Dinner Speech, May 23, Inflation targeting conference

We have gathered here in Stockholm to discuss IT. This topic is interesting on its own, but also chosen to celebrate ***Lars Svensson'***s work in academia, policy advice, and practical policymaking.

Lars's contributions to IT are well-known. But how did they come about? I will argue we can find roots in three domains – academic, social, policy – during a decade from the early 80s.

In full disclosure, I speak as a junior colleague at the IIES. ***Lars*** was not my advisor, but very much a mentor, to become a perennial co-author, and a very good friend. We first met in 1977 in the graduate PhD micro course he was teaching.

Academic domain Yes, the *micro* course – for ***Lars*** started out in theory, with a thesis on intertemporal resource allocation. There is a story about a first push in an applied direction, in the year ***Lars*** spent as a special student at MIT. Bob Solow said about one of his models "Well, you have nice horse here – now you just have to teach it to jump". Olivier, Solow's PhD advisee at the time, can probably give us more insights into this nudging. Anyway, in the late 70s, ***Lars*** did begin to do more applied research, starting with international trade.

Soon, ***Lars*** was absorbed by studying how supply shocks and expectations formed international borrowing and lending – a shift of the research frontier which was to reshape international macro, and regular macro as well. This shift into dynamics was largely driven by young stars like Maury Obstfeld, Ken Rogoff, and Jeff Sachs. It emanated from Cambridge, Tel-Aviv, and a few other spots.

The IIES was indeed one of these hot spots. Many research leaders visited us for short or long periods – I can remember the thrill as new results and approaches were presented in our seminars and conferences. In parallel, ***Lars*** and others at the IIES visited Cambridge and Tel-Aviv.

Via this academic exchange, ***Lars*** began to collaborate with a number of frontline scholars: Assaf Razin, Alan Stockman, Bill Ethier, Nanvy Marion, Guiseppe Bertola, Andy Rose, et al. He also wrote his first papers on monetary policy. The two of us had great fun, writing a sequence of papers about the credibility of fiscal and monetary policy.

Social domain IIES researchers and visitors spent a lot of time together, far beyond after-seminar dinners. As an example, take the sailboat, Agda, an International Folkboat, that ***Lars*** came to co-own with Harry Flam and me (Harry still owns it).

Each summer in the early 80s, we would spend several weeks on Agda, exploring Stockholm's beautiful archipelago, often together with other boats owned by economists and their friends.

And, we brought our academic guests on board for a weekend or longer. Some of you will remember going on such trips. For sailing together – and meeting perils and privations at sea – fosters memories and friendships. When you weather out a gale together in a 26-foot boat, and finally anchor up in a safe bay, you also build a lot of trust in each other.

As it offers more drama than regular life, sailing quickly reveals many things about basic personalities and attitudes. For instance, at Agda it became obvious that ***Lars*** often believes there is a single, optimal way of doing something – the best angle to tack against the wind, or best way to navigate a tricky channel – though this optimal way may shift over time, as he sees new data or invests in new tools. It was also easy to see how gladly ***Lars*** shares these beliefs with others. Some of you may recognize these traits from professional interactions with him.

Policy domain Sweden was also an interesting scene. It had met the 70s supply shocks by expansionary policies, giving large deficits in the government budget and current account that still loomed in the early 80s. So, the intertemporal macro approach offered an interesting outlook. I recall how ***Lars*** and I wrote a report for the Medium-Term Review the Treasury publishes every five years, applying a wealth perspective to deficits and government finances.

The need to sell tons of public debt forced rapid financial deregulation – from quantity controls of bank lending to markets for bonds, bills, and other securities. These markets provided a lot of new data. A few years later, foreign-exchange controls were dismantled. In parallel, the Riksbank had to reinvent itself. Elderly lawyers, who managed the old regulations, were replaced by younger economists trained to study the new markets – some of these had PhDs from the IIES with ***Lars*** as an advisor.

Yet another policy challenge was high and variable inflation. It was fed by a two-way spiral – wages kept rising faster than abroad, and higher relative costs were accommodated by repeated devaluations of the Krona. This eroded the credibility of the fixed parity as a nominal anchor. ***Lars*** showed how one could use the term-structure in the new forward markets to quantify the credibility loss.

In late 1992, these past profligacies all came together in a deep crisis. In sailing terms, rather than an occasional gale, this was a perfect storm: a financial crisis from excessive lending in deregulated markets, rapidly falling output and employment, and galloping government debt. Whether you looked at the long bond rate, total unemployment, or the deficit – it was 12%. At this juncture, the Krona peg had to go. Sweden's long-term nominal anchor was ripped up.

In the clean-up to follow, a primary issue was which new low-inflation anchor to lay out. Influenced by events in NZ, CA and UK, the choice fell upon an IT already in January 1993. But this posed new challenges. So, the Riksbank formed a small, informal advisory group, with a few economists and ***Lars*** at the center. Every two weeks, we met Governor Bengt Dennis and his deputies for dinner and subsequent discussions. How could the IT-anchor best be propped up with new tools and procedures? Spurred on by these practical questions, ***Lars*** drew on all he had learnt in the past decade and started doing the kind of thing he likes best, namely looking for such appropriate tools and procedures. To me, the hands-on challenges at a critical juncture are thus the key, not just to ***Lars*** 's research priorities, but to his long-term links to the Riksbank and its staff, first as a close advisor, then as a deputy governor.

As they say, the rest is history.

End It has been a pleasure and a privilege to have ***Lars*** as a close colleague and friend. I would like all of you to join me in a toast for Mr. Inflation Targeting and his extraordinary career, spanning nearly 50 years as a leading scholar, policy advisor, and policymaker.