Any serious challenge to the dominance of US financial markets is very far off

Advanced economies tend to have significantly larger financial markets, including relative to the size of their economies. Not only are their financial systems more diverse and sophisticated, but the size and liquidity of the financial markets in the advanced economies is superior compared to a typical EM. Domestic financial assets, defined as the sum of domestic debt securities, bank assets and stock market capitalisation, amount to 400-500% in advanced economies. This ratio tends to be significantly higher in economies with substantial off-shore financial activities (e.g., Luxembourg, UK).

By contrast, financially and economically less developed EM have financial assets in the range of 100-250%. Emerging Asian economies due to their high savings rates and solid track record of relative monetary stability have assets equivalent to 250% of GDP, compared to 180% of GDP in Latin America and a mere 100-120% in the Middle East, Africa and Eastern Europe.

In absolute dollar terms, not surprisingly, the difference between the EM10 and the G3 - and especially the US - is very striking. The size of US capital markets is greater than the size of all EM capital markets combined. If one disregards banking sector assets, and just focuses on the potentially investable universe of domestic debt and equity securities, the difference is even more striking.

Naturally, the size of financial assets does not necessarily say much about such market characteristics as liquidity, efficiency, diversity and openness. China has relatively large financial markets. Not only is liquidity relatively low and the market relatively closed to non-residents, but the domestic investor base is not as diverse as in an advanced economy. China, in fact, retains the heaviest restrictions with regard to non-resident investment.

Individually, EM financial markets, with the exception of China, remain tiny compared with the US as well as Japan and Germany. What about the future? If Chinese GDP reaches USD 16 tr by 2020 and if the stock of total domestic debt securities increase to 60% of GDP from 45% of GDP today, their value would amount to less than USD 10 tr. By comparison, US GDP is projected to be around USD 23 tr. Assuming that total domestic debt securities measured as a share of GDP decline from their present peak of more than 170% of GDP to 160% of GDP (150% of GDP being the pre-crisis average), the value of outstanding debt securities would amount to almost USD 37 tr – nearly four times the size of China. Last but not least, even if the share of outstanding Chinese debt securities climbed to 80% of GDP – due to increased local-government issuance and/or the central government assuming local-government liabilities – China’s domestic bond market would only be 1/3 of the size of the US.

Projections regarding US and Chinese stock market capitalisation are much more uncertain. Market cap is influenced by the number of issuers and volatile equity prices. In 2011, Chinese market cap amounted to ¼ of the US. Today it amounts to little more than 1/7. But this can change quickly should current US market valuation not prove sustainable or Chinese equities rally. For example, Chinese market capitalisation reached USD 4 tr at the end of 2007 (same as today) at a time when the US market cap was USD 18 tr (compared to USD 24 tr today). Then, though, the Chinese economy was only ¼ the size of the US, compared with more than ½ today.

That said, assuming Chinese and US market cap will increase in line with nominal GDP (9% vs 5%), and disregarding exchange rate effects, Chinese equity market capitalisation would be about 1/3 the level of the US by
2030. Even if one adds in 3% nominal currency appreciation, this number will remain below 1/2 by the end of the next decade. In other words, the US equity market, like the US debt market, is going to remain the largest, deepest and most liquid market for quite some time to come.

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