 1.

Table 2 shows the share of foreign investment liabilities in international financial centres (IFC) and in global economy (without IFC). It is worth adding that the impact of financial centres (with particular attention paid to offshore financial centres) upon global economy has for years been focusing the interest and research of the International Monetary Fund[2].

[2] In 1999 the IMF, acting upon the initiative of G7 countries, established the Financial Stability Forum comprising three groups that study the impact of offshore financial centres, hedging funds, and short-term capital flows upon financial markets stability.

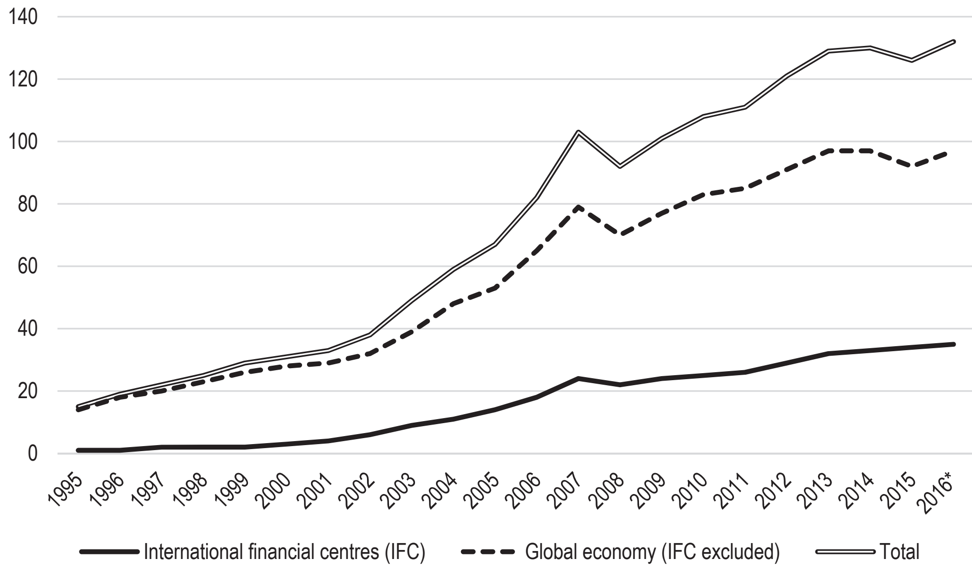

Diagram 1. Foreign investment liabilities in global economy 1995-2016 (in bn of USD)

Source: author's research based on data from Table 1.

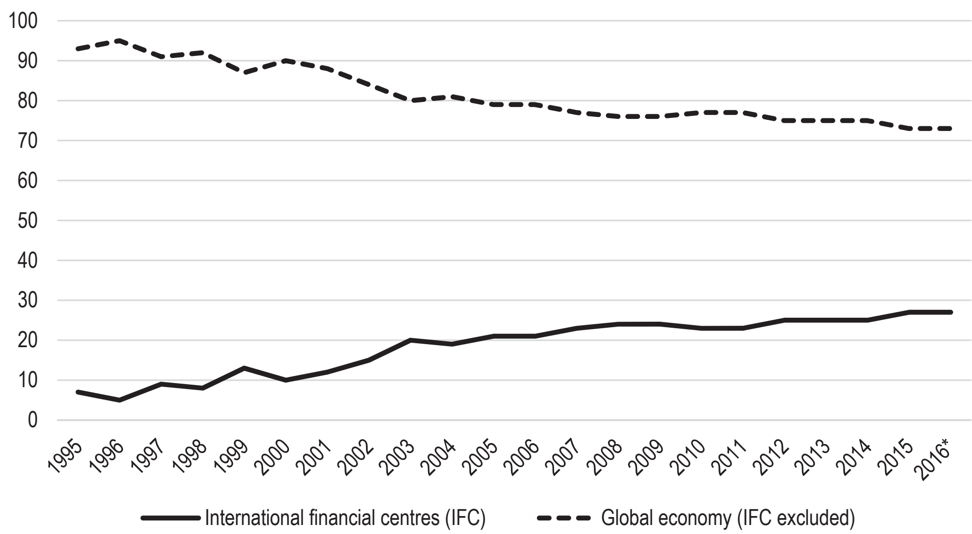

Diagram 2. Foreign investment liabilities in global economy, 1995-2016 (in %)

Source: author's research based on data from Table 2.

