

Lloyd Miller

## Mapping the global capital markets, January 2007: Europe rising

*A recent analysis of the world's financial markets shows how they are changing, with the eurozone countries wielding ever more influence.*

### Article at a glance

The world's financial assets now total more than \$140 trillion and are on pace to reach \$214 trillion by the decade's end.

Moreover, the value of the world's financial assets now exceeds global GDP by a factor of three—an unprecedented degree of financial depth, which largely bodes well for the world's economies.

While the United States remains the world's largest financial intermediary, the eurozone has emerged as a powerhouse in the financial landscape, and Japan remains strikingly isolated.

This collection of exhibits outlines the way capital markets around the globe are becoming stronger, more liquid, and increasingly integrated.

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## Mapping the global capital markets, January 2007: Europe rising

**Diana Farrell, Susan M. Lund, and Alexander N. Maasry**

**The world's** financial assets—including stocks, bonds, and other instruments—now total more than \$140 trillion and are on pace to reach \$214 trillion by decade's end. Moreover, the value of the world's financial assets now exceeds global GDP by a factor of three—an unprecedented degree of financial depth that largely bodes well for the world's economies. Deeper financial markets promote a more efficient allocation of capital and risk and offer households and businesses more choices for investing savings and raising capital, respectively.

The roles that countries and regions play in the world's capital markets are changing. While the United States remains the largest financial market, the eurozone<sup>1</sup> has emerged as a financial powerhouse; indeed, the eurozone, the United Kingdom, and the United States account for some 80 percent of all cross-border capital flows. By contrast, Japan is strikingly isolated: its capital flows are smaller even than China's, although China's stock of financial assets is only one-quarter the size of Japan's.

These are among the findings of the McKinsey Global Institute's comprehensive study of the global capital markets.<sup>2</sup> This effort—the third in a series begun in 2003—tracks the financial assets of more than 100 countries since 1990. In 2006 we added new data on cross-border capital flows. Understanding the evolution of the world's capital markets is important for institutions hoping to shape them, for executives seeking to raise money on them, and for policy makers who regulate them. The exhibits that follow outline the way capital markets around the globe are becoming stronger, more liquid, and increasingly integrated.

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<sup>1</sup> Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

<sup>2</sup> For more detail, see the original report, *\$118 Trillion and Counting: Mapping the Global Capital Markets*, available free of charge at [www.mckinsey.com/mgi](http://www.mckinsey.com/mgi).

## Mapping the global capital markets, January 2007: Europe rising

### Getting deeper

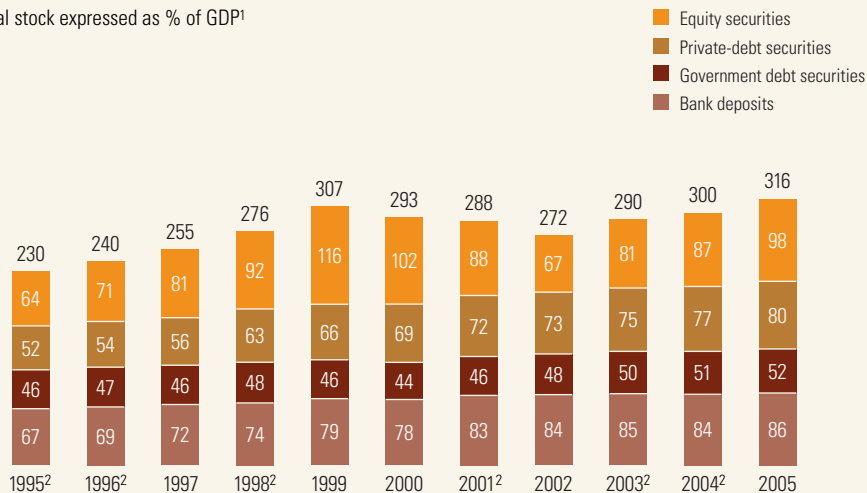
An important measure of the development of the world's financial markets is financial depth, or the value of financial assets expressed as a percentage of GDP. Financial depth can be many times GDP because the former reflects predicted future returns and growth, the latter current economic activity. In 1980 the global financial stock roughly equaled world GDP. By 1993 it was twice as big, and by the end of 2005 (the latest year when comprehensive data are available) it had risen to 316 percent—more than three times the size—of world GDP.

