Fisher's Rate of Interest

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There is less novelty, either in the course of the argument or in the results achieved, in the Rate of Interest(1*) than in Mr Fisher's earlier volume on the Nature of Capital and Income. Substantially the whole of it lies within the accustomed lines of that marginal-utility school of economics for which its author has so often and so convincingly spoken. It is true to the canons of the school, even to the point of making the usual error of logic in the usual place. But while it makes no material innovation, beyond a new distribution of emphasis among the factors held by the school to determine the rate of interest, it carries out the analysis of these determinants with unexampled thoroughness and circumspection, such, indeed, it may fairly be hoped, as will close the argument, on the main heads of the theory at least, within the school. There is all the breadth and facility of command over materials, which Mr Fisher's readers have learned to expect, such as to make the book notable even among a group of writers to whom such facility seems native. If fault is to be found with this exposition of the marginal-utility doctrines it is scarcely to be sought in details of fact or unauthorised discrepancies of logic. Exception may be taken to the argument as a whole, but scarcely from the accepted ground of the marginal-utility school. Nor should that remnant of the classical school which has not yet given its adherence to the marginal-utility doctrines readily find fault with an exposition which finds its foundations in so good and authentic a utilitarian theorist as John Rae.

The theory of interest arrived at is the so-called "agio" or discount theory, already familiar to Mr Fisher's readers and substantially in accord with the like theory spoken for by Böhm-Bawerk. Mr Fisher takes issue with Böhm-Bawerk on the one grave and far-famed point of doctrine concerning the "Roundabout Process". And on this head, I apprehend, it will be conceded that the later writer occupies the stronger and more consistent position, whatever exceptions may be taken to his line of argument in refutation of the doctrine in dispute. In his critical survey of competing and inadequate interest theories, occupying the first four chapters of the volume, this doctrine of the roundabout process comes in for more serious attention than all the rest; and justly so, since it is an alien in the school -- a heresy which has been brought in by oversight. Leaving on one side for the moment all question as to the merits of this doctrine, it may readily be shown not to belong in the same explanation of interest with the agio theory, at least not as a proposition correlative with the theorem about the differential preference for present over future income. Interest and the rate of interest is a matter of value, therefore to be explained in terms of valuation, and so in terms of marginal utility. with the scheme of value theory for which Mr Fisher and Böhm-Bawerk are spokesmen no analysis of a value phenomenon can be brought to a conclusion until it is stated in terms of marginal utility. All fundamental proposition, all theorems of the first order in this theoretical scheme must be stated in these terms, since these terms alone are ultimate. Facts of a different order bear on any question of value, in this scheme, only as they bear on the process of valuation, which is matter to be stated in terms of marginal utility. This scheme of theory is a branch of applied psychology -- of that school of psychology which was in vogue in the early nineteenth century; whereas the roundabout process is not a psychological phenomenon -- at least not of the same class with the doctrines of marginal utility. It is a technological matter. The roundabout process has a bearing on the rate of interest, therefore, only as it bears on the main theorem concerning the preference for present over future income; that is to say, the doctrine of the greater productivity of the roundabout process is, at the best, a secondary proposition, subsidiary to the main theorem. The valuations out of which the rate of interest emerges take account of various circumstances affecting the desirability of present as contrasted with future goods; among these circumstances may be the greater productivity of the roundabout process; but this is as near to the core of the problem as that phenomenon can be brought. The problem of the rate of interest in the marginal-utility system is a problem of applied psychology, more precisely a problem of the hedonistic calculus; whereas the alleged greater productivity of the roundabout process is a technological phenomenon, an empirical generalisation concerning the mechanical efficiency of given industrial ways and means. As an explanation of interest the doctrine of the roundabout process belongs among the productivity theories, as Mr Fisher has indicated: and as such it cannot be admitted as a competent, or indeed a relevant, explanation of interest in a system of theory whose purpose is to formulate a scheme of economic conduct in terms of the hedonistic calculus.

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It is quite conceivable that in some other system of economic theory, worked out for some other purpose than the hedonistic explanation of value, the roundabout process might be brought into the central place in a doctrine of interest; but such a doctrine would have as its theoretical core, upon which the theorist's attention should be concentrated, the physical production of that increment of wealth that is presumed to go to interest, rather than the pecuniary determination of the rate of interest through which this increment is distributed among its claimants. Such a doctrine would belong in a theory of production, or of industry, not in a theory of distribution, or of business. But the marginal-utility system is primarily a theoretical scheme of production; and, therefore, in so far as it is or aims to be primarily a theory of business traffic, not of the processes of industry, particularly not of technological efficiency or of technological changes. This is well shown, e.g., in Mr Fisher's discussion of invention (ch. x, ch. xi, sec. 4, ch. xvii, sec. 6).

