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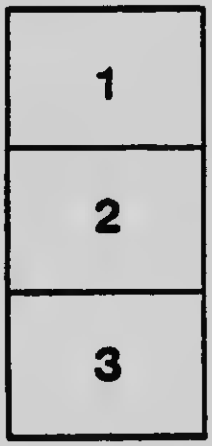

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ECONOMICS

LESSON 12

By

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THE

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ECONOMICS

LESSON XII.

Interest.

IN the last lesson we dealt with the great question of economic rent—that rent which every entrepreneur or captain of industry has to pay for the use of the site on which his business operations are conducted. Now we proceed to discuss the second division of the entrepreneur's product—the payment which he makes in return for the use of purchasing power which belongs to others. In order to begin or to extend his business, he secures the loan of this purchasing power, which is usually transferred to him by the lender in the form of money. In return he promises to make periodically an extra payment known as interest, in addition to returning the principal sum of the loan at some appointed time. He uses the borrowed purchasing power or money to further the process of production. It may, therefore, be known as **capital,** which we have already defined as "the product of past industry used to subserve the process of future production."

Interest is the extra payment made in return for the use of money or purchasing power, that is, the money which is paid for the use of a loan. The principal sum of this loan is being, or is supposed to be, or might possibly, at the option of the borrower, be used to further the process of production, and is thus actually or potentially **capital.**

Meaning of the Term "Interest."

The word "interest" itself, when its derivation is considered, throws some light upon our problem. It is made up of two Latin words: "inter," between, and "est," is;

*Of course, an entrepreneur may be his own landlord or his own capitalist, or both. In that case, however, he should, in order to find his net profit, deduct from his gross profit the sums which others would be ready and willing to pay him as rent for his land or as interest on his capital.

it means, therefore, "there is between," "the space or difference between." This refers to the difference between the position of the man who lends say $100 at the beginning of a year, and his position when he receives that $100 at the end of the year. There is a general impression that the man who lends $100 for a year and receives the same amount back at the end of the year has lost thereby, and is entitled to some payment as compensation, while a borrower who pays no interest on this amount secures a corresponding gain. Usually, in business transactions at least, the borrower agrees to pay to the lender an extra amount as compensation for the lender's having had to do without the use of his purchasing power during a certain period of time. This compensation is interest, the difference between the two positions. We shall later show what scientific truth there is back of this general popular impression.

In the question of interest we are concerned with both buyers and sellers of the use of money or purchasing power. I propose to deal first with the buyers. Some people might, as history shows, save money and lend it even if they received no interest in return; no one, in the business or economic world at least, would borrow money at interest if he did not expect to be able to make a net gain of some kind for himself by the use of it.

Why the Borrower Can Pay Interest.

Suppose that an entrepreneur who is already doing a flourishing business borrows for business purposes the sum of $400, the year's savings of a salaried man who earns $2,000 a year. Now, why does he borrow that money? Clearly because he expects to be able to use it in such a way that it will replace itself with interest and pay a net gain to the borrower as well. He feels that he can use the purchasing power of the $400 which he is now borrowing, in such a way that at the end of the year he will have commodities for which the public will be ready to pay say $450. Then the borrower will be able to pay back the

$400 with interest at say 6% and will still have a net gain of $26 for himself. He may, indeed, use the $400 in a number of different ways; he may devote it to the payment of wages or the purchase of a new piece of machinery. But whatever use is made of it will be in his opinion the most reproductive one, and at the end of the year, if his calculations are correct, he will be the richer man for having had the use of the $400—he will have made a profit for himself in addition to the repayment of the loan, principal and interest.

Not all entrepreneurs, of course, succeed in investing reproductively the purchasing power which they borrow. Whether they do or not depends partly on their own skill as entrepreneurs, but partly also on the chances of fortune —whether the season is a good or a bad one, etc. Every year some entrepreneurs fail to return the principal and interest due on the money—the purchasing power—which they have borrowed. Such entrepreneurs become bankrupt, and those who have loaned their money to them to be used as capital in their enterprises may lose all or a part of their investment.

