Volume 13, Number 6 ↝ July 2007
FEDERAL RESERVE BANK OF NEW YORK

Current Issues
IN ECONOMICS AND FINANCE
www.newyorkfed.org/research/current_issues

# Evaluating the Relative Strength of the U.S. Capital Markets

*Stavros Peristiani*

*Concern is growing that the U.S. capital markets are losing market share to overseas competitors. A decline in foreign initial public offerings indeed suggests that the U.S. equity market is becoming less attractive to certain issuers. However, evidence on the competitiveness of the U.S. equity market is mixed, since the trends affecting it are likewise shaping equity markets abroad. A less ambiguous decline in the share of global issuance can be seen in the U.S. corporate bond market, which is facing a growing challenge from the Eurobond market.*

Public capital markets in the United States make a vital contribution to the nation's wealth and prosperity by directing investments toward innovation, promoting economic growth, and ensuring the allocation of resources to the most efficient projects. The effective performance of the capital markets—where stocks and bonds are issued and traded—creates great economic advantages for U.S. financial centers, and New York City in particular, by helping to establish them as the leading sites for conducting business.

Over the past few years, however, there have been growing concerns that the U.S. capital markets are relinquishing market share to overseas competitors. Recently, the Committee on Capital Markets Regulation (2006), a nonpartisan group of business and academic professionals, concluded that the position of dominance held by these markets is waning. The committee proposed a variety of solutions, such as reforming the regulatory process, revising Section 404 of the Sarbanes-Oxley Act of 2002,[1] overhauling long-standing enforcement principles, and strengthening shareholders' rights. Many of the committee's concerns were echoed by a McKinsey & Company study (2007), commissioned by New York City, that examined ways to improve the city's competitive position as a major global financial center.

This edition of *Current Issues* considers whether the U.S. position in the major global equity and bond markets has eroded over the past ten years. Much of the recent debate on the competitive strength of the U.S. financial sector has focused on the primary and secondary equity markets—particularly, the ability of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations system (NASDAQ) to remain the dominant stock markets.[2] Indeed, a recent plunge in the number of foreign firms listing initial public offerings (IPOs) on the NYSE and the NASDAQ suggests that the U.S. equity market is becoming less attractive to certain issuers. Our analysis, however, reveals that evidence on the competitiveness of the U.S. equity market is mixed, and that the same trends seen in the U.S. market are also shaping equity markets abroad. Overall, the NYSE and the NASDAQ continue to be the world's most actively traded markets.

However, the U.S. corporate bond market—a key funding source for U.S. and foreign corporations—faces increasing challenges from abroad. The U.S. bond market has lost a large share to the Eurobond market, including a noticeable portion of U.S. debt issuers. Throughout the 1990s, the European financial system underwent a major transformation stemming from financial liberalization, a reduced reliance on banks as intermediaries between savers and borrowers, and the euro's emergence as a leading global currency. These developments have shrunk underwriting costs abroad and helped the Eurobond market surpass the U.S. bond market as the world's largest site for debt underwritings. Moreover, the self-regulatory environment and greater variety of financing instruments offered by the Eurobond market have been especially appealing to top-rated U.S. financial issuers.

### The Primary Equity Market

Although issues of new equity represent a relatively small fraction of global market transactions, they are a vital source of organic growth for stock exchanges. New listings are therefore an important barometer of stock market performance and strength.

Lately, the financial press has called attention to the declining U.S. share of global IPO volume.[3] A related concern is that the American equity market is no longer the first choice of many foreign IPO firms. Indeed, the recent downturn in equity issuance on the NYSE and the NASDAQ could signal to policymakers, finance professionals, and economists that the United States is ceding market share to overseas exchanges. Our examination of recent trends, however, suggests that a more nuanced assessment of the evidence is in order, largely because certain factors affecting U.S. market competitiveness are also influencing the performance of overseas markets.

