17 June 2015.

Social Capital and Crises with an Application to Iceland

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Abstract

Economic growth is propelled in part by the accumulation of different kinds of capital, including social capital in its several guises. This paper considers the interplay between financial crises and various aspects of social capital which, if it is allowed to depreciate, can undermine economic prosperity and growth and possibly also contribute to crises. Specifically, the paper offers some empirical comparisons between the experience of the United States in the 1920s and in the 1990s until 2008 with the experience of Sweden and Iceland. The working hypothesis is that social capital decay can be a precursor as well as consequence of slow economic growth and of financial crises. Iceland is a case in point. An increasingly unfair distribution of income and wealth is likely to exacerbate the problem.

Table of contents

Keywords: Social capital, inequality, corruption, trust, financial crises

JEL: D63, D73, G01

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1. Introduction

Economic growth is propelled in part by the accumulation of various kinds of capital, including social capital. By social capital is meant the various kinds of cement that keep our societies reasonably cohesive and cooperative. Its coagulative properties enable the economic and financial system to hum along efficiently and not bleed out. This social cement comprises many different components. Basic is reasonable equality of opportunity with resulting equality of incomes and wealth. History suggests that glaring disparities undermine social peace and prosperity. Another component is trust, especially the trust that ordinary citizens feel they can place in political and societal institutions but also in one another, that is, interpersonal trust. A third factor is public honesty with public accountability, that is, the absence of pervasive corruption – the abuse of public trust for private gain – in business as well as politics. A fourth component is good governance such as, for example, basing appointments to public office on merit.

In his book *The Great Crash 1929* (1988, 177-178), John Kenneth Galbraith lists five main reasons why the state of the US economy was fundamentally unsound in 1929. His list begins with the "bad distribution of income." Galbraith points out that, in 1929, the "proportion of personal income received in the form of interest, dividends, and rent – the income, broadly speaking, of the well-to-do – was about twice as great as in the years following the Second World War." Galbraith goes on to discuss rising inequality in the context of the "bad corporate structure" and "bad banking structure" of the Roaring Twenties: "American enterprise in the twenties had opened its hospitable arms to an exceptional number of promoters, grafters, swindlers, impostors, and frauds. This, in the long history of such activities, was a kind of flood tide of corporate larceny." Galbraith's story about the Great Crash of 1929 bears a recognizable resemblance to an increasingly widespread view of the events that unfolded in the United States in 2007-2008, culminating with the collapse of Lehman Brothers. The several warnings from academic and other circles (Akerlof and Romer, 1993; Black, 1995; Stiglitz, 2010, Ch. 5; Ferguson, 2012) that preceded the meltdown and followed in its aftermath echo Galbraith.

In his written statement to the US Senate Judiciary Committee in 2010, James K. Galbraith put the matter starkly, concluding his statement thus: "the country faces an existential threat. Either the legal system must do its work. Or the market system cannot be restored. There must be a thorough, transparent, effective, radical cleaning of the financial sector and also of those public officials who failed the public trust. The financiers must be made to feel, in their bones, the power of the law. And the public, which lives by the law, must see very clearly and unambiguously that this is the case."

This paper considers the interplay between financial crises and various aspects of social capital which, if it is allowed to depreciate, can undermine economic prosperity and growth and possibly also contribute to crises. Specifically, the paper offers empirical comparisons between the experience of the United States in the 1920s and in the 1990s until 2008 with the experience of Sweden and Iceland. Supported by examples from Iceland, the working hypothesis is that frayed social capital can be a precursor as well as consequence of slow or uneven economic growth and of financial crises.

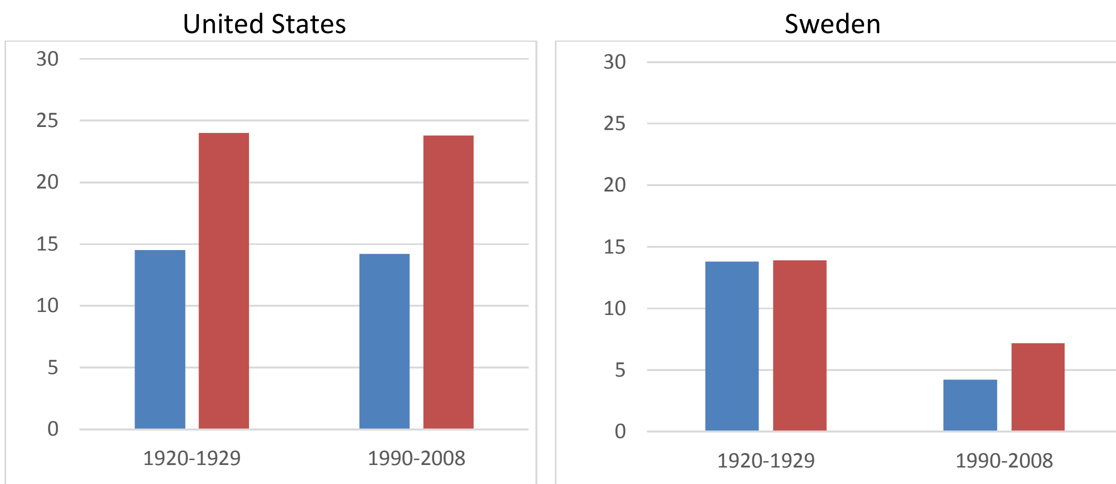
2. From inequality to crises

According to Galbraith (1988), the Roaring Twenties carried in them the seeds of the Great Crash of 1929. With hindsight, many now see a similar development in the United States from the 1980s onward when, as if it had forgotten the lessons from the Great Depression, Congress deregulated financial markets by, *inter alia*, repealing in 1999 the Glass-Stegall Act from 1934, thus dismantling the boundary separating commercial banking from investment banking and leaving bankers wholly to their own devices (Gylfason *et al*., 2010, Ch. 4). Several of the ultimately destructive processes in the 1920s described by Galbraith were reset in motion 80 years later.

