

## 2. US Findings

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The capital market of the US is of great interest because of its size as the largest national market in the world, its special hub role in the global capital market, and its reference function as the benchmark for market development. In the past 10 years, the US market continued its robust growth, fueled by expansion in private debt securities and undeterred by the boom-and-bust of the equity market bubble. Notably, the US financial stock is dominated by private equity and debt securities to a much greater extent than other markets in the world, with a limited role played by US government debt securities.

This chapter illuminates some of our findings regarding the US and is organized in these sections:

1. Key findings
2. Context
3. Overall size, growth, and financial depth of the US financial stock
4. Asset composition of the US financial stock
5. Role of the US in the global capital market.

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## Intepretation 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*.

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.*

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## **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—US

- **Size and growth.** The US accounts for the largest share of the global financial stock (37 percent of total GFS). The total US financial stock is now \$44 trillion, more than double its size of 10 years ago and nearly nine times its size in 1980.<sup>1</sup> The doubling over the past 10 years reflects a growth rate of 8.6 percent per annum since 1993, in line with the overall global rate of 8.4 percent.
- **Depth.** The size of the US financial stock relative to US GDP has increased from 179 percent in 1980, to 286 percent in 1993, to 397 percent in 2003. This depth exceeds that of the eurozone, but is close to the depth in Japan. However, in contrast to Japan, where the depth is largely driven by government debt expansion, the US financial depth is driven by the growth of private debt and equity securities.
- **Asset composition.** The US exemplifies the dominance of market-based financing and private securities. In contrast, bank intermediation and government debt securities play a smaller role than in the rest of the world.
  - **Private debt securities** are the largest asset class in the US financial stock (36 percent, compared to global average of 26 percent) and have grown faster than any other asset class (slightly more than 11 percent between 1993 and 2003). Two related processes have accelerated private debt securities growth: securitization and the activities of government-sponsored enterprises (GSEs).<sup>2</sup>
  - **Equity securities** are the second largest asset class in the US (33 percent, which is higher than the global average of 28 percent) and have grown at 11 percent over the same period, with significant fluctuations. The increase in equity stock came mainly from earnings growth, but P/E increases and IPOs also have contributed meaningfully.

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<sup>1</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.

<sup>2</sup> Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), Federal Home Loan Management Corporation (FHLMC).

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- **Bank deposits** represent only 20 percent of the US financial stock, a much smaller share than the world's average of 30 percent. Further, they have grown more slowly than private debt and equity securities.
  - **Government debt securities** form the least important asset class in the US financial stock, with 12 percent share (as compared to 18 percent global share). They have grown at a mere 2 percent per year since 1993, despite recent rapid expansion. The government has contributed modestly to the growth of US financial stock since 1980 (11 percent of increase), and even less since 1993 (only 4 percent).
  - **Role in the global capital market.** The US acts as the hub in the global capital market. The US is a large, very liquid, deep, developed, and growing market fueled by the robust economic growth of the largest consumer economy in the world and by the special role of its currency. The US attracts the lion's share of cross-border equity flows, and foreigners hold an increasing share of its financial stock.

## 2. CONTEXT—US

To provide context for the development of the financial stock in the US we highlight a few facts around the US economy, recent developments in its financial market, and the degree of integration within the financial system.

### **Economic facts**

At \$11 trillion, the US is by far the largest national economy in the world (Exhibit 1). It has grown steadily despite cyclical slowdowns: the 1990s were marked by robust growth, which ended with the burst of the equity market bubble in 2000. A recession started in March of 2001, but it was relatively short-lived; following economic stimulus measures, the country resumed its growth in 2003. Overall, the US GDP grew by 5.0 percent per year between 1993 and 2003 (as compared to 0.1 percent growth in Japan, 3.5 percent growth in the eurozone, and 4.4 percent growth in Europe as a whole).<sup>3</sup> Even during the recession of the early 2000s, consumer spending continued to grow, unlike during previous downturns.

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<sup>3</sup> All GDP growth figures in this report are in nominal terms.

## Exhibit 1

### TOP 10 CONTRIBUTORS TO GLOBAL GDP, 2003

Rank	Country	Nominal GDP \$ Trillions*	Share of global GDP 100% = \$36 trillion	1993-2003 CAGR Percent
1	US	11.0	30	5.1
	Eurozone	8.2**	23	3.5
2	Japan	4.3	12	-0.1
3	Germany	2.4	7	2.1
4	UK	1.8	5	6.4
5	France	1.7	5	3.2
6	Italy	1.5	4	4.0
7	China	1.4	4	8.9
8	Canada	0.9	2	4.4
9	Spain	0.8	2	5.3
10	Mexico	0.6	2	4.4
				<b>4.0</b>

\* All dollars throughout this report are US dollars

\*\* We use Europe as a comparative region in this report, including the eurozone, the UK, Switzerland, Sweden, Denmark, Norway, and all of Eastern Europe; the combined 2003 GDP of these countries was \$12.1 trillion, or 33% of the global GDP, with 4.4% 1993-2003 CAGR

Source: Global Insight; MGI analysis

### Recent developments

The biggest recent development in the US financial market was the unprecedented equity market growth driven by technology, media, and telecom stocks during the 1990s and the subsequent bubble burst in 2000. In addition, a wave of corporate governance scandals shook the markets—the likes of Enron, WorldCom, and Global Crossing—and led to massive revision of profit expectations and stricter securities regulation (e.g., Sarbanes-Oxley legislation).

Fluctuations in foreign exchange rates also affect the US financial stock, especially in its relative size and growth when compared to other regions (see Box).

### Integration

Finally, in light of the cross-regional comparison of the degree of integration of financial markets, it is important to note that the US is truly a single market, unlike both Europe, where the process of unification is still under way, and Asia, where there is little cross-country integration.

