McKinsey Global Institute

Mapping Global Capital Markets
Fourth Annual Report

Executive Summary

January 2008

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MGI's research is conducted by a group of full-time MGI fellows based in offices in San Francisco, Washington, DC, London, and Shanghai and led by MGI's director, Diana Farrell. MGI project teams also include consultants drawn from McKinsey's offices around the world and are supported by McKinsey's network of industry and management experts and worldwide partners. In addition, MGI teams work with leading economists, including Nobel laureates and policy experts, who act as advisors to MGI projects.

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Charles Atkins

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

Executive summary

Abu Dhabi buys a stake in Citigroup. China's stock market doubles in value, while Japan's stagnates. The dollar slides as the euro surges. And oil prices rise to new records. All these headlines reflect a world financial system in flux, as global capital markets grow bigger and more linked.

They also tell the story of countries' shifting positions and power in the world financial order—a microcosm of globalization at work. This report paints a portrait of the long-term trends in global capital markets. Our research stems from several proprietary McKinsey Global Institute databases that cover the financial assets, cross-border capital flows, and foreign investments of more than 100 countries since 1990. In this year's update, we focus on how world financial markets evolved in 2006, the latest year for which comprehensive data are available. It remains to be seen how the 2007 credit market turmoil plays out, but we expect the fundamental trends we discuss here to continue: Europe's capital markets growing in size and financial clout, and emerging markets rising. Financial power is spreading beyond the United States as other markets mature.

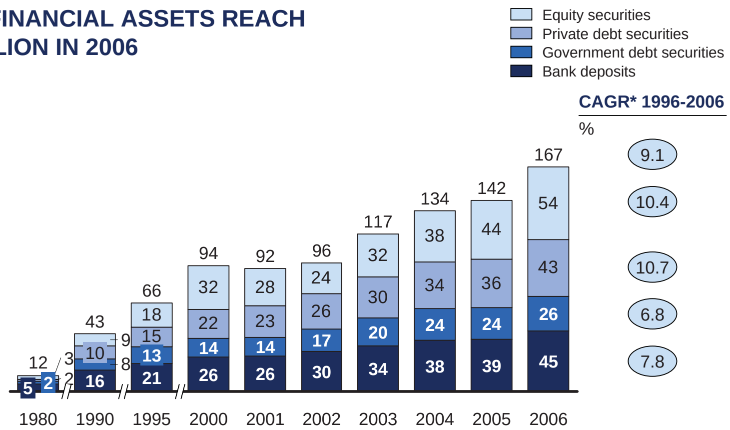
Through the data, we seek to illuminate the ways in which world financial markets are evolving—and dispel some myths and misunderstandings that result from focusing on just one statistic in isolation. In this report we do not discuss whether financial globalization is ultimately beneficial or not, or the regulatory issues faced by policy makers. Instead, we seek to provide a robust fact base that depicts the structural, long-term changes taking place in global capital markets.

WORLD FINANCIAL ASSETS REACH $167 TRILLION

The total value of the world's financial assets grew faster in 2006 than the historical average rate. This sum—including equities, private and government debt securities, and bank deposits—climbed by $25 trillion in nominal terms, or 17 percent, to reach $167 trillion (Exhibit 1). At constant exchange rates, growth was $18.9 trillion, or 13 percent—still above trend.

Exhibit 1

GLOBAL FINANCIAL ASSETS REACH $167 TRILLION IN 2006
$ trillion



	1980	1990	1995	2000	2001	2002	2003	2004	2005	2006	CAGR* 1996-2006 %
Nominal GDP $ trillion	10.1	21.5	29.4	31.7	31.6	32.8	36.9	41.6	44.8	48.3	5.7
Financial depth % of GDP	109	201	223	294	290	292	318	323	317	346	

* Compound annual growth rate.

Note: See Technical Notes in the appendix for summary of revisions to data from 2005 and earlier years. Some numbers do not add up due to rounding.

Source: McKinsey Global Institute Global Financial Stock Database

Growth in financial assets also outpaced growth in global GDP. World financial depth, measured as the ratio of financial assets to global GDP, rose to nearly 350 percent. Moreover, the gains in financial market evolution are broad-based. In 1990, only 33 countries in the world had financial assets that exceeded the value of their GDP. By 2006, this figure had more than doubled to 72 countries. Today, all the industrial economies and even the largest emerging markets have financial markets that are two to three times the size of their GDP.

