Rational Individuals and Irrational Societies: The Path to Iceland's Financial Collapse

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Bankruptcy for profit

- Before 2008, borrowers and lenders in Iceland engaged in a corrupt scheme that was bound to make its banks collapse
- In misplaced belief in a softly regulated market economy where morals and ethics play no role, authorities failed to align private incentives with social prudence
- Iceland offers lessons in "bankruptcy for profit," relevant also to other larger countries where economic prosperity and social peace depend on honesty, integrity, and mutual trust in human interactions, including banking

Outline

I. Introduction
II. From history to theory
    A. Economic rent
    B. Limited competition
    C. Corruption
III. Crash followed by recovery
IV. Incentives and morals gone wrong
V. Conclusion

Background

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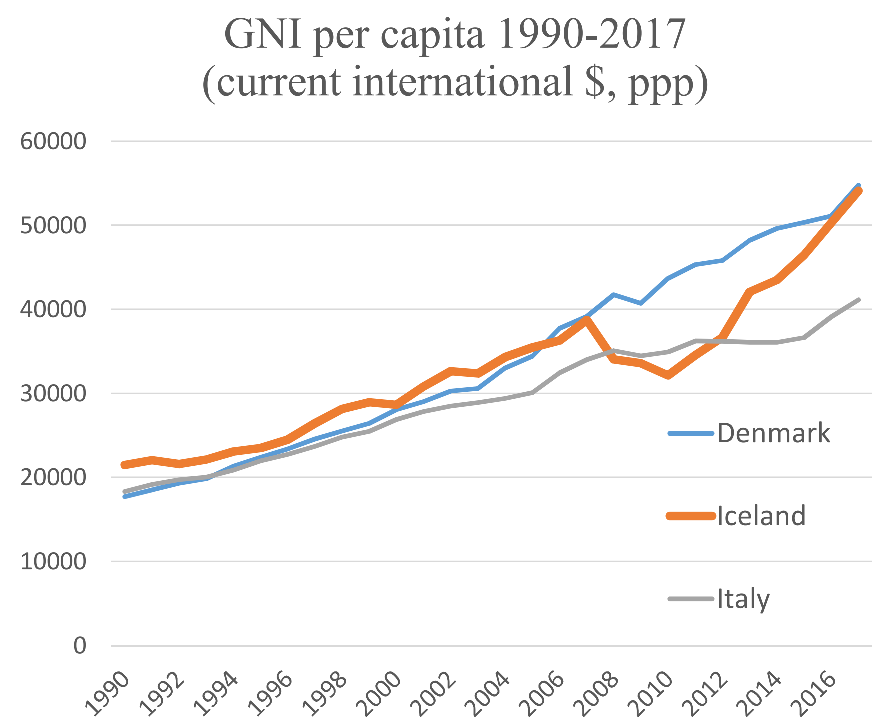
- From 1900 to 2018, real per capita GDP increased by a factor of 20
  - 2.6% per capita growth per year on average
  - Sources of growth: Education, fish, energy, trade, tourism
- Rapid growth masked several weaknesses
  1) Tardy foreign trade
  2) Limited local competition
  3) Mismanagement of economic rents, exacerbating corruption and undermining trust and democracy

