

XV: INFLATION AND INTEREST RATES

Unemployment seems hard to eradicate. Many of the measures now used to counter unemployment boost prices and foster inflation. These measures, and the inflation they spawn, also cause land prices to rise unduly. In this way they retard the growth of the economy and unemployment soon worsens again.

The situation is bad enough when inflation merely smoulders along at two to three percent per year. It becomes far worse when inflation escalates to double figures.

Double digit inflation has a drastic effect on the real value of savings, and on the monetary value of real estate. Through these effects it potentiates unemployment and negates any job-creating or job-preserving measures that may be tried.

Rampant Inflation Leads to Soaring Property Prices

Rampant inflation causes money to lose value at a rapid rate, but it has no such effect on the value of real estate. Rampant inflation therefore:

- (a) ruins saving as a means of providing for retirement or for any other future need, and:
- (b) encourages anyone who can do so to invest in real estate.

Hence, when inflation is rampant, more and more people turn to property ownership as a means of saving. That increases the demand for all forms of real estate, reduces the number of homes and building blocks on the market, and adds dollars upon dollars to the price of sites, thereby:

- 1: preventing more and more people from establishing new businesses or expanding existing ones, and:
- 2: limiting:
 - (a) employment opportunities,
 - (b) the nation's total output of goods and services, and:
 - (c) the upswing in standards of living that normally occurs in a progressive society. (The average standard of living depends upon society's total output. This is below the optimum when would-be workers are unemployed.)

Inflationary Psychology

That check to production is not the only means whereby inflation gobbles up jobs. When inflation continues, year after year, it creates an "inflationary mentality" or "inflationary psychology" in society. This gives an upward push to interest rates, while interest, it seems to me, is a subject to which far too little attention is paid.

A Cost for Many

As already noted, interest is a very significant cost for manufacturers, home builders and farmers who mortgage property or purchase on terms. The interest payable on large or long-term mortgages reduces the profitability and even the practicability of numerous enterprises.

Interest also adds to costs for shopkeepers and other business or professional men who lease equipment, buy on terms, or purchase stock with borrowed funds. All such persons must limit the

size and scope of their enterprises when interest rates are high. In these ways, interest checks all forms of production, and robs many would-be workers of a job.

But that does not exhaust the ill-effects of interest. Interest can also check consumption when inflationary psychology interferes with the normal market movement of interest rates.

Automatic Adjustment

Interest limits the amounts many would-be borrowers can borrow. It also increases the amount of money available for loans - thereby providing a mechanism for the automatic adjustment of interest rates.

Thus, a borrower who could repay \$1,000 per annum for twenty years could borrow:

- # \$12,400 with interest at 5% per annum,
- # \$8,500 with interest at 10% per annum, and:
- # \$6,200 with interest at 15% per annum -

as shown in Tables 11, 12 and 13.

These tables show how rising interest rates limit the size of loans and increase interest payments. In these examples, interest rises from \$7,400 on the first loan to \$12,800 on the much smaller but more expensive loan - with interest on the third loan being more than twice the original principal.

Profits for Lenders

Interest comes into the hands of lenders. It augments their funds quite rapidly - a fact anyone with a calculator can verify for himself.

TABLE 11: LOAN OF \$12,400 @ 5%
 REPAID AT \$1,000 PER ANNUM

YEAR	INTEREST (\$)	REPAYMENT (\$)	BALANCE (\$)
1	620.00	380.00	12,020.00
2	601.00	399.00	11,621.00
3	581.05	418.95	11,202.05
4	560.10	439.90	10,762.15
5	538.11	461.89	10,300.26
6	515.01	484.99	9,815.27
7	490.76	509.24	9,306.03
8	465.30	534.70	8,771.33
9	438.57	561.43	8,209.90
10	410.50	589.50	7,620.40
11	381.02	618.98	7,001.42
12	350.07	649.93	6,351.49
13	317.57	682.43	5,669.06
14	283.45	716.55	4,952.51
15	247.63	752.37	4,200.14
16	210.01	789.99	3,410.15
17	170.51	829.49	2,580.66
18	129.03	870.97	1,709.69
19	85.48	914.52	795.17
20	39.76	795.17	
Totals:	7,434.93	12,400.00	