For the most part, deeper financial markets are beneficial because they are more liquid, give borrowers better access to capital, and offer more efficient pricing and increased opportunities for sharing risk. However, financial deepening can also result from asset price bubbles or unhealthy increases in government debt. During the late 1990s, global financial depth grew because of very high equity market valuations, which later declined. But if we exclude the equity bubble period—1998 to 2000—we see a constant increase in world financial depth. In 2005, it increased by 16 percentage points, exceeding its previous record, in 1999. Nearly 70 percent of the deepening came from growth in equities, largely as a result of higher corporate earnings rather than higher P/Es.

Exhibit 1

### Increasing depth

Global financial stock expressed as % of GDP<sup>1</sup>



<sup>1</sup> At constant 2005 exchange rates.

<sup>2</sup> Figures do not sum to total, because of rounding.

Source: McKinsey Global Institute global-financial-stock database

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### A cross-border surge

In 2005, worldwide cross-border capital flows, which include foreign purchases of equity and debt securities, cross-border lending, and foreign direct investment—increased to more than \$6 trillion. Since 1990, cross-border capital flows have grown by 10.7 percent annually,<sup>3</sup> outpacing growth in world GDP (3.5 percent), trade (5.8 percent), and financial stock (8.7 percent). Advances in technology and the deregulation of financial markets around the world have made this growth possible and given rise to a growing class of global investors. Although most investors

still show a marked preference for the financial assets of their home countries, roughly one in four debt securities and one in five equities is now owned by investors outside the local issuing markets (for instance, a US investor buying Thai equities or a German investor buying US bonds). National financial markets are increasingly integrating into a single global market for capital.

Exhibit 2

### Capital surges across borders



<sup>1</sup> At constant 2005 dollars and exchange rates.

<sup>2</sup> Compound annual growth rate.

Source: McKinsey Global Institute capital flows database

<sup>3</sup> Measured at constant, 2005 year-end exchange rates.

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### Three financial hubs

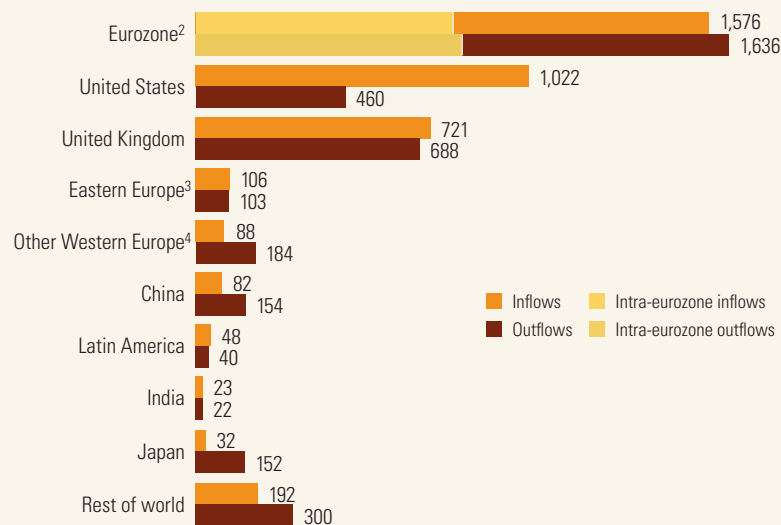
Some 80 percent of global capital flows involve three regions: the eurozone, the United Kingdom, and the United States. The United States plays the role of the world's financial intermediary, receiving mainly debt inflows and sending out equity and outflows of foreign direct investment. Its capital inflows and outflows totaled roughly \$1.5 trillion in 2005. Capital flows between the eurozone and the rest of the world were similar in size. (In addition, cross-border capital flows *within* the eurozone totaled \$1.7 trillion.) Despite a relatively small domestic financial market, the United Kingdom also is an important global

financial intermediary, particularly for cross-border bank lending: its total inflows and outflows averaged \$1.4 trillion each year from 2001 to 2005. By contrast, though Japan has the world's third-largest financial market, it is strikingly isolated: its capital flows in recent years have been smaller than China's, even though China's stock of financial assets is only one-quarter the size of Japan's.

Exhibit 3

### Three big players

Average annual cross-border capital flows,<sup>1</sup> 2001–05, \$ billion



<sup>1</sup> Because of greater difficulty in tracking capital outflows, figures for global capital inflows exceed outflows by an average \$150 billion per year from 2001–05.

<sup>2</sup> Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

<sup>3</sup> Includes Russia.

<sup>4</sup> Includes Denmark, Norway, Sweden, Switzerland, and small non-eurozone nations (eg, Andorra, Lichtenstein).