GNI per person and per hour worked

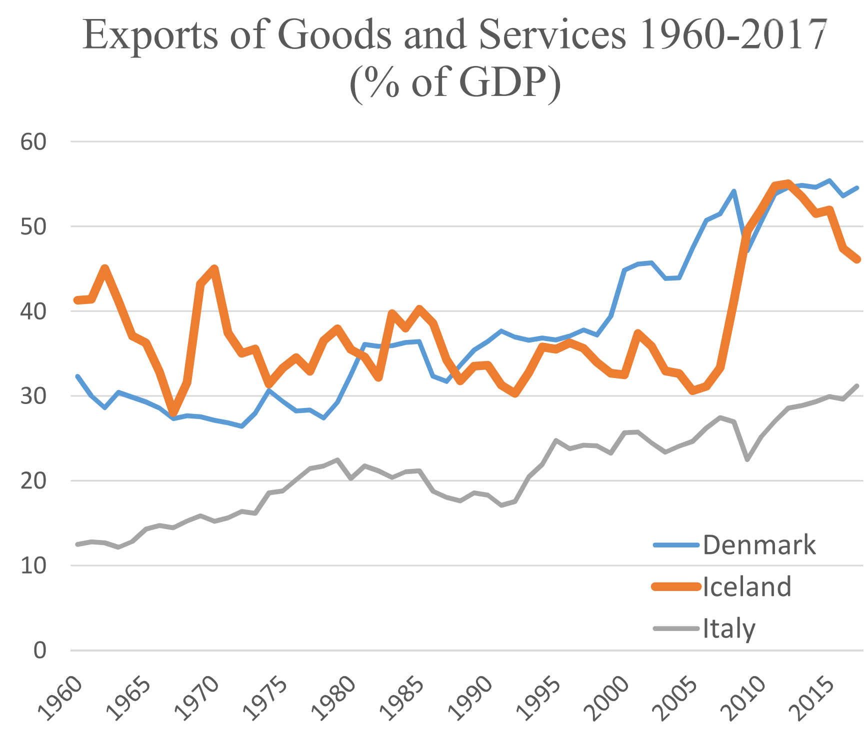
- A more revealing measure is per capita income per hour worked that takes into account the work effort behind national output
- Icelanders worked 1,500 hours per worker in 2017 compared with 1,400 hours in Denmark and 1,700 hours in Italy
- Long-standing inefficiency caused by, e.g., not enough competition in agriculture, banking, fisheries, etc., has kept real wages lower than in Denmark, encouraging long hours and high labor force participation
- GNI per hour worked in 2017 was USD 63 in Iceland against USD 72 in Denmark and USD 54 in Italy (source: Groningen Data Base)



Source: World Bank, *World Development Indicators.*

Weakness 1: Tardy foreign trade

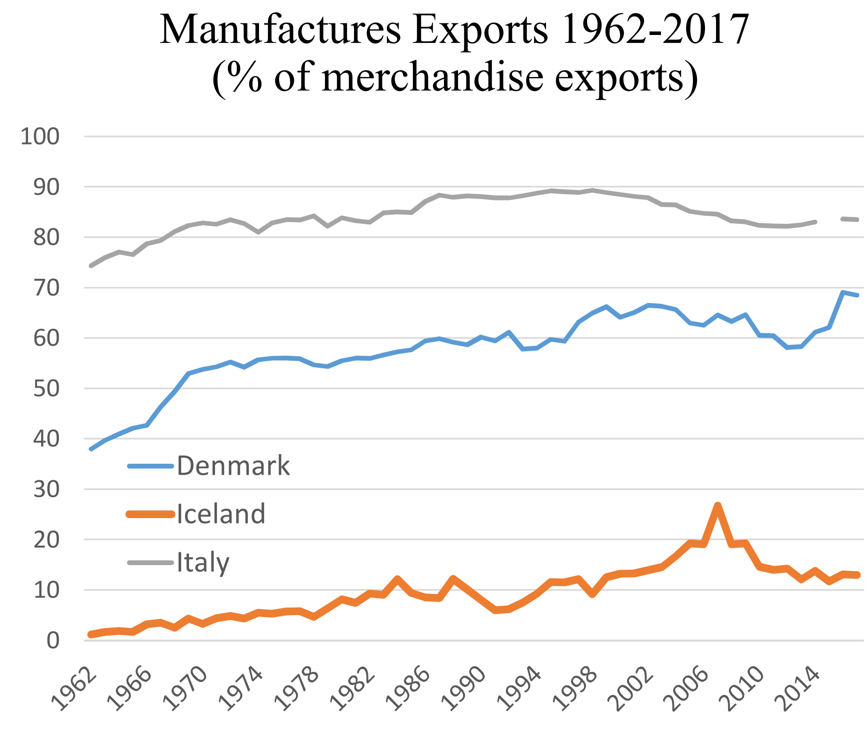
- Icelandic economy had stagnant ratio of exports to GDP at 30% to 40% from 1870 to 2008
- In 2008, ISK lost one third of its real value in real terms
  - Tourism became competitive
- After 2008, exports-to-GDP ratio rose from 30% to 55% and then fell to 46% as real depreciation after the crash was reversed



Source: World Bank, *World Development Indicators*.

