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SOME ETHICAL AND ECONOMIC ASPECTS OF INTEREST.

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The suggestion has recently been advanced simultaneously in two very responsible periodicals, the *Economic Journal*[1] and *Studies*[2] that modern developments of monetary theory have vindicated the moral teaching of the Catholic Church on interest and usury. Transactions, it is claimed, which would have been condemned as immoral by mediæval theologians now stand condemned as noxious from the economic viewpoint as well. This interesting suggestion has involved its proponent in two keenly contested controversies—the controversy, on the one hand, waged among theologians regarding the ethical aspect of interest, and, on the other hand, the controversy between economists regarding the relation between the rate of interest and the value of money. Some aspects of the former controversy have been explained in *Studies,*[3] and some points arising out of the latter controversy have been discussed by Mr. Keynes and others in the *Economic Journal.*[4] The object of the present paper is to elucidate the main issues involved in the two controversies, and to indicate in what manner, if at all, they bear on each other, in language intelligible to those who, while interested in the issues involved, do not pretend to any expert knowledge either of moral theology or of modern monetary theory.

It is obvious, of course, that the moralist and the economist, though dealing with the same subject matter, are concerned with it for quite different reasons. The moralist is concerned primarily with considerations of justice in human relations and is indifferent to the effect of his conclusions on the production and distribution of wealth; while the economist is concerned primarily with considerations relating to the production and distribution of wealth and is indifferent to the justice or injustice of the arrangements made between contracting parties. It may be that the same transaction is objectionable both to the moralist on ethical grounds and to the economist on economic grounds, and will thus stand doubly condemned at the bar of two tribunals. But it is important clearly to separate the two sets of considerations involved. There is no foundation, for example, for the suggestion made by Mr. Keynes[5] that the condemnation of usury by the Canonists had its roots in the realisation of the economic evil of saving unaccompanied by investment. One might as truthfully suggest that Mr. Keynes's desire to abolish interest on bank deposits in certain circumstances is the result of a subconscious conviction of the sinfulness of usury. The ethical and economic issues involved in the discussion are essentially different, and any failure to keep them apart will result in confusion.

The teaching of the Catholic Church regarding the legitimacy of

[1] Vol. xli, p. 646. [2] Vol. xx, p. 627. [3] Vol. xxi, p. 123.
[4] Vol. xlii, p. 123. [5] *Economic Journal,* Vol. xlii, p. 136.

different types of so-called unearned incomes has formed in recent years the subject of a good deal of controversy from which strong disagreement and *odium theologicum* have not been entirely absent. Certain general conclusions sufficient for the purpose of this paper can, however, be drawn from the discussion. In the first place, usury in the strict sense of the word always has been and still is condemned. The sinfulness of usury arises from the attempt to exact payment for the use of things which are incapable of any use apart from their consumption (*res quæ ipso usu consumuntur*). The loan of fungible things, of which money is one example, is the subject of the contract known as *mutuum,* the only just consideration in which is the return of an equivalent quantity of the things lent. Usury is but a single, though peculiar, example of an unjust price. If a purely usurious transaction could be found, there is no doubt that it would be condemned; the difficulty is to isolate the payment for the use of money from the other legitimate payments with which it is almost invariably combined. This is a type of difficulty which is very familiar to the economist, who is constantly attempting to break up composite incomes into their component parts. The fact that any type of income, for example, pure profit, is never found in isolation does not render its existence unreal or its analysis unimportant. It is doubtless the realisation of difficulties of this kind that has rendered ecclesiastical authorities slow to condemn particular transactions, while reserving the right of further examination.

A second conclusion is that there is no objection to one's advancing money to another person to participate in an industrial or commercial adventure, provided that one is prepared to share in losses as well as gains. The income, if any, yielded by such an adventure is in the nature of profit, and is unquestionably valid. Thus there is nothing in the teaching of the Canon Law to prevent trading partnerships or the ownership of ordinary shares in joint stock companies. Some authorities suggest that debentures can be justified on the same ground, since debenture holders do in fact share the risks of the enterprise, though less directly than other types of shareholders. If however interest on debentures is not capable of being resolved into a variety of profit, it can nevertheless be justified on other grounds, as will be explained later. It is perhaps worth drawing attention to the fact in passing that there is nothing in the Canonist teaching to hamper the development of modern forms of business organisation or financial structure.