Thus, if a lender could obtain continuous compound interest, then, after twenty years:

at 5% per annum, his wealth would double - as every \$1.00 of the original principal would have become \$2.65,

at 10% per annum, his wealth would increase sixfold (each \$1.00 would grow into \$6.73), and:

at 15% per annum, each \$1.00 would become \$16.37 - a sixteenfold increase in monetary terms!

TABLE 12: LOAN OF \$8,500 @ 10%
 REPAYED AT \$1,000 PER ANNUM

YEAR	INTEREST (\$)	REPAYMENT (\$)	BALANCE (\$)
1	850.00	150.00	8,350.00
2	835.00	165.00	8,185.00
3	818.50	181.50	8,003.50
4	800.35	199.65	7,803.85
5	780.39	219.61	7,584.24
6	758.42	241.58	7,342.66
7	734.27	265.73	7,076.93
8	707.69	292.31	6,784.62
9	678.46	321.54	6,463.08
10	646.31	353.69	6,109.39
11	610.94	389.06	5,720.33
12	572.03	427.97	5,292.36
13	529.24	470.76	4,821.60
14	482.16	517.84	4,303.78
15	430.38	569.62	3,734.14
16	373.41	626.59	3,107.55
17	310.76	689.24	2,418.31
18	241.83	758.17	1,666.14
19	166.01	833.99	826.15
20	82.62	826.15	
Totals:	11,408.77	8,500.00	

Even after ten years of continuous compound interest:

at 5%, \$0.63 is added to every dollar loaned,

at 10%, \$1.59 is added to every dollar loaned,
 and:

at 15%, \$3.05 is added to every dollar loaned.

Abundant Borrowers?

No lender could obtain continuous compound interest without an abundant and ever-expanding army of borrowers. Nevertheless, there are some lenders who almost achieve this end.

TABLE 13: LOAN OF \$6,200 @ 15%
 REPAID AT \$1,000 PER ANNUM

YEAR	INTEREST (\$)	REPAYMENT (\$)	BALANCE (\$)
1	930.00	70.00	6,130.00
2	919.50	80.50	6,049.50
3	907.43	92.57	5,956.93
4	893.54	106.46	5,850.47
5	877.57	122.43	5,728.04
6	859.21	140.79	5,587.25
7	838.09	161.91	5,425.34
8	813.80	186.20	5,239.14
9	785.87	214.13	5,025.01
10	753.75	246.25	4,778.76
11	716.81	283.19	4,495.57
12	674.34	325.66	4,169.91
13	625.49	374.51	3,795.40
14	569.31	430.69	3,364.71
15	504.71	495.29	2,869.42
16	430.41	569.59	2,299.83
17	344.97	655.03	1,644.80
18	246.72	753.28	891.52
19	133.73	866.27	25.25
20	3.79	25.25	
Totals:	12,829.04	6,200.00	

For instance, financiers who lend money all over the world may lend and re-lend money almost continuously. Similarly, in poor countries, where borrowers vastly outnumber lenders, some lenders have access to an almost unlimited supply of borrowers.

Interest allows such people (and their families) to acquire fortunes that just grow and grow. It also allows them to outbid or undercut more and more competitors in the nation's markets, and to increase the amount of land, the number of factories or other productive enterprises, and the number of retail outlets they control.

In this way, interest allows such people to control the lives, health and employment prospects of an ever-increasing number of their fellow citizens.

Progressive Income Tax

The reader may now see why governments tax incomes progressively, and why they redistribute the revenue thus obtained.

Progressive income tax reduces the amount of interest available for re-investment. It therefore lowers the lender's net interest rate, and slows down the growth of private fortunes. At the same time, the redistribution of revenue can help borrowers to repay their loans - thereby increasing the number of citizens who are independent of money-lenders and free of debt.