Limited manufactures exports

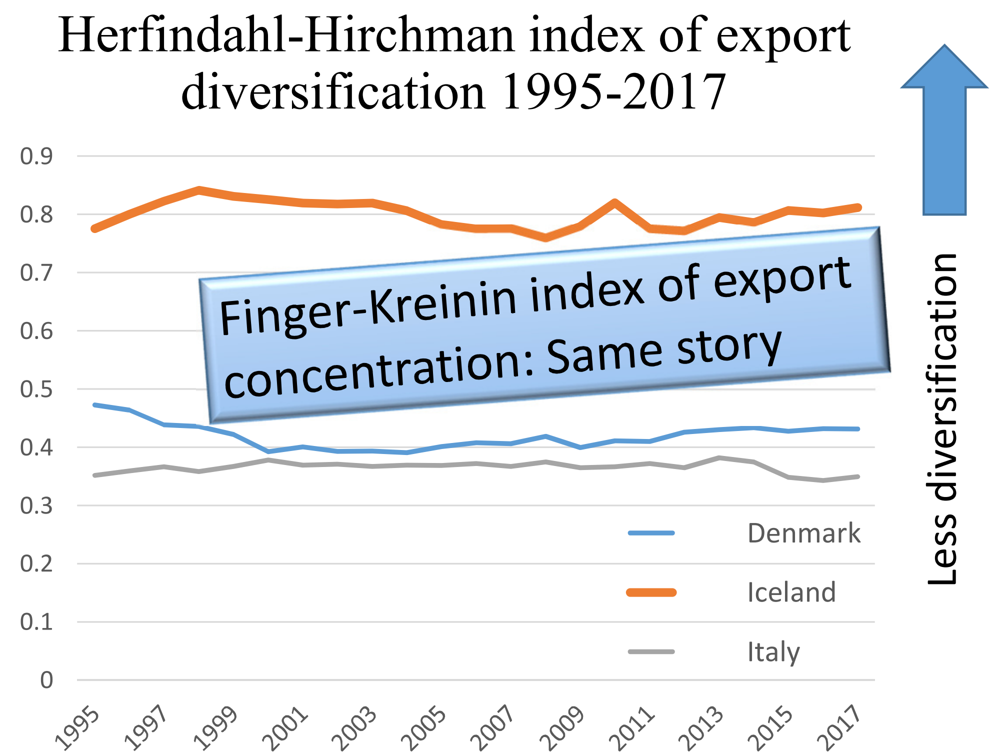
- Manufactures account for only 13% of merchandise exports in Iceland against 69% in Denmark
- Iceland still produces relatively few goods that others want to buy
- Yet, significant diversification of exports has taken place
- Fisheries are no longer dominant export industry as tourism and energy-intensive aluminum and ferrosilicon now contribute more than fishing industry to foreign exchange earnings



Source: World Bank, *World Development Indicators*.

Weakness 2: Limited local competition

- Excessive specialization can increase macroeconomic risk and volatility and destabilize or undermine economic growth
- In local markets, oligopoly reigns supreme
- Two to three firms dominate banking, oil retail, insurance, etc.
- Illegal collusion has been exposed in all of those industries



Source: UNCTAD.

