Amir Alizadeh: In this session, I'm gonna focus on growth of finance industry and financial services industry. So we're going to talk about what were the drivers behind the growth in financial markets, including globalization, trade, innovation, technology, and sort of deregulation and so on.

Amir Alizadeh: Now, today is about the growth of financial markets and also the growth of finance industry. The banking system developed in the mid sort of 18th century, slowly the banks, they started to pop up, and the banks started to issue their own promissory notes. And these promissory notes, for example, was from bank A, may not be acceptable to bank B as well, yeah?

Amir Alizadeh: So what happened the governments they came and said that, "Okay, let's issue notes," because if you issue notes and it is backed up by government, it is acceptable to, for example, everybody and all the banks, and it is easier to trade with that rather than carrying gold and so on.

Amir Alizadeh: Actually the first notes that were used, they were ... there are stories that they were issued in China first on leather pieces, but the notes in Europe, apparently they started in 1790 and so on, were UK type where notes were published and used.

Amir Alizadeh: At the same time, people started to establish cooperations. They started to make cooperations like ship owners that they had ... Investors, they put money together, and each one had 1/64th of a ship, then you could trade. For example, if I had 1/64th of a ship, I could sell it to someone else. But this was sort of unestablished, these were cooperations and people could trade share of the ship or a company.

Amir Alizadeh: And later on, these cooperations, they came under umbrella of an exchange, like London Stock Exchange. So money became note, industries became cooperations. And hand in hand, people said, "Okay, we can buy and sell shares of these companies." And then companies said, "Okay, why we get money direct from investors, well, they have for example, a say in our day-to-day operations." Because if you buy a share, normally you have a vote. But people said, "Okay, what we can do, those industries, we can issue bonds, we can issue debt. We can borrow money from investors in a formal bond, or we can borrow money from banks."

Amir Alizadeh: And this exploded in the 20th century where the finance industry grow exponentially. So the financial market grew at a very fast rate, even faster than the economic growth and faster than trade growth.

Amir Alizadeh: What was the driver behind this growth in the 20th century or later part of the 20th century? Globalization, and we're going to talk about globalization a lot. Trade, free trade, where for example, I can bring iron ore from Australia or Brazil, and make steel for example, in the Talbot factory, a steel mill, and then make it to other forms of goods and machinery, and sell back, for example, to Brazil, yeah?

Amir Alizadeh: Technology. Technology has a big say in growth in financial markets, yeah? Because nowadays investors are connected. And connection through Internet, through telephone, through messengers, can facilitate deals very fast. You can see what's happening, for example, in Japan on the screen this morning and make your decision instantly.

Amir Alizadeh: Until the Second World War, if the governments they wanted to issue these notes to print money, they had to have enough gold reserves to be able to print the money. Why? Because when they print a note and give it to someone, that note means that you can exchange this note for a certain amount of gold. Yeah? So that was [inaudible 00:04:42]. We call that system gold standard. Yeah? So if you have a gold standard, it means that the government can only print money according to their gold reserves.

Amir Alizadeh: Now, what happened after Second World War, some people they said that, "Okay, some countries, they buy and sell gold in order to move their economy or money, print more money and so on, or less money." So one committee from the UN had a meeting and the finance ministers of sort of developed countries at the time, they got together and they started to negotiate, to say that, "Look, we cannot continue with this gold standard system of printing money, so what we can do, we can select one currency, which is sort of dominant currency," and at the time it was US dollar, and we say that, "Okay, all other currencies can be pegged to US dollar, and then US dollar is pegged to gold, for $35 per ounce."

Amir Alizadeh: And this system worked for a while until what happened in the 60s, late 60s, was the Vietnam war, yeah? And that put a lot of burden on the US government in terms of debt. So they wanted to print money, but they couldn't because of gold reserves and so on. So President Nixon abandoned, basically announced the abandonment of sort of Bretton Woods, so they came off. And also other countries, they came off as well, because they wanted to control their currency, because if the inflation goes up or if the inflation goes down, you want to print more money or less money, you want to have your own monetary policy.

Amir Alizadeh: So they came out of this Bretton Woods, 1971. And after 1971, the currencies or the economies, they were printing their own money, they were controlling their own monetary policy, interest rate and so on, so they were more free. But what was the result of that? It becomes more volatile, yeah? So the exchange rate can go up and down, because the market determines how much that exchange rate should be.

Amir Alizadeh: Now regulation. A couple of things about regulation. What is the aim of regulation from the authorities' point of view? From the regulatory authorities' point of view? They want to protect the investors, they don't want to sort of financial institutions or companies to act fraudulently in order to sort of mislead their customers.

Amir Alizadeh: And the other important issue about regulation nowadays is prevention of money laundering as well as terrorism activities or terrorism funding and so on. And also the other big aim of financial regulation is to prevent financial meltdown or crisis, yeah?

Amir Alizadeh: What regulation came about over sort of these many years that is aiming to prevent financial meltdown in financial institutions. That's Basel Accord, yeah? Capital adequacy rules, Basel I, Basel II, Basel III.

Amir Alizadeh: Problems? If you have more regulation, it costs more to institutions because you have to have a compliance, you have to have people to sort of implement those regulation to your system and to your trade. And also, if you protect too much financial institutions, if you put them in too much protection, there is always a risk of what we call moral hazard, that was say, "Okay, I'm protected, so I don't need to be worried about this and that, yeah?"