Apart from all question of consistency or conclusiveness within the premises of the marginal-utility school, the test to which Mr Fisher's theory of interest must finally be brought is the question of its adequacy as an explanation of interest in modern business. Mr Fisher has recognised this, and the most painstaking and most admirable portions of the volume are those which discuss interest as involved in current business transactions (e.g., ch. xii-xvi). In modern life distribution takes place almost wholly in pecuniary terms and by means of business transactions. In so far as it does not, e.g., in the distribution of consumable goods within the household or in the distributive use of public utilities, it does not bear sensibly on any question of interest, particularly does it not bear immediately as a determinant on the rate of interest. Interest, as demanding the attention of the modern economist, is eminently a pecuniary phenomenon, and its rate is a question of business adjustments. It is in the business community and under the guidance and incitement of business exigencies that the rate is determined. The rate of interest in any other bearing in modern life is wholly subordinate and subsidiary. It is therefore an inversion of the logical sequence when Mr Fisher, with others of the school, explains pecuniary interest and its rate by appeal to non-pecuniary factors. But such are the traditions of the school, and such a line of analysis is imposed by their premises.

As has been remarked above, Mr Fisher's development of the doctrine of interest is true to these premises and traditions to a degree of nicety never excelled by any of the adepts. These premises or postulates on which the marginal-utility scheme rests are derived from the English classical economists, and through them from the hedonistic philosophy of the earlier decades of the last century. According to the hedonistic postulates the end and incentive is necessarily the pleasurable sensations to be derived from the consumption of goods, what Mr Fisher calls "enjoyable income" or "psychic income" (see Glossary, pp. 339-340), and for reasons set forth in his analysis (ch. vi), it is held that, on the whole, men prefer present to future consumption. This is the beginning of economic (marginal-utility) wisdom; but it is also the end of the wisdom of marginal utility. To these elemental terms it has been incumbent on all marginal-utility theorists to reduce their formulations of economic phenomena. And from the acceptance of these limitations follow several characteristic excrescences and incongruities in Mr Fisher's theory, presently to be spoken of.

To save argument it may be conceded that the hedonistic interpretation of human conduct is fundamentally sound. It is not requisite for the purpose in hand to discard that postulate, however frail it might prove on closer scrutiny. But if it be granted that the elemental motive force of economic life is the hedonistic calculus it does not follow that the same elemental calculus of preference for present over future sensations of consumption is to be directly appealed to in explanation of a phenomenon so far from elementary as the rate of interest. In point of historical fact anything like a consistent rate of interest emerges into the consciousness of mankind only after business traffic has reached some appreciable degree of development; and this development of business enterprise has taken place only on the basis and within the lines of the so-called "money economy", and virtually only on that higher stage of the money economy specifically called a "credit economy." Indeed interest is, strictly, a phenomenon of credit transactions alone. But a money economy and the consequent credit transactions which give rise to the phenomena of interest can emerge only on the basis afforded by the mature development of the institution of property. The whole matter lies within the range of a definite institutional situation which is to be found only during a relatively brief phase of civilisation that has been preceded by thousands of years of cultural growth during which the existence of such a thing as interest was never suspected. In short, interest is a business proposition and is to be explained only in terms of business, not in terms of livelihood, as Mr Fisher aims to do. Business may be intimately concerned with livelihood, it may even be that in modern life business activity is the sole or chief method of getting a livelihood, but the two are not convertible terms, as Mr Fisher's argument would require; neither are business gains convertible with the sensations of consumption, as his argument would also require.

The reason why these terms are not convertible, and therefore the reason why an argument proceeding on their convertibility or equivalence must reach a fallacious outcome, is that a growth of institutions intervenes between the two -- granting that the hedonistic calculus is the primary incentive and guide of economic activity. In economic life, as in other lines of human conduct, habitual modes of activity and relations have grown up and have by convention settled into a fabric of institutions. These institutions, and the usual concepts involved in them, have a prescriptive, habitual force of their own, although it is not necessary at every move to ravel out and verify the intricate web of precedents, accidents, compromises, indiscretions, and appetites, out of which in the course of centuries the current cultural situation has arisen. If the contrary were true, if men universally acted not on the conventional grounds and values afforded by the fabric of institutions, but solely and directly on the grounds and values afforded by the unconventionalised propensities and aptitudes of hereditary human nature, then there would be no institutions and no culture. But the institutional structure of society subsists and men live within its lines, with more or less questioning, it is true, but with more acquiescence than dissent.

Business proceeds on the ground afforded by the institution of property, more particularly of property as rated in terms of money values. The rate of interest is one of the phenomena involved in this business traffic, and its theoretical explanation must run in terms of business, and so in terms of money. When the question is removed from this institutional basis and is pushed back to the grounds on which property and money are conceived to rest, it ceases to be a question of interest and becomes a detail of the analysis of the phenomena of value. But value, as understood by living economists, has no existence apart from the institution of property -- since it is concerned with the exchange of property. Interest is a pecuniary concept having no validity (except by force of an ambiguity) outside of the pecuniary relations of the business community, and to construe it in other, presumably more elementary, terms is to explain it away by dissolving it into the elements out of which it is remotely derived, or rather to which it is presumed to be remotely related. The phenomena of modern business, including the rate of interest, can no more be handled in non-pecuniary terms than human physiology can be handled in terms of the amphioxus. The difference is that between explaining current facts and endeavouring to explain them away.