However, once people become free of debt, they often borrow again. Consequently, the redistribution of income may not only facilitate repayment of debt. It can also increase the demand for loans, and allow interest rates to rise.

The same thing happens when interest payments are made an "allowable deduction" for income tax purposes. Such concessions increase the amount of interest many persons can pay - thereby lifting the demand for loan funds and allowing interest rates to float upwards again.

Because of this, measures to "soften" the effect of interest are of little permanent value. Instead of relying on such measures, governments should look closely at interest itself, and at the factors now affecting interest rates. If that were done, then adverse factors could be identified and removed. Interest rates may then fall of their own accord - to lighten the burden interest now places on all too many citizens.

MARKET ADJUSTMENT OF INTEREST RATES

Rising interest rates reduce the amount each individual can borrow, and increase the quantity of funds lenders acquire. Therefore, as interest rates rise, the supply of loan funds tends to increase, while the demand for them should slacken off.

In the absence of inflation, that would cause interest rates to rise and fall, with the equilibrium point depending on:

- # the supply of loan funds,
- # the demand for them,
- # the number of lenders competing for borrowers,
- # the number of borrowers competing for funds,
- # risk factors,
- # the borrower's earnings,
- # the urgency of the loan,
- # and so on.

Poor Countries

In poor countries, the most important factors are the borrower's earnings and the urgency of the loan.

Many of the inhabitants of poor countries are mere tenants with no savings of their own. A bad season or other adversity soon drives them to money-lenders - many of whom are quite unscrupulous.

Under these circumstances, interest will absorb a large proportion of the borrower's earnings. These earnings, in turn, determine the final interest rate.

Thus, a lender may demand compound interest at twenty percent per annum or more. But if the borrower can only pay ten percent - after keeping himself alive - then that is all the lender will get. Ten percent per annum from a living victim is better than a zero quantity from the borrower's corpse!

Developed Economies

Lenders are more plentiful in the developed nations. In these, borrowers often shop around to obtain loans at a favourable rate.

In the absence of inflation, this rate would rarely exceed ten percent per annum except, perhaps, for very high risk loans.

If there were no inflation, then interest at ten percent would limit the size of many loans. It would therefore cause the demand for loans to slacken off. At the same time, it would increase the supply of loan funds rapidly, by adding ten percent per annum to lender's funds.

It seems, therefore, that interest should not persist at such levels for any length of time, and that interest in double figures should be relatively uncommon in a developed economy.

Inflation vs. Falling Interest Rates

However, while that may be true when a currency is stable, it does not apply in an inflation-ridden economy.

Inflation causes money to lose value at a rate equal to the rate at which the currency is debased. Therefore, to lend money at five percent, with currency debasement running at ten percent, would be akin to giving some of the money away.

Under those circumstances, the lender's funds would not keep pace with inflation, even with continuous compound interest. And few lenders compound interest effectively. Most lenders are also taxpayers - so the government claims some of their interest as income tax.

Hedges Against Inflation

Consequently, when inflation is rampant, people with savings tend to:

- # use their money before it rots away - by spending it on holidays or on consumer goods,
- # purchase precious metals, jewellery, art works, antiques or other goods that tend to increase in monetary value as the currency is debased,
- # invest in income-producing property or shares - in the hope of getting their money back as dividends or rent, or in the selling price of the shares or property,
- # buy land - again in the hope of getting their savings back, intact, when they eventually sell the land, or:
- # seek borrowers who will pay interest above the rate at which the currency is debased, with, if possible, an additional margin to cover the effect of income tax.

Hence, banks, housing societies and other financial institutions must now coax funds away from immediate consumption, from the purchase of items that increase in monetary value as currencies are debased, and from investments in real estate.

They do that by nudging interest rates upward as they compete against one another for the available funds. In this way, they counteract the

normal market effect of rising interest rates, and allow double digit interest to become a fact of life.

