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Small states, Nationalism and Institutional Capacities:

The paradox of the Danish and Irish Responses to the Financial Crisis

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SMALL STATES, NATIONALISM AND INSTITUTIONAL CAPACITIES:

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1. Introduction

This paper presents a paradox to the "Varieties of Capitalism" school of comparative political economy. Proponents of this approach typically describe Denmark as a coordinated market economy in which the state works with centralized corporatist institutions to coordinate economic activity. In contrast, Ireland is seen as a liberal market economy in which state intervention is limited and corporatism largely absent, with market forces dominating economic activity instead (Hall and Soskice 2001, p. 19; Soskice 2007). This leads one to expect that the Danish state would have shouldered the costs of rescuing the banking sector during the financial crisis, which began in 2008, while private actors in Ireland would have done so. Yet the opposite was true.

Resolving this paradox requires attention to literatures that rarely speak to each other. The first concerns size. Katzenstein (1985) argued that small states are especially vulnerable due to their dependence on international trade and their need to navigate geopolitical seas dominated by larger states (see also Cameron 1978; Garrett 1998; Jones 2008). Fear concentrates minds whilst small size allows close linkages. There was an elective affinity between this situation and corporatism—defined best as a centralized system of interest groups, decision making through continous political bargaining between business, labor, the state, and political parties, and a national ideology of social partnership. Much has been written about the first two points (e.g., Becker and Schwartz 2005; Hemerijck et al. 2000; Ó Riain 2004; Schwartz 1994, 2001), but little about the ideology of social partnership.

The second literature on nationalism helps here. Nations are often vulnerable, with linkages tending to be dense given a shared sense of belonging (Gellner 1983; Hall 2010). So cultural homogeneity can be a useful resource for a modern society because it too allows those engaged in bargaining to understand each other without the sorts of religious, ethnic, racial or linguistic cleavages that might otherwise undermine cooperation (Bates 2008; Laitin 2007; Posner 2005). Others have confirmed this in various ways through statistical analysis (e.g., Alesina et al. 1997, 2003; Patsiurko et al. 2013, 2012).

Our argument about the different responses to the banking crisis in Denmark and Ireland—two small, culturally homogeneous countries—draws on and sheds new light on both literatures. Two claims are made. First, the beneficial effects of small size may be diminished if the small nation-state exists within the protective realm of a larger one in ways that shield it from vulnerability and otherwise undermine the development of institutions fostering the cooperation, self-sacrifice and flexibility that the small states literature deems important. This was the Irish but not the Danish experience. Second, the effect of nationalism is not inevitably beneficial. It may be distorted in detrimental ways if the founding nationalist party gains a hegemonic position that leads to corruption, cronyism and clientelism. Again, this was the situation in Ireland but not Denmark.

We will describe the different responses made to the financial crisis. Ireland had weak regulatory institutions, a dearth of necessary economic expertise, and clientelist politics. Much of this stemmed from the legacy of British rule and colonial dependence that led to the hegemony of a single party and severe limits to institutional development. Decision-making in the banking crisis involved opaque backroom clientelism where, in the absence of expert advising, the state was convinced to cover all losses. In contrast, Denmark had a long history of independent institutions and of national unity. Hence when the crisis emerged it had better regulatory oversight, greater input from experts, and transparent corporatist institutions. This facilitated a broad based and inclusive consensus that the state would cover losses but only above a very high threshold below which private actors would foot the bill—a threshold that was never reached. In this regard, decision making in Denmark was geared clearly toward the interests of the people as a whole rather than the individual banks and investors. That this was so in Ireland is much less clear.

We begin by drawing a contrast between thick and thin institutional surroundings, in Denmark and Ireland respectively. This mattered for both the origins and resolution of the crisis in each country. Second, we describe in more detail the paradox of the Danish and Irish responses to the financial crisis. Third, we discuss each country's institutional surroundings as they pertained to the origins and management of crisis. Denmark's thick institutions served it well during the crisis; Ireland's thin institutions did not. Our analysis is based in large part on interviews we conducted in 2012-2013 in each country with politicians, regulators, bankers, journalists, and academics involved in or knowledgeable about the events in question.

1.1 Thick and think institutions

This paper concerns institutional capacity broadly construed. What we mean here is in part infrastructural power—well-developed administrative institutions that allow states to penetrate their societies effectively, not least so as to foster economic success (Mann 1984; Evans and Rauch 1999). But states need transmission belts in society in order for this to take place; civil society must have well institutionalized organizations representing group interests capable of engaging in the politics of reciprocal consent with their states (Evans 1995). A successful political economy rests on strong institutional capacities in state and civil society.

To be clear, institutions are formal and informal rules, including monitoring and enforcement mechanisms, and systems of meaning, including identities that define the context within which individuals and organizations operate and interact with each other (Campbell 2004, p. 1). The importance of formal and informal rules was emphasized by Katzenstein. The importance of systems of meaning and identity was emphasized by Gellner.

Of course, institutional capacities are variable and multidimensional. To capture this we distinguish between “thick” and “thin” institutions. Thick institutions are similar to Weber’s emphasis on the legalism and professionalism of bureaucracy. Crucially, bureaucrats are recruited on the basis of expertise rather than of tradition, clientelism, or patronage. Further, the thick institutions with which we are concerned are oriented toward the goals of the nation as a whole, rather than particular interests within it. Finally, thick institutions are those that have developed over a long enough period of time allowing them gain legitimacy in society. Thin institutions are less developed and less taken-for-granted—indeed some question their legitimacy, preferring to see them changed.

This last point is as true of systems of meaning as it is of the formal institutions of state and civil society. In this regard it is worth remembering the words of George Bernard Shaw (1907, pp. xxxiv-xxxv) in his discussion of nationalism: “A healthy nation is as unconscious of its nationality as a healthy man of his bones…But if you break a nation's nationality it will think of nothing else but getting it set again. It will listen to no reformer, to no philosopher, to no preacher, until the demand of the Nationalist is granted." Put differently, when nationalism is buried and consensual—that is, when nation-building has taken place—it can help small states cope with the challenges of vulnerability. But if nationalism is closer to the surface and contested, it can have such nasty consequences as political division, acrimony and corruption.