A third conclusion is, that there is no objection to the payment for the use of infungible things, such for example as land, houses, animals or motor cars. Such payments are in the nature of rents, and are made for the use of the object hired, which can take place without involving its consumption. Considerations of justice may arise concerning the amount of such rents, but that point is irrelevant in the present discussion. The important thing is that the payment is not in its very nature unjust, because it is in respect of what the economist would describe as a flow of utilities (income in the strict sense) which takes place without the destruction of the object enjoyed (capital in the strict sense). This income would arise whether the capital were hired to another person or not; it would arise if the owner of the object were to retain its possession himself; and the only change brought about by letting the object to another person is to translate the direct income into an income

accruing in the form of money. Indeed, to deny the validity of payments of this nature would lead to the condemnation of the use of property itself, since letting at hire is but one of the uses to which property can be applied.

The incomes described in the last paragraph are defined in modern economic terminology as rents or quasi-rents: rents when the capital from which they flow is the gift of nature and quasi-rents when it is the result of human production. The distinction between rents and quasi-rents is of great importance in the theory of value, but the two types of income need not be distinguished for the purpose of the present discussion. All income flowing from capital is in the nature of rent, and to describe such income as interest is confusing. Interest in the strict sense is the income paid by the borrower to the lender of a loan of money; it is usually expressed as a percentage per annum of the sum lent, and the two sums involved are always amounts of money and cannot be any other type of wealth. The use of the expression "loan interest" by some of those who have taken part in the controversy which we are considering suggests that interest on loans is a species of a larger genus of interest in general; whereas the fact is that all interest is in its essence a money payment for a money loan, and the expression "loan interest" is tautological.

It is in regard to the validity of interest in the strict sense that the greatest difficulties arise. Usury is invalid; profits and rents are valid; but what is to be said about interest? Here again it is possible to state certain general conclusions without delving deep into the controversy. The lender of money, by the fact of making the loan, may have incurred some inconvenience in respect of which he is entitled to be indemnified; a payment of this kind is known as interest because it places the lender in the same position as if the loan had not been made (*id quod inter est*). Interest requires to be validated by some such extrinsic title, the principal titles being known as *damnum emergens, lucrum cessans* and *periculum sortis*—which may be translated respectively as a loss sustained by the lender, the deprival of the lender's possibility of using the money lent in some alternative profitable employment, and the risk of not being repaid. It seems a reasonable suggestion that every loan in modern times involves a *lucrum cessans,* and that one of the titles to interest may be therefore safely presumed at the present day. In the highly developed capital market of to-day money need never be idle, and every time a lender makes a loan he is depriving himself of the opportunity for the time being of employing the sum lent profitably in some other direction.

It is the difference between the conditions of a pre-capitalist and a capitalist age that is responsible for the difference in presentation of the subject of payment for loans by mediæval and modern theologians. The difference however is merely one of emphasis; the doctrine remains the same. In the middle ages there was nothing corresponding to the capital market of to-day, and the presumption therefore was that money, if not lent, would be idle in its owner's hands. To-day no such presumption would be legitimate, and consequently Catholics freely lend and borrow at interest in modern times without any suggestion on the part of their moral advisers that they are doing anything improper or unjust. To use economic terminology, every loan to-day subjects the lender to an opportunity cost; that is to say, it imposes on the

lender an inconvenience arising from his forfeiture for the time being of the possibility of using the money lent in any of the innumerable alternative directions that are available. This conception of opportunity cost has cleared away certain difficulties regarding the sacrifices incurred by the suppliers of the factors of production. It is now recognised that each time a factor is applied in one direction the opportunity of applying it in every other direction has been sacrificed, and this is equally true of land, labour and capital. The term *lucrum cessans* would appear to be exactly translatable as opportunity cost, and accurately describes the nature of the sacrifice incurred by the maker of a money loan.