Weakness 3: Mismanagement of resource rents

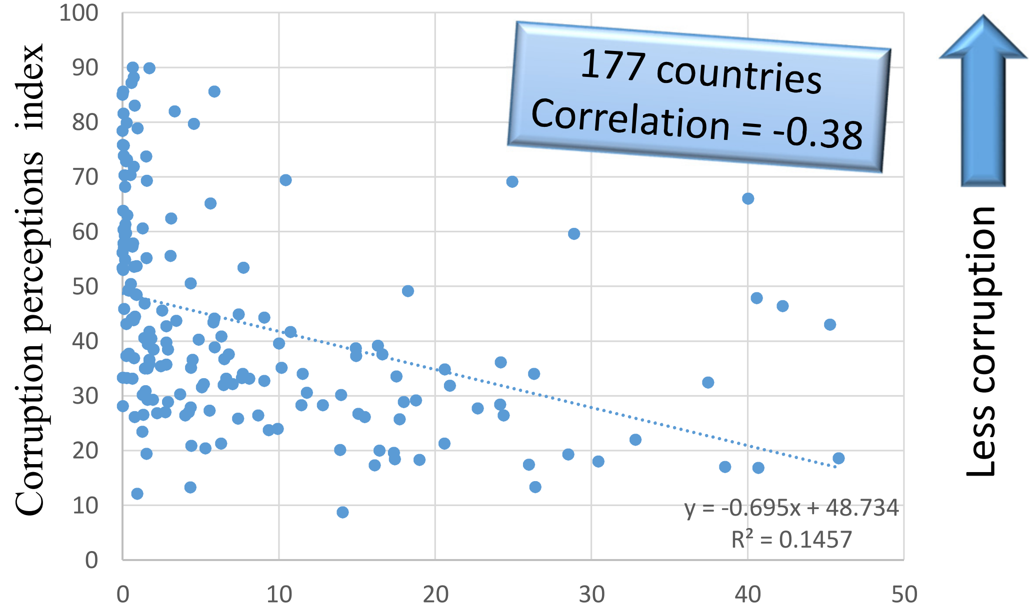
- Long history of extensive rent seeking in Iceland
  - From outset: Close connection between banking and politics
  - WW1: Trade restrictions
  - WW2: US military-base profiteering plus Marshall Aid
- More recently
  - Fishing rents equivalent to 2% to 3% of GDP
    - Dissipated at first, then handed free of charge to vessel owners
    - Nominal fishing fees since 2002 leave 90% of rent with vessel owners
  - Energy rents equivalent to 1.5% to 2% of GDP
    - Dissipated through sale of energy to foreign firms at low prices
  - Bank privatization 1998-2003 added to pre-existing class of oligarchs

Value of Iceland´s fish and energy resources is roughly USD 170,000 per each family of four

Resource rents and corruption

- Inverse cross-country relationship between the average share of natural resource rents in GDP during 1970-2017 and corruption during 2012-2018
- Drop in resource rent share in GDP by 20 points goes along with a 14-point reduction of corruption index

Corruption Perceptions Index 2012-2018 and Resource Rents (% of GDP) 1970-2017

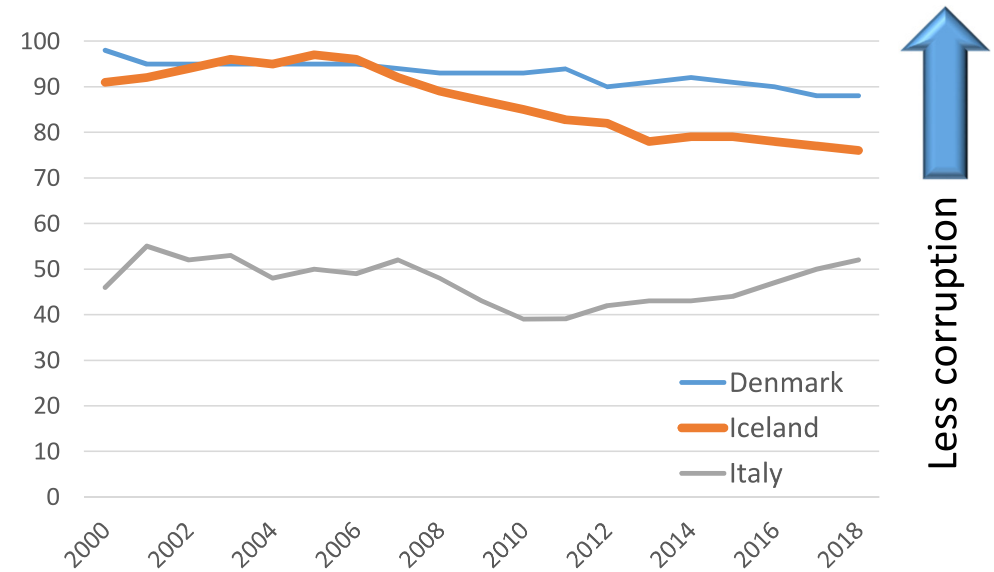


Source: Authors´ computations based on data from World Bank, *World Development Indicators,* and Transparency International.

