

Theories of Interest

The five theories of interest are as follows: 1. Productivity Theory 2. Abstinence or Waiting Theory 3. Austrian or Agio Theory 4. Classical or Real Theory 5. Loanable Fund Theory.

1. Productivity Theory:

According to productivity theory, interest can be defined as a reward for availing the services of capital for the production purpose.

Labor that is having good amount of capital produces more as compared to the labor who is not assisted by good amount of capital.

2. Abstinence or Waiting Theory:

The abstinence theory was propounded by Senior. According to him, interest is a reward for abstinence. When an individual saves money out of his/her income and lends it to other individual, he/she makes sacrifice. The term sacrifice implies that the individual refrains from consuming his/her whole income that he/she could spend easily. Senior advocated that abstaining from consumption is unpleasant. Therefore, the lender must be rewarded for this. Thus, as per Senior, interest can be regarded as the reward for refraining from the use of capital.

3. Austrian or Agio Theory:

Austrian theory is also termed as psychological theory of interest. This theory was advocated by John Rae and Bohm Bawerk in an Austrian school. According to Austrian theory, interest came into existence because present goods are preferred over future goods. Therefore, the present goods have premium with them in the form of interest. In other words, present satisfaction is of greater concern as compared to future satisfaction.

Therefore, future satisfaction has certain type of discount if compared with present satisfaction. The interest is the discounted amount that is required to be paid for motivating people to invest or transfer their present requirements to future.

4. Classical or Real Theory:

Classical theory helps in the determination of rate of interest with the help of demand and supply forces. Demand refers to the demand of investment and supply refers to the supply of savings. According to this theory, rate of interest refers to the amount paid for saving.

Therefore, the rate of interest can be determined with the help of demand for saving money to be invested in the capital goods and the supply of savings. Let us understand the concept of demand of investment. Capital goods are used for the production of consumer goods and provide returns continuously for many years.

However, a certain degree of uncertainty is associated with capital goods due to their future use. In addition, operation and maintenance costs are involved in using capital goods. This makes organizations to calculate the net expected return on the marginal cost that is represented as the percentage of cost of capital good.

In case, an organization has similar type of capital goods, then the increase in one more capital good would not yield them high revenue. The increase in the rate of interest would result in the fall of demand of capital goods.

Figure-18 shows the demand for capital investment:

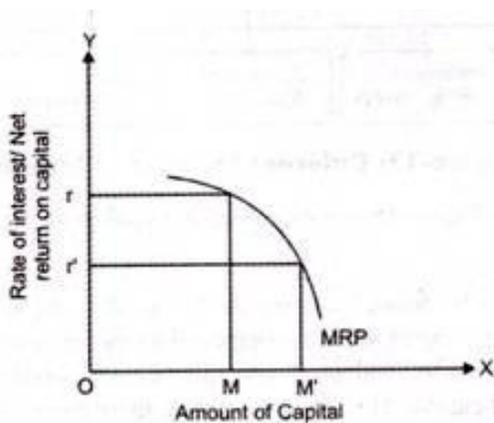


Figure-18: Demand for Investment

In Figure-18, MRP represents the marginal revenue productivity curve. When the demand of capital is OM, then the rate of interest is Or. The net rate of return becomes equal to the current rate of interest (Or) at the OM demand of capital.

In case, the rate of interest decreases to Or', then the demand of capital increases to OM'. The net rate of return is equal to Or' when the amount of capital demanded is OM'. The demand for capital goods increases with a decrease in the rate of interest.

On the other hand, the supply of capital increases by the amount saved by an individual and the saving is done by transferring the present requirement to the future requirement. The rate of interest would increase with the increase in the amount of saving by an individual

The rate of interest can be determined with the help of demand of investment and supply of savings. It would be the point of equilibrium where demand and supply intersect each other or get equal.

Figure-19 shows the determination of rate of interest with the help of demand and supply curves:

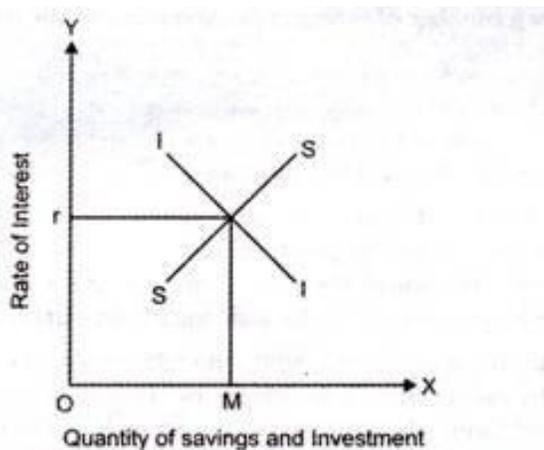


Figure-19: Determination of Rate of Interest

In Figure-19, SS is the supply curve of saving and II is the demand curve of investment that intersect each other at Or rate of interest with quantity of saving and investment is OM. OM represents the amount that is lent, borrowed and used for investment. The rate of interest can be changed by changing the demand and supply of savings and investment.

5. Loanable Fund Theory:

Loanable fund theory agrees with the view that time preference plays an important role in determining the occurrence of interest. This theory is also termed as neo-classical theory of interest. According to neo-classical economists, interest is the amount paid for loanable funds. It focuses on the determination of rate of interest with the help of demand and supply of loanable funds in the credit market. Let us understand the concept of supply of loanable funds.