To be sure, recent statistics point to a shrinking U.S. share of global IPOs.[4] In 2000, the total IPO issuance volume in the United States exceeded $70 billion, compared with only about $20 billion in London and in Hong Kong. This wide gap virtually disappeared in 2006, as London and Hong Kong each nearly matched the $52 billion issuance volume in the United States. Moreover, only one of the top twenty global IPOs in 2006, ranked by volume of proceeds, was listed in the United States.[5] In addition, the U.S. share of global dollar-denominated IPO proceeds fell from an average level of 35 percent in 1990-2004 to a low of 20 percent in 2005-06.

While these figures indicate a declining U.S. market share, they present an incomplete picture. Despite the pronounced decrease in global IPO volume, it is not unusual for IPO proceeds to fluctuate significantly from year to year. Thus, it may be too soon to determine whether the decrease suggests a permanent change in the competitive position of the U.S. equity market or merely a temporary shift.

The influence of the tech sector is another important consideration. The NYSE and the NASDAQ *have* seen generally dwindling numbers of new listings over the past few years (Chart 1, upper left panel). However, the falling numbers do not necessarily stem entirely from a loss of competitiveness. Rather, they reflect in part the boom-and-bust cycle of the tech sector and are comparable to trends in other markets. The NYSE's drop in new issues in the 1990s reflected fierce competition from the NASDAQ, which appealed to the growing number of high-tech issuers. However, the NASDAQ's status as a high-tech market made it more vulnerable to the Internet collapse at the turn of the century, and the exchange saw a dramatic slowdown in new listings after 2000 (although its share rebounded to almost 5 percent by the end of 2005). In contrast, the NYSE's lower reliance on tech enabled it to sustain a greater flow of new listings after 2000.

The competitiveness of overseas exchanges was similarly affected by tech's boom-and-bust cycle. Venues such as Euronext, Deutsche Börse, and the Hong Kong Stock Exchange had also attracted many new firms in the late 1990s. Deutsche Börse in particular was the favored destination of many American high-tech companies opting for a dual listing on a German exchange. Needless to say, the collapse of the dot-com sector caused a significant slowdown in IPO activity in these markets as well. New listings were also weak in Japan from 1995 to 2005 as the country endured an extended recession.

[1]Following the collapse of Enron and numerous accounting scandals, the U.S. Congress enacted Sarbanes-Oxley to establish proper controls on accounting and financial management and to ensure better corporate governance and shareholder protection. However, the more rigorous disclosure requirements introduced by the legislation, coupled with the additional costs faced by public firms, have raised concerns that the act may have tilted incentives in favor of private ownership (Engel, Hayes, and Wang 2004). In particular, Section 404, which governs internal controls and financial reporting procedures, is often seen as burdensome for public firms. Section 404 requires both management and company auditors to certify the effectiveness of their internal control structure and their procedures for financial reporting.

