

# Finance & real capital

Edward Dommen

---

---

---

---

---

---

---

---

**First we assemble the  
building materials we  
need**

---

---

---

---

---

---

---

---

*Resources needed for  
production*

---

---

---

---

---

---

---

---

Many classifications can be used, e.g

- Land
- Labour
- Capital
- Raw materials and other purchased inputs

---

---

---

---

---

---

---

---

- Raw materials and other purchased inputs are in turn produced by combining land, labour and capital (and other purchased inputs)

---

---

---

---

---

---

---

---

Collective goods and services are also indispensable to the firm's work

- Participatory democracy
- The law & order which follows from it
- Education
- Public health
- Public infrastructure
- Etc.

---

---

---

---

---

---

---

---

## These are normally financed by taxes

- So firms need to pay taxes, to contribute to the cost of providing these inputs into their processes of production.

---

---

---

---

---

---

---

---

## *Money*

---

---

---

---

---

---

---

---

## The uses of money

- **A means of exchange**
- **A standard of value**
- **A store of value**
  - Note 'a', not 'the': other devices can play these roles as well.
- **An object of trade in its own right.**

---

---

---

---

---

---

---

---

# Time

- A good or service at one point in time  
≠ a good or service at another point in time

---

---

---

---

---

---

---

---

# Now we start building

---

---

---

---

---

---

---

---

- Let us take money as a
  - means of exchange
  - store of value
- together.
  
- In money I include every financial title which can be immediately used to purchase goods & services (in particular current bank accounts).

---

---

---

---

---

---

---

---

# Liquidity

- Liquidity depends on the
  - Speed
  - Certainty
- With which an asset can be turned into money
- Assets (financial or other) can be more or less liquid.

---

---

---

---

---

---

---

---

- In a suitably organised market economy, money can be exchanged for
- *all the purchased inputs*
- *Many of the collective goods & services*

---

---

---

---

---

---

---

---

Money provides an undifferentiated command over a wide range of goods & services

- For that reason, money is often called capital
  - In economics, **Capital** is a stock of resources that may be employed in the production of goods and services (Encyclopedia Britannica 1994-99).
  - cf. stem cells.

---

---

---

---

---

---

---

---

## Money and time

- **Money can buy at this moment**
- a good or service now (*spot*)
- a good or service to be supplied at a fixed date in the future (a *future*)
- the right – but not the obligation – to buy a good or service under specified conditions (especially price) at a fixed period in the future (an *option*).
- insurance: the right to be compensated if some unfortunate specific event happens (fire, bad weather, the failure of a customer to meet a contract).

06/08/04

16

---

---

---

---

---

---

---

---

## Many of the things which money can buy can be sold for money

- Even if they were bought to serve in the process of production, they can be sold if that is more profitable.
- Thus goods & services can also be a store of value or a means of exchange.

06/08/04

17

---

---

---

---

---

---

---

---

- Example:
- The airline Swiss had bought fuel forward so that it could plan with a fixed and known price of this important input, thus concentrating on its business of flying airplanes.
  - It needed liquidity, and money is more liquid than kerosene!
- It sold this contract early this year at a profit, but soon after was faced unprotected with the need to buy fuel at much higher spot prices at the time of the invasion of Iraq.

06/08/04

18

---

---

---

---

---

---

---

---

- An enterprise which wants to concentrate on a particular activity can sell to others or buy from them all sorts of incidental aspects of their activity of which they wish to be relieved – at a price.
- Taking on other people's risk is itself a productive service.

---

---

---

---

---

---

---

---

## speculation

- to buy or sell with the sole purpose of making a profit from changes in price.

---

---

---

---

---

---

---

---

## Speculation can be useful

- In some countries (e.g. Haiti), the trader who buys agricultural produce from the farmers (at harvest time) and holds it until consumers need it (spread throughout the year) is called a 'speculator'.
- The speculator provides a storage service, which is useful.

---

---

---

---

---

---

---

---

## *Money as a standard of value*

06/08/04

22

---

---

---

---

---

---

---

---

- Because so many things can be bought & sold for money, money provides a convenient standard of value.
  - Are 2 apples worth more than 3 pears?
  - What is the value of 1 sausage + 1/2 litre of beer?
- Thanks to money, questions like that are easy to answer.

06/08/04

23

---

---

---

---

---

---

---

---

## **What is a firm worth?**

- In principle, the same method gives the answer: add up the value of every thing the firm owns.
- But it is not always obvious what the value of these things are.

06/08/04

24

---

---

---

---

---

---

---

---

## Inputs

- Supposing it owns inputs. Are they worth -
- What it paid for them?:
  - the simplest answer, but perhaps a useless one.
- What it could now sell them for?
- What it expects to earn by using them?

06/08/04

25

---

---

---

---

---

---

---

---

## Expects ?

06/08/04

26

---

---

---

---

---

---

---

---

## In particular, what about **trust & confidence?**

- Will the firm's suppliers supply? And on the expected terms?
- Will the firm's customers still want to buy? And will they pay?

06/08/04

27

---

---

---

---

---

---

---

---

## At what point can income be taken as certain?

- When it is actually paid? The most obvious answer,
- but some firms prefer to record the income earlier, e.g. as soon as they are sure it is going to be paid.