Corruption

- Transparency indices
  - Denmark is least corrupt of all countries
  - Icelandic corruption has increased since 2005
  - Italy´s has decreased since 2010

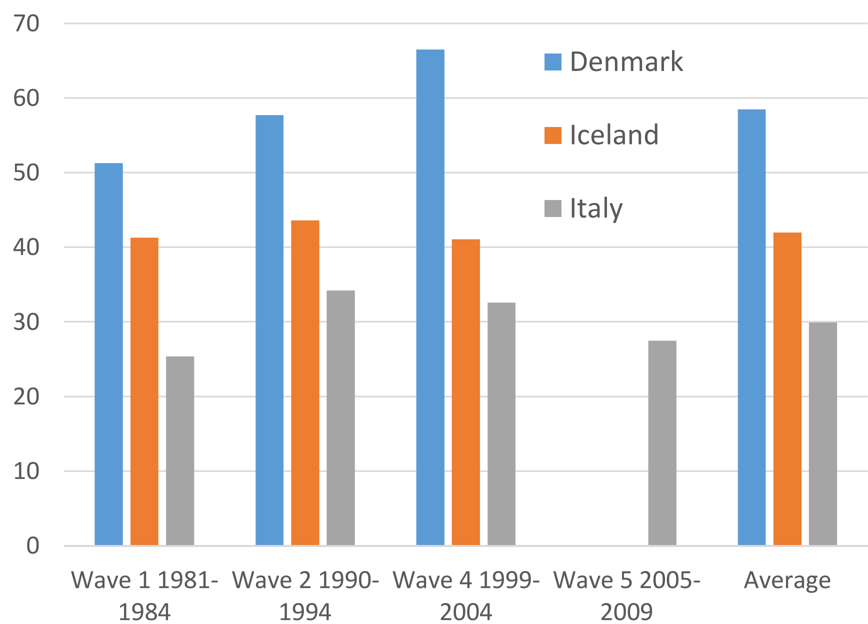
Corruption Perceptions Index 2000-2018



Source: Transparency International.

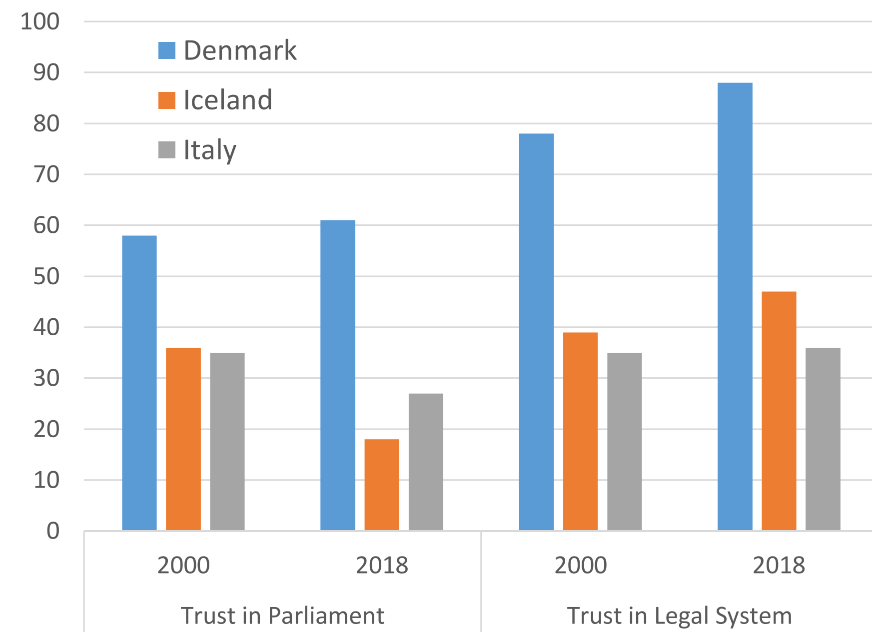
Trust in institutions

Most People Can Be Trusted (% of respondents)



Source: World Values Survey (2014).

