Third Lecture
Instruments: What Does Finance Look Like?

In what sense are bonds and stocks “income generating”? In what sense are currencies, commodities and derivatives “income distributing”?

Money
- Neutrality or power?
- Inflation – does the tide really lift all boats?
- Money: is ownership “unreal”?

Instruments
- Finance as capital
  - Value = expected future income / (rate of interest * risk factor)
  - Debt, equity, commodities, derivatives
  - “income-generating” vs. “income redistributing”

Debt
- Promise vs. expectation
- Bond value = interest payment / (rate of interest * risk factor)
- How the rate of interest is determined?
- Government debt and taxation: commodifying state power
- Government debt and the birth of capitalism
- The bond market
- Liquidity and benchmarking
- Monetary policy: short term rates, long-term yields – what determines what?
- Fiscal policy: government deficit, government debt

Equity
- Equity vs. debt
- Balance sheet and income statement
- Interest \( \rightarrow \) debt
- Profit \( \rightarrow \) equity
- Equity value = expected profit / (rate of interest * risk factor)
- Bigger returns, bigger risk
- Stock prices and the economy: a very imperfect fit

Securitization and the commodification of power
- Equity and the corporation
- Capitalization: mother credit
- Structure of corporate finance
- Capitalism: debt-based versus equity-based

Redistributive investment
- Currencies, commodities and derivatives
- What makes the exchange rate move – relative prices, relative return, speculation
- Commodities: the roulette of finance
- Derivatives: the Russian roulette of finance
- Risk transfer and stabilization
Capitalization:

\[
capitalisation = \frac{expected\ earnings}{risk \times normal\ rate\ of\ return}
\]

\[
$1bn = \frac{$60mn}{1.2 \times .05}
\]
US INTEREST RATES (%)

NOTE: Series are expressed as 3-month moving averages.
SOURCE: US Federal Reserve Board; DRI

US GOVERNMENT DEFICIT AND DEBT ($billions, 1996 prices)

SOURCE: DRI.
US Total Return (Annual % Change)

S&P 500

10-Year US Government Bond

SOURCE: Global Financial Data

US Total Return (with reinvested dividends and interest)

log scale

S&P 500 (left)

10-Year US Government Bond (left)

Stock/Bond Ratio (right)

SOURCE: Global Financial Data
STOCKS PRICES AND THE ECONOMY (annual % change)

* Converted from quarterly figures.
NOTE: Series are expressed as 12 month moving averages
SOURCE: DRI

STOCK PRICES, EARNINGS AND INTEREST RATES (annual % change)

* Long term earnings divided by long term bond yields
NOTE: Series are expressed as 5-year moving averages
SOURCE: DRI
MARKET VALUE OF US CORPORATIONS (% of GDP)

EQUITY

DEBT

*Equity FFUNDS code: 893064105, Corporate debt FFUNDS code: 893163005, 263163003.
SOURCE: Federal Reserve Board; US Bureau of the Census; DRI.

US CORPORATE EQUITY TO DEBT RATIO

*Equity FFUNDS code: 893064105, Corporate debt FFUNDS code: 893163005, 263163003.
SOURCE: Federal Reserve Board; DRI.
Capitalization and Capital Structure in 39 Countries*

* Data points are averages of 1990 and 1996
SOURCE: WORLD BANK; IFC; US Department of Commerce
EXCHANGE RATES AND RELATIVE PRICES: GERMANY VS US

EXCHANGE RATE
($ / DM, left)

RELATIVE PRICES
(US CPI / GERMAN CPI, right)

SOURCE: IMF; DRI

PRICES (annual % change)*

World Commodity Prices

CPI in the Industrialised Countries

* In SUS.
SOURCE: IMF; DRI