A critical view and ...

Interest, usury and time

J.P. Tiemstra
Dept. of Economics and Business
Calvin College
Grand Rapids
Michigan, USA

Abstract

This paper argues that there are both ethical and economic reasons to support a normative claim that lower interest rates are preferable to higher ones. Biblical material as well as general ethical norms favours economic decisions that give a high weight to the future. High interest rates make the economy less stable, economic growth less sustainable, and the income distribution less equal. Policy directions are offered for government, business, and households.

1. Theology

John Calvin usually gets the credit for clearing the theological way for capitalism by dispensing with the troublesome question of usury. Calvin argued that the biblical prohibitions on interest applied only to consumption loans given to the poor, and not to loans made for commercial purposes. With commercial loans at interest made theologically acceptable, it became possible to finance large business enterprises.

I do not want to suggest that Calvin was wrong. I firmly believe that commercial loans at interest are morally acceptable. (I also firmly believe that interest-free loans to the poor are desirable, but that is a topic for another paper.) But the biblical language forbidding usury is very broad and it is frequently repeated. I think we should look more closely at this material to see if it might contain some wisdom about how our attitude toward time affects economic performance.

The Old Testament writings seem to forbid any usury, and praise as righteous the one who eschews lending at interest (Deut. 23:19; Lev. 25:36-37; Ps. 15:5; Ezekial 18:8,13). The context seems to indicate that only loans to the poor were

contemplated, however. The calculation of a land price in Leviticus 25:14-17 applies a zero discount rate to future returns. Again it seems that the relief of the financially distressed is the point of the exercise, but neither is there any support in any of these passages for discounting the future.

The theme is carried forward into the New Testament, but with more nuance. Jesus himself preached that we should lend to those (the poor, presumably) who cannot even pay the principal back, let alone interest. He thus reinforces and extends the Old Testament teaching as it relates to those in need. The epistles teach that patience is a Christian virtue (Gal. 5:22), and believers are warned that they should not use the expected immanence of the Second Coming as an excuse not to provide for themselves and their families (2 Thess. 3; 1 Thess. 5). All of this suggests that Christians are to be forward-looking people, making provision for the future without worrying about it. This has been the teaching of most modern Christian ethicists when faced with issues like the purchase of life insurance. The *James Watt doctrine* of using things today because the Lord may come tomorrow, was rightly ridiculed, because it has no scriptural basis.

The modern secular ethicist, John Rawls, has also given thought to the issue. Behind the famous 'veil of ignorance' the question arises whether one generation deserves more economic benefits than another? Clearly, the answer is *no*. This result causes difficulties for economists, since the distribution of wealth and income across generations has been far from equal. There does seem to be moral pressure to do cross-generational income transfers in growing economies, however, which is the point of social security. There is little pressure, however, to reduce investment in schooling children or otherwise increasing their human capital. We do want future generations to be better off, even if we have trouble conceiving why they should be. The Rawlsian argument does not support a positive rate of time discount, though our revealed sentiments might.

Such concerns have sometimes been reflected within the economics profession. The fact that future generations are not present now to bid for resources that they may want to use, has suggested to some economists that the market will not efficiently allocate resources between present and future. Some economists have also suggested that the sustainability of economic activity is an independent criterion for assessing an allocation of resources, apart from efficiency. There is no reason to think that market forces will lead to a sustainable allocation.

2. Economic implications

In societies where people are impatient or present-oriented, people prefer to have things now rather than later. This preference leads to a low rate of saving and high levels of debt. The consequence is that real interest rates will be very high,

especially at the long end of the yield curve. Most economists do not see anything fundamentally wrong with this situation, since it is merely a case of market prices (in this case, interest rates) reflecting people's preferences. If the economy merely ought to respect preferences, this is fine, but our theological and ethical discussion suggests that there may indeed be something wrong with this situation if it is examined from a Christian point of view. We therefore ought to look for ways in which economic performance is affected, and indeed compromised, in a society with a high rate of time discount.

First, we know that high interest rates lead to more rapid depletion of natural resources and deterioration of the environment. Many well-established theoretical propositions show this. Exhaustion of non-renewable resources is more loaded toward the present. Resource-conserving investments are less likely to be socially cost-effective. Irreversible land use decisions are more likely to be taken. Stocks of renewable resources will be smaller. Again, if the point is merely to give people what they want, there is no problem. But if we are the stewards of God's creation, which has value in its own right, and if we are at all concerned about the well-being of future generations, there is indeed a problem. High interest rates undermine efforts to protect the natural environment and insure the sustainability of the economy.

In an environment of high interest rates businesses that must borrow to finance operations must commit a high proportion of their cash flow to debt service. This situation leaves businesses very vulnerable to bankruptcy in the event that a downturn in sales reduces cash flow. What is true of businesses can also be true of countries, as the international debt crises of the 1980"s demonstrated. The result is an unstable economy – one that easily tips over into recession and is difficult to right again. While some economists take the rather crass view that recessions are periodically necessary to preserve an economy's dynamism, the social and moral cost of unemployment leads sensitive Christians to believe that recessions are evil, and we must work to make them shorter and less frequent. High interest rates work the opposite way.

