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 ➔ debt**
- **Profit ➔ 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**

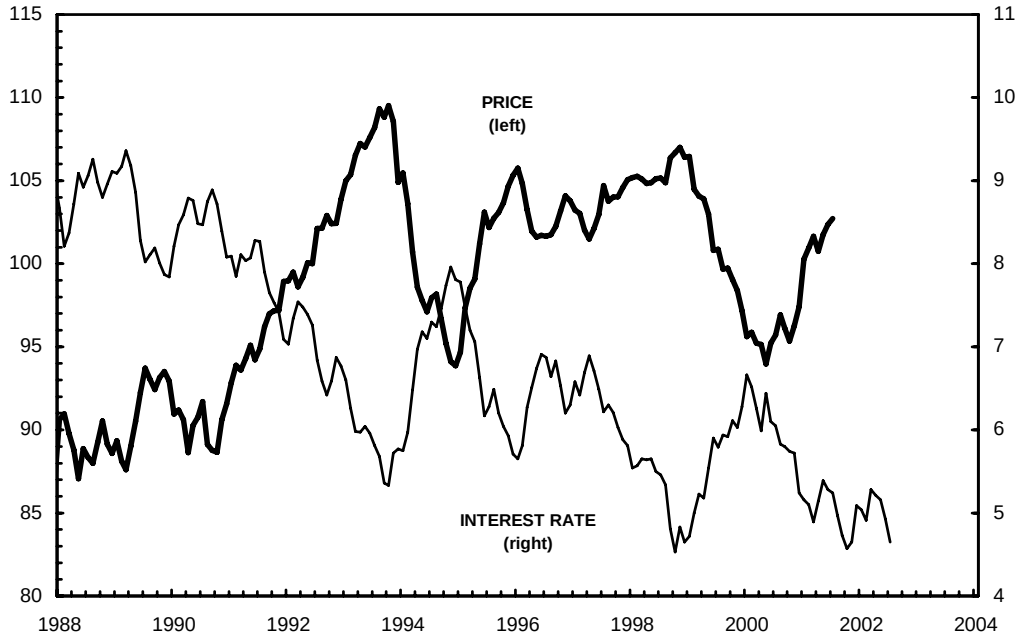
Redistributive investment
- **Currencies, commodities and derivatives**
- **What makes the exchange rate move – relative prices, relative return, speculation**
- **Commodities: the roulette of finance**
- **Derivatives: the Russian roulette of finance**
- **Risk transfer and stabilization**

Capitalization:

$$capitalisation \equiv \frac{excpected\ earnings}{risk \times normal\ rate\ of\ return}$$

$$\$1bn \equiv \frac{\$60mn}{1.2 \times .05}$$

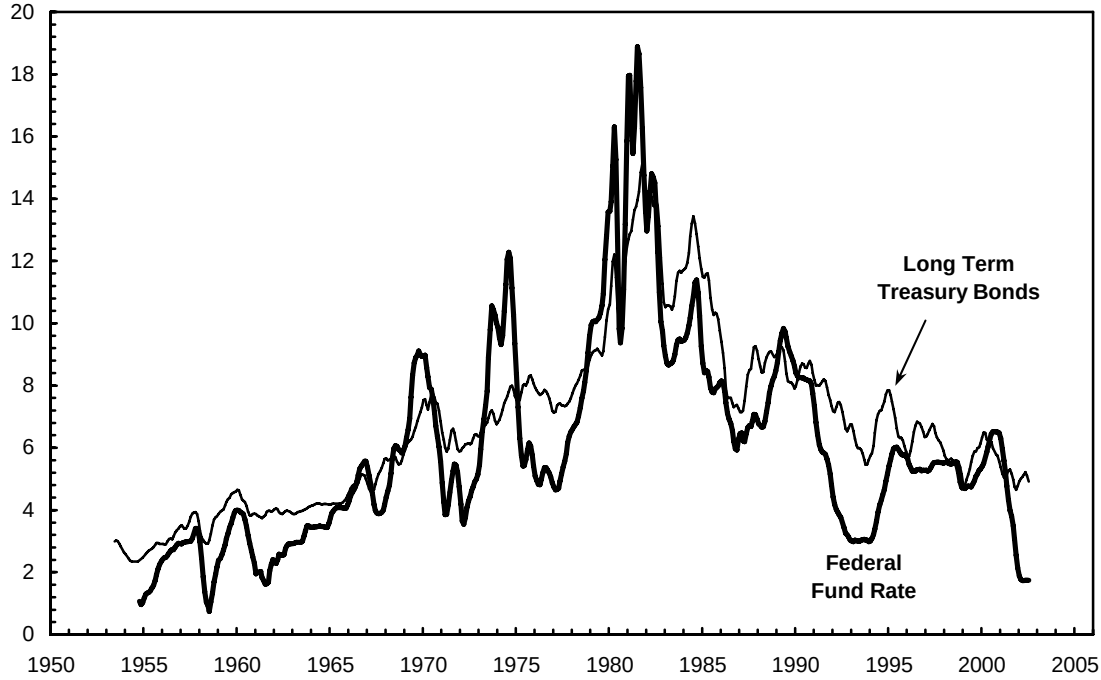
US GOVERNMENT BOND PRICES AND INTEREST RATES