Data in Table 1 (illustrated in Diagram 1) dispel all doubts as to the continuous growth of the value of foreign liabilities in global economy and the value of international capital flows (see Milesi-Ferretti, Tille 2010; Bussière, Schmidt, Valla 2016; Lane, Milesi-Ferretti 2017). However, it is worth noting that the period covered by the study 1995-2016 is clearly inhomogeneous and can be divided into three sub-periods: 1995-2002 – stable growth; 2003-2007 – dynamic growth; 2008-2016* (* – preliminary data) – uneven growth. Undoubtedly, growth dynamics of total foreign liabilities between 2003 and 2007 was so high that maintaining it at identical level within a longer time perspective was practically impossible. Growth that started after 2008 is clearly much more „flattened". At the same time, over the entire studied period the share of foreign liabilities in international financial centres was increasing (see Diagram 2), although it also includes growth adjustment in 2007. Thus, significant portion of international capital flows, currently almost 30%, escape the supervision and jurisdiction of their respective home countries. Assuming that capital in international financial centres may potentially destabilise international financial markets, it is hard to argue that the growth of such centres supports sustainable growth of financial markets. Besides harmonious growth of both sides of the market: demand and supply, the term includes stability of growth, which is not favoured by sudden and unexpected occurrences connected with distortion of such harmony.

3. Foreign direct investment as the most desired form of foreign investment

Researchers remain divided over the impact of foreign direct investment upon the growth of the host country (see, e.g., Borenszteina, De Gregoriob, Leec 1998; Alfaro, Chanda, Kalemli-Ozcan, Sayek 2004; Li, Liu 2005; Almfraji, Almsafir 2013; Iamsiraroj, Ulubaşoğlu 2015). Nevertheless, this category of capital inflow is the most desired from the point of view of national economy due to long-term nature of capital engagement and additional benefits entailed by FDI (know-how, new jobs, bigger share in international trade, etc.). Under such circumstances, to achieve harmonious sustainable growth we need the highest possible share of FDI as the most stable form of investors' capital engagement in host country markets. From individual country perspective it is not only the volume of incoming capital that matters but, in line with the so called structure hypothesis, its structure (see Wei 2005, Janicka 2013). Vast majority of countries prefer receiving long-term equity (direct investments and equity portfolio investments), while the least desired inflows include potentially speculative capital (debt short-term portfolio investments, loans, and borrowings) (see Bekaert, Campbell, Lundblad 2005; Rajan, Subramanian 2005).

The structure of capital inflows is also relevant for the sustainable growth of financial markets. Excessive volume of cross-border flows of short-term capital may seriously impact the supply and demand side of the market. During the global financial crisis 2008+

a question was raised whether and how destabilisation in international financial markets and national economies has influenced the structure of international capital flows.

Table 3. Foreign liabilities structure in global economy, 2005-2016* (in %)

Year	Global foreign liabilities (in bn of USD)	Direct investment	Equity portfolio investments	Debt portfolio investments	Loans and borrowings
2005	67 019	24	18	25	34
2006	82 337	24	19	24	32
2007	103 017	25	18	23	34
2008	91 852	26	12	26	36
2009	101 051	27	15	26	32
2010	107 718	27	16	25	31
2011	111 087	28	15	26	32
2012	120 571	29	16	25	29
2013	128 977	30	18	24	28
2014	130 297	30	19	24	27
2015	125 889	31	19	24	26
2016*	131 746	32	18	24	26

* preliminary data.

Source: author's calculations based on https://www.mckinsey.com/industries/financial-services/our-insights/the-new-dynamics-of-financial-globalization (data visualization), accessed on 01.11.2017.

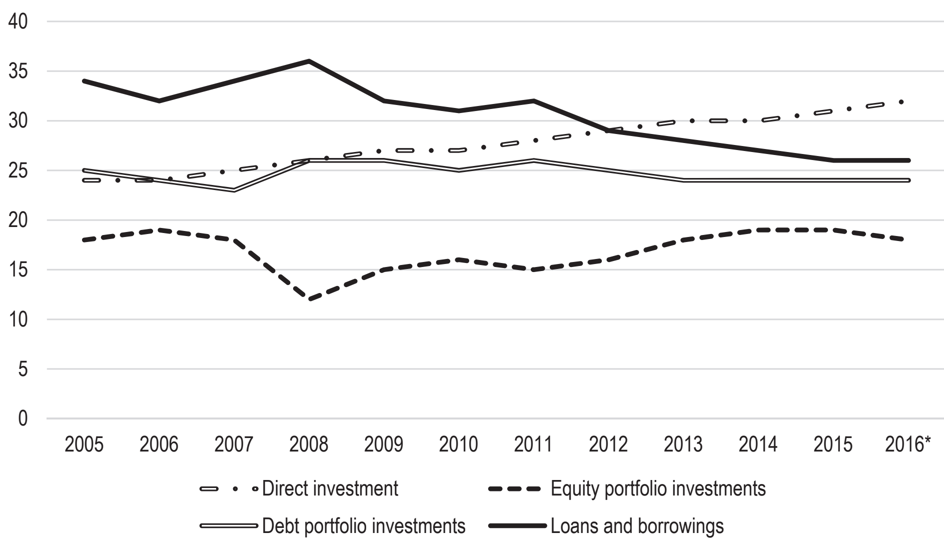

Diagram 3. Foreign liabilities structure in global economy, 2005-2016* (in %)

Source: author's calculations based on data from Table 3.

