

## 4. Asia Findings

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In contrast to the US, which is a single market, and Europe, which is in the process of integrating its capital markets, there is little cross-country capital market integration in Asia.<sup>1</sup> Thus, the Asian capital market is largely a sum of the parts—a collection of distinct, national markets. The more developed of these markets have strong links with the global capital market, yet they seek only limited cooperation with one another. Still, in this chapter we offer the aggregate picture of the individual Asian markets because it is interesting in itself and because the real sector of the Asian economies is becoming increasingly integrated through trade.<sup>2</sup> China is playing a particularly important role in this process, having become a major trade partner for many economies in the region (e.g., Korea) and contributing 40 percent of incremental GDP growth.

The aggregate picture of Asia combines vastly different dynamics from the individual countries: Japan is large, but declining in its importance, while China is rising as a force on the global capital market. Korea is developed and India has an untold economic potential, but neither of them come close to the size of China's financial stock. In the last section of this chapter we discuss each of these markets individually.

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<sup>1</sup> With the exception of foreign direct investments and some cross-border bank lending.

<sup>2</sup> In our analysis of Asia's financial stock we include all countries with 2002 financial stock greater than \$20 billion, namely Japan, China (including Hong Kong and Macao), Korea, India, Taiwan, Malaysia, Singapore, Myanmar, Turkey, Thailand, Indonesia, Philippines, and Pakistan.

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The chapter is organized in the following sections:

1. Key findings
2. Context
3. Overall size, growth, and financial depth of Asia's financial stock
4. Asset composition of Asia's financial stock
5. Subregional composition of Asia's financial stock.

### Interpretation of Our Results

We define financial stock as the sum of equity securities, private and government debt securities, and bank deposits. Thus, a financial stock represents the capital that is intermediated through the securities markets and the banking system in a given economy.

Two important distinctions underlie the findings in this report: intermediation by markets versus banks, and government debt securities versus other asset classes.

#### **1. Market intermediation versus bank intermediation (also tradable versus non-tradable instruments)**

The stock of equity and debt securities represents the degree of *market intermediation* in an economy, since they are the instruments used by the financial market to directly match up those who want to invest money with those who want to raise capital. Because equity and debt securities may be traded on the markets, we often refer to them collectively as *tradable instruments* (although depending on their liquidity and turnover, some securities may not be actually traded).

In contrast, the stock of bank deposits represents the degree of *bank intermediation* in an economy, since bank deposits are the capital that the banking system channels from savers to borrowers (simplistically speaking, bank deposits fund bank lending). Since capital intermediated through the banks is less easily transferable than stocks or bonds, we refer to bank deposits as *non-tradable*.

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In general, governments have greater ability to regulate the banking sector than they do the financial markets. Thus, the degree of government control over the financial system bears an important relation to the extent of bank intermediation.

*Note: Our bank deposit numbers include a small amount of currency in circulation that does not conform to the definition of bank intermediation; however, it has minimal impact on our findings.*

## **2. Government debt securities versus other asset classes**

Equity securities, private debt securities, and bank deposits (which fund bank loans) are the main classes of instruments for intermediating capital between borrowers on one hand and investors and savers on the other. As these three elements of the financial stock increase, the economy becomes more efficient at allocating capital to its best use.

Government debt securities are quite different. They function more as an instrument to redistribute taxes across generations than as a means to allocate capital from savers to borrowers. Although a well-developed market for government debt securities supports the development of a private debt securities market, government debt does not *directly* help firms to raise capital and grow.

The distinction between government debt and the other asset classes is not always clear cut. For example, in some developing countries the government may direct bank lending, support bank balance sheets, control corporate activity, or guarantee corporate debt. In such cases, a portion of bank deposits and corporate debt may be a disguised form of government debt.

Because of such differences across asset classes, cross-regional comparisons are meaningful only when the size of a financial stock is understood relative to its *composition*. For example, a large financial stock dominated by government debt securities is a sign of a high degree of future generation liabilities, rather than a sign of more efficient capital allocation.

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## 1. KEY FINDINGS—ASIA

- **Size and growth.** After growing slower than the global average rate over the past 10 years (6.0 percent versus 8.4 percent per year), and thus consistently losing share in the global financial stock, Asia now commands 23 percent (\$27 trillion) of the global financial stock.<sup>3</sup> Growth rates vary widely within Asia, with Japan at 4.0 percent per year, Korea at 11.2 percent, and China at 14.5 percent.
- **Depth.** Similar to other regions, Asia's depth has increased from 230 percent in 1993 to 330 percent in 2003. However, the drivers behind this deepening, as well as its significance, are quite different in the various parts of Asia.
- **Asset composition.** Compared to the US and Europe, bank deposits constitute a higher share of Asia's total financial stock, accounting for 41 percent of total. Government debt securities and equity securities represent 26 and 22 percent, respectively. Private debt securities are the smallest asset class with 11 percent share of total.
- **Growth components.** In contrast to the US, where equity and private debt securities drove the increase in financial stock, in Asia bank deposits and government debt securities were the dominant growth components, contributing 42 and 40 percent of the total financial stock increase since 1993, respectively.
- **Regional composition.** The four countries in Asia we analyzed in depth, Japan, China, India, and Korea, have each experienced different developments over the last two decades:
  - **Japan** remains an important part of the global capital market, although its role is rapidly diminishing. Within Asia, it has the anchoring role in Asia's financial system, accounting for two thirds of the entire Asian financial stock. The bulk of Japan's financial stock growth comes from government debt expansion (growing at 12 percent per year, or three times the overall growth rate of Japan's financial stock), while the equity and private debt securities markets have stagnated.

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<sup>3</sup> All dollars are current US dollars. All growth rates are nominal growth rates based on financial stock numbers expressed in current US dollars; thus, they reflect inflation and exchange rate shifts.

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- **China** has emerged as an important player in the global capital market. It is one of the global growth hot spots, growing nearly twice as fast as the world average (14.5 percent per year since 1993) and gaining global share in every asset class. Further, it commands a meaningful share of the global bank deposits (9 percent) and has become the country with the second largest financial stock in Asia (\$5.1 trillion, or 19 percent of Asia's total).
  - **India** is often compared to China for its rapid economic development. However, in the context of the global financial stock, the importance of India is still not apparent: its financial stock is one sixth that of China, its depth is also a fraction of China's (137 percent of GDP versus 323 percent), and it grows at a slower pace (11.9 percent versus 14.5 percent). This finding is surprising given India's Anglo-Saxon heritage and institutional setup.
  - **Korea** is also behind China in the context of the global financial stock, despite its relatively well-developed capital markets. Korea's financial stock is the third largest in Asia, accounting for 5 percent of the total (while China's share is 19 percent). Korea has recovered from the financial crises in the region and has seen its financial stock grow at a brisk 11.2 percent per year between 1993 and 2003.