The great majority of entrepreneurs, however, are able to pay this interest on borrowed capital and still make profits for themselves. The great majority of business enterprises, especially in a young and rapidly developing country like this, are successful. The failures are comparatively few. It is this fact that makes holders of capital willing to lend it to skillful entrepreneurs at a moderate rate of interest. Entrepreneurs who are not recognized a skilful, or who have a risky enterprise to finance, must pay higher interest to compensate the lenders for the possibility of loss. There is a certain possibility of loss in all investments, of course, and the rate charged for money is closely correspondent to the risk.

Why the Lender Receives Interest.

Now we must turn around and discuss the matter from the point of view of the lender of money. Why does he receive interest for that money? Why is he not satisfied or why should he not be satisfied with the return of the money which he actually lent to the entrepreneur? The entrepreneur is able to pay interest for the use of purchasing power because he is usually able to use that purchasing power in such a way as to make a net gain for himself by the use of it. His **ability** to pay interest, however, does not make him the more **willing** to do so. He pays interest on the purchasing power which he borrows because he cannot usually get the use of money or purchasing power for nothing. Why not?

The answer to this question lies very deep down in human nature. It is simply this—that to the normal economic human being, future goods to a certain amount are less valuable than present goods to the same amount. The promise of $100 in a year from now is less valuable than the payment of $100 cash down, even though the promise of future payment is absolutely certain to be fulfilled. If one is offered the choice of $100 in cash now and $100 to be paid to one from the Canadian Treasury a year from now, there is no doubt which one would prefer. "A bird in the hand" may not always be "worth two in the bush," but it is certainly true that a bird in the hand is always worth more than one in the bush. All things future are like the bird in the bush—more or less uncertain. Our own lives are uncertain. We cannot be certain of living out the year until the treasury note comes due. And even if we were, we should still prefer the $100 down, because if we did not, we should lose the year's use and enjoyment of those commodities which the $100 would buy for us. We should lose during the year various pleasures which that $100 would have secured for us, and we could never catch up and secure those identical pleasures again.

The Psychology of Interest.

The workman who, let us say, lends $100 of his savings on the 1st of January, 1913, foregoes the pleasure of using the purchasing power of these dollars for himself; he gives up the possible pleasure to be gained from the use of those commodities which he might have purchased with that purchasing power—say a bicycle, a phonograph—articles out of which he and his family could get a very considerable degree of pleasure. He hands that money, that purchasing power—either directly or indirectly through depositing it in a bank—to an entrepreneur who uses it in developing his business. At the end of the year, let us say, he reappears and draws his money with interest, which presumably at least means an increase of purchasing power, and uses it (assuming for the moment the prices have not changed in the meantime) precisely as he might have done a year previously. Now this man is minus a year's enjoyment of the use of those commodities, but he is receiving as compensation for this loss, additional purchasing power by which he may secure increased pleasure and more commodities in the following year. He has given up his claim to certain enjoyments and satisfactions during the year 1913; consequently he is entitled to receive greater enjoyments and satisfactions in the year 1914. If he did not, where would be the use in anyone saving?

There would be some use in doing so. A man might save for "a rainy day," or he might save and deny himself in order to prevent his family suffering after he was dead, even if there were no such thing as interest. But certainly very much less would be saved than is now the case, and the entrepreneurs would likely find their enterprises tied up for lack of capital. The average man is not any too willing to postpone his enjoyments to the future even as it is. He would be much less so if he found this postponement unaccompanied by any gain of purchasing power.

Our position, then, is this: There is a sacrifice to the lender in giving up the use of his money (his purchasing power) for a certain given period of time, and therefore he must have, in business loans at least, a reward to compensate him for his sacrifice and to induce him to make that sacrifice which it is important for our industries that he should make. Of course, a man will lend money to a friend without expecting to receive interest for the use of it. This is, however, exceptional; such a man is making a sacrifice on the altar of friendship; he is not acting from economic motives at all.

Generally speaking, then, any sane person asked to choose between a certain amount of money down and the same amount at some period in the future, would choose the former.* If, however, he were asked to choose between \$100 now and say \$106 a year from now, he might very well hesitate. The extra \$6.00 might or might not seem to him sufficient recompense for the amount of waiting involved.

