

McKinsey Global Institute



March 2013

# Financial globalization: Retreat or reset?

Global capital markets 2013

## **The McKinsey Global Institute**

The McKinsey Global Institute (MGI), the business and economics research arm of McKinsey & Company, was established in 1990 to develop a deeper understanding of the evolving global economy. Our goal is to provide leaders in the commercial, public, and social sectors with the facts and insights on which to base management and policy decisions.

MGI research combines the disciplines of economics and management, employing the analytical tools of economics with the insights of business leaders. Our “micro-to-macro” methodology examines microeconomic industry trends to better understand the broad macroeconomic forces affecting business strategy and public policy. MGI’s in-depth reports have covered more than 20 countries and 30 industries. Current research focuses on six themes: productivity and growth; natural resources; labor markets; the evolution of global financial markets; the economic impact of technology and innovation; and urbanization. Recent reports have assessed job creation, resource productivity, cities of the future, the economic impact of the Internet, and the future of manufacturing.

MGI is led by McKinsey & Company directors Richard Dobbs and James Manyika. Michael Chui, Susan Lund, and Jaana Remes serve as MGI principals. Project teams are led by the MGI principals and a group of senior fellows, and include consultants from McKinsey & Company’s offices around the world. These teams draw on McKinsey & Company’s global network of partners and industry and management experts. In addition, leading economists, including Nobel laureates, act as research advisers.

The partners of McKinsey & Company fund MGI’s research; it is not commissioned by any business, government, or other institution. For further information about MGI and to download reports, please visit [www.mckinsey.com/mgi](http://www.mckinsey.com/mgi).

McKinsey Global Institute

March 2013

# Financial globalization: Retreat or reset?

## Global capital markets 2013

Susan Lund  
Toos Daruvala  
Richard Dobbs  
Philipp Härle  
Ju-Hon Kwek  
Ricardo Falcón

# *Retreat ...*

**1.9%** annual growth in global financial assets since 2007, down from 7.9%

**60%** decline in cross-border capital flows from their 2007 peak

**\$3.7 trillion**  
decline in cross-border claims by Eurozone banks since 2007

**\$15.4 trillion**  
increase in government debt securities since 2007

**7%** emerging economies' share of global foreign investment in equities and bonds

# ... *or reset?*

**32%** share of global capital flows going to emerging economies in 2012, up from 5% in 2000

**\$1.4 trillion**  
annual corporate bond issuance since 2009, double pre-crisis levels

**40%** of cross-border capital flows now made up of FDI, the most stable type of flow

**\$1.9 trillion**  
in “South-South” foreign investments between emerging economies

**30%** reduction in global current account imbalances as percent of GDP



# Executive summary

As this report went to press, a number of major global equity markets were on the rise. Many were eager to take this rebound as a sign that the last vestiges of the financial crisis and the Great Recession are finally behind us.

But a deeper analysis finds that the financial crisis continues to have lingering and profound effects. For three decades, capital markets and banking systems rapidly expanded and diversified, but now that process—called financial deepening—has largely ground to a halt. Although global financial assets have surpassed their pre-crisis totals, growth has hit a plateau. In many emerging markets, the development of financial systems has fallen behind the pace of GDP growth.

Financial globalization has also stalled. Since 1980, unprecedented capital mobility has linked national financial markets into an ever more tightly interconnected global system. This process accelerated dramatically with the creation of a monetary union and a single currency in Europe, but the phenomenon of financial integration extended worldwide. When the 2008 crisis erupted, the intricate web of connections in the global financial system spread shocks very quickly. In the wake of the crisis, however, there has been a pullback. Cross-border capital flows collapsed, and today they remain 60 percent below their pre-crisis peak.

Using our proprietary database of the financial assets of 183 countries around the world, this report considers the trends of financial deepening and financial globalization in tandem.<sup>1</sup> In a healthy ecosystem, these two forces would interact in a virtuous cycle, with borrowers and savers from different countries connecting in robust, transparent, and liquid financial markets. But the financial crisis ushered in a period of retrenchment—some of which, especially in advanced economies, reflects a necessary correction. Nevertheless, there is also a chance that this correction may overshoot, reducing the flow of private-sector financing needed for recovery and a return to economic growth.

Today global financial markets are at an inflection point. One path leads to a more balkanized structure that relies primarily on domestic capital formation and concentrates risks within local banking systems, while another points toward a healthier model of financial globalization that corrects the pre-crisis excesses while supporting more robust economic growth. Achieving this second outcome will require concerted actions by policy makers and financial institutions.

