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Abstract

This study discusses the economic, political, and judicial aftermath of Iceland´s financial collapse in 2008. It considers lessons learned, or not learned, with emphasis on unsettled issues concerning the distribution of incomes and wealth, banking, and politics. The study makes three main points. First, the measurement of income flows and living standards needs to be adjusted in two respects. Second, since the crisis, Ireland has made a significantly stronger recovery than Iceland in terms of per capita income. Third, Iceland´s economic recovery from the crisis is marred by a visible deterioration of various components of the country´s social capital.

JEL-Codes: G010.

Keywords: financial crisis, social capital, Iceland.

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Ten Years After: Iceland´s Unfinished Business

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1. Introduction

This study discusses the economic, political, and judicial aftermath of Iceland´s financial collapse in 2008. It considers lessons learned, or not learned, with emphasis on unsettled issues concerning the distribution of incomes and wealth, banking, and politics.

The study makes three main points.

First, the measurement of income flows and living standards needs to be adjusted in two respects. Just as assets must be assessed in two dimensions, in terms of their returns and risk, national incomes and wealth need to be gauged in terms of their level as well as their dispersion across the population. This is hard to do. Commonly used measures of the distribution of incomes and wealth are incomplete for two reasons. They customarily include only income from labor but not from capital and private wealth in tax havens and such is significantly underreported. Zucman (2013) reported that nearly $6 trillion of global household financial wealth goes unreported, at the time equivalent roughly to ten percent of world GDP (see also Zucman 2015). Further, macroeconomic flows and stocks, incomes and wealth, need to be assessed side by side because high incomes can be misleading if they are sustained by the depletion of stocks (natural resources, net foreign assets, social capital, etc.). This means that observers need beware of extolling the beauty of volcanoes that are about to erupt – as the IMF learned the hard way when its staff wrote as follows in 2007 (Wagner 2010, 11):

> Iceland's medium-term prospects remain enviable. Open and flexible markets, sound institutions ... have enabled Iceland to benefit from the opportunities afforded by globalization … the banking sector appears well-placed to withstand significant credit

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> and market shocks … [B]anks took important steps over the past year to reduce vulnerabilities and increase resilience.

The IMF was not alone. The Iceland Chamber of Commerce boasted that nearly all of its policy recommendations were adopted by the government and declared in print a few months before the collapse: "The Chamber of Commerce recommends that Iceland stop comparing itself with other Nordic countries because we are superior to them in most respects." (Iceland Chamber of Commerce 2008, 22, my translation, TG). The IMF can be said to have apologized (Wagner 2010).

It was not until 2016 that the purchasing power of Iceland´s nominal per capita GNI was restored to its 2007 level while the purchasing power of wages took eight years to recover, from 2007 to 2015. Thus, the restoration took Iceland the same eight to nine years as other countries have needed on the average to recover from many past financial crises (Reinhart and Rogoff 2014).

Second, since the crisis, Ireland has made a significantly stronger recovery than Iceland in terms of per capita income. So has Latvia. Portugal is not far behind. This weakens the argument that Iceland depended on its flexible exchange rate regime to drive its economic recovery. The evidence seems to suggest that, if Ireland and others could recover so well within the EMU, then probably Iceland could have recovered just as well within the EMU. If so, perhaps lower local prices in terms of foreign currencies were not as important to the rapid expansion of tourism in Iceland after the crash as many seem to think. This matters because high interest rates and financial indexation that are sensitive to exchange rate fluctuations remain a source of controversy exacerbated by a unique feature of Iceland´s banking system compared with the rest of Europe, namely, the complete absence of foreign competition from the local financial market. Small size need not stand in the way of foreign competition. For example, Estonia´s economy is only slightly larger than that of Iceland and yet Scandinavian banking groups account for more than 90 percent of total bank assets in Estonia.

Third, Iceland´s economic recovery from the crisis is marred by a visible deterioration of various components of the country´s social capital, by which is meant a nation´s societal institutions and relationships that supplement other kinds of capital in producing cohesive economic benefits. This corrosion manifests itself in reduced democracy scores from Freedom House as well as increased corruption as perceived by the public and reported by Transparency International and Gallup. These perceptions are exemplified by several glaring facts on the ground, including the disproportional presence of Icelandic politicians and others in the Panama Papers exposed in 2016. Five European cabinet ministers were exposed in the Panama Papers, three of them Icelandic. Relevant also is the fact that two parties in Parliament are led by individuals straight from the Panama Papers, including the current finance minister, while a third party is led by an MP second on the list of ten MPs each of whom owed the failed banks one million euro or more when they collapsed.[1] Those three parties won 27 seats out of 63 in the 2017 parliamentary election. It is, in this light, hardly surprising that the political class shows as yet no signs of intending to keep the promise made in Parliament´s unanimous 2010 resolution that "criticism of Iceland's political culture must be taken seriously and [Parliament] stresses the need for lessons to be learned from it." Further, side by side, the political class and the business community have endangered the post-crash economic recovery by creating, through excessive wage hikes to self-dealing elites, conditions that may trigger competing wage claims echoing the past by threatening to reignite inflation.

In what follows I address these three concerns in turn.