## 2. CONTEXT—ASIA

To provide context for our findings on how the financial stock in Asia has developed, we list a few select facts around the Asian economy and highlight recent developments in Asia's financial market by country.

### Economic facts

Asia's GDP is \$8.3 trillion, or 23 percent of global GDP, and its population of 3.7 billion people is 60 percent of the world's total. In the period 1993 to 2003, Asian GDP grew at an average of only 2.3 percent per year, with large differences across countries.<sup>4</sup> This low GDP growth is largely due to Japan's economic stagnation (since 1993, Japan's nominal GDP has fallen on average by 0.1

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<sup>4</sup> All GDP growth figures in this report are in nominal terms.

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percent per year). Several other countries, China in particular, experienced rapid economic growth and development in the same period.

### **Recent developments**

Over the last couple of decades, Asia's capital markets experienced a mix of developments.

- The most developed economy in the region, Japan, entered a prolonged period of economic stagnation following the bursting of a stock market and real estate bubble in the early 1990s. Also, Japan has experienced significant fluctuations in the foreign exchange rate of the yen against the US dollar since 1980. These fluctuations impact our findings, especially when making cross-regional comparisons of relative size and growth<sup>5</sup> (see Box).
- The two nations with the world's largest populations, China and India, made considerable economic progress. China in particular has become a force in the global economy, with a significant impact on the trade balance and capital flows of developed economies. While India's economy remains much smaller than China's (nominal GDP of India is \$631 billion and that of China is \$1.4 trillion), its status as a preferred global destination for outsourcing of business processing jobs and IT development is increasing its global importance.
- Several countries in Southeast Asia, most notably Korea, have achieved breakthroughs in development, raising their living standards considerably, and practically joining the club of developed nations. Yet this group of countries, called the Asian Tigers,<sup>6</sup> was struck by a large-scale financial crisis from 1997 to 1998 that sent shock waves throughout the global financial markets.

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<sup>5</sup> Since Japan accounts for approximately two-thirds of total financial stock in Asia, we focus on the exchange rate development of the JPY against the USD only. In the period 1980 to 1993, the JPY appreciated against the USD by 81 percent in nominal terms, while in the period 1993 to 2003 it appreciated by an additional 4 percent. Growth rates for financial stock denominated in USD in these periods are therefore higher than if the financial stock were denominated in the JPY.

<sup>6</sup> Asian Tiger economies include Hong Kong, Korea, Taiwan, Malaysia, Singapore, Thailand, Indonesia, and Philippines. Taiwan, Hong Kong, and Singapore avoided the financial crisis.

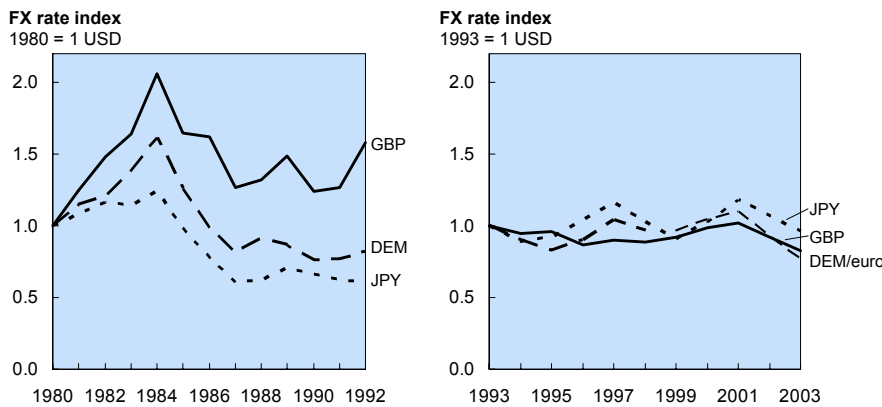
## Foreign Exchange Rate Fluctuations

We express the financial stock of all countries in US dollars (to aggregate the national stocks on a global level), so foreign exchange rate dollar fluctuations against major currencies play a role in our findings on the relative size and growth of financial stock among regions in the global capital market.

Overall, exchange rate fluctuations since 1993 have been tamer than the 1980s. However, the US dollar has significantly depreciated against the euro, the British pound, and the Japanese yen since end-2001. Consequently, our findings potentially overstate the growth rates and relative sizes of the eurozone, the UK, and Japan, since these reflect not only the growth and size of the underlying financial stock in local currency, but also the impact of currency rate translation (Exhibit 1).

### Exhibit 1

#### FOREIGN EXCHANGE RATES AGAINST THE US DOLLAR



	Exchange rate USD equivalent	
	2001	2003
GBP*	1.45	1.79
EUR*	0.89	1.25
JPY	131.80	107.10

\* Expressed conventionally; the chart has these values converted in terms of 1 USD = X foreign currency units  
Source: International Monetary Fund (IMF) International Financial Statistics exchange rates – national currency per US dollar (end of period average)

To illustrate the impact of foreign exchange fluctuations, the 32 percent annual growth of eurozone bank deposits, expressed in US dollars 2001–2003, can be disaggregated into 10.3 percent annual growth in underlying bank deposit stock expressed in euros and 19.7 percent of annual growth in the foreign exchange rate of the euro against the dollar.

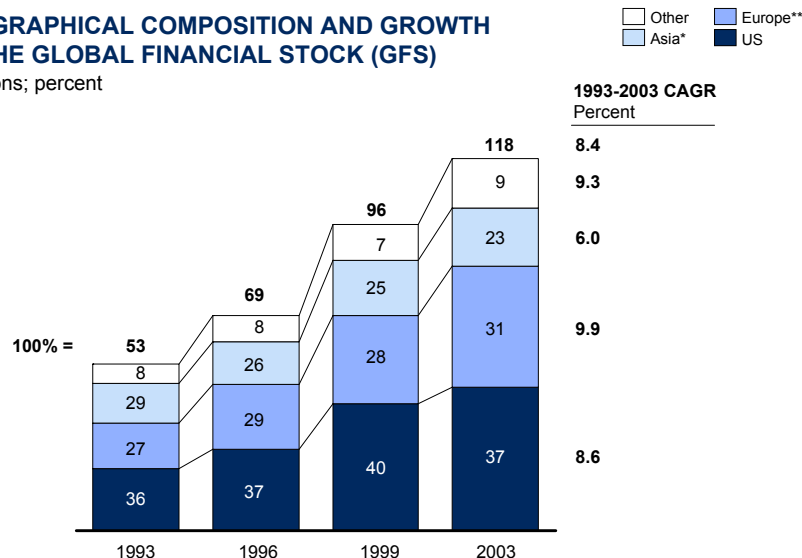
### 3. OVERALL SIZE, GROWTH, AND DEPTH OF ASIA'S FINANCIAL STOCK

Asia, with total 2003 financial stock of \$27 trillion, has seen its share of the global financial stock fall since 1993 from 29 percent to 23 percent. Since 1993, Asia's financial stock has grown at 6.0 percent per year, much slower than the US or Europe (8.6 and 9.9 percent, respectively). However, there are significant differences within Asia: while the financial stock in Japan has grown at an average rate of only 4.0 percent, China's and India's have grown by 14.5 and 11.9 percent per year, respectively (Exhibits 2–4).