---

1 This is the latest in a series of McKinsey Global Institute reports on the state of global capital markets. See our previous research at [www.mckinsey.com/mgi](http://www.mckinsey.com/mgi).

## GLOBAL FINANCIAL MARKETS STALL

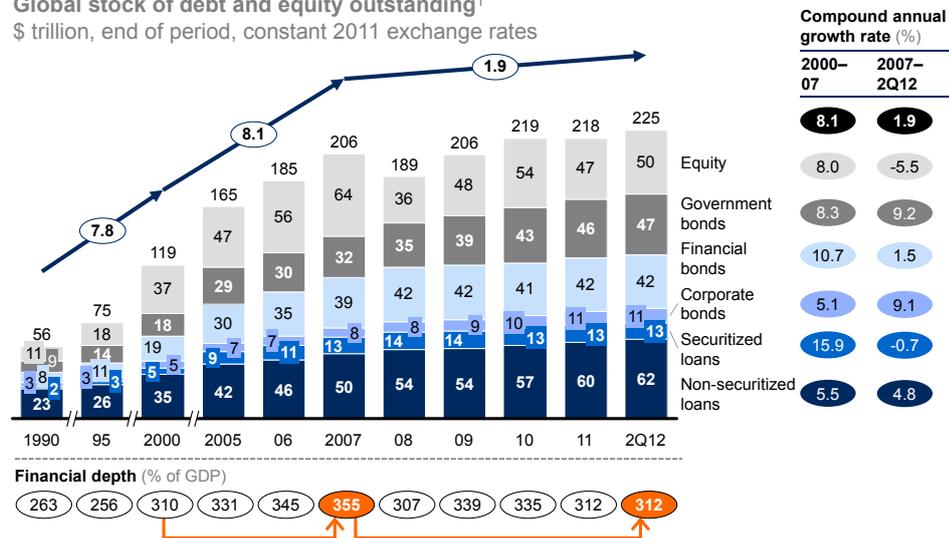
The world's financial assets—or the value of equity market capitalization, corporate and government bonds, and loans—grew from around \$12 trillion in 1980 to \$206 trillion in 2007. Financial depth, which measures those assets relative to GDP, rose from 120 percent to 355 percent of global GDP over the same period. But this rapid growth has stalled. Today the value of the world's financial assets stands at \$225 trillion, above the pre-crisis peak (Exhibit E1). But global financial assets have fallen by 43 percentage points relative to GDP since 2007—and by 54 percentage points if we exclude the recent rise in government debt. Their annual growth was 7.9 percent from 1990 to 2007, but that has slowed to an anemic 1.9 percent since the crisis.

### Exhibit E1

#### Global financial assets have grown to \$225 trillion, but growth has slowed since 2007

Global stock of debt and equity outstanding<sup>1</sup>

\$ trillion, end of period, constant 2011 exchange rates



1 Based on a sample of 183 countries.

SOURCE: McKinsey Global Institute Financial Assets Database; McKinsey Global Institute analysis

The loss of momentum is not confined to the advanced economies<sup>2</sup> at the heart of the crisis. Emerging markets weathered the crisis well, but their financial depth is on average less than half that of advanced economies as of 2012 (157 percent of GDP compared with 408 percent of GDP). This gap was narrowing before the crisis, but it is no longer closing.

Some of the slowdown in the growth of global financial assets represents a healthy correction. Looking back, we can see that several unsustainable trends propelled a large share of the pre-crisis gains. The most notable of these factors was the increasing size and leverage of the financial sector itself.

2 We use the terms *developed country*, *advanced economy*, and *mature economy* interchangeably throughout this report. We also use the terms *emerging market*, *emerging economy*, *developing country*, and *developing economy* interchangeably.

While Exhibit E1 offers an asset-class view of growth, our database allows us to separate out the financing available for different sectors of the economy: households and non-financial corporations, financial institutions, and government. This analysis reveals that the financial sector generated more than one-third of global financial deepening prior to the crisis. Bonds issued by financial institutions to fund lending activities and other asset purchases grew to \$39 trillion by 2007—roughly five times the value of bonds issued by non-financial companies.

One-quarter of financial deepening before the crisis was due to equity market valuations rising above long-term norms—gains that were erased in the crisis.<sup>3</sup> Initial public offerings and new equity raising have fallen significantly since the crisis. Another factor adding to financial deepening during this period was a steady rise in government debt—a trend that is sustainable only up to a certain point.