To argue that interest is legitimate in some cases is not to suggest that every contract for the payment of interest is defensible. Injustice may creep into transactions which are in their nature quite valid. The contract of sale has never been branded as objectionable, but a sale may be unjust if an unjust price be extorted. If, under the disguise of interest, a payment really usurious in nature be contracted, such a contract would unquestionably be condemned. Similarly, if the two parties to the loan were not of equal bargaining strength, an element of exploitation might enter into the transaction which would result in an unduly high rate of interest being paid. What constitutes a just rate of interest is a thorny subject which we can fortunately ignore for the purpose of the present discussion; the only point arising here is that, even when the legitimacy of the payment in itself is allowed, the question of its amount may still need to be decided from the standpoint of justice. Contracts for interest may therefore contain elements of injustice at the time they are being made sufficient to justify their subsequent condemnation or modification.

It is important that we should be clear on one point which is a common source of error in this connection. The purpose for which the loan is applied by the borrower is irrelevant in determining whether interest is legitimate. It is sometimes suggested even by quite responsible writers that interest is justly payable on productive but not on unproductive loans. There is no foundation for this suggestion, which is based on a fundamental misunderstanding of the issues involved, and would lead to the most absurd consequences if logically applied. The purpose for which the money is borrowed is quite irrelevant as between borrower and lender, in the same way that the purpose for which an article is bought does not affect the just price that must be paid by the buyer to the seller. No distinction therefore can be drawn between different types of loans based on the purpose for which the borrowing takes place; there is nothing to choose between a loan by a money-lender or a pawnbroker on the one hand and an industrial debenture or a loan to a Government to finance productive public works on the other. Loans by a banker to his customers, known as advances, or by his customers to him, known as deposits, are no exception to the general rule, and the legitimacy of interest paid in connection with such loans is not dependent upon the purpose for which the money is borrowed or the use to which it is applied.

Assuming that no initial injustice is present, and that a perfectly valid contract has been made, events may arise later which give rise to a new possibility of injustice. Interest, as has been explained, is essentially a ratio between two sums of money. If

the intentions of the parties to the contract are not to be defeated, it is vitally important therefore that the value of the money in which the terms of the contract are expressed should remain stable throughout the whole period of performance. Any variation in the value of money that is not foreseen by the parties at the date of the contract alters their mutual rights and obligations; and, assuming that the terms of the contract were just originally, such an unforeseen alteration must necessarily render it unjust subsequently. A fall in the value of money benefits the borrower and injures the lender, while a rise in the value of money injures the borrower and benefits the lender. In the language of economics, the nominal rate of interest remains the same, but the real rate is changed to the detriment of one or other party. The effects of such changes in the real rate of interest are of course most marked when the period during which the interest is to be paid is long, as is the case in the majority of loans. It is obvious therefore that what renders contracts for the payment of interest so pregnant of possible injustice is not the fixity but the concealed variability of their terms together with the length of the usual loan. It is through their effect on the real, as distinguished from the nominal, terms of long period contracts, not alone in respect of interest, but also in respect of rents, salaries and other payments fixed in terms of money, that unforeseen fluctuations in the value of money give rise to injustice It is obvious that one of the causes of injustice in respect of all long period contracts, of which loans at interest are an important but only a single example, would be removed if such fluctuations in the value of money could be abolished.

It is at this point that we touch the fringe of the second controversy; namely that waging among economists regarding the relation between interest rates and the price level. Economists are impressed just as much as moralists with the evils of certain types of change in the value of money, but the reasons for their disapproval of such changes are totally different. Whereas the moralist's objection is based on considerations of injustice between contracting parties, the economist's objection is based on considerations relating to the adverse effect of such changes in the price level on the size and distribution of the national dividend. Relative stability of the general price level may increase the size of the dividend, and may distribute it more regularly through time than is possible when the value of money is subject to unforeseen variations. There is one type of price change that is regarded as peculiarly objectionable, namely the cyclical fluctuation, in which the upward movement is of such a kind as to generate a subsequent movement in the downward direction. Cyclical price changes are responsible for such evils as over-speculation and over-production during the rise of prices and unemployment of labour and capital during the fall, and are regarded as one of the leading causes of the trade cycle or industrial fluctuation. A rapid fall of prices is accompanied by the most dire consequences, as the present generation has learned from bitter experience. The explanations of the causes of such price changes are very numerous, and the proposals for reducing them are even more numerous still. The outstanding feature of Mr. Keynes's contribution to the discussion is the suggestion that the price level can be at least partly controlled by means of action by central banks directed towards influencing the prevailing market rate of interest on loans. The

possibility of such control is the central problem of contemporary monetary theory.

