



Mapping Global Capital Markets Fourth Annual Report

Chapter 1: \$167 trillion and counting

| January 2008

McKinsey Global Institute

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Preface

Mapping Global Capital Markets: Fourth Annual Report is the latest research by the McKinsey Global Institute on the evolution of the world's financial markets. This report is based on findings from three proprietary databases that document the financial assets, capital inflows and outflows, and cross-border investments of more than 100 countries around the world since 1990. By examining this data, we see the process of globalization at work and countries' shifting positions and power in the world financial order.

Susan Lund, a senior fellow at the McKinsey Global Institute based in Washington, DC, worked closely with me to provide leadership on this project. The project team included Christian Fölster, a McKinsey consultant from the Berlin office; Raphael Bick, a consultant from McKinsey's Munich office; Moira Pierce, a senior research analyst at the North American Knowledge Center; and Charles Atkins, an MGI analyst. Essential research support was provided by Tim Beacom and Susan Sutherland.

This report would not have been possible without the tireless support of several MGI professionals: Nell Henderson, senior editor; Rebeca Robboy, external relations manager; Deadra Henderson, practice administrator; and Sara Larsen, executive assistant.

Our aspiration is to provide business leaders and policy makers around the world with a fact base to better understand some of the most important trends shaping global financial markets today. As with all MGI projects, this research is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

Diana Farrell
Director, McKinsey Global Institute
January 2008
San Francisco



1. \$167 trillion and counting

Global capital markets had a banner year in 2006. The value of the world's financial assets rose by \$25 trillion, in nominal terms, to \$167 trillion. This stunning growth occurred amid shifts in the roles played by different countries, regions, and asset classes.

The US financial market remains the largest in the world and posted the greatest absolute growth in 2006. But Europe's markets continued to deepen and gain share. China burst onto the scene, with more financial asset growth than any country other than the United States. Japan's financial recovery stalled, but its market remains the third largest in the world (after the United States and the combined eurozone markets).¹ Emerging markets reached new financial heights but still accounted for a smaller share of world financial assets than of global GDP. And equities accounted for the largest share of growth in global financial markets for the fourth consecutive year.

Together, these and other changes in capital markets illustrate the shifting positions of countries within the world economy and provide a window on the process of globalization. In this chapter, based on the McKinsey Global Institute's proprietary database of the financial assets of more than 100 countries around the world, we assess the size and growth of the world's financial markets in 2006, the latest year for which comprehensive global data are available. We examine the sources of growth and the different roles that regions and countries are playing in the global financial system. In doing so, we illustrate the long-term

¹ In our analysis, the eurozone comprises Austria, Belgium, France, Finland, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Slovenia, and Spain. Cyprus and Malta joined in January 2008.

trends that are reshaping global capital markets—trends likely to continue and not be significantly altered by the credit market turbulence in the United States and Europe in 2007.

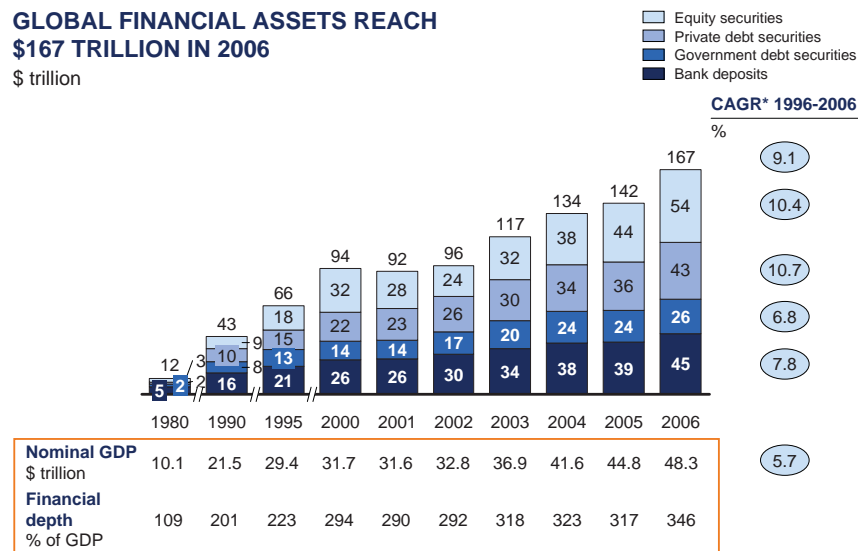
GLOBAL FINANCIAL ASSETS REACH \$167 TRILLION IN 2006

In 2006, total global financial assets reached an unprecedented \$167 trillion, up from \$142 trillion in 2005 and just \$12 trillion in 1980 (Exhibit 1.1).² We measure the size of the global capital market by adding together the market value of publicly traded equities, the value of all bank deposits, and the outstanding face value of government and private debt securities. The sum represents the amount of capital that is intermediated through banks and securities markets. When measuring a country's total financial assets, we counted the value of equity and debt securities issued by the public companies of the country.³ (For information on the derivatives market, see *A look at the global derivatives market*.)

Exhibit 1.1

GLOBAL FINANCIAL ASSETS REACH \$167 TRILLION IN 2006

\$ trillion



By our count, global financial assets grew 17.5 percent in 2006, more than double the average annual growth rate of 8 percent from 1995 through 2005. The nominal value of total assets rose by \$24.8 trillion. But this partly reflects

2 All dollars are current US dollars. All growth rates are nominal growth rates based on financial asset numbers expressed in current US dollars; thus, they reflect inflation and exchange rate shifts.

3 See Technical Notes in the appendix for more on how we measure global financial assets.

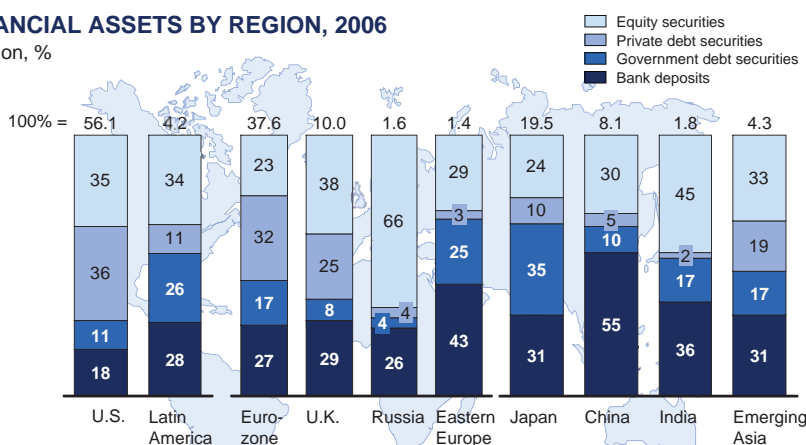
exchange rate movements, including the depreciation of the dollar against other major currencies. When measured at constant end-of-2006 exchange rates, to remove the effect of such distortions, we see the “real growth” in financial assets was \$18.9 trillion—more than twice the “real” \$7.7 trillion increase in 2005.

The United States, the United Kingdom, the eurozone, and Japan account for more than 75 percent of global financial assets, reflecting the huge size of their economies and financial markets. Despite growing concerns that the United States is losing ground to new rivals, it remains the world’s largest market by a significant margin. In 2006, the United States had \$56.1 trillion of financial assets, or nearly one-third of the global total (Exhibit 1.2).

Exhibit 1.2

FINANCIAL ASSETS BY REGION, 2006

\$ trillion, %



Financial depth	424	159	356	422	162	130	446	307	202	250
% of GDP										
CAGR (90-06)*	8.7	23.0	9.2	9.5	54.2	26.9	3.6	25.7	19.9	15.5
%										

* Compound annual growth rate at constant 2006 exchange rates.