A CHECK TO CONSUMPTION

When inflation continues, year after year, it creates an "inflationary psychology" in society. This causes interest rates to rise to levels above the expected rate of currency debasement, and discourages anyone from lending money at less than the likely inflation rate. It also checks consumption, by reducing the effective volume of the nation's circulating currency.

High interest rates place limits on the size of many loans. They therefore force private lenders and financial institutions to shop around for borrowers who can afford the ruling interest rates. As a result, loan funds remain in safes or safe deposit boxes for longer periods than usual, while banks tend to carry more than the usual quantity of cash on hand. (And, at times, to advertise vigorously, as they search for borrowers.)

The same thing happens when people are choosing between lending their savings or buying gold, silver, art works or real estate. Such persons may also withdraw currency from circulation while making up their minds.

A Semi-Automatic Credit Squeeze

In these ways, inflationary psychology produces a semi-automatic "credit squeeze". It reduces the amounts loaned for investment, for building, and for all types of entrepreneurial activity. It also reduces the amount of money available for the purchase of goods and services - because money loaned for any of the above purposes is spent on goods and services eventually.

Therefore, whenever money is withdrawn from circulation - either through a credit squeeze or because no one can afford to borrow it - there is a drop in the demand for goods and services. As a result, unsold goods accumulate in shops and warehouses and less work is available in service industries.

Unsold goods and services are then offered for sale at bargain prices. Hence, incomes in retailing and in service industries tend to fall - whether sales continue or not.

Those whose incomes are falling cannot afford their usual quantity of goods and services. Therefore, once sales start falling, the process tends to be progressive. Consumption is checked and retrenchments begin. If the process is not arrested a chain reaction may ensue - with the recession leading to a depression in the manner described on page 112.

A General Fall in Wages and Prices?

An upsurge in interest rates, or a credit squeeze, need not produce a recession if wages and prices fell in unison. Under those circumstances, wages and prices could remain in balance and consumption may not be checked.

Union Fears

However, today's unions will not allow wages to fall. Unionists fear that any fall in wages may continue until wages reach subsistence level. That is a daunting prospect for the labour force. Consequently, when prices fall because of a credit squeeze or for any other reason, wages rarely follow them down.

Prices, Too?

But unionists are not the only people who object to any drop in monetary income. Producers and businessmen do the same.

After all, a producer's wage depends upon the price he obtains for his product. If the market price of primary produce is falling, then farmers' incomes are going down. (Unless output is increasing at the same time, which is not the situation under discussion here.) Similar considerations apply to producers in service or secondary industries.

Hence, when prices begin to fall, producers bombard the government with requests for tariffs and quotas, for anti-competitive or price-support mechanisms, or for an early end to any credit squeeze.

Easy Ways Out

Governments do not want to fall from favour amongst both unionists and business people. So credit squeezes are usually short-lived. In addition, when markets are becoming glutted, prices are falling and jobs are in jeopardy because of high interest rates, then governments usually mint additional coins, print additional banknotes and write additional cheques.

This new money passes into circulation and is spent. It clears glutted markets by taking the place of money that has been temporarily withdrawn from circulation. It also debases the currency - again! - and adds further impetus to the upward march of interest rates.

BORROWING, LENDING AND CONTINUING INFLATION

Australia's currency has been debased so often in the past that citizens now expect the process to continue into the future as well.

That expectation allows people to borrow quite large sums of money - for various purposes - and to assume that continuing inflation will help them clear the debt.

Borrower-Lenders

It also slows down the rate at which low interest loans are repaid.

Some lucky persons have mortgages that bear interest at a fixed rate well below the inflation rate. Many such persons are not hurrying to discharge their debts. Instead, if they have money on hand, they lend it at market rates of interest, or invest in real estate.

These "borrower-investors" are counting on continued inflation. They know it will help them pay their debts.

They also fuel the fires of inflation:

- # by increasing the demand for loan funds and helping interest rates to rise,
- # by contributing to the upward march of property prices, or:
- # by using land they purchase to a lower than optimum extent.