We have now noticed the two factors connected with the existence of interest: (1) that of the buyer of purchasing power—the entrepreneur; (2) that of the seller of purchasing power—the capitalist.

Market Rate of Interest.

These people are, as we have seen, in the position of buyer and seller—the buyer and the seller of purchasing power. They will higgle over the price to be paid for the

*Some economists dispute this, saying that a man is often ready to pay a larger sum now to secure a smaller sum in his old age. This is, no doubt, true in certain cases. Some people have such a morbid fear of dying from starvation in their old age that they would be ready to pay \$1,000 now to be absolutely sure of receiving \$500 at the age of seventy. Such persons are, perhaps, more numerous in older societies. Their comparative rarity in Canada is well established by the relatively small amount of money received by the Dominion Government under its old age pension scheme, even though that scheme, far from giving people less than they pay in, guarantees to give them or their heirs more.

The average person shares somewhat in this fear of being left without money, and is ready to a certain extent to sacrifice interest for the sake of having cash on hand. The ordinary man likes to have available a few dollars more than he is likely to spend. Practically all of us are prepared to put up with the loss of interest on a limited sum, rather than lock that sum up in some permanent investment and then perhaps suffer for the lack of ready cash. These special exceptions, however, in no way invalidate the general economic principle.

use of purchasing power, just as buyers and sellers higgle in any other buying and selling transaction. This would be the case even if there were only one buyer and one seller. But, as a matter of fact, there are many buyers and very many sellers of purchasing power or capital on a money market, and the current rate of interest is decided by the higgling that takes place between all of them. It is worthy of notice, too, that on the whole the price of money—the price of capital—tends to be more uniform in different markets than the price of almost anything else. This is the case because money or purchasing power can be so easily transferred from one country to another and from one market to another.

Pure or Net Interest, and Gross Interest.

This uniformity exists, however, only with respect to pure interest, that is, interest which is not complicated with payments for risk.* A great deal of what we usually call interest is in fact payment for risk, or payment for inconvenience due to having one's money tied up when one needs it. Most of us are satisfied to have our funds earning a very low rate of interest or even no interest at all in a bank, provided that we feel perfectly certain of being able to use them at any moment we may require them. If we want an absolutely secure investment which will give us an idea of what pure interest really is, I suppose we cannot have a better example than British consols—that is, the Perpetual Annuities of the British National debt, guaranteed by the whole credit of the British people. The price of such an annuity of £2 10s per annum is at the present time about £75 or 30 times the interest payment. In other words, the rate of interest earned is 3 1/3%. One may, perhaps, regard this as pure interest so far as England is concerned.

Pure interest in Canada is rather higher, but we have

*Marshall calls this **net** interest, while the market rate, including payments for risk, for inconvenience of having money tied up, etc., is **gross** interest.

no such well-known standard to measure it by, as most of our Canadian Government securities are held in London. Perhaps the government bonds of the Province of Ontario, which has a very favourable financial position, enormous resources and a comparatively small debt, might be recognized as an investment where the element of risk is and is known to be practically eliminated. In January, 1913, these were advertised to yield 3.90 per cent. We may consider this rate an approximation to pure interest as we have it in Canada. There are lower yields on stocks quoted in our stock markets, but in such cases the stocks are being dealt in for speculative purposes rather than as an investment—rather for prospective advance in the selling price than for the interest yield.

If we look at the stock prices and yields of dividend paying stocks as shown in any number of a Canadian financial paper, we shall see the rates of yield going all the way up from about 4% in the case of provincial government loans to about 4½% in the case of large Eastern cities, to 5% in the case of small Western cities, 6% in the case of industrial bonds, 7% to 8% in the case of preferred industrial stocks, and as high as from 20% to 25% in the ease of mining stocks where there is or is thought to be a great risk of loss through the failure of "pay dirt." All these extra returns are payments for risk and are not a part of true interest at all. It is worthy of notice that the reputation of a stock—which may be undeserved—will affect the price of its issues and therefore the yield on an investment in it.