#### Exhibit 2

#### GEOGRAPHICAL COMPOSITION AND GROWTH OF THE GLOBAL FINANCIAL STOCK (GFS)

\$ Trillions; percent



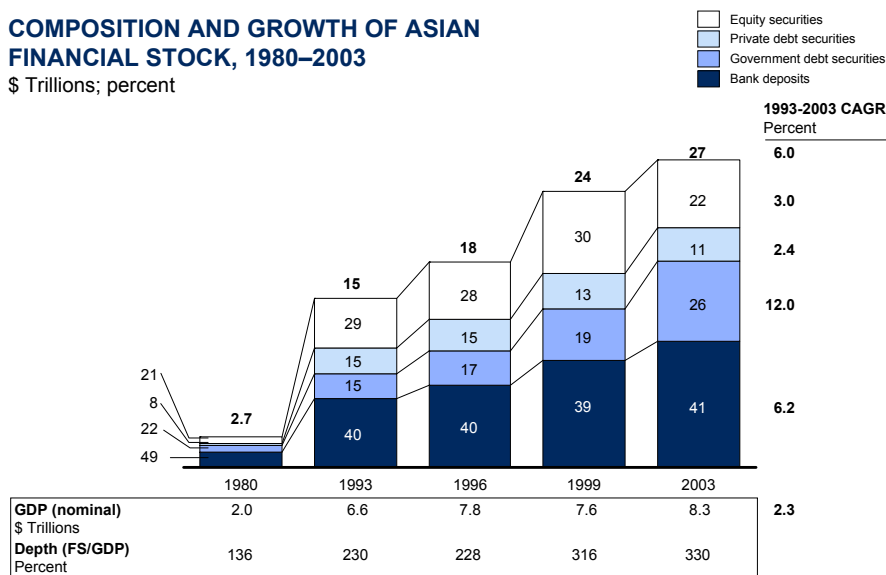
\* Asian numbers include countries with 2002 financial stock >\$20 billion: Japan, China, Korea, India, Taiwan, Malaysia, Singapore, Myanmar, Turkey, Thailand, Indonesia, Philippines, and Pakistan  
 \*\* Europe includes the UK, the eurozone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain), Switzerland, Sweden, Denmark, Norway, and Eastern Europe  
 Note: Some numbers do not add to 100% due to rounding error  
 Source: McKinsey Global Institute Global Financial Stock Database

As in the US and Europe, the size of the Asian financial stock relative to underlying GDP has increased over the past 10 years, from 230 percent in 1993 to 330 percent in 2003. However, in contrast to the US, where deepening reflects the differential growth of a rapidly expanding financial stock that outpaces a robust economic growth, the deepening in Asia reflects a modest growth of the financial stock and even lower growth of the underlying GDP (2.3 percent per year). Overall, Asia has still plenty of room for growth if the depth of its financial stock is to reach the depth of the US or Japan (at 397 and 411 percent, respectively; Exhibits 3–5).

### Exhibit 3

#### COMPOSITION AND GROWTH OF ASIAN FINANCIAL STOCK, 1980–2003

\$ Trillions; percent

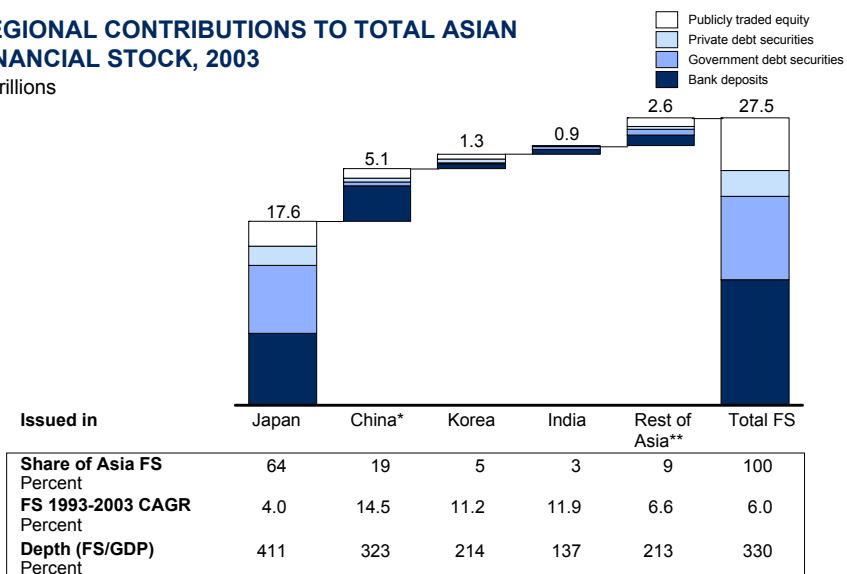


Note: Some numbers do not add to 100% due to rounding error; Asian numbers include countries with 2002 financial stock >\$20 billion: Japan, China, Korea, India, Taiwan, Malaysia, Singapore, Myanmar, Turkey, Thailand, Indonesia, Philippines, and Pakistan; in the period 1980-1993 JPY appreciated by 81% against the dollar in nominal terms, while in the period 1993-2003 it appreciated further by 4%; the 1993-2003 CAGR for FS denominated in dollars is therefore higher than if it were denominated in JPY  
Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Global Insight

### Exhibit 4

#### REGIONAL CONTRIBUTIONS TO TOTAL ASIAN FINANCIAL STOCK, 2003

\$ Trillions

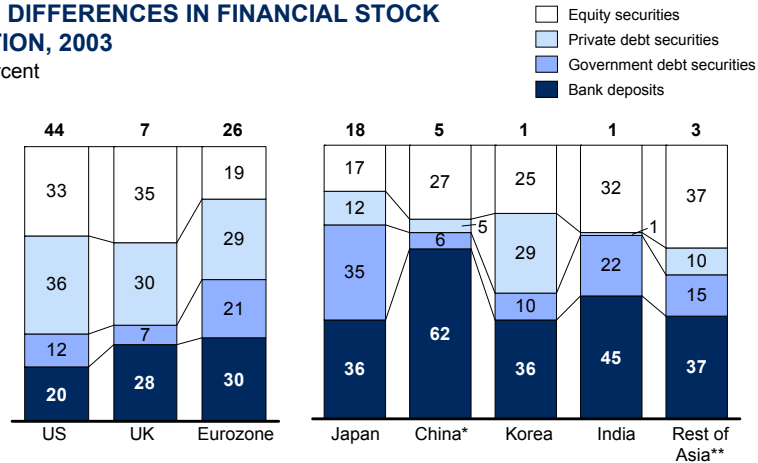


\* Includes China, Hong Kong, and Macao  
\*\* Includes countries with 2002 financial stock >\$20 billion: Taiwan, Malaysia, Singapore, Myanmar, Turkey, Thailand, Indonesia, Philippines, and Pakistan  
Note: In the period 1993-2003, JPY appreciated by 4% against the dollar in nominal terms; the 1993-2003 CAGR for FS denominated in dollars is therefore higher than if it were denominated in the local currency  
Source: McKinsey Global Institute Global Financial Stock Database

