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Long-term trends in the global capital markets

Several current trends will continue to influence the world's financial markets long after the present bout of turbulence ends.

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Struggling credit markets, slumping stocks, and a sliding dollar have been generating anxiety among executives and policy makers in early 2008. Amid the turmoil, it's easy to forget that long-term structural change in the world's capital markets will probably prove more important than short-term fluctuations, as it did after the 1987 US stock market crash, the 1992 assault on the British pound, and the 1997 unraveling of Asia's financial markets.

Recent McKinsey Global Institute (MGI) research highlights several trends that look set to continue during the years ahead, long after the present bout of market turbulence has ended:

- the continued growth and deepening of global capital markets as investors pour more money into equities, debt securities, bank deposits, and other assets around the world
- the soaring growth of financial markets in emerging economies and the growing ties between financial markets in developed and developing countries
- the shift of financial weight in Asia from Japan toward China and other fast-growing emerging markets
- the growing financial clout of the eurozone countries and the significance of the euro
- the burgeoning role of oil-rich Middle Eastern countries as suppliers of capital to the world, along with the rise of new financial hubs in the Middle East to complement the rapidly growing hubs in London and Asia

While these trends reflect a shift in financial power from the United States toward other parts of the world, the sheer size and depth of the US market will give it a leading role on the international financial stage for years to come.[1]

The exhibits that follow track the progress of these long-term shifts. The research rests on several proprietary MGI databases that cover the financial assets, cross-border capital flows, and foreign investments of more than 100 countries since 1990. Most of the analysis focuses on developments through 2006, the most recent year for which comprehensive data are available. But some data also show that many of the broad trends continued through late 2007 and will probably persist in years to come.

Notes

[1]Readers interested in additional detail should refer to the full MGI report, *Mapping Global Capital Markets: Fourth Annual Report* (part of a series begun in 2003), available online.

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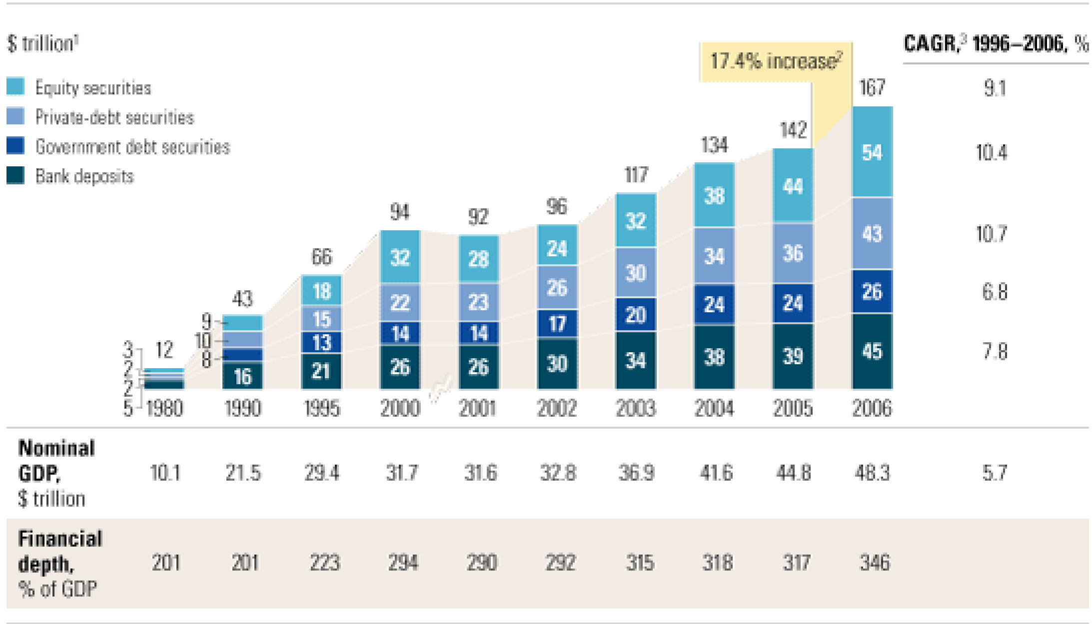
The continued growth of global financial assets

