McKinsey Global Institute

Mapping the Global Capital Market 2006
Second Annual Report

January 2006

McKinsey&Company

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The McKinsey Global Institute (MGI) was established in 1990 as an independent economics think tank within McKinsey & Company to conduct original research on important global issues. Its primary purpose is to provide insights into the workings of the global economy and a fact base for decision-making for the benefit of business leaders and policymakers.

MGI's staff members are drawn primarily from McKinsey's consultants. They serve 6- to 12-month assignments and then return to client work. MGI also commissions leading academics to participate in its research. MGI's director is Diana Farrell, a McKinsey director.

Preface

This perspective updates a year-long project by the McKinsey Global Institute (MGI), working in collaboration with our colleagues in McKinsey offices and practice groups around the world. This work is the latest in a decade-long series of MGI research efforts on the global capital market, which have produced a best-selling book – Market Unbound by Lowell Bryan and Diana Farrell (1996) – several widely discussed articles and reports, and ongoing dialogues with governments, financial institutions, and opinion leaders.

The global capital market is an integral part of MGI's research agenda focused on informing the transition to a global economy. Among the three most important types of markets – those for capital, products, and labor – the global capital market is the farthest along the road to true global integration (marked by the operation of an international law of one price), and the one of the three that could best stake a claim to being an independent, motive force. The global capital market is thus a critical driver of growth and wealth creation.

Aneta Marcheva Key, an engagement manager in our Global Financial Institutions Practice based in San Francisco, managed the original project team, playing a critical role in structuring the analysis, overseeing the research, and crafting this report. Essential research support was provided by Tim Beacom, MGI's dedicated research and information specialist, and Moira Sofronas, a knowledge professional in McKinsey's North America Knowledge Center.

We have benefited enormously from the extensive and thoughtful input received from our Academic Advisory Board members. Our board included Martin Baily, senior advisor to MGI and senior fellow at the Institute for International Economics and formerly chief economic advisor to President Clinton; Richard Cooper, professor of international economics at Harvard University; and Ken Rogoff, professor of economics and public policy at Harvard University and former chief economist at the International Monetary Fund. While building upon the methodologies and findings developed by MGI over the past decade, this project tackled new approaches and issues as well. We are heavily indebted to our advisors for their excellent contributions in helping develop our approach and conclusions.

As with all MGI projects, this work is independent and has neither been commissioned nor sponsored in any way by any business, government, or other institution. As always, the findings and conclusions draw from the unique perspectives that our McKinsey colleagues bring to bear on the issues and countries researched here.

Our aspiration is to provide a fact base for better decision making and contribute to the public debate on the evolution of the global capital market, its role in global economic integration, and its implications for business leaders, investors, and policy makers.

Diana Farrell
Director, McKinsey Global Institute
January 2006

Mapping the Global Capital Market Second Annual Report

The world's capital markets now enjoy unprecedented breadth and strength. Financial institutions routinely move trillions of dollars of assets – stocks, bonds, and other instruments – around the globe. Cross-border capital flows and foreign holdings of financial assets continue to grow rapidly, linking individual financial markets into an increasingly integrated global one.

Executives who seek to raise money, institutions hoping to shape the global capital market, and policy makers who regulate it must all understand its evolution. The McKinsey Global Institute (MGI) has conducted an exhaustive review of the world's capital markets and created a comprehensive database of the financial assets of more than 100 countries since 1980. Together, these assets make up the global financial stock.

In our second annual report, several notable observations emerge. One of them is simply that the global capital market is huge: we calculate that the world's financial assets now total more than $136 trillion and will exceed $228 trillion by 2010 if current trends persist. The stock of global financial assets has grown faster than the world's GDP, indicating that financial markets are becoming deeper and more liquid. With a few qualifications, this trend bodes well for the world's economies, since deeper markets provide better access to capital and improve the allocation of risk.