## Exhibit 5

### REGIONAL DIFFERENCES IN FINANCIAL STOCK COMPOSITION, 2003

\$ Trillions; percent



<b>1993-2003 CAGR</b>	8.6	11.3	9.8	4.0	14.5	11.2	11.9	6.6
Percent								
<b>Depth (FS/GDP)</b>	397	385	314	411	323	214	137	213
Percent								

\* Includes China, Hong Kong, Macao  
 \*\* Includes countries with 2002 financial stock >\$20 billion: Taiwan, Malaysia, Singapore, Myanmar, Turkey, Thailand, Indonesia, Philippines, and Pakistan  
 Note: Some numbers do not add to 100% due to rounding error  
 Source: McKinsey Global Institute Global Financial Stock Database

The actual drivers of financial deepening are very different across the region. In China, the deepening is driven by the rapid growth of the economy and the development of its financial sector, and thus is the expression of China's growing prosperity (the issue of nonperforming loans and their impact in overstating true depth notwithstanding). At the same time, the deepening in Japan is driven by the increasing indebtedness of its government, a side effect of a massive fiscal stimulus injected to revive the ailing Japanese economy; thus, deepening in Japan does not necessarily reflect the improved ability of the market to intermediate private capital.

#### 4. ASSET COMPOSITION OF ASIA'S FINANCIAL STOCK

Compared to the US and Europe, bank deposits constitute a high share of Asia's total financial stock, while private debt securities play a limited role (Exhibit 5).

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## **Bank deposits**

Bank deposits are the largest asset class in Asia, with 41 percent share of total financial stock (as compared to 20 percent for the US) and have grown in line with the total financial stock (6.2 percent versus 6.0 percent). In general, Asian markets have high shares of bank deposits, with differences in the specific levels (for example, 36 percent share in Japan and Korea and 62 percent in China; Exhibits 3, 5).

Bank deposits made the largest contribution to the increase in total financial stock, adding \$5.1 trillion, or 42 percent of the total increase (Exhibit 6). China contributed the most to this increase (\$2.3 trillion), since bank deposits remain the main viable investment option for households in a period of rising income levels and high savings rates. Japan contributed a further \$1.6 trillion, as bank deposits were not only the traditional savings instrument but also the preferred one given the country's stagnant securities markets.

## **Government debt securities**

Government debt securities are the second largest asset class in Asia, with 26 percent overall share. They are the fastest growing asset class since 1993 (12 percent per year). This is in sharp contrast to other regions of the world, notably the US and the UK, where government securities are the least important asset class in the financial stock and grow the slowest. Within Asia, government securities play a minimal role in China where the market for them is nascent. In contrast, they form 35 percent of Japan's financial stock<sup>7</sup> (Exhibits 3, 5).

Government debt securities have contributed \$4.8 trillion (\$4.1 trillion of that from Japan), or 40 percent, to the increase in Asia's financial stock over the past 10 years. In fact, the rapid government debt expansion in Japan has transformed the makeup of debt in the whole region. While private and government debt were nearly equal in size in 1993, by 2003 the stock of government debt securities was more than 2.4 times the size of private debt securities stock (Exhibits 6–7).

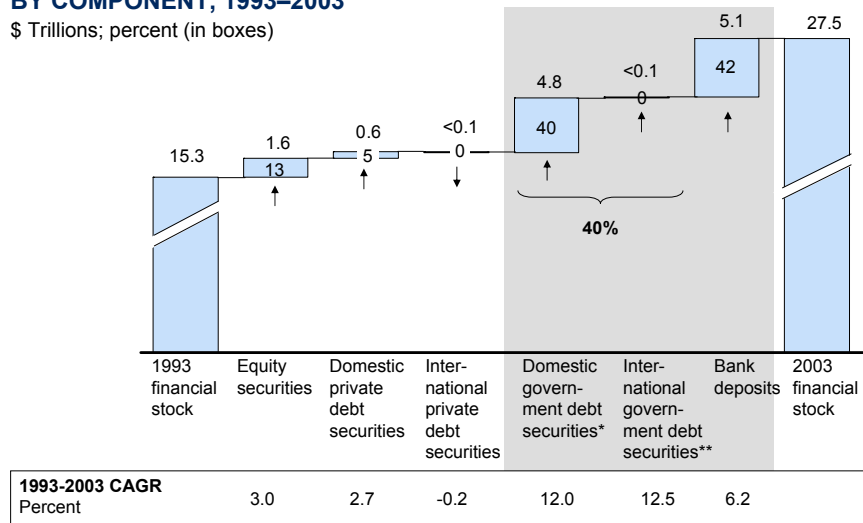
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<sup>7</sup> There is significant cross-holding of government debt by public institutions in Asia. This is particularly true for Japan where as much as 60 percent of government bonds are held by the public sector.

## Exhibit 6

### CONTRIBUTION TO ASIAN FINANCIAL STOCK GROWTH BY COMPONENT, 1993–2003

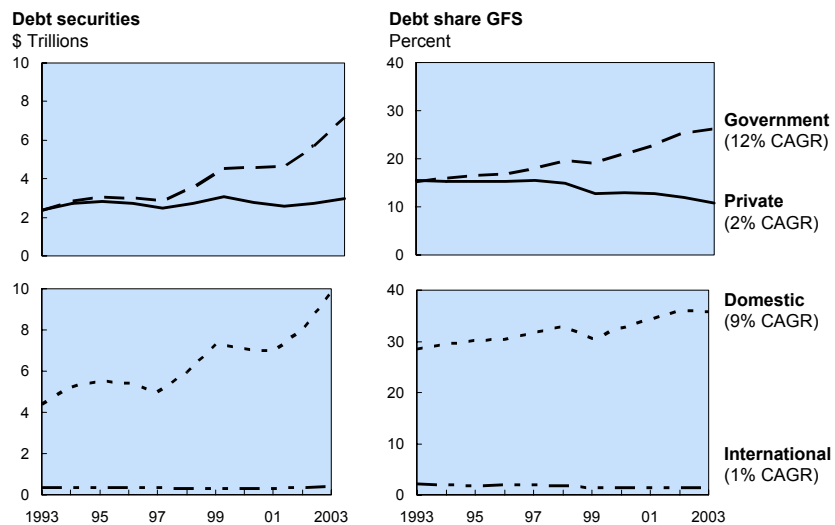
\$ Trillions; percent (in boxes)