Financing for households and non-financial corporations accounted for just over one-fourth of the rise in global financial depth from 1995 to 2007—an astonishingly small share, given that this is the fundamental purpose of finance. Since then, financing for this sector has stalled in the United States, as households and companies have deleveraged.<sup>4</sup> Despite the lingering euro crisis, however, financing to households and corporations in Europe has continued to grow in most countries, as banks have stepped up domestic lending while reducing foreign activities.

The risk now is that continued slow growth in global financial assets may hinder the economic recovery, stifling business investment, homeownership, and investment in innovation and infrastructure. Our analysis suggests a link between financing and growth, showing a positive correlation between financing for the household and corporate sectors and subsequent GDP growth. A continuation of current trends could therefore slow the economic recovery.

### **CROSS-BORDER CAPITAL FLOWS DECLINE**

Cross-border capital flows—including lending, foreign direct investment, and purchases of equities and bonds—reflect the degree of integration in the global financial system. While some of these flows connect lenders and investors with real-economy borrowers, interbank lending makes up a significant share. In recent decades, financial globalization took a quantum leap forward as cross-border capital flows rose from \$0.5 trillion in 1980 to a peak of \$11.8 trillion in 2007. But they collapsed during the crisis, and as of 2012, they remain more than 60 percent below their former peak (Exhibit E2).

As with financial deepening, it is important to disentangle the different components of growth and decline in capital flows. In the decade up to 2007, Europe accounted for half of the growth in global capital flows, reflecting the increasing integration of European financial markets. But today the continent's financial integration has gone into reverse. Eurozone banks have reduced cross-border lending and other claims by \$3.7 trillion since 2007 Q4, with \$2.8 trillion

---

3 We measure equity valuations by changes in the price-to-book ratio of listed companies. As of early 2013, some major stock market indices were nearing or had surpassed their pre-crisis peaks. However, equity market capitalization relative to GDP is still below the 2007 level globally and in most countries.

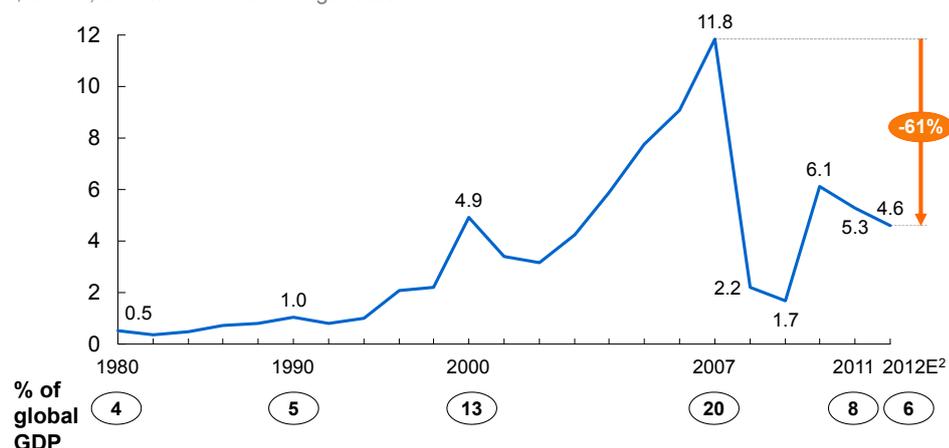
4 See *Debt and deleveraging: Uneven progress on the path to growth*, McKinsey Global Institute, January 2012.

of that reduction coming from intra-European claims (Exhibit E3). Financing from the European Central Bank and other public institutions now accounts for more than 50 percent of capital flows within Europe. With hindsight, it appears that capital mobility in Europe outpaced the development of institutions and common regulations necessary to support such flows.

### Exhibit E2

#### Cross-border capital flows fell sharply in 2008 and today remain more than 60 percent below their pre-crisis peak

Global cross-border capital flows<sup>1</sup>  
\$ trillion, constant 2011 exchange rates



<sup>1</sup> Includes foreign direct investment, purchases of foreign bonds and equities, and cross-border loans and deposits.

<sup>2</sup> Estimated based on data through the latest available quarter (Q3 for major developed economies, Q2 for other advanced and emerging economies). For countries without quarterly data, we use trends from the Institute of International Finance.