We start by looking at the distribution of income.

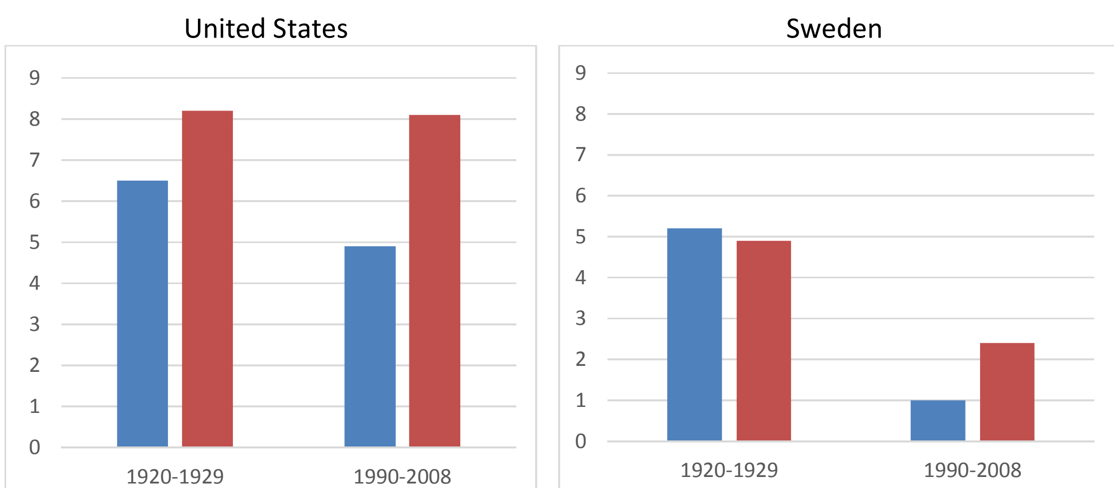
The Economic Policy Institute (2011) reports that the ratio of US executive salaries to ordinary salaries rose from 30 in 1960s to 270 in 2008. In his seminal work *Capital in the Twenty-first Century,* Piketty (2014) presents data that expose the striking parallel between the 1920s and the 1990s in the US and other countries, showing how the share of the top 10% of income earners in US national income rose from 40% to 50% from 1920 to 1929 and again from 1990 to 2008. This compares with 20% in Scandinavia and 25% in rest of Europe at present. Figures 1 and 2 present the figures for the top 1% and top 0.1% of income earners the US and Sweden. In the US, the crash of 1929 and the crisis of 2008 were both preceded by a marked increase in income inequality.

Figure 1. United States and Sweden: Share of Top 1% in Total Income (%)



Source: Piketty (2014). Note: Blue represents 1920 and 1990, red represents 1929 and 2008.

Figure 2. United States and Sweden: Share of Top 0.1% in Total Income (%)

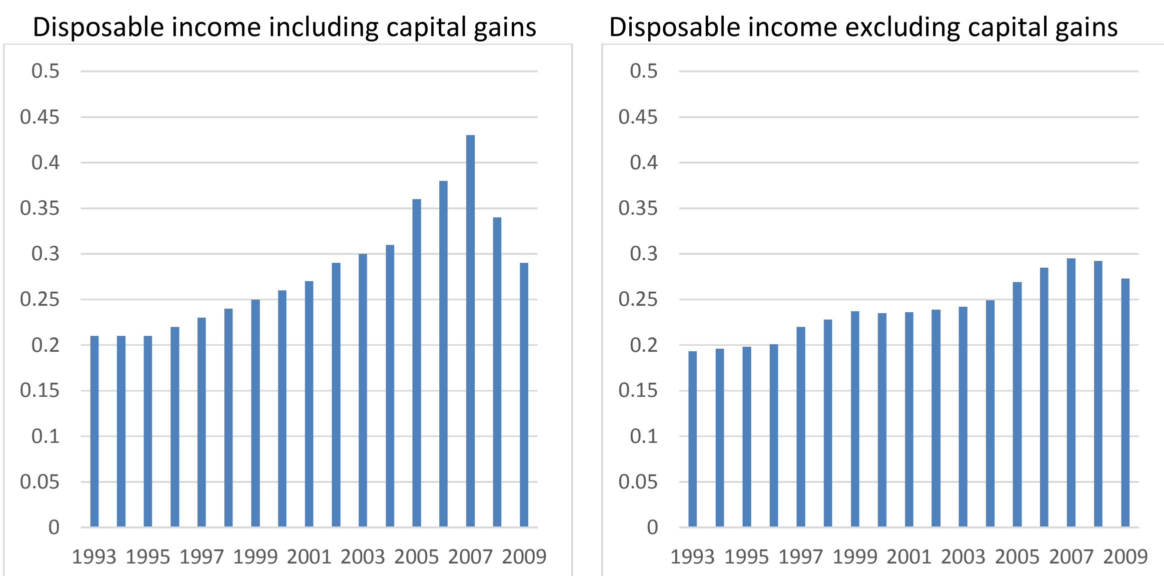


Source: Piketty (2014). Note: Blue represents 1920 and 1990, red represents 1929 and 2008.