Note: Some numbers do not add to 100% due to rounding.

Source: McKinsey Global Institute Global Financial Stock Database

The eurozone—the countries that share the common continental currency—ranks second, with \$37.6 trillion of financial assets. Japan places third with \$19.5 trillion. The United Kingdom has just \$10 trillion in financial assets but is nevertheless an important intermediary for cross-border capital flows and international banks. Asian financial markets remain fragmented and have very different characteristics. For instance, Japan has a very large government-debt market; but more than half of China’s \$8.1 trillion in financial assets are bank deposits.

Countries’ and regions’ shares of the world’s financial assets have shifted over time. The United States’ share grew from 34 percent in 1990 to 42 percent in

A look at the global derivatives market

Complex derivatives were at the heart of the credit market turmoil that rippled through financial markets in 2007, raising concerns about the financial players' abilities to manage risk as capital markets rapidly evolve.

Unlike equities, debt securities, and bank deposits, which represent financial claims against future earnings by households and companies, derivatives are risk-shifting agreements among financial market participants. Because of this fundamental difference, McKinsey Global Institute (MGI) does not include derivatives in the calculation of the value of global financial assets. However, it is worth noting that the size of the market for derivative contracts has boomed over the past 15 years, as its impact has grown.

According to the Bank of International Settlement (BIS), global derivatives markets have grown at an annual rate of 32 percent since 1990 and the total notional value outstanding amounted to \$477 trillion in 2006, or three times the value of global financial assets. However, notional value—the value of the underlying asset—does not provide an accurate measure of risk exposures. Gross market value,⁴ or the cost of replacing all derivative contracts, was just \$10 trillion in 2006. After considering netting agreements, the net credit exposure, that is, the amounts truly at risk, from global derivative contracts outstanding amounted to just 1 percent of global financial assets in 2006.

That would appear to be a small risk. But the credit crunch that began in mid-2007 arose from the markets' sudden inability to value many of the newest complex financial products, collateralized debt obligations. When defaults began to rise on US subprime mortgages, investors shunned products that had mixed these loans with others into asset-backed securities that were pooled, sliced, and priced according to the purported level of risk.

The growth of derivatives has brought benefits to the world's financial system by helping many investors hedge risk, adding liquidity, and even creating an alternative investment class for less risk-averse market participants. But in recent years, as has happened in the past, risk management lagged financial innovation—a challenge worth keeping in mind as global capital markets grow ever more complex.

⁴ Defined as gross market value (cost of replacing contracts at market value) after taking into account legally enforceable bilateral netting agreements.

2001, but then shrank back to 34 percent in 2006. The eurozone experienced the opposite, losing share between 1990 and 2001 (from 23 to 19 percent), and then gaining share back to 23 percent in 2006. The United Kingdom's share has been fairly stable since 1990 at 5 to 6 percent.

Changes have been more dramatic in other regions. In Asia, Japan's share of global financial assets has fallen from 23 percent to 12 percent, while China's share has increased from less than 1 percent to 5 percent. Today, the financial assets of Asian countries outside Japan are nearly equal to Japan's \$19.5 trillion—and they are growing much faster. Emerging markets have seen their share of financial assets slowly rise over time.

FINANCIAL MARKETS GET DEEPER AND DEEPER

Financial depth, or the ratio of a country's financial assets to its GDP, is an important measure of the development of global capital markets. In 1980, the total value of global financial assets was roughly equal to world GDP. By 1993, assets were double the size of GDP, and by the end of 2006, assets were worth nearly 3.5 times world GDP.

Financial deepening has occurred across all regions. In 1990, only 33 countries in the world had financial assets that exceeded the value of their GDP (excluding financial hubs such as Hong Kong). By 2006, this number had more than doubled to 72 countries. In 1990, only 2 countries had financial depth exceeding 300 percent—whereas 26 countries do today (Exhibit 1.3). By 2006, China, Russia, India, and Brazil each had financial assets worth far more than their respective GDP (Exhibit 1.4).

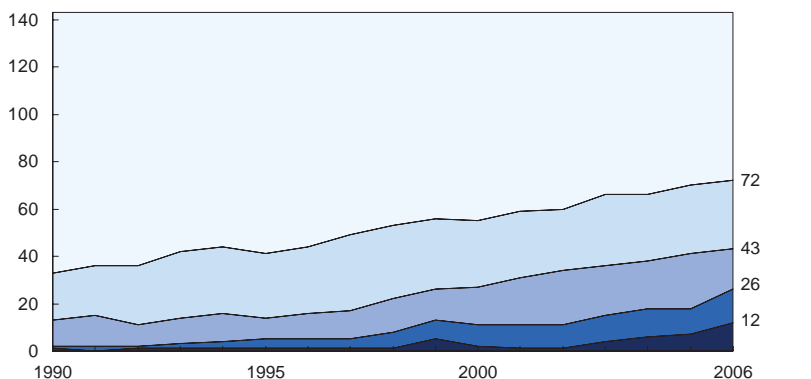
For the most part, deeper financial markets are beneficial because they are more liquid, create better access to capital for borrowers, offer more efficient pricing, and increase opportunities for sharing risk. In some developing countries with shallow financial markets, the main available savings instrument for households is a low-yielding bank account, and the only source of external funding for companies is a bank loan. In developed markets, however, households can invest their savings in stocks, bonds, mutual funds, and other instruments; borrowers can go to a bank, issue debt, or sell stock.

The value of financial assets can be many times larger than GDP because it reflects predicted future returns of companies and economic growth. A country's financial market deepens through several mechanisms. One is the issuance of more publicly traded equities, as has occurred over the past decade with the

Exhibit 1.3

THE NUMBER OF COUNTRIES WITH FINANCIAL DEPTH OVER 100% HAS MORE THAN DOUBLED SINCE 1990

Number of countries by financial depth**



* Financial assets as % of GDP.

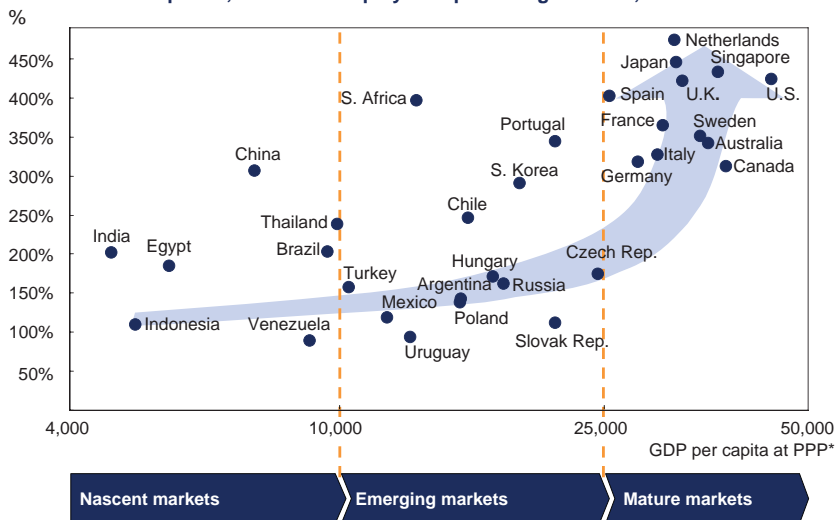
** Excludes financial hubs such as Hong Kong and Luxembourg.

Source: McKinsey Global Institute Global Financial Stock Database

Exhibit 1.4

MAP OF GLOBAL FINANCIAL DEPTH

Value of bank deposits, bonds and equity as a percentage of GDP, 2006



* Log scale.