We can now perceive the connection between the two controversies. Interest on loans is one of the leading examples of payments fixed in terms of money which are liable to give rise to injustice when the value of money changes. But, according to Mr. Keynes, changes in the value of money are themselves frequently the result of changes in the rate of interest. It is therefore interest which is, to use the words of one of the parties in the present controversy, " the villain of the piece "; the new monetary theory confirms the Canonist attitude towards the payment for loans; the abolition of such payments will prove both ethically and economically beneficial. Let us inquire how far this conclusion is justified.

In attempting to explain the leading points in the monetary controversy we shall concentrate on the matters which are relevant to the problem discussed in the present paper. The controversy is full of difficulties regarding which the most profound difference of opinion prevails among leading economists, and it is being conducted with an *odium economicum* at least as intense as the *odium theologicum* engendered by the other controversy All that can be attempted here is to draw attention to those aspects of the discussion which throw light on the relation between the new monetary theory and the ethical problems connected with interest. Needless to say the statement of the new theory does not imply its unqualified acceptance; the purpose of the present paper is simply to explain the relevant issues without seeking to prove or to defend any of the propositions described.

One well-known explanation of the cyclical movement of prices and the resulting industrial fluctuation is that of over-investment, according to which an unduly large portion of the products of industry are utilised for further production with the result that production outruns consuming power and over-production takes place. That some such disequilibrium occasionally occurs is undeniable, but it is important to understand that it is not this type of maladjustment to which Mr Keynes refers in his treatment of the subject. The new theory, indeed, regards under-investment as at least as important a factor in producing fluctuations as over-investment, and lays great stress on the distinction between the processes of saving on the one hand and investment on the other. Saving, it is pointed out, is a purely negative operation, involving nothing more than the refraining from spending either on consumption or capital goods. Saving may take the form of depositing money with a bank, of purchasing some security which involves no outlay on new capital investment or of liquidating pre-existing obligations. An increase of pure saving can have no other result than that of causing a fall in prices, as it is equivalent to a diminution of demand for goods and services. Investment, on the contrary, involves expenditure on new capital goods and the employment of the factors of production: and it is the central thesis of Mr. Keynes's theory that investment and saving must proceed at the same pace if a change in the price level is to be avoided. If investment proceeds more rapidly than saving profit (in the narrow sense in which the word is used by Mr. Keynes) arises, output and enterprise are stimulated and prices rise; while, if saving outruns investment profit disappears, losses are incurred,

output and enterprise are retarded and prices fall. Since the persons who take decisions regarding the amount saved and the amount invested are not identical, some method must be devised of keeping the two operations balanced, and the method proposed is the appropriate regulation of the market rate of interest by means of action on the part of the banking system.

This distinction between saving and investment is of great importance, and has not been sufficiently appreciated until recently, at least among English economists. An increase of saving, unaccompanied by an act of investment, is equivalent to hoarding. Whether the effect of what happens is better described by saying that the amount of money in circulation has been diminished or that the velocity of circulation of money has been reduced, the effect is the same, namely a reduction in demand and a fall of prices. Serious differences of opinion have arisen as to whether bank money, as distinguished from real money, can ever be effectively saved, as it is sometimes suggested that, even if the bank's customers will not make use of their deposits, the banks can neutralize their inaction by enabling other people to do so. However the better opinion seems to be that bank money can be rendered idle by the refusal of its owners to use it, or by its being used by the other customers of the bank to liquidate old liabilities and not to engender new investment, in which case the outlet for the savings of one person will be found in financing the losses of another.