The full fallout from the credit market volatility of 2007 remains to be seen. But over the longer term, the volume of global financial assets (the value of all bank deposits, government debt securities, corporate debt securities, and equity securities) will continue to expand. Over the past 25 years, through stable and stormy times alike, financial assets have grown robustly. In 2006, their value rose to $167 trillion, from $142 trillion the year before—a 17 percent increase, more than double the average annual growth rate (8 percent) from 1995 through 2005.[2]

For many years, as equity and bond markets thrived, bank deposits have accounted for a shrinking share of total financial assets. That trend continued in 2006, but the rate of decline slowed because the absolute value of bank deposits around the world jumped by $5.6 trillion—twice the average increase of the previous three years.[3] The largest contributor to this rise was the United States, thanks largely to strong income growth and the housing boom, which enabled many households to tap their home equity for quick cash. This source of growth was shaky by 2007. Looking forward, the growth of deposits will depend to a large degree on China, where they are the primary savings vehicle.



[1]Figures may not sum to totals, because of rounding.
[2]$5.9 trillion of increase in 2006 (from 2005) was caused by depreciation of US dollar against other currencies. Even at constant exchange rates, growth in 2006 was faster than average from 1995 to 2005.
[3]Compound annual growth rate.

Source: McKinsey Global Institute global-financial-stock database

Notes

[2]Some $5.9 trillion of the increase resulted from the depreciation of the US dollar against other currencies. Even at constant exchange rates, growth in 2006 was faster than the average growth from 1995 to 2005.

[3]Or $3.8 trillion when exchange rates are held at end-of-2006 values.

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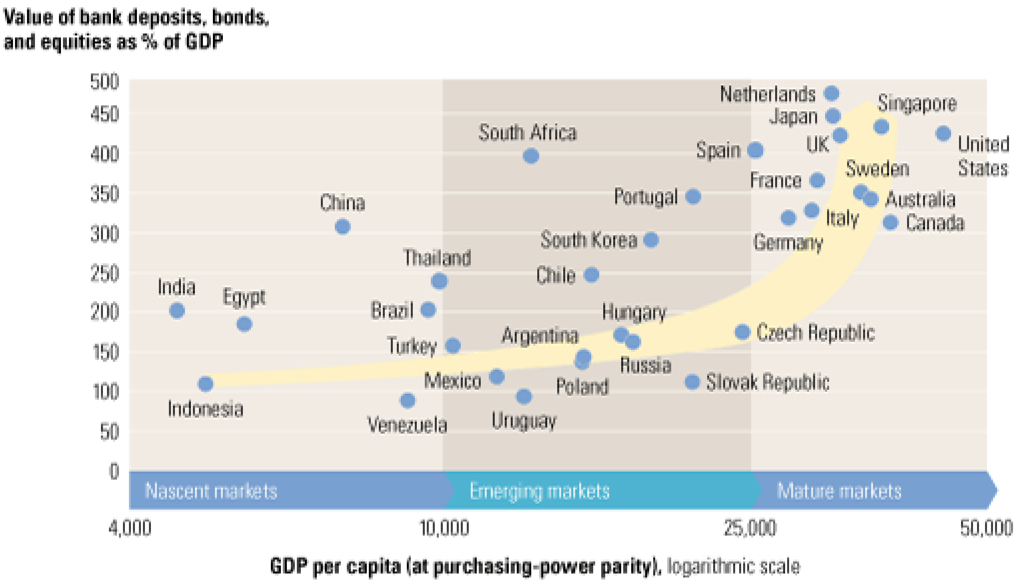
Ever-deeper financial markets

Financial markets have been growing faster than global GDP for many years. As a result, financial depth, or the ratio of a country's financial assets to GDP, has been increasing consistently across all regions. This deepening makes markets more liquid, improves access to capital for borrowers, helps to price financial assets more efficiently, and increases opportunities to share risk. In 1990, only 33 countries had financial assets whose value exceeded that of their respective GDPs. By 2006, this number had more than doubled, to 72 countries; Brazil, China, India, and Russia rank among those with financial assets worth far more than their gross national products. In 1990, only 2 countries had a financial depth exceeding 300 percent; 26 do today.

