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Book Review

by Richard M. Ebeling

Should We Have Faith in Central Banks?

by Otmar Issing (London: Institute of Economic Affairs, 2002); 53 pages; \$12.

One of the momentous events of the new century has been the establishment of a single, common currency for many of the member nations of the European Union. The German mark, the French franc, the Austrian schilling, the Italian lira, the Irish punt, the Spanish peseta are now all gone, collector's items, along with the national currencies of Belgium, Holland, Greece, Finland, Portugal, and Luxembourg.

In their place is the Euro, managed and controlled by a European Central Bank with its headquarters in Frankfurt am Main in Germany. The debates within and outside Europe about the rationales and workability of such a common currency have been going on for more than a decade, since the first steps that have led to the reality of the Euro were taken.

Otmar Issing has been on the executive board of the European Central Bank since 1998. He is a market-oriented economist who believes in making Europe a common free-trade zone in which private enterprise can effectively operate within a political environment of minimal government intervention and regulation.

Yet Issing also considers that the smooth functioning of a freer European economic order requires a common currency managed by a common central bank. He explains his reasons in a monograph recently published by the Institute of Economic Affairs (IEA) in London under the title *Should We Have Faith in Central Banks?*

He points out that "faith" often means belief in something and its desirability on the basis of authority or religious doctrine. That is, "faith" frequently means accepting something without

reasoned argument and without supporting historical or empirical evidence to justify believing in it. By this definition of “faith,” Issing states that no one should just have faith in central banks.

There is a different meaning, sometimes, to the word “faith.” In this context it refers to trust or confidence in something or someone on the basis of past experience that something has a high likelihood of working or that someone can be relied on to do something that has been promised. On the basis of this second meaning, Issing states,

“At least in the example of the institution I represent, I see good reasons for believing that the public in Europe can have such faith, and that it can rely on the European Central Bank (ECB) to fulfil its mandate and maintain price stability. This sort of ‘reasoned faith’ or ‘confidence’ is (as it should be) underpinned by a sound institutional set-up, the application of well-established economic principles, and, last, but not least, by the quality and determination of the people dedicated to this task.”

He argues that for a market economy to function properly in both ensuring a continuous and properly balanced flow of goods and services to the consuming public and in providing a confidence in undertaking long-term investment for future, higher standards of living, there must be trust that the value of the monetary unit will remain fairly stable within a narrow range. Without that consumers and investors can have little certainty concerning the market worth of their purchases and investments in the future, when making their decisions today.

In addition, the monetary authority must enjoy credibility with the public that it will do its job in maintaining a regime of general price stability. “An independent central bank thus presupposes a broad consensus on the ‘quasi-constitutional’ nature of the common good of price stability,” says Issing. “Assigning the central bank a clear overriding objective also imposes limits on its discretionary exercise of power and makes it easier for the public to hold the central bank accountable for its mandate.”

Such “sets of rules ... are a way of reducing reliance on faith in the wisdom and moral virtue of individuals in the pursuit of desirable objectives. Institutions delineate the power of individuals and limit their discretion in the exercise of power.”

Issing also reasons that credibility implies accountability, that is, that those to whom central bank responsibility has been given are answerable for their actions in meeting the goal of general price stability within the geographical area covered by the monetary union.

The problem is that most monetary-policy decisions are made by committee at the executive level in the central bank and the full effects from monetary policies undertaken are observed only after a fairly long time lag. So Issing rejects holding individual central bankers responsible for central-banking policy. He argues that, instead, accountability may have to be achieved in less formal and explicit ways and applied to the relationship between the public and the central bank as an institution, rather than primarily with respect to individual central bankers.

Hayek and free-market money

Issing's defense of a European central bank is a continuation of an argument he made in 2000, in another IEA monograph entitled *Hayek, Currency Competition and European Monetary Union*. In that earlier work, he rejected Friedrich A. Hayek's proposal, in *Denationalization of Money* (1976), for competitive currencies issued by private banks instead of a government monopoly monetary and banking system. Issing said that he did not believe that a private, competitive monetary system would be as stable and effective as a well-managed centralized monetary system.

Separate from the issue of central banking versus private, competitive banking, in 1975 Hayek had called for the end of all legal tender and other political restrictions in *Choice in Currency*.

At least with a variety of national currencies, Hayek said, people could respond and protect themselves more easily by shifting out of the national currency that had lost their confidence and trust.

This at the same time would put a greater pressure on the abusing monetary authority because that currency would lose its external value even more and more rapidly as people shifted into alternative monies they considered more useful and more stable in value than their own. Hayek, therefore, opposed the emerging idea at that time for a united monetary system for Europe.

In his view, a united monetary system would move Europe in the wrong direction, towards more rather than less centralized power and control, with fewer options and escape hatches for the European population if monetary abuse and mismanagement were to occur.

But more important in response to Issing's arguments, if the fundamental issues over a monetary system and regime concern matters of trust, credibility, and accountability, then a private, competitive monetary and banking system promises more of each.

To begin with, under a private monetary and banking system, no individual is required to accept any medium of exchange that he does not want to hold and use.

Nor does it prevent him from holding any combination of such media to hedge against the uncertainties of the future and to facilitate various transactions for which using different currencies would be most advantageous.

Thus each market participant can and indeed would have to demonstrate his degree of trust in those private suppliers of currencies among which he will be able to choose.

Every day the private issuer of a currency backed by some market-chosen monies such as gold and silver would have to demonstrate his credibility by being willing and able to redeem the currency claims against the gold or silver deposited in his banking or other financial intermediary institution at the publicly promised redemption ratio.

And his accountability would be the automatic flip side of this credibility, because he would be immediately made aware of and penalized for any monetary mischief or mismanagement through loss of depositors and core money reserves upon which his banking establishment operated and was based.

Indeed, the existence of private competing banks would more readily and effectively bring a halt to any monetary mismanagement by any private banker or group of private bankers. Their loss of depositor clients and a depreciation of the market value of their currencies relative to others used on the market would be the direct result.

This, at the same time, would decentralize control and power over the monetary order as a whole. Thus, if any bank within the market arena were to mismanage its currencies by overissuing relative to the amount of gold or silver it had on deposit and which it was obligated to redeem on demand at a specified rate, its abuses need not compel other more conservatively managed banking houses to follow it in this “inflationary” policy. In fact, it would then be in the self-interest of those other banks to be even more demonstrative in their noninflationary banking practices to attract clients wary of their own banks’ “easy money” policies.

At the most fundamental level, the real issue is, as always, one of freedom versus coercion. Should people be free to select the medium or media of exchange they wish to use for various purposes in voluntary transactions with their fellow market participants? Or should the government (or governments) impose a single, monopoly money on the market arena under the jurisdiction of its political authority?

Should people be able to show their trust and confidence through their individual acts of choice in accepting the money (or monies) they want to use? Or will they be required to “trust” and have “faith” in the central monetary institution imposed by governments over which they have little direct influence or power, and concerning which they seldom have a very clear understanding?

If freedom is to triumph in the 21st century, one crucial arena will have to be the privatization of money and the monetary order. Otherwise, we will all continue to depend on the “wise” and “good” intentions of monetary central planners, in an age that claims to have rejected the socialist model for society.

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