

THE THEORY OF INTEREST

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THE THEORY OF INTEREST

BY

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FOREWORD

FEW topics in economics have aroused so much academic debate as the theory of interest. Few topics have led to so many divisions of opinion among economists, so many misconceptions and so much of vigorous attack and equally vigorous defence. The publication of Keynes's *General Theory* did nothing to appease the fratricidal war, rather it added to the fury of the battle. It seemed to unsettle points which had already received wide acceptance and emphasize the differences that already existed among the warring economists. Mr. S. Lakshminarasimhan has addressed himself to the task, an arduous task, of appraising the different theories of interest, of reconciling the differences between rival schools of thought and of building up a theoretical structure based on the greatest common measure of agreement among economists.

For long we have been familiar with two sets of interest theories, non-monetary and monetary, each further subdivided into subjective and objective. (The subjective non-monetary theory is associated with Böhm-Bawerk and Fetter. For them the rate of interest is a function of an individual's time-preference. The objective non-monetary theory is represented by Wicksell and Knight. For them the rate of interest is the outcome of the marginal productivity of capital. There is also a group of economists, led by Irving Fisher, who explain the rate of interest in terms of both the subjective and objective elements of the non-monetary theory.)

The monetary explanation of the phenomenon of interest rendered so popular by Keynes has its exponents both on the subjective and objective sides. While agreeing among themselves that interest was a purely monetary

phenomenon, the rate of interest being determined by the demand and supply of money, some like Lerner and Robinson stress the subjective factor while others like Robertson, Haberler and Ohlin stress the objective factor. Subjectively considered the rate of interest is the result of liquidity preference, that is, it is a payment made for parting with liquidity. Objectively considered the rate of interest is the result of the supply of and demand for loanable funds, that is, it is a price paid for sums lent per unit of money per unit of time. It is thus seen that there are five variants of interest theory—the two non-monetary and the two monetary theories and the theory, which in the Wicksellian fashion attempts to reconcile the monetary with the non-monetary. The impression that is left on the reader's mind is that the author discards no theory *in toto* but proves that each theory is true under given conditions or valid under given assumptions. He proceeds to discover the extent to which interest functions as a regulator of the economic system. After the manner of Wicksell he traces the influence of the interest rate on banking policy and price-level and in doing so provides us with some tools for regulating the regulator.

At any given moment an individual has certain economic resources at his disposal. He has the power of allocating these resources among various uses or for various purposes such as holding ready cash, investing in securities, engaging in production, or spending on consumption. The apportionment of his resources on each of these yields a return to him. One could thus speak of rates of return on resources devoted to each of these purposes. The returns may be expressed in marginal terms, that is, as marginal rates of substitution between the respective resources. The rates of return

may be compared with one another either objectively or through the conversion of a subjective satisfaction into something measurable such as price.

An individual when confronted with these alternative rates of return from the outlay of his resources would, other things being equal, seek to obtain the maximum amount of gain. Applying the technique of marginal analysis, the maximum amount is reached through that distribution of resources which equalizes the marginal revenue in the several uses. These decisions have to be made not only by individuals but also by corporate bodies such as business concerns, banks and governments. If, due to economic friction or any other cause, no attempt is made to maximise returns the marginal principle will lose its significance. But the existence of a desire to maximise returns by the application of the marginal principle is fairly universal. For example, whenever a change takes place in any one of the marginal rates there will be a tendency on the part of individuals or firms to re-allocate the resources until once again equality of rates at the margin, though at a different level, is restored. In economic analysis the rate of interest refers to the marginal rate of return on a standard investment made by a representative institution or as Pigou would say, by a representative Englishman.

The development of the theory of interest appears to have proceeded along the familiar logical steps of thesis, antithesis and synthesis. Propositions have been made, counter-propositions have been adduced and finally conflicts have been resolved and reconciliations brought about between rival theories. One could be wise after the event and propound the doctrine that every one of the theories takes account of some factor or other which must be considered in any scientific exposition of the

theory of interest. (The several seemingly independent theories can be brought together under one umbrella, as it were.) (The time-preference theory stresses the marginal rate of return on consumption; the productivity theory emphasizes the marginal rate of return on production; the liquidity-preference theory assigns the leading role to the marginal rate of return on cash; finally the loanable-funds theory concentrates on the marginal rate of return on securities.) In proportion as people act on the self-regarding principle of maximum satisfaction the diverse marginal rates tend to equality. All these elements play a part, the importance of each varying with circumstances, in bringing about an adjustment whenever the equilibrium is upset.

The author has worked his way through the alternative formulations of the theory of interest. He has shown that the different approaches to interest-theory are not mutually exclusive nor are they irreconcilable. He has unravelled the knots in the theory of interest tied up by the Cambridge school and the Swedish economists.

In sum, there has occurred in recent years an incessant debate in the theory of interest and the cognate subjects of money and trade fluctuations. The debate has turned partly on questions of the meaning of words, partly on questions of the right mode of approach and partly on questions of banking policy. One has to discover, as our author has tried to do, how far the disputants are really at issue on matters of substance. The debate has now reached a point, the author rightly claims, where it is possible to sum up the whole position broadly in general terms and to distinguish between the various parts of the controversy that are concerned primarily with words, methods or substantial issues. He has attempted to give an account of the new developments

in interest theory, rejecting what is superfluous or merely superficial and taking care not to expose himself to the charge of distortion and misrepresentation. The long-felt need for a readjustment of views and shift in emphasis has now been supplied by the author.

V. L. D'SOUZA.

PREFACE

DESPITE the large number of works on the theory of interest there is none which deals with all aspects of the problem. In this book I have attempted to present a co-ordinated picture of the various strands of thought. The contributions of the more important economists are appraised and fitted into their proper place in a reconsideration and restatement of the interest theory. I have bestowed particular attention on the monetary approach to the problem. I have also argued out the case for co-ordinating the Theory of Value and the Theory of Money.

It is impossible for me to mention, in a book of this kind, all the sources from which I have derived inspiration. But it is only just that I should make special mention of Böhm-Bawerk's *Positive Theory and Capital and Interest*, Keynes's *General Theory*, Fraser's *Economic Thought and Language*, Wicksell's *Lectures* and Lindahl's *Studies in the Theory of Money and Capital* (particularly the section on the Rate of Interest and the Price-Level).

I cannot adequately express my gratitude to Professor V. L. D'Souza for the keen and continuous interest he has taken in my studies. This essay was written under his guidance, and he has offered many valuable suggestions and much helpful criticism. He has saved me from many a slip in the dense thicket of modern monetary controversy.

I must express my profound obligation to *Rajakarya-pravina* Mr. N. S. Subba Rao, Vice-Chancellor, University of Mysore, for the great interest he has evinced in me

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Mr. S. L. Rama Rao was good enough to read the last six chapters. Dr. A. N. Narasimhaiah, University Librarian, has been extremely kind to me in the matter of books and journals. My friend Mr. A. N. Subrahmanyam has rendered me much valuable service at various stages of this book.

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B. ARTICLES

The following abbreviations are used.

- AER.* = American Economic Review.
Ec. = *Economica*.
Ect. = *Econometrica*.
EJ. = *Economic Journal*.
ER. = *Economic Record*.
IJE. = *Indian Journal of Economics*.
ILR. = *International Labour Review*.
JPE. = *Journal of Political Economy*.
JRSS. = *Journal of the Royal Statistical Society*.
QJE. = *Quarterly Journal of Economics*.
RES. = *Review of Economic Studies*.
RESt. = *Review of Economic Statistics*.

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