Several mechanisms help to deepen financial markets. One is the issuance of more publicly traded equities, as happened over the past decade with the privatization of state-owned companies in Western Europe, as well as in China, Eastern Europe,[4] Russia, and other emerging markets. Another is the issuance of corporate bonds or asset-backed securities. In addition, bank deposits can swell with the growth of incomes and the appearance of new savings products, such as certificates of deposit and money market accounts. Rising equity values from stronger corporate earnings make markets deeper as well. Finally, rising asset prices and government debt can also have that effect. In 2006, with assets worth roughly 3.5 times world GDP, global financial depth increased to an all-time high. Nearly half of the increase came from growth in equities, largely the result of higher corporate earnings rather than increased price-to-earnings ratios.

Financial depth for selected countries, 2006



Source: McKinsey Global Institute global-financial-stock database

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[4]Eastern Europe includes Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Ukraine.

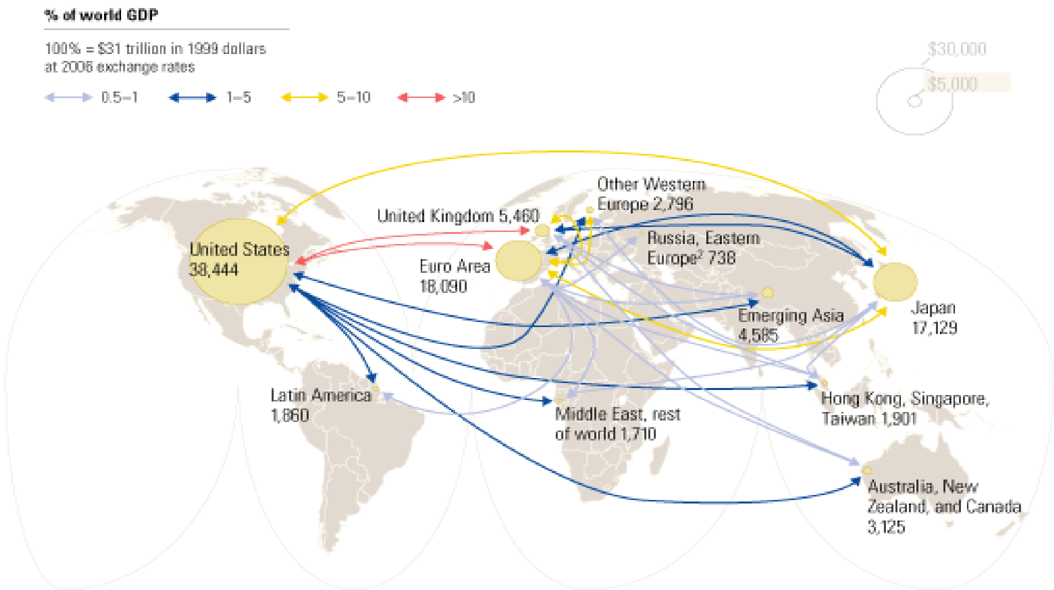
Growing cross-border investment links financial markets

The rising level of foreign investment is making the world more financially inter-dependent than it was even a few years ago. By the end of 2006, the outstanding stock of cross-border investments reached the highest level, in real terms, in history—$74.5 trillion of assets. This sum includes the foreign investments of multinational corporations, purchases of foreign debt and equity securities by investors around the world, and foreign lending and deposits. Preliminary data indicate that the total grew to another record level in 2007, despite the disruptions in European and US credit markets during the second half of the year.

What’s more, the source and direction of cross-border investment flows are shifting. In 1999, the United States was the dominant hub of the global financial system. By 2006, it remained the largest single foreign investor and a major hub in global capital markets—but the eurozone countries together had as many financial links with other parts of the world, including emerging markets. The United Kingdom too has become a more significant global financial hub, and Middle Eastern countries are now major investors in global financial markets, thanks to the windfall generated by rising oil prices. In 2006, for the first time since the 1970s, the oil-exporting countries joined those of East Asia as the world’s largest net suppliers of capital.[5]