Source: McKinsey Global Institute Global Financial Stock Database

privatization of state-owned companies in China, Russia, and Eastern Europe.⁵ Another is the issuance of more corporate bonds or the creation of asset-backed securities. In addition, bank deposits can swell with income growth or the creation of new savings products, such as certificates of deposit and money market accounts. Markets will also deepen when equity values rise because of stronger corporate earnings.

However, financial deepening also can result from unhealthy increases in government debt or from asset-price bubbles. During the late-1990s stock market boom, global financial depth increased due to soaring equity-market valuations, and then declined in 2001 and 2002 as those valuations tumbled. Excessive government debt can lead to economic stagnation because it can crowd out private lending and hamper growth; when issued in foreign currencies, it can trigger a costly financial crisis, as happened in Argentina in 2002 and Mexico in 1994.

Over time, we see a consistent upward trend in world financial depth. In 2006, depth increased by 16 percentage points to an all-time high. Nearly half of the deepening came from growth in equities, largely due to higher corporate earnings rather than increases in price-earnings ratios.

IT'S ALL ABOUT EQUITIES

For the fourth year in a row, equities made the largest contribution to the growth of global financial assets. During 2006, equities rose by \$9 trillion,⁶ accounting for nearly half of the total increase. Just three countries account for 52 percent of equity growth that year: the United States, China, and Hong Kong (Exhibit 1.5).

Equity markets have grown faster than debt markets in 11 out of 16 years since 1990. However, debt markets have grown more in absolute terms than equity markets since 1990. This is because of falling equity prices after the stock bubble started losing air in 2000, which caused global market capitalization to decline. Equities increased by \$45 trillion from 1990 to 2006 while debt securities increased by \$50 trillion.

Since equity market growth picked up in 2003, gains in developed countries have mainly reflected higher earnings, not higher P/E ratios. US and Japanese P/E ratios fell during this time and remained flat in Europe, even though market capitalization increased (Exhibit 1.6).

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

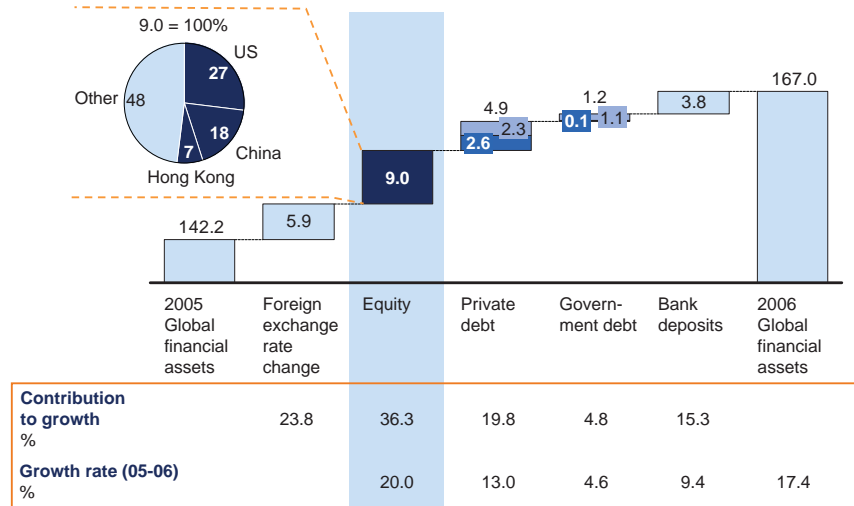
6 Growth excludes exchange rate changes.

Exhibit 1.5

EQUITIES WERE THE MOST IMPORTANT CONTRIBUTOR TO GROWTH IN 2006

\$ trillion, constant 2006 exchange rates

Domestic
International

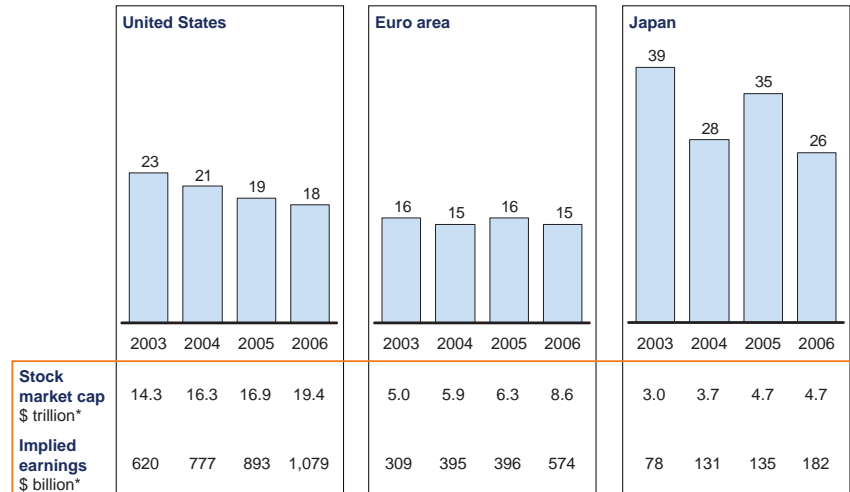


Source: McKinsey Global Institute Global Financial Stock Database

Exhibit 1.6

PRICE-EARNINGS RATIOS HAVE NOT INCREASED IN DEVELOPED MARKETS

Price-earnings ratios of selected developed markets



* Market exchange rates during the year.

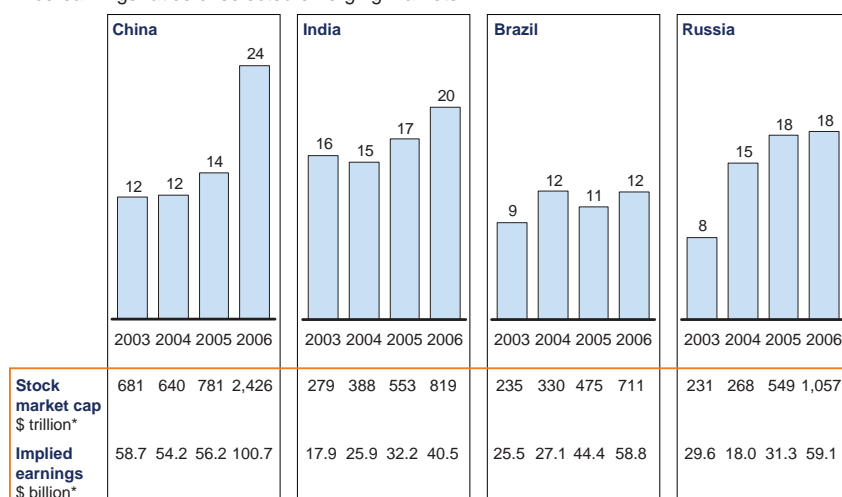
Source: Datastream; McKinsey Global Institute Financial Stock Database; McKinsey Global Institute analysis

Stock markets also have soared in emerging economies, accounting for more than one-third of global equity market growth from 2003 through 2006. Emerging-market equity valuations increased by \$3.3 trillion during these years, with Chinese companies accounting for almost half the gain. This reflects rising commodity prices, partial privatization of some huge state-owned companies, and the emergence of some new global companies. Even so, equity growth in many emerging markets has been due mainly to rising P/E ratios—an indication we could see trouble ahead. Since 2003, P/E ratios have doubled in China and Russia, and increased more than 20 percent in India and Brazil (Exhibit 1.7).

Exhibit 1.7

PRICE-EARNINGS RATIOS HAVE INCREASED SIGNIFICANTLY IN EMERGING MARKETS

Price-earnings ratios of selected emerging markets



* Market exchange rates during the year.