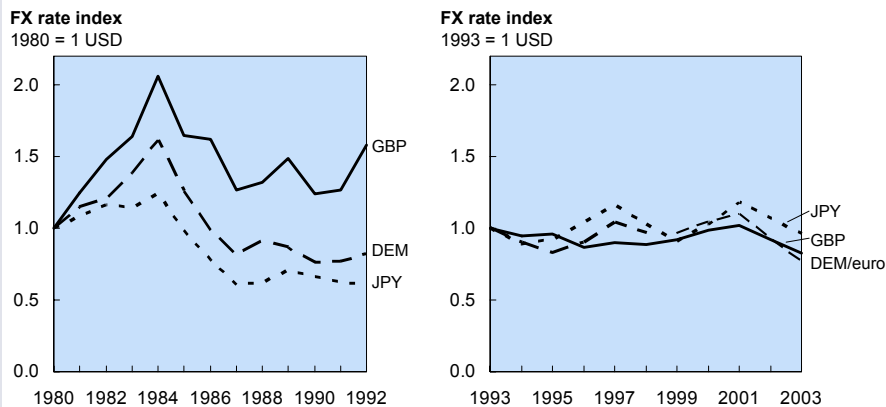
## Foreign Exchange Rate Fluctuations

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 2).

### Exhibit 2

#### FOREIGN EXCHANGE RATES AGAINST THE US DOLLAR



Exchange rate USD equivalent	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.

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### 3. OVERALL SIZE, GROWTH, AND DEPTH OF THE US FINANCIAL STOCK

The US is the largest single market in the world, accounting for 37 percent of the global financial stock. The US financial stock stood at \$44 trillion in 2003, up from \$5 trillion in 1980 and \$19 trillion in 1993 (Exhibit 3). Despite the volatility occasioned by the equity market boom-and-bust, the US financial stock more than doubled over the past 10 years, growing at 8.6 percent between 1993 and 2003, a rate comparable to that of Europe and much faster than that of Japan<sup>4</sup> (Exhibit 4).

The size of the US financial stock relative to US GDP has increased from 179 percent in 1980, to 286 percent in 1993, to 397 percent in 2003 (Exhibit 5). This financial depth is among the greatest in the world; it exceeds the depth in the eurozone and is close to the depth in the UK and Japan. However, when making cross-regional comparisons, one must keep in mind the underlying composition of the financial stock. Despite the similar overall depths of the US and Japan (397 percent versus 411 percent) the nature of the financial depth in the two countries is strikingly different: Japan's deepening has been a product of government debt expansion and a stagnant GDP, while the US's deepening resulted from an expansion of private securities that outstripped the growth of its vibrant economy (Exhibit 6). Thus, the quality of financial deepening in the US surpasses that of Japan as it reflects increased efficiency of the financial system rather than mounting obligations to future generations.

As discussed in Chapter 1, financial deepening accompanies the development of financial systems as the increase in financial instruments leads to financial stock growth beyond the growth of GDP. The US financial stock is already far along this process and will likely continue to deepen in the future. What is more significant for the global capital market is that the US foreshadows what may happen in other parts of the world. We see at least three potential sources of further deepening in the rest of the world: securitization, accumulation of pension funds, and privatization.

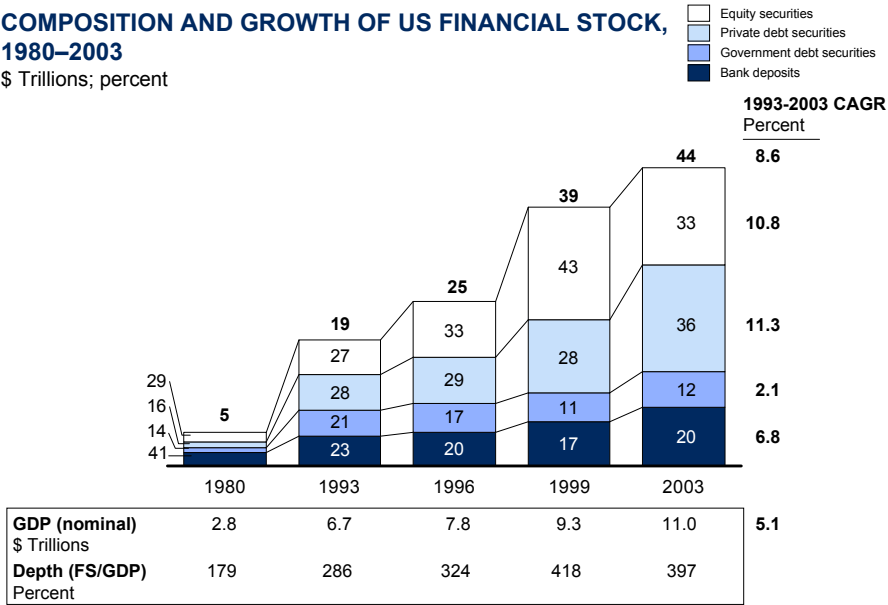
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<sup>4</sup> As discussed, growth rates are very sensitive depending on start and end year and must also be put in the context of foreign exchange movements. For example, in the period 1993 to 2003 Europe's financial stock grew faster than the US; but if we calculated the growth rates for 1993 to 2002 instead, the US stock grew faster.

### Exhibit 3

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

\$ Trillions; percent

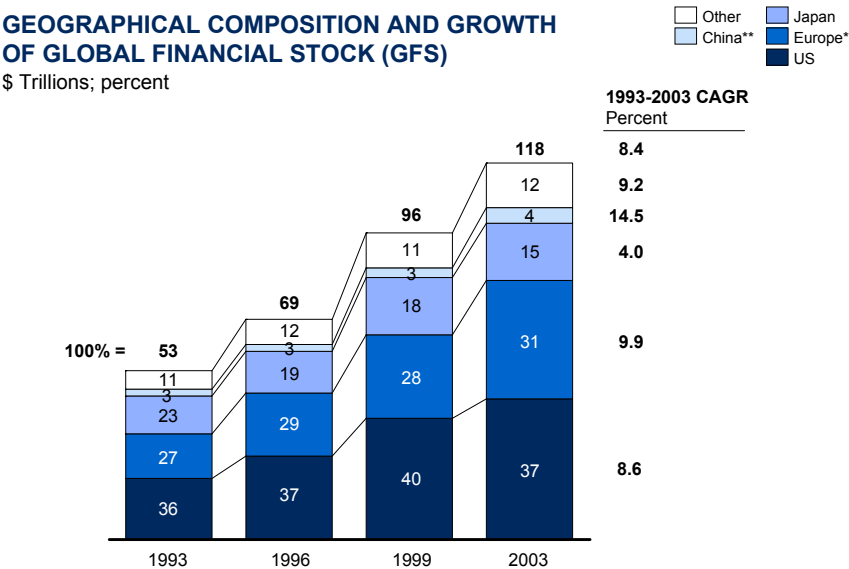


Note: 1993, 1996, 1999, and 2003 shares do not add to 100% due to rounding errors  
 Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Global Insight