Variations in Rate of Net Interest.

We have said that pure interest in Great Britain as measurer by the price of Consols, is about 3 1-3%. Now it has not always been so high as that. In 1897 the rate of pure interest in Great Britain was only about 2½%—it eost £112 to buy an annuity of £2 15 shillings. Why is there such a difference now? The reason may be stated briefly. Pure interest is a market price of capital, arrived at between the buyer of capital and the seller of capital. If there are many buyers and few sellers of capital, the rate of pure interest is high; if there are few buyers and many sellers, the rate of interest is low. In 1897 the supply of money for investment was greater than the demand; to-day the demand is greater than the supply.

Interest Rate and Its Influence on Saving.

It may be said that in a period like the present when the rate of pure interest is comparatively high, the sellers of capital will use every endeavour to increase their savings. The increased yield on those savings will make it worth their while to do so. It must be remembered that every dollar saved means a doing without something that they might possibly have had, and that it costs a man more and more self-sacrifice to increase his savings.

When a man who has been saving nothing out of his $2,000 salary begins to save $100 a year by reducing his expenses, he naturally sacrifices first of all those articles which out of all that he has bought during the year, have had least utility to him. When he determines to save $200 a year, he must cease to purchase articles whose utility to him was greater than that of the articles which he might have purchased with the first $100 saved. Every additional hundred that our man with the $2,000 salary saves means a greater sacrifice of his tastes, his little luxuries, his comforts. At last he may come to the point where he is ready to sacrifice the very necessities of life in order to be able to save a few extra dollars, and here it may well cost him as much hardship and sacrifice to save an additional $5 or $10 as it did to save the first $100.

Just as we all know people who sacrifice the future to the present, who save nothing at all for future needs, so we probably know people who sacrifice the present to the future, who save so strenuously for their possible future needs that their life in the present is hardly worth living. They are more rarely met with than the spendthrifts, but there are a good many of them all the same.

Now as it demands a greater sacrifice on the part of the owner to save the second hundred of his $2,000 income than the first, it will in all probability take a higher rate of interest to induce him to save it. It will take a higher rate of interest to induce him to save the third hundred than the second, and a higher rate to save the fourth hundred than the third.* If he saved $300 a year when the rate of pure interest was 3½%, he may save another hundred when the rate of pure interest goes up to 4%. The stimulus leading him to save is just so much greater. Of course, he may not invest in the 4%, but in something where there is a risk of losing and where the return is higher. Still the return in the enterprise chosen is likely to be higher when the rate of pure interest is 4% than when it is only 3%. He probably receives 1% more than he otherwise would in either case.

Denunciation of Interest.

The institution of interest has been extensively denounced of late years by many so-called social reformers, particularly by the Marxian Socialists, as involving the robbery of the wage-earners and their reduction to a state of what is known as "wage-slavery." The return paid to the shareholders in a railway or a business is, according to them, filched from the wage-earners of that railway or that business institution. They have to do the work while the shareholder sits back and takes the money which he has not earned.

Early Prohibition of Interest.

The best answer to such an argument is to he found in the history of interest. The socialists pornt to the pro-

*If you neglect his life insurance as savings, and consider it as a sort of replacement allowance for the loss of the human machine to those dependent upon him, the truth of our illustration will be more obvious. The average salaried man with a family and no saved-up capital, will take out a policy to replace his earning power in case of his death, whether he does any other saving or not. Of course, the amount he will need to take will vary with the cost of living and rate of interest obtainable on money.

hibition of interest in early times as a ground for its abolition to-day, but they fail utterly to understand the difference of conditions which we shall now proceed to explain.

The laws of Moses, the philosophy of Aristotle, the ethical teachings of the early Christian Church, all forbade or discountenanced the payment and the receipt of interest. The reason for this prohibition of interest in early societies is simply this: among a primitive agricultural people the money advanced to a borrower by a lender was not intended to be nor was it likely to be used in a reproductive way by either of them, so that the borrower made no profit in money or commodities by its use, nor did the lender lose anything special by parting with it for a time. His wants could probably be quite satisfied without it. In a simple agricultural society like that of Palestine at the time of Joshua or of England in the reign of William the Conqueror there was very little opportunity for the reproductive investment of capital; in fact there was little capital needed by the ordinary cultivator, except a yoke of oxen, a few rude tools and seed corn. If he borrowed, he did so, not to improve his land or to increase his live stock, not to earn a bigger dividend, but simply to buy corn enough to feed himself and his family until the next harvest.

