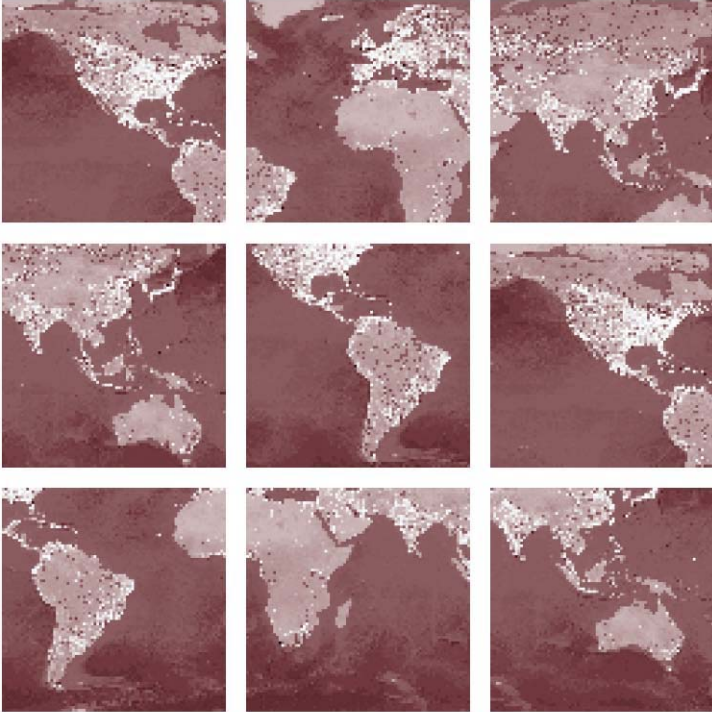


CHAPTER SEVENTEEN

IS WALL STREET DOOMED?

February 2007





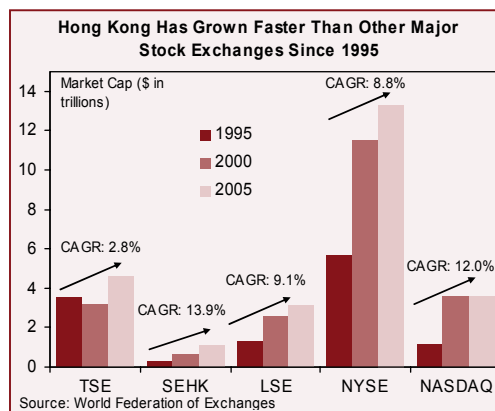
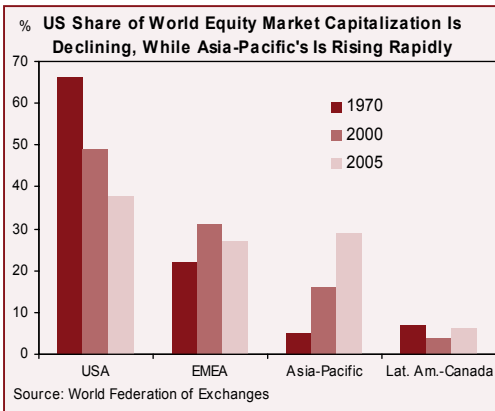
IS WALL STREET DOOMED?

Two recent reports have focused considerable attention on the question of New York's relative performance and future as a financial centre. The Committee on Capital Markets Regulation, involving senior Wall Street figures, argued prominently in a November 2006 report that increased regulatory restrictions (such as the Sarbanes-Oxley legislation) were causing capital markets activity to move away from New York. In January, a McKinsey report commissioned by New York's Mayor Bloomberg and Senator Schumer predicted New York could lose 4%-7% of its market share in the global investment banking and sales and trading markets over the next five years, causing it to forego some 60,000 new jobs. The politicians introduced this report with a reference to 'the chilling fact that if we do nothing, within ten years, while we will remain a leading regional financial centre, we will no longer be the financial capital of the world.'

Both of these studies cited legal and regulatory practices as prominent drivers behind the shift in capital markets activity away from New York and toward other financial centres, most notably London. Sarbanes-Oxley, the insistence on US GAAP, the multiplicity of US regulatory bodies, the risk and unpredictability of litigation, and US immigration restrictions, were all cited as obstacles or deterrents to the growth of the US capital markets. Typically these factors are contrasted with London's 'light touch' regulation, absence of class action lawsuits and ease of migration.