If the central doctrine that changes in the price level are the result of disequilibria between saving and investment be admitted, it follows that any authority than can influence the disposition of people to save or to invest respectively can exert some control over the price level. Such a power it is claimed, is possessed by the banking system, which is in a position to alter the relative attractions of investment and saving by the manipulation of interest rates. The precise way in which changes in bank rate affect the dispositions of business men towards investment is not the subject of universal agreement, but it is generally conceded that a rise in bank rate discourages and that a fall in bank rate encourages investment. A reduction in bank rate, among its other effects, reduces the cost of borrowed capital and increases the rate of capitalisation of income-yielding goods, thus raising the price of bonds. The opposite results are caused by an increase of bank rate. In a modern banking system the rates charged by the member banks always vary in the same direction as the central bank rate, and it is suggested that the central bank, by appropriately timed changes in its rate, can influence the disposition of business men towards investment. It is further claimed by the proponents of the new theory that the long term rate of interest follows the short term rate in the same direction, and that the level of the long term rate is of great importance in determining outlay on housing, public utilities, transport services and other types of investment requiring large amounts of fixed capital. This correlation between the short and the long interest rates can be shown to exist by a large volume of inductive evidence, and appears to be supported by deductive reasoning. Moreover, it is further argued that a change of rate which influences investment in one direction influences saving in the other, because the rate allowed by the member banks to their customers on deposits varies in the same direction as bank rate, and also because

of the inverse relation between the rate of interest and the price of bonds.

Assume for example, that a rising price level has indicated the presence of investment in excess of saving that may signify an incipient boom. The central bank by raising its rate raises at the same time the rates at which the member banks lend to and borrow from their customers. Some customers are now deterred by the higher rate charged by advances from borrowing as much as before, while others are attracted by the higher rate allowed on deposits to save more than before, that is to leave more money idle in the bank or to increase their holding of bonds. The disequilibrium has been resolved by the bank's action; the incipient boom has been checked, and the rise in the price level has been prevented. Similarly, it is urged, a reduction in bank rate will succeed in checking an incipient slump by rendering investment more and saving less attractive, and a fall in prices may thus be prevented.

The power of central banks to influence the price level by action of this kind depends on the presence of certain conditions which are not always realised in practice. In the first place, the central bank must have complete control over the member banks, not only in respect of the rates of interest which they charge for advances and offer for deposits, but also in respect of the amount of money at their disposal. Modern banking systems are designed to give central banks such control in considerable measure by reason of their note issuing power, supplemented by open market operations. Such power of control would be extended if the central bank were to possess the right of varying within narrow limits the ratio of cash to deposits maintained by the member banks. Secondly, the central bank must be free to pursue its policy regardless of reactions on the foreign exchanges. In other words, we must assume the existence of a closed system, which may be the result either of the absence of an international money standard or of the possession of a considerable power of action independent of any intenational standard that does exist. The combination in the same system of the advantages of an international standard with those of wide powers of independent action is perhaps the principal unsolved problem of modern banking.

Even if both these conditions are realised, the power of the central banks to influence the price level is admitted to be subject to several limitations. It is easier to prevent equilibrium from being disturbed than to restore it once a condition of disequilibrium has developed. Moreover, it is less difficult to check a boom than a slump, as it is easier to discourage willing than to encourage unwilling borrowers. The necessity of checking a slump, it may however be pleaded, would not arise if the preceding boom had not been permitted to develop; and the difficulty of restoring confidence to timid and disappointed investors would not arise if the cause of their timidity and disappointment were removed. Again, the mere regulation of the amount and the price of credit may be ineffective to prevent unsound conditions without some control over its direction as well, and the control of the direction of credit is a matter, not for the central, but for the member banks. The choice of suitable index numbers on which to base action may give rise to acute differences of opinion, and the correct interpretation of the trend of the business situation contains wide scope for errors. These however are practical difficulties which

do not detract from the theoretical argument, which is all that concerns us in the present discussion.

The part played by the rate of interest allowed on bank deposits should now be clear. Variations in the rate paid on bank deposits caused by variations in the central bank rate may encourage or discourage saving. A good deal of confusion has been caused in this discussion by the suggestion that time deposits (or deposit accounts) and demand deposits (or current accounts) are essentially different; that time deposits alone represent money which is being saved; and that it is the rate of interest allowed on time deposits only that is relevant. It has been pointed out by critics of the new theory that the line between time and demand deposits is not always clearly defined, that in some cases no interest is paid on time deposits and that in other cases interest is paid on demand deposits. While the criticism is valid, it does not undermine in the slightest the position of the advocates of the new theory, who, however, would state their case better by emphasising that the important thing is whether bank money of all kinds is being used or let lie idle. It is perfectly true that a change in the proportion of total deposits held as time and demand deposits respectively is a reliable index of changes in the activity of bank money, but it is nothing more. The placing of money on time deposit is the symptom and not the cause of its idleness, or to use the older terminology of its low velocity of circulation.