\* Stock of outstanding domestic government debt securities in 2003 was \$7.1 trillion  
 \*\* Stock of outstanding international government debt securities in 2003 was \$0.06 trillion  
 Note: In the period 1993-2003, JPY appreciated by 4% against the dollar in nominal terms; the 1993-2003 CAGR for FS denominated in dollars is therefore higher than if it were denominated in the local currency  
 Source: McKinsey Global Institute Global Financial Stock Database

## Exhibit 7

### GROWTH OF ASIAN DEBT SECURITIES, 1993–2003



Note: In the period 1993-2003, JPY appreciated by 4% against the dollar in nominal terms; the 1993-2003 CAGR for FS denominated in dollars is therefore higher than if it were denominated in the local currency  
 Source: McKinsey Global Institute Global Financial Stock Database

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### Equity securities

Equity securities are the third largest asset class with 22 percent share of Asia's financial stock, and have contributed 13 percent of the increase in Asia's financial stock over the past 10 years. They have grown at only 3 percent since 1993, largely due to a prolonged stagnation in the Japanese stock market that followed the bursting of a speculative bubble in the early 1990s (Exhibits 3, 6).

### Private debt securities

Not only are private debt securities<sup>8</sup> the least important asset class, their role has diminished over time, as they have grown by a mere 2.4 percent per year since 1993. While the share of private debt securities in total financial stock was low in 1993 (15 percent), it has fallen further to only 11 percent in 2003 (as compared to 36 percent in the US; Exhibits 3, 5).

## 5. SUBREGIONAL COMPOSITION OF ASIA'S FINANCIAL STOCK

The geographic composition of Asia reflects immense differences in the level and path of development as well as in socio-economic and political circumstances. Below we discuss four economies—Japan, China, India, and Korea—or their significance to Asia's financial stock, their respective developmental paths, and their projected importance in the future.

### Japan

On the global stage, Japan remains an important region, although its role is rapidly diminishing. Within Asia, it has the anchoring role in Asia's financial system, accounting for two thirds of the entire Asian financial stock (Exhibit 4).

- **Size and growth.** In absolute terms, Japan's financial stock stood at \$17.6 trillion in 2003, up from \$2.1 trillion in 1980 and \$11.9 trillion in 1993. Over the past 10 years, Japan's share of the global financial stock has shrunk from 23 percent to 15 percent. During this period, Japan's financial stock grew at only 4.0 percent, compared to 8.4 percent world average. Within Asia, Japan has been losing importance as China and other countries have grown rapidly (Exhibits 8–9).

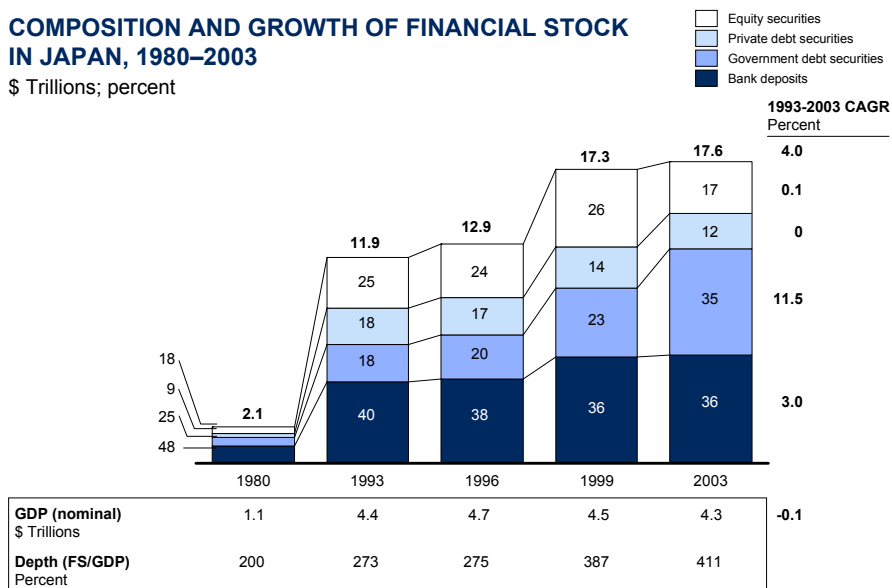
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<sup>8</sup> In several Asian countries the distinction between corporate and government debt is rather unclear as the governments often effectively guarantee parts of the corporate debt.

### Exhibit 8

#### COMPOSITION AND GROWTH OF FINANCIAL STOCK IN JAPAN, 1980–2003

\$ Trillions; percent

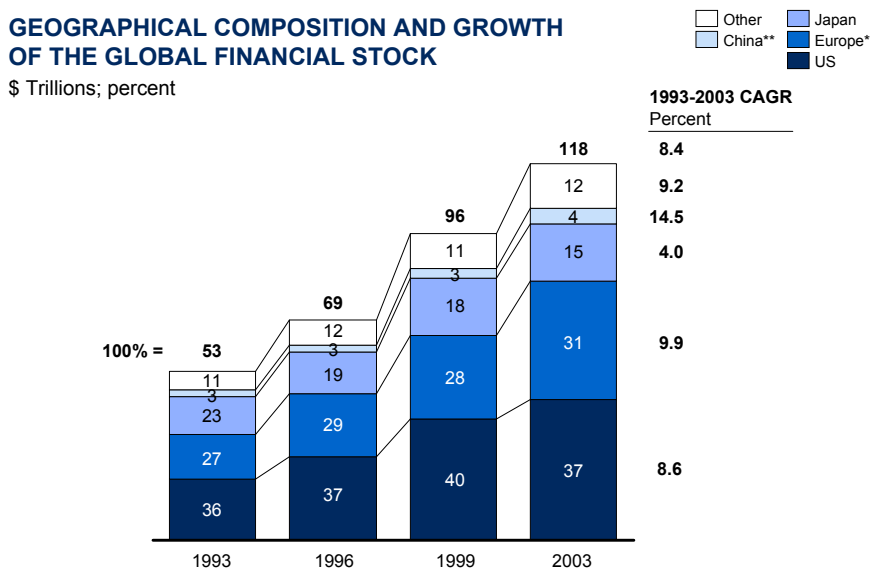


Note: Some numbers do not add to 100% due to rounding error; in the period 1980-1993 JPY appreciated by 81% against the dollar in nominal terms, while in the period 1993-2003 it appreciated further by 4%; the 1993-2003 CAGR for FS denominated in dollars is therefore higher than if it were denominated in JPY  
 Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Global Insight

