# Study unveils hidden driver of economic volatility: Central bank discretion

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In the last article of his prolific career, the late Marvin Goodfriend, who held the Allan H. Meltzer Professorship of Political Economy at Carnegie Mellon's Tepper School of Business and was a lifelong student

of inflation and central bank policy, identified a subtle yet significant factor contributing to fluctuations in inflation and employment rates. This factor is the discretionary decision-making by central banks, combined with economic agents trying to forecast both the central bank's actions and the forecasts of their peers.

"Marvin's macro- and our micro-level research interests intersect in how information interacts with commitment problems," explained Pierre Jinghong Liang, Professor of Accounting at the Tepper School of Business, and co-author of the article. "Our study tries to better understand how the economy at the macro-level works when individual economic players at the micro-level have limited or imperfect information about what motivates the Federal Reserve's monetary policies. In our model, the Fed's uncertain policy intentions, combined with its inability to commit, create fluctuations in real variables like inflation and unemployment."

The working channel to such fluctuations, identified within a mathematical model presented in the paper, is facilitated by the practice of individual economic agents trying to forecast not only the central bank's decisions but also others' predictions. These forecasting activities, driven by the uncertainties in the central bank's objectives and differing levels of information among economic agents, create disagreements and information imperfection at the macro-level, leading to more significant economic volatility.

Imperfect information about what the central bank will do can make the economy more unstable, which can lead to more dramatic swings in inflation and employment. The paper paints a picture of layered beliefs as follows. Central banks, acting as economic stewards, have the authority to set and adjust policies affecting key economic indicators such as interest rates and the money supply.

But when the central bank is unable to fully commit its future policies, it causes companies and consumers to form their own forecasts or beliefs of what the future central bank will do and of other companies' and consumers' forecasts or beliefs about what future central banks will do. The second layer, the forecast of others' forecasts, constitutes what economists call higher-order beliefs.

"The induced coordination mechanism compels the central bank to choose a monetary policy that responds to fluctuations that match what most people think it wants," says Gaoqing Zhang, Visiting Professor of Accounting at the Tepper School, who also coauthored the article. "As a result, discretion can vastly increase fluctuations in employment and inflation, especially when people mostly agree on what the central bank will do."

The research further highlights how different economic players adjust their actions based on the central bank's unpredictable behavior and how that influences the central bank to select monetary policies that match what most people believe about its goals and intentions.

A leading expert in international monetary policy, Marvin Goodfriend joined Carnegie Mellon in 2005 after 25 years with the Federal Reserve Bank of Richmond, where he was director of research and policy adviser from 1993 to 2005. Goodfriend focused much of his teaching and research on monetary theory and monetary policy practice, with a focus on macroeconomic fluctuations, money and banking, international finance, and economic development. The article was completed after his passing in December 2019 and dedicated to Goodfriend by the surviving authors.

The article, "Disagreement and Discretionary Monetary Policy", is the culmination of decades of research and important contributions made to the field by Goodfriend, along with his colleagues. It has been accepted

for publication in the International Journal of Central Banking.

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