2. The paradox in brief

2.1 Denmark's Bank Packages

Denmark's response to the crisis was state-led but largely privately financed. Nationalization of banks was not in the cards but imposing haircuts (i.e., losses) on bank debt holders, recapitalizing and consolidating banks, and financing much of this through private means dominated the Danish response. All of this was worked out over four years in five pieces of legislation, termed the "Bank Packages" (Bjerre-Nielsen and Lang 2011; Danske Bank 2012; Woll 2014).

The first package involved an unlimited state guarantee for depositors and senior unsecured debt to all banks belonging to the Private Contingency Association (PCA)—a banking industry organization for dealing with distressed banks. It was financed with DKK 35 billion (€4.5 billion) from the banking sector to the PCA. Only if these funds ran out would the state guarantee become liable. Furthermore, the government and PCA established the Financial Stability Company, a public company that managed the dismantling of financial institutions that had become insolvent.[1] It was designed to avoid a run on the banks that would undermine the stability of the Danish currency.[2] It is important to highlight the fact that efforts were geared primarily toward national rather than private interests.

The second package was a recapitalization scheme whereby banks were given the option of selling bonds to the government, which could eventually be paid back. If they were not paid

[1] The state eventually took over the activities of seven distressed banks. 132 of 138 banks applied for the government guarantee and thus had to contribute to the PCA. When the Stability Package expired the state had lost about DKK 12 billion (€1.6 billion) but covered this loss with funds drawn from the PCA and associated pledges and guarantees from the banks (Bjerre-Nielsen and Lang 2011, pp. 2-4).

[2] Peter Straarup, former CEO Danske Bank.

back, they could be converted into equity shares.[3] The state could then presumably sell these to private investors thus insuring against serious losses, indeed perhaps even making a profit someday. Fifty banks and mortgage lenders applied for capital contributions for a total of DKK 63 billion (€8.2 billion) by the closing date.

However, in order not to overburden taxpayers the idea of the third package was to replace the initial state guarantee in the first bank package. Distressed banks would now be closed temporarily, all unsecured and uninsured creditors would be subjected to haircuts, and depositors with deposits over DKK 750,000 (€97,500) would be exposed to losses. As it turned out two banks went bankrupt in 2011 and haircuts were imposed on senior creditors. Denmark was the first country to impose haircuts on senior creditors in the wake of the global financial crisis.

The fourth package entailed a new process to facilitate the consolidation of small and medium-sized banks into larger entities. The plan was for a distressed bank to be taken over by a healthy bank. The state's Financial Stability Company and the Guarantee Fund for Depositors and Investors—similar to the FDIC in the United States—would provide state guarantees and compensation to private institutions willing to take over a distressed bank or its risky assets. Haircuts could be imposed on those holding debt in the distressed bank. The Financial Stability Company took over or wound down twelve banks by the summer of 2012.

The final bank package afforded banks the possibility of transferring commercial real estate to the Financial Stability Company. Overall, then, the costs of handling the Danish crisis would be borne largely by the banks and investors and not by the state.

2.2 Ireland's Guarantee and Bailout

Things were less complicated in Ireland. When the global financial crisis hit, Anglo-Irish Bank revealed in private that it would default without government support. Both the Bank of Ireland and Allied Irish Bank (AIB) admitted that without help they would be in trouble too. The Cabinet met on 29 September 2008, and a decision was taken that night to issue a complete state guarantee to Irish banks, potentially involving a commitment of over €400 billion. No plans for haircuts were made.

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[3] Peter Straarup.

The National Asset Management Agency (NAMA) was set up in 2009 to repair the balance sheets of key financial institutions that had made significant loans in the housing and property development markets. Five banks joined: Anglo-Irish Bank, AIB, Bank of Ireland, Irish Nationwide Building Society, and EBS Building Society. The banks began turning over loans to NAMA in 2010 in exchange for government-guaranteed securities. The first phase of transfer involved €71 billion in outstanding loans.

As the state gave more and more money to the banks a solvency crisis was transformed into a state fiscal catastrophe. In 2010 Ireland was forced to apply to the European Union for bailout funds. With mounting concern that Ireland would go bankrupt it is believed that there were direct calls from European Central Bank (ECB) President, Jean-Claude Trichet insisting that a full bailout was necessary to ensure the stability of the Irish financial system. At this point, Ireland might have had a chance again to impose haircuts on bondholders—many of whom were German and French.[4] This chance was lost; a €67 billion bailout from the ECB was taken instead. In the end the taxpayers suffered whilst bondholders lost nothing.

3. Institutional surroundings

So the corporatist state in Denmark made the banks pay, the liberal one in Ireland guaranteed them! In order to explain the paradox we need to review the processes by which decisions were made.

3.1 Denmark: Nationalist Unity and Thick Institutions

Denmark has been a sovereign state for centuries and used to be a medium sized empire. However, the realm suffered a series of humiliating defeats culminating in the loss of Schleswig and Holstein in 1864 to the Germans, leaving behind a rump state populated wholly by Danish ethnics. The country's history of absolutism and empire building left behind a well-developed state apparatus. Further, Denmark has a long history of constitutional democracy. In 1849 a liberal democratic constitution was introduced finalizing the shift away from absolutism. Henceforth Denmark would be governed by the people rather than by the crown. Since then

[4] Philip Lane, Trinity College Dublin.

politics has been marked by truly competitive political parties across a wide ideological spectrum vying for power.

Following the 1864 debacle there was general realization that another military defeat could eliminate the Danish state from the map (Kaspersen 2013, chap. 2). In consequence, measures were taken—from below as much as from above, from folk high schools to advanced welfare provisions—designed to unify and homogenize Danes as a people. National identity is now secure and unquestioned, and the fabric of institutional life is thick. Today Denmark is often described as a coordinated market economy in which all participants embrace the notion that they are part of a "community of fate" that must act in concert for the good of the nation (Pedersen 2006).