Legal and regulatory factors probably do matter, and policy reform might strengthen New York's competitiveness. Nonetheless, we do not see them as the critical drivers behind the shift in financial market intermediation, even in the aggregate. Quite simply, economic and geographic factors matter more. New York's pre-eminence as a global financial centre reflects the remarkable rise of the US economy over the past century. If the world continues to evolve broadly in line with our BRICs projections, it seems highly likely that capital markets outside the US will develop more quickly. In this regard, both London and Hong Kong have natural advantages that New York lacks.

This would not spell the end of New York as a global financial centre. Capital markets growth is not a zero-sum game. Growth in global markets would probably stimulate activity in New York—in absolute if not relative terms. Two other factors are important to remember:



Is Wall Street Doomed?

- Much of the growth of financial markets outside the US is due to the spread of US capital market ‘culture’.
- We would expect US-based but globally-minded firms—both intermediaries and investment banking companies—to benefit from further growth in any global capital markets.

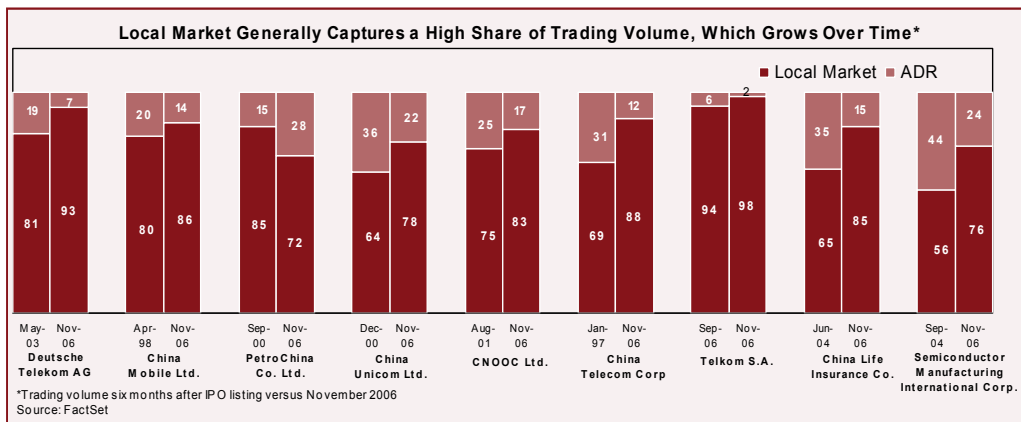
Capital Markets Have Been Shifting for Decades

The charts on page 227 show the evolution of global equity markets. As is clear, the relative decline of the US is not new; it has been underway for several decades, though it does seem to have accelerated in recent years. This reflects two factors: the growth of the capital markets culture outside the US since 1970 and the rapid growth of many emerging economies since 2000. This phenomenon is particularly well illustrated by the Asia-Pacific markets, which have soared from just 5% of world equity market capitalisation in 1970 to 29% in 2005.

In general, regional exchanges have grown faster than the NYSE over the past decade (the Nasdaq too has grown faster, although its market capitalisation is only now returning to 2000 levels). In all likelihood, this reflects the fact that the technology boom of the late 1990s was US-based. As that boom has turned to bust, other markets have grown more rapidly. It is also interesting that the capitalisation of the NYSE and LSE have grown at comparable rates over the last decade.

In terms of trading volumes, all markets have seen their turnover rise sharply. The increased turnover outside the US demonstrates that investors have become more confident in local markets. Consider the chart below, which contrasts daily trading volumes in local markets with ADRs. The vast majority of turnover takes place on the home market, and this share typically increases over time. This ‘flowback’ to the home market increasingly undermines the importance of an ADR listing, at least for secondary market trading and liquidity.

Growth outside the US has been most dramatically illustrated by the initial public offering (IPO) activity of the last two years. In each of 2005 and 2006, only one of the world’s ten largest IPOs was listed on a US exchange. London participated in three of the ten largest IPOs of 2006, only one of which was for a British firm. Three of the ten originated in China in each