NOTE: Data based on long term government bonds.
SOURCE: DRI

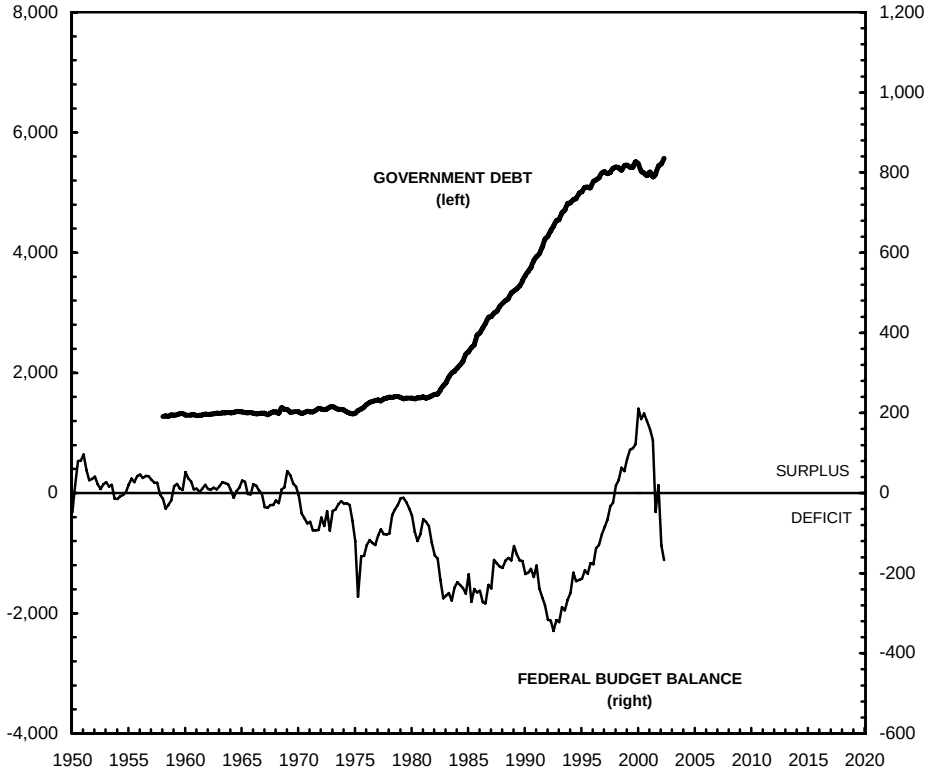
USStkBon.xls

US INTEREST RATES (%)



