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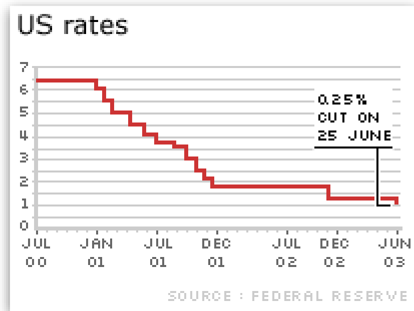
Rate Cuts and Profitability

[first published at mises.org, July 7, 2003]



We have now seen yet another interest rate cut by the Federal Reserve, intended to stimulate a recovery. However, you don't have to be a particularly skeptical person to doubt that the rate cut will work this time—after all, it is the 13th cut in the last 2½ years.

The idea behind the cuts is more or less that by forcibly lowering the interest rates, the costs of businesses and households will fall, consumption and investment will commence, and profits will recover. But why hasn't it worked the former 12 times? Is there something wrong with this idea? It is tempting to say yes, since there are strong reasons to believe that this idea involves a reversal of the causality. And as with all economic relationships, such attempts are futile.

To illustrate that this idea hasn't worked out in the past, let us perform a financial quiz:

QUIZ: What country is the text referring to?

- ✓ 14 months back in time: The central bank announced that "prices will be stable," the decline in year-to-year domestic wholesale prices "will become smaller" and that "the rate of increase in consumer prices may virtually stop dwindling". "In sum, [the] economy will probably continue to recover."
- ✓ 11 months back in time: "Domestic wholesale prices have now stopped declining but are likely to go down again. The year-to-year increase in consumer prices will stay about zero as the increase in cheap imports will exert downward pressures on consumer prices, the so-called 'price destruction' phenomenon." "In sum, while moderate economic recovery has been under way [the central bank] lowered the official discount rate."
- ✓ 8 months back in time: The "economic recovery has paused […] despite expansionary forces that underlie the economy." Furthermore, "prices are expected to continue a weak trend owing to the weak economic recovery" and "the declining trend of domestic wholesale prices is expected to persist while consumer prices are also forecast to decrease somewhat year to year […]." "[I]n these circumstances, […] considering the influence that an excessive decline in prices may have on the economy," the central bank cut rates again, this "expected to contribute to the sustainability of economic recovery by stimulating demand […]."
- ✓ 5 months back in time: "[T]he pause in [the] economic recovery continues' and 'prices are expected to remain unchanged or decline marginally."

- ✓ Present time: "I am often asked, both in and outside [the country], whether continued recovery is assured, and how much possibility there is of the recovery running out of steam, especially since the […] economy stalled [last year] after barely starting a long-awaited recovery. In fact, recovery this time has, up until now, been dependent mainly on public investment and interest rate-sensitive housing investment; namely, it has been supported by the effects of monetary and fiscal policies. Thus, the important question now is whether the current momentum of recovery will gather further strength and stimulate private demand such as business fixed investment and personal consumption. In light of the following factors, we at the Bank believe that compared to [last year], there is a far smaller risk that the recovery will be disrupted."

Can you name the country? Does the scenario sound familiar? Where are these words found? Is it from the latest the Federal Reserve speech about the U.S. economy? The ECB about the European? The Bundesbank about the German economy or the Riksbank about the Swedish?

No, the "present time" of the quiz happens to be April 1996, when the Governor of Bank of Japan (BoJ) in a speech addressed the recent economic development in Japan of that time, and the earlier quotes are from the BoJ Quarterly Economic Outlook for 1995.

BoJ had just lowered the interest rate to a record low level and in the speech he was assuring the public that everything was going according to the plans, despite the fact that he openly admits that the rate cuts hadn't been effective. After all, had the rate cuts been effective, the speech wouldn't have been about the risk of "running out of steam" or the small "risk that the recovery will be disrupted," would it?

The main tool BoJ used to try to force the economy to recover was cutting interest rates. Now, cutting interest rates clearly hasn't worked out in the past in Japan. After all, the BoJ rates are at 0.1%, i.e. almost zero, without profits recovering. And now the Federal Reserve rate is at 1.0% and the ECB rate is at 2%. These are almost desperate attempts to make things work out according to the central bank planning.

But what exactly is wrong with the idea behind the rate cuts? In what way could it be said to involve a reversal of causality?

In his 1912 The Theory of Money and Credit, Austrian economist Ludwig von Mises (1881–1973) elaborated on an idea about interest rates that was originally developed by Swedish economist Knut Wicksell (1851–1926). According to this idea, by setting the rate of interest at a level diverging from the 'natural rate of interest', this could in the end have real effects[i]. For example, according to Wicksell, by setting the rate of interest below the natural rate, this could cause prices to rise in a non-neutral way, thereby providing a short-run interpretation to the quantity theory of money. With his book, Mises laid the foundation to what later has been referred to as the Austrian Business Cycle Theory.