2. Distribution of incomes and wealth

There was a time, not long ago, when the distribution of incomes and wealth was widely considered to be of little relevance to macroeconomic theory and even to policy. An exception was Scandinavia and Austria where distributional issues were implicitly if not explicitly imbedded in economic policy through "social partnership" from the 1950s onward on the grounds that an equitable income distribution would, through social peace, lead sustainably to more favorable economic development. Some brushed distribution

[1] See Panama Papers, "Politicians, Criminals and the Rogue Industry That Hides Their Cash," https://panamapapers.icij.org/, accessed 22 September 2018. For the ten heavily indebted MPs, see Special Investigation Commission (2010, Vol. 2, 200–201). Their personal debts to the failed banks ranged from 1 million to 40 million euro. The average debt of the ten MPs was 9 million euro. For the most part, it is not known whether these debts were settled or written off.

issues aside as normative considerations that would be out of place in positive macroeconomic analysis. Theoretical and empirical research on distribution issues was a separate field of enquiry. Mainstream macroeconomics had no room for Gini coefficients or Theil indices of distribution. The publication of Piketty´s *Capital* (2014) was especially helpful in resetting the course.

2.1 Mismeasured inequality

Over the past generation, the situation changed as researchers studied the relationship between income distribution and economic growth, for example,[2] as well as the interplay among inequality, household heterogeneity, and macroeconomic outcomes.[3] The IMF has begun paying attention to distribution as a macroeconomic policy concern in theory and practice as it did in Iceland during 2008–2010.[4]

Thus far, empirical work on the relationship between the distribution of income and wealth and other macroeconomic outcomes has relied mostly on inequality measures based on Gini indices rather than Theil indices. This is because Gini indices, though sporadic, are more readily available in cross-country data sets. Even so, a well-known drawback of Gini indices is that they are non-additive while the less intuitive and less widely used Theil indices are additive and can thus be decomposed. Income distribution as measured by the Theil index can be assessed across as well as within groups and regions as emphasized by Galbraith (2012). Another concern is the deficient treatment of capital income and especially capital gains in existing statistical sources. Available internationally comparable data from the OECD and the Luxembourg Income Study leave out capital gains on the grounds that they can be viewed as windfalls, like, say, lottery winnings. But this is incorrect. Capital gains have in many cases been shown to result from self-dealing through stock options that members of economic elites bestow on one another, for example. This phenomenon is very different from unexpected windfalls.

[2] See, e.g., Alesina and Rodrik (1994), Persson and Tabellini (1994), Gylfason and Zoega (2003), Galbraith (2012), and Ólafsson and Kristjánsson (2013).
[3] For two recent surveys, see Rios-Rull and Quadrini (2015) and Krueger, Mitman, and Perri (2017).
[4] See Berg and Ostry (2017) and Berg *et al*. (2018).

Exposures of sundry financial misbehavior by self-dealing elites in recent years make it imperative to acknowledge the limitation of looking at the distribution across households of disposable wage income from labor and underestimated interest income from capital alone, underestimated because of the huge sums of money stashed away in tax havens as shown by Zucman (2015) among others. What is needed is comprehensive measures of the distribution of total income, properly defined, before and after tax, as well as the distribution of wealth and of health in view of emerging discrepancies in life expectancy across income groups in the United States and, to a lesser extent, also in Europe.[5] Wealth distribution measures were until recently difficult to come by except in a handful of countries, and such measures as are available may not be easily comparable across countries. Hidden wealth in tax havens exacerbates the problem. Health distribution data are even more recent. Chetty *et al*. (2016) report that the wealthiest one percent of American men live 15 years longer than the poorest one percent and that the wealthiest one percent of American women can expect to live ten years longer than their poorer counterparts. The gap is widening.

These things matter for the assessment of Iceland´s recovery from the 2008 crash. Iceland provides a good illustration of some of the difficulties described above because its Gini index, based on total disposable income, rose by one point a year from 1993 to 2008, a unique occurrence that statistical and political authorities pretended not to notice as described in Gylfason *et al*. (2010, Fig. 7.5). Ólafsson and Kristjánsson (2013, 2017) document these developments and their background in detail. In their 2017 book, they present new information on the distribution of wealth, showing Iceland´s wealth distribution to be the third least equal in a group of 29 countries based on the assets held by the richest ten percent of households. By this measure, only the United States and Switzerland have a less equal wealth distribution than Iceland. Further, Ólafsson and Kristjánsson (2017, Chart 4.11) show Iceland´s wealth distribution to be the sixth least equal in the same group of countries based on the assets held by the richest one percent of households. By this narrower measure, only the United States, Switzerland, Denmark, Sweden, and Indonesia have a less equal wealth distribution than Iceland. These findings

[5] See Case and Deaton (2015) and Hederos *et al*. (2017).

strengthen the afore-mentioned suspicion that something is amiss in income distribution statistics that suggest that Iceland has the most equal distribution of disposable income among the OCED countries as reported, e.g., by Pareliussen and Robling (2018, Fig. 1). Among their sources, Ólafsson and Kristjánsson (2017) cite the Global Wealth Report (2017) from the Credit Suisse Research Institute. The OECD and other international organizations need to start gathering and reporting internationally comparable statistics on the distribution of incomes and wealth without their present flaws. This is imperative because inequality has suddenly become one of the most pressing political and moral issues of our time.

There is one further complicating factor. When Iceland´s financial system collapsed in 2008, the ensuing destruction of assets was considered to amount to seven times the country´s GDP. The recapitalization of three commercial banks cost the equivalent of 18 percent of GDP, the recapitalization of the Central Bank cost another 18 percent of GDP, the local stock market was virtually wiped out, and pension funds took a big hit, for a total loss to local residents of two times GDP. On top of this, foreign creditors, shareholders, and depositors were thought to have lost a total amount equivalent to five times GDP, an estimate that through subsequent asset recovery has been reduced to four times GDP (Gylfason 2015; Benediktsdóttir *et al*. 2017).