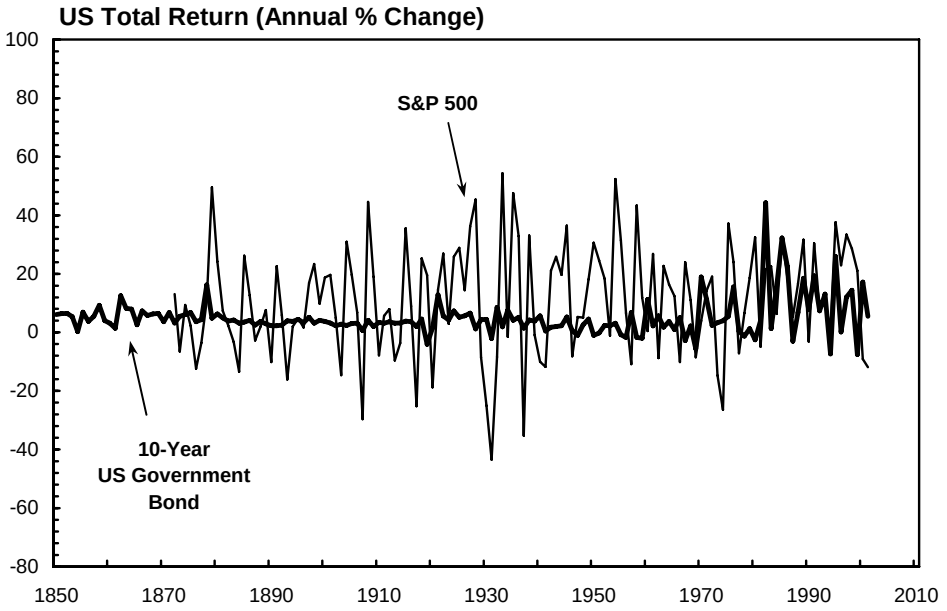
NOTE: Series are expressed as 3-month moving averages.
SOURCE: US Federal Reserve Board; DRI

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

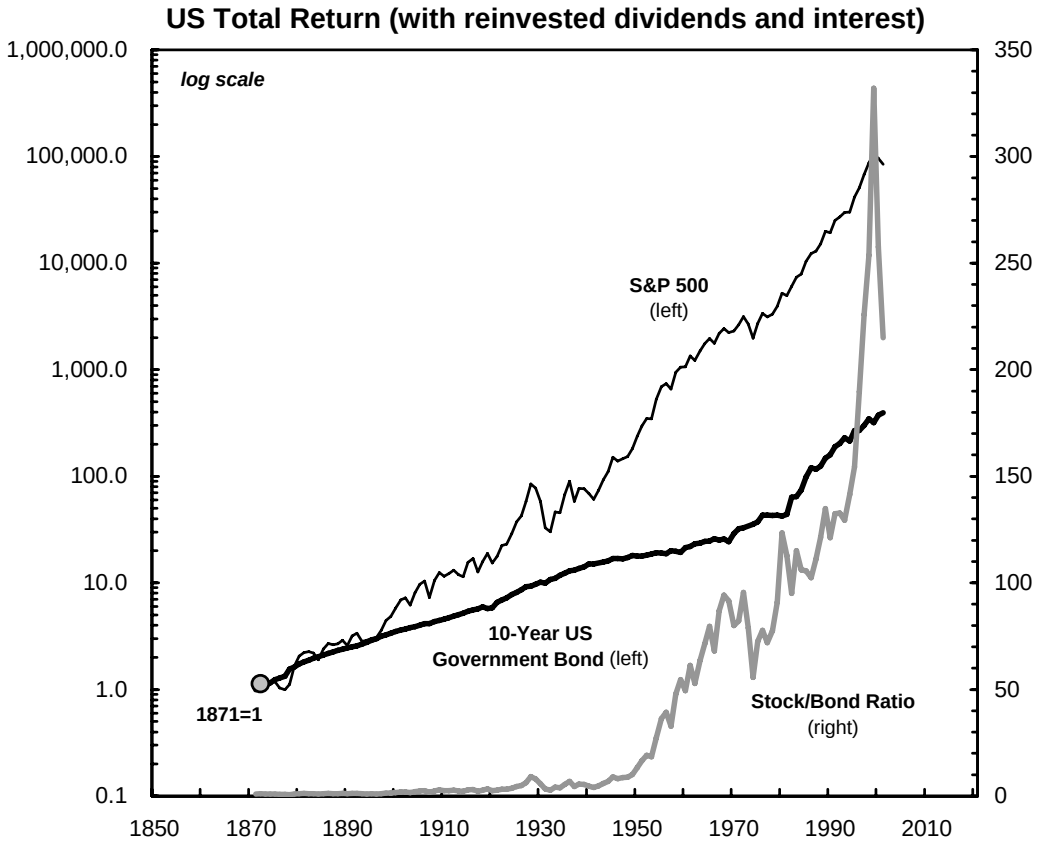


SOURCE: DRI.

