Correspondence on Marx's analysis of interest rates

19 October 1999

The following is a reply drafted by Nick Beams, a member of the World Socialist Web Site *Editorial Board, to an inquiry regarding Marxist economics and the role of rising interest rates in the onset of economic recession.*

Dear World Socialist Web Site,

I follow your website daily with the greatest interest. This query concerns the role that rising interest rates play in ending economic expansions.

Recently, I have read a fair amount of Marx's writing—a good portion of *Capital* Volume I as well as a lot of *Theories of Surplus Value*. In the latter book, I have gained some solid insights into the Marxist understanding of the trade cycle. Essentially, my understanding is that Marx sees the process of capitalist tranformation in M-C-M as containing within it the real possibility of economic calamity. What effect do rising interest rates play in the transformation process? Essentially, does the initial M become more costly to acquire? Does this make the acquisition of fixed capital more costly during the second stage—the time that the capitalist tranforms raw materials into a finished product? Does this increase in the cost of acquiring the initial start-up money require that more surplus value be extracted from labor so that overall profit margins can be maintained? Am I completely misinterpreting Marx? I eagerly anticipate your answer.

In Solidarity,

AW

Dear AW

In answering your query I should like to begin by restating some of the fundamental points of Marx's analysis. As you will know from your reading of Volume I of *Capital*, Marx demonstrates that the sole source of surplus value in the capitalist process of production is the living labour of the working class. The circuit of capital is represented by the formula M—C—M', where M represents the initial quantity of money possessed by the capitalist, C the commodities he purchases for the production process (raw materials, machinery and labour power) and M' the expanded amount of money held by the capitalist when he has turned the commodities created by the production process back into money and realised the surplus value embodied in them.

Surplus value arises from the difference between the value of labour power, which the capitalist purchases on the labour market, and the value added by the worker in the course of the working day. The value of labour power, or the capacity to work, which the worker sells to the capitalist, is determined, like every other commodity, by the amount of socially necessary labour needed to produce it. This is embodied in the value of the commodities needed to sustain the labourer himself and his family so that a new generation of wage labourers is available.

Suppose, for example, labour power embodies 4 hours of socially necessary labour. That is, it takes 4 hours on average to produce the commodities (food, clothing, housing etc.) needed to sustain the worker and his family. But the capitalist has the right to the use the labour power not just for 4 hours (the time taken by the worker to reproduce the value of his labour power) but for 8 hours, the length of the working day.

As Marx explains: "The fact that half a day's labour is necessary to keep the labourer alive during 24 hours, does not in any way prevent him from working a whole day. Therefore, the value of labour power, and the value which that labour power creates in the labour process, are two entirely different magnitudes; and this difference of the two values was what the capitalist had in view, when he was purchasing the labour power" [*Capital* Volume I p. 188].

In order to lay bare the origins of surplus value in Volume I of Capital, Marx assumes that the organic composition of capital—the ratio of constant capital, comprising raw materials and machinery, to variable capital, labour power—is the same in all industries.

In Volume III, as he proceeds from this abstraction to a more concrete analysis of capitalist production, Marx drops this assumption. There he shows that the profit received by each section of capital is not equal to the mass of surplus value, which it individually extracts. If it were the rate of profit would vary in each industry according to the amount of living labour it directly exploited, contradicting the historically observed tendency for the formation of a general or average rate of profit across all sections of industry.

Marx shows that the total mass of capital is divided up among the different sections of capital according to their share of the total capital, which has been used to extract it. This means that commodities produced by capital do not sell at their value. Rather, the price in the market oscillates around the "price of production"—the price necessary to return to each section of capital profit at the average rate, provided that it produces at the average level of productivity.

But this process does not take place at all peacefully. It is effected through the continuous competitive struggle in the market. Those sections of capital which are able to lower their costs to below the social average will receive a higher rate of profit. As these more productive methods become increasingly widespread, those sections of capital which have not introduced them find that their productivity falls below the social average and their profit declines.

Furthermore, if the general rate of profit falls this will set in motion a competitive struggle among the different sections of capital as they each try to maintain their share.

As Marx explains: "So long as things go well, competition effects an operating fraternity of the capitalist class ... so that each shares in the common loot in proportion to the size of his respective investment. But as soon as it is no longer a question of sharing profits, but of sharing losses, everyone tries to reduce his own share to a minimum and to shove it off upon another. The class, as such, must inevitably lose. How much the individual capitalist must bear of the loss, i.e, to what extent he must share in it at all, is decided by strength and cunning, and competition then becomes a fight among hostile brothers. The antagonism between each individual capitalist's interests and those of the capitalist class as a whole, then comes to the surface, just as previously the identity of these interests operated in practice through competition" [*Capital* Volume III p. 248]

In order to maintain its share of the total surplus value each section of capital is forced to continually develop the means of production in order to increase the productivity of labour and lower its costs.