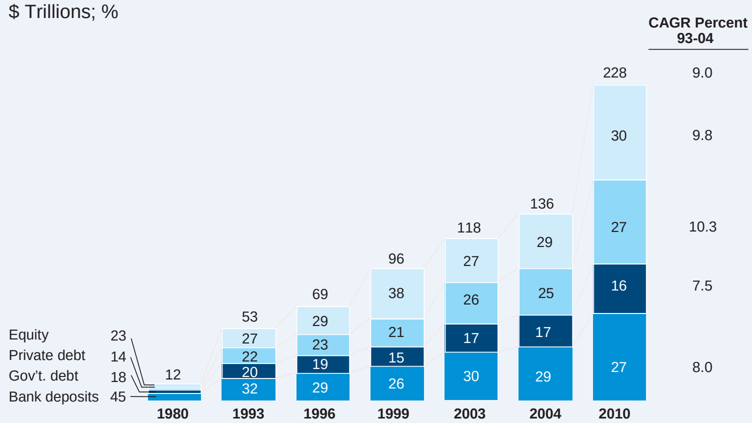
Second, much of the growth in global financial assets comes from a rapid expansion of private and government debt, with all of the attendant benefits and risks. Last, the roles that major countries and regions play in capital markets continue to be in flux. The United States, which has the largest stock of financial assets, saw a recent slowing of growth in the past year, as did China, despite strong growth in both economies. Meanwhile, Europe's capital markets continued to integrate, grow, and deepen. In Japan, we detected a slight pickup in the previously anemic growth of its financial stock, reflecting a large expansion in public debt.

$136 trillion and growing

The total value of the world's financial assets (including bank deposits, government debt and private debt securities, and equity securities) stood at $136 trillion at the end of 2004, up from $118 trillion the year before and from just $12 trillion in 1980. This $136 trillion is the total amount of capital intermediated through the world's banks and capital markets and made available by them to households, businesses, and governments. A simple extrapolation indicates that the value of global financial assets will exceed $228 trillion by 2010. The growth so far has been accompanied by a striking shift away from banks and toward market institutions as the primary financial intermediaries. That change can be seen in the declining share of bank deposits in the global financial stock – to 29 percent today, from 45 percent in 1980 – and in the corresponding increase in the share of debt and equity securities. The liquidity of world capital markets has increased as a result.

COMPOSITION AND GROWTH OF THE GLOBAL FINANCIAL STOCK

$ Trillions; %



	1980	1993	1996	1999	2003	2004	2010	CAGR
GDP (nominal) $ Trillions	10.1	24.4	29.9	30.5	36.4	40.6	60.8	4.7
Depth (FS/GDP) Percent	109	215	229	314	324	334	375	

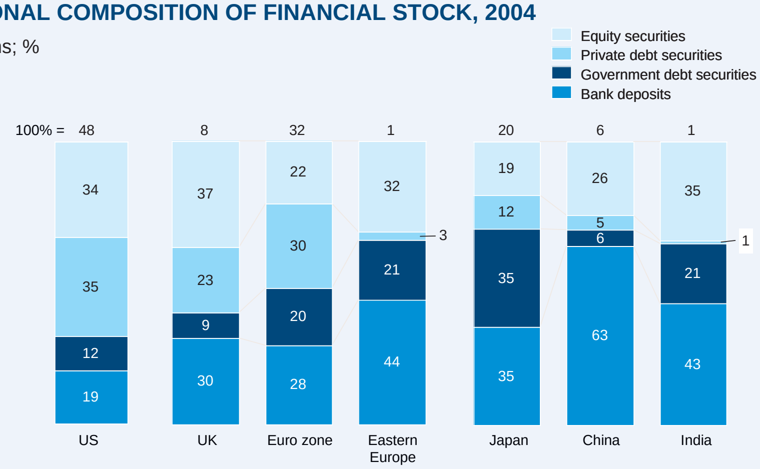
Note: Extrapolation off of 2004 base, with components grown at 1993-2004 CAGRs
Source: McKinsey Global Institute Global Financial Stock Database; World Federation of Stock Exchanges; Merrill Lynch; Global Insight

Different profiles in different regions...