Source: McKinsey Global Institute analysis

## Mapping the global capital markets, January 2007: Europe rising

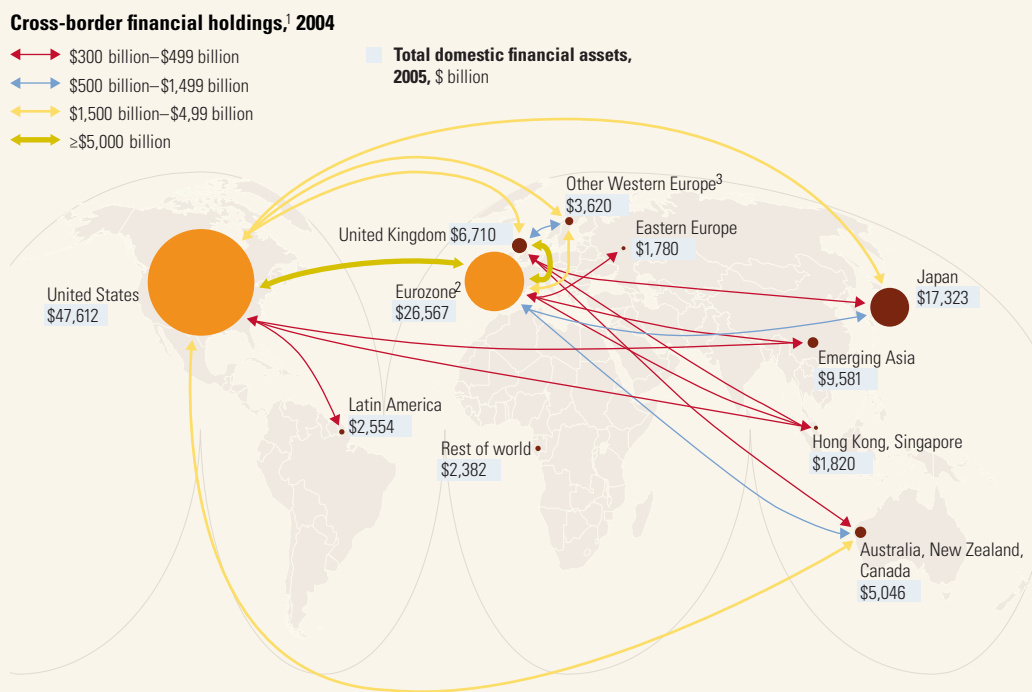
### An intricate web

Although cross-border capital flows remain concentrated in the world's financial hubs, flows of money to and from other, smaller parts of the global landscape are increasing as well. Since 1990, capital inflows to emerging markets have grown twice as fast as those to developed ones. Latin America and Eastern Europe have opened up significant capital flow links with the United States and the eurozone. Perhaps more surprising,

the largest links of Asian countries are not with Japan or Hong Kong but with the United States, the United Kingdom, and the eurozone—thus underscoring the lack of an integrated Asian financial market.

Exhibit 4

### An intricate web



<sup>1</sup> Includes cross-border equity, debt, lending, and foreign direct investment.

<sup>2</sup> Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

<sup>3</sup> Includes Denmark, Norway, Sweden, Switzerland, and small non-eurozone nations (eg, Andorra, Lichtenstein).

Source: McKinsey Global Institute analysis

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### Debt dominates capital flows

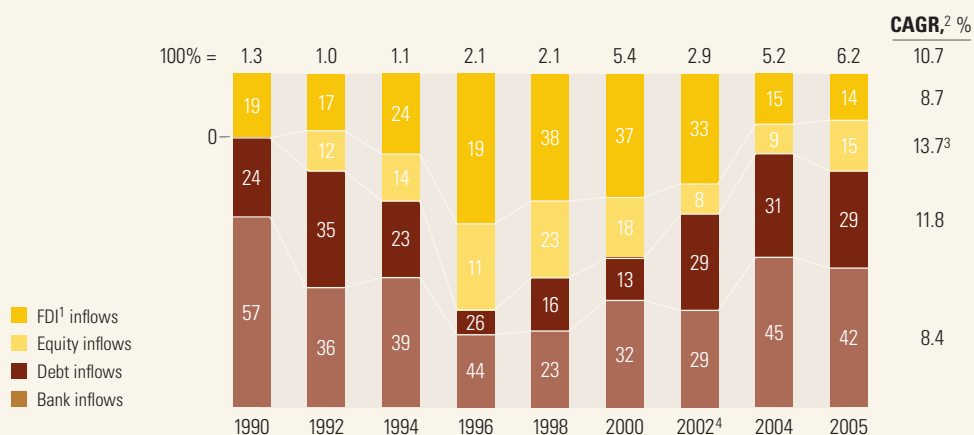
The driving forces behind record cross-border capital flows in 2005 were loans and debt securities, which together accounted for nearly three-quarters of total capital flows. Cross-border lending—including loans between banks and nonfinancial institutions—was the largest component, accounting for 42 percent of the total. Since 2002, the volume of foreign lending has tripled, with \$2.6 trillion of net new loans in 2005 alone. The second-largest type of capital flow was cross-border investment in debt securities, with 29 percent of the total, or \$1.8 trillion. An estimated 25 to 30 percent of this money was invested in government debt around the world, the remainder in corporate debt.