SOURCE: International Monetary Fund (IMF) Balance of Payments; Institute of International Finance (IIF); McKinsey Global Institute analysis

### Exhibit E3

#### Since 2007, Eurozone banks have reduced foreign claims by \$3.7 trillion, \$2.8 trillion of which was intra-European

Consolidated foreign claims of Eurozone reporting banks  
(includes loans and other foreign financial assets)<sup>1</sup>

By counterparty location, constant 2011 exchange rates

Eurozone bank claims on:	Change		Change	
	4Q99-4Q07	Compound annual growth rate (%)	4Q07-2Q12	Compound annual growth rate (%)
GIIPS <sup>2</sup>	1,732	17	-1,176	-14
Other Eurozone	2,033	12	-665	-5
United Kingdom	1,609	16	-771	-9
Other Western Europe	291	11	-140	-7
<b>Total Western Europe</b>	<b>5,665</b>	<b>14</b>	<b>-2,752</b>	<b>-8</b>
United States	1,382	13	-781	-9
Other developed	509	6	-438	-9
Developing countries	1,182	13	240	3
<b>Total</b>	<b>8,737</b>	<b>13</b>	<b>-3,732</b>	<b>-7</b>

<sup>1</sup> Includes banks from Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, and Spain.

<sup>2</sup> GIIPS comprises Greece, Ireland, Italy, Portugal, and Spain.

SOURCE: Bank for International Settlements; McKinsey Global Institute analysis

Outside of Europe, global lending flows have also slowed. The modest increase in assets of banks in the United States, United Kingdom, Canada, and Australia is not nearly enough to fill the gap left by retreating European banks.

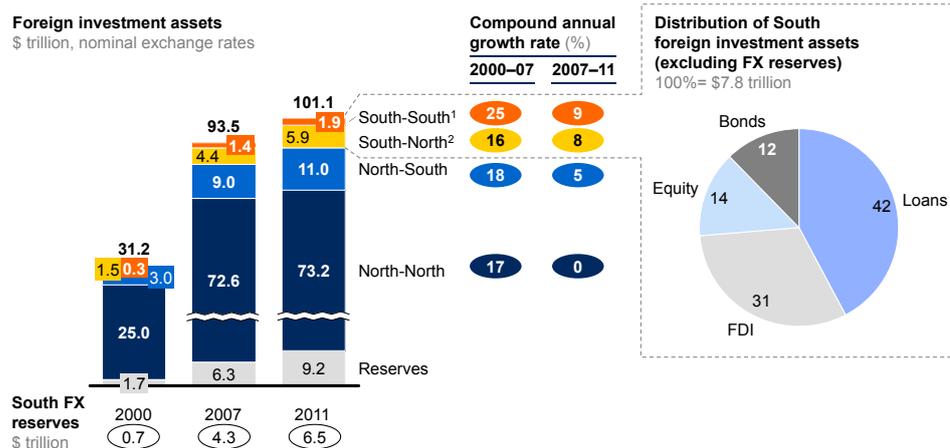
Facing new regulations on capital and liquidity as well as pressures from shareholders and regulators to reduce risk, many banks in advanced economies are winnowing down the geographies and business lines in which they operate. Since early 2007, commercial banks have sold off more than \$722 billion in assets and operations, with foreign operations accounting for almost half of this total. Regulators in many countries are moving to exert more control over the foreign banks that remain active in their jurisdictions, in some cases requesting that banks operate as subsidiaries rather than branches.<sup>5</sup>

In contrast to advanced economies, capital flows involving the world's developing countries have rebounded since the sharp decline in 2008–09. In 2012, we estimate that some \$1.5 trillion in foreign capital flowed into emerging markets, surpassing the pre-crisis peak in many regions. This amounted to 32 percent of global capital flows that year, up from just 5 percent in 2000. Capital flows *out* of developing countries rose to \$1.8 trillion in 2012. Central bank foreign reserves account for roughly 45 percent of the total stock of foreign assets. Foreign direct investment (by private-sector companies as well as state-owned enterprises and sovereign wealth funds) and cross-border loans (from commercial and development banks) have also risen sharply in recent years. Although most emerging-market investments are in advanced economies, some \$1.9 trillion of these assets are in other emerging markets—giving rise to the trend of so-called South-South investment (Exhibit E4).

#### Exhibit E4

### Most developing countries' foreign investment assets are in advanced economies, but "South-South" foreign investment has also increased

Stock of total foreign investment assets of developing (South) and advanced (North) economies



1 Foreign investment assets of developing countries in other developing countries.  
2 Foreign investment assets of developing countries in advanced economies.  
NOTE: Numbers may not sum due to rounding.  
SOURCE: McKinsey Global Institute Bilateral Foreign Investment database; McKinsey Global Institute analysis

5 A foreign subsidiary is a legally incorporated entity in the country and has its own capital base, while foreign branches do not. Over the past four years, cross-border lending through branches in Europe has declined twice as much (in both dollar and percentage terms) as foreign lending through subsidiaries.