With such fragile financial structures, and with so much money to be made from the clever management of cash, executives devote increased attention to the financial side of the business. Financial planning and restructuring become the most important aspects of business. The production and marketing sides of business are relatively neglected, to the detriment of long-term competitiveness. This dynamic aspect of the high interest rate environment is hard to capture in the standard static models, and so tends to be neglected by economists.

Economists do more clearly understand the effect that high rates have in depressing capital investment and research and development. This will have a

detrimental effect on economic growth in the long term. If generations are considered to be equally deserving, it may be that growth in the long run is not that important. Nevertheless, competitiveness is important, and an enterprise that fails to stay current in product and process technology will not just fail to grow – it will die. Such events entail large costs to the society for re-allocating the resources to new activities. Furthermore, simply because we do not hold later generations to be more deserving, it does not mean that we want to forego potential real improvements in technology that will make their lives better: that would be a failure to exercise proper stewardship of the gifts God has given us. The question does not concern increasing the quantity of goods, about which Christians have many serious questions. Rather, it has to do with improving the quality of life, which is quite a different matter. Improving the quality of life requires investment, which high interest rates make unprofitable. It also bears on the issue of the sustainability of economic activity in the long run, which is compromised by high interest rates.

Finally, high interest rates make the distribution of income less equal, widening the gap between rich and poor. The distribution of financial and real wealth is more unequal than the distribution of income, and high real interest rates mean a higher return to financial and real wealth. This leads to an increased sense of hopelessness and alienation and envy on the part of the poor, and sometimes to an increased sense of superiority on the part of the rich. All of this, while perhaps not immoral, is certainly unjustifiable, and destructive of social harmony and stability. It is best avoided.

To summarize: there is good reason to think that high interest rates damage economic performance. Neoclassical economics is inclined to shrug off these effects as simply the legitimate reflection through the market system of the subjective preferences of consumers and the resource constraints of the economy. The biblical teachings about Christian attitudes toward time and the future, however, suggest that these phenomena have normative significance. Secular ethics may also lead to this conclusion. We must therefore ask what actions by government and the private sector can move us toward an economy that reflects appropriate concern about the future.

3. Ethical responses

The government's monetary and fiscal policies clearly have an effect on interest rate levels, and an ethical set of policies will keep rates low in order to avoid performance problems. Monetary policy has strong effects on short-term credit conditions and on inflation, which affects long-term nominal rates. Keeping credit conditions easy while keeping inflation in check will help to orient private-sector decisions toward the future. Some would claim that monetary policy can not

change the underlying preferences and resource constraints that determine real interest rates, but that position ignores the real benefits that come to the economy from a well-functioning financial system. The needs of the future will not be well met if savers and investors can not be brought together efficiently in the market. The monetary authorities can ease this process by keeping the system liquid.

Fiscal policy has a more direct impact on long-term real rates. If the fiscal deficit absorbs a large proportion of the society's savings, long-term real rates will remain high, and economic damage will result. The fiscal authorities have a responsibility to keep the size of the deficit within bounds.

The tax structure can also bias the economy toward the present. The prescription here is less clear, because tax policies that favour savers and investors are often regressive in their distributional effects; e.g., heavy reliance on sales taxes or a VAT, or low taxes on capital gains. Nevertheless, some useful measures can be taken, including ending deductibility of interest on consumer debt, allowing expensing of business research and development, and ending tax subsidies for the production of exhaustible resources. Investments in tangible capital should all be treated alike for tax purposes.

It is important for businesses and consumers alike to perform sensitivity analyses on time-dependent decisions, to determine exactly how the interest rate is biassing the decision. I suggest that in addition to the conventional present-value calculations, economic agents should run through decision analysis using the assumptions of Leviticus 25, i.e., a zero discount rate with a fifty-year time horizon. If the decision looks very different, agents should consider taking the more farsighted approach, both for the good of the economy and for the good of the household or firm.

In the literature on the productivity and competitiveness problem in the US, business executives are often castigated for having too short a time horison. It has been suggested that one of the reasons for this is that managers often do not consider the option value of an investment. The option value is less easily quantified or estimated than a simple, maximum-likelihood present value, and so it is often left out. Proper strategic planning in business must be based on the assumption that the firm will be an ongoing enterprise for the indefinite future, and the planning should anticipate the competitive environment that the firm will have to survive. This approach does not necessarily coincide with the short-term self-interest of the managers themselves, or perhaps even of the stockholders. However, it does recognize the interest of other stakeholders in the firm – its workers, their communities, and the general public of the nation. It is therefore the only approach consistent with the ethical social responsibility of the firm.

There are, then, actions that can be taken by households, businesses, and governments that recognize the Christian responsibility to approach the future in a concerned, farsighted, and courageous way. We all can have a part in restoring a healthy concern for the future to our economic life.