The propensity for negotiation and consensus is very strong and is reinforced by political institutions. Since 1925 only rarely has a party formed a government without at least one coalition partner. Further, the rules of parliamentary procedure positively encourage consulting opposition parties as a matter of course. Moreover, legislative rules are such that the executive branch is not overwhelmingly dominant over the legislative branch; the two must work together to get things done. The importance of seeking consensus is still reinforced by the taken-for-granted belief that people need to pull together in a small country like Denmark in order to cope with big international pressures.[5]

Finally, Denmark has impressive institutional capacities for expert economic analysis. The use of independent expert advisory commissions is common and their recommendations often constitute the basis of legislative proposals in parliament (Campbell and Pedersen 2014, chap. 5). There are several reasons for the centrality of such expertise to policymaking. The economics departments at the University of Copenhagen and Arhus University have well-established graduate programs in quantitative economics. State bureaucrats working on economic policy characteristically graduate from these departments.[6] More important, in the wake of stagflation and fiscal crises in the 1970s the political parties began to set aside

[5] Mogens Lykketoft, Danish Parliament.
[6] Henrik Bach Mortensen, Danish Employers Association; senior official, Danish National Bank; senior official, Danish Bankers Association.

ideological arguments in favor of those based more on sound economic analysis. They realized that this was necessary not only to resolve these crises but also to bolster Danish competitiveness in increasingly global markets. This de-politicization of economic policymaking was reinforced by instituting a system of automatic stabilizers, such as unemployment insurance and active labor market policies—a further extension of the nineteenth century legacy of bolstering the Danish nation in the face of small-state vulnerability.[7]

Overall, then, Denmark in the early 2000s was characterized by a number of long-standing, well-developed and taken-for-granted institutions that facilitated negotiation, consensus making, and social partnership. There were extensive institutional capacities for expert analysis in economic matters. The institutional capacities for cooperation, consensus making, and expert analysis are rooted deeply in a common national identity insofar as Danes have learned that they live in a small vulnerable nation-state and therefore must pull together.[8] A symbol of shared consensus is worth noting. All parties to the political economy, capital and labor, left and right, make arguments based on the use of the same set of quantitative economic models, shared by all!

3.2 Ireland: Nationalist Division and Thin Institutions

Whereas Demark was once a medium sized empire with a developed state apparatus, Ireland suffered from a long history of colonial repression. Denmark was more exposed and vulnerable to international forces; under British rule nationalist conflict surged and institutional development was stunted.[9] The situation as a whole is straightforward: "We're still a very young state, still learning how to manage the shop while the parents are away."[10]

The national question remained unresolved far longer in Ireland than in Denmark. Even after Irish independence, partition meant that there would be an open wound within the new state. Some wanted to unify the nation but others accepted the division. In 1922 this dispute led to a short but brutal civil war. The Republic slowly lost its Protestant population, through

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[7] Senior official, Danish National Bank; Henrik Bach Mortensen.
[8] Senior economist, Danish Bankers Association.
[9] A contrast can be drawn with Scotland. Incorporation into the Great Britain a century earlier, in 1707, did not lead to the destruction of many native institutions, making the move to increased powers at the end of the twentieth century smooth and easy.
[10] Ruairi Quinn, Minister for Education and Skills.

accommodation and exit, thereby becoming homogeneous in ethnic and religious terms. But the country remained deeply fractured with the identities of the two main political parties—Fianna Fáil and Fine Gael—thereafter based on the civil war divisions. The former was far more anti-British than the latter, but in policy terms both belonged to the center-right of the political spectrum. In further contrast to the way in which small-state vulnerability had served to unite Danes as a nation, a measure of continued protection from England enabled nationalist divisions to fester in Ireland.[11]

A measure of accommodation was achieved in 1932 when Fianna Fáil formed a government, thereby allowing the whole population to participate in national developments. But even this did not end the fracture at the heart of the state. Fianna Fáil "defined itself very early on not as a party but as a national movement," which helped ensure its hegemonic position for decades to come.[12] The party had the character of a southern European populist affair: brokerage politics, backed by holding on to the national identity because of its claim that the North needed to be reclaimed. But there is another factor that helps explain its hegemony. The Irish proportional representation system is largely based on multi-member constituencies that encourage local engagement and patronage at the expense of forward thinking expertise.[13]

Several additional points must be made about this political economy. To begin with, it was light on regulation, especially on the multinational sector (Ó Riain 2014). State agencies are modeled on the British example: "the philosophy is British nineteenth century [liberalism]."[14] Very much related to this, the necessary economic expertise was for various reasons in short supply, particularly within the state (Donovan and Murphy 2013, p. 88). First, the Irish education system, also modeled on that of nineteenth century Britain, favored economic theory rather than quantitative economics. Making matters worse, the Catholic Church, which rode roughshod over education especially in the countryside, concentrated on teaching the humanities and religion at the expense of economics and science. Further Irish families pushed their

[11] It is hard to get over civil wars for the scars they leave can be deep and visceral. The Finns managed this because in a sense they had no choice. The nation was absolutely vulnerable, threatened as it was by both Nazi Germany and the Soviet Union. Differences had to be put aside if the nation was to survive. Such discipline was not called for in the Irish case.
[12] Rory O'Donnell, Director, National Economic and Social Council
[13] Dan O'Brien, The Irish Times.
[14] John Fitzgerald, Economic and Social Research Institute.

children to pursue careers in medicine or law rather than in economics or other fields if they scored highly on the national tests.[15] Second, key regulatory appointments had little to do with economic expertise. The Governor of the Central Bank traditionally came from within the civil service, as normal promotion for the Secretary General of the Department of Finance, with its Board of Governors lacking economists. Notably, the Governor in 2008 had a legal background and the Financial Regulator had served in the civil service since he was seventeen.[16] Third, the Irish state was much less reliant on expert advisory boards than Denmark (Hardiman 2012, pp. 217-20). Finally, the Official Secrets Act—another British legacy—restricted the degree to which people inside the state could discuss policy with experts outside the state.