Foreign direct investment (FDI), defined as investment that establishes at least a 10 percent stake in a foreign entity, has maintained better momentum than cross-border lending since the crisis. Although we estimate that FDI flows declined by 15 percent in 2012, they accounted for roughly 40 percent of global capital flows that year. This reflects in part the continued expansion of multinational companies as they build global supply chains and enter new consumer markets—and since many major non-financial corporations currently have large cash reserves, there is room for them to assume an even greater role as providers of capital, especially within their own supply chains. The growing share of FDI in global capital flows may have a stabilizing influence: our analysis shows that it is the least volatile type of capital flow in emerging markets and developed countries alike, as companies and investors typically make such commitments as part of a multiyear strategy. By contrast, cross-border lending, which dominated capital flows in the years leading up to the crisis, tends to be short term and can dry up quickly.

There is a bit of positive news to be found in the world's far smaller capital flows: global current account imbalances have declined some 30 percent from their peak when measured relative to global GDP. Although the current account deficits and surpluses in different countries did not directly spark the financial crisis, they did contribute to rapid growth in debt in some countries. In Europe, most of the periphery countries that were later at the center of the euro crisis ran large and growing current account deficits from 2000 to 2008—deficits that have been reduced sharply since then. Similarly, the current account deficit in the United States has shrunk by roughly 40 percent since its peak in 2006. Maintaining these smaller imbalances in the future would reduce one source of risk and volatility in the global financial system.

## **THE PATH FORWARD: TWO SCENARIOS FOR GLOBAL FINANCIAL MARKETS**

With the ramifications of the financial crisis still unfolding and new regulations being implemented, two starkly different futures are possible. In one, the world remains on its current trajectory, with little financial market development and subdued capital flows. Although such an outcome may reduce the risk of a future financial crisis, slower economic growth may become the new normal. An alternative scenario would involve a “reset” of the financial system that corrects past excesses while enabling financial deepening and globalization to resume.

### **Scenario 1: Financial globalization retreats**

If current trends continue, the value of financial assets relative to GDP would remain flat or even decline by 2020. This would reflect ongoing deleveraging of the household, corporate, and financial sectors in advanced economies, despite a continuing rise in government debt. It would also reflect no further financial deepening in developing countries. The retrenchment of global banks could lead to a loss of competition and expertise in the financial sectors of some smaller countries, driving up the cost of borrowing, and bank lending would be a smaller source of financing in advanced countries. Without robust cross-border capital flows or the presence of securitization and corporate bond markets to provide alternative channels, borrowers in these regions could face a credit crunch.

In this scenario, cross-border capital flows would not regain their pre-crisis peak for many years. Europe would stay on its current course—with no breakup, but only slow progress toward a banking union framework—and the continent's cross-border activity would continue to wane. Banks would focus on domestic activities and enter only those geographies where they have a clear competitive advantage. Investors would find limited options for entering potentially high-growth emerging economies; foreign capital would shy away from shallow markets in these countries that lack transparency and enforcement. Savers around the world would find it more difficult to diversify their portfolios geographically, potentially harming returns.

Sharp regional differences could emerge in the availability of capital. Some regions with high savings rates would find themselves with surplus capital, and a shortage of good investment opportunities in these countries could potentially result in lower returns for investors and savers. By contrast, other countries (including some advanced economies and many emerging markets) would find capital in short supply, constraining growth.

The crisis underscored the need for greater prudence and stability. But in fighting the last battle, it is easy to lose sight of new hazards that lie ahead. The current path runs the risk of choking off the financing needed for investment in business expansion, infrastructure, housing, R&D, and education. In a more credit-constrained world, all companies would need to consider how and where to raise capital.<sup>6</sup>

### **Scenario 2: Financial globalization resets**

With the right actions by financial institutions and policy makers, the world could take a more balanced approach to financial market development and globalization that would support economic growth. This scenario hinges on putting in place a solid global regulatory framework to correct the excesses of the pre-crisis years. This includes well-capitalized banks, a clear plan for cross-border resolution and recovery, improved macroprudential supervision, and mutual confidence and cooperation among national regulators. A revitalized system would include healthy competition among an array of financial intermediaries and institutions that serve both borrowers and savers. Foreign capital would flow to where there are investment needs.