A striking thing about these foreign losses is that no one claims to know where the money went, easy as it would have seemed to follow the money. This applies, for example, to the Central Bank´s 500 million euro loan to one of the banks (Kaupthing) on the day, 6 October 2008, when the first of the three banks crashed. This was a few hours before Parliament passed the emergency legislation aiming to contain the consequences of the crash. The Central Bank governor, it was disclosed in late 2017, said to the prime minister over the phone: "I expect that we will not get this money back." The Central Bank kept the recording and transcript of the telephone conversation under lock and key for nine years, and then, out of the blue, a daily newspaper edited by the discredited former governor published the transcript. The leak was not investigated. Further, in connection with the tenth anniversary of the crash, just as the statute of limitations took force, the prime minister at the other end of the line divulged that he had been duped and did not know where the money went. On the same day it was announced that he would leave his post as ambassador to Washington, D.C. to join the Executive Board of the World Bank.[6]

In sum, the view that Iceland´s earlier equality of after-tax incomes and wealth as reported by, for example, the OECD has been more or less restored since the crash needs to be taken with a grain of salt for three mains reasons: (a) Capital gains are still excluded from the Gini index; (b) Iceland´s disproportionate presence in the Panama Papers suggests that large amounts of Icelandic wealth are still likely to be hidden also in other tax havens; and (c) No one claims to know what became of the loot from the 2008 crash. This important issue is not confined to Iceland, however, as Zucman (2015) describes.

2.2 Wage rivalry

The rapid rise in inequality in Iceland before the crash accords with Galbraith´s (1988) description of the roaring 1920s in the United States as well as with more recent developments in that country where chief executive officer (CEO) compensation rose from 20 times the typical worker's compensation in 1965 to 58 in 1989, to 270 in 2008, and to 312 in 2017 (Mishel and Schieder 2018). Iceland imported the essence of this aspect of American business culture if not the scale of it. Statistics comparable to those for the United States are not available for Iceland. What is known is that the average compensation of CEOs of firms listed on the Icelandic Stock Exchange in 2017 was 17 times the minimum wage. The most highly paid CEO received 30 times the minimum wage, a low ratio by American standards but high by historical standards in Iceland. The CEOs serve on the boards of each other´s companies, awarding one another generous compensation by local comparison. The fluctuation in CEO pay reflects mostly variable income from capital. Ólafsson and Kristjánsson (2017, 224) report that the top one percent of Icelandic households earned seven times as much as the bottom 90 percent in 1992–1995, 30 times as much in 2007, and ten times as much in 2015.

Politicians took notice. Some small-town mayors in Iceland, political appointees all, have recently been reported to receive salaries exceeding those of the mayors of Chicago,

[6] "Former PM Haarde Takes Position on Board of World Bank," *Iceland Review*, 7 October 2018, http://icelandreview.com/news/2018/10/07/former-pm-haarde-takes-position-board-world-bank, accessed 8 October 2018.

Houston, London, Los Angeles, New York, Paris, Tokyo, and Vienna. The salaries of MPs have increased by 111 percent since 2011 or by 11 percent per year on average from 2011 to 2018. Meanwhile, consumer prices rose by 26 percent from 2011 (January) to 2018 (September). These salary decisions were made by a public Wage Council that kept no minutes of its meetings, offered no explanations for its sometimes retroactive decisions, and awarded the newly elected President of Iceland an unwanted salary increase that he refused to accept and decided to donate to charities. The Wage Council was disbanded when both the Icelandic Confederation of Labor and the Confederation of Icelandic Enterprise warned that the Council´s decisions would create havoc in the centralized labor market where unions have long had a strong influence on wage setting.

When wage earners are told that they have to reconcile themselves to a four percent wage increase in upcoming wage negotiations – 2.5 percent inflation plus 1.5 percent productivity increase – so as not to endanger macroeconomic stability, they hear an echo of John F. Kennedy saying: “You cannot negotiate with people who say what’s mine is mine and what’s yours is negotiable.” Experience suggests that wage earners care about relative wages as well as absolute wages (Gylfason and Lindbeck 1984; Thaler 2015, Ch. 14). This helps to explain why nominal wages are stickier downward than real wages. Wage earners resist nominal wage cuts because they suspect that not everyone will be invited to a seat at the same table. By contrast, higher prices reduce the purchasing power of everyone´s unchanged nominal wages by the same proportion, a more acceptable, more widely shared form of reduced real wages.

In a decentralized labor market such as in the United States, workers frustrated by sky-rocketing executive pay while median household income has remained flat for 20 years have nowhere to go to protest but the ballot box. Many of them apparently voted for Donald Trump in 2016. In a centralized labor market such as the Icelandic one, workers have an additional outlet. They can demand a big wage hike or else stage a national strike, something they did often in the past. This is one reason why Iceland has the OECD region´s second highest average inflation rate since 1960, second only to Turkey. The laws governing the Icelandic labor market have remained unchanged from 1938, granting the trade unions undiminished ability to flex their muscles when their members feel that they have been taken for a ride. For this reason, several fairly docile union leaders have recently been ousted by more assertive leaders who demand justice that they feel they have been denied since the crash. For starters, the new leaders have announced that they will demand a 42 percent increase in minimum wages. From their point of view, a legitimate reason for a big wage hike now may be that that is the only way to reverse the relative wage hikes of self-dealing business and political elites. Also, they may want to use the powers granted them by law since 1938 to throw their weight about the political arena and to punish, even topple, the government (as happened in 1958). Ten years after the collapse, Iceland is still a powder keg.