Despite the public attention given to cross-border mergers and acquisitions and to foreign direct investment, these were the smallest components of total flows, accounting for just 15 percent, or \$900 billion, in 2005—less than half their peak, in 2000, and only marginally higher than their level in 1998.

Exhibit 5

### Cross-border debt

Global capital inflows by type, 1990–2005



<sup>1</sup> Foreign direct investment.

<sup>2</sup> Compound annual growth rate.

<sup>3</sup> CAGR taken from 1991 because of zero inflows in 1990.

<sup>4</sup> Figures do not sum to 100%, because of rounding.

Source: McKinsey Global Institute analysis

## Mapping the global capital markets, January 2007: Europe rising

### The United States absorbs most capital flows

Over the past four years, the United States has absorbed, on average, 85 percent of total global capital flows—more than \$500 billion each year—to finance its current-account deficit. Asia and Europe are the world's largest net suppliers of capital, followed by the Middle East and Russia. Partly because of oil revenues, the latter two regions together have had larger net capital outflows than the eurozone in recent years. Since 1999, emerging markets also have been net exporters of capital as their central banks aggressively build foreign-

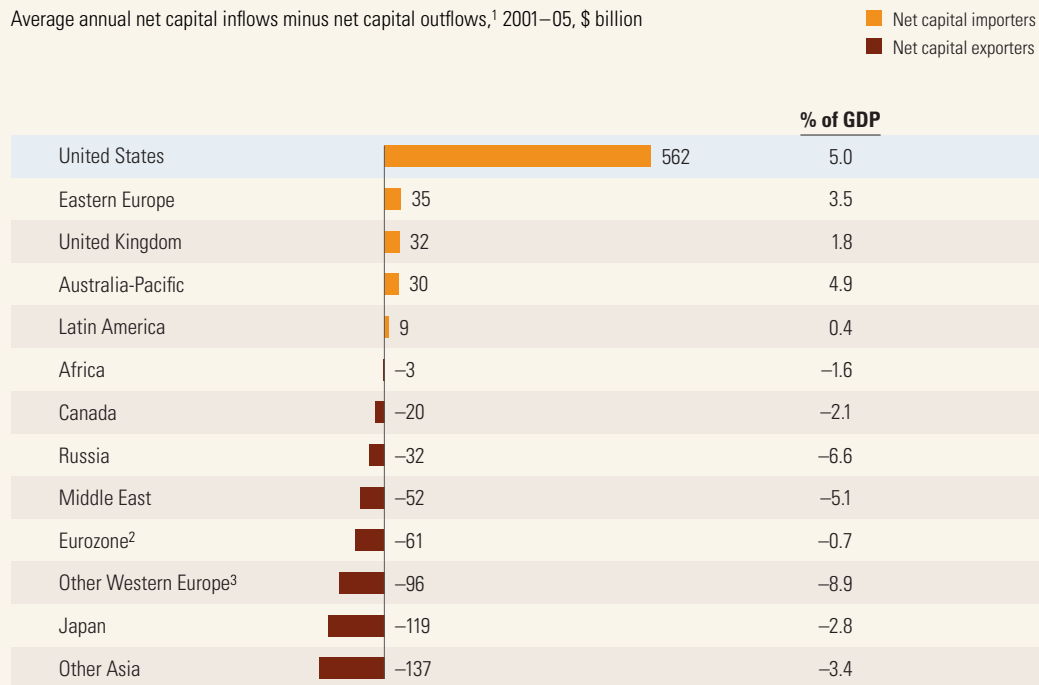
exchange reserve assets in rich countries. This trend is not just about China, which has some \$1 trillion in foreign reserves; Brazil, India, Malaysia, Russia, South Korea, and Thailand, to name a few, also are net suppliers of capital to the global market.