In this scenario, countries would pursue opportunities for sustainable financial deepening, such as the expansion of corporate bond markets. In many countries, even the largest companies get most of their debt funding from banks rather than capital markets. But as banks reduce leverage and in some cases need to reduce the size of their balance sheets, shifting some of this credit demand to bond markets would be beneficial. Our calculations suggest there is room for corporate bond markets to grow by more than \$1 trillion if large companies in advanced economies were to shift 60 percent of their debt funding to bonds—and significant additional growth could come from emerging markets. This is only a rough estimate of the scale of the opportunity, and a shift of this magnitude would take years to play out. However, we can already see that corporate bond issuance has increased significantly in all regions of the world since the financial crisis.

---

6 For more on this topic, see *Farewell to cheap capital? The implications of long-term shifts in global investment and saving*, McKinsey Global Institute, December 2010.

Developing nations also have significant room to deepen their financial markets. On average, equity market capitalization is equivalent to 44 percent of GDP in developing countries, compared with 85 percent in advanced economies. Credit to households and debt of corporations combined is only 76 percent of GDP in emerging markets, compared with 146 percent of GDP in advanced economies. McKinsey research has estimated that small and medium-sized enterprises (SMEs) in emerging markets face a \$2 trillion credit gap, and 2.5 billion adults around the world lack access to banking services.<sup>7</sup> If developing nations converge to the average financial depth currently seen in advanced economies over the next two decades, their financial assets could grow from \$43 trillion today to more than \$125 trillion by 2020.<sup>8</sup>

Cross-border capital flows would post steady growth in this scenario. But instead of reopening the floodgates of volatile short-term lending and interbank lending, portfolio flows of equity and bond purchases and FDI would become larger components of international capital flows, enhancing stability. Investors would be able to gain much greater exposure to growth and diversification in the emerging world.

This alternative scenario could result in a system that provides financing for innovation and investment without sacrificing stability—if policy makers can balance these two goals. Without the proper regulatory framework in place, a return to rapid growth in financial assets and cross-border capital flows leaves the world vulnerable to the risk of yet another crisis—and all the collateral damage that would entail.

## NAVIGATING THE NEW LANDSCAPE

Whether financial globalization retreats or resets, the post-crisis world demands a new and more nimble approach to public policy, banking, and investing. Decision making is more complex in a time of uncertainty, but the ideas below offer a starting point.

### **Policy makers: Resetting financial globalization**

It will take concerted efforts by both national and international policy makers to move to the alternative scenario of a healthier global financial system. The following proposals would help to restore confidence and widen access to capital, setting this process in motion.

- Complete the current agenda for global regulatory reform.** The 2008 financial crisis and the subsequent euro crisis brought home the dangers of unsustainable financial deepening and capital flows. Healthy financial globalization cannot resume without robust and consistent safeguards in place to provide confidence and stability. Much is riding on the successful implementation of regulatory reform initiatives that are currently under way. These include working out the final details and implementation of Basel III, developing clear processes for cross-border bank resolution and recovery,

---

<sup>7</sup> See *Two trillion and counting: Assessing the credit gap for micro, small, and medium-size enterprises in the developing world*, McKinsey & Company and the International Finance Corporation, October 2010, as well as Alberto Chaia, Tony Goland, and Robert Schiff, “Counting the world’s unbanked,” *The McKinsey Quarterly*, March 2010.

<sup>8</sup> We created several scenarios for emerging market financial asset growth, based on different assumptions about GDP growth rates and exchange rates. See also *The emerging equity gap: Growth and stability in the new investor landscape*, McKinsey Global Institute, December 2011.

building robust macroprudential supervisory capabilities, and, in the Eurozone, establishing a banking union.<sup>9</sup>