Insofar as civil society was concerned, Ireland only flirted with corporatism. The National Economic and Social Council (NESC) founded in the late 1960s sought to convene negotiations between business and labor, and to provide advice to the Department of Finance. The idea was to try to reach consensus, especially in regard to wages. In the late 1980s this process was expanded but social partnership broke down in the 2000s for several reasons: union density was low to begin with compared to Demark; U.S. foreign investment did not want to deal with the unions; EU expansion brought an increase in foreign workers; and union concerns shifted from wages, which were rising during the Celtic Tiger boom, to workplace issues.[17] Moreover, the trade association for the construction industry, which counted for a large proportion of the Irish economy, did not belong to the Irish Business and Employers Confederation (IBEC), the peak association representing most other industries. Importantly, the multinational sector had greater access to the state than other sectors. We were told that "the premier institution in this state is the Industrial Development Agency (IDA)" representing the multinational sector. The Irish-American Chamber of Commerce and the financial services industry also enjoyed privileged access to the state. Certainly by the time the financial crisis hit the NESC and unions were much less influential than they had been, and certainly much less influential than IDA or the Irish-American Chamber of Commerce.[18] In sum, neither the business community nor labor was nearly as well organized as they were in Denmark.

[15] Cormac O'Grada, University College Dublin
[16] Philip Lane.
[17] Rory O'Donnell; Tony Donohoe, Irish Business and Employers Confederation.
[18] David Begg, Irish Congress of Trade Unions, and Central Bank board member.

The institutional character of the Irish electoral system also differs greatly from that of Denmark—again because of Ireland's historical relationship with Britain. The political system was based on that prevalent in Westminster. The ruling party—so often Fianna Fáil—had enormous power. The executive branch very much dominated the legislative branch (Hardiman 2012, pp. 217-220). This was not a world that was based on continual consultation with the other parties. Nor was there a committee structure in parliament that created consensus.

4. Resolving the paradox

Both Denmark and Ireland experienced significant housing bubbles that burst. They also had financial industries whose assets were much larger than GDP at the time of the crisis. In 2007 domestic credit provided by the banking sector as a percentage of GDP in each country was high among European countries—only Iceland and Cyprus were higher (Hardiman 2013). Denmark's financial industry's assets were twice as large as GDP while Ireland's were three times as large.[19] We begin each country case with a brief discussion of the origins of each crisis before explaining why they handled things so differently.

4.1 Danish Resilience

From the 1990s there was a booming housing market in Denmark thanks to reforms under both social democratic and liberal governments.[20] Mortgage and equity loans to homeowners became easier to obtain, mortgage interest tax deductions became more generous, rent controls on new private rental property were removed, mortgage repayment schedules were extended from twenty to thirty years, and adjustable rate and eventually interest-only loans became available. As a result, from 1995 through late 2006 prices tripled for houses and quadrupled for owner-occupied apartments. The boom was fueled as well by the availability of international capital from Europe and the United States.[21]

Things began to sour badly in late 2007 with a sudden drop in housing prices that was

[19] Woll 2014.
[20] Kent Petersen, Union of Financial Sector Employees; Henrik Bach Mortensen.
[21] Senior official, Danish National Bank.

among the sharpest in the industrialized countries and even worse than in Ireland (OECD 2009, p. 18). As prices fell some small and medium-size banks began having trouble raising capital due to their aggressive lending policies and heavy exposure in the building sector.[22] Bank Trelleborg became insolvent. Roskilde Bank, Denmark's eighth largest, went bankrupt, and in 2008 the National Bank put it up for sale. Moreover, Danske Bank, Denmark's largest, was so deeply invested in the Irish and Baltic banking sector that investors were unsure how sound was its balance sheet.[23] With the onset of the international financial crisis in 2008 the international capital markets froze, liquidity disappeared, and Danish banks suffered severe liquidity problems for the next few years (Carstensen 2011). "They had huge problems of refinancing their needs."[24]

This was not Denmark's first financial crisis. Between 1987 and 1995, 102 Danish financial firms disappeared often through merger with more robust ones. Importantly, in 1994 the public Guarantee Fund was established to help distressed financial institutions cover their liabilities and if necessary the costs of winding them down. But when this was deemed contrary to EU rules the industry set up in 2007 a private alternative, the PCA for distressed banks. This eventually became the backbone of the Danish bailout program (Woll 2014). Virtually all banks are members of the PCA (Kluth and Lynggaard 2012). Moreover, legislation was passed that removed the right of shareholders to veto the transfer of distressed bank assets to another firm rather than go into bankruptcy. Under the law, the bank's board had strong powers to transfer troubled assets to another bank if it was facing solvency problems. Why? "The interest of financial stability requires that shareholders…will just have to be wiped out if that's necessary."[25] Put differently, the national interest trumped the interests of individual investors.

[22] In 2004, residential mortgages were valued at 88.4% of GDP as compared to 52.7% in Ireland (Schwartz and Seabrooke 2009, p. 16).
[23] Danske Bank invested in retail banks in Sweden, Finland, Norway, the Baltic Republics, Ireland and the United Kingdom (Woll 2014). Of particular concern at the time was its Irish branch. Danish decision makers worried in the wake of the Irish banking crisis and the Irish government's subsequent guarantees to its banking sector that there might be a run on Danske Bank's Irish branch. Nevertheless, Danske Bank's exposure to truly bad loans was only a small percentage of its balance sheet—much less than some of the troubled Irish banks. "Compared to the size of the bank it was not extraordinary" (Peter Straarup).
[24] Senior official, Danish National Bank.
[25] Henrik Bjerre-Nielsen, Financial Stability Company.

When the crisis hit in 2008 Denmark's thick institutions were well poised to handle it. The Guarantee Fund and the PCA that were in place enabled the bank packages. Further, in 2007 the Financial Supervisory Authority (FSA) joined forces with the Danish National Bank and the Ministry of Economic and Business Affairs to consider ways to bail out banks in the event of a crisis. This involved a Financial Stability Committee with representatives from each organization to discuss the issue and run a number of simulations to see how to handle a bank failure. Based on their analyses they fashioned a rudimentary set of crisis guidelines just in case they would ever be needed for bank bailouts.[26] All this reflected the institutionalization of experts and professional economists in helping to manage Danish economic policy.