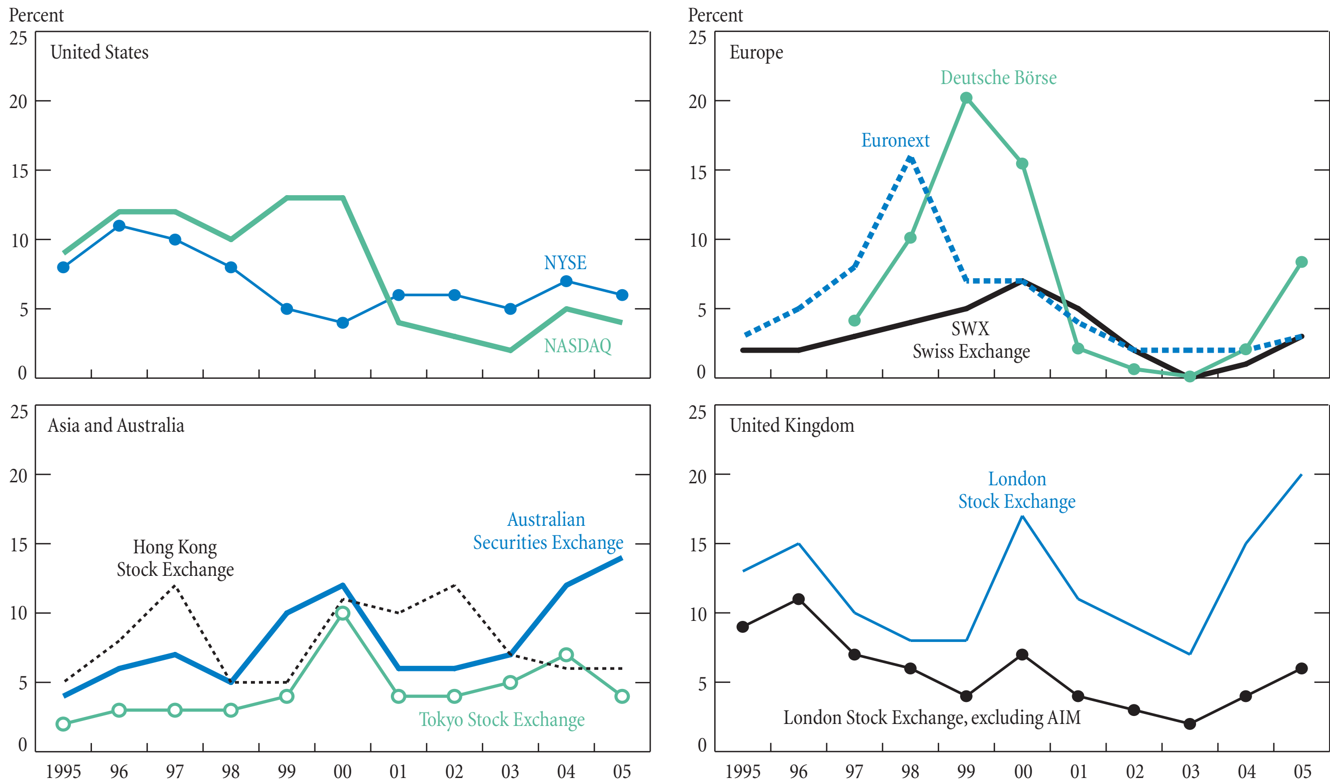
[2]Charles Schumer and Michael Bloomberg, "To Save New York: Learn from London," *Wall Street Journal*, November 1, 2006, p. A18; Daniel Gross, "The U.S. Is Losing Market Share. So What?" *New York Times*, January 28, 2007, sec. 3, p. 5.

[3]See, for example, Jeremy Grant, Francesco Guerrera, and Krishna Guha, "The Cost of Compliance: As Listings Go Elsewhere, U.S. Regulators Take a Fresh Look," *Financial Times*, November 20, 2006, p. 11; "What's Wrong with Wall Street," *The Economist*, November 25, 2006, p. 11.

[4]The sources for the figures in this discussion are Securities Data Corporation and various stock exchange fact books, as well as the author's own calculations.

[5]The largest U.S. IPO in 2006 was MasterCard Inc., which listed on the NYSE on May 24. The top twenty rankings exclude closed-end funds, unit trusts, and other specialized IPOs.

Chart 1
New Listings on Large Stock Exchanges
As a Share of Total Listings



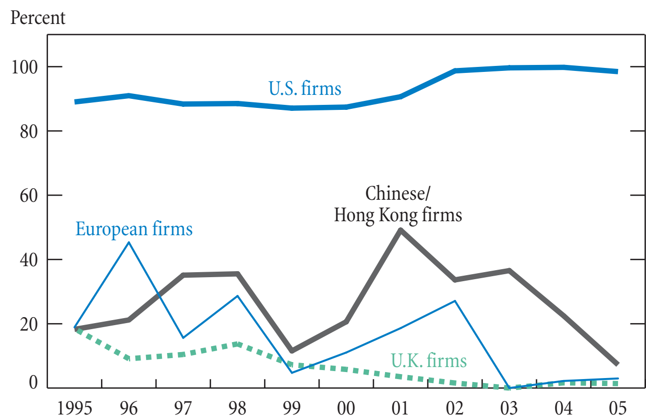

Sources: World Federation of Exchanges; various stock exchange fact books.