In Sweden, the Great Depression of the 1930s was milder than elsewhere – in part, presumably, due to the deliberately countercyclical macroeconomic policy measures undertaken under the influence of the Stockholm School well before the publication of Keynes´s *General Theory* in 1936. Furthermore, income distribution did not change significantly during the 1920s in Sweden. Between 1990 and 2008, however, income inequality increased significantly in Sweden like elsewhere. However, having learnt its lesson from the financial crisis that engulfed Sweden as well as neighboring Finland and Norway during 1989-1994, Sweden weathered the global crisis in 2008 quite well. Deregulation without effective financial inspection and without markedly increased inequality preceded the Nordic financial crisis of 1989-1994 (Jonung *et al*., 2009).

The evolution of the distribution of income in Iceland provides a noteworthy comparison with the US and Sweden. From the mid-1990s onward, the Gini index for total disposable income in Iceland rose by one point a year until the crash of 2008, an unprecedented development (Figure 3, left panel). In Iceland, moreover, the incomes of the top 1% of income earners rose from less than 4% of total incomes in 1995 to more than 20% of total incomes in 2007, the year before the crash of 2008, or by a factor of more than five in just twelve years (Figure 4, right panel). For comparison, the incomes of the top 1% of income earners in the US rose from 14% of total incomes in 1990 to 24% in 2008 (Figure 1, left panel). In Sweden, the incomes of the top 1% of income earners rose much less rapidly, or from 4% in 1990 to 7% in 2008 (Figure 1, right panel). Neither the US nor Sweden come even close to the fivefold increase in the income share of the top 1% observed in Iceland. Figures on the income share of the top 0.1% are not available for Iceland.

Figure 3. Iceland: Inequality in Distribution of Disposable Income 1993-2009 (Gini Index)



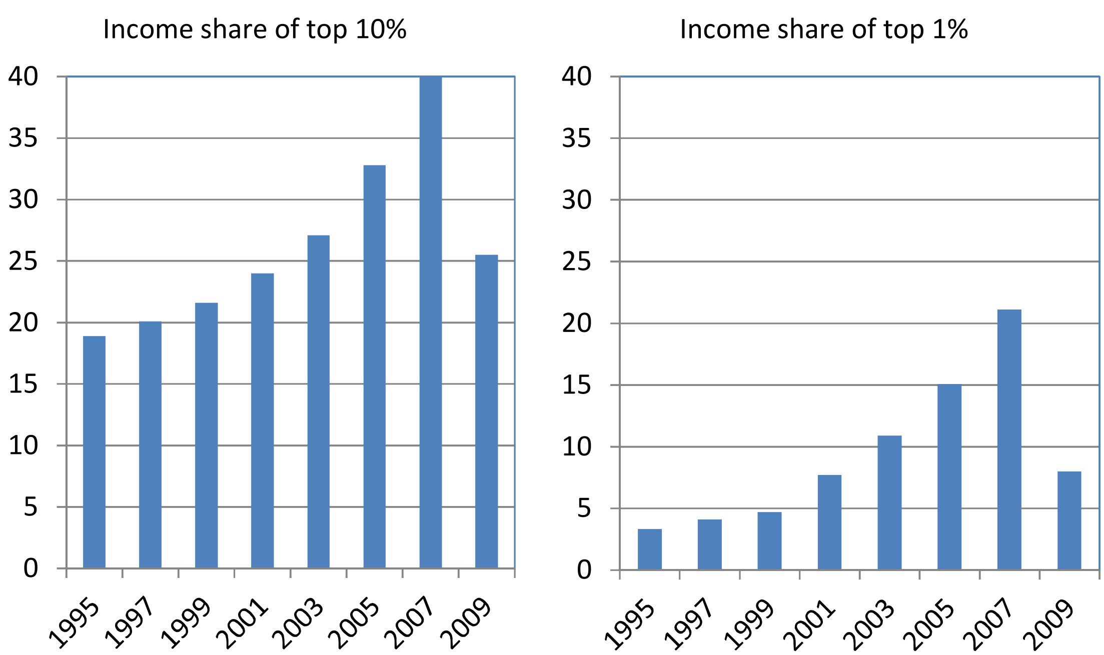
Source: Internal Revenue Directorate, http://www.rsk.is/, and Statistics Iceland, www.hagstofa.is
Note: A Gini index of 0 denotes perfect equality. A Gini index of 1 denotes extreme inequality.

Like Finland, Norway, and Sweden (but not Denmark), Iceland also suffered a financial crisis in 1989-1994 on a comparable scale judging by the amount of debt write-offs relative to GDP (Gylfason, 2015). The crisis was covered up, however, through high domestic interest spreads between lending rates and deposit rates made possible by the absence of foreign competition in the local financial market, paving the way to the cliff again in 2008. Similarly, increased inequality after 1995 was not officially acknowledged by the Icelandic authorities, including Statistics Iceland, until after the crash.