Source: Datastream; McKinsey Global Institute Financial Stock Database; McKinsey Global Institute analysis

Worldwide, corporate-debt securities rose by \$4.9 trillion in 2006, making them the second-largest contributor to total asset growth. Just over half of this increase came from international debt issues—bonds issued outside the home country and usually in a foreign currency, such as the dollar or the euro—which rose \$2.6 trillion, or 18.9 percent. The US domestic market alone accounted for almost half of the total increase in private debt (\$2.2 trillion), largely because of heavy corporate issuance, but also because the still-strong housing market generated a flood of securities backed by mortgages and home-equity loans. Spain and the United Kingdom were the next largest contributors to the growth of private debt, with \$498 billion and \$353 billion respectively.

One surprise in 2006 was the surge in bank deposits. For many years, bank deposits have accounted for a shrinking share of total financial assets, as equity and bond markets have thrived. But the absolute value of the world's bank deposits continues to climb, jumping in 2006 by \$3.8 trillion—the biggest annual gain ever. The largest contributor to the 2006 increase was the United States, largely because of strong income growth and the housing boom, which enabled many households to tap their home equity for quick cash. China, where bank deposits are the primary savings vehicle in a fast-growing economy, was the second-largest source of growth. The United Kingdom was third, in large part because of London's role as an international financial center.

Government debt showed the smallest growth across asset classes in 2006, expanding by \$1.2 trillion. This is the smallest increase in government debt since 2000 when government debt increased only \$0.6 trillion. The largest source of growth was the United States, with an increase of \$312 billion. Japan was second, with an increase of \$197 billion, followed by China, with \$122 billion in new government debt.⁷ Together, these three nations accounted for more than half of the total growth. Government debt declined in some Latin American countries such as Chile and Venezuela, in several smaller European countries such as Sweden and Denmark, and in oil-rich Saudi Arabia.

UNITED STATES AND CHINA POST LARGEST GROWTH IN 2006

There is much gloomy talk in the United States these days about the eclipse of New York City by London as a global financial hub. In 2006, for the first time, the funds raised by all IPOs in London exceeded New York's total, and the value of London's IPOs by foreign companies was three times the value of those in the United States.

But don't write off the US markets just yet. In 2006, they posted the largest growth in financial assets in the world, adding \$5.7 trillion (Exhibit 1.8). Equities contributed 43 percent of that growth—and this reflected earnings growth, not rising equity market valuations. And as of November 2007, New York looked likely to reclaim the top ranking in IPOs in 2007 (Exhibit 1.9). As noted above, US financial asset growth in 2006 also reflected strong corporate bond issuance, increases in mortgage-backed securities, and increases in other types of asset-backed securities. The US government debt, although very large, accounted for only 5 percent of growth.

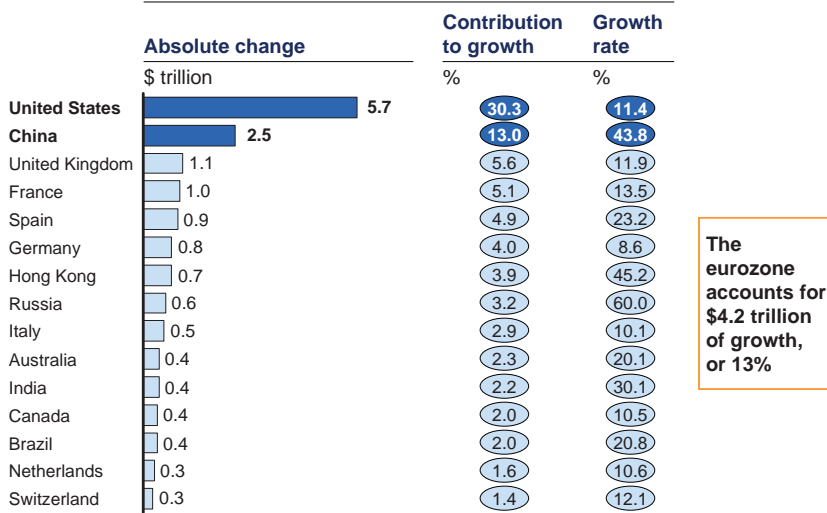
⁷ Not counting sterilization notes issued as monetary instruments by the People's Bank of China.

Exhibit 1.8

THE U.S. AND CHINA SHOW THE LARGEST ABSOLUTE GROWTH IN 2006

Constant exchange rates

Financial asset growth by country, 2005-2006



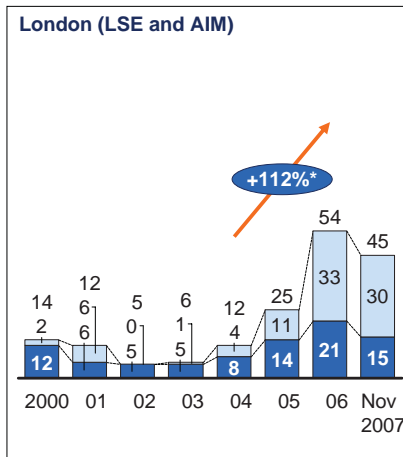
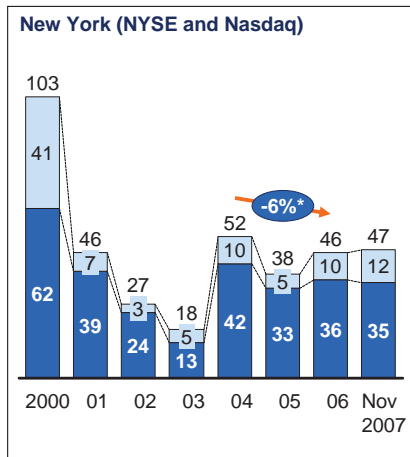
Source: McKinsey Global Institute Global Financial Stock Database

Exhibit 1.9

IN 2006, VALUE OF LONDON IPOs EXCEEDS NEW YORK

Total value of initial public offerings, \$ billion

Foreign companies
Domestic companies



* Compound annual growth rate 2004-2006.
Source: Dealogic

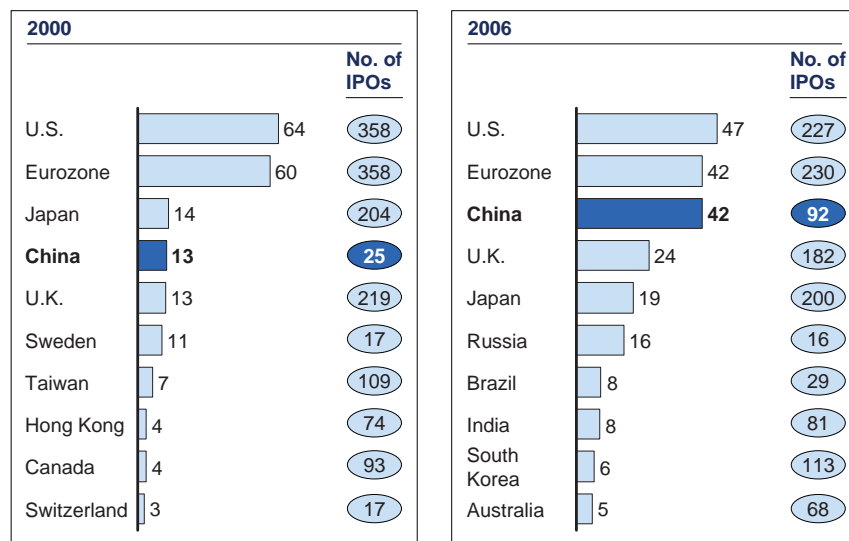
Growth in China's roaring financial markets was second only to the US increase. China's financial assets grew by \$2.5 trillion during 2006—nearly half the US amount. This represents a 44 percent increase over 2005, the second-highest growth rate in the world after Russia's 60 percent. China's total value of domestic financial assets reached \$8.1 trillion in 2006, boosting financial depth to 307 percent of GDP. This far outstrips India's financial assets, which grew to \$1.8 trillion in 2006.