### Exhibit 9

#### GEOGRAPHICAL COMPOSITION AND GROWTH OF THE GLOBAL FINANCIAL STOCK

\$ Trillions; percent



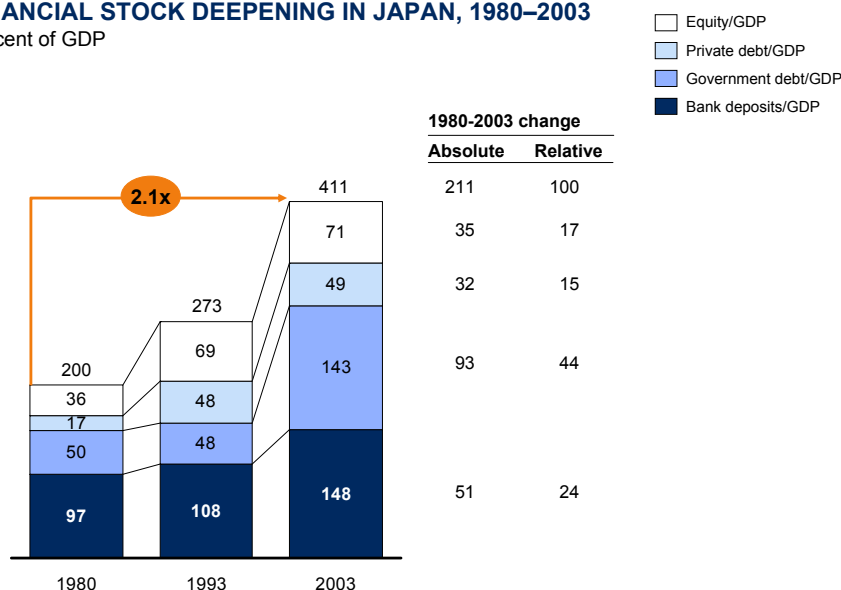
\* Europe includes the UK, the eurozone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain), Switzerland, Sweden, Denmark, Norway, and Eastern Europe  
 \*\* China also includes Hong Kong and Macao  
 Note: 2003 shares do not add to 100% due to rounding error  
 Source: McKinsey Global Institute Global Financial Stock Database

- Depth.** The size of Japan's financial stock relative to the underlying GDP increased from 200 percent of GDP in 1980, to 273 percent in 1993, to 411 percent in 2003, overtaking the depth of the financial stock in the US and the UK (397 and 385 percent, respectively). Deepening in Japan came heavily from increase in government debt (44 percent of the overall deepening between 1980 and 2003), signaling great tax liabilities of future generations. By comparison, the US deepened through growth of equities and private debt securities—a sign of improved financial intermediation between savers and borrows (Exhibit 10).

### Exhibit 10

#### FINANCIAL STOCK DEEPENING IN JAPAN, 1980–2003

Percent of GDP



Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Global Insight

- Asset composition.** Japan's asset composition is quite different from those of the US, the UK, and the eurozone because it is dominated by bank deposits and government debt securities, with equities and private debt securities playing a much smaller role.

— **Bank deposits.**<sup>9</sup> Bank deposits are currently the largest asset class in Japan, with 36 percent share (but soon to be displaced by government debt

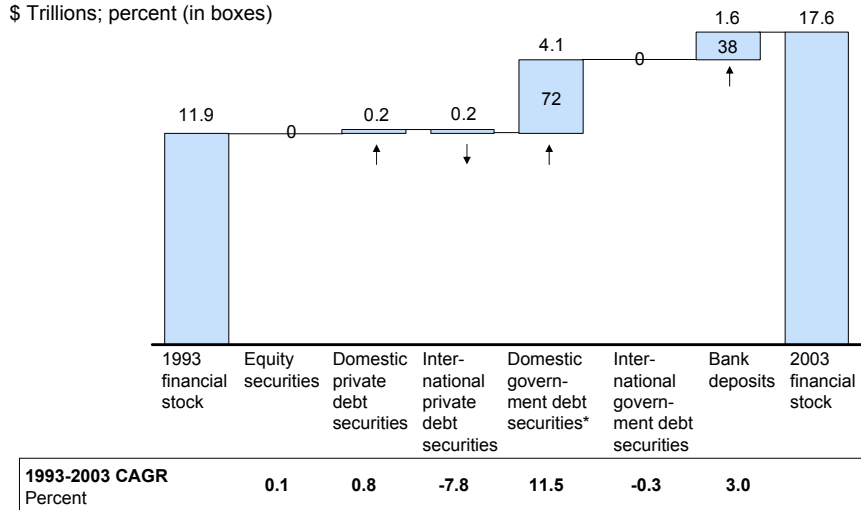
<sup>9</sup> Since a large share of investable Japanese postal savings is invested in government securities (\$0.9 trillion or 80 percent of total) there would be a possibility for double-counting of financial stock in Japan. This is not the case however, since bank deposits in Japan do not include Japanese postal savings.

securities, which already have 35 percent share and are growing four times faster). Bank deposits contributed 38 percent of the increase in Japan's financial stock since 1993 (\$1.6 trillion out of \$5.7 trillion) and 32 percent of the increase since 1980. They have grown at 3 percent per year since 1993, a growth rate lower than both the total Japanese financial stock (4 percent) and the bank deposits in all other regions we analyzed. As a result of this slow pace, the global share of Japan's bank deposits shrank from 29 percent to 18 percent over the period (Exhibits 8, 11–13).

**Exhibit 11**

**CONTRIBUTION TO JAPANESE FINANCIAL STOCK GROWTH BY COMPONENT, 1993–2003**

\$ Trillions; percent (in boxes)



\* ~60% of Government bonds are held by the public sector, e.g., Bank of Japan  
 Note: In the period 1993-2003, JPY appreciated by 4% against the dollar in nominal terms; the 1993-2003 CAGR for FS denominated in dollars is therefore higher than if it were denominated in the local currency  
 Source: McKinsey Global Institute Global Financial Stock Database

— **Government debt.** Government debt securities are the other dominant asset class in Japan's financial stock, with 35 percent share. They grew at a rate of 11.5 percent, the fastest for all asset classes, thereby doubling their share of total financial stock from 18 percent in 1993 (when government debt securities were the size of private debt securities) to 35 percent in 2003 (or three times more than private debt securities). Government debt securities contributed the most to the total increase in Japanese financial stock, accounting for 72 percent of the increase over the past 10 years (\$4.1 trillion out of \$5.7 trillion) and for 37 percent of the total increase since 1980 (\$5.7 trillion out of \$15.2 trillion; Exhibits 8, 11–12).