In sum, the short- term prospects of the Icelandic economy appear uncertain at the time of writing in late 2018 for reasons that seem to have much to do with the failure of the elites to draw appropriate lessons from the crash and from the culture that caused it.

3. Exchange rates, Iceland, and Ireland

One letter and six months was said to be the sole significant difference between Iceland and Ireland when, ten years ago, they were struck half a year apart by a mostly home-made financial tsunami triggered by the collapse of Lehman Brothers. But this was an understatement for, among other differences, Ireland is an EU and EMU member and thus uses the euro while Iceland is outside the EU and EMU and does not use the euro. See, many said: Iceland can devalue its way out of its difficulties whereas Ireland, tied to the euro, cannot. Not so fast, said others: Ireland has access to the European Central Bank and the rest of the EU´s financial rescue apparatus which Iceland does not have. This is about as close as economists can come to a controlled experiment. Both countries share a long history of inward-looking attitudes rooted in difficult relations with foreign rulers in Denmark until 1904 and in Great Britain until 1922 (Gylfason 2013).

So how did Iceland and Ireland weather the storm?

3.1 Recovery 2007-2015

From peak to trough, the purchasing power of real per capita GNI fell by more in Iceland than in Ireland, or by 21 percent from 2007 to 2010 in Iceland compared with 14 percent from 2007 to 2009 in Ireland (Figure 1).[7] It was not until 2015 that the purchasing power of real per capita GNI was restored to its 2007 level in both countries. By this yardstick, the economic recovery took eight years in both places, the average time it takes according to Reinhart and Rogoff (2014). By 2015, Ireland´s real per capita GNI at PPP had risen 14 percent above that of Iceland. Broader measures of economic performance accord with this pattern. In its most recent ranking, for 2017, the United Nations Human Development Index that reflects per capita income as well as education and health ranks Ireland 4th and Iceland 6th, up from 6 and 16 in 2014. Iceland had dug itself a deeper hole than Ireland. True, Ireland has much higher unemployment than Iceland but that has been the case for decades and has little to do with the 2007–2008 crises and their aftermath.

Ireland was able to recover without ditching the euro while Iceland recovered mostly through a massive influx of tourists attracted by a 50 percent decline in the value of the local currency, making Iceland a much less expensive destination than before. Both countries received significant help from the IMF. Ireland´s EU membership, with the euro, apparently did more than compensate for Iceland´s ability to let the króna sink. By 2018, the real value of the króna had been restored to its pre-crash level. In 2008, the króna was clearly overvalued because the short-term capital inflows keeping the exchange rate so high were not sustainable. Whether the króna is now again overvalued at its current rate depends on whether foreign tourists keep flocking to Iceland and, in particular, perhaps, whether tourists can be as fickle as flows of capital. If the inflow of tourists slows down, the króna will depreciate, increasing further the gap that separates Ireland´s per capita GNI at PPP from that of Iceland. Tourist arrivals to Iceland rose by less than eight percent per year on average from 1949 to 2010, from 5,000 to 500,000, and have since then risen by 24 percent per year on average, reaching 2.2 million in 2017, nearly seven times the local population.

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[7] I use GNI in this comparison because Ireland´s GDP is severely distorted by the base erosion and profit shifting ("BEPS") tools of U.S. multinational tax schemes. In 2015, Irish GDP exceeded GNI by 50 percent, leading the Central Bank of Ireland in 2017 to develop a new metric, "Modified Gross National Income," or GNI* for short. The difference between GNI* and GNI is that GNI* does not include the retained earnings of re-domiciled firms in Ireland whose earnings ultimately accrue to foreign investors, nor does it include depreciation on foreign-owned capital assets located in Ireland which inflate the size of Irish GDP, benefiting foreign investors.

3.2 Prosecutions and prison terms

Two other differences between Iceland and Ireland deserve mention.

First, while Iceland´s failed private banks, with IMF approval, repudiated their debts because they were impossible to pay back, Ireland's tax payers were made to shoulder responsibility for bank losses even beyond the limits stipulated by law (O´Toole 2009; Donovan and Murphy 2013). This painful solution was possible in Ireland because, relative to GDP, the debts of the Irish banks to their foreign creditors and stock holders were several multiples of GDP lower than the debts of the failed Icelandic banks and also because the European Central Bank and the EU backed Ireland. So, unlike in Ireland where the government decided to bail out the banks even beyond the call of the law at huge cost to Irish taxpayers and to economic recovery, the Icelandic government abandoned the banks. There was no other way out of the mess because the hole that the banks had dug themselves into while the government looked the other way or even egged them on was too deep. Had the scale of the problem been smaller, the Icelandic government might have done what the Irish government did and what most people do if they find it at all feasible – that is, pay back. In Iceland, that was quite simply not an option (Gylfason 2013).

Several observers suggested that it was appropriate to invoke the legal principle of odious debt – that is, borrowed money that is used to undermine the public interest or is misappropriated in other ways. If such misappropriation of borrowed funds can be shown to have taken place with the knowledge of the creditors, they cannot reasonably expect to be paid back. If the banks were ripped off with the help of insiders, a widely held view in Iceland, innocent taxpayers should not be asked to pick up the tab. Most of the cases brought by the Special Prosecutor thus far have resulted in conviction. In Ireland, by contrast, bribery, tax evasion, and false evidence under oath went unpunished for the most part.