Note: AIM is the Alternative Investment Market segment of the London Stock Exchange; it was launched in 1995 as a market mainly for smaller companies backed by venture capital.

Even the London Stock Exchange, which achieved a 20 percent new-listing share in 2005 (Chart 1, lower right panel), was not immune to a declining trend. Much of the London Stock Exchange's growth stems from listings of "micro-cap" companies on the Alternative Investment Market (AIM) segment of the exchange.[6] However, if one excludes AIM, the London Stock Exchange's new-listing share is actually substantially lower over the period and comparable to the shares of other exchanges.

Another frequently cited concern that merits further scrutiny is the U.S. equity market's loss of distinction as the first choice of many foreign IPO firms. Although U.S. stock exchanges have clearly seen a decline in their share of IPO

Chart 2
U.S. Stock Exchanges' Share of Initial Public Offerings from Different Regions




Source: Securities Data Corporation.

Note: Figures are based on the volume of proceeds.

[6]AIM was launched in 1995 as a market primarily for smaller companies backed by venture capital. Since then, more than 2,100 companies listing there have raised about $2.2 billion in new capital. Firms are attracted to AIM's simplified regulatory environment, which is designed specifically for the needs of smaller companies that typically find it difficult to list on more established international exchanges.

offerings by European, U.K., and some Asian firms (Chart 2), this development may not be as troubling as it appears.

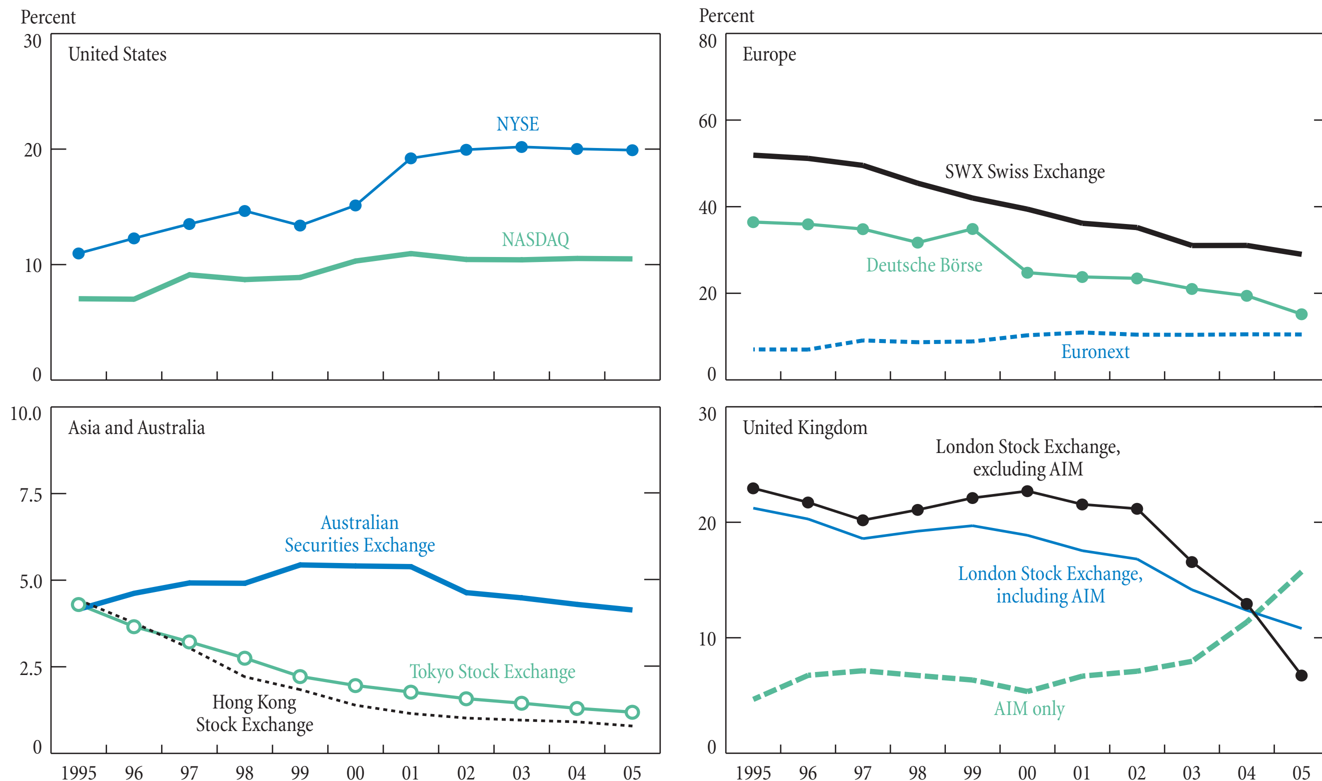
U.S. firms exhibit a strong home market bias, as evidenced by the sizable share of dollar IPO proceeds remaining in the domestic markets. Moreover, during the 1990s, the NYSE and the NASDAQ did attract a good share of foreign IPO firms.