Money used for such a purpose cannot be called capital at all, since we have already defined capital as "the product of past labour used to subserve the process of future production." Capital is loaned for reproductive purposes; these loans were made for unproductive consumption. There was usually a charitable motive in them, as indeed is indicated by several New Testament passages, as well as by innumerable mediaeval references. They were charitable or paternal, not economic or business loans. The borrower did not gain anything by borrowing; the lender who had money to lend, lost little by lending it, since he could not usually invest it reproductively. Loans were made, therefore, "for the love of God," and not for any economic motive whatever. If the lender were not influenced by "the love of God" he would probably not lend at all.

Interest in the Middle Ages.

In mediaeval times only the Jews and irreligious persons took interest on money loaned, and at one time excommunication was pronounced upon all Christians receiving interest from their debtors. Slowly, however, certain changes took place; indeed, almost all through this period there was some slight recognition of the right of a lender to compensation in certain cases. For instance, if a debtor promised to pay his creditor by a certain day, and disappointed him, so that the creditor was prevented from meeting his own obligations and suffered loss thereby, it was, even from the first, acknowledged that his debtor ought to compensate him for that loss. This judgment was all right, but what was to prevent the two coming to an arrangement beforehand that the loan, while purporting to be for a certain time, should really be for a longer time, and that the creditor should pretend to be injured, and should receive money from the debtors as compensation for this injury? This was continually done throughout the Middle Ages in order to avoid the Church's restrictions.

Interest Becomes Common with the Growth of Trade.

The old doctrine, that all interest was usury, and that the taking of interest on money lent was a mortal sin, lasted until the time when trade began to grow. Then we find merchants inducing persons who possessed some capital to go into a sort of silent partnership with them to share the gains and losses of their enterprises. This the Church approved, provided that the capitalists were really partners, sharing in losses as well as in gains. However, these capitalists were often more anxious to have the safe return of their capital, with a small interest, than to run the very considerable risk of loss; and in the sixteenth century we find interest thoroughly established in the countries where the Reformation prevailed, which were the chief trading countries. Later on we find even the Roman Catholic Church giving up the old doctrine, which regarded the receipt of interest as a sinful act.

Reasons for Change in Modern Times.

Why did this change take place? Why do our modern views differ so absolutely from those of the mediaevals? If we find the reason, and if it commends itself to our judgment, we shall have an answer to give to our Socialist critics, who declare that interest is simply the product of the exploitation of the poor by the rich—of the proletarian by the capitalist.

The distinction lies here: Mediaeval loans were, in the main, not for reproductive or economic purposes. They were made in order to help the poor cultivator to survive the failure of his crops, or to aid the knight to equip himself for war or a crusade. Here it is quite true that the money lent did not reproduce itself; did not help, by the use to which it was put, to discharge the loan with interest and still leave the debtor better off than before. On the contrary, it made him worse off than before, just as the small loans which salaried people and wage-earners often secure to-day in time of illness or unemployment are unproductive, often resulting in the ruin of the debtor when the exorbitant rate of interest usual to the small advertising money-lender is exacted. Perhaps in such cases it would be well even to-day that philanthropic people should subscribe a fund from which such loans could be made without interest (except for the cost of management of the fund) or at a very low rate. But such loans should be made, as the mediaeval phrase put it, "for the love of God" if they are made at all. They have nothing whatever to do with the business or economic loans of to-day.

Does Interest Involve Oppression?

These present-day loans are, as we have seen, made for productive purposes. They are made because the borrower, who is often very much wealthier than the lender, believes that he can afford to pay a reasonable rate of interest and still make a profit for himself. In the majority of cases he carries out his schemes successfully and pays interest to those who have advanced him capital. Who is injured by his doing so? Clearly he is not; neither are his creditors. Who is there who has any complaint to make? No one.

