THE PROGRESS REPORT

Capital and Interest

By Fred E. Foldvary

The concept of interest is often taught in a confusing and misleading way. Interest is not the same as profit. Also, interest should not be defined as a return to capital. Interest is about time, not money or capital goods or profit.

Most folks most of the time prefer to have goods sooner rather than later. There are two reasons for this.

- First, the human life span is limited, so the sooner we get something, the more time we will have to enjoy it.

- Secondly, the future is uncertain. We don't know what our situation will be like in the future, so we prefer to have things when we know they are useful now.

Since present-day goods are more highly valued than future goods, future goods are discounted, having a lower price than present-day goods if we were to pay for the future goods today. **The rate of discount then becomes the rate of interest.** If you want to shift buying a car from the future to the present day, you will pay a premium, which is interest. The car costs more if you take delivery today than if you pay for it now and take delivery of it in the future.

Since time-preference is rooted in human nature, it is present in all societies, and this makes interest a natural and inevitable phenomenon. Religions and laws which prohibit the payment of interest are futile, because interest is always there, even if not explicitly paid in money and even if not called by that name. **We can no more abolish interest than abolish the rent of land.**

The time premium paid to shift buying to the present-day can be a return to any factor of production.

- If a worker borrows money and uses it to improve his skills, and pays the interest from the higher wage, the interest paid is really wages paid to the lender.

- If one borrows money to buy land and pays the interest from the rent of the land, the interest is really land rent.

- If one borrows money to buy machines that make one more productive, the interest is a return to capital goods.

So interest is not specifically a return to capital goods, but can be wages and rent.

Some who think interest is a return on capital confuse financial capital with capital goods. If you want to think clearly about economics, don't use the term "capital." Use "financial capital" if you mean funds, and "capital goods" if you mean tools, goods used to

<u>produce other goods.</u>

The return on capital goods that are loaned out includes **depreciation** as well as interest. **Depreciation means the using up of economic value, because the tool wears out or becomes obsolete.** Suppose a company produces wooden hammers selling for $20, and they wear out in one day. The $20 is almost all for depreciation, with only a trivial amount of interest. On the other hand, if the hammer is made out of industrial diamonds and never wears out, then there is no depreciation, and much of the rental paid for its use is interest. **So interest is paid only for the rental of that portion of capital goods which does not wear out during some time interval; the rest pays for the depreciation.**

"Profit" equals revenue minus costs. It is incorrect to say that the return on capital goods is profit, or that profit is a return on capital. A self-employed worker profits when he hires out his labor for a higher wage than he could earn if employed by others. A landowner profits when he receives rent for the use of his land. Like interest, profit can be a return to any factor.

To summarize, the factors of production, i.e. the categories of inputs, are land, labor, and capital goods. Any of these can pay interest and receive profits. Interest is a premium paid to shift buying from the future to the present day.

Most folks today receive "interest" from funds, money in savings accounts or bonds. They think of "interest" as a return on their "capital." But in economic reality, the return comes from one or more of the factors as wages, rent, or the equivalent of a rental of capital goods.

Much of what is called "interest" is not really economic interest. The quoted rate or money income obtained from a savings account is the "nominal" interest. This is interest in name, the appearance of what is received. But appearance and reality often differ. To get the economic or real rate of interest, you have to subtract out the rate of inflation. Suppose the bank says you are getting five percent, and indeed, for every $100 in your account, you get $5 per year. But inflation is three percent. The real gain is only two percent, or $2.

Moreover, what is called "interest" on a loan includes overhead. If a bank charges eight percent for a loan, and pays five percent to depositors, then three percent of the loan rate is not real interest, but the overhead expense. If there are bad loans, when some borrowers don't pay it back, and the bank charges nine percent to borrowers, the extra one percent makes up for the bad loans. <u>This extra percent is not real interest, but a risk premium. Bankruptcy laws that allow folks to cancel their debts increases the risk premiums for all borrowers.</u>

"Interest" can also be an exploitation premium paid to monopoly lenders who squeeze borrowers who are desperate for loans, where there are interventions or ignorance that prevents the market for loanable funds from being competitive. This exploitation premium is usury, not real interest.

Finally, we need to distinguish the skewed-market rate of interest from the natural rate of interest. The **natural rate** is what it would be, based only on time preference, if there were a pure free market. With central banking, such as the Federal Reserve system in the USA, providing the money instead of the market, the central bank manipulates the short-run interest rate by changing the amount of money banks have to loan out. So the interest rates we see today, even after subtracting inflation and risk premiums, is most likely not the natural rate, but a distorted rate either pushed below or above the natural rate.

The rate of interest plays an extremely important role in the economy. It is not just what savers receive or borrowers pay. It is the job of the interest rate to equilibrate, or make equal, savings and investment. If more people want to borrow money to invest, the interest rate rises. If more folks save, the interest rate falls. The natural rate of interest is based on the supply of savings and the demand to borrow funds. **But when a central bank injects funds into the banking system, this masquerades as more savings, decreasing the interest rate, even though folks have not reduced their intended consumption. The result is an artificial stimulus that ends up being destabilizing the economy.**

Interest is about time preference. It usually takes the form of money paid on financial capital, but it is in economic reality wages, rent, and rentals of undepreciated capital goods. So let’s not hear any more about interest being a “return on capital.” Clarify your economic thinking by never saying just “capital” but rather “financial capital” when you mean funds and “capital goods” when you mean tools. That goes double for those who teach economics.