Although we talk about a global capital market, just four areas account for more than 80 percent of the world's financial stock: the US, the euro zone, Japan, and the United Kingdom. Furthermore, regions differ starkly. The market of the United States – which, with about $48 trillion in financial assets, accounts for 35 percent of the world's financial stock – is dominated by private debt and equity securities. The growth in the US' share of financial stock has slowed recently across all asset classes, averaging 8.8 percent a year, slightly below the 9 percent growth rate of the global stock. Europe, which retains a larger share of bank deposits, saw an increase in both its share of private and government debt securities, and was the main contributor to the 2004 growth in the world's financial assets. Asian financial markets are relatively isolated from one another and differ in important ways. Japan has the region's largest financial stock, which recently expanded slightly, fueled by government debt. China's financial market, though less than one-third the size of Japan's, continues to grow significantly faster than the world average, and the country continues to amass a sizable portion of the world's bank deposits.

REGIONAL COMPOSITION OF FINANCIAL STOCK, 2004

$ Trillions; %



	US	UK	Euro zone	Eastern Europe	Japan	China	India
Depth (FS/GDP) Percent	409	354	346	105	420	311	175
CAGR (93-04) Percent	8.8	10.4	10.9	20.7	4.7	14.2	13.2

Note: Some numbers do not add to 100% due to rounding error
Source: McKinsey Global Institute Global Financial Stock Database; Global Insight

...and divergent growth patterns

Patterns of growth in financial assets since 1993 vary across geographies. Private debt explained much of the growth in the UK, while equities were the main driver in of growth in the US and Europe. In the US, initial public offerings are a significant source of growth in equities, as are higher price-to-earnings ratios. In Europe, by contrast, earnings and newly floated shares from the privatization of state-owned companies explain most of the growth in equities. In Japan, a huge expansion of public debt is the only source of growth in the financial stock; equities and corporate-debt securities haven't changed. And in China and Eastern Europe all asset classes are growing quickly.

COMPOUND ANNUAL GROWTH BY ASSET CLASS, 1993-2004 %

<9%
9-18%
>18%

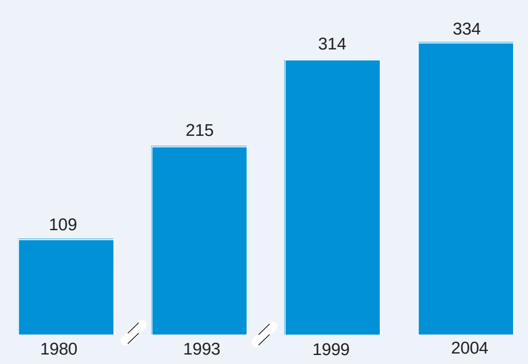
	US	UK	Euro zone	Eastern Europe	Japan	China	India
Equity securities	11	8	14	54	2	12	13
Private debt securities	11	19	12	31	1	20	5
Government debt securities	3	7	9	19	12	25	15
Bank deposits	7	10	8	15	3	14	13

Source: McKinsey Global Institute Global Financial Stock Database

Steadily deeper

An important measure of the development of financial markets is depth: the ratio between the financial stock and the size of the underlying economy as measured by GDP. Because financial assets reflect the expectation of future value, a country's financial stock can be many times larger than its GDP, which reflects current economic activity. Since 1980, the value of global financial assets has grown from an amount roughly equaling the global GDP to more than three times its size. Financial deepening is usually beneficial, giving households and businesses more choices for investing their savings and raising capital as well as promoting a more efficient allocation of capital and risk.