Analysis of data in Table 3 (illustrated in Diagram 3) shows that over the last decade the structure of capital inflows underwent a positive change, which got reflected in the structure of foreign liabilities in global economy; there is a clear increase in the share of direct investments and drop in the share of loans and borrowings. However, the landscape of changes triggered most probably with the outbreak of the global crisis in 2008 (a clear positive change in the trend in loans and borrowings, as well as equity portfolio investments) may look a bit differently if we consider relevant facts with regard to the share of FDI. As already indicated, FDI incoming to a country often change the picture of the economy of the host country through a variety of channels through which they impact this economy. FDIs reinforce, or at least should reinforce, growth potential of a country. Nevertheless, there are cases of countries in the global economy, which receive substantial FDI inflows but their impact upon host country economy is absent, simply nonexistent. Table 4 provides very interesting data with regard to such impact.

Data in Table 4 suggest that some international capital flows classified as foreign direct investments do not remain in the host country but target it to reap benefits. Such is principally the solution adopted by transnational corporations, who „park" their capital in the so called special purpose vehicles/entities (SPV/SPE) established in a given country to further invest it in another economy. This way for Luxembourg, which judging by the rate of foreign assets and liabilities to GDP (over 36 k % GDP) is the biggest global financial centre, the value of invested FDIs represents more than 8 k. % GDP, while the value of foreign FDI assets in Luxembourg is over 9 k % GDP of the country. Considering the average relationship of foreign investment assets or liabilities (FDI) in individual countries, which does not exceed 100% GDP, a situation similar to that in Luxembourg (although at a much smaller scale) can be observed also in the Netherlands, Ireland, Hong Kong, Switzerland, Singapore, and Mauritius. It means that data in Table 3, which suggest positive changes in the structure of international capital flows, may not faithfully reflect the reality, i.e., increases in the share of FDI in international capital flows recorded over recent years might not have happened. International institutions are aware of the growing role of international financial centres in intermediation in cross-border FDI flows. Lack of data is the problem, which emerges when trying to describe the phenomenon. However, we can grasp its scale based on available data published by the OECD. Table 5 presents data for selected member countries of the organisation.

Table 4. Foreign liabilities and assets of selected economies with particular stress on FDI 2016* (in bn of USD, %GDP)

Category		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	[…] 33	[…] 36
Country		United States	**Luxembourg**	United Kingdom	**the Netherlands**	Germany	Japan	France	China	**Ireland**	**Hong Kong, China**	**Switzerland**	Canada	Italy	**Singapore**	Spain	Poland	**Mauritius**
Total foreign assets (bn of USD)		21 708	10 643	10 577	8 045	8 064	8 215	6 149	6 594	4 963	4 471	4 290	3 212	2 713	2 976	1 760	242	379
Total foreign liabiities (bn of USD)		29 922	10 825	10 492	7 970	6 617	5 472	6 983	4 739	5 572	3 402	3 537	3 071	2 878	2 350	2 906	548	357
Foreign assets (% GDP)	Foreign direct investment	40	**9 088**	71	**659**	57	29	66	12	**478**	**537**	**232**	83	34	**230**	55	14	**1 687**
Foreign liabilities (% GDP)	Foreign direct investment	39	**8 231**	59	**576**	42	5	44	26	**474**	**574**	**192**	66	26	**359**	60	51	**2 142**
	Equity portfolio investment	35	6 376	58	86	20	30	35	5	903	135	145	30	10	52	25	8	195
	Debt portfolio investment	59	1 797	99	206	61	28	109	2	183	16	16	65	66	13	69	26	71
	Loans and borrowings	28	1 799	183	167	68	48	96	9	338	336	183	39	53	368	81	33	577
Total foreign assets and liabilities/ GDP (%)		278	**36 101**	801	**2 077**	424	277	533	101	**3 588**	**2 455**	**1 186**	411	302	**1 793**	378	169	**6 158**

* preliminary data

Source: author's calculations based on „MGI Financial Connectedness Ranking" in: „The New Dynamics of Financial Globalization" McKinsey Global Institute, August 2017, p. 8

Table 5. Foreign direct investment (liabilities) in selected OECD countries, 2014-2016 (bn of USD)

