



PHOTO: MICHAEL CAMPANELLA

CENTRAL BANKING REVOLUTIONARY

*Prakash Loungani profiles former Swedish central banker
Lars E.O. Svensson, a leader of the inflation-targeting revolution*

These are challenging times for central bankers. The 2021 upsurge in inflation took many central banks by surprise. “We now understand better how little we understand about inflation,” Federal Reserve Chairman Jay Powell declared last year.

The challenges would have been far more difficult but for significant enhancements in central banking over the past three decades—specifically, advances in a framework known as inflation targeting. While bringing the changes about has been a team effort, the person as responsible as anyone is Lars E.O. Svensson, a former deputy governor of Sweden’s Riksbank who is currently an affiliated professor at the prestigious Stockholm School of Economics.

“Lars has provided great insights into critical issues in monetary policy,” Ben Bernanke, the former Fed chairman and 2022 Nobel laureate, told F&D. “His creativity and independence of thought are truly impressive.”

Under inflation targeting, central banks explicitly commit to a goal for long-term inflation and work to achieve it by moving the policy interest rates, which they control. Raising interest rates, as central banks are doing now for instance, tends to cool inflation by curtailing spending on housing and other interest-sensitive goods. Svensson was an early convert to inflation targeting. He has since been a vocal advocate, nudging central bankers to continuously improve the framework, particularly by being open with the public about the path of future policy to achieve the inflation target.

The enhancements to monetary management advocated by Svensson and others helped the world’s central bankers keep the financial crisis of 2007 from turning into another Great Depression. In his role as deputy governor, Svensson helped the Riksbank successfully manage the early phases of the crisis.

Getting there

This was not the path Svensson envisioned his life taking. In 1971, he completed an MS in physics and applied mathematics

at the Royal Institute of Technology in Stockholm. During a “sabbatical” to decide what to do next, he enrolled in some undergraduate economic history courses. One of his professors advised him to switch to economics, pointing out that job prospects in Sweden were good for economists. “It was one of the best pieces of advice I received in my life,” Svensson told F&D.

He went on to get his doctorate in economics in Stockholm, also spending a year at the Massachusetts Institute of Technology. His professors there included Nobel laureates Paul Samuelson, Robert Solow, and Peter Diamond; former Fed Vice Chairman Stan Fischer; and Google chief economist Hal Varian. Among his fellow students were Nobel laureate Paul Krugman, former IMF Chief Economist Olivier Blanchard, former European Central Bank President and former Italian Prime Minister Mario Draghi, and former Fed Governor Frederic Mishkin. “That year gave me a network that has helped me greatly over the years,” Svensson says.

His first job was at the Institute for International Economic Studies at Stockholm University. In the 1970s and 1980s, he focused largely on economic theory and international economics. His friend and longtime colleague and collaborator, Torsten Persson, describes working with Svensson at the time. “In his work, he sticks to his guns unless someone comes up with better intuition and a formal model,” Persson says. “And he takes his hobbies seriously too—we were avid sailors together, and then he turned to rock climbing with great passion.”

Inflation targeting

In the 1990s, Svensson turned his attention squarely to monetary economics, his interest triggered in part by his role as an external advisor to the Riksbank. It was a turbulent time. The economy was adrift after the krona’s exchange rate peg to the ECU collapsed in 1992, despite the central bank’s heroic attempt to defend it by raising rates to 500 percent. Svensson and a small group of internal and external economists were

given two weeks to advise the Riksbank on a new monetary framework.

Luckily, a prototype was at hand. In 1989–90, the Reserve Bank of New Zealand had adopted inflation targeting, which was successful in bringing inflation down sharply. The Bank of Canada had also turned to inflation targeting in 1991 and successfully reduced inflation to 2 percent. In a report to the Riksbank, Svensson argued that there were “strong reasons” for monetary policy to target “a narrow range for the inflation rate.” In early 1993, the Riksbank adopted inflation targeting with a 2 percent long-term goal to be achieved by 1995—a goal the Riksbank undershot in the years that followed.

In the late 1990s and the 2000s, Svensson devoted himself to showcasing the success of inflation targeting and developing improvements. By 2001, he had moved to the prestigious economics department at Princeton University, where a number of professors—among them Bernanke, Krugman, former Fed Vice Chairman Alan Blinder, and influential economist Michael Woodford—were engaged in a similar pursuit. Scott Sumner, a noted monetary theorist at George Mason University, dubbed them the “Princeton School,” which he credits with bringing about changes in central banking that were crucial in managing the Great Recession.

One of Svensson’s early contributions was to urge that central banks implement inflation targeting in a flexible manner, recognizing their dual responsibility to keep inflation near the target and the economy close to full employment. These days, Svensson told F&D, “hardly any central banks are ‘inflation nutters,’” a term coined by former Bank of England Governor Mervyn King to refer to central banks obsessed with inflation at the expense of employment.

Inflation forecast targeting

An even more critical contribution of Svensson’s has been nudging central banks toward inflation forecast targeting. Under inflation targeting, central banks were already growing more transparent about announcing and explaining their latest policy decision. Svensson argued that central banks needed to go further. Because the impact of monetary policy actions unfolded with a long lag, it was important for central banks to tell markets and the public what their plan was for the future.