- **Consider the hidden costs of closed-door policies.** Openness to foreign investment and capital flows entails risk, as the global financial crisis and subsequent euro crisis demonstrated, but it also brings clear benefits. Tightly restricting foreign banks and capital inflows may reduce the risk of financial contagion and sudden reversals of capital, but it also limits the benefits that foreign players can bring to a financial sector, such as greater capital access and competition. The right answer for each country will depend on the size and sophistication of its domestic financial sector and the strength of its regulation and supervision. But the objective of building a competitive, diverse, and open financial sector deserves to be a central part of the policy agenda.
- **Build capital markets to meet the demand for credit.** Capital markets are good sources of long-term finance—and they can provide crucial alternatives as banks scale back their activities. Most countries have the basic market infrastructure and regulations, but enforcement and market supervision is often weak. Standardized rating systems, clearing mechanisms, and a solid regulatory foundation are necessary prerequisites. Underlying the development of both equity and debt capital markets are robust corporate governance, financial reporting, and disclosure of companies seeking to tap these markets. When these elements are in place, a financial system is better equipped to attract capital and deploy it productively.
- **Create new financing mechanisms for constrained borrowers.** In an era of bank deleveraging, funding for large investment projects, infrastructure, and SMEs may be in short supply in many countries. But policy makers could promote the development of new financial intermediaries and instruments aimed at filling gaps in the current landscape. Public-private lending institutions and innovation funds, infrastructure banks, small-business lending programs, and peer-to-peer lending and investing platforms can increase access to capital for underserved sectors. These actions will become more urgent in an increasingly credit-constrained world.
- **Promote stable cross-border flows of finance.** Regulatory efforts have focused on containing the dangers of cross-border lending. By contrast, there has been relatively little discussion of unlocking what could be a major source of stable, long-term capital and higher returns at lower risk for savers and investors. Many public pension funds and insurance companies have strict geographic restrictions on their investment portfolios; these are meant to encourage investment at home, but they limit the potential returns and diversification that might come from seeking out growth in emerging markets. Designed to contain risk, they actually concentrate it by increasing domestic exposure. In addition to allowing the international diversification of portfolios, policy makers can look at removing legal barriers to foreign ownership and foreign direct investment, creating new channels (such as mutual funds) for retail investors in emerging markets, and creating cross-border resolution mechanisms for financial institutions and companies.

---

9 Three elements are under discussion in establishing a banking union in the Eurozone: common supervision of banks, common deposit insurance, and common authority for resolving failing banks. The European Central Bank is expected to assume supervisory responsibility for the largest banks in the Eurozone in 2014.

- **Use big data to improve information flows and market monitoring.** Poor information and data collection hampered the ability of financial institutions and regulators to recognize and act on the accumulation of unsustainable debt and leverage, opaque connections among institutions, and the concentration of risk. Healthier, deeper, and more open financial markets require more granular and timely information from market participants. Policy makers can draw on new analytic tools being deployed in the private sector to gather and analyze vast quantities of information and more closely monitor potential market risks.

### **Global banks: Searching for new business models**

The future direction of the global financial system depends in part upon actions by policy makers that will take years to realize. Nonetheless, certain elements of the landscape are becoming clear and will require new approaches.

First is a more selective focus on geographies and new operating models abroad. New regulations and shareholder pressures call into question the benefits of pursuing a global banking model, and banks have already begun the process of exiting some geographies.

Foreign operations may need new organizational models. The “sudden stop” problems associated with foreign lending—particularly the risks of foreign “suitcase” lending—have become clear to recipient countries, and national regulators are moving to impose new capital requirements and other controls on the banks that operate within their jurisdictions. Whether banks operate through branches or subsidiaries, there will be a greater emphasis on local deposits, local funding sources, and engagement with local regulators.

In the slow-growth environment that characterizes most advanced economies, cost efficiencies take on new importance. On this front, there is wide variation in performance across banks within the same country and across countries. This challenge does not call for simple budget cutting within departments, but rather end-to-end process redesigns to streamline back-office functions and operations.

Lending may not grow faster than GDP in advanced economies, but it will always remain a core product—and some banks may benefit from a renewed emphasis on relationship-based lending. This will require sharpening fundamental credit-assessment skills that were deprioritized during the peak of the bubble. Basic lending also presents a major opportunity in emerging economies, especially for those institutions that can find viable models to tap underserved mortgage markets, other consumer lending, and SME lending.

In addition, banks may consider acting more as conduits of capital rather than leveraging their own balance sheets to provide capital. Such a shift may involve focusing on underwriting, advisory services, and other fee-based activities. The potential for large-scale expansion in global bond markets will open new opportunities. Banks can act as brokers between institutional investors and borrowers, providing credit-assessment skills and deal-sourcing capabilities. They may also be at the forefront of new platforms for capital raising and lending, such as online peer-to-peer markets.

Finally, institutions that weathered the financial crisis well (such as those in emerging economies and some regional banks in advanced markets) will find new opportunities to gain market share where the largest global banks are exiting. This shift is already playing out in Asian trade finance, as regional banks pick up business from retreating European banks.