Part 1: Global web of cross-border investments, 1999

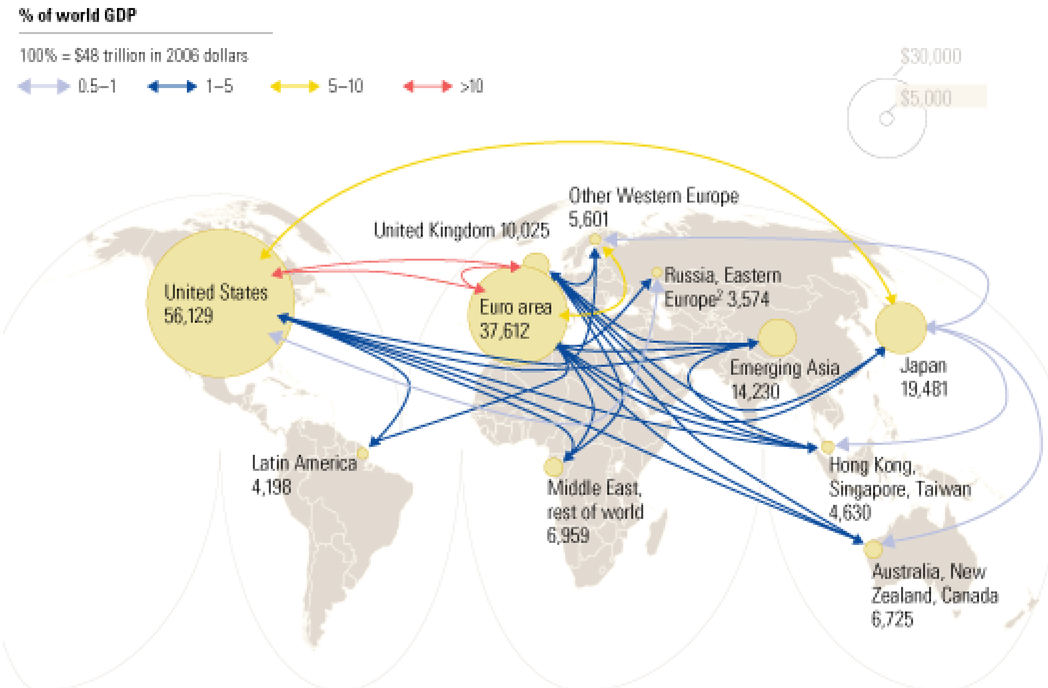
Lines show total value of cross-border investments between regions[1]
Figures show size of total domestic financial assets, $ billion



[1]Includes total value of cross-border investments in equity and debt securities, lending and deposits, and foreign direct investment.
[2]Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Ukraine.
Source: McKinsey Global Institute analysis

Part 2: Global web of cross-border investments, 2006

Lines show total value of cross-border investments between regions[1]
Figures show size of total domestic financial assets, $ billion



[1]Includes total value of cross-border investments in equity and debt securities, lending and deposits, and foreign direct investment.
[2]Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Ukraine.
Source: McKinsey Global Institute analysis

Russia, and Venezuela. See Diana Farrell and Susan Lund, "The world's new financial power brokers," mckinseyquarterly.com, December 2007.

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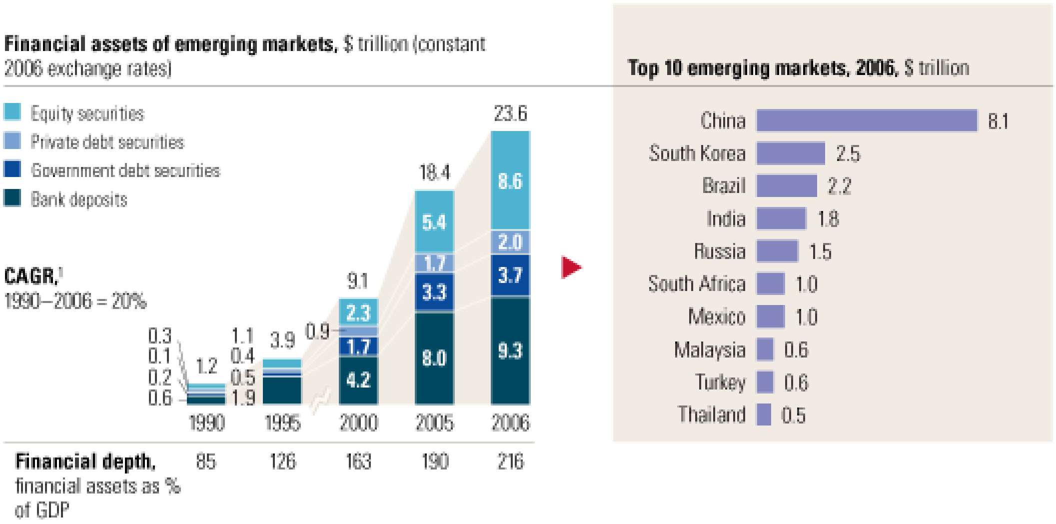
Surging emerging markets