Another institutional support put into place in the 1990s influenced the way that Denmark managed the banking crisis. This had to do with norms. The decision to impose haircuts on bank creditors and avoid the state shouldering the financial responsibility for rescuing the troubled banks was rooted in the legacy of the banking crisis of the 1990s where, "everybody just said this is how it should be: If you supply risk capital to private firms, you should be losing money if the bank goes into trouble…this was not a sort of point of debate…This was the accepted norm that this is how it should be."[27] In particular, the Financial Stability Company believed that "the consistent principle is that shareholders or the investors should pay in line with the principles of bankruptcy." By 2008 these expert-supported views were taken for granted by almost everyone and, as a result, helped set the stage for the haircuts and privately funded bailouts imposed by the bank packages. [28]

The National Bank and FSA had plenty of information about the condition of the banks to help guide crisis management. In fact, they were the only ones with access to all the banks' balance sheets.[29] The state's capacity in this regard was clear during negotiations about the bank packages. People tended to defer to the National Bank by virtue of the fact that its information was the best available.[30]

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[26] Henrik Bjerre-Nielsen; Senior official, Financial Supervisory Authority; senior official, Danish National Bank. This exercise was not designed to look at systemic bank failures, only individual ones.
[27] Senior official, Financial Supervisory Authority.
[28] Henrik Bjerre-Nielsen.
[29] Peter Schütze, former CEO, Nordea Bank.
[30] Senior official, Danish Bankers Association.

Negotiation, consensus and experts played a big role in managing the crisis. Echoing long-standing corporatist traditions, the Danish National Bank, the Danish Bankers Association, and the Ministry of Economic and Business Affairs took the lead in negotiating the first bank package, including forcing the banks to pay for it by contributing to the PCA. Throughout the negotiations over the bank packages the Bankers Association was in close touch with its members, easily able to garner their support for its ideas.[31] The FSA and Financial Stability Company were also involved. Labor, as represented by the Union of Financial Sector Employees, was not represented but agreed with much of what was decided.[32] So did all the political parties, except the Socialist People' Party on the far left.

There were two reasons for such agreement. First, here was general realization that huge danger loomed for this small and vulnerable nation-state. On the one hand, according to a senior official with the National Bank, there was deep concern for the currency so the government needed to prevent a run on the krone by shoring up the banking sector. On the other hand, the Danish banking sector—above all, Danske Bank—faced a major liquidity problem following the failure of Lehman Brothers. Something needed to be done very quickly or the banking sector would collapse. This is why in the first bank package it was agreed that the government would simply issue a blanket guarantee to depositors of all banks—albeit a guarantee backed by private funds.[33]

Second, there was equally general recognition that the very technical issues involved required experts and professionals who knew what they were doing. Politicians lacked such expertise and did not want to get too involved for fear of messing it up. So the National Bank, the Ministry, and the Bankers Association with the assistance of the FSA and Financial Stability Company put it all together (Finansforbundet 2009, p. 8). Once they were done, they presented the package to the political parties and banks; their plan was accepted without fuss. In fact, all the bank packages were formulated without much formal input from anyone else, including the labor unions or business peak associations, except the Bankers Association.[34] But there was informal backchannel communication with them. The political parties were formally involved

[31] Senior official, Danish Bankers Association; Peter Schütze.
[32] Kent Petersen. See also Finansforbundet (2009, p. 8).
[33] Senior official, Financial Supervisory Authority.
[34] We did hear in one interview that Danish Industry (DI), the peak association representing Danish industries, was "very involved" informally (Henrik Bach Mortensen).

only late in the process when they had to approve the packages in parliament.[35] This was in keeping with Denmark's sense of small nation-state vulnerability and the institutional trend since the 1970s toward less ideological and more expert oriented negotiation and decision making in economic matters.

The fact that economic experts were central to crafting the bank packages facilitated consensus. The Bankers Association had a team of five economists modeling the likely impact of the bank package scenarios. They were in close touch with their representatives at the negotiating table. The National Bank and the Ministry of Economic and Business Affairs did too. There was considerable agreement among the expert analysts that was conveyed to people doing the negotiating. This is not surprising. After all, the analysts were using data from Statistics Danmark in their models and received similar training at Copenhagen or Arhus University. And there was plenty of informal communication among experts across these organizations.[36]

The principals involved in the negotiations produced papers describing various rescue models. Discussions occurred, politicians and banks were consulted, and plans were revised accordingly. When we asked whether this sort of cooperation was typical we were told often that was totally normal. As a result, the bank packages were assembled and passed within a very consensus-oriented process.[37]

This is not to say that everyone agreed automatically on everything. For one thing, the Social Democratic Party wanted the government to take shares in the failing banks, that is, to push though partial nationalization. The National Bank was also in favor of this. But all they gained was agreement that investors in banks would receive haircuts. There were several reasons for this. First, there was the desire to minimize the risks of moral hazard that might crop up if the government provided too much relief to the banks. Second, people wanted to ensure

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[35] Senior officials, Financial Supervisory Authority and Danish National Bank; Peter Straarup; and Peter Schütze.
[36] Senior economist, Danish Bankers Association. The Union of Financial Sector Employees as well as other unions and labor peak associations may not have been involved in the negotiations due partly to their lack of economic expertise in such matters. In this regard, the president of the union told us that since the crisis began his organization has tried to hire more economic advisors, "to try to get more influence on…the situation about the crisis."
[37] Peter Schütze.

that tax payers did not foot the bill for bailouts. [38] Third, those negotiating the bank packages knew as well that Nordea, a large Swedish-based bank with extensive Danish operations, would not accept any form of nationalization.[39] So neither the government nor the Bankers Association was willing to accept nationalization. For another thing, some of the healthy banks were unhappy that they were being punished in the first two bank packages for the sins of others as funds were taken from the bailout fund. They agreed anyway. Equally, the Bankers Association was unhappy with the idea raised in the third bank package that banks and investors would have to take haircuts. But in the end they acquiesced.[40]

Compromise and consensus was necessary because the banks had not violated any regulations.[41] The banks went along with it all because they recognized the severity of the situation, accepting that steps were necessary for the financial services community and for the country.[42] According to Peter Schütze, who was CEO of Nordea as well as head of the Danish Banking Association at the time, ever since the 1864 defeat by Prussia the financial, business and political elites have been aware of Denmark's position as a small, vulnerable country—something he and others understood fully when they negotiated the bank packages. The commitment to national unity continued to reverberate over a century later!