How could this happen in Iceland? That is a long story recounted, *inter alia*, in Gylfason *et al*. (2010), Aliber and Zoega (2011), Wade and Sigurgeirsdóttir (2012), Ólafsson and Kristjánsson (2013), Johnsen (2014), and Gylfason (2015). Suffice it here to mention the pre-crash government's aggressive policy of redistribution shifting the tax burden from the rich to the rest, taking its cue, without saying so, from the Bush Administration in the US. The Iceland Chamber of Commerce went along, boasting that nearly all of its policy recommendations were adopted by the government and declaring in print a few months before the collapse of 2008: "The Chamber of Commerce recommends that Iceland stop comparing itself with other Nordic countries because we are superior to them in most respects." According to their testimony before a special Court of Impeachment in 2012, senior Central Bank officials realized in 2006 that the banks could not survive, likening them to a Ponzi scheme, but this did not keep the Central Bank from continuing to lend the banks money for another two years nor did it keep the Chamber of Commerce from sponsoring two infamous reports co-authored by foreign experts claiming that the banks were sound, thus helping to delay the reckoning until 2008 (Aliber and Zoega, 2011, Chs. 9 and 10; Ferguson, 2012, Ch. 8). From this it seems likely, or at least plausible, that the exuberant atmosphere in business circles as well as in the political arena during the boom years, the widespread feeling that money is no object, that anything goes, contributed to the recklessness that broke the banks within a few years of their crony privatization 1998-2003, Russian style, bringing the country literally to its knees.

John Kenneth Galbraith would not have been surprised. Be that as it may, a clear identification of causality as opposed to coincidence is not possible here, nor was it in 1929.

Figure 4. Iceland: Share of Top 10% and Top 1% in Total Income (%)



Source: Internal Revenue Directorate, http://www.rsk.is/.

Several authors have argued that a direct causality exists from inequality to crisis. Rajan (2011) reasons that bad conscience among members of Congress due to increased inequality led congressmen, generously underwritten by bankers, to encourage the extension of cheap loans to low-income earners. The subprime loans turned out to be anything but cheap for the borrowers, however, and helped trigger the near-collapse of the US banking system in 2008 as described by Gramlich (2007), Johnson and Kwak (2010), Admati and Hellwig (2013), and Blinder (2013). Galbraith (2012, Ch. 13) tells a slightly different story, stressing the Bush Administration's launch of the "ownership society" aimed at stimulating the US economy with "a massive expansion of weakly supervised, poorly underwritten, underdocumented, and in the final analysis fraudulent loans made in vast quantities to people who, it was known, would not be able to keep up their payments." Stiglitz (2015, 96-97) stresses the depressing effect of increased inequality on consumption and hence also on output and employment. His argument is that an annual income of $20 million accruing to one individual is mostly saved, whereas 500 individuals earning $40,000 each would spend most of their income. Earlier, Galbraith (1988) had viewed the rambunctious atmosphere of the 1920s, accompanied by rampant inequities under the corrupt and incompetent administrations of Presidents Warren Harding (1921-1923) and Calvin Coolidge (1923-1929), as a conducive catalyst behind the Great Crash. Other stories abound.

It is also possible to view increased inequality and the increasingly reckless behavior of bankers, financiers, and members of the corporate class as joint consequences of other factors, including intensified rent seeking (Admati and Hellwig, 2013) plus the realization that "The Best Way to Rob a Bank is to Own One" (Black, 1995), leading to the wholesale liberalization of financial markets from the 1980s onward, facilitated by huge payments from the financial industry to politicians in a general atmosphere of irrational exuberance (Reinhart and Rogoff, 2009; Shiller, 2015). The difficulty of identifying causes and effects does not necessarily reduce the relevance of the likely linkages involved. For one, Mel Brooks was most likely not surprised by the meltdown of 2007-2008 because the plot in his Oscar-winning film *The Producers* (1968) revolves around a Broadway producer and his accountant who realizes that they can profit from producing a spectacular failure (Gylfason, 2010). Akerlof and Romer (1993) were on the same track in their seminal article "Looting: The Economic Underworld of Bankruptcy for Profit." A basic fault was lack of proper financial surveillance and inspection by the government, the economic equivalent of insufficient checks and balances in the political process.

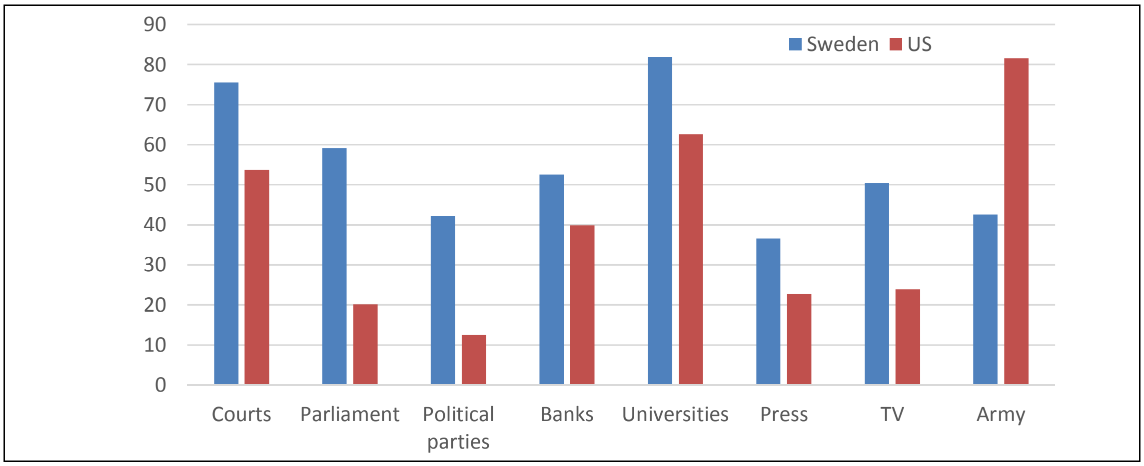
3. Broken trust and corruption

If gross disparities in the distribution of income and wealth undermine social cohesion, increased inequality is a sign of deteriorating social capital. Another such sign of frayed social capital is lack of trust. In *Bowling Alone* (2000), Robert Putnam documents the US case. More recent survey measures confirm Putnam's findings. For example, in June 2014, only 30% of US respondents told Gallup they had a great deal or quite a lot of confidence in the Supreme Court (down from 37% in 2012), and only 7% said they had confidence in Congress (down from 13% in 2012). Further, Gallup reports that 73% of US respondents claim that corruption is widespread in their government compared with 14% in Sweden, 43% in the United Kingdom, 58% in France, and 77% in Ukraine.