However, it is the case that in recent years, most foreign equity issuers, except for some firms in Hong Kong and China, have withdrawn from the American exchanges. The diminishing presence of foreign IPOs in the U.S. market may be a response to the costs of implementing U.S. accounting standards, arguably greater legal obstacles faced by companies operating in the country, and higher equity underwriting fees. Some in the business community also contend that the more rigorous regulation introduced by Sarbanes-Oxley has raised the costs of listing in the United States. (Note, however, that at least with regard to the trends depicted in Chart 2, the evidence does not seem to support this view because the out-migration of U.K. and European issuers started in the mid-1990s, long before adoption of the Sarbanes-Oxley Act.)

But while these factors may be influencing some issuers, what is most notable is that foreign equity issuers are largely shifting to their *home* markets. Thus, this development does not necessarily mean that the U.S. equity market is becoming less attractive in an absolute sense. Rather, it may mean that markets in other countries are advancing and therefore achieving parity with their U.S. counterpart.

The changing role of the U.S. equity market in many ways mirrors the nation's changing role in the global economy, where other countries are now more prosperous than in the past, have deeper pools of capital, and offer more liquid and sophisticated financial markets that adhere to strengthened corporate governance principles. In particular, the European financial system underwent a major transformation in the 1990s, brought about by financial sector liberalization, the emergence of the euro, and bank disintermediation—the reduction in the role of banks as financial intermediaries for corporations. More competitive and integrated European equity markets now have the capital depth to retain their home companies. Significantly, almost all continental

Chart 3
Share of Foreign Company Listings



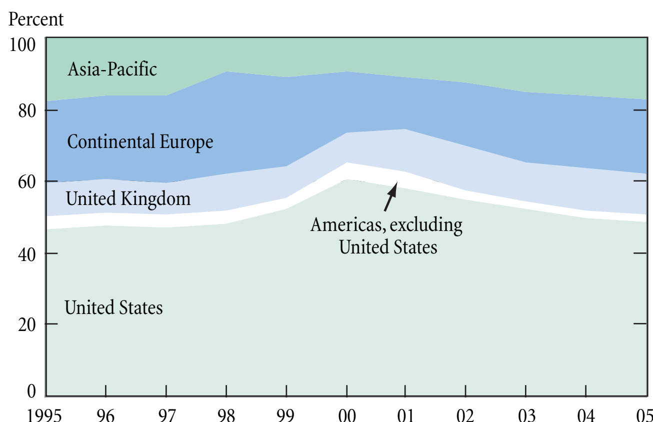

Sources: World Federation of Exchanges; various stock exchange fact books.

Note: AIM is the Alternative Investment Market segment of the London Stock Exchange; it was launched in 1995 as a market mainly for smaller companies backed by venture capital.

European issuers that may have chosen to bypass the U.S. markets in favor of an issuance elsewhere opted to list in their home market: the fraction of European firms listing domestically rose from approximately 60 percent in 1995 to more than 90 percent in 2005.