So, there was nothing particularly courageous or virtuous about Iceland's "standing up to" foreign banks. The road taken was necessary and inevitable. The constitutional validity of the emergency laws enacted during the 2008 crash to ensure that depositors had priority over other claims on the assets of the failed banks was upheld by the Supreme

Court, paving the way to a settlement of Iceland's IceSave debt to the governments of the United Kingdom and the Netherlands.

In second place, unlike in Ireland, several Icelandic bankers were prosecuted for financial fraud (breach of trust, embezzlement, false reporting, insider trading, and market manipulation). The key to these prosecutions was an independent Financial Supervisory Authority (FSA), separate from the Central Bank, as well as the office of the Special Prosecutor that received a steady stream of referrals from the FSA. After a while, however, the crime-busting director of the FSA was hounded from office and the budget allocations to the Special Prosecutor´s office were curtailed to the point where several important investigations had to be discontinued for lack of funds. Even so, the Supreme Court of Iceland has thus far sentenced 36 individuals (30 bankers, 3 executives, and 2 auditors as well as a cabinet secretary in the finance ministry) to a total of 88 man-years in prison for crash-related offenses, for an average jail term of 2.5 years (Jensdóttir 2017). The 30 bankers include the CEOs of all three of the failed banks and the Board Chairman of one of the three. The Supreme Court has yet to hear on appeal a few cases where district courts sentenced more bankers (some among the 30 already jailed) to additional time in jail.

Even if the banks were essentially all alike, the 88 years of total prison time have not been evenly divided among them: Kaupthing got 32 years, Glitnir got 19, Landsbanki got 11 years, Savings and Loans got 12 years, and others 14. The Supreme Court has heard cases involving 52 individuals and found 41 of them guilty (79 percent) and acquitted 11 (21 percent). Because some were found guilty or acquitted more than once, the number of those sentenced for crash-related crimes thus far is 36 and the number of those acquitted is ten.

The jailed bankers and their lawyers complain that the Supreme Court sacrificed them to pacify an angry public. They seem to have been gently treated in jail, however. Some of them continued to run their affairs from their cells. Some have been released ahead of time, leading a local theater to announce by loud speaker before curtain: "Ladies and gentlemen. Welcome to the theater. Please turn off your mobile phones and ankle bracelets." The day after one of the bankers was released with his bracelet on, he crashed his private helicopter; no one was hurt.

It was not until 2015 that high-ranking public officials in the United States and the IMF voiced their support for the Icelandic approach to prosecution of financial fraud. In the United States and Europe, including Ireland, the government has mainly let it suffice to impose fines on banks, not bankers, for fraud – the practical equivalent of fining Route 66 for speeding. The shock that Icelanders were exposed to in 2008 produced a different outcome: Penalties by law for the perpetrators of financial fraud in the name of justice as well as deterrence. Recent advocates of individual accountability for financial fraud include former Federal Reserve Chairman Ben Bernanke,[8] former Federal Reserve Vice Chairman Stanley Fischer,[9] and IMF Managing Director Christine Lagarde.[10] Each of them voiced their opinion on only one occasion, however, *sotto voce*. If you really mean what you say, it is a good rule to say it at least twice, loud and clear.

In sum, while both Iceland and Ireland have made an impressive economic recovery under different exchange rate regimes, Ireland´s recovery within the euro area shows that a strong recovery was possible with the euro. The experience of Latvia and also Portugal points in the same direction. If they could do it, why not Iceland? Their experience can be seen to support Andersson and Jonung´s (2018) case for a currency board as a stepping stone for Iceland´s future membership of the EU and EMU. After all, the Icelandic króna has lost 99.95 percent of its value vis-à-vis the Danish krone since 1939. The Icelandic parliament´s application for EU membership in 2009 was laid on ice in 2013. It remains to be seen whether the membership negotiations will resume any time soon. The Faroe Islands, Iceland´s neighbor (pop. 50,000), have their own króna bills. The Faroese króna is, however, not an independent currency but rather a version of the Danish krone, and is issued by Denmark´s National Bank. Thus, the exchange rate between the two is one-to-one, as was the case in Iceland vis-à-vis Denmark before 1939. Since Denmark is a *de facto* member of the euro area, the example of the Faroes, whose sole significant export

[8] "Ben Bernanke: "More execs should have gone to jail for causing Great Recession," *USA Today*, 13 November 2015. See https://eu.usatoday.com/story/news/politics/2015/10/04/ben-bernanke-execs-jail-great-recession-federal-reserve/72959402/, accessed 23 September 2018.
[9] "Stanley Fischer pushes for harsher banker penalties," *Financial Times*, 1 June 2015. See https://www.ft.com/content/4b0dd16c-087a-11e5-b38c-00144feabdc0#axzz3qSF3VtR1, accessed 23 September 2018.
[10] See Lagarde (2015).

commodity is fish, shows that even less diversified exports than those of Iceland are fully compatible with a fixed exchange rate in a sound setting. If the Faroes can do it, and also Greenland, why not Iceland?

4. Social capital under stress

Now comes the part that some readers may perhaps find hard to swallow. To prepare the ground, let me refer briefly to recent developments in the United States.