Economists debate whether this phenomenon is sustainable. Some argue that it is not; others say that it mainly reflects the underdevelopment of financial systems and infrastructures in emerging markets and anemic domestic demand in Europe and Japan.<sup>4</sup>

Exhibit 6

### Financing the US deficit

Average annual net capital inflows minus net capital outflows,<sup>1</sup> 2001–05, \$ billion



<sup>1</sup> Total net inflows exceed net outflows by ~\$1 trillion because of data inconsistency—capital outflows are more difficult to track than capital inflows for reporting countries.

<sup>2</sup> Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

<sup>3</sup> Includes Denmark, Norway, Sweden, Switzerland, and small non-eurozone nations (eg, Andorra, Lichtenstein).

Source: McKinsey Global Institute analysis

<sup>4</sup>See, for instance, Carmen M. Reinhart and Kenneth S. Rogoff, "Serial default and the 'paradox' of rich-to-poor capital flows," *American Economic Review*, 2004, Volume 94, Number 2, pp. 53–8; and Michael P. Dooley, David Folkerts-Landau, and Peter M. Garber, "The revived Bretton Woods system: The effects of periphery intervention and reserve management on interest rates and exchange rates in center countries," National Bureau of Economic Research working paper number 10332, March 2004.

## Mapping the global capital markets, January 2007: Europe rising

### \$140 trillion and growing

The value of total global financial assets (including equities, government and corporate debt securities, and bank deposits) expanded to \$140 trillion by the end of 2005, an increase of \$7 trillion from a year earlier.<sup>5</sup> Just four areas—the eurozone, Japan, the United Kingdom, and the United States—continue to account for more than 80 percent of the world’s financial assets. The United States remains the largest market, with \$50 trillion in assets at the end of 2005, nearly 70 percent of them in equity and private-debt securities. The eurozone has the second-largest financial market, with nearly \$30 trillion in financial assets; Japan ranks third with \$19.5 trillion. The UK market has less than

\$8 trillion in financial assets but is an important intermediary for cross-border capital flows and international banks.

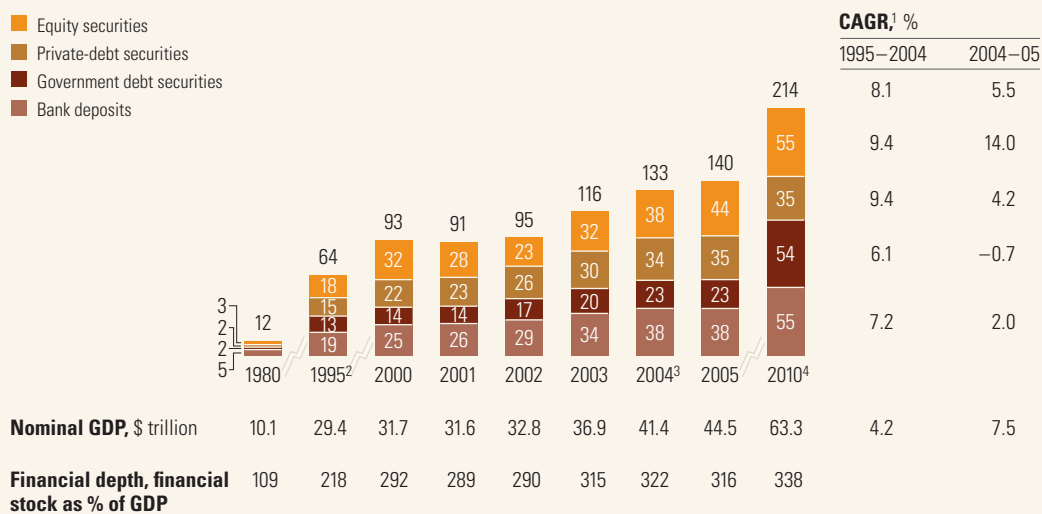
Asian financial markets remain fragmented and differ widely. Japan, for instance, has a very large market for government debt, whereas nearly three-quarters of China’s more than \$5 trillion in financial assets is held as bank deposits. India’s financial system, with \$1.4 trillion in assets, is significantly smaller than China’s, even after adjusting for relative wealth. But India’s financial system is more balanced, since banks are offset by a relatively large equity market.<sup>6</sup>

Exhibit 7

### The world’s financial stock soars

\$ trillion

- Equity securities
- Private-debt securities
- Government debt securities
- Bank deposits



<sup>1</sup> Compound annual growth rate.

<sup>2</sup> Figures do not sum to total, because of rounding.

<sup>3</sup> 2004 figure dropped to \$133 trillion, from \$136 trillion, following restatement of data by individual countries.

<sup>4</sup> Extrapolation from 2005 base with components increasing at 2000–05 compound annual growth rates.