Another factor cited as evidence of declining U.S. competitiveness—the drop-off in cross-listing ratios—also merits a second look. Consistent with the slowdown in foreign IPOs, the NYSE's and the NASDAQ's cross-listing ratios—the share of foreign companies listed on the exchanges—remained flat after 2000 (Chart 3). Here too, however, the U.S. experience closely parallels that of other countries: cross-listing ratios actually trended downward for most major exchanges, including Euronext, the Hong Kong Stock Exchange, and the Tokyo Stock Exchange. A notable exception again was the AIM segment of the London Stock Exchange, which attracted numerous international companies (Chart 3, lower right panel). However, the total market capitalization of the 1,400 companies listed on AIM at the end of 2005 was only about $140 billion, a small fraction of the London Stock Exchange's $3 trillion market.[7] Despite AIM's strong performance, the overall cross-listing ratio of the London exchange—representing trading in foreign shares on the exchange and on AIM—decreased in line with the ratios of most other European exchanges.

Chart 4
Global Share of the U.S. Equity Market by Region




Source: World Federation of Exchanges.

Note: Shares are calculated from information on dollar-denominated trade value reported to the World Federation of Exchanges.

## The Secondary Equity Market

Have the recent struggles of the U.S. primary equity market to attract IPO business adversely affected the secondary equity market? With overseas stock markets better able to retain their home base and draw a greater share of more dynamic and internationally active companies, it is reasonable to conclude that they could also reap the benefits of increased secondary global trading volume. However, we find no persuasive evidence that the secondary equity market in the United States has lost a significant volume of business to competitors abroad.

The global share of the U.S. equity market has remained fairly stable from 1995 to 2005 (Chart 4). It rose briefly above 50 percent during the Internet boom, fueled largely by NASDAQ trading, and gradually reverted to its pre-dot-com level more recently. Furthermore, while the London Stock Exchange has gained hundreds of new companies in the past few years, its share of global trading has remained flat.[8] The ability to attract a large number of stock listings therefore is not necessarily the best criterion for gauging success. Equity markets may find it more important to bring in sound and dynamic companies with the capacity to grow.

## The Corporate Bond Markets

The corporate bond markets, another key source of financing for U.S. and foreign corporations, also offer valuable insight into market strength. Accordingly, we consider recent underwriting trends in the U.S. bond and Eurobond markets—the largest and most viable sources of debt financing for internationally active American and foreign companies. The U.S. bond market is dominated by domestic firms, but it also attracts many foreign issues. Moreover, many American companies that issue domestically also participate actively in the Eurobond market.[9]

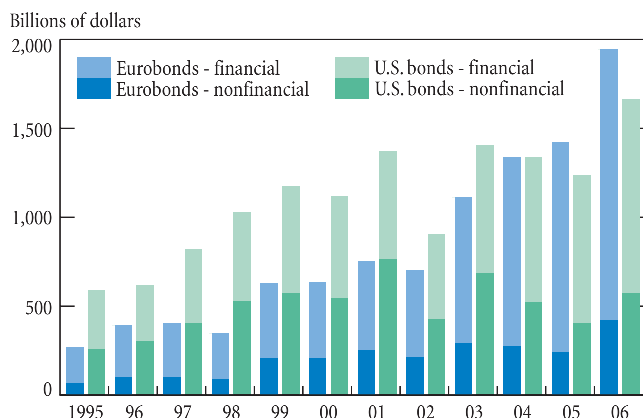
The growth of corporate bond markets in continental Europe was long hindered by a financial intermediation system dominated by close ties between banks and corporations. Over the past ten years, however, the accelerating pace of bank disintermediation and the launch of the euro have greatly strengthened the Eurobond market by reducing underwriting costs. Meanwhile, the U.S. bond market has gradually lost ground to its overseas competitor. The volume of corporate issuances in the U.S. bond market totaled $564 billion in 1995, roughly double the volume originated in the Eurobond market. More recently, the strong lead enjoyed by the U.S. bond market has vanished, as the volume of corporate issuances is now greater in the Eurobond market (Chart 5).