GLOBAL FINANCIAL STOCK AS % OF GLOBAL GDP



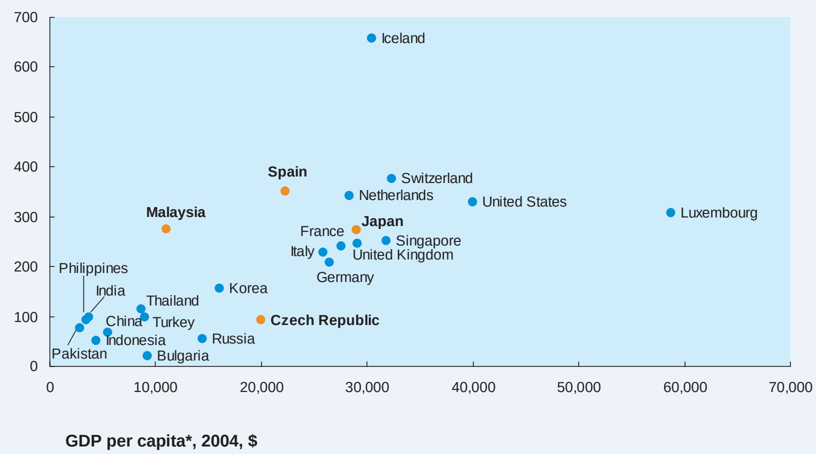
Source: McKinsey Global Institute Global Financial Stock Database; Global Insight

Depth does not equal wealth

Financial depth alone, however, doesn't indicate the strength of an economy or its financial system. The financial depth of Spain is more than twice that of the Czech Republic, for example, though both countries have similar GDPs per capita. Japan and Malaysia, by contrast, have similar financial depth at greatly different income levels. Financial depth also doesn't necessarily mean that an economy's financial system is in relatively good health. Japan, for instance, has great financial depth but struggles with nonperforming bank loans and with shrinking corporate-bond and equity markets. Asset price bubbles and the issuance of excessive government debt can lead to an unhealthy financial deepening – and painful corrections.

LINK BETWEEN FINANCIAL DEPTH AND INCOME

Global financial stock, 2004, % of GDP



* At purchasing-power parity

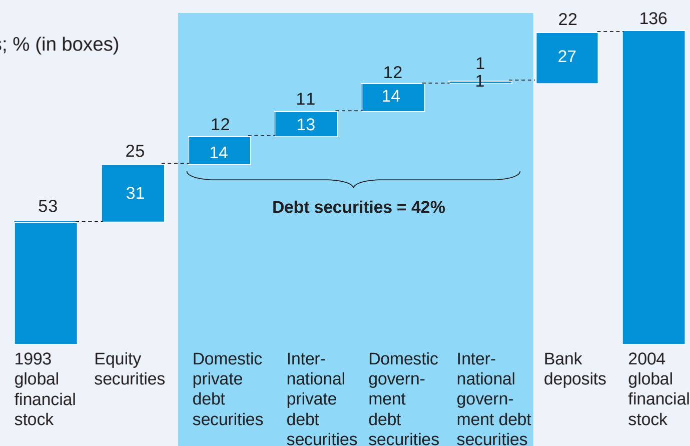
Source: McKinsey Global Institute Global Financial Stock Database; World Bank

Debt, debt, and more debt

One of the biggest stories remains the world's debt levels. Debt has increased across all major countries and regions. While the 1980's saw a rapid expansion of government debt, the 1990's were fueled by growth in private debt. Since 2000, the story so far appears to be the return of more government debt. Together, government and private debt securities account for more than half of the overall growth in global financial assets from 2000-2004. International issues of private debt, though still small, are growing more than three times as fast as domestic issues (21 and 7 percent a year, respectively), reflecting the increasing globalization of capital as companies seek funds outside their domestic borders.

DEBT SECURITIES HAVE CONTRIBUTED 42% OF GLOBAL FINANCIAL STOCK

$ Trillions; % (in boxes)



	Equity securities	Domestic private debt securities	International private debt securities	Domestic government debt securities	International government debt securities	Bank deposits
1993-2004 CAGR Percent	9.8	7.3	21.4	7.3	11.4	8.0
1993-2003 CAGR Percent	8.4	7.1	21.6	6.6	10.7	7.7

Source: McKinsey Global Institute Global Financial Stock Database

What drives debt?