China's equity markets accounted for 65 percent of the country's overall growth in financial assets in 2006. This is due in part to P/E ratios that have doubled since 2003, pushing company valuations sky-high. But it is also due to major new listings of state-owned companies. For example, Industrial and Commercial Bank of China (ICBC), which only a few years earlier had been mired in bad loans, overtook Citigroup to become the biggest financial institution in the world in terms of market value. This trend continued into 2007, as PetroChina's first public sale of shares in Shanghai left it with market capitalization in November of more than \$1 trillion—more than twice the size of ExxonMobil—albeit with a P/E ratio of 54. China emerged as the second-largest equity issuer in the world in 2006, running even with the eurozone and only slightly behind the United States (Exhibit 1.10).

Exhibit 1.10

IN 2006, CHINA ON PAR WITH EUROZONE EQUITY ISSUANCE

Money raised by initial public offerings, \$ billion



Source: Dealogic

China's equity market growth in 2006 marked a sharp rebound after the Shanghai stock index lost 50 percent of its value between 2001 and mid-2005.⁸ Several reforms helped spark the turnaround. When the government first started privatizing state-owned enterprises in the 1990s, it retained control of roughly two-thirds of the shares issued. These "nontradeable" shares could neither be sold nor transferred without government approval. Then in 2005 and 2006, the government adopted reforms to end this two-tier equity system, requiring companies to plan to make all their shares fully tradeable over the next five years. These reforms have already spurred expansion of both the supply of and the demand for public shares in these companies, whipping their prices higher. Many investors expect the gradual increase in public ownership to improve corporate governance and performance over time, eventually resulting in mergers, acquisitions, and other forms of needed restructuring. In addition, more foreign investors have been allowed to enter the mainland stock market, further accelerating market reforms but also adding to recent price increases. As China's equity market has grown, its bank deposits—the country's predominant financial asset—fell to 55 percent of overall financial assets in 2006, from 70 percent in 2005. Still, Chinese bank deposits totaled \$4.4 trillion in 2006—an increase of \$2.4 trillion over the past five years, reflecting savings of both households and corporations.

EUROPE CONTINUES TO SHOW ROBUST GROWTH

Europe's financial markets continued their ascent. If we add together the financial assets in the eurozone, the United Kingdom, and other Western European countries,⁹ the total rose by \$6 trillion in 2006, to reach \$53.2 trillion. That's nearly equal to the US total of \$56.1 trillion and represents a third of the world total. Moreover, Europe's combined financial market depth is increasing faster, albeit from a lower base. Financial depth has grown at a compound annual growth rate of 4.4 percent from 1996 through 2006, compared with the US rate of 2.8 percent.

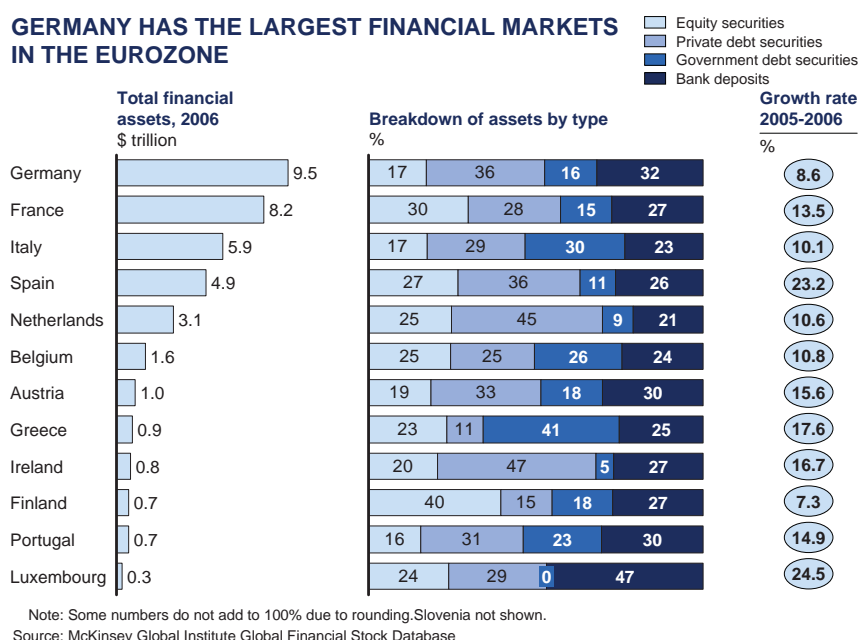
Europe's financial deepening reflects healthy development of its financial markets. In the eurozone, the expansion of equity markets has been due mainly to rising corporate earnings rather than rising valuations. The corporate debt market is growing rapidly, and government debt has remained steady or even decreased in some countries.

8 For more on China's financial system, see *Putting China's Capital to Work: The Value of Financial System Reform*, McKinsey Global Institute, May 2006. Available online at www.mckinsey.com/mgi.

9 This includes Denmark, Iceland, Norway, Sweden, and Switzerland.

Within Europe, we see that the eurozone countries together have the most financial assets (\$38 trillion) and account for most of the growth. The eurozone added \$4.2 trillion in financial assets in 2006 at constant exchange rates, or 5.5 trillion euros. Germany, France, and Italy—the eurozone’s largest financial markets—accounted for the most growth in absolute terms in 2006. However, the rates of growth were highest in Spain and Luxembourg, followed by Ireland and Greece (Exhibit 1.11).

Exhibit 1.11



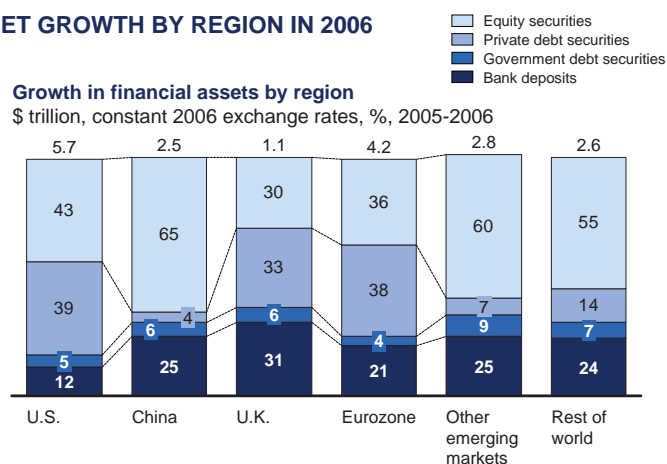
Outside the eurozone, other major Western European economies saw their financial assets grow by \$660 billion, or 13.4 percent. The largest driver was equity, accounting for \$442 billion, or nearly two-thirds of total growth. The second largest was private debt, which accounted for a fourth of total growth. Government debt decreased by \$23 billion, or 5 percent, from its 2005 level.

UK financial assets increased by \$1.1 trillion in 2006 to reach \$10 trillion. This represents the same percentage increase as US financial assets, and reflects London’s increasingly prominent role as a global financial hub, particularly for eurozone companies and investors. As noted above, London attracted more listings by foreign companies than New York in recent years and also attracted significant private foreign wealth. As a result, bank deposits accounted for nearly one-third of the growth in UK financial assets in 2006, compared with around 10

percent of US growth (Exhibit 1.12). Although hard data on the source of these deposits are not available, their size of \$330 billion suggests that at least part must be foreign wealth.

Exhibit 1.12

FINANCIAL ASSET GROWTH BY REGION IN 2006



Financial depth % of GDP	424	307	422	356	157	355
CAGR* (1990-2006) %	8.7	25.7	9.5	9.2	19.0	6.3

* Compound annual growth rate.

Note: Some numbers do not add up due to rounding.