[7]AIM is essentially an early-stage market that does not compete directly with large international exchanges.

[8]The attractiveness of the London Stock Exchange owes in large part to the perception that it is a model market, offering issuers less costly listing terms and simpler disclosure requirements (Oxera Consulting Ltd. 2005). For recent press accounts, see Erika Brown, "London Calling," *Forbes*, May 8, 2006, p. 51; Clay Risen, "Is London the World's New Financial Capital? The New New York," *The New Republic Online*, November 17, 2006; and "Commentary: London's Freewheeling Exchange," *Business Week*, November 27, 2006, p. 40.

[9]The Eurobond market is described in greater detail in Choudhry (2006).

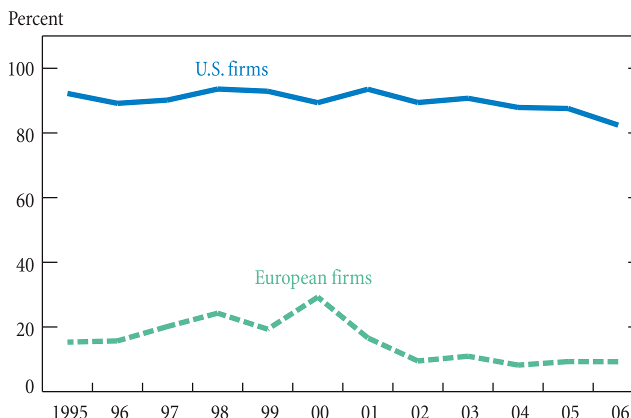
Chart 5
Corporate Issuances in the U.S. Bond Market and the Eurobond Market




Source: Securities Data Corporation.

Note: Figures exclude asset-backed issues.

Chart 6
U.S. Market Share of Bond Issuers from Different Regions




Source: Securities Data Corporation.

Note: Figures are based on the dollar volume of issuances.

In contrast to the equity markets, where nearly all American IPO firms exhibit a strong home bias, in the U.S. bond market, a large fraction of U.S. issuers also rely on the Eurobond market for funding. Perhaps even more disconcerting for the U.S bond market is the steady decline in the share of American firms issuing domestically, from 92 percent in 1995 to 82 percent in 2006 (Chart 6). The erosion in U.S. market share is also evident in the decrease, from 95 percent in 1995 to 83 percent in 2006, in domestic nonfinancial issuers, as these firms seek greater access to the Eurobond market. Furthermore, the share of European issuers borrowing in the U.S. bond market dropped from more than 20 percent in 2000 to approximately 9 percent in 2006. In addition to issuing more equity in their home markets, European firms are increasingly turning to the Eurobond market for their debt financing.

The Eurobond market offers several advantages that may account for its rising popularity. It gives U.S. borrowers access to a wider range of lenders and debt instruments, enabling them to diversify their sources of long-term funding. In addition, the market provides a good environment for internationally active companies to hedge foreign currency exposures as well as to enhance their global profile. The rapid growth of international and domestic corporate debt markets was also boosted by investor demand for higher yielding corporate securities, which, however, typically have greater credit risk exposure. The increased appetite for risky securities was aided by the development of hedging technologies and products such as credit and foreign exchange derivatives.

Interestingly, the Eurobond market's global market share would be even larger if we factored in specialized asset-backed issues such as collateralized debt and loan obligations. The explosive growth in asset securitization over the past decade has made these structured financial products an important asset class in the bond markets. As such, the total volume of asset-backed issues in the Eurobond market surged from $45 billion in 2000 to more than $700 billion by the end of 2006. The Eurobond market has traditionally been the domain of top-rated large banks and other financial issuers; together, they accounted for roughly 75 percent of Eurobond volume from 1995 to 2006. It is therefore not surprising that the market would serve as home to other highly rated issues such as structured securities. The market's self-regulated environment offers another important advantage for structured products, because this debt is often sponsored by hedge funds, whose trading strategies are best suited to this type of environment.