Largest 10 IPOs in 2006

	Issuer Name	Size (mn \$)	Issuer Nation	Exchange
20/10/2006	Industrial & Commercial Bank of China - ICBC	19833	China	Hong Kong; Shanghai
24/05/2006	Bank of China Ltd	11186	China	Hong Kong
14/07/2006	Rosneft	10656	Russia	London; Moscow
03/05/2006	KKR Private Equity Investors LP	5049	United States	Amsterdam
07/07/2006	Standard Life Assurance Co	4444	United Kingdom	London
27/01/2006	Lotte Shopping Ltd	3738	South Korea	Korea; London
06/11/2006	Aozora Bank Ltd	3218	Japan	Tokyo
12/05/2006	Saras SpA	2643	Italy	Milan
24/05/2006	MasterCard Inc	2579	United States	NYSE - New York
11/12/2006	China Communications Construction Co Ltd	2379	China	Hong Kong

Largest 10 IPOs in 2005

	Issuer Name	Size (mn \$)	Issuer Nation	Exchange
20/10/2005	China Construction Bank Corp - CCB	9227	China	Hong Kong
18/11/2005	Electricite de France SA - EDF	9032	France	Paris
07/07/2005	Gaz de France	5465	France	Paris
08/06/2005	China Shenhua Energy Co Ltd	3272	China	Hong Kong
21/11/2005	Link Real Estate Investment Trust	2801	Hong Kong	Hong Kong
20/06/2005	Bank of Communications	2161	China	Hong Kong
27/06/2005	PartyGaming plc	1897	Gibraltar	LSE
14/12/2005	Goodman Fielder Ltd	1594	Australia	ASX
10/02/2005	Huntsman Corp	1593	United States	NYSE
08/03/2005	Premiere AG	1561	Germany	Xetra (Germany)

Source: Dealogic Analytics

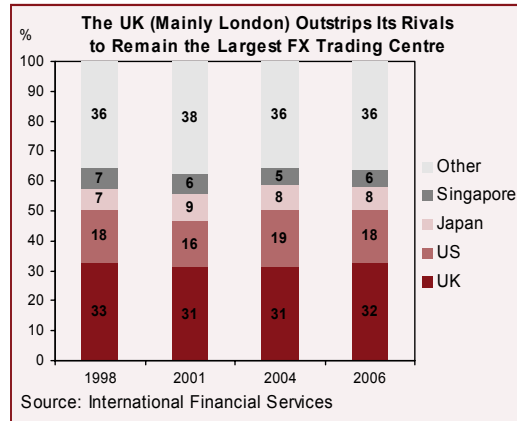
year. None of these Chinese transactions listed in the US; they were able to achieve attractive size and valuations in Hong Kong and Shanghai—including the \$20bn IPO of Industrial and Commercial Bank of China, the largest IPO on record. A Russian transaction, the third largest of 2006 (and larger than any in 2005), was listed in Moscow and London.

In many of these cases, legislative and regulatory burdens did appear to influence the companies' decisions not to list in the US. However, the key factors were liquidity and execution—the fact that the deals could be transacted effectively and attractively in domestic markets and/or in other markets outside the US.

Of course the IPO market is not the only market; many others have been considerably larger outside the US than inside for some time. London has historically been the centre of the global foreign exchange market and has recently expanded its dominance. Nearly one-third of the roughly \$2.7trn daily turnover in the FX market trades in London—more than the next three largest markets (New York, Tokyo and Singapore) combined. According to International Financial Services, more Dollars trade in the UK than in the US, and more Euros in the UK than in all the Eurozone countries together. European markets also have a leading share in the OTC derivatives markets; many of these markets have sprung up in recent years and “could be located anywhere”, in the words of the McKinsey study. Debt financing activity, traditionally a US-oriented market, is picking up in Europe as well.