The broadening of global financial linkages partly reflects the growing importance of emerging markets. Their financial assets rose by $5.3 trillion in 2006, to a total of $23.6 trillion—an increase accounting for one-quarter of global growth in financial assets. Over the past ten years, the value of those assets has increased more than twice as quickly in emerging markets as in developed ones. China accounted for a third of all financial assets in emerging markets and for almost half of their growth in 2006.

Although bank deposits are the largest asset class in these countries, reflecting their immature financial systems, much of the growth in recent years has come from the development of their equity markets. Companies in emerging markets accounted for 35 percent of all money raised globally through IPOs in 2006, up from 10 percent in 2000. Chinese companies raised more money through IPOs in 2006 than British, German, or Japanese ones did—and as much as all companies in the eurozone combined.

Rising price-to-earnings ratios (reflecting higher company valuations) explain a significant part of the equity growth in many emerging markets. P/Es have doubled in the equity markets of China and Russia since 2003—a sign of potential trouble ahead. Still, in the long run, emerging financial markets appear to have considerable room for additional expansion: they still account for only 14 percent of global financial assets—significantly less than their share of global GDP (23 percent).



[1]Compound annual growth rate.

Source: McKinsey Global Institute global-financial-stock database

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Emerging providers of capital

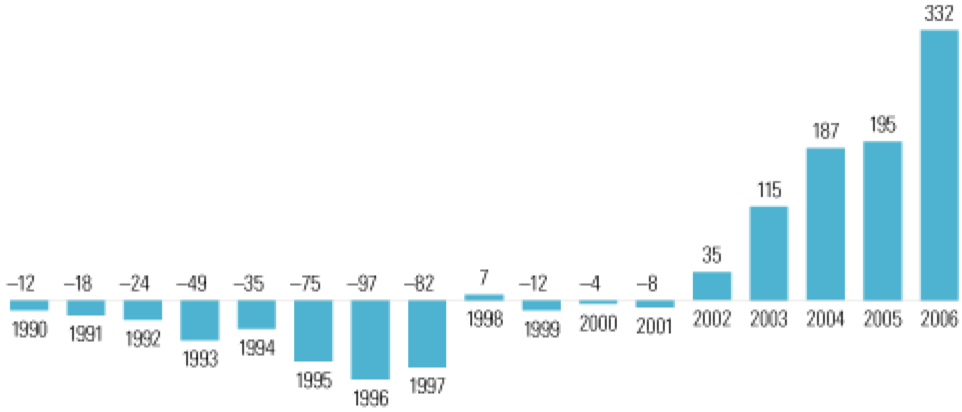
Contrary to what economic theory would predict, emerging markets are net providers of capital to the rest of the world—a recent trend fueled by soaring exports and rising commodity prices. In 2006 (as Exhibit 5 shows), they invested $332 billion more abroad than they received in foreign investment. Among major emerging markets, only the Eastern European countries are now net recipients and run large current-account deficits.

Total capital outflows from emerging markets reached a landmark $1 trillion in 2006, with purchases of foreign reserves by central banks accounting for half of the total. Foreign direct investment from companies in emerging markets rose to $139 billion in 2006, nearly twice its level in 2005 and six times its level five years earlier.

China, the biggest source of capital outflows from emerging markets, invested $383 billion abroad in 2006, nearly two-thirds of it in foreign reserves purchased by the central bank. China also received $166 billion in foreign investment during that year, more than twice as much as second-ranking Russia.

But even as emerging markets invested abroad, foreign capital inflows to them reached a new high in 2006 as well: $700 billion, or 6.4 percent of their collective GDP, surpassing the previous peak (5.6 percent), in 1996. Capital inflows and outflows alike are linking emerging markets to global capital markets more and more closely.

Net capital flows in emerging markets[1] (capital outflows minus capital inflows), $ billion (constant 2006 exchange rates)



[1] 34 emerging markets, including Argentina, Brazil, China, Czech Republic, India, Indonesia, Philippines, Poland, Russia, South Korea, Thailand, Turkey.