Recent reductions in underwriting costs associated with Eurobonds are likely another factor compelling many top-rated U.S. financial firms to borrow overseas. Ultimately, the true cost to issuers is measured by the net price of the bond, or the price after gross underwriting expenses. In the United States, underwriting fees, or the gross spread, paid by borrowers on a conventional ten-year dollar-denominated bond with an A rating have remained fairly stable, at around 50 basis points, rising only slightly during the 2001-02 recession. In contrast, there has been a significant reduction in underwriting costs—from more than 100 basis points in 1996 to approximately 50 in 2006—for an A-rated Eurobond of the same maturity.[10] The sharp decline in gross spreads in

[10]Santos and Tsatsaronis (2003) attribute the reduced underwriting expenses to the introduction of the euro and other reforms associated with European monetary unification.

the Eurobond market has thus made it more attractive to investment-grade corporate borrowers, at the expense of the U.S. bond market.

In many ways, the rush of investment-grade U.S. corporations to issue in the Eurobond market is a by-product of financial globalization trends; nevertheless, it does raise concerns for the American debt market. Foremost, the growing reliance on cross-border markets by many high-quality large U.S. financial firms could undermine the credit quality of the U.S. bond market. In an extreme scenario, most high-grade U.S. companies could issue exclusively overseas, leaving the domestic bond market to be dominated by lower rated companies. A primary debt market composed mainly of high-yield issuers would be more vulnerable to macroeconomic fluctuations and systemic risks.

The evidence thus far suggests that the surge in cross-border issuances by many American financial firms has not affected the credit quality of the U.S. corporate debt market. Overall, the median Standard and Poor's rating of U.S. firms borrowing domestically has actually improved, from A in 1995 to around A+ in 2006. In contrast, the influx of riskier American, European, and other international issuers has undermined credit standards slightly in the Eurobond market, where the median rating deteriorated from AA in 1995 to AA- in 2006.

## Conclusion

In recent years, the shrinking number of companies listing on the New York Stock Exchange and the NASDAQ has suggested that the U.S. capital markets may be ceding their lead to overseas exchanges. Indeed, the U.S. equity market is no longer drawing the same large number of foreign IPOs. The decrease in listings on the NYSE and the NASDAQ, however, is not an isolated occurrence—most other large exchanges are experiencing similar declines in new foreign listings. This phenomenon can be attributed to several factors, such as the effects of the tech sector's boom-and-bust cycle and the significant technological gains made by competing financial markets. The decrease in listings on the NYSE and the NASDAQ therefore is not necessarily a sign of weaker U.S. markets. Overall, the NYSE and the NASDAQ remain the world's most actively traded markets.

Rather, it is in the global corporate bond markets where some signs of eroding U.S. strength are showing. The U.S. bond market has fallen behind the Eurobond market in terms of the total volume of debt issued, and it is no longer the first choice for some U.S. debt issuers. Nevertheless, despite borrowing from the Eurobond market in greater numbers, American companies continue to use the U.S. and Eurobond debt markets in a complementary fashion to meet their funding needs. U.S. firms in particular still rely on their home market for a large share of debt financing.

Several proposals to reform the regulatory process and legal enforcement principles are being considered to address trends in the U.S. equity market. Other forces are also at work that could affect the competitiveness of the market. For example, in April 2007, the NYSE formally acquired Euronext, and in May 2007, the NASDAQ and the OMX Nordic Exchange agreed to merge. In addition, the NASDAQ has shown strong interest in acquiring the London Stock Exchange. These trans-Atlantic activities are perhaps the first steps toward the establishment of truly global stock markets.

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### About the Author

Stavros Peristiani is an assistant vice president in the Banking Studies Function of the Research and Statistics Group.



*Current Issues in Economics and Finance* is published by the Research and Statistics Group of the Federal Reserve Bank of New York. Leonardo Bartolini and Charles Steindel are the editors.



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