### Exhibit 4

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

\$ Trillions; percent

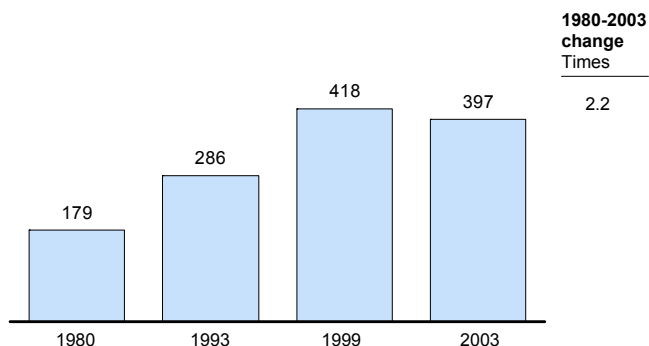


\* Europe includes the UK, the eurozone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain), Switzerland, Sweden, Denmark, Norway, and Eastern Europe  
 \*\* China also includes Hong Kong and Macao  
 Note: 2003 shares do not add to 100%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

## Exhibit 5

### DEPTH OF US FINANCIAL STOCK, 1980–2003

Financial stock expressed as percent of GDP



Compare with

	1980	1993	1999	2003	1980-2003 change Times
UK	103	245	407	385	3.8
Eurozone	77	175	262	314	4.0
Japan	200	273	387	411	2.1

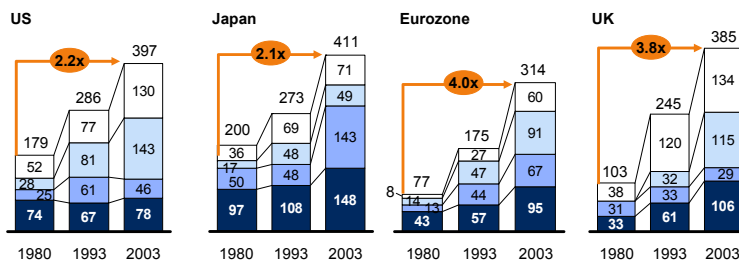
Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Global Insight

## Exhibit 6

### REGIONAL VARIATION IN FINANCIAL DEPTH, 1980–2003

Financial stock expressed as percent of GDP

■ Equity/GDP  
■ Private debt/GDP  
■ Government debt/GDP  
■ Bank deposits/GDP



	1980-2003 change							
	Absolute*	Relative	Absolute*	Relative	Absolute*	Relative	Absolute*	Relative
Equity/GDP	78	36	35	17	52	22	96	34
Private debt/GDP	115	53	32	15	77	33	115	41
Government debt/GDP	21	10	93	44	54	23	-2	-1
Bank deposits/GDP	4	2	51	24	52	22	73	26
<b>FS/GDP</b>	<b>218</b>	<b>100</b>	<b>211</b>	<b>100</b>	<b>237</b>	<b>100</b>	<b>282</b>	<b>100</b>

\* In percentage points: e.g., the US depth for 2003 was 397 and for 1980 was 179, yielding a 218 points increase  
 Note: Some numbers do not add up due to rounding error  
 Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Global Insight

- **The process of securitization** (that is, pooling financial assets and issuing debt securities backed by them) has become an important source of new debt issues in the US.<sup>5</sup>

— The universe of securitized assets has steadily increased. It now includes various residential and commercial mortgage-backed securities (MBS) issued by GSEs and other private institutions, and various consumer and commercial asset-backed securities (ABS) (Exhibit 7). While securitization is also picking up in Europe and Japan, the process has not yet penetrated other parts of the world.<sup>6</sup>

### **Exhibit 7**

#### **VARIETY OF SECURITIZED ASSETS IN THE US**

	<b>Consumer/residential</b>	<b>Commercial</b>
<b>Mortgage-backed securities (MBS)</b>	<ul style="list-style-type: none"> <li>• Standard mortgages</li> <li>• Prime jumbo</li> <li>• Alt-A</li> <li>• Subprime/home equity</li> <li>• Net interest margin securitizations (NIMs)</li> <li>• Manufactured housing</li> </ul>	<ul style="list-style-type: none"> <li>• Multiborrower transactions</li> <li>• Single borrower transactions</li> <li>• Large loan transactions</li> <li>• Multifamily properties</li> <li>• Retail properties</li> <li>• Office and industrial properties</li> <li>• Hotel properties</li> </ul>
<b>Asset-backed securities (ABS)</b>	<ul style="list-style-type: none"> <li>• Auto lease</li> <li>• Auto loans – prime</li> <li>• Auto loans – subprime</li> <li>• Credit cards – prime</li> <li>• Credit cards – retail</li> <li>• Credit cards – subprime</li> <li>• Student loans</li> <li>• Timeshare receivables</li> </ul>	<ul style="list-style-type: none"> <li>• Equipment loans/leases</li> <li>• Aircraft</li> <li>• Dealer floor plan</li> <li>• Tobacco settlements</li> <li>• Franchise loans</li> <li>• Rental fleet finance</li> <li>• Small-business loans</li> <li>• Stranded costs</li> </ul>

Source: FitchRatings

<sup>5</sup> A broader definition of securitization addresses the greater degree of financialization in the economy, and includes the process of companies floating equity and debt securities instead of funding themselves through bank loans.