US-R-M1.xls; US-FA1.xls



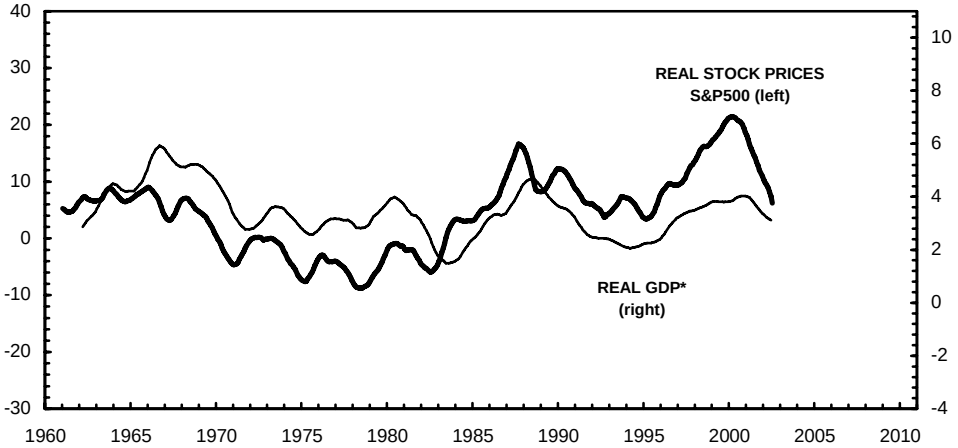
SOURCE: Global Financial Data



SOURCE: Global Financial Data

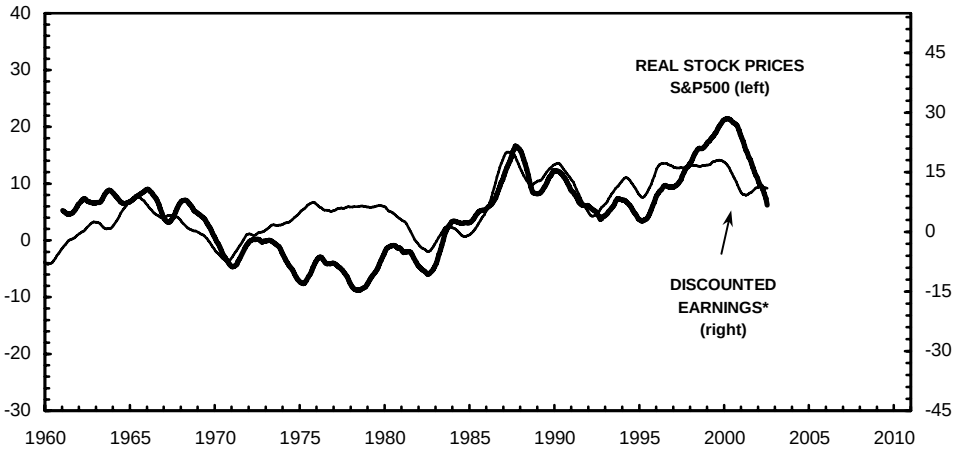
Total Return Indices.xls

STOCKS PRICES AND THE ECONOMY (annual % change)