## Exhibit 12

### CONTRIBUTION TO JAPANESE FINANCIAL STOCK GROWTH BY COMPONENT, 1980–2003

\$ Trillions

Asset class	Component	Government	Business	Households	Total	Share Percent
Equity securities	• New issues	–	0.1	–	–	1
	• P/E growth	–	–	0.1	–	1
	• Earnings growth	–	2.4	–	2.6	16
Private debt securities	• Increased private debt	–	1.8	–	–	12
	• Securitization	–	0.1	–	1.9	1
Government debt securities	• Increased government debt	5.7	–	–	5.7	37
Bank deposits	• Increase in currency	–	–	0.6	–	4
	• Increase in business bank deposits	–	0.8	–	–	5
	• Increase in HH bank deposits	–	–	3.6	–	23
<b>Total</b>		<b>5.7</b>	<b>5.2</b>	<b>4.3</b>	<b>15.2</b>	<b>100</b>
<b>Share Percent</b>		<b>37</b>	<b>35</b>	<b>28</b>	<b>100</b>	

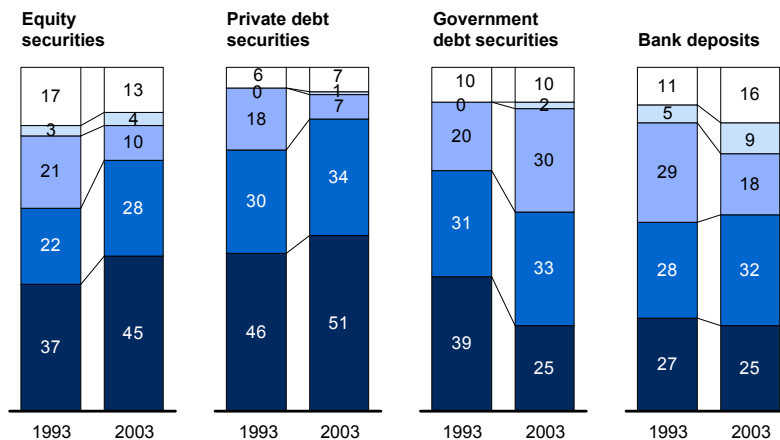
Note: In the period 1980-1993 JPY appreciated by 81% against the dollar in nominal terms, while in the period 1993-2003 it appreciated further by 4%

Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Federal Reserve; Thomson Financial Securities Data; Datastream; Compustat

## Exhibit 13

### GEOGRAPHIC COMPOSITION OF THE GLOBAL FINANCIAL STOCK BY ASSET CLASS

Percent



\* Includes China, Hong Kong, and Macao

\*\* Europe includes the UK, the eurozone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain), Switzerland, Sweden, Denmark, Norway, and Eastern Europe

Source: McKinsey Global Institute Global Financial Stock Database

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The fast growth in government debt is a result of the Japanese government's fiscal policy expansion in the 1990s designed to stimulate the sluggish economy. In another sign of their increasing importance, the global share of Japan's government securities increased from 20 percent to 30 percent over the same period and was the only asset class where Japan gained global share (Exhibit 13).

- **Equity.** The share of equity securities in Japan's total financial stock (17 percent) is small, both by the standards of developed economies and within Asia. The stock of equity securities has been stagnating since 1993, mainly due to the bursting of the stock market bubble in the early 1990s, prolonged economic stagnation, and the resulting poor prospects for Japanese corporations. Correspondingly, the global share of Japan's equity securities fell from 21 percent to 10 percent between 1993 and 2003 (Exhibits 8, 13).

Still, equities have contributed 18 percent of the financial stock increase since 1980, mainly through earnings growth. Stock valuations had a minimal impact on overall financial stock increase, because by 2003 P/E ratios in Japan had largely returned to the pre-bubble levels observed in 1980<sup>10</sup> (Exhibits 12, 14–15).

- **Private debt.** Private debt securities are the least important asset class in Japan's financial stock with only 12 percent share, which is much smaller than the shares of the US, the UK, and the eurozone (36, 30, and 29 percent, respectively). This stock has not grown at all since 1993, negatively impacted by the grim economic conditions in the country. Consequently, Japan's global share of private debt securities declined from 18 percent to 7 percent over the same period. However, private debt securities had grown in the 1980s, thus contributing 13 percent of the financial stock increase since 1980, with a minimal contribution from securitized issues (Exhibits 5, 8, 12–13).

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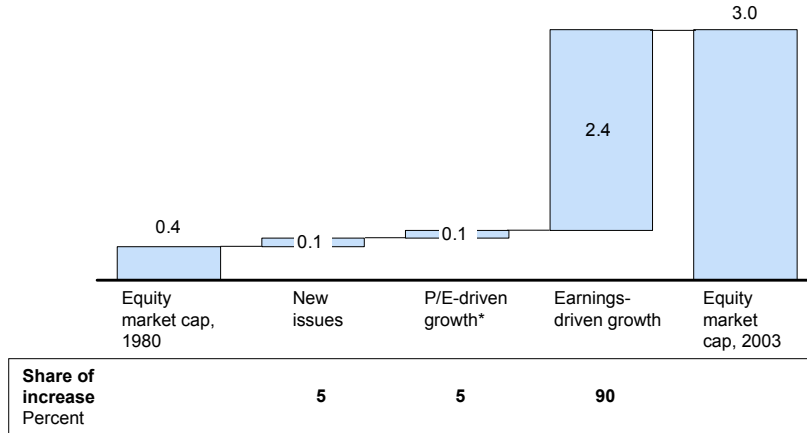
<sup>10</sup> Note that the analysis of drivers of stock market capitalization growth is sensitive to the start and end point. As Exhibit 16 indicates, there have been large variations in P/E ratio in most major markets since 1980. Since the bursting of the stock market bubble in 1999, the P/E ratio fell for all markets analyzed except for the US market.

## Exhibit 14

### EQUITY MARKET CAPITALIZATION GROWTH IN JAPAN, 1980–2003

ESTIMATE

\$ Trillions

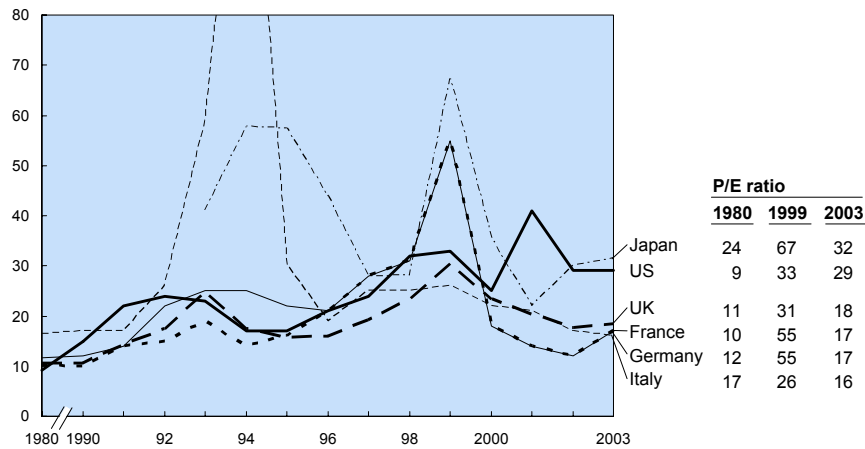


\* P/E ratio was 24 in 1980, 67 in 1999, 32 in 2003

Note: Nikkei 225 stock market index was 7,063 in 1980; it reached the end-of-year peak of 38,916 in 1989, and it was 10,677 in 2003; in the period 1980–1993 JPY appreciated by 81% against the dollar in nominal terms, while in the period 1993–2003 it appreciated further by 4%  
Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Thomson Financial Securities Data; Datastream; Compustat