Source: McKinsey Global Institute analysis

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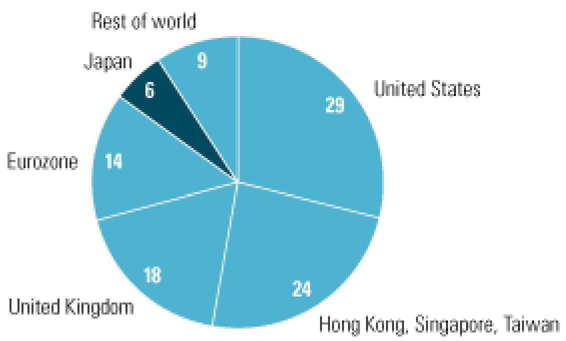
Continued financial challenges for Japan

Japan is losing ground as a regional financial center in Asia. It accounted for just 6 percent of the foreign money invested in emerging Asian countries, despite its geographic proximity to them. The other potential Asian financial centers—Hong Kong, Singapore, and Taiwan—accounted for 24 percent, or $530 billion. Japan's main cross-border investment relationships are still with the eurozone, the United Kingdom, and the United States.

Although Japan remains the world's third-largest financial market (after the United States and the eurozone), the country's total domestic financial assets remained essentially flat at $19.5 trillion in 2006, an increase of just $140 billion from 2005. What's more, Japan's huge government debt accounted for more than one-third of its financial assets and exceeded 150 percent of GDP in 2006. Excluding this, the country's financial depth would be at its 1990 level. In contrast, over the same period, the financial depth of the United States and the eurozone increased by 168 and 173 percentage points, respectively.

Foreign investment[1] in emerging Asian countries,[2] 2006, %

100% = $2.2 trillion



[1] Includes equity and debt securities, lending and deposits, and foreign direct investment.
[2] China, India, Indonesia, Macao, Malaysia, Philippines, South Korea, and Thailand.

Source: McKinsey Global Institute analyais

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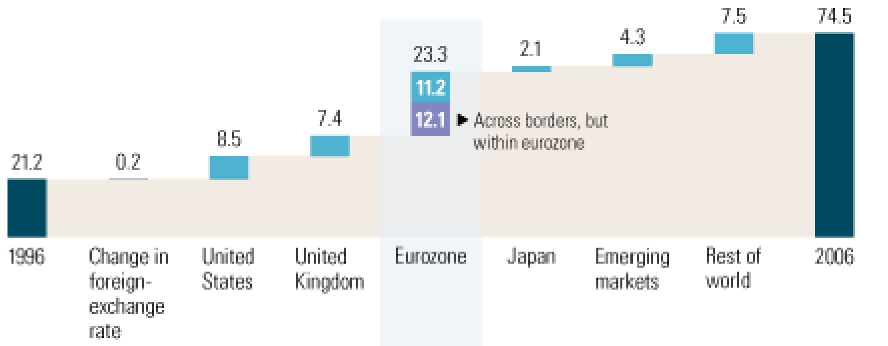
Capital markets in Europe continue to surge. Over the past ten years, its investors have contributed almost half of the total growth in foreign investments around the world. This phenomenon reflects growing cross-border investments both among eurozone countries and between them and the rest of the world.

By the end of 2006, eurozone investors owned $14.7 trillion in cross-border investments within the region, a reflection of the increasing integration of its financial markets. One in three of its equities and one in five of its bonds (by value) belongs to an investor from a different eurozone country. Eurozone investors also owned $14.7 trillion in foreign assets in the rest of the world, making the region collectively a larger foreign investor than the United States. Reflecting London’s emergence as a financial hub for Europe, around 30 percent of capital flows from the eurozone went to the United Kingdom in 2006. Overall, around 75 percent went to the United States or to the United Kingdom and other Western European countries.

Distribution of foreign-investment assets, $ trillion (constant 2006 exchange rates)



	1996	Change in foreign-exchange rate	United States	United Kingdom	Eurozone	Japan	Emerging markets	Rest of world	2006
CAGR,[1] 1996–2006, %			12.0	13.2	17.0	6.0	19.0	23.9	13.4
Contribution to growth, %		0.4	15.9	13.8	43.6	3.9	8.0	14.4	

[1]Compound annual growth rate.