We heard frequently that throughout this process things were made easier because the ministers, representatives from FSA and the Financial Stability Company, and the politicians knew each other—thanks to Denmark being such a small country.[43] But unlike the cronyism that such small state intimacy engendered in Ireland, the Danish state enjoyed a certain amount of autonomy from the banking industry. Indeed, the Banker's Association was not in the driver's seat at the negotiations, as noted, and so had to accept policies that they did not like. The former CEO of Danske Bank, explained: "You know you lose authority when you have issues, and I

[38] Senior officials, Financial Supervisory Authority and Danish National Bank; Peter Straarup.
[39] Senior official, Danish National Bank. Nordea was a Swedish bank created through the merger of various Swedish, Danish, Norwegian and Finnish banks. According to Peter Schütze, had Nordea pulled out of the early agreements over the issue of the government owning shares in the banks, this would also have meant that Nordea would not contribute to the private fund underwriting the government's guarantees—a rather large contribution to that paid by the other banks. So Nordea's position was taken seriously. Put differently, the Bankers Association, the National Bank, and the Ministry deliberating over the early bank packages knew that they could not impose such extreme measures as to alienate the banks to the point of refusing to sign on to the agreements.
[40] Senior official, Financial Supervisory Authority.
[41] Peter Straarup.
[42] Peter Schütze.
[43] Senior official, Financial Supervisory Authority.

suppose in hindsight the banks have to accept the fact that this has been a situation where they gradually have lost authority in the legislative process, because losses have been material."[44] Moreover, there was an explicit institutional division of labor. The FSA determined which banks were in trouble. The Financial Stability Company then figured out how to wind down the troubled bank once it had been identified by FSA. Finally, the Ministry and the National Bank decided which banks would receive capital injections. On balance, this institutional arrangement was well suited to guarding against the sweetheart deals and cronyism we found in Ireland.

4.2 Irish Misery

The financial crisis in Ireland, like that of Denmark, was rooted in a housing bubble. But there were differences. To begin with, nationalism was important. Irish history has been marked in the years following the potato famine of the 1840s by dispossession and eviction.[45] Having lived in fear of being displaced at the whims of British landlords, home ownership became an important part of national identity. The Irish dream was to marry and quickly buy a house, have some kids, and then buy another bigger one. The dream became eminently affordable as the rules governing mortgages were relaxed, especially as easy money became available.[46] The latter was especially facilitated by Ireland's entry into the euro zone in 1999: Ireland could borrow very large amounts of money at low rates. This resulted in borrowing of 40% of GDP, an enormous amount when considering that the Swedish banking crisis of the 1990s followed from borrowing 5% of GDP.[47]

Further elements that contributed to this classic housing bubble need to be noted. First, it became easier to get loans as the result of mistaken economic policy. A particular policy that proved disastrous was the Special Saving Incentives Account Scheme introduced in 2001 by Charlie McCreevy, the Finance Minister in Bertie Ahern's government. Having been told by the European Union to cool the economy he introduced a tax-free savings scheme in which the state contributed funds directly to individual accounts provided that they were not spent within five years. Large amounts of money accordingly became available in 2006, at the moment when

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[44] Peter Straarup.
[45] George Lee, RTÉ television, and former Fine Gael parliamentarian.
[46] Alan Dukes, former chair, Anglo-Irish Bank, and former Fine Gael leader.
[47] Philip Lane

cooling of the property market was needed.[48] Second, there were of course strong links between Fianna Fáil and property developers. But the manifesto of Fine Gael for the 2007 election did not suggest any real alternative. In fact both parties sought to outdo each other in favors offered to the public, often at the local level, including all manner of incentives (e.g., tax breaks, zoning variances, etc.) to property developers.

When house prices began to come down in 2007 the great hope was that there would be a soft landing for the economy. We know now that this was wildly optimistic. A disastrous situation resulted. The supply of housing had increased enormously in the 2000s. Furthermore, the political economy became wildly unbalanced. Job growth after 2001 depended massively on construction, to the tune of 14%, and so too did the finances of the state as the Stamp Duty brought in ever larger sums as property prices boomed.[49] The monies gained were not saved, but rather used to increase spending in the public sector—without much thought that the former can collapse quickly while the latter, once expanded, is hard to cut.[50] That this was so meant that a fall in housing prices would not just hurt the banks, either in the form of a liquidity or solvency crisis, but the state too—hollowing out its revenues and sparking a fiscal crisis. Warning signs were available, not least in the Bacon Report on Housing, in the collapse of Paribas in 2006 and Bear Stearns in 2007, and in critical comments coming from the NESC and from Morgan Kelly, an economist at University College Dublin.[51] All these warnings were ignored, with the Taoiseach (Prime Minister) Bertie Ahern famously recommending doomsayers to consider suicide. This was an instance of hubris and groupthink. Perhaps the most stunning example of such groupthink was that no one even thought to consult Patrick Honohan, an economist at Trinity College, Dublin possessed of a world class reputation on financial crises.[52] Even the most intelligent and careful analysts never thought of looking at the banks' asset books.[53]

The fateful decision of September 2008 for the state to guarantee the banks was taken behind closed doors with little economic expertise on hand. Consider expertise first. The Finance Minister, Brian Lenihan, had little economic expertise and was closeted for most of the

[48] George Lee.
[49] Pat Rabbitte, Minister of Communications, Energy and Natural Resources, member of parliament, and former leader of Labour Party.
[50] Alan Dukes.
[51] George Lee.
[52] Philip Lane.
[53] John Fitzgerald.

time with members of the threatened banks and with politicians from the government rather than with economic experts. In fact, there was only one economist in the room—an environmental economist not versed in banking and finance, present only because the Green Party was part of the government. So this was a decision taken by a very small group of politicians and bankers, not experts. A particular conjectural reason for this is simple. The Financial Regulator and Central Bank had been thoroughly discredited because they had not seen the crisis coming, perhaps not surprisingly as they lacked the necessary expert economists on staff. This is why many of the top employees in the Central Bank were soon replaced with people having such expertise. Patrick Honohan became the new Governor. Many of the replacements were foreigners because few in Ireland were qualified. Similarly, the Department of Finance lacked the necessary technical skills and was out of touch with the broader economic community (Donovan and Murphy 2013, chaps. 5 and 6).