Source: McKinsey Global Institute global-financial-stock database

<sup>5</sup> In our last annual update, the global financial stock stood at \$136 trillion at year-end 2004. The subsequent restatement of some national statistics, however, has cut this figure to \$133 trillion, with equities and bank deposits explaining 97 percent of the downward revision.

<sup>6</sup> For more on China’s and India’s financial systems, see *Putting China’s Capital to Work: The Value of Financial System Reform* and *Accelerating India’s Growth through Financial System Reform*. Both are available free of charge at [www.mckinsey.com/mgi](http://www.mckinsey.com/mgi).

## Mapping the global capital markets, January 2007: Europe rising

### A stronger dollar hides growth

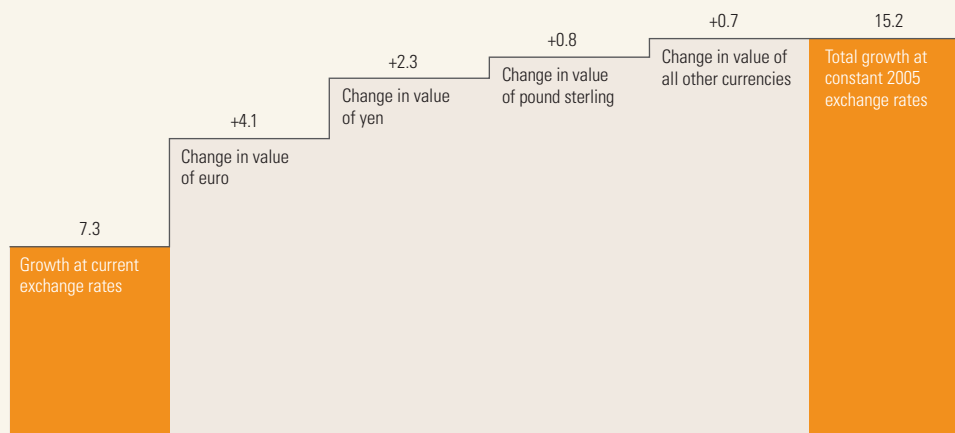
From 2004 to 2005, the global financial stock grew by \$7 trillion, compared with \$17 trillion from 2003 to 2004. But was growth in 2005 actually so much slower than it had been during the previous year? No. Most of the difference reflects changes in the value of the US dollar against major currencies.<sup>7</sup> As the dollar's exchange rate appreciated in 2005, financial-stock growth in countries other than the United States appeared to be lower when converted into dollars. Measured at constant exchange rates, the growth in the global financial stock came to \$15.2 trillion in 2005. If we had applied the 2005 exchange rate to the global financial stock at year-end 2004, it would have been \$125 trillion, not \$133 trillion.

In the past, the McKinsey Global Institute reported global financial-stock figures in current dollars because of the dominance of US financial markets and the dollar's role as the world's reserve currency. Other regions are now growing in importance, however, and the dollar's value has been more volatile in recent years. Therefore, this year we are using constant 2005 exchange rates, which should give a more accurate picture of global financial-market trends, undistorted by movements in exchange rates.

Exhibit 8

### Veiled by exchange rates

Growth of global financial assets, 2004–05, \$ trillion



Source: McKinsey Global Institute global-financial-stock database

<sup>7</sup> The strengthening of the dollar against the euro accounted for 52 percent of the difference in 2005 growth between constant-dollar and market exchange rates, its strengthening against the yen for 29 percent, against the British pound for 10 percent, and against other currencies for 9 percent of the difference.

## Mapping the global capital markets, January 2007: Europe rising

### An emerging eurozone

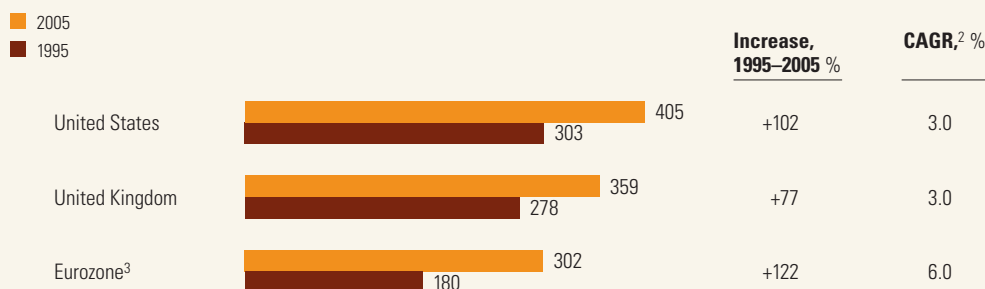
The roles that major countries and regions play in the global capital market are clearly in flux. The eurozone's financial markets, for instance, added \$3.3 trillion of financial assets in 2005,<sup>8</sup> boosting their financial depth to more than three times the eurozone's combined GDP. Although the traditional financial hubs—the United States and the United Kingdom—have greater financial depth, the eurozone's financial depth has grown at a rate of 6 percent annually over the past ten years, twice the pace of those two hubs. Growth in financial assets in 2005 was spread across eurozone countries, with France, Germany, Italy,