There is (probably) no science except economics in which such an endeavor to explain the phenomena of an institution in terms of one class of the rudiments which have afforded the point of departure for the growth of the institution would be listened to with any degree of civility. The philologists, for example, have various infirmities of their own, but they would have little patience with a textual critic who should endeavor to reduce the Homeric hymns to terms of those onomatopoetic sounds out of which it is presumed that human speech has grown. What fortune would have overtaken E.B. Tylor's Researches into the Development of Mythology, Philosophy, Religion, Language, Art and Custom, if he had set out to explain away the facts and show these institutions are of no effect because he knows something about the remote sources from which they have come? Scientific vagaries of that heroic stature are not unknown among ethnologists, but it is to be noted to the credit of the craft that they are know vagaries.

Mr Fisher's theory of the rate of interest suffers from the same oversight of this difference between explaining facts and explaining them away, as do the common run of marginal-utility doctrines. So, since interest is to be formulated in terms of consumptive hedonism, instead of in business concepts, and since price is to be formulated in the same terms, there arises an unavoidable confusion between the two, as appears in the discussion of "Appreciation and Interest"(ch. v, and elsewhere). In the main, this discussion belongs properly in a theory of prices. Appreciation and depreciation of the standard of payments may of course -- so far as they are foreseen -- affect the rate of interest; but they are, after all, phenomena of price. Business transactions run in terms of money. Interest is rated in money and paid with a view to money gain. Many contingencies bear on the changes of such gain, and changes of price are notoriously among those contingencies. Speculative buying and selling look to this contingency chiefly, and may look to such a change in the price of the goods bought or sold as shall offset the interest on the funds tied up in the speculation, but the rate of interest does not thereby come to be conceived or stated in terms of the advance or decline of the price of goods. Appreciation and depreciation, if foreseen, are circumstances to be taken into account by lender and borrower very much as the productivity of the roundabout process (if that doctrine be allowed) will be taken into account in making the rate of interest. But this state of the case does not make either of these phenomena a rate of interest; nor does it reduce interest to a technological matter on the one hand or to a variation of prices on the other hand.

Now and again, especially in ch. xiv (pp. 276-285), Mr Fisher cites facts showing that neither investment nor interest are counted in terms of livelihood or in the sensations of consumption, and showing also that questions of livelihood touch these phenomena only uncertainly and incidentally. He well shows (a) that business men habitually do not (adequately) appreciate variations in the commodity-value of money, and (b) that with rising prices they simply do business at a high money profit and are content to pay a high rate of interest without suspecting that all this has any connection with the "commodity interest" of Mr Fisher. (Cf. the passages cited from Baxter and from Jevons). But his hedonistic preconceptions lead him to take note of this state of things as exceptional and anomalous, whereas, of course, it is the rule. It is not only the rule, but there is no avoiding it so long as business is done in terms of money, and in the absence of a foregone conclusion these facts should persuade any observer that money value has an institutional force in the counsels of business men.

This chapter (xiv), and in good part the succeeding one, explain interest without support from or reference to Mr Fisher's "agio" theory, although they are offered as an "inductive verification" of that theory. Except for the author's recurrent intimations, nothing in this inductive verification bears on, or leans on, the doctrine of a preference for present over future income. Not only so, but chapter xiv, incidently helped out by various passages elsewhere, goes far to disprove that the rate of interest is a matter of the preference for present over future income, taking "income" in Mr Fisher's sense of the term. There is a strikingly ingenuous passage in ch. xv, (p. 315): "For him [the farmer] the lowest ebb is in the fall, when gathering and marketing his crops cause him a sudden expenditure of labor or of money for the labor of others. To tide him over this period he may need to borrow... The rate of interest tends upward." The farmer, in other words, bids up the rate of interest when his crops are in hand or are coming in; particularly just after he has secured them, when he is required to meet certain pecuniary obligations. But the farmer's crops are his "income" in the case assumed, and when his income has come in, at this springtide of his income stream, his preference for present over future goods should logically be at its lowest, and, indeed, there need be little question but such is the case. There is also no doubt that the farmer is willing to bid high for funds at this period; and the reason seems to be that then the fresh access of income enables him to bid high, at the same time that he needs the funds to meet pecuniary obligations. His need of borrowing is due to the necessity of marketing his crops and so "realising" on them; that is to say, it is a business or pecuniary need, not a matter of smoothing out the income stream. Farming is a business venture in modern times, and the end of business is gain in terms of money. The cycle of business enterprise closes with a sale, a conversion of "income" into money values, not conversely, and the farmer is under more or less pecuniary pressure to bring this pecuniary cycle to a close.

NOTES:

1. The Rate of Interest: Its Nature, Determination and Relation to Economic Phenomena, By Irving Fisher, New York, 1908.

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