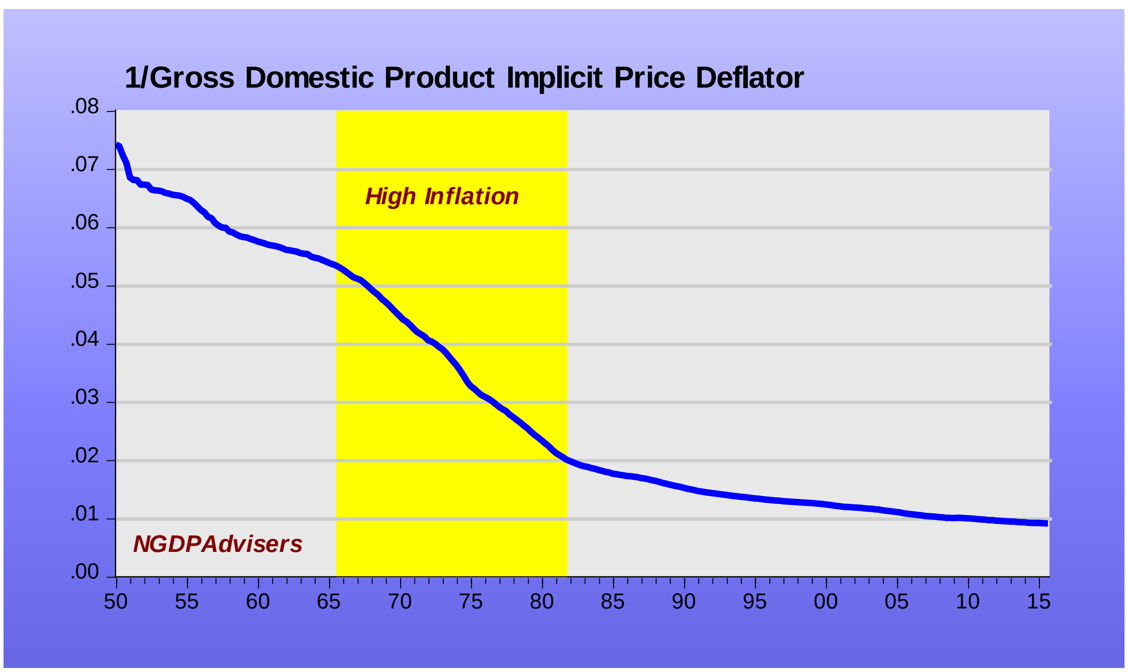
The Price of Money

When economists and other analysts write about monetary policy, be it to praise or criticize a particular regime or decision, or simply to teach the subject to laymen, they almost always commit a subtle but costly error: they say '*interest rates are the price of money*'. “Why is this an error?” you might reasonably ask. “When I take a loan, I get money from a bank, I then pay the bank back, with interest, so the interest is the 'price' of the money I was lent”. This argument, which I've rhetorically forced upon you seems right, but it doesn't take account of the important distinctions between *money* and *credit*.

It's pretty simple. Money is the good used to keep account in contracts and to facilitate exchange, so we don't have to barter and pay in kind. It's worked well since the bronze age. Credit is something else. Credit involves money, but it isn't money. Credit is vehicle for money, a contract. Credit is a contract: I choose to give you my spending power, my command on resources and other people's time, and in exchange you pay me back with interest, according to some schedule we work out. To conflate money and credit, is akin to thinking of a library book, and one's own book, as the same thing.

Because every good in the economy has a money price: a laptop is $600, a car is $30,000, it follows that the “price” of money is the value of money in goods. One dollar is worth 1/600th of a laptop, 1/30,000th of a car. If I want to 'buy' money, I can do so with laptops, cars or, more likely, my labor. The price of money is given by billions of goods and services, the average price of money is thus well summarized by the GDP deflator, the economy-wide price index used to map nominal GDP into real GDP.

The price of the US dollar, within the US, over time



Why does this matter? It matters because economics is all about subtlety, and small errors can cause one to frame issues the wrong way. By wrongly labeling interest rates the price of money, analysts will tend to overstate the importance of interest rates. Changing interest rates is *not* changing the price of money. Central banks certainly affect the price of money when they change their policy rate, but the interest rate itself doesn't tell us much by itself.