the Netherlands, and Spain gaining the most. Just as important, the eurozone's financial markets are shifting away from banking, which has traditionally been more important than equity and bond markets: equities and corporate debt accounted for nearly three-quarters of the region's 2005 growth in financial assets. As the eurozone's financial markets grow and mature, they are becoming an increasingly important part of the global financial landscape.

Exhibit 9

### The eurozone gains ground

Financial depth, financial stock as % of GDP,<sup>1</sup> by region



<sup>1</sup> At constant 2005 exchange rates.

<sup>2</sup> Compound annual growth rate.

<sup>3</sup> Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

Source: McKinsey Global Institute global-financial-stock database

<sup>8</sup> Measured at the constant year-end 2005 exchange rate.

## Mapping the global capital markets, January 2007: Europe rising

### A boom in equities

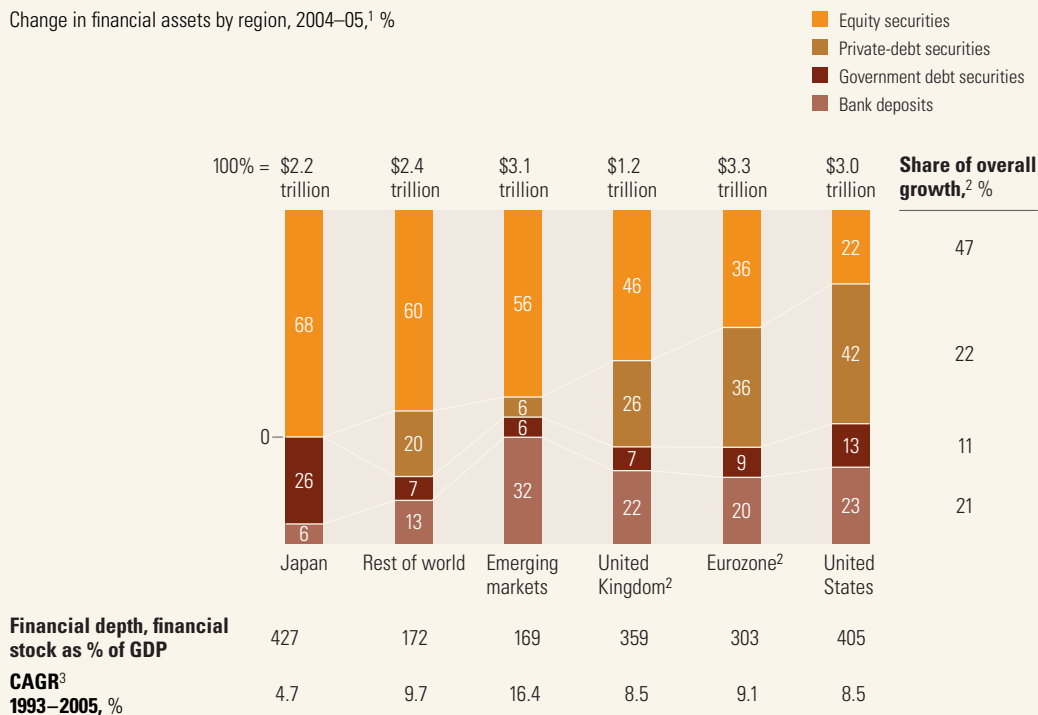
Equities accounted for nearly half of the growth in global financial assets in 2005, increasing by \$7.1 trillion. Although Japan had the largest single gain in equity markets, with an increase of \$1.5 trillion, the growth of equities was broad based. Equity securities increased by \$1.2 trillion in the eurozone, by \$650 billion in the United States, and by \$550 billion in the United Kingdom. Equities also accounted for more than half of the emerging markets' growth in financial assets, with an increase of \$1.7 trillion. As we've noted in previous reports,<sup>9</sup> debt was the main contributor to overall

growth in the global financial stock after 1993, but this development mainly reflected the decline in global equity market values in the late 1990s; 2005 was the third straight year when equities were the largest contributor to the growth of global financial assets.<sup>10</sup> Our analysis shows that, while some individual markets may have overheated, the vast majority of equity market increases around the world resulted from increased earnings and new issuance, not increased P/Es. In the United States and the eurozone, earnings accounted for all of the growth, as total market P/Es declined slightly. Earnings growth also accounted for most of the rise in the Japanese market. Corporate-restructuring efforts are clearly starting to pay off.