Figure 5 compares trust in institutions in the US with Sweden on the basis of the results reported in the World Values Survey (Medrano, 2015). With a single exception, Swedish respondents express markedly more trust in their institutions than do Americans. The sole exception concerns the military which more than 80% of Americans say they trust. This exception suggests that limited trust does not stem, at least not solely, from a distrustful public. On the contrary, if 80% of Americans express confidence in the army, why couldn´t other institutions inspire comparable public confidence? And if Swedes express markedly more trust in most of their institutions than do Americans, why couldn´t US institutions emulate their Swedish counterparts and thus earn more trust among the American public?

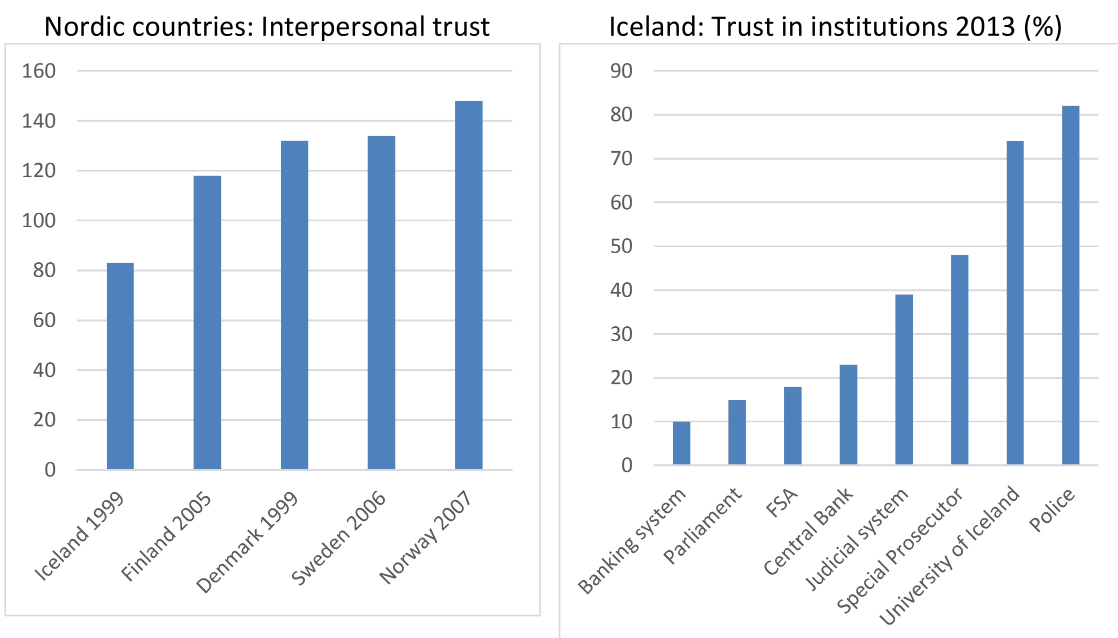
Figure 5. Sweden and the United States: Trust in Institutions

(% answering Yes to "Do you have a great deal or quite a lot of confidence in the courts, etc."?)



Source: World Values Survey (Medrano, 2015).

Figure 6. Nordic Countries: Interpersonal Trust and Trust in Institutions



Source: World Values Survey (Medrano, 2015). Note: See formula in text.

Source: Capacent (Gallup).

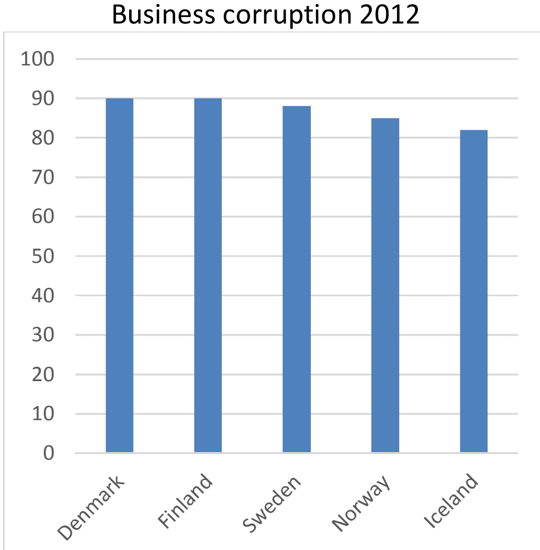
The question of trust concerns also interpersonal trust. The World Values Survey compiles an index that is designed to reflect the extent to which ordinary people feel they can trust one another by asking them whether they think that most people can be trusted and whether they think they need to be careful in their dealings with others. The index is defined as

TRUST INDEX = 100 + (% Most people can be trusted) - (% Can't be too careful)

The index is above 100 in countries where trust outweighs distrust and less than 100 where the opposite holds. Figure 6 (left panel) shows the results for the Nordic countries where most people trust one another reasonably well with the sole exception of Iceland. The level of trust in Iceland was low years before the crash of 2008, suggesting 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 crash and back. The same observation applies to the United States whose trust index is 73. Figure 6 (right panel) also provides a breakdown of public trust in different institutions in Iceland. The significant level of trust enjoyed by the police suggests, once again, 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. There is a pattern here. In Iceland, the crony privatization of the banks during 1998-2003 was conducive to their crash in 2008 (Gylfason *et al.*, 2010). Further, the two political parties which, through their botched 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 themselves (specifically, for 76 of the 81 years from 1927 to 2008), dominated judicial appointments, sowing distrust.