However, it does not follow that under conditions where it is forced to carry out such a re-organisation of production, capital will necessarily have on hand the money required for such a process. If it were to wait until it had turned the value embodied in fixed capital back into money it could be forced out of business by its rivals. Hence capital is forced to go to the credit markets to obtain the money necessary to expand production (and lower costs) or to introduce completely new production processes. In return for these funds from the banks, it undertakes to repay them, with interest, out of the share of surplus value (profits) which it thereby obtains. In other words, interest entitlements are a claim on future or anticipated surplus value.

So long as the rate of profit—determined by the ratio of total surplus value to the total mass of capital—continues to expand, or at least remains stationary, the economy continues to expand and productive capital and finance capital divide up the surplus value between them. But inevitably with the accumulation of constant capital relative to variable capital, the rate of profit tends to decline. This brings about a struggle both between the different sections of productive capital (those engaged in the actual extraction of surplus value) and finance capital, with its claims on surplus value.

One of the ways in which the dominant sections of capital have sought to maintain their profits is to use their monopoly position in the market to increase prices. They seek to delay the effects of falling profit rates by lifting their own prices and demanding that the government expand credit within the economy to finance demand. However, such a process brings about an increase in the rate of inflation and this has a deleterious effect on the banks, and finance capital in general. We saw this process in operation in the mid to late 1970s when the major corporations increased prices following the downturn in the rate of profit from around 1973 onwards and sought Keynesian measures to sustain markets and prevent the deepening of recession. This policy was associated with the Carter administration from 1976 onwards. But as inflation increased, and real interest rates declined (reaching negative levels in some cases) finance capital demanded an end to inflationary measures. This was the essence of the rapid interest rate rises imposed by the US Federal Reserve under Volcker in the early 1980s.

The increase in interest rates, the consequent recession and the rise in the value of the US dollar were the means through which finance capital forced a restructuring of industry in the US and internationally—the closure of large sections of industry, the transfer of operations internationally and the development of new systems of production based on computer technology in order to lower costs.

Now to come to your specific questions. An increase in interest rates does not increase the cost of fixed capital—that is determined in the market—but reduces the portion of surplus value, which would have otherwise gone to productive capital in the form of profits. Finance capital increases its share of the available surplus value.

The whole structure of the US and the international economy has become extremely sensitive to interest rate increases. There are a number of factors involved in this. In the first place, since the end of the post-war boom there has been a continuous downward pressure on profit rates. In the halycon days of the boom, firms fixed their prices on the basis of cost plus mark-up. They were able to do so because the overall mass of surplus value was rising. This is no longer the case. Every firm today is faced with a fixed or even declining price for its products and so must seek to ensure its profits through cost-cutting.

This requires large amounts of capital, both to introduce new production technologies or to finance mergers and acquisitions in order to enable cost cutting through economies of scale. In order to maintain share values, either to finance mergers or prevent themselves from being taken over, firms strive to maintain share values, often through share buybacks financed by the banks and other financial institutitions. This replacement of equity with debt has made many firms very sensitive to interest rate rises.

An increase in interest rates means that each firm is forced to pay out a larger proportion of the profit it acquires to the banks and financial institutions. This sets in motion continuous cost cutting through all the methods with which we have become all too familiar—reductions in wages and the elimination of jobs through downsizing.

The more dependent capital becomes on credit, the more severe will be the impact of rising interest rates on profits.

A simple arithmetical example will make this clear. Suppose that a capital of 100 consists of 50 of borrowed funds and 50 supplied by the firm itself. Let us suppose that the average rate of profit is 10 percent and the interest rate is 5 percent. Then out of a profit of 10 (on the total capital of 100), the firm will be required to pay 2.5 to the banks, leaving 7.5 in profit. Now suppose that interest rates rise to 6 per cent. Out of the same profit, capital will be forced to pay 3 to the banks and profit will have fallen to 7. That is, for an increase of 1 percentage point in interest rates profits will fall by 0.5/7.5 or 1/15, that is by 6.7 percent.

Now consider a firm in which the proportions are 60 and 40. The profit will fall from 7 to 6.4, or a decrease of 8.7 percent.

One of the effects of such a fall in profits is a reduction in the demand for investment goods. As investment demand falls so the demand for labour contracts, leading in turn to a drop in consumption demand and a reduction in economic growth, even to the point of recession. This can have a cumulative effect. Faced with declining markets, firms require greater injections of cash just to maintain their operations. But under conditions where markets are contracting, the banks impose harsher conditions for the repayment of loans, thereby intensifying the slump. The present nervousness in US markets over the direction of interest rates may well indicate that we will see these processes in operation in the not too distant future.

Obviously, the overall process is more complicated than I have indicated here. But I hope my reply begins to answer some of your questions.

Yours sincerely,

Nick Beams