4.1 An American prelude

In recent years, the United States has shown several disappointing signs of social capital decay, including declining trust as exemplified by Putnam´s (2000) striking book title, *Bowling Alone*. Consider the following:

- Transparency International (2018) has lowered the corruption perceptions index for the United States from 78 in 2000 to 75 in 2017, ranking the US 16th in a group of 180 countries reviewed, well below Canada whose score is 82 with rank 8. In 2012, 73 percent of Gallup (2013) respondents in the United States considered corruption to be "widespread throughout the government in the United States" compared with 46 percent in Canada and 68 percent in Poland.

- Gallup (2018a) reports that the proportion of its American respondents expressing a great deal or quite a lot of confidence in the Supreme Court of the United States declined from 49 percent in 1975 to 37 percent in 2018. Two of the five justices forming what some hope will be a solid conservative majority on the Supreme Court for many years to come have been credibly accused of sexual harassment or assault. Confidence in Congress has dropped from 42 percent in 1973 to 11 percent in 2018 (same source).

- Life expectancy in the United States declined in 2015 and 2016. If it turns out to have dropped further in 2017, this will be the first time since the First World War that US life expectancy has declined three years in a row (Case and Deaton 2017).

- Freedom House (2018a) has gradually lowered the democracy score of the United States from 94 in 2010 to 86 in 2017. For comparison, Canada´s score is 99 and Poland´s is 85.

> Most recently, the US democracy score was lowered "because of the cumulative impact of flaws in the electoral system, a disturbing increase in the role of private money in election campaigns and the legislative process, legislative gridlock, the failure of the Obama administration to fulfill promises of enhanced government openness, and fresh evidence of racial discrimination and other dysfunctions in the criminal justice system, … growing evidence of Russian interference in the 2016 elections, violations of basic ethical standards by the new administration, and a reduction in government transparency."

The point of this inventory, which could be extended, is that we live in a changed world where even liberal democracies show disquieting signs of decaying social capital. By the above measures and several others not listed, the United States now lags behind not only Canada but also behind an increasing number of European countries. The decay of social capital can be contagious. Misbehavior by elites in the United States provides cover for comparable misconduct in other countries such as NATO partners Hungary, Poland, and Turkey – and perhaps Iceland as well.

4.2 Decaying social capital

Like the United States, Iceland shows signs of social capital decay that has accelerated since the 2008 collapse. Let us look at some evidence.

- Transparency International (2018) has lowered the corruption perceptions index for Iceland from 93 (rank 5) in 1998 to 89 (still rank 5) in 2008 and to 77 (rank 13) in 2017. In 2012, 67 percent of Icelandic Gallup (2013) respondents considered corruption to be "widespread throughout the government in Iceland" compared with 15 percent in Denmark and 14 percent in Sweden. Local opinion polls point in the same direction (Ólafsdóttir 2017). In this regard, Iceland has parted company with the rest of the Nordic countries just as the United States has fallen behind Canada.
- Gallup (2018b) reports that the proportion of its respondents expressing trust in the judicial system declined from 46 percent in 2002 to 36 in 2018. Survey measures of popular confidence in the Supreme Court produce similar results. Trust in Parliament dropped from 42 percent in 2008 to ten percent in 2012 and then crawled back up to 29

percent in early 2018 (same source) as the real exchange rate of the króna was restored to its pre-crash level of 2007, a restoration unlikely to last.

- Life expectancy in Iceland, which reached 82.5 years in 2012 – 81 for males and 84 for females – remained unchanged in 2016 even as child mortality continued to drop (World Health Organization 2018). In modern times, it is uncommon but not unheard of for life expectancy to be stagnant for four years. In Iceland, where life expectancy rose from 30 years in the 1860s to 73.4 years in 1960 and to 82.5 years in 2016, life expectancy was slightly lower in 1971 (73.6) than in 1967 (73.8) following a sharp economic downturn caused by the collapse of herring fisheries. Life expectancy was also lower in 1988 (77.1) than in 1984 (77.6) following a clampdown on high inflation that had increased to an annual rate of 83 percent in 1983. A comparable economic interpretation may apply to the stagnation of life expectancy from 2012 to 2016.
- Freedom House no longer views Iceland as a full-fledged democracy. Iceland´s democracy score was 100, full house, during 2004-2009, dropped to 99 points during 2010-2012, and then reclaimed its 100 points in 2013, 2014, and 2016. Thereafter, in 2017 and 2018, Iceland´s democracy score was lowered to 95 (rank 19).

When OECD countries fail to be awarded a top score of 100 by Freedom House (e.g., Australia, Canada, Denmark, the Netherlands, and New Zealand), the reason given almost invariably has to do with some form of discrimination against immigrants or indigenous peoples. The grounds for lowering Iceland's score from 100 to 95, by contrast, are quite different. Freedom House asks:

- "Are the people's political choices free from domination by … economic oligarchies … not democratically accountable?" No. Iceland loses one point because "close links between politicians and various business sectors allow well-coordinated business interests to exert influence over politics."
- "Are safeguards against official corruption strong and effective?" No. Iceland loses one point because "officials implicated in corrupt or unsavory behavior often continue to serve in government. For example, while former prime minister Sigmundur David Gunnlaugsson resigned after being implicated in the Panama Papers – a trove of leaked

legal documents that revealed potentially corrupt business activities by powerful individuals around the world – he was eventually replaced by [Bjarni] Benediktsson, who was also named in the Panama Papers."