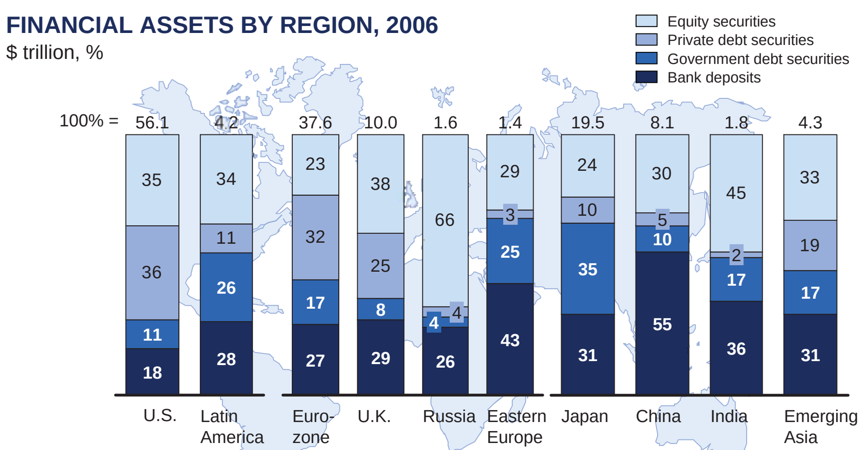
Deeper financial markets are beneficial because they create broader access to capital for borrowers, offer more efficient pricing, and increase opportunities for sharing risk. This can promote economic growth through better allocation of capital. Sometimes, however, financial deepening is the result of unhealthy increases in government debt levels or in equity market valuations—both of which can lead to painful corrections. Moreover, too much liquidity in financial markets can lead to inflationary pressures in many asset classes, as too much money chases too few productive investments.

In 2006, equities drove the growth in global financial assets. The value of the world's equities rose by $9 trillion at constant exchange rates, or 20 percent, accounting for nearly half the total increase in financial assets. In developed countries, the equity gains primarily reflected higher corporate earnings, not inflated price-earnings ratios—an example of healthy financial deepening. Stock markets also soared in emerging markets for a combination of reasons, including rising commodity prices, the partial privatization of some huge state-owned companies, and the emergence of some new global companies. But rising P/E ratios have also been a factor—a potential sign of trouble ahead. In China and Russia, P/E ratios have doubled since 2003.

THE UNITED STATES HOLDS THE LEAD, BUT EUROPE CONTINUES TO ASCEND

As financial globalization gains momentum, the pecking order in world markets is beginning to shift. The United States remains the world's largest and most liquid financial market, with $56.1 trillion in assets, or nearly one-third of the global total (Exhibit 2).

Exhibit 2



	U.S.	Latin America	Euro-zone	U.K.	Russia	Eastern Europe	Japan	China	India	Emerging Asia
Financial depth % of GDP	424	159	356	422	162	130	446	307	202	250
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

But Europe's financial markets collectively are approaching the scale of the US market. Including the United Kingdom, Europe's financial markets reached $53.2 trillion in 2006—still less than the US total, but growing faster. We find that three-fourths of the gain came from the deepening of Europe's equity and private debt markets. The eurozone's financial markets reached $37.6 trillion, the UK markets $10 trillion, and other Western European nations[1] $5.6 trillion. Equally important, the euro is emerging as a rival to the dollar as the world's global reserve currency, reflecting in part the growing vibrancy and depth of Europe's financial markets. In mid-2007, the value of euro currency in circulation surpassed that of dollar notes in the world for the first time, and the euro has been the top choice in the issuance of international bonds.

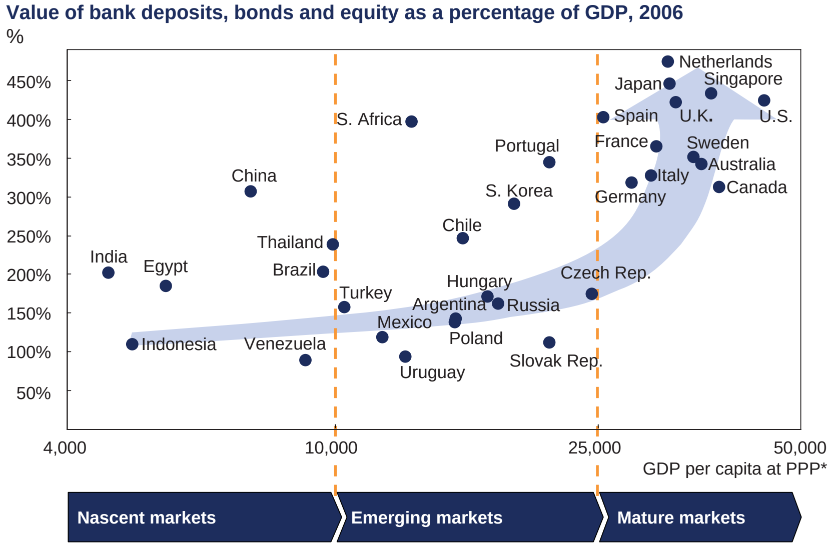
CHINA SURGES, WHILE JAPAN FALTERS

China's financial influence is growing. The value of its domestic financial assets increased by 44 percent in 2006 and grew more in absolute terms than the assets of any country other than the United States. Chinese companies were second only to those in the United States in raising capital through initial public offerings (IPOs). Part of China's financial growth, however, is due to soaring equity market valuations that may not last. Still, at $8.1 trillion, China's financial market is now roughly three times its GDP (Exhibit 3). Enriched by bulging trade surpluses, China also became the world's largest net exporter of capital in 2006. China's investments abroad exceeded foreign investments in China by $217 billion—an amount that surpassed for the first time those of Japan, Germany, and any of the oil exporters.