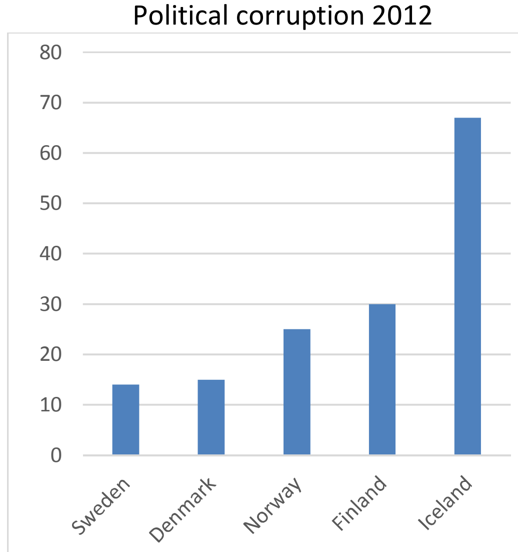
Figure 7. Nordic Countries: Corruption in Business and Politics

Business corruption 2012



Source: Transparency International.
Note: Transparency rates countries´ business corruption from 0 (corrupt) to 100 (clean).

Political corruption 2012



Source: Gallup, http://www.gallup.com/poll/165476/government-corruption-viewed-pervasive-worldwide.aspx
Note: Gallup reports the percentage of respondents who claim that corruption is widespread in their country´s government

The deep distrust that permeates Icelandic society needs to be seen in context. Throughout the 20th century until the botched privatization of the banks beginning in the late 1990s, 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, 2015). Favoritism and discrimination among customers in the state banks was taken for granted without creating strong reactions because Iceland seemed to be doing well in the economic sphere, keeping up with Denmark, Sweden, and Finland (but not Norway which through judicious management of its oil wealth 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. Figure 7 shows the difference between Iceland and the rest of the Nordic region. Two thirds of Icelandic respondents told Gallup in 2012 that they thought corruption is widespread in government compared with 14% and 15% in Sweden and Denmark (Figure 7, right panel).

4. From crash to social conflict: The case of Iceland

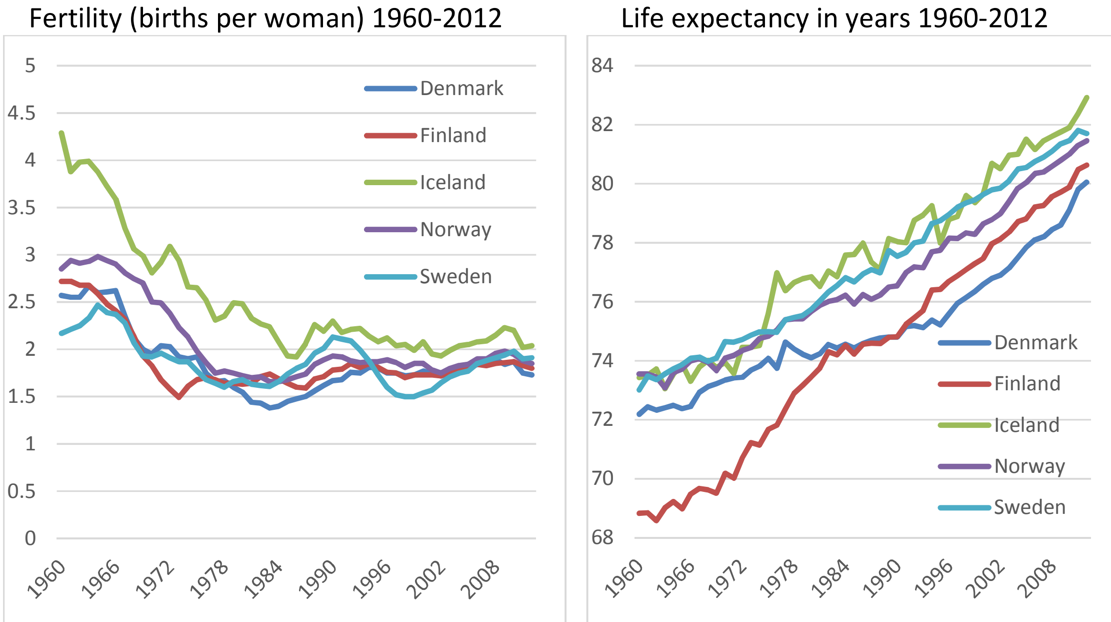
The world is changing. Suddenly, the distribution of income and wealth has entered the mainstream of economic and political discourse in Europe and America (Piketty, 2014; Stiglitz, 2013, 2015). Some writers attribute the polarization and gridlock of US politics to increased inequality (McCarty *et al*., 2006). Others attribute political polarization to deep constitutional flaws that have been exacerbated by the increased role of money in politics which in turn is encouraged by increased inequality (Levinson, 2006). The International Monetary Fund has recently issued several papers showing how gross disparities can undermine economic growth (e.g., Berg and Ostry, 2011, and Ostry *et al*., 2014). This finding accords with some earlier empirical work (e.g., Alesina and Rodrik, 1994; Persson and Tabellini, 1994; and Gylfason and Zoega, 2003) while others disagree (e.g., Barro, 2000). The misbehavior of bankers and corporate leaders (Enron, WorldCom, etc.) has done much to call popular attention to increased disparities as well as to corruption and distrust. The preceding pages of this paper provide some information on Iceland to show how its experience of increased inequality, corruption, and lack of trust fits into the emerging international picture of social capital fraying at the fringes.