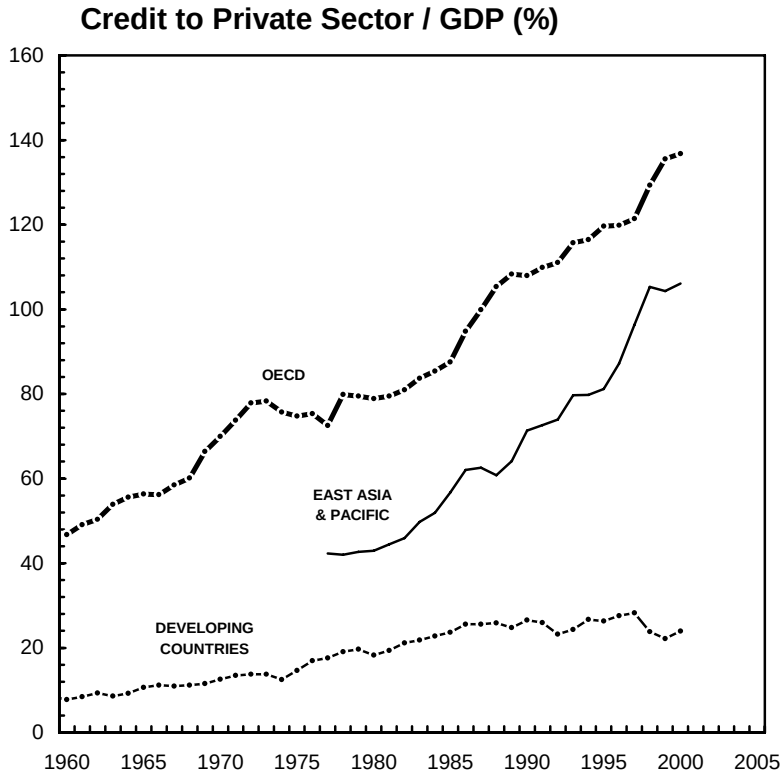
* Converted from quarterly figures.
NOTE: Series are expressed as 12 month moving averages
SOURCE: DRI

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



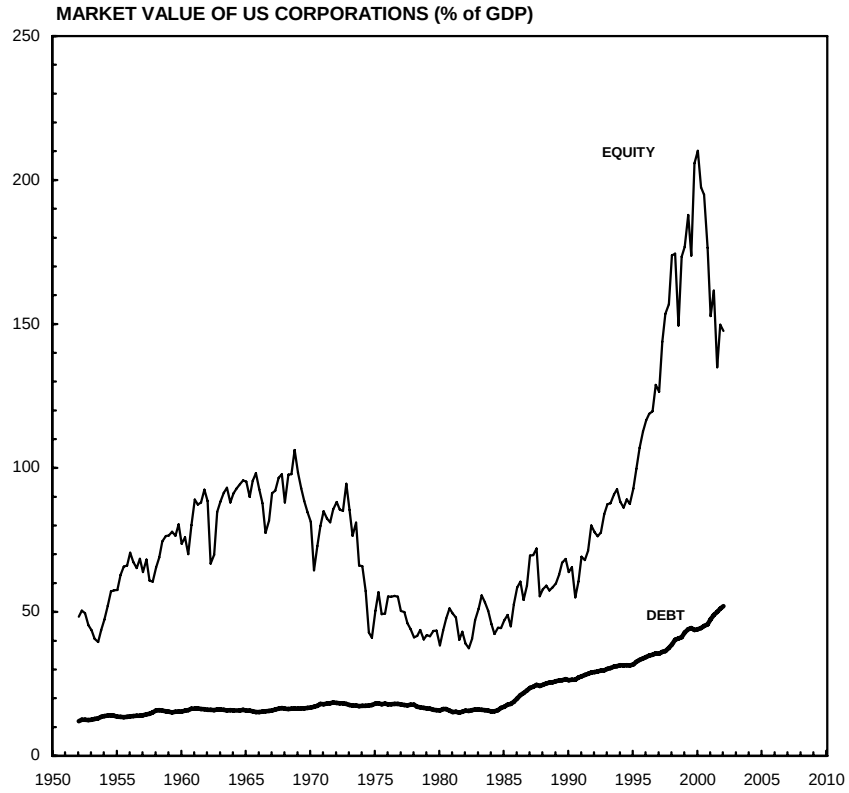
* Long term earnings divided by long term bond yields
NOTE: Series are expressed as 5-year moving averages
SOURCE: DRI

