How Interest Causes Unemployment

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A number of nations are currently mired in an economic recession. Conventional economic theory seems unable to point to a way out. Many households, individuals, firms and even governments are trapped in sizable levels of debt. Keynes argued in favour of overcoming the Great Depression by raising government spending in order to stimulate economic growth. This was to be financed by borrowing. This solution worked then but is unlikely to work now, as many governments are already deeply in debt.

One solution is to write off the debt (debt forgiveness), or at least the interest portion of it. But this is only a short-term solution. The longer-term solution requires abandoning the practice of financing spending and investment by borrowing, and replacing it with financing on the basis of profit and loss sharing. As all borrowed funds have to be repaid with interest, even if economic activity initially accelerates as a result of spending borrowed funds, economic growth is bound to slow down during the stage when debt has to be repaid with interest. Thus, what is required is phasing out financing on the basis of interest-based lending and replacing it with profit and loss sharing.

The problem with Keynes' model is that it assumes that interest-based financing is indispensable. He did not see that profit as an incentive is in principle better suited for ensuring an efficient allocation of resources than interest. Not only did Keynes not see that interest hinders the efficient allocation of resources, he did not see interest as problematic even from an ethical point of view.

He did not see a problem with paying someone a reward (interest) without giving a tangible contribution to production in exchange. But all payments made without receiving a meaningful counter value in exchange constitute glaring evidence of inefficiency, if not also injustice. Moreover, Keynes did not see that the main cause of unemployment, inflation, as well as sluggish economic growth, came at a cost (interest). In particular he did not see that no economic system would reach full employment as long as capital came at a cost. He assumed that full employment could be reached if a sufficient amount of (government) spending took place.

Moreover, Keynes assumed, mistakenly, that interest rates are determined by market forces. Thus, his model of equilibrium in the money markets assumes that a positive equilibrium rate of interest is established by the demand for money (by businesses for investment purposes) and the supply of money (provided by savers).

But this is far from the case. In fact it is the central bank that determines the rates of interest through monetary policy, and open market operations in particular. Interest rates are fixed by central banks, which thus effectively control the “price” of credit. Capital coming at a price, and moreover at a price that is fixed, is the main source of inefficiency as well as instability throughout the financial and economic system.

Standard economic theory teaches that whenever a price is controlled at any level other than the equilibrium level, a shortage or a surplus will arise and persist as long as the price remains controlled. A (minimum) “price” of capital (interest rate) causes a surplus of funds to develop within the financial system (an excess of savings over investment), in the same way as any minimum price (such as a minimum wage), will cause a surplus of labour in the labour markets.

Like many who followed him, Keynes did not see that for the economy to operate at full employment, interest rates have to be zero, which is the true “equilibrium price” of capital, something that Milton Friedman recognised. However, for some reason Friedman did not follow up on this idea.

It is commonly recognised in conventional economic theory that when central banks raise interest rates, investment declines, economic growth slows down and unemployment rises. Conversely, when central banks lower interest rates, investment economic activity accelerates, and unemployment declines. However, as long as interest rates remain positive (are greater than zero), some unemployment remains even at a time of growth.

The existence of this unemployment has been accepted as an “unavoidable” fact of life. But in fact it is not inevitable. This unemployment comes at a cost, even if the cost (interest rates) appears to be relatively low, acting as a deterrent (disincentive) for investment. Of course, the higher the cost, the greater will be the reduction in investment.

Thus, unemployment can be eliminated by phasing out financing by lending at interest and replacing it with financing by way of profit and loss sharing. In financing investment by way of profit and loss sharing, funds can be obtained without the need to pay for them in the form of interest. Instead, investors are rewarded with profits, and even then only after it has been confirmed that profits have indeed been earned.

The chart below shows the relationship between interest rates and unemployment. The graph shows that unemployment is a function of interest

rates. The rate of unemployment depends directly on the rates of interest. The unemployment rate rises and falls with the interest rates.

The reason that the unemployment rate and the interest rates are positively correlated is that as the cost of (loan) capital rises, fewer and fewer businesses are able to afford to borrow at interest for the purpose of investment. Thus, whenever the cost of capital (the marginal cost of capital) exceeds their profit levels (marginal efficiency of capital), some firms will find borrowing unaffordable.

As businesses profits range from zero (break-even point) and up, whenever interest rates are greater than zero, some businesses will be unable to borrow. Thus, some resources, in particular human resources, will remain unemployed. The higher the cost of capital, the greater will be the quantity of unemployed resources.

Graph 1 Unemployment and interest rates

In the chart, the level of unemployment is plotted on the vertical axis (%) while interest rates are indicated on the horizontal axis. The graph shows that as interest rates increase, so does unemployment. For example, when (lending) interest rates are 2.5%, the unemployment rate is 5%. When the interest rates rise to 5%, unemployment also doubles to 10%. In other words, a direct relationship exists between the level of interest rates and unemployment. This means that unemployment decreases as interest rates decrease. Thus, only when the cost of capital reaches zero, in other words only when interest rates become zero, and the economy becomes interest-free, can full employment be reached.

Full employment of resources can be reached under conditions of financing on the basis of profit and loss sharing, constituting a powerful incentive for phasing out interest based on financing and replacing it with profit and loss sharing.

Thus, achieving full employment requires phasing out financing on the basis of interest-based lending and its replacement by profit and loss sharing. This will ensure a long-term full employment equilibrium that Keynes wanted but could not achieve because he assumed that interest-based financing had to be an integral part of the modern financial system.

Full employment cannot be reached in an interest-based system, because in such a system only those firms will obtain investment capital from financial institutions whose marginal efficiency of capital (profit rate) exceeds its marginal cost (interest rate).

Capital comes at a cost in preventing the economy from ever reaching full employment. The money that would have been paid to the unemployed in an interest-free system in exchange for productive activity is instead paid to lenders in exchange for unproductive activity: lending.

This perpetuates not only inefficiency but also injustice, as those who are willing to work in exchange for wages are unable to do so, while those who lend are paid for remaining idle, as lending at interest allows them to earn income without the need to work or even to take risk.

There is no reason to fear that reducing the cost of capital to zero will cause inflation, because in the absence of interest, businesses will no longer have any interest expenses to pass on to consumers in the form of higher prices. Moreover, more workers will produce more goods and services. The increase in the supply of goods and services will reduce pressure on prices to rise, and may even cause them to decline. Thus, with the phasing out of financing by lending at interest, all three major economic objectives, stronger growth, higher employment and more affordable prices, can be realised at the same time. The intractable problem presented by stagflation can likewise be overcome by utilising profit and loss sharing forms of financing in preference to financing by way of lending at interest.

Note

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