The lack of expertise is so important that it requires some elaboration. First, the argument is not that there were no economists in these organizations but that they were not the right sort of economists—that is, economists who specialized in "macro-prudential" issues, notably the implications of lending and funding by banks and other financial institutions for the stability of the financial system and the economy in general. Second, the Financial Regulator, Department of Finance, and the Central Bank's boards lacked economic expertise. They were filled instead with prominent people from all strands of Irish society, such as unions, business and academia. At the Central Bank whatever expertise there was resided at much lower levels in the organization—and even there the expertise was more in accounting than economics and finance. In fact, many appointments to both the Central Bank and Department of Finance were based on patronage rather than qualifications—a long-standing practice in Irish politics. Third, the banks themselves often lacked the appropriate expertise in risk management and auditing to be able to understand their own situations. Fourth, prior to the crisis the lack of expertise was of no particular concern because all of these agencies subscribed to neoliberalism and the so-called Efficient Market Hypothesis, pervasive in academic economics, which argued that competition and the discipline of the market could be relied on to avoid reckless financial behavior. Hence, only a very light regulatory touch was required—a view that facilitated groupthink and shut out any naysayers that might raise concerns (Donovan and Murphy 2013, chaps. 4, 5 and 8). Finally, the Secrecy Act, as noted, ensured that civil servants and politicians were not allowed to consult freely with independent economists outside the state. So there was an institutional barrier that prevented economic advice from getting to policymakers when they needed it most.[54] In sharp contrast to Denmark, then, Ireland's political-economic institutions were particularly thin.

The closed nature of the crisis deliberations between politicians and bankers was another manifestation of the cronyism and inside deal making that characterized Irish politics. Although independent boards controlled the Financial Regulator and Central Bank, a majority of the Regulator's board, including its Chairman and Chief Executive, also sat on the Central Bank's board. Nowhere was there the sort of extensive formal and informal consultation with people and organizations we saw in the Danish case (Donovan and Murphy 2013, p. 83). There were many complaints, not least in our interviews, about such highly insulated, closed-door political arrangements. The thin nature of Irish institutions led to a lack of legitimacy.

When the crisis hit in Denmark there was much open debate about how to handle it; in contrast, there was little room for dissent in Ireland. One source stressed "an absence of an infrastructure of dissent" by which he meant that unions, academics, experts, business associations, and other stakeholders were never consulted either formally or informally. This was due partly to the fact that corporatist institutions were poorly developed in Ireland.[55] As one minister told us, corporatism "was on the back burner" by the time the crisis hit.[56] Of course, this also contributed to the crisis in the first place insofar as decision-making was so insulated that a kind of hubris set in during the boom days whereby people were afraid to raise concerns for fear of rocking the boat even if they suspected trouble ahead. Groupthink was pervasive.[57] This mentality even extended to the media, which according to one journalist we interviewed, was not nearly critical enough of policies leading up to the crisis.[58]

Many have noted that Ireland was a victim of crony capitalism. There is certainly some truth to this. But two further points are necessary. First, the central institutions of the state were not so much corrupt as they "were not up to it."[59] Institutions relying on expertise and facilitating open debate and consensus making were clearly lacking. Second, there was certainly

[54] Philip Lane.
[55] Tony Donohoe.
[56] Ruariri Quinn.
[57] Dan O'Brien.
[58] Jamie Smyth, The Financial Times.
[59] John Fitzgerald.

concern for the national interest. In part, the guarantees were designed to calm markets down, especially given the importance that the state attached to its international reputation. After all, the Celtic Tiger's economic success since the early 1990s was based on attracting foreign direct investment. The guarantee of bank deposits and creditors was driven in large measure by the fear that a run on the banks could trigger a massive exodus of foreign capital. Perceptions of small state vulnerability loomed large. But cronyism was involved as banks tried to save their own skins. We know now that at least one bank—Anglo-Irish—deliberately hid its liabilities from the regulatory authorities thereby putting its own interests ahead of those of the nation. We heard nothing like this in Denmark where the regulatory authorities had access to bank balance sheets; where bankers and others acknowledged their commitment to the community of fate; and where in important instances they made sacrifices in the national interest—including accepting haircuts. In Ireland institutional thinness and individual deceit explains why decision makers mistook a solvency crisis for a liquidity crisis as they presumed that the troubled banks possessed real assets, an illusion which made it possible to imagine an orderly winding down of troubled assets during the two years of the guarantee.[60]

All of this was compounded by the absence of adequate checks and balances in the political system. There is considerable difference in parliamentary matters, that is, between Ireland's Dail and Denmark's Folketing. The former differs from the latter in being weak vis-à-vis the executive branch and the Prime Minister, and its committee system is rudimentary. The party whipping system in the Dail is extraordinarily harsh: failure to toe the party line can lead not just to forfeiting your committee seat but even expulsion from the party.[61] Within the executive branch the cabinet is weak; the real power is held by a very small, tight group of people including the Taoiseach, the Minister of Finance, and very few others. Again the thinness of Irish institutions is clear. For these and other reasons one person in Ireland told us that Denmark was the "mirror image" of Ireland.[62]

Several of our interviewees stressed the role played by nationalism. On the one hand, Ireland recognized since the 1950s that it needed to catch up with the rest of Europe in terms of

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[60] George Lee.
[61] While we were in Dublin members of parliament were being threatened with expulsion if they failed to vote for an abortion bill currently under consideration.
[62] David Begg.