06/08/04

28

---

---

---

---

---

---

---

---

## If the firm owns futures or options on inputs, what are they worth?

- If it is considering selling them now,
- the price depends on what potential
  - buyers
  - other sellers
- think may happen in the future.

06/08/04

29

---

---

---

---

---

---

---

---

## If it is considering using the inputs in the course of its productive activities

- their value = the flow of income which can be generated for the firm by using them.
- What that amounts to depends on the firm's expectations for its own future.

06/08/04

30

---

---

---

---

---

---

---

---

## Capital goods

- (e.g. machines)
- Everything we have said about inputs applies to machines as well.
- + depreciation

06/08/04

31

---

---

---

---

---

---

---

---

## Depreciation

- Machines wear out with time & use, or they become out of date: their value declines.
- If the firm wants to stay in business, it needs to make reserves so that it can replace the machine when the time comes.
- How to calculate the provisions needed?
- What are the provisions worth until they are needed (they can meanwhile be invested)?

06/08/04

32

---

---

---

---

---

---

---

---

- Those are just examples of the questions which need to be answered to know the value of a firm. And many of the questions are more complicated!
- **That is the work of the accounting profession.**

06/08/04

33

---

---

---

---

---

---

---

---

## Accounting norms and standards

- There are international norms for answering these questions, in particular the *International accounting standards*, determined by the *International accounting standards committee* ([www.iasc.org.uk](http://www.iasc.org.uk)), or the *Generally accepted accounting practices* (GAAP) used in the USA.
- But rules and regulations cannot determine everything. There remains considerable scope for differences in appreciation and treatment.

06/08/04

34

---

---

---

---

---

---

---

---

There is no single objective answer to the question "What is a particular firm worth?"

06/08/04

35

---

---

---

---

---

---

---

---

Accounts are important for determining e.g.

- the value of the firm's shares
- its creditworthiness as a borrower (its "credit rating")
- what it should pay in taxes.

06/08/04

36

---

---

---

---

---

---

---

---

## *Money as a tradable good*

06/08/04

37

---

---

---

---

---

---

---

---

## Money here – money there

- transfer of funds
- foreign exchange trading

06/08/04

38

---

---

---

---

---

---

---

---

## Money now – money later

- forward exchange
- loans at interest?

06/08/04

39

---

---

---

---

---

---

---

---

## People prefer money now to money later

- "a bird in hand is worth two in the bush", so they want to be paid to put off until later the enjoyment of their money

06/08/04

40

---

---

---

---

---

---

---

---

## Money put to good use earns a return over time

- to buy productive goods
- as an object of trade itself, as a raw material for the financial trades

06/08/04

41

---

---

---

---

---

---

---

---

So money provided to someone else to use can earn a return, interest, rent.

06/08/04

42

---

---

---

---

---

---

---

---

## providing capital = creating securities

- Alienating money in this way generates a title:
  - a security, a bond, a share...
- While the person or firm to whom the money has been provided is putting it to use
- the person or firm who provided it owns a
- security which they can
  - sell
  - use as security for a loan
- and so on.

06/08/04

43

---

---

---

---

---

---

---

---

---

---

## What is the main purpose of an enterprise?

06/08/04

44

---

---

---

---

---

---

---

---

---

---

- **Is it to produce goods and services?**
  - better still, useful goods & services
- to provide work?
  - decent work (ILO)
- **or to produce**
- a financial return for some set of the firm's stakeholders?
- securities which can be used as a basis for speculation?

06/08/04

45

---

---

---

---

---

---

---

---

---

---

- The capitalist system has changed its focus from production to finance (p. 2) ...the capitalist market no longer serves the exchange of useful goods and services for all, nor is it willing to be held politically and socially accountable for the common good. (p. 4)

- - *Faith stance on the global crisis of life*, WARC South-South Member Churches' Forum on Confessing/Covenanting for Justice in the Economy and on the Earth (*Processus confessionis*), 23-26 April 2003, Buenos Aires, pp. 2, 4

---

---

---

---

---

---

---

---

- When he purchases an investment, the American is attaching his hopes, not so much to its prospective yield as to a favourable change in [its price], i.e. ... he is ... a speculator.

- J.M. Keynes, *The General Theory of Employment, Interest & Money*, 1936, p. 159

---

---

---

---

---

---

---

---

## Like chicken & egg: which comes first?:

- Does the drive to produce goods & services inspire the search for supportive financial services & instruments?
- or
- Does the urge to financial gain drive the production of goods and services as instruments to that end?
- The two approaches are not exclusive. It is a matter of the relative importance given to each.

---

---

---

---

---

---

---

---

In their 2003 consolidated profit & loss accounts

- Schindler (lifts, escalators etc.), largely dominated by the Schindler family, details
  - material cost
  - personnel cost
  - other operating cost
- Other firms, like Nestlé or Holcim (cement etc.) simply provide in one line
  - Production cost of goods sold
- This concision illustrates an attitude focussed on financial rather than productive concerns.

---

---

---

---

---

---

---

---

## Conclusion

---

---

---

---

---

---

---

---

- finance all mixed up with the real economy.
- The prospect of financial gain can distract funds from investment in the real economy.

---

---

---

---

---

---

---

---

● Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.

● J.M. Keynes, *The General Theory of Employment, Interest & Money*, p.159

---

---

---

---

---

---

---

---