In a celebrated 1997 paper, Svensson recommended that central banks select a path for current

and future rates so that the central bank’s own forecasts for inflation and employment “looked good” for getting the economy over time to the target inflation rate and to full employment. “Let’s say you have a 2 percent inflation target,” explains George Mason University’s Sumner. “You set policies such that you’re also forecasting [that you’ll get to] 2 percent inflation.... This is just common sense. Why wouldn’t you set [the path of future] policy rates so that you expected the policy to be successful?”

And yet, before Svensson’s work, central banks were prone to assuming a path for policy rates that would lead them to undershoot or overshoot their targets. “It was as if a ship captain heading across the Atlantic had set the steering wheel at a position expected to result in the ship being 200 miles off course when it reached the other side of the ocean,” Sumner wrote.

Some central banks, such as the Norges Bank, the Riksbank, and the Czech National Bank, started publishing their interest rate paths, in line with Svensson’s recommendations and following the New Zealand central bank’s lead. Many others adopted practices that went considerably in that direction. Svensson’s work helped bring about a more forward-looking approach to monetary policy and a willingness to innovate in times of crisis, says Robert Tetlow, senior advisor at the Fed and a collaborator of Svensson’s.

“Lars has always managed to be preternaturally calm but hard-nosed, polite but forthright,” when advising central bankers, Tetlow told F&D. Philip Turner, a former senior official at the Bank for International Settlements (BIS), recalls that “at a Bank of Japan conference in 2000, Svensson was one of the first” to urge radical monetary policy actions. “Japan has already lost a decade to economic stagnation and deflation,” Svensson bluntly said in a paper for the conference. “With continued bad policy, it may lose another.”

Going negative

The enhancements in monetary management that Svensson and others advocated paid off during the Great Recession. Central banks quickly pivoted to taking actions that most likely helped stave off another Great Depression. They cut interest rates sharply, making it clear that they were not inflation nutters and took the goal of full employment seriously. They let markets know that they expected to keep interest rates

“low for long”—giving forward guidance very much in keeping with the spirit of Svensson’s advice about transparency.

So deep was the Great Recession, however, that central banks faced a quandary: What more could they do once they’d already lowered policy rates to zero and signaled that they planned to keep them there for a while? Svensson advocated moving to negative interest rates, levying fees on deposits to push banks into making loans to encourage spending.

“The most vocal advocate of the policy is Deputy Governor Lars Svensson, a world-renowned expert on monetary policy theory and a close associate of Ben Bernanke,” the *Financial Times* wrote at the time. The Danish central bank took the leap into negative interest rates in 2012, followed by the European Central Bank and several others.

While still controversial, negative interest rates have expanded the tool kit of central banks, some economists maintain. Former IMF Chief Economist Ken Rogoff says that “if done correctly ... negative rates would operate similarly to normal monetary policy, boosting aggregate demand and raising employment” in future crises.

Different and separate

Before the financial crisis began, the Riksbank had managed to attract Svensson back from Princeton in 2007 to serve as a deputy governor. By this time, the Swedish central bank was already following Svensson’s advice to publish and justify its interest rate path. And by July 2009, the Riksbank had already cut rates to 0.25 percent.

But Svensson was unable to persuade his colleagues to cut the rate to zero and then to consider negative interest rates if needed. In fact, in 2010 the Riksbank started raising rates. Svensson opposed the move, arguing that the inflation forecast was still far below target and unemployment remained high. He was also opposed to “leaning against the wind.” That was the idea that interest rates should be raised to counter risks to financial stability posed by rising house prices and mortgage debt levels, for instance, even if macro considerations such as inflation and output dictated otherwise.

After a couple of years of polite dissent, Svensson finally left the Riksbank at the end of his term in mid-2013. He forthrightly announced that he had “not managed to get support for a monetary policy” he preferred. Svensson’s former Princeton colleagues rushed to his defense. Krugman called

the 2010–2011 rate hikes “possibly the most gratuitous policy error” of the global financial crisis, saying they had “no obvious justification in terms of macro indicators.”

Svensson’s judgment proved right: by 2014 it became clear that the rate hikes weren’t taming housing price inflation and were leading to deflation and economic weakening. The Riksbank was forced to cut rates to zero. And then in 2015 the Riksbank ventured into negative interest rate territory, an experiment deemed successful by a subsequent IMF working paper by Rima Turk.

Following his departure from the Riksbank, Svensson devoted himself to making the case for why monetary policy should concern itself with inflation and output goals, leaving financial stability considerations to macroprudential policy. The two policies are “different and best conducted separately,” he has written. To bolster his case, Svensson made several presentations at the IMF and elsewhere, demonstrating that the benefits of raising interest rates to enhance financial stability by lowering the odds of a financial crisis were small and uncertain. In contrast, the costs in terms of higher unemployment and deflationary pressures were high and far more certain.

Svensson’s cost-benefit calculations were featured in a 2015 IMF staff paper on “Monetary Policy and Financial Stability,” which concluded that in most cases the costs are higher than the benefits. Turner, the former BIS official, told F&D that “by rigorous logic and using empirical magnitudes most favorable to the case he opposed, Svensson decisively won this debate.”

Always active

At 75, Svensson remains active in research, with his most recent work devoted to showing that commonly used indicators of housing price overvaluation—such as the house-price-to-income ratio—are misleading and can lead to poor policy actions by financial agencies. He has also challenged the common view that households cut back more on their spending in a crisis when they have higher levels of outstanding mortgage debt. Turner is happy to see Svensson continue to challenge received wisdom: “Wherever he goes, economists are forced to raise their game.” **FD**

PRAKASH LOUNGANI is assistant director of the IMF’s Independent Evaluation Office.