The most common "Austrian" explanation to what the natural rate actually should be is that it is connected to time preference. It is the rate that would be established in a free market where individuals make judgments over how much to consume today as opposed to investing today in order to be able to consume tomorrow.

By forcibly keeping the interest rates below the natural rate, investment activities commence that would otherwise not have been started, i.e. malinvestment occurs, at the expense of current consumption. As champions of the free economy, "Austrians" consistently oppose all kinds of government intervention, including government money creation and interest rate manipulations.[ii]

Let's see how Mises's ideas could provide support for the claim that cutting interest rates to force profits to recover involves a reversal of the causality. To do this we might have a look into the ideas that were around when Mises first formed his ideas. For example, Adam Smith (1723–1790) noted that "[t]he interest [rate] of money is always a derivative revenue […] paid from the profit that is made by the use of money […]." He thus claimed that the rate of interest was determined by the rate of profit. With this in mind he even tried to track the rate of profit back in time by studying the official rates, for he was certain that "[n]o law can reduce the common rate of interest below the lowest ordinary market rate." In the same manner, David Ricardo (1772–1823) was considering what was "the cause of the permanent variations in the rate of profit, and the consequent permanent alterations in the rate of interest," clearly indication his view on the causal relation.[iii]

However, Smith was only partly right in asserting that no law per se could keep the rate of interest below the rate of profit. In the shorter term, this is indeed possible, as later Wicksell showed and as we just have discussed. Wicksell later asked himself if it would 'at all be possible for the banks to keep the rate of interest either higher or lower than its normal level, prescribed by the simultaneous state of the average profit on capital?'[iv] While he provided a negative answer to this question, the interesting thing in this context is that here we suddenly see that he referred to the natural rate as equal to the average rate of profit[v]. After all, it seems as though Wicksell actually shared the same idea as Smith and Ricardo.

But is this really any different from Mises's view? All of the economists mentioned here could be said to agree that the interest rate is determined by the natural rate of interest. But while the pre-Mises economists argued that the natural rate was equal to the rate of profit, Mises himself claimed that it was determined by the rate of the time preference. Who was right? Or were all of them wrong? Well, for instance, the average rate of profit is more or less observable, while the rate of the time preferences isn't. But that is hardly a sufficient theoretical argument in favor of the former. However, there might be a straightforward solution available.

That solution would be to say that the rate of profit is the natural determinant of the rate of interest, while the time preference is a major determinant of the rate of profit. In this way, the time preference is a major determinant of the rate of interest, however only in an indirect way, via the rate of profit.[vi] And consequently, we could say that all the great economists mentioned here are in agreement over the causal relationship between time preference, profit and interest.

Fed and other central banks are not succeeding in their attempts to force the respective economies to recover simply because they are acting on ideas that have reversed the causal relation between the rate of interest and the rate of profit. The rate of profit is the natural determinant of the rate of interest, not the other way around. On this there seems to be full agreement among economists like Adam Smith, David Ricardo, Knut Wicksell and Ludwig von Mises—a pretty impressive line-up with some pretty impressive arguments.

In order for profitability to recover, it is essential that we let profits and the economy recover on their own. All attempts to the contrary will be futile[vii]. If the economy is left on its own, profits will recover because the springs of profitability are inherent. And remember, from an economy-wide perspective, "a low rate of profit actually works to encourage more capital investment than less"[viii].

Endnotes

[i] He propounded this idea in his Interest and Prices from 1898, calling it the ‘cumulative process’. Incidentally, he found much of his ideas in the works of Austrian economist Eugen von Böhm-Bawerk’s (1851–1914) Capital and Interest.

[ii] Interestingly, Mises wrote that “[i]t is not possible to determine Wicksell’s natural rate of interest.” See On the manipulation of money and credit. 1978. P. 157.

[iii] See Smith’s The Wealth of Nations, Bk.I, Ch.VI, Bk.I, Ch.IX and Bk.II, Ch.IV, Pt.II and Ricardo’s Principles of Political Economy and Taxation. 1911. Ch.VI.

[iv] See his essay The Influence of the Rate of Interest on Prices, Economic Journal XVII (1907), pp. 213–220.

[v] Although he for some reason called it the normal rate.

[vi] This is a feature of economist George Reisman’s Net Consumption and Net Investment Theory. See his 1996 book Capitalism: A Treatise on Economics, Ch. 16.

[vii] The current rate cuts are thus not likely to raise overall profits in any lasting way. However, if profits actually were to rise in the near future, it would be despite the rate cuts. Sure, the statistical relation would look pretty from the rate cutter’s perspective. But the plausible causal relation still is that the rate of profit determines the rate of interest, not the other way around. We would then have to find another cause for the rising profits; a cause strong enough to counter the rate cuts. But that’s another story.

[viii] For more on these last points, see George Reisman’s book Capitalism: A Treatise on Economics, Ch.16, pp. 778.