Lesson Plan: Central bank mandates (120 minutes)

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The aim of this class it to introduce students to the intricacies of designing a central bank and the importance of mandates. The class provides a self-contained introduction to the topic that does not presuppose knowledge beyond introductory economics, but students who do know more can draw on that knowledge in the more creative later parts of the class.

Students design a central bank mandate in small groups based on a secret assignment. They represent the banking lobby, a green politician, the Greek government or Donald Trump. Their aim is to design the mandate so that is appeals to other groups, who do not know the assignments of the other groups. After drafting mandates in small groups, everyone votes individually based on which mandate from the other group they believe fits best with their secret assignment. The groups that gets the most votes wins. The course ends with a discussion of why groups designed the mandates they did, what determined their vote as well as a more theoretical discussion concerning the significance of central bank mandates.

Take-home message: There are real political choices to make in designing a central bank mandate that go beyond a simple trade-offs between more independence and more inflation. There is a politics of designing a mandate, where governments can use central bank mandates to achieve their objectives. This also raises normative question concerning the independence of central banks.

The assignments and handouts are included in as appendices

Indicative outline of the class:

Brainstorming and discussion (10 minutes)

Explain structure of the class:

1. Discuss mandates
2. Draft mandates
3. Vote
4. Discuss

Go into groups

What is a central bank? (20 minutes)

Students‘ Task: In small groups answer the questions below (ca 5 min each).

- Why should the central bank be independent?
- What are the main objectives of central banks? What are potential conflicts between the objectives of price stability on the hand and employment, investment and growth on the other?

Purpose: Determine students‘ familiarity with the topic and ensure a shared level of understanding.

Interaction: Students speaking with each other, instruction

Input and overview of material (10 minutes)

Interactive lecture on the objectives, tools, independence and appointment procedure for an independent central bank. Review material on handout.

Students‘ Task: Listen and take notes. Ask questions.

Purpose: Make sure students have the necessary information for the assignment

Material: Handout with existing and proposed central bank mandates with different objectives, instruments, independence and appointment procedures.

Interaction: Students give answers to questions about the material.

Instructions

Explaining how to design a central bank mandate. Handout the secret assignment.

Work in groups (40 minutes)

Drafting a mandate in small groups – Donald Trump, German government, Italian government, Climate change NGO.

Students‘ Task: In groups of three, students draft their ideal mandate for the European Central Bank (20 minutes)

Break (10 minutes)

Student prepare presentations after break.

Purpose: Have students think through the consequences of alternative central bank mandates.

Materials: Paper to draft the mandate on.

Interaction: Students working with each other in groups, I walk around to answer questions.

Instruction:

Do not worry: it is difficult, but you will manage.

You need three elements on a page:

(1) Objective
(2) Instrument
(3) Independence

You will vote on the other mandates from the perspective of your assignment, so make sure there are also good elements for other groups.

Group presentations and discussion (40 minutes)

Presentation of Mandates and Big Group Discussion

Students' Task: Present mandate and talk about insights gained.

Purpose: See what students did, ensure

Materials: -

Interaction: Presenting, group discussion

Take-home message: There are real political choices to make in designing a central bank mandate that go beyond a simple trade off between more independence and more inflation.

Appendix 1: Assignments

1. You are Donald Trump. Elections are coming up, and you intend to win. For this you want a strong economy, but the central bank might raise interest rates to stop inflation. Design the central bank so that it does not raise. Other interest groups need to accept your proposal. Can you get to your goal while hiding your intentions?

2. You are Ska Keller, leader of the Greens in Europe. You think preventing inflation is important, but not as important as achieving a green transition. The other interest groups will worry that green investments will cause inflation and make banks less profitable. How will you accommodate their worries?

3. You are Frédéric Oudéa, president of the European Banking Federation, which is the most important lobby organization for EU banks. You worry that the ECB’s low (even negative) interest rates reduce bank’s profits. You also worry about inflation because it reduces the real value of financial assets. Independence is very important to you, but you know that growth and employment is very important to other interest groups. Can you accommodate their worries?

4. You are Yannis Stournaras, the president of the Greek central bank. Greece is slowly recovering from one of the worst economic crises ever to have happened to an advanced economy. Unemployment is at 18% and public debt at 176% of GDP. A new ECB mandate can help you, but other groups will be worried about inflation and independence. How will you accommodate their worries?

Appendix 2: Handout

The key elements of a central bank's monetary policy mandate are articles that pertain to (1) objectives, (2) instruments and (3) independence and appointment procedures.

Objectives

- The most prominent objective of central banks is **price stability**, but central banks can contribute to achieving almost any economic policy objective.
- Tinbergen's law: For every objective policymakers wish to achieve they should have at least one lever with which to influence the economy.

Instruments

- Central banks have a **monopoly over the issuance of legal tender**. Central banks influence interest rates in financial markets by issuing new money. More money lowers interest rates, less money raises interest rates.
- **Channel of transmission**: Using Open Market Operations, the central bank influences influence interest rates and the exchange rates, which influences investments, consumption and employment, which over a period of 2 to 5 year affects price setting and inflation expectations.
- The central bank is in **close contact with the banking system**, which it often supervises and needs to achieve its policy objectives.
- **Very unconventional policies**: New money can, of course, also be used to fund investment directly or handed out to citizens.

Independence

- Central banks (1) generate their own income, (2) make highly technical decisions, and (3) are often highly trusted by citizens.
- Economic stability has long term benefits, but government (i) face short-term electoral pressures and (ii) do not have time to study the complex transmission mechanism.
- But, how much power should unelected officials have in a democracy? The ideal of democratic legitimacy holds that power can only be exercised with the consent of those who are governed.
- The tension between independence is less pronounced when central banks have a narrow mandate: "If independence is one side of the coin, the flipside is a narrow mandate." (Jens Weidmann)