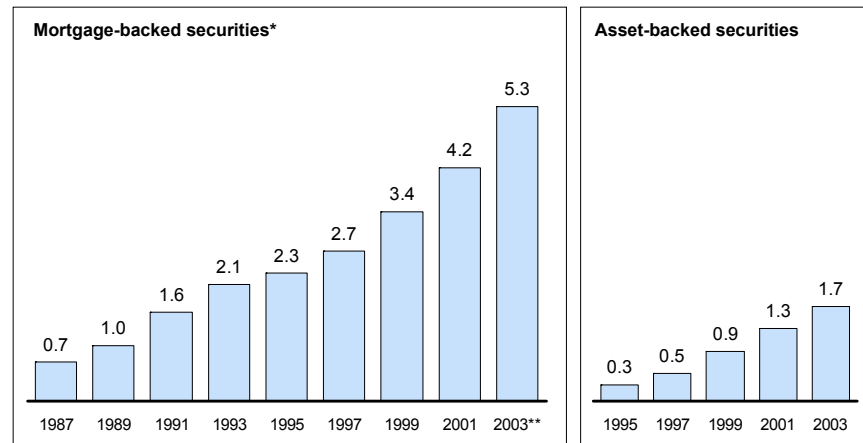
<sup>6</sup> Securitization in the form of Pfandbriefe instruments has been an important factor in the German financial stock growth; see Chapter 3 for details.

— At the end of 2003, securitized debt in the US reached \$7.0 trillion, including \$3.5 trillion of agency MBS, \$1.0 trillion of agency collateralized mortgage obligations (CMO), \$0.8 trillion of non-agency MBS, and \$1.7 trillion of ABS (Exhibit 8). In fact, in the first half of 2004, for the first time in history the volume of new securitized corporate issues outstripped the volume of new issues of non-securitized corporate debt.<sup>7</sup>

### Exhibit 8

#### GROWTH OF SECURITIZED ASSETS IN THE US

\$ Trillions



\* Includes data for agency MBS, agency collateralized mortgage obligations (CMO), and non-agency MBS  
 \*\* Includes \$3.5 trillion of agency MBS, \$1.0 trillion of agency CMO, and \$0.8 trillion of non-agency MBS  
 Source: Bond Market Association; *Inside MBS & ABS*; MGI analysis

— Well-developed mortgage markets in the US are fueling MBS securitization. As of June 2004, total mortgages in the US reached \$9.9 trillion, or 85 percent of GDP, of which \$5.3 trillion are securitized.<sup>8</sup> In contrast, the mortgage market is underdeveloped in many developing countries (for example, only 5 percent of GDP in Mexico) suggesting room for growth.

<sup>7</sup> Federal Reserve Flow of Funds, Table F.212.

<sup>8</sup> Federal Reserve Flow of Funds, Table L.217 and Bureau for Economic Analysis.

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- **Pension funds** are amassing sizeable pools of investable assets in the US, reaching \$7.3 trillion (63 percent of GDP) in June 2004.<sup>9</sup> Pension funds are growing fast in countries with recent pension system reforms, but are still low relative to GDP (for example, Mexico, Argentina, and Brazil all have less than 15 percent of GDP in private pension fund assets).
  - **Privatization** has largely run its course in the US, but can still provide a significant source of deepening in other parts of the world. In the US, few government-owned companies could potentially be privatized (for example, the postal service), as opposed to countries with significant state business ownership (China, Mexico, India, and even developed countries in Europe).

#### 4. ASSET COMPOSITION OF THE US FINANCIAL STOCK

Private debt and equity securities dominate the US financial stock in terms of their share of asset composition and their contribution to financial stock increase and to corresponding financial deepening. Bank deposits and government debt securities play a small role.

##### **Private debt securities**

Private debt securities<sup>10</sup> are the most important asset class in the US. They account for the largest share of the US financial stock (36 percent, compared to the global average of 26 percent) and have grown faster than any other asset class over the period 1993 to 2003 (11.3 percent; Exhibit 3). On a global level, US private debt securities account for 51 percent of all private debt securities in the world, up from 46 percent in 1993. In contrast, Japan's share has fallen from 18 percent to 7 percent over the same period (Exhibit 9).

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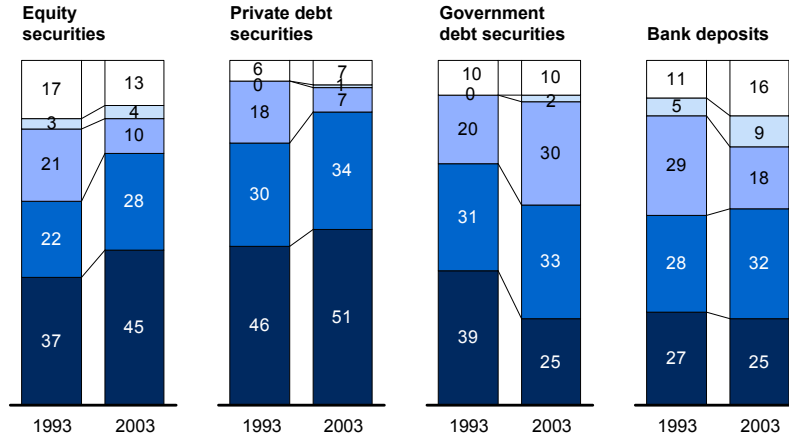
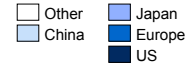
<sup>9</sup> Includes \$4.3 trillion in private defined benefit plans and defined contribution plans (including 401(k) type plans), \$2.0 trillion of state and local government employee retirement funds, and \$1.0 trillion in federal government retirement funds. Federal Reserve Flow of Funds, Tables L.119–121 and Bureau for Economic Analysis.

<sup>10</sup> Private debt securities in the US include those issued by corporations and financial institutions, including the agencies GNMA, FNMA, and FHLMC.

**Exhibit 9**

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

Percent



Source: McKinsey Global Institute Global Financial Stock Database

Further, private debt securities contributed 42 percent of the total increase in the US financial stock over the past 10 years—37 percent through growth in securities issued by financial institutions, and 5 percent through securities issued by corporations (Exhibit 10). They contributed 39 percent of the overall increase since 1980; securitization alone contributed 18 percent, mainly through GSE activity.<sup>11</sup> (See Exhibit 11, which breaks out the overall growth in the US financial stock since 1980 by component).