But, say the Socialists, the workers or proletariate suffer injustice in that they do not receive the full value of their labour. The case may be boiled down to this:

Let us suppose that we have two workers—equally good—in an agricultural community, one of whom is a thrifty and saving fellow, while the other spends all he makes. The saving man employs his spare time in trying to produce tools which will enable him to do his work more efficiently; let us say that he produces a tool that would enable either himself or his spendthrift neighbor to increase the product of their labor by 50 per cent. He uses it himself for awhile and perhaps produces a second tool of the same kind which he lends to his neighbor on condition that he receives half of the increase in the latter's product. Can the first man be justly called an oppressor of the other? They both stand to gain under the new arrangement—both the lender and the borrower. Of course, we cannot consider the lender a disinterested philanthropist. But then few men are. Neither can he be called a robber. He belongs to the great mass of men who, although they do not mean to practise any injustice, are still resolved to seek their own economic advantage in their business transactions.

Non-Economic Loans.

Many loans are even to-day made for non-productive purposes. Conspicuous examples of these are the national debts of the European powers, mainly incurred on account of wars or armaments. Here the borrower makes no economic use of the money borrowed. Why, then, does he pay interest?

The borrowing nations, which we may take as typical of all non-economic borrowers, pay interest because they have to in order to get money. All around them, in the great money markets of the world, are real economic borrowers, trying to secure capital for reproductive uses and investing that capital at the very ends of the earth where lie the new countries that can be developed most rapidly by its aid. These borrowers, in many cases already masters of potential natural resources which will be actualized by the railways or factories which they intend to build, are in a position to pay a comparatively high rate of interest without being in any danger of overstepping the mark—of paying away all their profits in interest on their loans.

Therefore the non-economic borrowers whose credit is (let us say) equally good with that of the economic borrowers, must pay equally high rates for money, and must pay these rates, like any other spendthrifts, out of their capital resources. The credit of certain nations, however, is better than that of any individual economic borrower, and accordingly they can get money at a lower rate of interest. Of course when the demand for capital is greater than the supply, the rate of interest will be higher than when the supply is greater than the demand. From this point of view, the nations of the world would be doing the greatest possible service to the economic borrowers and to the economic development of the newer countries if they would abolish armaments, pay off their national debts, and thus set free enormous masses of saved-up capital to be used for reproductive purposes. The rate of interest would naturally decline on account of the lessened demand for capital, and this fact would make possible many schemes of development which, at the present high rates of interest on capital, cannot be made to pay.

Conclusion.

From all that has been said we come to the general conclusion that, our Socialist friends to the contrary notwithstanding, the receipt and the payment of interest, in the modern world, are quite natural, inevitable and legitimate transactions. The lender suffers a certain deprivation by lending; the interest which he receives is his compensation for this deprivation. The borrower makes a gain through the use of the capital that is lent to him; it is only right that he should divide that gain with the person who has made it possible. The rate of interest is decided in the open market by the free and open competition of the buyers and sellers of capital, and by the risk of loss. No one, through the institution of interest, loses anything to which he has a natural right; millions would lose their all if it were abolished. Fortunately, there is no real danger of this coming to pass.

EXAMINATION QUESTIONS

ECONOMICS.

LESSON XII.

1. Define interest and give the derivation of the term.
2. Why can the entrepreneur afford to pay interest? Why does he do so?
3. Why does the lender of money for business purposes receive interest?
4. Compare the value to a man of a certain future commodity with that of a present commodity of the same kind.
5. Would any saving take place if interest were abolished? If so, why?
6. Distinguish pure or net interest from gross or market interest.
7. What is the probable influence on saving of a rise in the rate of interest? Of a fall?
8. Why was the receiving of interest prohibited in primitive societies? When and why did that prohibition become a dead letter?
9. Does interest to-day involve oppression of the borrower?
10. Why is interest paid on loans for non-productive purposes? Why can nations raising loans for non-productive purposes get their money more cheaply than entrepreneurs raising money for reproductive purposes?