The relative role of government debt securities and corporate-debt securities in explaining the overall increase in debt varies among countries. Higher government issuance accounts for most of the growth of debt in Japan. By contrast, the issuance in corporate debt securities is the primary factor in the UK, US, France, and Italy. The process of securitization has become an important source of debt, as illustrated by the experience of the US and Germany. The United States is at the forefront of the trend, with $7.3 trillion in securitized assets: $5.5 trillion in mortgage backed securities (fueled by a $10.5 trillion mortgage market) and $1.8 trillion in asset-backed securities. Other countries are far behind, suggesting that this market could grow significantly in the future.

CONTRIBUTION TO OVERALL INCREASE OF ISSUANCE OF DEBT SECURITIES BY COMPONENTS, 1996-2004

% contribution to growth

<5%
5-50%
>50%

	US	UK	France	Germany	Italy	Japan
Private debt	55	66	54	39	56	2
Government debt	7	8	37	20	31	93
Securitization	39	26	9	41*	13	5
Total Issuance (96-04) Trillion $	**18.7**	**1.8**	**1.3**	**3.2**	**1.3**	**4.2**

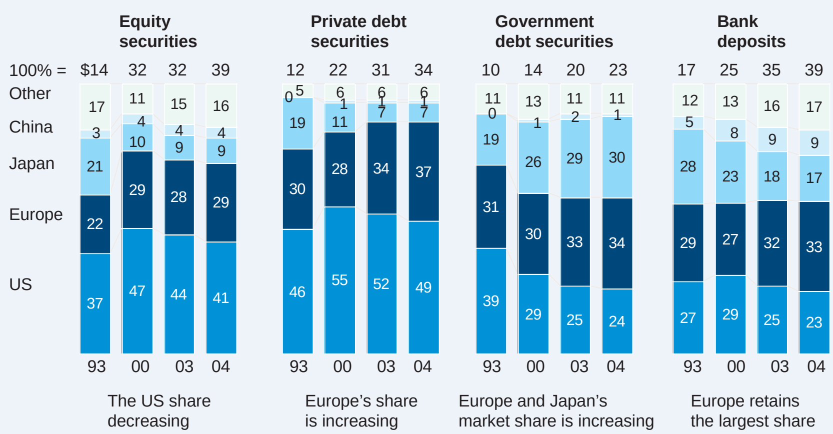
* Almost all of it are Pfandbriefe
Source: Bank of International Settlement, Dealogic

The US remains the world's capital hub

The roles major countries and regions play in global capital markets are in flux. The United States has a unique position not only as the world's largest financial market but also as the global hub and conduit of capital. With the creation of the euro, however, European financial markets are integrating and gaining share. Japan's financial markets are becoming less important in the global financial system, while China's are growing. Financial markets in the rest of the world are negligible in a global context. Latin America's financial markets are notably underdeveloped compared with those of middle-income countries in other regions: despite representing over 4 percent of global GDP, Latin America has less than 2 percent of the world's total financial assets.