- "Does the government operate with openness and transparency?" No. Freedom House subtracts one point because "Public officials have sought to conceal information that may be embarrassing or implicate them in wrongdoing."
- "Are there free and independent media?" Yes, but Freedom House subtracts one point because "the Reykjavík district commissioner issued an injunction that hampered some media organizations' ability to cover suspicious financial transactions by the prime minister."[11]
- "Do laws, policies, and practices guarantee equal treatment of various segments of the population?" No. Freedom House subtracts one point because "in 2017, the European Commission against Racism and Intolerance (ECRI), noted an apparent rise in racist discourse in Iceland in recent years." Further, Freedom House notes that "the rate of refugee recognition in Iceland is very low compared to its Northern European neighbors, with just 18 percent of asylum seekers receiving protected status in 2017."

In sum, Freedom House´s lowering of Iceland´s democracy score reflects social capital decay due to unseemly relations among politicians and oligarchs, corruption, lack of transparency, and infringement of press freedoms as well as discrimination against immigrants. Popular perceptions reported by Transparency International and others appear firmly anchored in facts on the ground. Foreign as well as local observers are now at last paying attention, their eyes open since the crash and the crass lawlessness exposed by the crash. Iceland is not unique in this respect, however. Corruption and crypto-fascism can be contagious. Some Icelandic politicians no doubt are relieved by events unfolding in the United States and elsewhere as they deflect attention from like developments in Iceland. This part of my story accords with the dire warnings issued in the new political

[11] Having been held hostage for a year, press freedom prevailed in court in October 2018. At the time of writing, it is not known whether the court ruling in favor of the news organizations in question, including the *Guardian*, will be appealed to the Supreme Court. In the meantime, the prime minister in question (Benediktsson) became finance minister.

science literature on democracy in America and Europe (see, e.g., Levitsy and Ziblatt 2018, Mounk 2018, and Stanley 2018).

There are indications that Freedom House may lower Iceland´s democracy score further in coming years.

- Local news reports of discrimination against guest workers in Iceland comprising perhaps 12 percent of the country´s labor force have attracted the attention of foreign monitors of human trafficking.[12]
- In a way that recalls the German *Dolchstoßlegende* (Stab-in-the-back myth) after the First World War, some of those whom the parliament´s Special Investigation Commission (2010), along with large swaths of public opinion, held primarily responsible for the 2008 collapse insist with their entourage that foreigners, including even those who helped finance the IMF-orchestrated rescue operation, are to blame for the home-made crash (Logason 2018).
- The same forces seem determined to disregard the result of the 2012 constitutional referendum in which 67 percent of the voters declared their approval of a new post-crash constitution for Iceland drafted by a constituent assembly directly elected by the nation with important provisions on public ownership of natural resources, equal voting rights, freedom of information, and environmental protection, among other things (Carrillo 2018).[13]

The readiness of Parliament to disregard the result of the constitutional referendum called by Parliament itself is perhaps the single most significant sign of Iceland´s decaying social capital. Like in the United States, the role of money in politics is the root source of the problem which manifests itself mainly through the politicians´ evident subservience to a small group of wealthy oligarchs that Parliament created with the stroke of a pen by

[12] "Reports of Violations of Foreign Workers' Rights Raise Concerns," *Iceland Review,* 3 October 2018, http://icelandreview.com/news/2018/10/03/reports-violations-foreign-workers-rights-raise-concerns, accessed 8 October 2018.

[13] Full disclosure: I was one of 25 representatives in the 25-member constituent assembly elected by the nation in 2010 and appointed by Parliament in 2011 to revise or redraft Iceland´s constitution.

granting them virtually free access to Iceland´s fish resources, a common property resource by law as well as by the new constitution that Parliament remains to ratify.

4.3 Corruption undermines trust

Different pillars of social capital tend to support one another. Corruption undermines democracy just as impunity undermines accountability, and so on. When trust recedes, other aspects of social capital tend to deteriorate as well.

Even long before the crash of 2008, the World Values Survey (2014) ranked interpersonal trust in Iceland far behind that in other Nordic countries (Gylfason 2015b). These surveys were taken before Iceland surfaced at the center of the Panama Papers scandal in early 2016 when it came to light that the names of about 600 Icelanders, including three cabinet ministers and the first lady,[14] were among those exposed. Two of the three ministers in question were still in office as prime minister and minister of the interior in early 2017 after having run successfully for reelection in October 2016, as did the former prime minister, who resigned from office under public pressure after the scandal broke. Thereafter, one of the three became prime minister briefly before becoming finance minister again as if nothing had happened.

The low level of trust in Iceland before the crash of 2008 suggests that low trust may have been instrumental in creating the conditions leading to the crash. If so, the causation runs both ways: from distrust to collapse and back. The significant level of trust enjoyed by the police suggests that limited trust cannot solely be traced to a distrustful public. Rather, a more reasonable inference appears to be that bankers, politicians, and judges, in particular, need to clean up their act to win the people’s trust. The crony privatization of the banks during 1998–2003 was conducive to their crash in 2008 (Gylfason *et al*. 2010, Ch. 7). Further, the two political parties which, through their self-serving privatization of the banks as well as by other means during their reign 1995–2007, created conditions conducive to the crash, have, by almost always keeping the ministry of justice to

[14] Ms. Dorrit Moussaieff was first lady 2003–2016, married to President Ólafur R. Grímsson in office 1996-2016.

themselves (specifically, for 76 of the 81 years from 1927 to 2008), dominated judicial appointments, sowing distrust.