Country	Unit	2014	2015	2016
Austria	All resident units	314 585	281 402	247 847
	Special purpose entities (SPE)	99 214	87 429	90 432
Belgium	All resident units	1 110 005	1 007 704	956 723
	Special purpose entities (SPE)	232 466	176 402	112 772
Denmark	All resident units	167 463	150 687	159 975
	Special purpose entities (SPE)	32 774	24 215	29 551
France	All resident units	1 097 459	1 051 871	1 053 550
	Special purpose entities (SPE)	0	0	0
Germany	All resident units	1 465 302	1 367 852	1 381 252
	Special purpose entities (SPE)	0	0	0
Hungary	**All resident units**	**273 224**	**266 331**	**314 566**
	Special purpose entities (SPE)	**148 876**	**136 938**	**205 767**
Ireland	All resident units	909 763	1 381 244	1 410 949
	Special purpose entities (SPE)	nd	nd	nd
Luxembourg	**All resident units**	**4 744 740**	**5 195 536**	**4 994 009**
	Special purpose entities (SPE)	**4 397 260**	**4 901 769**	**4 712 800**
the Netherlands	**All resident units**	**4 550 081**	**4 369 712**	**4 435 456**
	Special purpose entities (SPE)	**3 767 269**	**3 588 030**	**3 581 027**
Poland	All resident units	252 400	222 979	223 399
	Special purpose entities (SPE)	2 562	1 308	2 119
Switzerland	All resident units	1 174 013	1 255 093	1 216 829
	Special purpose entities (SPE)	nd	nd	nd
United Kingdom	All resident units	2 066 047	1 889 938	1 798 409
	Special purpose entities (SPE)	nd	nd	nd
United States	All resident units	6 369 524	6 700 834	7 569 251
	Special purpose entities (SPE)	0	0	0

Source: OECD Stat. http://stats.oecd.org/Index.aspx?QueryId=64109 accessed on 01.11.2017.

Examination of data in Table 5 confirms our earlier conclusions that huge FDI inflows to some European economies do not stem from especially investor-friendly climate and competitive advantages of the country, which encourage investing in it. These data prove that not only Luxembourg (94% FDI resources in 2016) and the Netherlands (81% FDI resources in 2016) have become destinations for the so called „capital in transit" but also, e.g., Hungary (65% FDI resources in 2016). The same indicator for Poland is practically insignificant and amounts to ca. 1%. We need to add that some countries (e.g., Ireland, Switzerland or the United Kingdom) do not provide information about FDI in special purpose entities. Hence the scale of the phenomenon is hard to assess globally. However, provided data challenge the general opinion about the significance of FDI for the growth of the host country. Referring to the issue of sustainable growth of financial markets tackled by the paper, FDI are one among categories of cross-border capital flows, which by definition positively stabilise domestic economy, including its financial sector, and external equilibrium of the country. Yet, the nature of FDI flows evolves and, as a result, the structure of international capital flows broken down by transaction criterion discussed in section 2 of this paper may look much less favourably than suggested by the data.

Conclusion

Sustainable growth can be traced in different aspects of social and economic reality. However, it is most commonly interpreted as growth respecting CSR and SRI principles. Apparently, in the financial sector focusing exclusively on following the CSR principle and undertaking socially responsible investments is a far reaching simplification. Sustainable growth does not only involve environmental protection but also broadly understood social wellbeing connected with ensuring equal opportunities, reducing social imbalances, preventing social exclusion, etc. Sustainable growth is the type of conduct, which, by taking account of cyclic nature and volatility of economic processes seeks to prevent their escalation and mitigate their root-causes. If we agree that the financial sector serves the real economy, its over-alienation destroys the relationship. As a result of advancing financialization, the financial sector gets „detached" from real economic processes and international capital flows are no more linked with transactions in the real economy. Before the outbreak of the 2008+ crisis, highly developed countries thought they were in control of the financial sector. Illusiveness of such thinking was revealed by the scale and depth of crisis, which originated exactly from these countries. Thus, sustainable growth of the financial sector is not just a stable and harmonious growth but growth that is subject to certain ramifications, which would mark a fundamental qualitative change in the age when national monetary authorities may create liquidity without any limitations. Their absence generates ressentiments over the gold currency system (gold standard). The system, despite its disadvantages, had one clear advantage, i.e., it linked money creation with the accumulated resources of gold and no country was privileged with respect to that (at least theoretically). The paper identifies three aspects that threaten sustainable operation of financial markets: dynamic increase in the value of global foreign assets and liabilities, increasing importance of international financial centres global economy, and partial transformation in the role of cross-border FDI flows, i.e., the category which until the present has been considered the most stable. Remarkably, unstable and unpredictable environment generated by an alienated financial system poses a threat of subsequent destabilisation of global economy. Changes taking place in international financial markets should thus be examined with caution and in the context of their impact upon the wellbeing of economies and societies.

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