Look at a Map

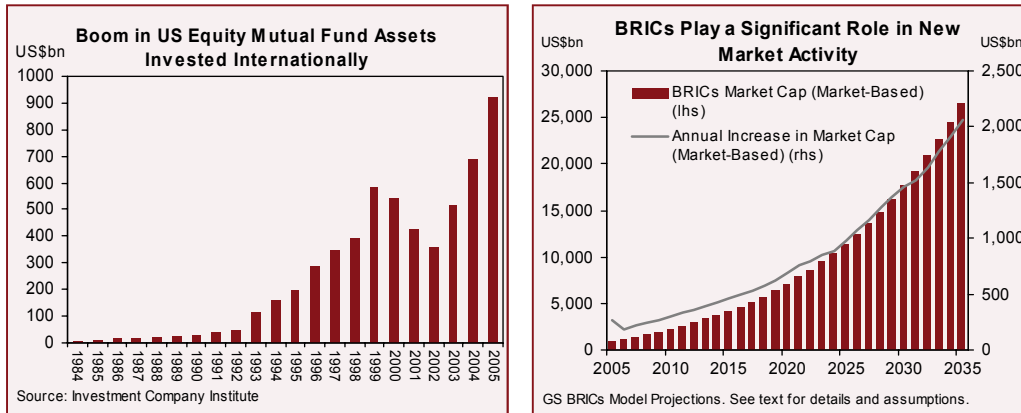
The question of ‘is New York losing out?’ is typically phrased as ‘is New York losing out to London?’. While we don’t see this as a head-to-head competition, it is true that London has some natural advantages over New York. London’s time zone gives it a real advantage, as has been evident for decades in its leading role in the truly global FX market. As the equity market culture spreads and deepens around the world, the time zone is likely to give London a similar leg up: 1pm in London in July is equivalent to 8am in New York, 4pm in Moscow and Dubai, and 8pm in Hong Kong and Beijing. In contrast, 1pm in New York is after the close of the trading day in London and everywhere east of the UK. New York afternoons are only ‘active’ trading time zones for the rest of the Americas, Australia and New Zealand.



London enjoys additional advantages in geography and language. The creation of the Euro and the deepening of Europe’s capital markets since the introduction of the single currency have given London a great ‘adjacency’ advantage. Despite fears that the UK’s choice not to join the Eurozone would hurt London, the city has instead expanded its role in Euro-denominated businesses, particularly in the interest rate and foreign exchange markets. Many global financial securities firms, including some from Eurozone member countries, base their international bond trading businesses in London. As the Eurozone economies slowly adopt structural reforms and more developed capital market techniques, London often benefits from much of the resulting business. Moreover, the dominance of the English language gives London a comparative advantage over other European cities, and many of those in the emerging world. London’s generally ‘light touch’ regulatory framework may work to its favour, but the city’s ‘natural’ advantages should not be underestimated either.

Other cities, including Hong Kong, Shanghai, Dubai and Moscow, are already echoing London’s success by emerging as financial hubs for neighbouring big emerging economies and oil exporters. They receive similar geographic and language boosts from their proximity to important economies and large pools of money. A case in point is the growth of the Islamic finance market, which has increased in size from a small figure at the start of the decade to an estimated \$400bn today. Dubai and London in particular have emerged as the centres of this market, largely thanks to their proximity to Gulf oil revenues and their openness to innovation in this sphere; the market in the US is extremely small.

The evolution of China’s equity market culture offers one road-map for big emerging economies. In the early 1990s, the few Chinese firms seeking overseas equity capital turned to New York (issuing ADRs) and Hong Kong. Later in the decade, Chinese companies began to look closer to home, with the largest IPOs at the time listing in both New York (directly) and Hong Kong. The focus has increasingly shifted toward Hong Kong and Shanghai, which have proven able to absorb very large transactions. Since 2005 alone, the IPOs of four Chinese



banks have raised more than \$42bn in total in Hong Kong and Shanghai. Trends that have supported the growth of capital markets in China—such as the privatisation of state-owned firms, rising household wealth, an aging population, and improved corporate transparency and governance—are likely to support the growth of capital markets in other countries too.

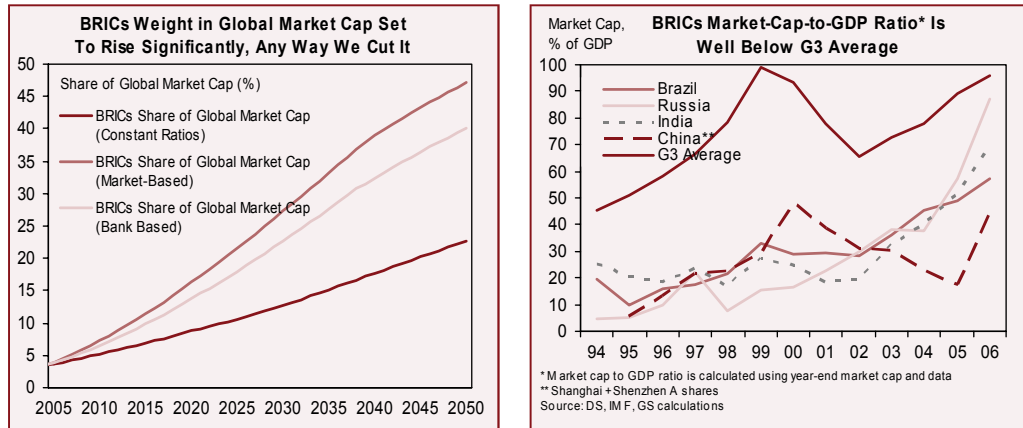
Trends in Investment Management

The surge in both traditional and non-traditional forms of investment management has been an additional advantage for some non-US markets. Three different forms of investment management are growing strongly outside the US:

- Hedge funds appear to be growing faster outside the US, although their absolute size is still much bigger in the US.
- Mutual funds and other forms of pension-related entities are starting to grow as European countries begin to develop a pension savings culture. Since 2000, mutual fund assets have grown nearly 13% annually in Europe and 11% in Asia. Annual growth in the US was only 5% over the same period.
- Thirdly, and possibly of greatest importance, government-backed investment entities are starting to emerge in many big developing countries, largely as a by-product of excess FX reserves. This is a key factor to watch going forward. Norway and Singapore have set the standard for many other wealthy nations to follow and, as discussed in the media recently, China may well move in this direction. Russia and other holders of significant FX reserves may follow.

Moreover, US investors are increasingly turning overseas. US mutual funds have close to \$1trn invested in international equities, roughly five times the figure of the mid-1990s.

Is Wall Street Doomed?



The BRICs, the World Economy and the Future

Wall Street's long-standing pre-eminence probably reflects a number of factors: the absolute importance of the US economy; its role in financial innovation; its history of solid regulation; and indeed the 'brand' itself.

Looking into the future, the way the world economy unfolds is likely to be a critical factor in determining the overall pattern of global capital markets development. Recent Chinese and Russian leadership in the IPO market may just be a taste of things to come. Just as we project that the world economy will look significantly different in just two decades' time, thanks to the BRICs, so too may global capital markets.

The BRICs' capital markets are currently small as a share of GDP, at least by the standards of most developed countries, especially the US. We expect these markets to grow in two ways in coming decades: in Dollar terms (keeping pace with the growth of their economies) and as a share of GDP (as their capital markets deepen).

In *Global Economics Paper No.118*, 'Crude, Cars and Capital', we applied our BRICs GDP projections to a stylised view of how the BRICs capital markets might develop. The chart above illustrates three alternative paths for the BRICs capital markets by 2050. Each path reflects the varying degrees to which the BRICs might 'embrace' what is typically deemed the Anglo-Saxon model of capital markets. If the BRICs were fully to adopt the Anglo-Saxon model, their capital markets could become vastly bigger than the US. Even in a scenario where BRIC countries follow the 'bank-based' model of development, their likely level of GDP growth will probably result in much bigger capital markets.

Similarly, we recently projected the growth of the Chinese domestic debt market in *Global Economics Paper No.149*, 'Bonding the BRICs: The Ascent of China's Debt Capital Market'. We estimated that China's DCM could double in GDP terms over the next decade, rising from just under 30% to some 60% of GDP in 2016—making it roughly the size of the US Treasury market today. Even if the market-cap-to-GDP ratio remained at today's levels, the market would still grow roughly threefold (in Dollar terms) as it matched growth in the overall economy.

Regulation Does Matter

All of this is not to say that regulatory issues are irrelevant. A large number of participants in the McKinsey survey cited stringent NYSE listing requirements as a deterrent to listing there. Similarly, the top 10 IPO issuers in both 2005 and 2006 frequently mentioned regulatory hurdles as an impediment to a US listing. The ‘light touch’ of the UK’s Financial Services Authority is seen as allowing smoother and more nuanced regulation, which is appropriate for today’s complex, fast-changing and globalised markets. At the individual level, corporate executives may feel that the challenge of gaining entry to the US in light of tighter immigration rules further disposes them not to list in New York. While we doubt that any of these factors are the primary motivator for non-US listings, they are probably unhelpful, particularly in the aggregate.

Is Wall Street Doomed?

So, is Wall Street doomed? Certainly not. The depth of the US domestic market, the fact that it is the home market for many of the world’s leading companies, the tradition of innovation and the deep equity culture all point to a continued future as one of the world’s key financial centres. But the long-standing dominance of the US markets is likely to continue to fade as the global equity culture spreads. We see this as a not-surprising aspect of the rise of the BRICs economies, and one that should be welcomed. At the very least, many US-based firms are likely to profit from this trend—including financial intermediaries, lawyers and accountants.

Jim O’Neill and Sandra Lawson
February 14, 2007