Now consider Iceland further.

Iceland managed several aspects of its economic affairs quite well after the crash of 2008 with generous help from the International Monetary Fund. While output fell by 10% during 2009-2010, unemployment stayed below 8% of the labor force and is now 4% (early 2015). While the crash took a heavy economic toll, the immediate macroeconomic effects proved smaller than could have been expected. By and large, social indicators were not affected, a point worth noting because social indicators are often more resilient and more reliable than more widely employed economic indicators (Deaton, 2013). There is no sign of an increased incidence of suicides or of shortened life expectancies, on the contrary (Figure 8, right panel). Further, there are only weak signs of reduced fertility following the crisis (Figure 8, left panel).

Even so, after six years of austerity, there remains significant economic distress combined with pent-up frustration that manifests itself at the time of writing in a bitter labor market conflict with scattered strikes threatening to spread and to paralyze the economy or significantly increase unemployment or inflation or both. With explicit reference to inequality, executive pay, bank profits and bonuses, and regressive government policies, particularly the allocation of common-property fishing licenses to vessel owners at a fraction of full price, labor unions now demand wage increases plus minimum wage stipulations far beyond what employers consider feasible. The workers´ demands can be viewed as an uprising of the Have Nots against the Haves. The wage earners seem to be saying: It´s our turn to eat (Wrong, 2010). The strife between wage earners and employers is accompanied by rivalry among wage earners as described in Gylfason and Lindbeck (1984). For example, hospital workers in Iceland now demand wage increases commensurate with the 20% to 25% wage hike recently granted to striking hospital doctors.

Figure 8. Nordic Countries: Fertility and Longevity



Source: World Bank, *World Development Indicators*.

While similar in several respects, the Icelandic post-crash experience differs from that of other countries in one important way: After the crash, several Icelandic bankers and others were prosecuted. This has been a slow process, starting with a change of guard at the Financial Supervisory Authority (FSA) soon after the crash and the establishment of the office of the Special Prosecutor whose staff quickly grew from three to about 100. Under a new post-crash director installed to stop the FSA from looking the other way, the FSA was fundamentally restructured and strengthened, making it possible for it to refer nearly 80 cases of suspected violations of the law involving a large number of individuals to the Special Prosecutor. Based for the most part on these FSA referrals and further analysis by the Special Prosecutor´s office, the Supreme Court had by early 2015 sentenced eight individuals, including bankers and Savings and Loans officers, to a total of more than 30 prison years for fraud relating to the crash (insider trading, breach of trust, and market manipulation). Among those sentenced in 2015 were the Chairman of the Board and the CEO of Kaupthing Bank (they got 4 years and 5.5 years, respectively). Cases involving the other two big banks, Glitnir and Landsbanki, and involving false reporting as well as insider trading, breach of trust, and market manipulation, remain to be heard by the Supreme Court which is expected to need at least until 2018 to complete its crash-related case load. If the banks were essentially all alike before the crash, a widely held view, and if their management teams are equal before the law, the total number of prison years to emerge from the crisis appears likely to rise, an outcome quite different from that in, for example, the United States where the government has let it suffice to impose fines on banks for legal violations – the practical equivalent of fining Route 66 for speeding.

In fact, Iceland has been attempting to do what Black (2005), Galbraith (2010), Stiglitz (2015) and others have advocated in the United States – that is, prosecute cases of suspected financial fraud. For Iceland, this has not been an easy journey. The parliament´s Special Investigation Commission (SIC, 2010, vol. 2, 2) states clearly that "The largest owners of all the big banks had abnormally easy access to credit at the banks they owned, apparently in their capacity as owners. ... in all of the banks, their principal owners were among the largest borrowers." Further, the SIC (2010, vol. 2, 313, my translation) states: "The banks not only broke the law but they also exceeded their own limits, or moved the limits as needed." The SIC identified seven politicians and public officials deemed to have neglected their duties as laid down by law, including four individuals from the Independence Party, among them its leader and prime minister at the time of the crash. A special parliamentary committee appointed to review the case added to the roster an eighth name, that of the foreign minister and Social Democratic leader at the time of the crash. Even so, parliament decided to indict only the former prime minister and none of the others. The Court of Impeachment, convened for the first time in the country´s history, subsequently found the former prime minister guilty of violating the constitution and the law on ministerial responsibility, but without punishment (he was later appointed ambassador to Washington). There were other anomalies in the process, including the parliament´s failure to implement its resolution to investigate the privatization of the banks 1998-2003 and SIC´s decision not to include among its nearly 200 interview subjects a former CEO of Landsbanki (one of three from before its privatization) who, in a number of newspaper articles, had leveled specific accusations at several key bankers and politicians pertaining to alleged violations of the law before and during the privatization of the banks, individuals who until the crash remained key players on the banking scene, including the Vice Chairman of the Board of Landsbanki who was also the long-standing CEO of the Independence Party.