Exhibit 3

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

1 Includes Switzerland, Sweden, Denmark, Iceland, and Norway.

Japan's short-lived financial market recovery ground to a halt in 2006, with total financial assets flat compared with the previous year. Meanwhile, the financial markets of the rest of Asia combined grew to $18.8 trillion, just shy of Japan's $19.5 trillion. Asia's other contenders for financial hubs—Hong Kong, Singapore, and Taiwan—now have larger cross-border investments with China and other emerging Asian nations than Japan does.

EMERGING MARKETS STILL SMALL BUT GROWING FAST

Emerging markets have rebounded from the financial crises that rocked many of their economies a decade ago. China is the heavyweight, but the group also includes Russia and other rapidly developing nations in Asia, Latin America, Eastern Europe, and Africa. Altogether, their financial assets grew $5.3 trillion in 2006 in constant exchange rates, or 29 percent, to a total of $23.6 trillion. That increase accounted for one-quarter of total global growth in financial assets.

Since 1990, the total value of financial assets in emerging markets has grown at more than twice the rate of those in developed countries, or 21 percent and 8 percent, respectively. Growth over that period has been mainly in deposits and equities, which accounted for 39 and 38 percent of growth, respectively. Still, emerging markets accounted for just 14 percent of global financial assets at the end of 2006. Although this is up from 10 percent in 2000, it is significantly less than their 23 percent share of global GDP.

Within this group, emerging Asia has the largest, most developed financial systems; Eastern Europe has the fastest-growing financial markets, dominated by Russia; Africa's financial markets are very small but enjoying a growth spurt fueled largely by rising commodity prices; and Latin America's financial markets remain surprisingly shallow, given the long history of banking and foreign investment in the region.

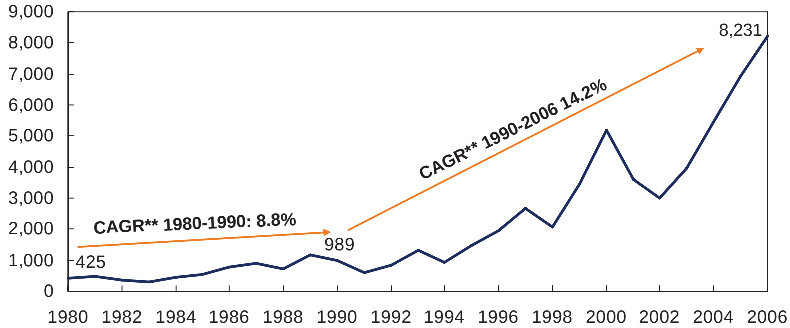
CROSS-BORDER CAPITAL FLOWS REACH $8.2 TRILLION, WITH THE EUROZONE ACCOUNTING FOR NEARLY HALF OF THE GROWTH

As world financial markets grow, more money than ever is flowing between countries and regions as investors seek opportunities outside their home market. Cross-border capital flows take many forms, including foreign direct investment (FDI), purchases of foreign equity and debt securities, and cross-border lending and deposits. US companies build factories in China, while American workers snap up Latin American stocks. Middle East investors buy stakes in private equity firms, while German banks lend to Eastern European companies. Such flows climbed in 2006 to a record $8.2 trillion—$1.3 trillion more than the year before and triple the amount just four years earlier (Exhibit 4).

Exhibit 4

GROWTH IN CROSS-BORDER CAPITAL FLOWS

Total cross-border capital inflows*
$ billion, constant 2006 exchange rates



% of global GDP	4.7	3.5	3.7	5.6	4.5	5.2	3.8	3.9	7.1	7.0	15.3	8.1	13.1	17.2
% of global imports	23.1	17.2	18.1	31.5	24.9	27.4	21.1	20.6	34.8	30.6	58.5	32.4	48.5	62.1

* Due to a discrepancy in data collection, global capital inflows exceed recorded outflows by an average of $87 billion per year.
** Compound annual growth rate.
Source: McKinsey Global Institute Global Capital Flows Database

Cross-border investing is still dominated by the most developed economies. Together, the eurozone, the United States, and the United Kingdom accounted for 80 percent of the growth in global capital flows over the past ten years. The eurozone alone accounted for nearly half of the growth over that period. This is due in equal parts to rising capital flows between the individual eurozone countries, reflecting integration of the region's financial markets, as well as growing capital flows between the eurozone and the rest of the world.