SP500-M1.xls

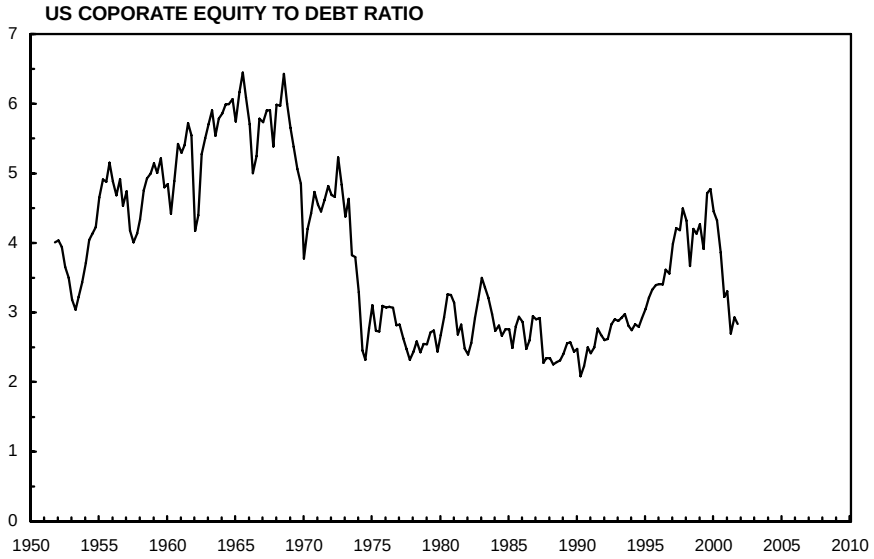


SOURCE: WORLD BANK

Capitalization-world.xls



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



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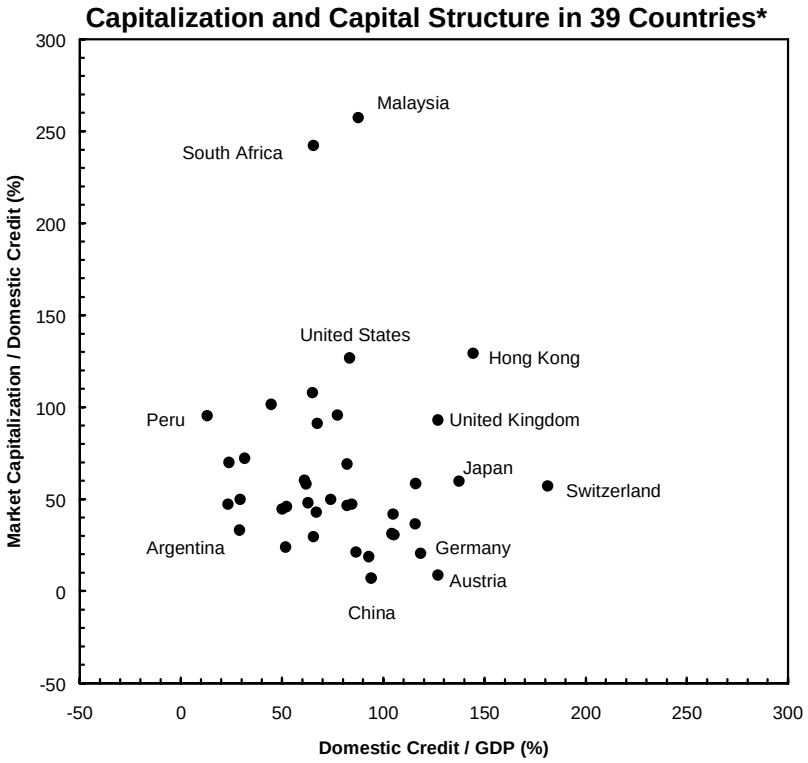
