2 July 2014

Post-Crisis Recovery and the Reconstruction of the Financial Sector

Opening address at a SUERF/Central Bank of Iceland conference in Harpa, Reykjavík, entitled *Post-Crisis Recovery and the Reconstruction of the Financial Sector,* 2 July 2014.

Distinguished speakers, excellencies and other dear guests,

On behalf of the Central Bank of Iceland, I am pleased to welcome you here in Harpa Concert and Conference Centre to this conference that we are hosting and have organised with SUERF. This applies especially to those of you that have come from abroad to participate in the conference. The Harpa is interesting but I do hope that many of you will be able to see some more of Iceland during your visit.

It is a special feeling for me to be playing this role today as it has been ten years since we last hosted a SUERF event in Iceland. I was then the Chief Economist of the Central Bank and was scheduled to leave later that month to become the Deputy Head of the monetary and economic department of the Bank for International Settlements in Basel. In that role I later became a member of the Council of Management of SUERF. I have fond memories of these involvements with SUERF.

Ten years ago, the topic of the conference was the interaction of monetary policy and financial stability in small open economies. Some of us at the Central Bank were worrying about the build-up of risks to financial stability and we felt we needed more instruments. We were groping around for what is now-a-days called macro-prudential policy. But the outcome turned out much worse than we expected and even worse than we feared. The risks did indeed accumulate on a massive scale in the years following the conference, both internationally and here in Iceland. In this country, we both experienced the most unsustainable boom in our history and developed a relatively huge cross-border banking system with a risk profile that was very vulnerable to the kind of shocks that hit the financial sector during the panic state of the international financial crisis.

We have since been through what is currently called the Great Financial Crisis and the Great Recession. We, however, avoided the Great Depression. It is still not clear how much of a risk it was but much clearer that a forceful crisis management by central banks played a big role in averting it. Still, we have not had the Great Recovery. On the contrary the recovery has, in general, been slow and uneven and, in a number of crisis countries, unemployment is still at dramatic levels. Recent discussion has come up with many candidate explanations such as secular stagnation due to sustained lack of aggregate demand; slowing innovation; adverse demographics; lingering uncertainty; political risk; and policy mistakes. Even if some of these factors are contributing to slower growth, I think the main causes for weak recovery are financial and economic imbalances that built up prior to the crisis and the disruption of the crisis itself. Therefore, there are big legacy issues to deal with, such as high debt levels and still fragile banking systems. And the problems surmount when debt crisis and banking fragility interact in a vicious circle, as they have done in many countries in Europe.

We know from several studies that recoveries from recessions that are associated with financial crisis are weaker than recoveries of traditional business cycles. One reason is that it takes a while to take down a mountain of debt. Another reason is that credit booms tend to create economic imbalances and sectoral misallocations that cannot be undone overnight. Yet another is that the financial crisis can partly be caused or accentuated by a flawed institutional set-up. Some of these explanations and related issues are dealt with in the first session of the conference.

The financial sector was the epicentre of the crisis. It is on the mend both through its own efforts and regulatory initiatives. Banks have adapted business models in light of the crisis and the new environment. Capital levels have been increased, mostly through retained earnings. Basel-III rules on capital and liquidity are being phased in. However; there is a widespread perception that the task of creating a resilient and reliable financial system that serves the real economy is far from complete. The too-big-to-fail problem is, to a significant degree, unsolved. The framework for cross-border banking that turned out to be deeply flawed before the crisis is still to be satisfactorily reformed, both at the global and European level. There are still deep questions about the design of the financial system and its interplay with regulation and the safety net that need to be addressed. Some of these issues will be discussed in the second session after lunch.

This conference is not about Iceland; although it features in some cases as an interesting example. Let me therefore use the rest of my remarks to say a few words about Iceland´s crisis and recovery.

Iceland´s crisis was actually two crises wrapped in one. First, it was a traditional macroeconomic boom bust crisis where capital inflows, a credit and asset price boom followed by a sudden stop played the main role. Second, it was a collapse of three cross-border banks that amounted to 10 times GDP where over 2/3 of their balance sheet was in foreign currency, featuring the traditional maturity mismatch of banking but with no lender-of-last-resort to back it up.

Iceland´s recession was deep. But it was probably not as deep as many expected when they had in mind the image of a total collapse of a banking sector, a huge balance of payments crisis, and currency crisis where the value of the króna fell by 50% in the course of 2008. But then we need to bear in mind the nature of the shocks. A significant part of the impact of the banking collapse was felt in other countries. The economic shock affected overblown sectors (banking and construction); however, a significant part of the export base was intact and was subsequently boosted by the low real exchange rate.

Iceland has been recovering at around twice the rate of trading partners since 2011 and last year it was the fastest growing advanced country, where the prospects for this year and next are good. The slack in the economy is disappearing with unemployment already just under 5%. Moreover, inflation has fallen slightly below our inflation target of 2½%.

However, Iceland is still dealing with its legacy problems from the financial crisis. Debt levels are high, as they are in many other countries, but as a share of GDP public, household, corporate and external debt are all on a falling trend.

The biggest challenge facing economic policy makers in Iceland at this juncture is, however, the task of lifting comprehensive capital controls on outflows that were introduced after the collapse of the banking system in the autumn of 2008. These were helpful in stabilising the economy after the financial crisis but are increasingly detrimental as the domestic and international economic situation normalises. A resolution of the failed banks that is consistent with balance of payments equilibrium and financial stability in Iceland is a key element in the process of lifting the capital controls.

In the interest of time and in order to keep my powder dry let me stop here.

Dear guests. We have brought to together top academics, senior policy makers and financial industry leaders to address the topics of the conference and we have an interesting programme ahead of us.