economic development. The developmental push since then was bound up with the urge to become an independent nation. Once the Celtic Tiger was unleashed people believed that it was due to Irish policy—that is, it was of their own doing—rather than the influx of foreign direct investment from abroad and structural funds from the EU. This contributed further to hubris, groupthink, and fears of not rocking the boat by speaking out against current development practices, particularly as it concerned real estate and housing. In other words, national pride, which was swelling after decades of underdevelopment thanks to British rule, blinded most people to the reality of the situation. On the other hand, because everyone had bought into this mindset, nobody knew what to do when the crisis hit. This is another reason why they mistook a solvency crisis for a liquidity crisis—people could not believe that the banks, which had fostered such growth, were in such terrible shape. In the end, the inability to grasp the severity of the situation drove Ireland into the hands of the EU.[63]

5. Conclusion

The contrast we have drawn is clear. Denmark's response to the crisis was based on thick institutions derived from a secure sense of national identity expressed in corporatist traditions that utilized professional expertise. Ireland's response was based on much thinner institutions: closed, clientelistic, back-room deal making with a very small number of participants and a remarkable dearth of appropriate expertise—all derived from a very different nationalist experience. In the end, Ireland fared much worse than Denmark. Ireland's level of debt skyrocketed nearly tenfold from 11% to 102% of GDP between 2007 and 2012 but Denmark's only doubled from 27% to 50%. And by 2012 Ireland's government fiscal deficit and unemployment rate were twice as large as Denmark's. Income inequality also worsened in Ireland but not in Denmark.

We began this paper with a paradox for the "Varieties of Capitalism" school of comparative political economy. In Denmark, a coordinated market economy, policymakers pushed the costs of its banking crisis on to private actors whereas in Ireland, a liberal market economy, the state shouldered them. This paradox is resolved by introducing two variables missing from the school's intellectual approach in its accounts of national economic

[63] George Lee; Rory O'Donnell.

performance—small state vulnerability and nationalism. Both were important in the Danish and Irish cases.

Without understanding Denmark's long history of vulnerability, for instance, one cannot fully understand why corporatism and state institutions have such depth and power. Ireland, long under the protective umbrella of Britain, had no such impetus for institution building. Something similar holds for nationalism. Denmark rallied in unity around the flag and built institutions to solidify that unity after 1864 and again after the 1970s when ideology was largely set aside in favor of expert-oriented policymaking. When the banking crisis hit in 2008 stabilizing the national currency and financial system was the top priority. In Ireland, however, there had not been nearly as much time to develop national unity because of partition, civil war and continuing disagreements about the country's relationship with Britain. When the banking crisis hit, whatever concerns there may have been for Irish national interests were tempered by cronyism and special deals to save the banks—deals in which at least one of the banks, Anglo-Irish, and perhaps others, were not forthcoming with full disclosure about the status of their liabilities. The banks put their own interests ahead of those of the nation.

There is another lesson here for the "Varieties of Capitalism" school. Neither Denmark nor Ireland is as clear-cut an example of coordinated and liberal market economies, respectively, as is assumed. Although Denmark has strong corporatist institutions it also has a strong liberal streak, the presence of which explains the insistence that bondholders be subjected to haircuts and insolvent banks should either go bankrupt or be wound down when faced with insolvency. Moreover, although Ireland's regulatory touch was comparatively light (embracing neoliberalism and the Efficient Market Hypothesis and providing all sorts of incentives to attract foreign direct investment, notably extremely low tax rates) it did embark on some modest corporatist experiments in the 1960s. These were beefed up somewhat in the late 1980s and 1990s to facilitate economic development before falling apart in the early 2000s.

There is also a lesson here for the small state literature arguing that vulnerable states benefit from institutionalized capacities for flexibility, self-sacrifice, and policy learning.

Denmark is a prime example. For instance, Danes took lessons from the earlier banking crisis.[64] They created the Guarantee Fund as well as the PCA, which were central tools used to manage the 2008 crisis. Further, they tried to anticipate how to handle bank failures by running simulations in 2007. The second bank package, which involved capital injections, was fashioned after people learned that this was not just a liquidity crisis.[65] And whereas the first two bank packages were designed partly to solve the current crisis, the third one imposed haircuts once they recognized the need to correct moral hazard incentives that might trigger another crisis.

But not all small states are so flexible, self-sacrificing, or capable of policy learning. Ireland proved to be a slower learner. This was in part because it lacked sufficient professional expertise and otherwise thick state institutions thanks to its long-standing relationship to Britain, which buffered Ireland from the same sort of vulnerabilities to which Denmark had long been exposed. Put differently, there is more variation in this regard among small states than the small-state literature sometimes acknowledges. Small states are not equally vulnerable, and that matters.

Finally, while not all small states are equally vulnerable, nor are all culturally homogeneous ones equally equipped with a unifying nationalist sentiment. Both Denmark and Ireland are culturally homogenous. Each is predominantly of one religion, ethnicity, and language. Yet for reasons explained above Denmark enjoyed strong national sentiments that forged a common identity and willingness to work together for the common good during the crisis. Irish nationalism brought contention rather than unity. As a result, a single party gained sufficient hegemony to create a system of cronyism and particularism. Nationalism can have both positive and negative effects depending on how it plays out—that is, on whether it is secure or contested.

Whether Ireland learns from its experience in ways that allow for the beneficial side of nationalism to triumph—including the building of better institutions—remains an open question. There are grounds for optimism. The North is no longer a factor that helps assure Fianna Fáil's dominance in the future. The central focus of the cabinet is no longer on security but on the

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[64] Peter Schütze.
[65] Senior official, Danish National Bank.

economy, handled through the Economic Management Council.[66] Further, some steps have been taken to reduce, if not eliminate, cronyism and corruption. Ireland's score on Transparency International's corruption index has improved dramatically since 2007 from 7.5 to 9.6 in 2012, which even surpasses squeaky-clean Denmark's score. The alternative is that Ireland will remain beset by clientelism and brokerage politics with all the dangers they posed in the recent past. Denmark seems to have escaped this fate.

[66] Ruairi Quinn.

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