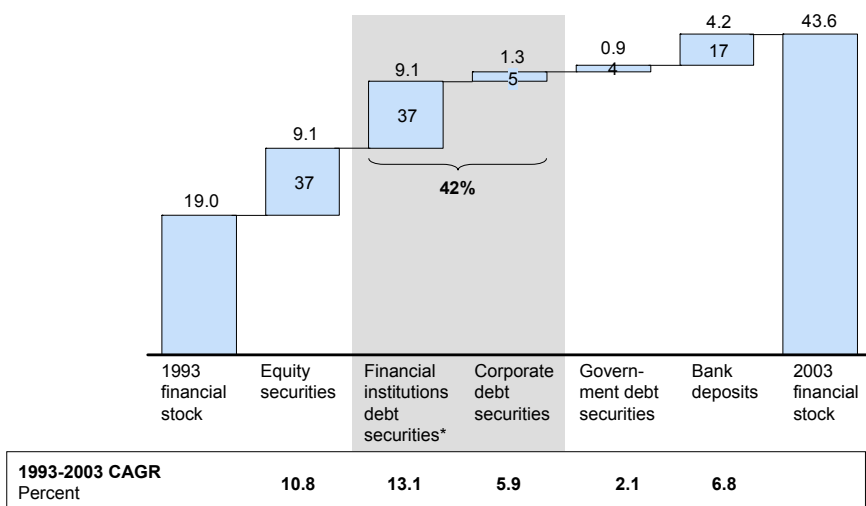
Finally, private debt securities contributed 53 percent of the increased depth in the US since 1980, increasing from 28 percent of GDP in 1980 to 143 percent of GDP in 2003 (Exhibit 12).

<sup>11</sup> GNMA, FNMA, and FHLMC.

## Exhibit 10

### CONTRIBUTION TO US FINANCIAL STOCK GROWTH BY COMPONENT

\$ Trillions; percent (in boxes)



\* Including MBS issued by Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), Federal Home Loan Management Corporation (FHLMC)  
Source: McKinsey Global Institute Global Financial Stock Database

## Exhibit 11

### CONTRIBUTION TO US FINANCIAL STOCK GROWTH BY COMPONENT, 1980-2003

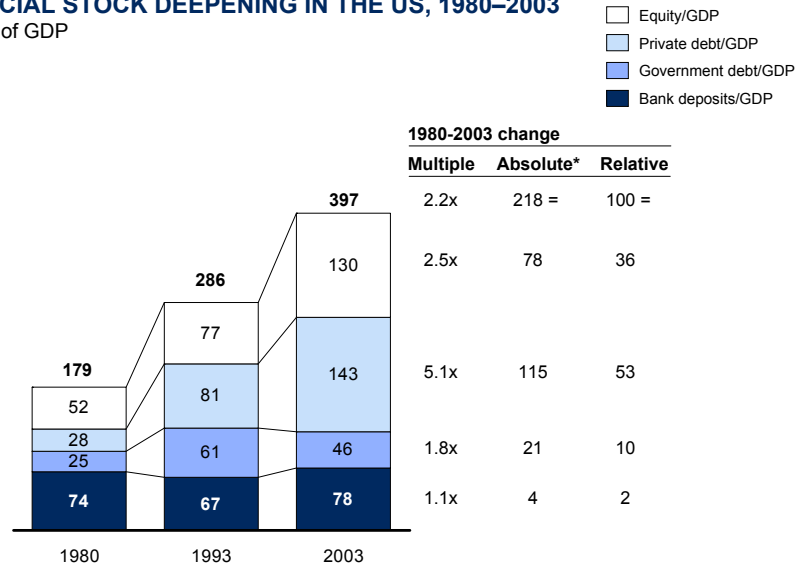
\$ Trillions

Asset class	Component	Private sector			Total	Share Percent
		Government	Business	Households		
Equity securities	• New issues	-	2.4	-	2.4	6
	• P/E growth	-	-	4.7	4.7	12
	• Earnings growth	-	5.7	-	5.7	15
Private debt securities	• Increased private debt	-	8.0	-	8.0	21
	– Non-ABS corporate	-	6.5	-	6.5	39
	– Government-sponsored enterprise (GSE) debt*	-	1.5	-	1.5	
	• Securitization	-	6.9	-	6.9	18
– ABS	-	2.5	-	2.5		
– GSE MBS	-	4.4	-	4.4		
Government debt securities	• Increased government debt	4.3	-	-	4.3	11
Bank deposits	• Increase in currency	-	-	0.6	0.6	1
	• Increase in business bank deposits	-	1.4	-	1.4	4
	• Increase in HH bank deposits	-	-	4.5	4.5	12
<b>Total</b>		<b>4.3</b>	<b>24.4</b>	<b>9.8</b>	<b>38.5</b>	<b>100</b>
	<b>Share Percent</b>	<b>11</b>	<b>63</b>	<b>26</b>	<b>100</b>	

\* Includes agency MBS and CMO  
Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Federal Reserve; Datastream; Compustat; Bond Market Association; Inside MBS & ABS

## Exhibit 12

### FINANCIAL STOCK DEEPENING IN THE US, 1980–2003 Percent of GDP



\* In percentage points: e.g., the US depth for 2003 was 397 and for 1980 was 179, yielding a 218 point increase  
 Note: Some numbers do not add up due to rounding error  
 Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Global Insight

### Equity securities

Equities are the second largest asset class in the US (33 percent, compared to the global average of 28 percent) and have grown at 10.8 percent over the past 10 years, with significant fluctuations related to the equity market bubble<sup>12</sup> (Exhibit 3). The global share of US equity securities increased from 37 percent to 45 percent between 1993 and 2003 (by contrast, Japan's share shrank from 21 percent to 10 percent over the same period; Exhibit 9).