Source: McKinsey Global Institute Global Financial Stock Database

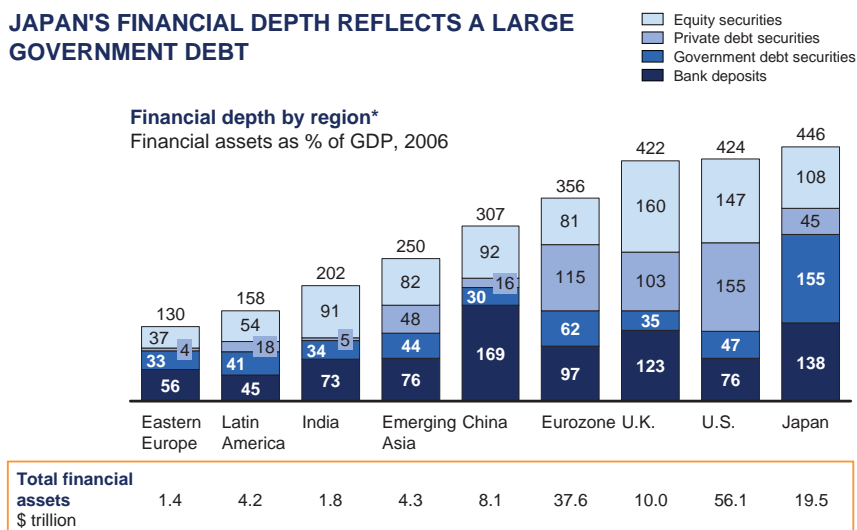
JAPAN'S FINANCIAL MARKET STAGNATES

Japan's financial recovery stalled in 2006. After three years of growth, Japan's total domestic financial assets remained essentially flat at \$19.5 trillion in 2006, an increase of just \$140 billion from 2005. Although government debt and equities grew slightly, private debt securities and bank deposits declined a bit. This reflected continuing weak economic conditions there.

Nonetheless, Japan remains the third-largest financial market in the world after the United States and the eurozone, and Japan has higher financial depth than the United States or the United Kingdom (Exhibit 1.13). However, Japan's huge government debt accounts for more than one-third of its financial assets and has exceeded 150 percent of GDP. The government over the past ten years has tried repeatedly to use fiscal policy to revive the economy, without much success. Excluding government debt, Japan's financial depth would be the same as it was in 1990. In contrast, over the same period, the United States has seen its financial depth increase by 168 percentage points, and the eurozone has seen financial depth increase by 173 percentage points.

Exhibit 1.13

JAPAN'S FINANCIAL DEPTH REFLECTS A LARGE GOVERNMENT DEBT



* Eastern Europe includes Bulgaria, Croatia, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovak Rep., Slovenia and Ukraine. Latin America includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Panama, Peru, Uruguay and Venezuela. Emerging Asia includes Indonesia, South Korea, Malaysia, Philippines and Thailand. Some numbers do not add up due to rounding.

Source: McKinsey Global Institute Global Financial Stock Database

MIDDLE EAST SEES A MAJOR CORRECTION IN EQUITIES

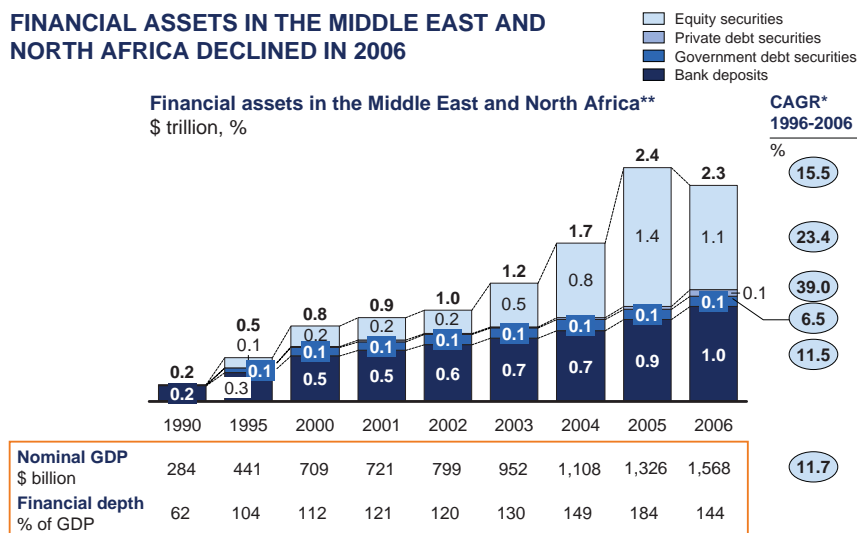
With the tripling of world oil prices since 2002, oil-exporting nations have become a significant force in global financial markets. As we will see in chapters 2 and 3, these nations are among the biggest cross-border investors and have accumulated large stores of foreign financial assets. In the Middle East, the oil windfall has also spurred the development of domestic financial markets and creates enormous potential for the future.

Since 2002, the domestic financial markets of the Middle East and North Africa have more than doubled in size. In 2002, these countries had \$1 trillion of assets in their domestic financial systems, equivalent to 120 percent of GDP. Sixty percent of these assets were in the region's banks, and the corporate and government bond markets were very small. By 2006, their financial assets had grown to \$2.3 trillion, or 144 percent of GDP (Exhibit 1.14).¹⁰ Equity markets were a big part of this growth, as the region's relatively new markets gained momentum. A nascent corporate bond market (including Islamic bonds) has emerged as well. Nonetheless, this level of financial depth remains far lower than that in mature economies or in emerging Asian nations, reflecting significant opportunity for further development.

¹⁰ The countries of the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates) had domestic financial assets of \$400 billion in 2002, which tripled to \$1.2 trillion in 2006. For more on their financial systems, investments, and the coming oil windfall, see forthcoming McKinsey Global Institute research in February 2008.

Exhibit 1.14

FINANCIAL ASSETS IN THE MIDDLE EAST AND NORTH AFRICA DECLINED IN 2006



* Compound annual growth rate.

** Includes Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, Tunisia, United Arab Emirates, Yemen.

Note: Some numbers do not add up due to rounding.

Source: McKinsey Global Institute Global Financial Stock Database

However, in 2006 the region learned that some markets can get too hot too fast, and cool down even more quickly. Equity markets suffered a major correction, with total capitalization in these countries falling by \$300 billion overall. The particularly overheated stock markets of the Gulf countries lost more than \$400 billion. Saudi Arabia saw its domestic equity market capitalization fall by 49 percent, while the United Arab Emirates' domestic equity market capitalization declined by 39 percent and Qatar's slid by 29 percent.

Saudi Arabia's equity market, which lost \$320 billion in market capitalization, was the largest contributor to the correction. At the beginning of 2006, Saudi Arabian equities had reached P/E ratios above 50 as swelling oil profits were invested in just 79 publicly listed companies. With few institutional investors, there were virtually no short sellers to restrain the price surge. Half the population—including many inexperienced investors—bought shares in the December 2005 IPO of the petrochemical company Yansab. In the buying frenzy, some Saudis even borrowed money to buy cars, and then immediately exchanged them for shares. The bubble burst in spring 2006, partly because of the cancellation of a popular after-work trading session. Saudi P/E ratios fell back to a more sustainable level of 15.