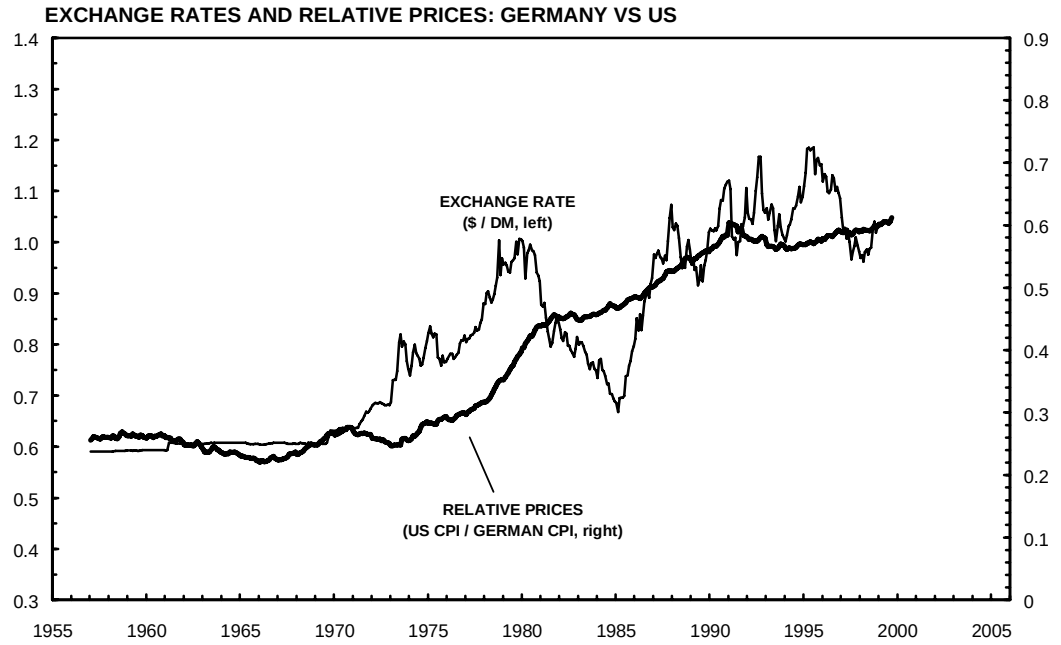
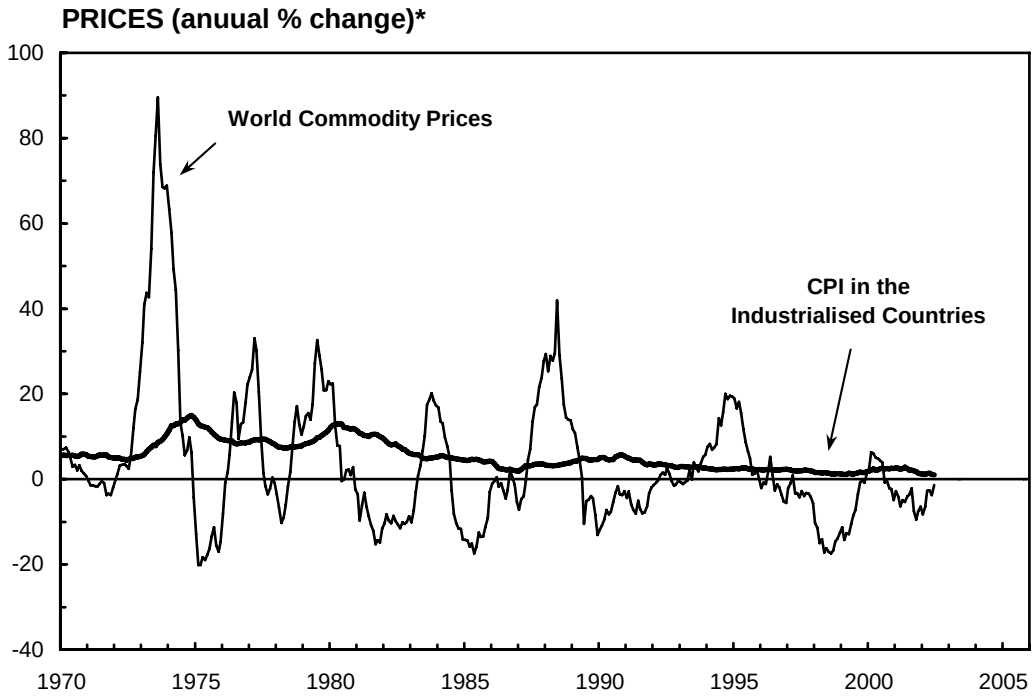
US-FA1.xls



* Data points are averages of 1990 and 1996
SOURCE: WORLD BANK; IFC; US Department of Commerce



SOURCE: IMF; DRI



* In $US.
SOURCE: IMF; DRI