Introductory Remarks

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Just a few words by way of introduction to the opening session of this important Conference.

First, I wish you all a very warm welcome on behalf of the Bank of Italy and, in particular, on behalf of the Governor himself. The Conference has been convened in a place that usually hosts courses and seminars for the Bank's internal training programs and for periodical exchanges of views with public and private institutions, experts, and academics. I hope this environment will prove suitable for your work and that you will spend a pleasant period in Perugia.

As you all know, this Conference sets out to be a follow-up of the one held on the same subject in Urbana in November 1981. Both events owe much to the generous sponsorship of private and official institutions, and particularly to the imaginative effort of Professor Donald Hodgman. I am sure that you will share my appreciation and gratitude for what they have done.

The importance of the subject matter—the political economy of monetary policy—hardly needs stressing, and its timing could not have been more appropriate. Almost throughout the four years that have elapsed since the second oil shock, the objective of reducing inflation has been given top priority in all major countries, and monetary policy has been in the van of the stabilization effort.

Interest rates have remained exceptionally high, well above inflation, for an exceptionally long period; financial innovation has accelerated dramatically; new techniques and procedures have been introduced to strengthen monetary control in a rapidly changing environment. Gradually, inflation in major industrial countries has been brought back to the levels of the sixties.

I suspect however that this experience has in varying degrees shaken some of the beliefs firmly held by academic economists and central bankers as well as government officials.

Allow me to elaborate a bit on these various points.

When we entered this troubled period, monetary policy had already been put in the dock for some time by both monetarists and rational expectations theorists, on the ground that it allowed a sustained rise in inflation and increased—rather than moderating—cyclical instability in the real economy. The monetarists stressed the long-term neutrality of money, the long operating lags of monetary policy, and the temporary nature of its

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effects on output and employment. The rationalists focused instead on the announcement effects of policies, which bring the future to the present; they short-circuit the relationship between money, activity levels and inflation, and reduce it to an instantaneous, one-directional causal chain.

Strict control of monetary growth thus came to be seen as the necessary, and perhaps also the sufficient, condition for disinflation; strong emphasis was laid on the need for steadiness and predictability in monetary policy management. Indeed, some extreme interpretations actually recommended the legislative introduction of monetary "rules."

The influence of these ideas coupled with the public's mounting concern about inflation led to much tighter monetary policy, to greater emphasis on controlling quantitative aggregates rather than interest rates, and to wider use of "targeting" as a way to enforce greater consistency and steadiness in monetary policy management.

Developments over the past four years have shown that monetary policy is indeed a powerful instrument for bringing inflation under control.

However, many of the views that became established in academic thinking and exerted great influence on policymaking do not appear to have passed the acid test of experience. The evidence for an expectations-type monetary restraint on inflation is scanty; nor have the separate effects of the supply of money on prices been clearly identified, other than those resulting from the movements of interest rates and their effects on demand and supply conditions in the goods and labor markets.

Moreover, monetary restraint pursued hand-in-hand with expansionary fiscal policies for long periods has clearly revealed the interdependence between these two instruments and the crucial role that their mix plays in producing the desired effects on output and employment.

Also, the attempts made to implement a rigid control of monetary growth have met with growing difficulties, as financial innovation has spread and altered both the nature of targeted aggregates and their functional relationships with final policy objectives. In some cases, there were legitimate grounds for suspecting that the announced monetary management rule generated "perverse" behavior by private agents, which counted on the automatic response of central banks to short-term disturbances in targeted aggregates. The new instability in financial relationships again emphasizes the need for judgment and discretion in monetary policy management.

Finally, the exchange rate has emerged as a major actor, not only in the transmission of monetary impulses to the domestic economy, but also in linking developments in domestic and external financial markets and thus constraining each country's room for maneuver. Fresh problems—notably the international repercussions of monetary policies and the coordination of these policies among the major countries—have thus come to the fore in international discussions.

To sum up, besides influencing our thinking on how monetary management techniques work, recent experience compels us to review our theories and practices. For these reasons, I consider that this Conference addresses extremely important and relevant subjects, and that its timing could hardly have been improved.

The quality of the papers which have been submitted and the eminence of the participants with us today justify my hope that significant advances will be made in our understanding of the problems such as those I have referred to, as well as our ability to cope with them.