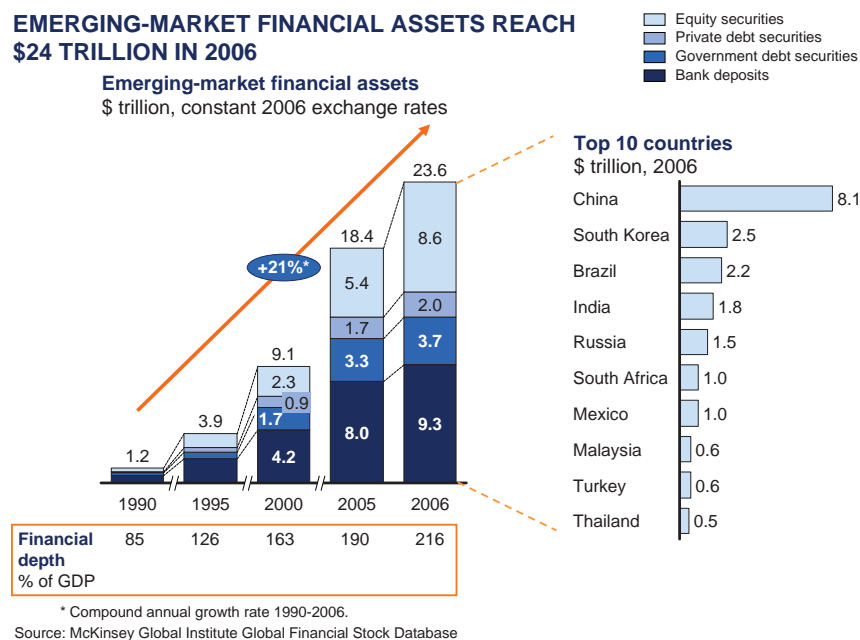
Overall, although 2006 brought losses for some investors, the equity market correction put the Gulf's financial markets on a more solid foundation. With oil

prices still high and most countries working to reform their financial systems, the region's markets hold great promise for future development. This bodes well for other parts of the world that benefit from the outflow of investment capital from the Middle East and North Africa. But the region's long-term economic health will depend largely on whether Gulf countries improve the flow of oil profits into productive domestic investment as well.

EMERGING MARKETS: SMALL BUT GROWING FAST

After being devastated by a string of financial crises ten years ago, emerging economies' financial markets are on the rebound. Their financial assets grew \$5.3 trillion in 2006, to a total of \$23.6 trillion. That increase—nearly as much as in the United States—accounted for one-quarter of total global growth in financial assets. And over the past ten years, emerging-market financial assets have grown more than twice as fast as those in developed countries (Exhibit 1.15).

Exhibit 1.15



The star performer among these countries is China, which accounted for a third of all financial assets in emerging markets and almost half of the growth in 2006. The group also includes Russia and other rapidly developing nations in Asia, Latin America, Eastern Europe, and Africa.

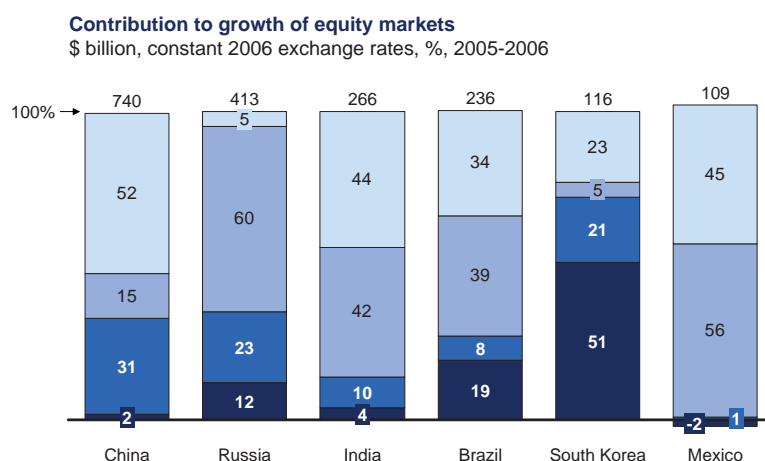
The largest asset class in emerging markets remains bank deposits, reflecting the immature financial systems in emerging markets. But much of the growth in

assets comes from equities. Companies from emerging markets accounted for 35 percent of all the money raised globally through IPOs in 2006, up from 10 percent in 2000. Most noteworthy is that China raised more money through IPOs in 2006 than Japan, Germany, or the United Kingdom—and as much as companies from all countries of the eurozone combined. However, rising P/E ratios also explain a significant portion of the equity growth in many emerging markets. The exceptions, among the largest markets, are South Korea, which has seen many IPOs and exchange-rate changes, and Russia, which is seeing higher corporate earnings due in part to rising commodity prices (Exhibit 1.16).

Exhibit 1.16

INCREASES IN PRICE-EARNINGS RATIOS EXPLAIN SOME OF EQUITY MARKET GROWTH IN EMERGING MARKETS

■ P/E driven growth
■ Earnings driven growth
■ Newly listed companies
■ Change due to exchange rates



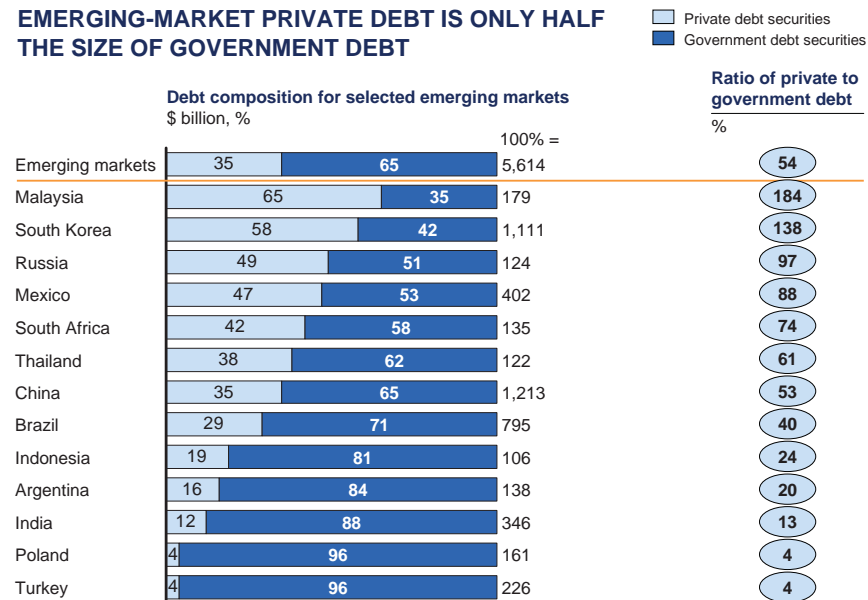
Source: Datastream; World Federation of Exchanges; McKinsey Global Institute analysis

Notably, emerging-market private debt grew faster than government debt for the second year in a row, a sign of the development of a healthy corporate sector in many countries. They have growing numbers of large, creditworthy companies with sophisticated financial management capable of drawing on global credit markets. Also, in many regions—particularly Latin America—governments are paying down their debts and getting their fiscal house in order.¹¹ Nonetheless, private debt securities remain just half the size of government debt outstanding for emerging markets (Exhibit 1.17).

¹¹ Latin America includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Panama, Peru, Uruguay, and Venezuela.

Exhibit 1.17

EMERGING-MARKET PRIVATE DEBT IS ONLY HALF THE SIZE OF GOVERNMENT DEBT



Source: McKinsey Global Institute Financial Stock Database

Despite rapid growth and promising developments, emerging markets still account for only 14 percent of global financial assets (Exhibit 1.18). Although this is up from 3 percent in 1990, it is significantly less than their share of global GDP (23 percent). This indicates significant room for further financial growth—and that today’s investment opportunities in emerging markets are smaller than some large investors may realize.