Mostly, however, the SIC has been criticized by those – bankers and also public officials and politicians – criticized in its report as well as by their lawyers. The Supreme Court has declared that the SIC findings cannot be used as factual evidence in court.

Repeated attempts were made to discredit and unseat the post-crash director of the FSA. The first two attempts to unseat him failed, but as the third attempt was also about to fail as well he was removed from office for having been instrumental in a leak to a newspaper in violation of the law on bank secrecy, and was subsequently handed a one-year conditional prison sentence. His position was that, as a private person, he was attempting to uncover political corruption and to protect the integrity of his office against his rogue attackers. Many hope that, during his three years of service as FSA director, the FSA managed to refer the most important cases of suspected fraud to the Special Prosecutor. Others hope not. Meanwhile, the Special Prosecutor´s office has seen its government budget allocation cut drastically two years in a row, necessitating commensurate downsizing of its staff, even if they still have their hands full. Again, many hope that the time and funds remaining will suffice for the Special Prosecutor to finish his job. Others hope not.

The atmosphere surrounding these developments has proved corrosive, further undermining social cohesion. At the heart of the problem is the unwillingness of those identified by the SIC (2010) and by other observers as being primarily responsible for the crash to accept their responsibility in the public consciousness or before courts of law. Several of them still talk about the "so-called crash" as if nothing happened, seemingly impervious to the suffering of all those who lost their homes and their savings at home and abroad as a direct result of the collapse. With the exception of the afore-mentioned Social Democratic leader, no one has apologized. Others grapple with the concept of collective guilt, having elected the politicians who installed the bankers who brought the country to its knees. Still others insist that every Icelander was responsible, for if everyone is responsible, no one is. There has been an escalation of politically motivated libel suits.

In this climate, chauvinism, peppered by anti-immigrant rhetoric, has made its mark in Icelandic politics for the first time, propelled in part by events in several other European countries, including Finland, France, Hungary, Sweden, and the UK, and also by the desire to deflect criticism of those locals considered primarily responsible for the crash by absurdly blaming the crash on foreigners, including the European Union and the IMF. Since the crash, for example, the President of Iceland who was criticized in the SIC report (2010, vol. 8, 170-178) for his brazen promotion of the banks and other business interests before the crash, has spoken disparagingly of the EU and of the Nordic countries, stressing instead Iceland´s affinity with Russia, China, and India. The implied repositioning of Iceland, a founding member of NATO since 1949 and an applicant for EU membership since 2009, reflects in part the perceived humiliation in some political circles of Iceland's having had to accept conditional assistance from the IMF because unconditional loans were not on offer in Europe or the US (or in Russia, for that matter). Iceland´s search for "new friends" needs to be viewed also in the context of the unilateral withdrawal of the US defense force from Iceland in 2006 against the wishes of the Icelandic government. From World War II until 2006, the US presence contributed the equivalent of about 2% of GDP to Iceland´s economy every year on average.

The emergence of chauvinism seems to serve a second political purpose, that of driving a wedge between Iceland and the EU to reduce the likelihood that the special interest groups – essentially, the boat-owning oligarchs and their associates – supporting, and supported by, the government in office since 2013 can be reined in by EU membership and the sharing of sovereignty that would entail. The government´s recent attempt to unilaterally withdraw Iceland´s membership application illustrates the problem. Rather than put the application on hold as the Swiss government did in 1992, allowing it to resume negotiations at any time, the Icelandic government´s intention is to pull out once and for all to make it necessary for a new parliament to restart the application process from scratch, securing renewed individual approval by each member country, a tall order. The government botched the attempted withdrawal, however, as the EU does not consider it possible for Iceland´s foreign minister to unilaterally withdraw an application approved by parliament in 2009.

5. Conclusion

This paper has considered the interaction between aspects of social capital and economic performance, including crises, drawing especially on recent experience from Iceland. Increased inequality preceded both the Great Depression of the 1930s and the Great Recession that began in 2007-2008. The question remains as to whether increased inequality can be viewed as one of several causes of those crises or whether both inequality and crises were triggered by some common causes, or both. The next question considered was whether a similar story can be told about other aspects of social capital. The World Values Survey and other sources, including Gallup, document deep and growing distrust in America, Europe, and elsewhere; both a widespread lack of trust in institutions and a lack of interpersonal trust. The observation was made that low trust is not a problem in Denmark, Finland, Norway, and Sweden, all of which weathered the Great Recession quite well, while the US and Iceland, where trust is much lower, were both struck quite hard by home-made crises. In Iceland, in particular, low levels of trust preceded the financial collapse of 2008 by several years, suggesting that broken trust, like increased inequality, can be a precursor as well as a consequence of crises. Further, greater disparities appear likely to undermine trust and conversely. Similar points were made about corruption.

In sum, the working hypothesis proposed here is that fraying social capital can be a precursor as well as consequence of slow economic growth and of substandard economic performance, including intermittent financial crises, thus creating vicious cycles of social decay and slow or uneven growth with possibly long-lasting economic consequences threatening to further weaken social cohesion by undermining trust and boosting chauvinism and other forms of extremism in the political arena that may jeopardize liberal democracy. None of this is necessary or inevitable, however. Social capital can be restored and strengthened through investments in education and public policies to narrow income and wealth inequalities to rebuild trust. Further, some writers (e.g., Sachs 2015) advocate moral instruction, professional codes of conduct, and public censure of violators of the public trust. Banks do not break laws, bankers do.

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