Amir Alizadeh: Now, Basel Accord. Perhaps you have heard of about it. This came about after the 1987 crash. So in 1988, the Bank of International Settlement in Switzerland, in Basel, they started to work to put some guidelines for financial institutions as how to manage the risk, or how to monitor the risk.

Amir Alizadeh: So, initially, Basel I started with classifying assets into five categories from lowest risky asset, basically cash, or gold, or deposit, that can be liquidated very fast. And then as the assets become more and more risky, then you have to have more reserves to meet the risk of those.

Amir Alizadeh: Then in 2004, they came about a new set of rule in a meeting again, they call it Basel II. And Basel II, they came about three pillars. The second pillar was what they call transparency, so they can ... financial institutions etc., they have to report their positions, their assets and so on, much better. And also they talked about market discipline as well.

Amir Alizadeh: Then in 2011 10/11, after the financial crisis again, they put more guidelines. This time in terms of management of risk and assessment of risk. And this time what they introduced was a stress testing, yeah? After 2010/11, they said, "Okay, what if things go wrong, how much you're likely to lose and so on." But in a bigger picture as a whole portfolio of the bank.

Amir Alizadeh: Not only all the financial institutions around the world, they follow these Basel Accord, but 100 countries, they adopted these Basel Accords now.

Amir Alizadeh: UK Central Bank also jumped on the bandwagon and said, "Okay, we do what we call asset quality review, AQR." Yeah? So they look at the banks and say, "Okay, we look at your assets and see what you have." So it's very similar to Basel Accord as well.

Amir Alizadeh: Deregulation is good. Privatization increased the number of companies in the stock market. Investors before ... For example, let's take one of the industries like, I don't know, rail industry. Before it was in the UK, it was with government employees and everybody was working for the government, but when they deregulated, then they privatized the whole system. So now we have several companies operating our rail services, and investors invest in those companies. Those companies they issue bonds, they raise capital from capital markets, and so and so forth. So that's privatization.

Amir Alizadeh: And also UK has introduced for example, tax incentives. Basically, okay, if you save money, they give you a tax break. Yeah? Whereas at the other end, they increased the VAT or tax on petrol or alcohol or cigarette and so and so forth. So the tax system is going from income tax base to consumption tax base. Yeah?

Amir Alizadeh: Financial innovation. We have different types of financial innovation like innovation that you can broaden the market, basically go to different countries, offer them different type of products. Risk management innovation, adopt the techniques that are sort of more suitable in order to reflect the risk. Arbitrage innovation, pricing innovation, and marketing innovations.

Amir Alizadeh: Emerging markets. We have economies like in South East Asia, Latin America, even in the Middle East, we have China, we have Russia, we have Brazil, South Africa. These are all examples of emerging markets, especially for example, in Europe, we have Eastern European countries like Poland, like Hungary, like Croatia and so on. These are all sort of new markets, emerging markets, there are opportunities there, but at the same time the risk is high.

Amir Alizadeh: Here is the change in basically global balance in emerging markets, part of it is forecast, but that's basically the GDP share of developed countries, but the emerging market share of the economy is increasing in the world, and the forecast is that by the time we reach 2020, the share will flip, the GDP share of the emerging market will go above.

Amir Alizadeh: The last thing is that what is the problem with emerging markets apart from risk? The problem is poor accounting standards, poor governance, information costs money, because it's not as transparent as developed markets, regulation is a bit more slack there. You have political risk, that's a big issue in emerging markets because you have political risk. You invest in China, Russia, etc. thing may change very quickly.

Amir Alizadeh: Foreign investment, if you want to invest in Chinese stock market, then there are some restrictions in terms of how much you will spend, or how much money can you take out, or how much money can you put in. Higher transaction cost, definitely, because the market is not as liquid, yeah? They're not as liquid as developed markets.

Amir Alizadeh: And then there are some markets that we call them frontier markets, but this is a sub-category of emerging markets. You have emerging markets, and sub-category is frontier markets. And these are much much newer market, a smaller market, like, I don't know, Cyprus, Vietnam, I don't know, Lithuania, and so on and so forth.

Amir Alizadeh: Here is just a graph that shows how the growth is in these economies, like Asia Pacific we have a lot of growth, but when you go to Latin America, higher political risk, lower growth generally there. Then you have Middle East, okay, Middle East is not quite reflective because they're oil-based economies. Sub-Saharan economies, actually they're doing quite well, 2016, you had 6%, Ghana for example, 4.7%, Nigeria and so on. And the best performers for example, East European countries, are ... they're very close to the market, yeah? East European countries are ... some of them integrated in Europe and they're very close to the European markets, but the growth is not very high unfortunately.

Amir Alizadeh: Now, here is the last graph that I want to show, to tell you about the growth in emerging markets and developed markets. Look at the US economy, nearly $23 trillion economy, yeah? The next one to it is China which is about 12 trillion. So the red bar is the growth, 2% growth in all these economies. 2% growth for US means something like 400 billion, whereas 2% growth, I don't know, for Russia, doesn't change the world economy. That's why people say that if America sneezes everybody [inaudible 00:15:07], so if they go bad, all the markets will go bad. If they're doing well, everybody else is doing well. That can have an impact, like a ripple effect on the other parts of the world, especially US and even China nowadays. Yeah? Growth in China is becoming more and more important to all of us. Yeah?

Amir Alizadeh: Okay, that was it for today, so thank you very much and see you soon.