

# About Interest

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Economist

One of the most controversial and confusing topics in economics is interest. The payment of interest has been condemned and misunderstood. The basic question is, why should there be a positive rate of interest? It seems that people who obtain interest on saved funds are not doing work to receive it. The money issue then gets mixed in, as banks loan out money by creating it, so where is the justice in getting interest from money expansion?

Pure interest is a payment made in order to shift a purchase from the future to the present day. Suppose you wish to buy a car for \$20,000. You have no savings, so your choice is either to, say, wait five years until you have enough savings to pay that amount, or else, to borrow the funds and buy the car now. The premium paid to shift the purchase is interest.

In the 1800s, classical economists defined interest as not just the yield of loaned financial capital (funds) but also the yield from capital goods. But just as rent is the yield of land aside from any interest for borrowing, the capital yield from buildings, tools, and inventory is aside from any interest. If one borrows to buy land, then the interest is rent paid to the lender. Only if one borrows to buy capital goods does the capital yield also become interest. Therefore it is antiquated and confusing to refer to the capital yield as "interest" when there is no borrowing. The confusion is compounded by referring to interest on "capital" rather than "capital goods," as this conflates interest from loaned funds with yields from capital goods.

The origin of interest is "time preference," the tendency of most people most of the time to prefer to obtain goods in the present day rather than in the future. Time preference is caused by our limited lifespan and the uncertainty of the future. If we knew for sure that we would live forever, it would not matter if we had to wait a few years to get that car.

Some people do save money even at a zero rate of interest. But with zero interest, the quantity of funds that people seek to borrow is greater than the quantity saved. That makes savings a scarce resource, which generates a positive price, the rate of interest. In a pure free market, time preference creates a "natural rate of interest." Since a higher rate of interest induces more savings and less borrowing, the interest rate has the economic job of equalizing savings and borrowing.

If interest income were completely taxed, there would be less savings, and so less borrowing, and therefore less investing, and less economic growth. Therefore, the positive income from savings has the beneficial economic role of inducing more savings so that more people are able to shift their purchases to the present day. The interest rate adjusts the purchase of present-day goods away from those with low time preference, those who seek to assure goods in the future, towards those with high time preference, who most want to have goods sooner.

Since time preference is rooted in human nature, every society has a natural rate of interest. If interest is not explicitly paid, interest is still there as an implicit reality. Suppose you loan a friend \$1000 without charging interest. If the friend had borrowed from a bank, he would have paid \$30 in interest per year, but your friend pays you back only the \$1000. The reality is that the interest still existed, but in effect, it was gifted by the lender to the borrower. Like land rent, interest is an implicit reality regardless of any explicit payment.

When interest is not allowed, that implies that borrowing is not allowed. Instead of borrowing funds, someone who seeks to obtain extra funds for a purchase would obtain a partner who would put up some of the funds. The partner would obtain a return that is a yield from the good rather than from a time shift. For example, instead of obtaining a mortgage on a house, the bank becomes a co-owner, and receives a rental from the co-owner (as also the tenant) from the bank's share of the property.

Government intervention distorts the "rate of payment for borrowed funds" (RPBF). One intervention is the excessive expansion of the money supply by a central bank such as the Federal Reserve, a creation of money greater than the demand to hold money. This monetary inflation causes price inflation. Suppose the natural rate of interest is two percent, and price inflation is three percent. The "nominal rate of interest" is five percent. The real rate is the nominal rate minus the inflation rate, thus two percent. The inflation portion is not really interest, but an inflation premium.

Bank loans also increase the money supply, as every bank loan is a money creation. If you borrow \$100 from a bank, the depositors still have their money. The depositors are loaning their savings to the borrowers; they still own their funds, but they are not spending the funds at that time. If you own a hammer and loan it to somebody, you still own a hammer, but the borrower also has a hammer. In effect, the hammer supply has gone up, and will go back down when the borrower returns the hammer. The governors of the Federal Reserve, or other central bank, understand that when they create money, the banks complete the expansion by their loans, so they factor the ultimate money creation in their decision to expand the money supply.

When a central bank creates excessive money, the banks have more funds on reserve. Just as more savings lowers the interest rate, more funds from money expansion lowers the RPBF. The money expansion pushes the transaction rate of interest, the rate paid by borrowers, below the natural rate. This artificially cheap credit induces more borrowing for goods of long duration, especially real estate. The cheap credit generates real estate booms that end in a financial crisis and depression when land values become unaffordable, and, as the money stops expanding, when interest rates go back up.

Another distortion of interest is taxes. In the USA, much of interest income is taxed, while interest payments are deducted from taxable income for business and for real estate loans. The effective RPBF gets reduced below the natural rate of interest.

When one borrows funds, what is called "interest" includes a payment to compensate the lender for risk, as some borrowers fail to pay the debt service, and fail to pay back the funds. Long-term interest rates usually appear to be higher than short-term rates, but the difference is really the risk of future inflation and possible default. The risk portion of the RPBF is not really interest. Loan payments also includes the overhead expense of the lender, which is not really interest.

The payment received from loaned funds is today not the natural rate of interest, but a distorted rate due to price inflation, excessive money creation, and taxes.

Another distortion in interest rates is government subsidies to land values. Public goods make locations more attractive and productive, increasing land rent and land values because the goods are paid mostly from taxes on wages and goods. Speculators then borrow funds to buy real estate. This extra speculative demand for borrowed funds is not due to pure time preference but is induced by the gain in land value from the subsidies of cheap credit and from public goods paid by others.

What is called "low interest rates" today is not really interest, but a subsidy for borrowing. Central banks around the world have pushed down the rate of payment for borrowed funds below the natural rate.

natural rate can be observed from ratios of net rentals to purchase prices, after adjusting for taxes and risk. The global natural rate of interest is about two percent.

In a pure free market, with the money supply and interest rates set by the market, with no taxes other than on pollution and land value, the transactions rate of interest would be the natural rate, and the interest rate would be able to do its job, the equalization of savings and borrowing. By pushing transaction rates of interest away from the natural rate, government interventions are once again generating distortions that will create the next financial crisis and depression.

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when borrowers take out loans, they only receive the principal. They are however expected to pay back that principal and any interest that accumulates over the life of the loan. While it is true that money expansion by the banks is detrimental to the economy, what is worse is that the money that is paid back as interest must also be created somewhere...the last time I checked the US Debt clock, it said that we had, as a nation, around \$57T in debt (government, corporate, business and individual) but a money supply of only about \$10T. Not only is there not enough money now to pay the PRINCIPAL owed to banks but there is certainly not enough to pay the INTEREST. So, individuals, governments, businesses and corporations must BORROW MORE PRINCIPAL in order to pay for its debts and interest. I would argue that THIS IS WHAT CAUSES INFLATION!!!!

Interest is unearned income. A good example would be found in the construction and sale of a new home. Let's say for instance, a contractor builds a home for \$100,000. He sells it for \$200,000. The buyer, usually, gets a loan from a bank for at least 80% of that sale price (or \$160,000, if they have the full 20% to put down). In the mortgage contract, the bank will require the buyer to repay about \$400,000 over the course of the loan. That means that the bank will make \$240,000 off of that house without having done a damn thing. The contractor only made \$100,000.

One might argue at this point that \$240,000 is over 30 years, but anyone who's ever looked at a mortgage schedule knows that within the first several years, the bank makes the majority of its revenue in interest. When they foreclose, they have already gotten the entire original principal back in payments. It's criminal and what is destroying our economy.

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## Economist

**FRED E. FOLDVARY, Ph.D.**, (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for [Progress.org](#) since 1997. Foldvary's commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary's areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.

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