In addition, equity securities contributed 37 percent of the total increase in the US financial stock over the past 10 years and 33 percent since 1980 (Exhibits 10–11). A number of factors have contributed to the US equity stock increase over the longer run: the main factor is earnings growth, but P/E increases and IPOs have also been meaningful contributors (Exhibit 13). Relative to European countries, US equity securities have increased more through P/E changes and

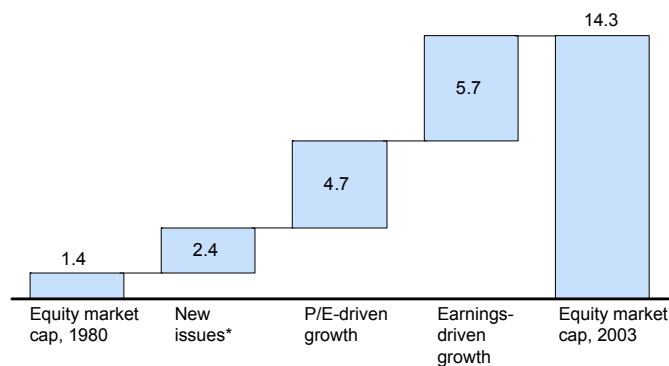
<sup>12</sup> The total market cap of US equities at the end of 1999 was \$16.6 trillion, it dropped to \$11.1 trillion at the end of 2002, and then recovered to \$14.3 trillion by the end of 2003. It is interesting to note that venture capital, which plays an important function of funding pre-IPO companies, is very small relative to the overall stock of equity securities. It peaked at \$100 billion in the US.

## Exhibit 13

### US EQUITY MARKET CAPITALIZATION GROWTH, 1980–2003

\$ Trillions

ESTIMATE



Share of increase	Percent
New issues*	19
P/E-driven growth	36
Earnings-driven growth	45

\* Net of buybacks

Source: McKinsey Global Institute Global Financial Stock Database; Merrill Lynch; Federal Reserve; Swiss Agency for Development & Cooperation (SDC); Datastream; Compustat

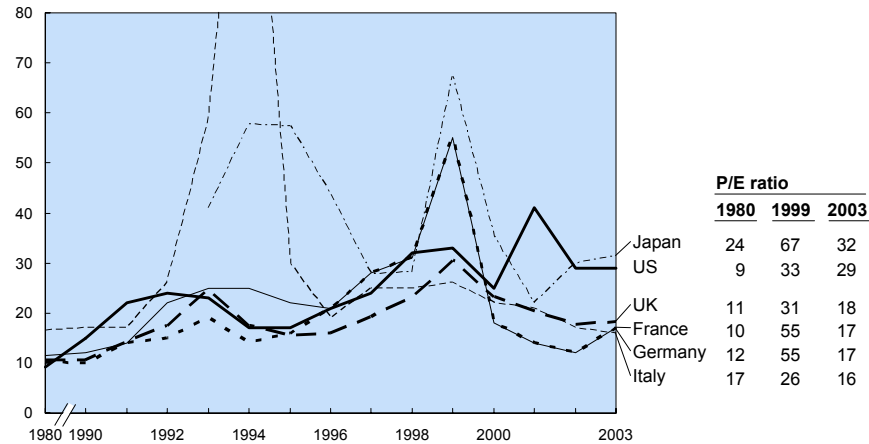
less through earnings growth. However, this analysis is highly sensitive to start and end point as P/Es are very volatile. In fact, reactions to a P/E rally in the 1990s illustrate the difference between the US and Europe: after 1999, the European P/Es largely reverted to 1980 levels, while US P/Es remained relatively high (Exhibit 14). There is a debate around the sustainability of current P/Es in the US: some believe they reflect an asset bubble or at least pose a puzzle, while others claim they are substantiated by real productivity improvements, globalization, and sectoral shifts in the US economy. In either case, P/E increases have contributed to the growth of equity stock.

Lastly, equity securities have been a meaningful contributor to financial deepening since 1980, contributing 36 percent of the total increase in depth, increasing from 52 percent of GDP in 1980 to 130 percent of GDP in 2003 (Exhibit 12).

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## Exhibit 14

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



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

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## Bank deposits

Bank deposits represent only 20 percent of the US financial stock, a much smaller share than the world's average of 30 percent. They grew more slowly than private debt and equity securities, at 6.8 percent between 1993 and 2003 (Exhibit 3). Over the same period, the global share of US bank deposits slightly decreased from 27 percent to 25 percent; for comparison, Japan's share dropped from 29 percent to 18 percent, while both China and Europe increased their shares (Exhibit 9).

Bank deposits contributed 17 percent of the total increase in the US financial stock over the past 10 years and since 1980, mainly through increase in household deposits (Exhibits 10–11). They have not contributed meaningfully to deepening, barely increasing from 74 percent of GDP to 78 percent since 1980 (Exhibit 12).

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## Government debt securities

Government debt securities form the least important asset class of the US financial stock.<sup>13</sup> Government debt represents only 12 percent of the US financial stock (in comparison, total government debt in the world has an 18 percent share of the global financial stock) and has grown at a mere 2.1 percent per year since 1993, despite recent expansion<sup>14</sup> (Exhibit 3). In another sign of its decreasing importance, the global share of US government securities declined from 39 percent to 25 percent over the same period (Exhibit 9).

Government debt securities have contributed modestly to the growth of the US financial stock since 1980 (11 percent of the increase), and even less since 1993 (only 4 percent; Exhibits 10–11). Similarly, they have not contributed meaningfully to deepening, as they have not grown much faster than GDP. Government debt depth increased from 25 percent of GDP in 1980 to 46 percent in 2003, contributing 10 percent of the overall increase in depth (Exhibit 12).

## 5. US ROLE IN THE GLOBAL CAPITAL MARKET

The global capital market comprises countries and regions that vary greatly in their financial stock's size, evolution, composition, growth, and role in the market (see also Chapter 1). For example, Europe is a large, growing, developed market that is being shaped by the processes of economic integration in the eurozone and by the dynamism of Eastern Europe. Within the greater European region, the UK is a deep, liquid hub that dominates the global foreign exchange, derivatives, and Eurobond markets. In another example, Asia is dominated by Japan's stagnant economy, but also encompasses China, a market surging ahead on a wave of economic growth.