Cross-border capital flows into emerging markets have grown at nearly twice the rate of flows into developed countries. They reached a new height of $700 billion in 2006—but that is still less than 10 percent of the global total. Moreover, capital outflows from emerging markets now exceed inflows, making emerging markets net capital providers to developed countries.

The increasing movement of capital around the world has significant ramifications. Domestic investment in any country is less dependent on local saving. Foreign funds can help spur economic growth and raise living standards. At the same time, however, there is growing unease as financial risk is spread more widely and as new investors around the world gain influence. And there is growing concern in some quarters about the lack of any clear international authority to regulate new activity and players in global capital markets.

CROSS-BORDER INVESTMENTS REACH $74.5 TRILLION

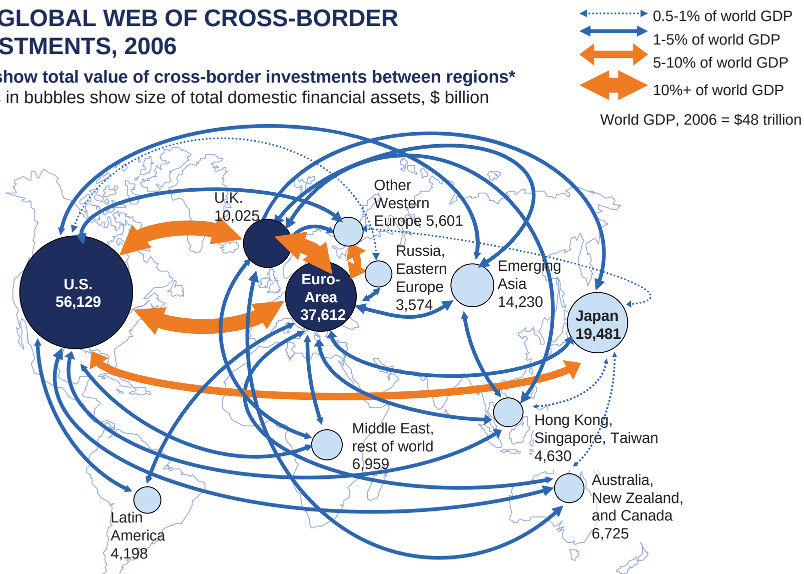
As global capital flows have grown, so has foreign ownership of financial assets. The global value of all foreign investments—the sum of those annual flows—grew by $10.8 trillion in 2006 at constant exchange rates, or 17 percent, to reach $74.5 trillion. Today, the world is more financially intertwined than ever before: foreign investors own one in three government bonds around the world, up from just one in nine in 1990. One in four equities and one in five private debt securities is now held by a foreign investor, triple the level in 1990.

Similarly, when we look at the financial ties between countries and regions, we see the web of cross-border investments between them has grown (Exhibit 5). The United States remains the largest foreign investor in other countries and the major hub in global capital markets. But the eurozone countries together now have as many financial links with other regions of the world, including emerging markets, as does the United States. Notably, Asia lacks a single dominant financial hub and has relatively weak cross-border financial ties within the region.

Exhibit 5

THE GLOBAL WEB OF CROSS-BORDER INVESTMENTS, 2006

Lines show total value of cross-border investments between regions*
Figures in bubbles show size of total domestic financial assets, $ billion



* Includes total value of cross-border investments in equity and debt securities, lending and deposits, and foreign direct investment.

Source: McKinsey Global Institute Cross-Border Investments Database

Other countries are exerting new influence in world financial markets as well. The oil-exporting nations of the Middle East and other parts of the world have reaped a windfall from rising oil prices and growing exports. Because their domestic financial markets are small, much of this wealth has been invested abroad. We estimate that the value of all petrodollar foreign investments rose to between $3.4 trillion and $3.8 trillion at the end of 2006.[2] In 2006, oil exporters rivaled East Asia for the first time as the world's net supplier of capital.

The world financial system is at the leading edge of globalization as capital markets grow larger and more interconnected. These and other developments are described in more detail in the chapters of this report. In chapter 1, we assess the growth in the domestic financial markets of countries around the world. In chapter 2, we examine the pattern of cross-border capital flows between countries. In chapter 3, we conclude by looking at the foreign assets and liabilities of countries, examining how the web of cross-border investments is growing and how the roles played by countries are shifting.

2 This includes countries of the Middle East as well as Norway, Russia, Nigeria, Venezuela, and Indonesia.

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