## Exhibit 15

### P/E RATIOS FOR MAJOR WORLD MARKETS, 1980–2003



Source: Standard & Poor's (S&P); Euronext; World Federation of Exchanges

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## China

The Chinese financial system is less integrated with the global market than is the Chinese economy, due to capital restrictions and the inconvertibility of the yuan. Still, China has emerged as an important player in the global capital market.

- First, it is one of the global growth hot spots, growing nearly twice as fast as the world average (14.5 percent per year since 1993) and gaining global share in every asset class. Interestingly, unlike Eastern Europe, which is growing rapidly from a low financial depth, China has already developed a relatively deep financial system and its depth of 323 percent of GDP exceeds that of the eurozone (Exhibit 5).
- Second, China commands a meaningful share of the global bank deposits (9 percent), despite its smaller overall share of the global financial stock. This share has nearly doubled over the past 10 years (Exhibit 13).
- Third, China has become the country with the second largest financial stock in Asia (\$5.1 trillion, or 19 percent of Asia's total); in fact, China made the largest absolute contribution to the growth of bank deposits in Asia over the past 10 years (Exhibit 4).
- Finally, China remains a wild card for financial development in Asia, given the uncertainties of when and how it will open up its capital markets, how it will deal with its nonperforming loans and develop its financial system more broadly, and how it will weather its continued rapid economic growth and social changes.

The asset composition of China's financial stock illustrates the developing nature of the country's financial system, with strong reliance on the banking system and underdeveloped securities markets (especially debt securities markets). The most striking characteristic of the Chinese financial stock is its very high share of bank deposits (62 percent), which is more than twice the world average share of 30 percent.<sup>11</sup> Equity securities account for a relatively

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<sup>11</sup> As we shall see below, Chinese banks are plagued with nonperforming loans. Since banks in China are mostly state-owned and the government guarantees the deposits, a portion of bank deposits is effectively disguised government debt.

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high share of total financial stock (27 percent). Finally, the stocks of private and government debt securities are small (5 and 6 percent of total, respectively), although there are signs of recent government debt expansion, especially on the local government level (Exhibit 5).

Looking ahead, it is expected that China's financial stock will continue to grow rapidly, fueled by China's economic development and high savings rates. However, nonperforming loans and thinly traded equities make it difficult to assess China's financial stock qualitatively.

- **Nonperforming loans.** The credit quality of China's financial system is rather poor. It is still developing its risk management skills, it is closed, and it is dominated by government ownership and intervention.<sup>12</sup> While it is impossible to give an exact outside-in estimate of the share of nonperforming loans on the balance sheet of Chinese banks, guesses range from 25 to 60 percent. Assuming that the government would not allow major loss of deposits in the case of bank failures and would take over the burden from the state-owned banks in the process of resolving the nonperforming loans problem, government debt could increase significantly.
- **Thinly traded equities.** A large share of the Chinese market capitalization comes from the flotation of a small portion of the equity of state-owned enterprises. Equities are thinly traded and their true value is difficult to gauge: some think that current valuations represent speculative hype, while others believe that stocks are traded at significant discount because they represent government-run enterprises with limited market control.

## India

India is often compared to China for its rapid economic development. Some even go so far as to claim that the two economies compete against each other in terms of their role in the global economy. However, this certainly does not seem to be the case in the financial sector, as India's financial stock is smaller

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<sup>12</sup> There is a significant amount of government-directed lending to borrowers who may not be able to repay the loans.

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than China's, both in absolute terms and relative to the underlying economy, and also grows at a slower pace. This finding is in itself quite puzzling if we consider India's long Anglo-Saxon tradition in the financial markets and its institutional settings, which are considerably more favorable than those in China.

- **Size and growth.** At \$0.9 trillion, India's financial stock is about one sixth that of China's, despite India's more open financial sector. This difference is only partially explained by the difference in the size of the underlying economies: the GDP of China is \$1.4 trillion, or 2.2 times the size of India's GDP of \$631 billion. Some claim that China's financial stock is overstated due to its nonperforming loans, and therefore its lead over India is not as pronounced. However, even if we assume that 25 percent of China's bank deposits can be wiped out because of nonperforming loans, the financial stock of China would be approximately \$4.3 trillion, still 4.8 times the size of India's. While growing faster than the world average, India's financial stock has not grown as fast as China's over the past 10 years (growth rates of 11.9 and 14.5 percent, respectively; Exhibit 4).
- **Depth.** At 137 percent of GDP, India's financial depth is quite low, especially when compared to China's depth of 323 percent. However, India maintains its potential for further deepening, for example, through large-scale privatization of state-owned enterprises (Exhibit 4).
- **Asset composition.** The asset compositions of India and China exhibit some similarities, but also some differences. On one hand, in both countries bank deposits are the most important asset class (with 62 percent share in China and 45 percent in India), while private debt securities are the least important given the early stages of development of their market (respective shares are 5 and 1 percent). On the other hand, while unimportant in China, government debt securities account for 22 percent of India's financial stock<sup>13</sup> (Exhibit 5).

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<sup>13</sup> However, this difference in asset composition may be overstated, since a part of the bank deposit stock in China may indeed be disguised government debt, since the government both directs lending and owns and/or implicitly supports China's banks.

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## **Korea**

Korea has a relatively developed capital market and the largest financial stock in the group of the so-called Asian Tiger countries, accounting for \$1.3 trillion, or 5 percent of total financial stock in Asia (compared to China's 19 percent share). Despite the fact that Korea was affected by the 1997–1998 financial crisis in the region, it has enjoyed rapid growth in its financial stock since 1993 (11.2 percent per year). Financial depth in Korea is 214 percent, which is significantly less than in Japan (411 percent) and also less than in China (323 percent), indicating that Korea has still a lot of room to grow its financial stock (Exhibits 4–5).

While Korea is similar to Japan in that the largest asset class of Korea's financial stock is bank deposits (36 percent share), it is very different from Japan when it comes to the other asset classes. Private debt and equity securities command 29 and 25 percent share, respectively, while the role of government debt securities is minimal with only 10 percent of the total financial stock (Exhibit 4).