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<sup>13</sup> The US government debt is comprised of marketable federal ("Treasury") securities (72 percent of total) and state and local government ("municipal") securities (28 percent of total). It is interesting to note that 17 percent of total Treasuries are held by the Federal Reserve Banks, which reduces the amount of securities available to the public. Another 38 percent are held by foreign residents: 24 percent are held by foreign official institutions, and 14 percent are held by private foreigners. Not included in our numbers are \$1.5 trillion (as of September 2003) of special, non-negotiable, non-marketable Treasuries issued as an investment tool for the assets of the Social Security and Medicare Trusts. Federal Reserve Flow of Funds Accounts, Social Security and Medicare Boards of Trustees Annual Report.

<sup>14</sup> The US government debt securities stock grew by 8 percent in 2002 and 11 percent in 2003.

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The US plays a unique role in the global capital market. As we already established, the US is the largest national financial market, with 37 percent of the global financial stock, and even greater shares of the global equities (45 percent) and private debt security stocks (51 percent). Additionally, the size of the US economy, the role of its currency, and its role as a global financial hub and conduit of capital all contribute to its unique place in the global capital market.

### **The world's largest economy**

The US as an economy is unique given its size—both in terms of its consumer market and the importance of its business base in the world. On the one hand, the US consumer market, because of its sheer size and its share of consumption of world output, attracts businesses from around the world who want to tap the US goods and services market. On the other hand, US businesses have become increasingly international and thus play an important role in the global economy. For example, US foreign direct investment (FDI) abroad totaled \$803 billion from 1997 to 2002<sup>15</sup>; in fact, estimates suggest that one fourth of the US market cap is attributable to profits from foreign subsidiaries (Exhibit 15).

Given the attractiveness of the US consumer market and the international activities of its business base, the US has enormous import and export flows of goods and services; for example, in 2003, US imports and exports totaled \$2.6 trillion, or 24 percent of GDP.<sup>16</sup> Trade on this scale necessitates huge settlement money flows and foreign exchange activity against the dollar.

### **A unique currency**

Clearly, the US currency has a special role in the world. The US dollar is the preferred reserve currency of central banks around the world and the trade and exchange currency of choice: 65 percent of foreign exchange official reserves are held in US dollars (Exhibit 16). Further, 89 percent of all foreign exchange trades are against the US dollar (Exhibit 17).

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<sup>15</sup> 2003 World Investment Report.

<sup>16</sup> Global Insight.

## Exhibit 15

### MARKET VALUE OF FOREIGN INCOME OF US MULTINATIONAL CORPORATIONS, 2002

\$ Billions

Industry	Income from foreign affiliates	Applied P/E ratio	Market value of foreign income*
Manufacturing	31.3	23.4	732.4
Finance**	16.3	15.8	257.5
Petroleum**	10.2	15.4	157.1
Wholesale trade	13.2	17.6	232.3
Services and information**	3.2	21.2	67.8
Mining**	10.2	21.2	216.2
Other**,**	49.8	21.2	1055.8
<b>Total US income from foreign affiliates</b>	<b>\$134.2 billion</b>		<b>\$2.7 trillion = ~1/4 of total US market cap</b>

\* As measured by income receipts from foreign affiliates, multiplied by relevant industry median or index P/E ratio

\*\* P/E ratios calculated by averaging 2001-2004 industry medians, to remove cyclicality

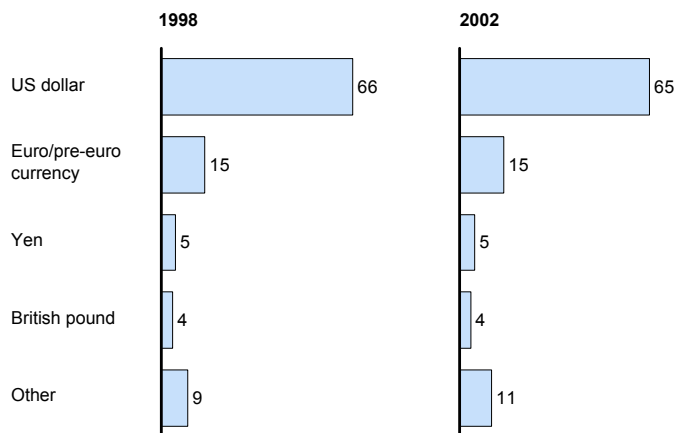
\*\*\* Includes utilities, agriculture/forestry/fishing, construction, retail trade, real estate, transportation, management of nonbank companies and enterprises, accommodation, health care, and miscellaneous

Source: Bureau of Economic Analysis (BEA); S&P Analysts' Handbook Supplement; MGI analysis

## Exhibit 16

### SHARE OF NATIONAL CURRENCIES IN TOTAL OFFICIAL HOLDINGS OF FOREIGN EXCHANGE

Percent



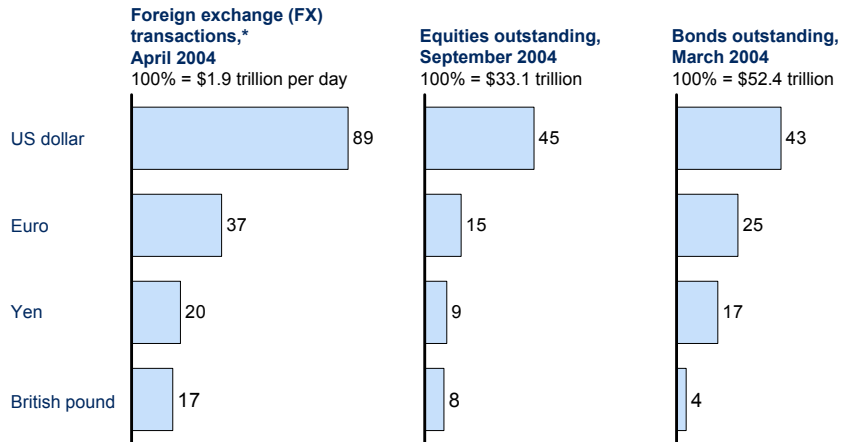
Source: International Monetary Fund

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## Exhibit 17

### PREFERRED EXCHANGE CURRENCY FOR FINANCIAL PRODUCTS

Percent



\* Because there are two currencies in a single FX transaction, the potential total is 200%; the share of other currencies comprise the remaining 37%  
Source: McKinsey Global Institute Global Financial Stock Database; Federation of World Stock Exchanges; Bank for International Settlements (BIS)

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Some view the US dollar as the center of what is being called a dollar zone, formed by countries that have linked their domestic currency tightly to the US dollar (China, for example) or through interventions (for example, Japan, Korea, India, and Singapore), thus turning the Federal Reserve into the world's central bank.<sup>17</sup>

Finally, the dollar is viewed as a safe value-storage and transaction currency in the developing world (for example, Latin America) where people prefer to keep their savings in the form of dollar-stuffed jars rather than to deposit local currency in a bank; in fact, about 60 percent of the US currency in circulation is held outside of the US.<sup>18</sup>

The sustainability of the US dollar as the dominant currency in the world has been questioned in light of the introduction of the euro (and the eurozone, which is comparable in size to the US) and in light of the recent depreciation of the US

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<sup>17</sup> See Martin Wolf, "Why the Fed is forced to fuel the global boom," Financial Times, March 31, 2004.