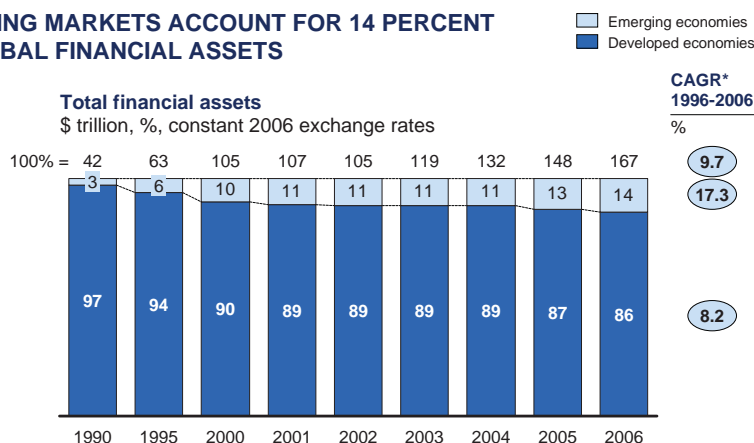
Across emerging markets, we see different trends:

Emerging Asia’s financial markets have recovered since the 1997 financial crisis, and the region now has the most developed financial systems across emerging markets.¹² With \$14.2 trillion in financial assets, or 9 percent of the global total, its financial depth was 250 percent of GDP at the end of 2006, far higher than that of Latin America or Eastern Europe. China alone accounts for more than half of the region’s assets, and South Korea and India together account for another 40 percent of the total (see *A Closer Look at China and India*). Although China’s financial system is still dominated by its banks, elsewhere in the region the asset distribution is fairly balanced, with about one-third each in equities, debt, and deposits. The region also has the largest private debt markets across emerging markets.

¹² Emerging Asia includes China, India, Indonesia, Macao, Malaysia, the Philippines, South Korea, and Thailand.

Exhibit 1.18

EMERGING MARKETS ACCOUNT FOR 14 PERCENT OF GLOBAL FINANCIAL ASSETS



Year	Emerging markets' share of GDP (%)
1990	6
1995	11
2000	18
2001	19
2002	20
2003	20
2004	21
2005	22
2006	23

* Compound annual growth rate.
Source: McKinsey Global Institute Global Financial Stock Database

Latin America's financial markets remain surprisingly shallow, despite a long history of banking and foreign investment in the region. By the end of 2006, financial depth in the region was only 158 percent compared with 250 percent in emerging Asia and more than 300 percent in China. One problem is that the region has been plagued for many years by financial crises and economic instability. Another factor that has historically stymied growth is the region's large government debt, which has deprived the private sector of credit. But in recent years, the region has posted significant growth and may be turning the corner.¹³ By the end of 2006, Latin America had \$4.2 trillion of domestic financial assets, up from \$3.5 trillion in 2005. Equities have accounted for nearly half the growth since 2003—and almost 60 percent of the growth in 2006. Most of this growth reflects increased earnings; the P/E ratio in Brazil, the region's largest market, remains quite low by international standards at 12. And the region's government debt declined to 41 percent of GDP by the end of 2006, on par with emerging Asia and the United States.

Eastern Europe has the fastest-growing financial markets of any emerging-market region. Its financial assets have risen 26 percent per year since 2000, compared with emerging Asia's annual growth rates of 17 percent. Russia

13 For more on this topic, see Luis Andrade, Diana Farrell, and Susan Lund, "Fulfilling the promise of Latin America's financial systems," *The McKinsey Quarterly*, January 2007. Available online at www.mckinseyquarterly.com.

dominates the financial landscape, with \$1.6 trillion in financial assets—just a bit less than India. Moreover, Russia’s financial assets have grown 47 percent per year since 2000. Equities account for two-thirds of Russia’s financial assets, reflecting in part rising oil and commodity prices. But Russia’s automobile, financial services, and real estate sectors also posted strong gains. The rest of Eastern Europe combined has \$1.4 trillion in financial assets. In other Eastern European economies, bank deposits account for more than half of all financial assets, reflecting the fact that equity and debt markets did not exist there before the fall of the Berlin Wall in late 1989. However, by 2006, equities accounted for 46 percent of growth.

Africa’s financial markets, although tiny in most countries, are having a growth spurt. Financial assets in sub-Saharan Africa increased by \$287 billion in 2006, reaching a total of \$1.2 trillion, or 183 percent of GDP.¹⁴ South Africa alone accounted for 81 percent of the total (\$1 trillion), leaving just \$235 billion for the rest of sub-Saharan Africa. The next five largest African financial markets—those in Nigeria, Zimbabwe, Kenya, Mauritius, and Cote d’Ivoire—accounted for 65 percent of the remainder. South Africa’s financial system is dominated by its equity market; mining accounts for about one-quarter of stock market capitalization, while the financial sector accounts for another quarter. Across the continent, equity markets and banking account for nearly all financial assets; debt markets are almost nonexistent. But equity-market indexes are soaring in some countries, with Nigeria’s skyrocketing 770 percent between 2000 and end of 2007, followed by Botswana’s jump of 680 percent, Mauritius’s increase of 320 percent, South Africa’s gain of 250 percent, and Kenya’s, up 130 percent.

A Closer Look at China and India

The world’s two emerging economic giants, China and India, have captured the imaginations of investors, industrialists, and economists alike. But the countries’ parallel bursts of growth are marked by striking differences. Their financial systems are one example.

At \$1.8 trillion, India’s financial assets were just one-fourth the size of China’s \$8.1 trillion in 2006—and growing more slowly.¹⁵ This gap is only partially explained by the size of their economies. India’s domestic financial assets

14 In addition, North African countries (Algeria, Egypt, Libya, Morocco, and Tunisia) account for \$423 billion in financial assets with a financial depth at 117 percent of GDP.

15 See Diana Farrell and Susan Lund, *A Tale of Two Financial Systems: A Comparison of China and India*, McKinsey Global Institute, September 2006. Available online at www.mckinsey.com/mgi.

that year were equal to just 202 percent of GDP—significantly below China’s 307 percent. This constrains India’s ability to invest in machinery, buildings, infrastructure, and other forms of physical capital necessary for economic growth.

Of course, size is not everything; equally important is how efficiently a financial system allocates capital. And both countries have a significant opportunity for improvement. Bank deposits account for more than half of China’s financial assets, and much of that money is loaned to inefficient state-owned enterprises, starving the more dynamic private enterprises of the funding needed to grow. MGI estimates that such financial system inefficiencies cost the nation 17 percent of GDP each year.

India’s financial system, meanwhile, funnels most of its capital to the government itself. Including state-owned enterprises, India’s large public sector absorbs nearly 70 percent of the nation’s savings. MGI calculates that if India’s financial markets allocated more capital to its thriving private enterprises, the country could raise its GDP growth rate to 9.4 annually, after inflation.¹⁶

One reason India has less money to invest is that its national saving rate is only half of China’s 40 percent. India’s households save as much as Chinese ones do, but many Indian families put their money in informal savings vehicles rather than banks, so the funds are not available for investment. Foreign capital inflows widen the investment gap: in 2006 foreign direct investment in China equaled 3 percent of GDP; in India, it equaled just 0.9 percent, due mostly to restrictions on foreign investment. As a result, India’s investment level is far lower than China’s.

Going forward, both China and India have significant opportunities to improve their financial systems, and they are pursuing reforms. Their future growth trajectories will depend in part on their success.

• • •

The world’s capital markets were buoyant in 2006, lifted by rapid growth in equities, financial depth, and the power of rising players such as China. That momentum was slowed but not stopped in 2007 by the US subprime mortgage crisis. Credit markets bore the brunt of the turbulence in 2007, as banks tight-

¹⁶ See *Accelerating India’s Growth Through Financial System Reform*, McKinsey Global Institute, May 2006. Available online at www.mckinsey.com/mgi.

ened lending standards, some leveraged buyout deals were shelved or repriced, and the most exotic debt securities plummeted in value. However, equity-market growth remained robust through the first three-quarters of the year, even in the United States. And early signs are that Asian and European financial markets continued to thrive, highlighting the shift in global consumption and growth away from the United States.

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