GEOGRAPHIC COMPOSITION OF THE GLOBAL FINANCIAL STOCK BY ASSET CLASS

$ Trillions; %

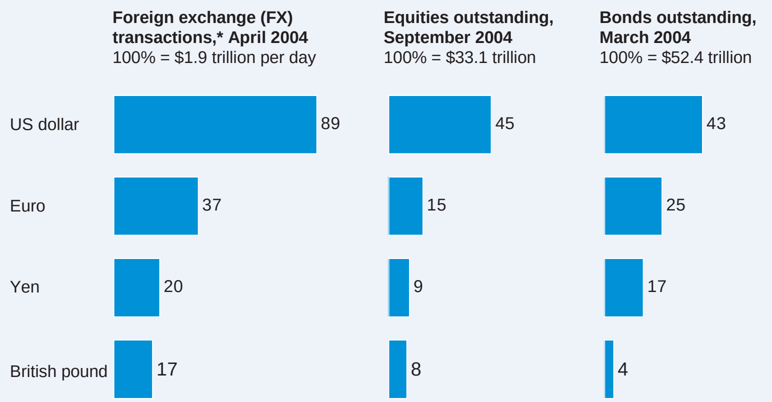


Source: McKinsey Global Institute Global Financial Stock Database

A weaker but still dominant dollar

Notwithstanding the recent decline in the value of the US dollar, it continues to dominate global financial markets. For starters, it is the world's most heavily traded currency and the preferred one for issuing equities and bonds. Many other countries, including China and Malaysia, have linked their domestic currencies to it. Although the euro is gaining notice among the world's central bankers, it is a long way from matching, let alone surpassing, the dollar's role in international finance.

PREFERRED EXCHANGE CURRENCY FOR FINANCIAL PRODUCTS, %



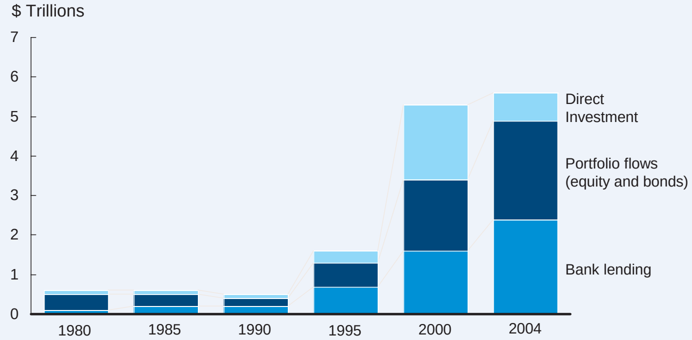
* Because there are 2 currencies in a single FX transaction, the potential total is 200%; the share of other currencies comprise the remaining 37%
Source: McKinsey Global Institute Global Financial Stock Database; Federation of World Stock Exchanges; Bank for International Settlements (BIS)

Growing cross-border capital flows

With a few exceptions, it no longer makes sense to think in terms of national financial markets: they are increasingly being integrated into a single global one as cross-border holdings of financial assets and cross-border flows of capital grow. Today, for example, foreigners hold 14 percent of US equities, 27 percent of US corporate bonds, and 52 percent of Treasury securities, up from 4, 1, and 20 percent, respectively, in 1975. Since 1995, cross-border capital flows have more than tripled, and they now total upward of $5 trillion annually, including foreign purchases of equity and debt securities, foreign direct investment by corporations, and cross-border bank lending. These flows create stronger links among national markets and clearly show that despite the past decade's financial crises and the backlash against globalization, the world capital market continues to integrate and evolve.

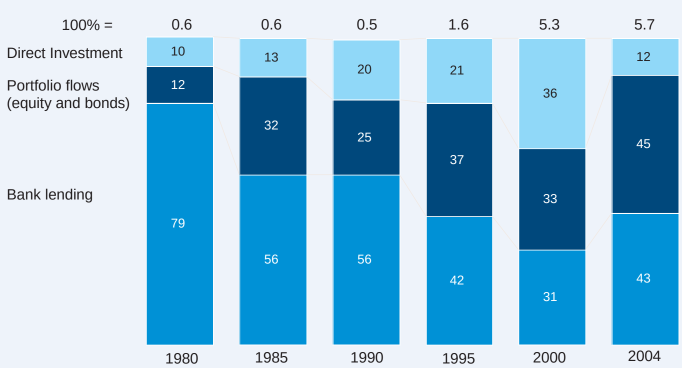
GROWTH AND COMPOSITION OF INTERNATIONAL CAPITAL FLOWS

$ Trillions



Note: Absolute value of capital inflows
Source: Balance of Payments, international Monetary Fund

$ Trillions; percent



Note: Absolute value of capital inflows, figures do not sum to 100% because of rounding
Source: Balance of Payments, international Monetary Fund