<sup>18</sup> United States Treasury Department, "The use and counterfeiting of United States currency abroad, Part 2," Report to Congress, March 2003.

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dollar (Exhibit 2 illustrates the fall of the dollar against the British pound, the euro, and the Japanese yen between 2001 and 2003). So far the dollar has largely maintained its position: foreign exchange transactions do not show a shift toward the euro over the US dollar, and local currency foreign exchange activity in most countries is typically transacted against the US dollar (with the exception of Eastern Europe); also, the majority of the global financial stock continues to be denominated in US dollars. However, there are signs that the euro is impacting the US's dominant position:

- First, there is a recent shift toward the euro in new bond issues. However, it is not yet clear whether this shift is caused by a temporary attractiveness of euro-denominated paper, or whether it is the beginning of a long-term trend driven by multinational corporations who want to hedge currency risk and by major global borrowers who want to widen their investor base in Europe (such as Freddy Mac, which is the largest single issuer of euro-denominated bonds outside of the eurozone).<sup>19</sup>
- Second, with the strong euro appreciation relative to the US dollar since 2001, the eurozone's relative share of the global financial stock has increased and its financial stock growth has accelerated in US dollar terms; again, these trends are a function of the euro to dollar exchange rate and could be reversed over the long run.

### **Global market hub**

The US financial market acts as a hub in the global capital market. The US market is very well developed and has many advantages on its own: it is large, deep, efficient, liquid, and transparent. It is also a very open market that is integrated with the global capital market, as evidenced by the large volumes of cross-border holdings and activity. Foreigners increasingly invest in US equity, corporate debt, and Treasury securities (Exhibit 18). Further, the US attracts the lion's share of cross-border equity flows (Exhibit 19). Foreign issuers raise capital in the US through fast-growing American Depositary Receipts (ADRs) and international debt. Similarly, US investors invest abroad and US companies raise capital in foreign markets.

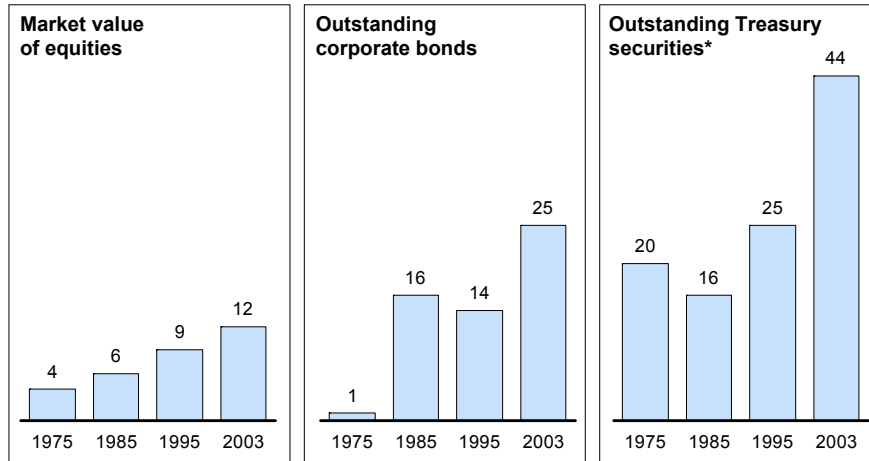
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<sup>19</sup> See Occasional Paper No. 18 of the European Central Bank, "The international role of the euro: evidence from bonds issued by non-euro area residents," July 2004.

## Exhibit 18

### FOREIGN-OWNED US SECURITIES, 1975–2003

Percent



\* Excluding Treasury securities held by the monetary authority  
Source: Federal Reserve Flow of Funds

## Exhibit 19

### CROSS-BORDER EQUITY FLOWS, 1999

Percent of investments from a given market going to a foreign market

0-10 21-50  
11-20 51-100

Investor from	Investing to										ROE**	Total \$ Billions
	US	UK	Neth.	Japan	Germ.	France	Switz.	Spain	Italy	Scanda		
US	n/a	30	5	11	3	3	2	1	2	5	4	4,689
UK	21	n/a	13	7	13	13	6	4	1	6	3	5,667
Netherlands	28	23	n/a	3	9	11	3	1	4	3	9	285
Japan	69	8		n/a	1		2	1	1		-1	270
Germany	21	6	12	17	n/a	13	9	3	6	4	2	808
France	57	6	10	2	10	n/a	2	1		1	5	634
Switzerland	47	13	5	5	7	10	n/a	1	1	2	2	530
Spain	29	15	10	13	3	4	2	n/a	3	2	3	69
Italy	39	11	3	18	3	8	2	1	n/a	1	2	218
Scandinavia*	20	14	1	2	1	1	1		1	50	2	272
ROE**	38	3	27	13	1	6		1	1	1	3	462
Canada	82	4			1	6	1			1		209
Australia	63	8		4		8		1	1	1		35
Hong Kong	29	24	2	18		5	3	1	1	1	1	93
Singapore	46	11	1	15		4	5	1	1			85
Rest of world	89											2,504

\* Sweden, Norway, Finland, and Denmark  
\*\* Rest of Europe: Austria, Belgium/Luxembourg, Greece, Ireland, Portugal, Turkey  
Source: Cross-Border Capital (unpublished data)