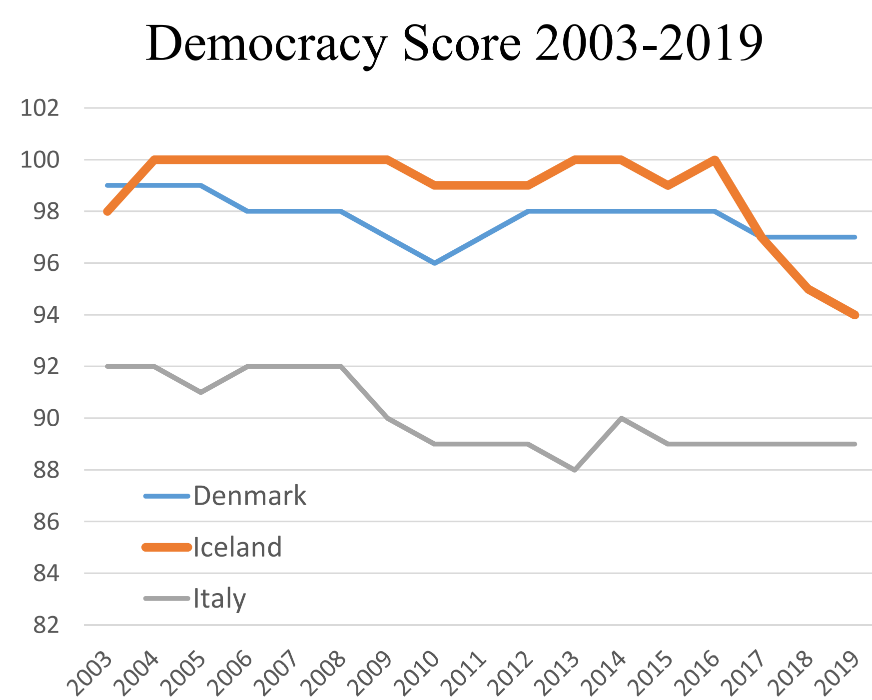
Trust in Institutions (% of respondents)



Source: Eurobarometer for Denmark and Italy, Gallup (2018) for Iceland.

Democracy

- Polity IV indices
  - Denmark´s condition is stable
  - Icelandic democracy has deteriorated in recent years …
  - … and so has Italy´s since 2003-2008



Source: Freedom House.

Whence corruption?

3

- Use of public office for private gain, including political allocation of rent to private parties through, e.g., protection from competition
- Key determinants of corruption
  - Trade restrictions (Krueger 1974)
  - Limited local competition (Ades and di Tella 1999)
  - Natural resource rents (Pendergast *et al.* 2011)
  - Weak government (Shleifer and Vishny 1993)
  - Low pay (Rijckeghem and Weder 2001)

Fits Iceland well – plus poorly supervised banking

Banking as source of corruption I

- From 1900 onward, politicians used banks to further their economic and political prospects, using them as places of employment for themselves and their friends and as sources of favorable loans to friends and allies
  - Negative real interest rates due to high inflation made banks especially attractive as political instruments
- Privatization of banks 1998-2003 was meant to sever links between politics and banking but, in mid-stream, it was considered safer to preserve umbilical cord connecting banks to politicians
  - Fatal error

Banking as source of corruption II

- Privatization was followed by foreign borrowing spree that increased bank assets from less than two times GDP in 2004 to eight times GDP in 2007
  - Another national resource, sovereign's credit rating, was privatized
- Banks collapsed in 2008
  - Bankruptcy for profit as in Akerlof and Romer (1993)
  - Inside job as in Black (2005) and Mel Brooks (1967)
- IMF was called to rescue
  - 36 bankers and others got 88 man-years in jail, and counting
  - Big fish vs. Small fry: Questions about equal justice

Incentives and morals gone wrong I

4

- Government decided to make Iceland an international financial center, relaxing requirements already in place and allowing banks to increase their capital through accounting gimmicks
- Banks made loans for purchase of theirs own shares, thus making equity out of nothing
  - Illegal elsewhere
- Banks made loans in foreign currencies to unhedged businesses operating in domestic currency as well as to households, creating currency mismatch for their customers

Incentives and morals gone wrong II

- Financial Supervisory Authority failed to prevent banks from lending to related parties
  - “[i]n all of the banks, their principal owners were among the largest borrowers” – Special Investigation Commission (2010)
- Authorities allowed banks to become too big to save, thus making them inherently unstable by creating incentives for private gain at the expense of financial stability
- Bankers profited while imposing risk on taxpayers, Iceland´s credit rating and foreign creditors

Conclusion: Failure of collective action 5

- Government set rules facilitating private gain at public expense, in effect allowing banks to be robbed from within
- This failure can be traced to incompetence as well as to culture of pervasive rent seeking, lack of competition and corruption
- A strong state would have passed laws to induce private agents to do what was best for the country but the state was weak
- Weakness of the state and its organs and massive wealth of bankers made society irrational as rational individuals ran the banks into the ground

Fini