The deep distrust that permeates Icelandic society needs to be seen in context. Throughout the 20th century until the privatization of the banks 1998–2003, Iceland was a heavily politicized and tightly regulated society where market forces were granted limited scope. This helps to explain why the privatization of the banks was designed to preserve the politicians' umbilical cord to the banks that had served prevailing political interests so well in the past (Gylfason 2015a). Favoritism and discrimination among customers of the banks were taken for granted without creating strong reactions because Iceland seemed to be keeping up with Denmark, Sweden, and Finland in the economic sphere (but not with Norway which through judicious management of its oil wealth and other things catapulted itself into a class of its own). The crash of 2008 blew the lid. Corruption existed all along even if no attempts were made to gauge it, but this changed after the crash. The question now is whether the economic recovery from the 2008 crash will survive the corrosion of social capital described above. Time will tell.

5. Conclusion

In sum, as I see it, at least three things need to be done, in an increasing order of urgency:

- Iceland needs a comprehensive accounting of its national wealth and its distribution, not least because vessel-owning oligarchs have been granted 90 percent of the natural resource rent from the fisheries while, through nominal fees levied on fishing firms since 2002, ten percent of the rent has accrued to the people, the right owner of the resource by law (Thorláksson 2015). The failure of the authorities to follow the money that disappeared during the crash underscores this need.
- Iceland needs to overhaul its banking system and monetary arrangements. There are different ways to arrive at this conclusion. One argument is the economic one presented by Andersson and Jonung (2018) and others, derived from Iceland´s history of high inflation. Another argument is that the example of Ireland shows that a flexible exchange rate is not necessary to stage a strong recovery from a financial crisis as argued in Section 3. If so, because accession to EU membership, like NATO membership, is

primarily a political issue largely immune to economic cost-benefit calculations, adoption of the euro is a foregone conclusion as a practical matter for Iceland even if Denmark like the United Kingdom negotiated a special exemption and Sweden has thus far managed to defer its legal obligation to ultimately adopt the euro. Also, in a country long marred by economic instability, a fixed exchange rate regime may be regarded as a potentially important part of an institutional framework aimed at fostering economic stability. A currency board is less amenable to manipulation than a floating exchange rate. Further, in view of the complete absence of foreign competition from the local commercial banking system contributing to systemically high interest rates and also in view of the role of commercial banks in creating money, it is imperative that the Icelandic banking system be put on a firm footing with a healthy mix of trustworthy private and public owners with foreign participation as was done in the Baltic countries following the collapse of communism.

- Iceland needs a better, more honest, and more competent political class as Parliament itself admitted *de facto* in its unanimous 2010 resolution that "criticism of Iceland's political culture must be taken seriously." Without an overhaul of the political class, through the ballot box, comprehensive accounting of national wealth and its distribution and a successful overhaul the banking system and monetary arrangements appear unlikely to materialize. A crucial first step in this direction is the ratification of the new constitution, ready since 2013. The new constitution is designed to address several of the factors that caused the crash and to solidify the country´s social capital. This will be accomplished through stronger checks and balances, greater transparency, and better judicial appointments in addition to urgent electoral reform (one person, one vote) as well as constitutional protection of the right of the people to the rents from their natural resources. Such protection will reduce the role of money in Icelandic politics (Carrillo 2018, Ch. 15) in the spirit of the opening salvo of the preamble: "We, the people of Iceland, wish to create a just society with equal opportunities for everyone."

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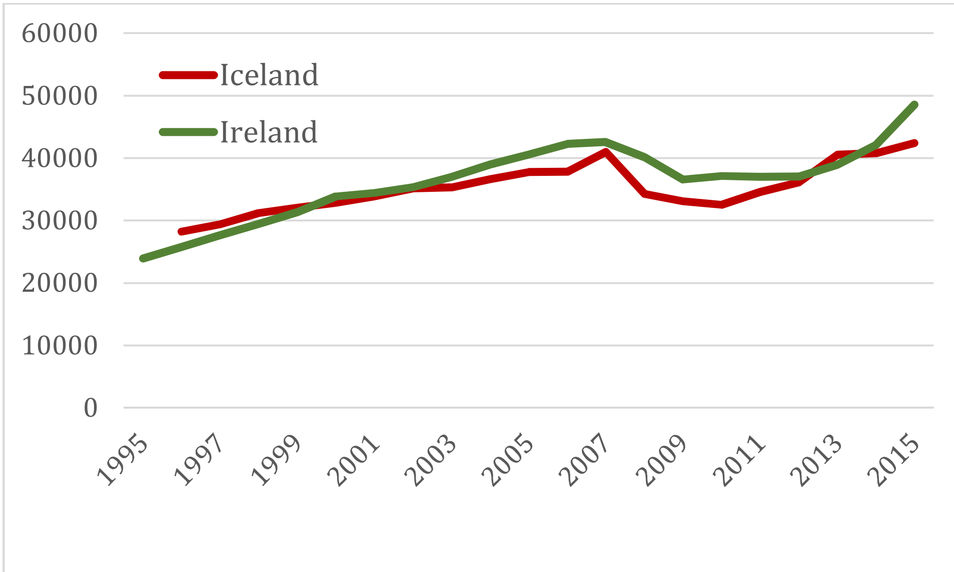
Figure 1. GNI per capita 1995-2015 (constant 2011 US $, PPP)



Source: World Bank, *World Development Indicators*.