Source: McKinsey Global Institute analysis

The strengthening euro

As the eurozone’s financial markets mature, the euro is emerging as an international currency that could challenge the dollar. The euro has not only been rising in value against the greenback but also, in April 2007, quietly passed another milestone: for the first time, the value of all euro notes in circulation surpassed the combined value of all the US dollars in wallets, piggybanks, and central-bank vaults around the world. Since 2003, the euro has been the currency of choice for companies issuing international bonds as well.

To be sure, the US dollar is still the world’s preferred reserve currency: central banks hold an estimated two-thirds of their reserves in greenbacks. But as the breadth and liquidity of the eurozone’s financial markets grow, the euro may gain ground. Already, it has become the second most popular reserve currency, accounting for 25 percent of global reserves, up from 18 percent in 1999. This share may rise as central banks and other institutions seek higher returns on their reserves and as China and other countries peg the value of their currencies less to the dollar and more to baskets of currencies in which the euro plays a prominent role.

Value of currency in circulation, $ billion
(constant 2006 exchange rates)

Source: International Monetary Fund (IMF); European Central Bank; US Federal Reserve; McKinsey Global Institute analysis

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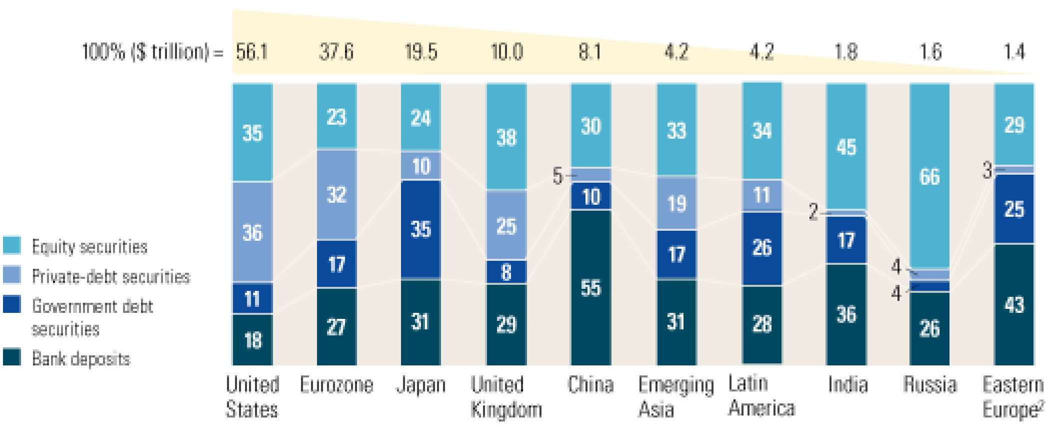
The relative strengths of the United States

Despite the flourishing of the eurozone, the United States remains the world's largest and most liquid financial market, with $56.1 trillion in assets, nearly one-third of the global total. What's more, financial assets in US markets posted the world's largest absolute level of growth, adding $5.7 trillion in value. Equities contributed 43 percent of that growth, a reflection of higher earnings rather than rising P/E ratios. The growth of US financial assets in 2006 also reflected strong corporate-bond issuance and an increase in the issuance of mortgage- and other asset-backed securities. US government debt, though very large, accounted for only 5 percent of the growth.

The United States continues to attract nearly 25 percent of all global capital inflows. Foreign investors purchased $1.9 trillion of US financial assets in 2006, an increase of $655 billion from 2005. The country is the world's largest destination for foreign direct investment and receives substantial inflows of foreign lending and deposits. It is also a large source of capital flows to other countries: in 2006 its companies, households, pension funds, and other investors made net purchases of $1.1 trillion in foreign financial assets, and US companies were the world's largest source of foreign direct investment and equity investments. Overall, the United States runs a large financial-account surplus that is the flip side of its current-account deficit.[6]

Distribution of financial assets by region,[1] 2006, %



	United States	Eurozone	Japan	United Kingdom	China	Emerging Asia	Latin America	India	Russia	Eastern Europe[2]
Financial depth, financial assets as % of GDP	424	356	446	422	307	250	159	202	162	130
CAGR,[3] 1990–2006, %	8.7	9.2	3.6	9.5	25.7	15.5	23.0	19.9	54.2	26.9

[1]Figures may not sum to 100%, because of rounding.
[2]Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Ukraine.
[3]Compound annual growth rate at constant 2006 exchange rates.