It has not been proposed by Mr. Keynes that interest on bank deposits should be abolished in all cases. On the contrary, the new theory, which suggests that the reduction, possibly to zero or a negative amount, of the rate of interest on deposits may succeed in averting a fall of prices, no less emphatically suggests that it may be necessary in other circumstances to raise the rate in order to check an incipient boom. It is obvious that the deposit rate is regarded merely as one of the controls in a very complicated machine, to be used by the central bank in its attempt to regulate the value of money. It is not suggested that the mere payment of interest on deposits in itself is an economic evil; indeed it is argued that in some circumstances economic evils may be the result of the rate on deposits being insufficient. A deposit is one peculiar type of loan, changes in the amount paid for which may produce desirable reactions in other parts of the economic system.

Nor is there any reason for regarding the payment of interest on bank deposits as ethically evil. Depositing money with a bank is one method of lending money, in which the benefit of extreme liquidity is paid for by the acceptance of a very low rate of interest. It cannot be maintained that such a transaction is usurious or otherwise unjust. It may be suggested that a bank deposit is an unproductive loan; but to this contention it may be replied that, from the ethical standpoint, the purpose for which loans are employed is irrelevant. In so far as the rate paid is such as to cause a disequilibrium between saving and investment and a consequent change in the price level, it may be indirectly the cause of injustice between the parties to long period contracts fixed in terms of money. In this respect the deposit rate is not peculiar, as a similar disequilibrium may be equally caused by the rate of interest on any other type of loan. If the deposit rate is such as to cause such a maladjustment, the remedy to be applied

is not its abolition but its alteration to a new level which may in some cases be higher and not lower than the old.

The following conclusions emerge from the foregoing discussion. Changes in the general price level frequently cause injustice between parties who have made long period contracts involving payments fixed in terms of money, of which loans are an important but by no means the only example. Changes in general prices are also responsible for disturbances which are objectionable on economic grounds. Certain ethical and certain economic evils arise from the same set of causes and could be reduced by the same remedy, namely a greater measure of control of the value of money than exists at the present time. Nothing has emerged to suggest that the moral teaching of the Catholic Church on usury has received any additional justification by modern developments of monetary theory. The economist objects to certain levels of interest rates, not because they are usurious, but because they tend to produce a condition of disequilibrium in the economic system.

The ethical and economic effects of price fluctuations differ in some important respects. From the ethical standpoint a rise and a fall of prices are equally objectionable, whereas many economists regard a rise of prices as being advantageous provided it is not the type of rise that generates a subsequent fall. Other economists argue that a fall of prices is less objectionable than a rise. From the economic point of view the secular price movement is far less objectionable than the cyclical, whereas, in so far as the moralist distinguishes between them, he would probably regard the cyclical movement with less disfavour owing to the possible compensations caused by the successive movements in opposite directions. Moreover the extent of the price fluctuation is only a matter of degree from the ethical standpoint; the smallest unforeseen change in the price level causes an injustice to arise. From the economic point of view moderate and extreme fluctuations differ fundamentally; while an extreme fluctuation is always objectionable a moderate fluctuation may in certain cases prove positively beneficial. The moralist must therefore regard stability of the price level as desirable in all cases, whereas what the economist seeks to attain is control of the price level with the object, not necessarily of absolute stabilisation, but of inducing appropriate moderate variations. Possible injustices between the parties to long period contracts caused by such changes as might be regarded as economically desirable could be to a great extent avoided by the adoption of a tabular standard of payment based on suitable index numbers. Precedents for such an arrangement are easy to find, and its more widespread adoption would remove much of the injustice between debtor and creditor caused by moderate fluctuations in the general price level. This suggests another respect in which the moralist and the economist may differ. A suitable tabular standard of payment, provided the practical statistical difficulties were successfully surmounted, would redress all the evils of price fluctuations to which the moralist might object; whereas, from the economic standpoint, devices to neutralize the effects of fluctuations that have actually arisen are regarded as inferior to devices which prevent the fluctuations from taking place or which enable them to be controlled by human volition.

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