Exhibit 10

### A boom in equities

Change in financial assets by region, 2004–05,<sup>1</sup> %



<sup>1</sup> At constant 2005 exchange rates.

<sup>2</sup> Figures do not sum to 100%, because of rounding.

<sup>3</sup> Compound annual growth rate.

Source: Global Insight; McKinsey Global Institute global-financial-stock database

<sup>9</sup> Diana Farrell, Aneta Marcheva Key, and Tim Shavers, "Mapping the global capital markets," *The McKinsey Quarterly*, 2005 special edition: Value and performance, pp. 38–47.

<sup>10</sup> Equities accounted for 41 percent of total growth in 2004 and for 53 percent in 2003.

## Mapping the global capital markets, January 2007: Europe rising

### Exploding US private debt

In 2005 the surprise element in US debt markets was not the well-established story of growing US government debt—up by \$400 billion during the year—but the rapid expansion in private-debt securities: US private debt increased by \$1.3 trillion. Within this category, mortgage-backed securities gained the most, reflecting the strong US housing market. In addition, the issuance of US asset-backed securities hit a record, owing to high levels of home equity lending, which was then securitized.

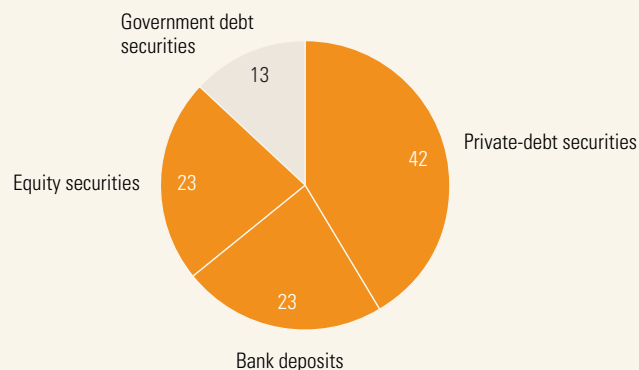
The United States was not alone in its private-borrowing spree. Around the world, private-debt securities posted the second-largest growth levels, after equities—increasing by \$3.3 trillion. Just over half of this growth came from international debt issues, which rose by \$1.7 trillion, or 15.5 percent, in 2005.

Exhibit 11

### A private-borrowing binge

Share of growth in US financial stock, 2004–05,<sup>1</sup> %

100% = \$3.1 trillion



<sup>1</sup> Figures do not sum to 100%, because of rounding.

Source: McKinsey Global Institute global-financial-stock database

## Mapping the global capital markets, January 2007: Europe rising

### Growing everywhere

The geographic distribution of growth in world financial assets was remarkably even in 2005. The eurozone was the largest regional contributor, with 22 percent of the total. Emerging markets, taken as a group, accounted for 21 percent, or \$3.1 trillion.<sup>11</sup> The United States weighed in with 20 percent of total growth, or \$3 trillion. Japan accounted for 14 percent—a healthy contribution after five years of low to nonexistent growth. The United Kingdom accounted for 8 percent, and the rest of the world for 16 percent.

Given the small size of financial systems in emerging markets (just \$15 trillion in assets), it is noteworthy that their growth nearly equaled that of the eurozone and exceeded that of the United States—by far the world’s largest financial market. Emerging markets now account for 14 percent of global financial assets, up from just 7 percent a decade ago.<sup>12</sup>

Exhibit 11

### Keeping pace across regions



<sup>1</sup> At constant 2005 exchange rates.

<sup>2</sup> \$2.8 trillion less than last year’s reported number because of revisions in figures published by countries.

<sup>3</sup> Figures do not sum to 100%, because of rounding.

<sup>4</sup> Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

Source: McKinsey Global Institute global-financial-stock database

<sup>11</sup> Growth was widespread among emerging markets. China gained the most, with an increase of \$800 billion. Eastern Europe gained \$700 billion, as did emerging Asia (excluding China and India). Latin America gained \$500 billion, India \$300 billion. The remaining \$100 billion was spread across Africa and the Asia-Pacific region.

<sup>12</sup> Over the past decade, 44 percent of the growth in the financial stock of emerging markets has been in bank deposits, 32 percent in equities, and 24 percent in government and private debt.