Source: McKinsey Global Institute global-financial-stock database

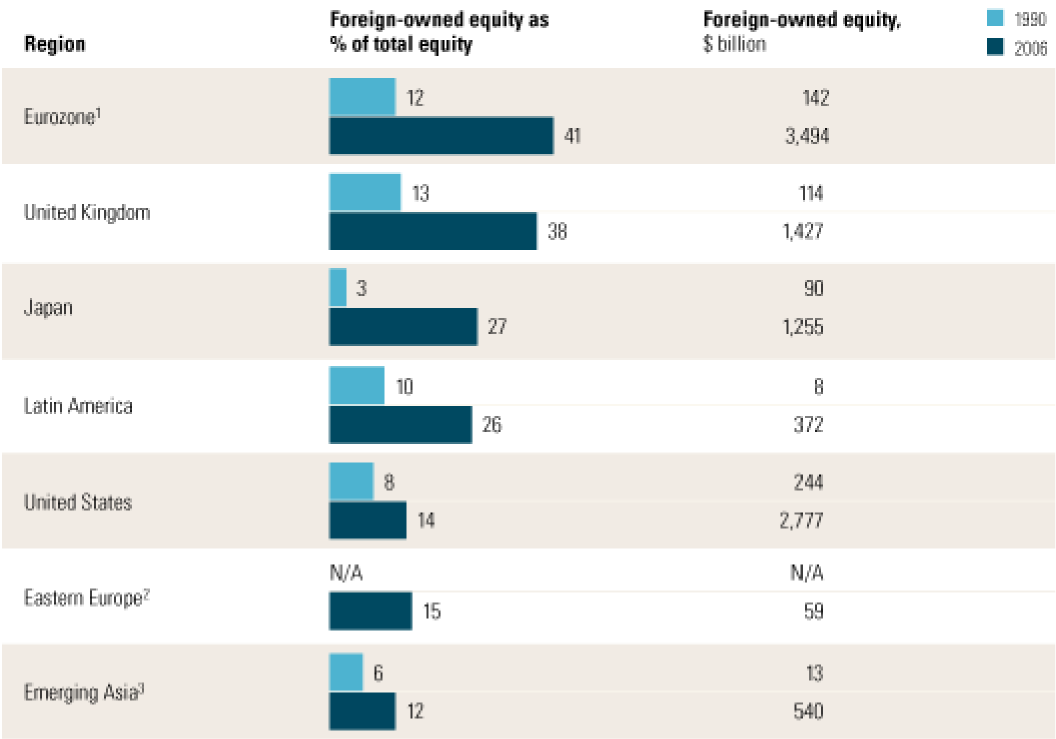
Notes

[6]For more information about the US current account, see Diana Farrell and Susan Lund, "What businesses need to know about the US current-account deficit," mckinseyquarterly.com, August 2007.

Foreign equity ownership

Although the sale of US companies and assets to foreign investors has raised concerns that the economic sovereignty of the United States may be compromised, foreign ownership of financial assets has increased in every region. In 1990, foreign investors owned less than one in ten equities around the world; by 2006, they owned more than one in four. The same pattern holds for government and corporate bonds: foreign ownership increased from 11 percent in 1990 to 31 percent in 2006 for the former and from 7 percent to 21 percent for the latter.

Indeed, the eurozone, more than the United States, stands out for its high levels of foreign ownership both of equities and bonds. In 2006, investors outside the region owned 41 percent of its equities ($3.5 trillion), and investors in other eurozone countries owned an additional 31 percent ($2.7 trillion). As for bonds, investors outside the region held 24 percent of the total ($4.5 trillion), while investors from other eurozone countries held an additional 20 percent ($3.7 trillion).



[1]Includes only investors outside eurozone. In 2006, cross-border investors within eurozone owned $2,682 billion, or additional 31%, of total equities.
[2]Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Ukraine.
[3]China, India, Indonesia, Macao, Malaysia, Philippines, South Korea, and Thailand.

Source: McKinsey Global Institute analysis

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