### **Institutional investors: Generating returns in a two-speed world**

The challenge for institutional investors in the coming years will be to navigate uncertain, volatile financial markets and find new sources of returns. Low yields and sluggish growth are the realities in mature economies, while emerging markets are expected to produce 70 percent of global GDP growth through 2025.<sup>10</sup> Shallow, illiquid financial markets in these countries can deter foreign institutional investors, however. Private equity investing, or partnering with local banks and investors, can get around these limitations. Some pension funds are considering direct deals with foreign companies, but they will need to develop new skills and possibly new organizational models in order to do so.

In advanced economies, institutional investors will need to identify new sources of alpha, or returns that are uncorrelated with broader market movements. This could come from several sources: for instance, pursuing market-neutral strategies that hedge a variety of long and short positions, or cultivating superior information and insights into specific sectors that enable identification of underpriced companies or future growth opportunities. Building these skills will be a formidable task and require major investments.

Despite these challenges, the shifting financial landscape will present institutional investors with new opportunities. Estimates show that by 2020, nine major economies alone will need to finance \$18.8 trillion annually in long-term investment to achieve moderate levels of economic growth.<sup>11</sup> With banks in a deleveraging mode, this could be a pivotal moment for institutional investors, whose pools of patient capital could finance infrastructure and other types of investment. With the appropriate policy changes, investors such as pensions and sovereign wealth funds with long time horizons could command liquidity premiums, earning extra returns for providing longer-term funding.

---

<sup>10</sup> *Winning the \$30 trillion decathlon: Going for gold in emerging markets*, McKinsey & Company, August 2012.

<sup>11</sup> *Long-term finance and economic growth*, Group of Thirty, February 2013. Also see *Infrastructure productivity: How to save \$1 trillion a year*, McKinsey Global Institute, January 2013.



After decades of strong momentum, the world is now experiencing a long, uncertain pause in financial market development and financial globalization. We could be entering a period in which banks and investors are less likely to venture beyond their home markets, or we may be witnessing the start of a new and more sustainable phase in the history of financial globalization. Policy makers will play an important role in shaping the outcome—and banks and investors need a flexible strategy for operating in a new and changing environment.

## Related McKinsey Global Institute publications



### Debt and deleveraging: Uneven progress on the path to growth (January 2012)

Safely reducing debt and clearing the way for economic growth in the aftermath of the global credit bubble will take many years and involve difficult choices. Major economies have only just begun deleveraging. The private sector leads in debt reduction, while government debt has continued to rise. But this MGI report points to history showing that under the right conditions, private-sector deleveraging leads to renewed economic growth and eventually public-sector debt reduction.



### The emerging equity gap: Growth and stability in the new investor landscape (December 2011)

Several forces are converging to reshape global capital markets in the coming decade and reduce the role of listed equities. The most important of these is the rapid shift of wealth to emerging markets, where private investors typically put less than 15 percent of their money into equities. At the same time, demand for listed equities in advanced economies is likely to fall due to aging, shifting pension regimes, growth of alternative investments, and new financial regulations.



### Mapping global capital markets 2011 (August 2011)

In this 2011 update, MGI finds that the recovery of financial markets remains uneven across geographies and asset classes. Emerging markets account for a disproportionate share of growth in capital-raising as mature economies struggle. Debt markets remain fragile in many parts of the world—the growth of government debt and of lending in China accounts for the majority of the increase in credit globally.



### Urban world: Cities and the rise of the consuming class (June 2012)

This latest MGI report on urbanization shows that the 600 cities making the largest contribution to a higher global GDP—the City 600—will generate nearly 65 percent of world economic growth by 2025. However, the most dramatic story within the City 600 involves just over 440 cities in emerging economies. One billion people will enter the global consuming class by 2025, and around 600 million of them will live in the Emerging 440.



### Investing in growth: Europe's next challenge (December 2012)

Private investment was the hardest-hit component of Europe's GDP between 2007 and 2011—but MGI analysis shows that it can also be a major driver of the region's recovery. Even in the face of weak demand and high uncertainty, some investors would start spending again if governments took bold measures to remove barriers that now stand in the way.

[www.mckinsey.com/mgi](http://www.mckinsey.com/mgi)

E-book versions of selected MGI reports are available at MGI's website, Amazon's Kindle bookstore, and Apple's iBookstore.

Download and listen to MGI podcasts on iTunes or at [www.mckinsey.com/mgi/publications/multimedia/](http://www.mckinsey.com/mgi/publications/multimedia/)

McKinsey Global Institute  
March 2013  
Copyright © McKinsey & Company  
[www.mckinsey.com/mgi](http://www.mckinsey.com/mgi)

 @McKinsey\_MGI

 McKinseyGlobalInstitute