Ireland is small enough to hold us to ransom

Guaranteeing Dublin's bank losses is far cheaper for Europe than letting them bring the whole system down

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Three years ago when all the banks in Iceland collapsed, destroying most of that tiny country's businesses and household savings and trapping its Government in a condition of permanent debt servitude to the British and Dutch Treasuries, financial traders in the City of London quickly came up with a new line in gallows humour: what is the difference between Iceland and Ireland? One letter and six months.

As Ireland prepares for its general election on Friday, its voters would do well to glance again across the North Atlantic. Last Sunday, the President of Iceland, Olafur Grimsson, refused to sign into law an international agreement that would have obliged his country to pay the Dutch and British governments between 1.3 and 5 per cent of national income every year from 2016 until 2046 as compensation for the losses of their depositors in Icelandic banks. Instead, he insisted that the deal be put to a referendum.

Considering that the sums involved would be equivalent, in a British context, to annual payments of up to £2,000 per family per year and would be roughly similar in relation to national income to the reparations imposed on Germany after the First World War, Mr Grimsson's insistence on a popular vote seems reasonable. And it would also be reasonable for Icelandic citizens to reject this deal, just as they overwhelmingly rejected in a referendum last year the even more onerous reparations originally demanded by Britain.

Whatever the outcome of the Icelandic referendum, Irish voters and politicians can draw two lessons from their tiny neighbour's defiance. The first is never to accept the first offer in an international negotiation. Iceland's creditors responded to last year's "no" vote by reducing the interest demand from 5.5 per cent to 3.3 per cent and stretching out repayments from eight years to thirty.

The second lesson is more surprising: small debtor countries can drive a hard bargain against big creditors. In fact, the smaller a debtor country, the stronger its negotiating power. This paradoxical conclusion follows from what economists call "cost-benefit analysis" of debt defaults.

> Irish voters would do well to glance across the Atlantic to Iceland

This month, the European Central Bank produced such an analysis.. Its main conclusion, presented in a lecture at the London Business School by Lorenzo Bini Smaghi, an ECB executive director, was predictable enough. For every European country, the costs of defaulting — what Mr Bini Smaghi called "Plan B" — would far exceed the costs of imposing severe budgetary cutbacks and faithfully servicing all debts (Plan A).

This would be true in almost all circumstances for three main reasons: First, because European governments, in contrast to Mexico and Brazil, which defaulted in the 1980s, borrowed largely from their own citizens and banks. A government default would therefore inflict huge losses on domestic savers and banks.

Second, a default would invalidate government bank guarantees, triggering a run on domestic banking systems and a Lehman-style credit crisis. Third, default by any one country in the eurozone would cause contagion in other countries, causing enormous economic and political dislocations to the whole EU. And this euro-wide chaos would, in turn, rebound on domestic conditions in the defaulting country.

All these arguments make eminent sense, but raise a crucial question that the ECB, for obvious reasons, prefers not to answer. If debtor countries such as Ireland start to view the choice between default under plan B and belt-tightening under plan A as a strictly financial calculation, won't creditor countries such as Germany carry out a similar analysis? Indeed, won't the EU as whole work out the costs and benefits of allowing one member to default?

Applying cost-benefit logic at the pan-European level, it becomes clear that the cost for the EU as a whole of subsidising, or bribing, a small country such as Ireland to stick to Plan A, will always be much smaller than the cost of letting it default and disrupt the entire eurozone. The potential defaulter's calculation becomes even more favourable if, as in Ireland, most of the national debt takes the form of bank guarantees that benefit bondholders in Germany, Britain and France.

> The big countries will resist demands for a Europe-wide guarantee

As Irish banks operated across the whole of Europe, why shouldn't their debts be guaranteed by Europe as a whole, instead of being loaded entirely on to Irish taxpayers? At present the Irish Government protects German and British bondholders against any losses they might suffer when they lend to banks that happen to be based in Dublin. Imagine what would happen if the US, the only other comparable economy with a single currency, had attempted a similar response to the financial crisis. Would anyone suggest that Bank of America's liabilities be covered only by the citizens of North Carolina, where it is incorporated?

Germany, Britain and other big European countries would, of course, resist any demand for a pan-European bank guarantee but that is when the analysis comes into its own. Once a small country such as Ireland thoroughly understands this analysis, its bargaining power is transformed.

Ireland should realise that, when the chips are down, the EU as a whole and Germany in particular will agree to relieve its entire debt burden, which is small in relation to the EU and German economies, if the only alternative is a sovereign default that would trigger a pan-European crisis and a possible break-up of the euro. Ireland can therefore drive a hard bargain with Germany and Europe.

Paradoxically, larger debtor countries such as Italy or Spain are in a weaker bargaining position, as the cost to Europe and Germany of taking over their enormous liabilities would probably be bigger than the cost of suffering a financial crash.

Cost-benefit analysis therefore implies that Spain and Italy may need to impose harsher deflationary measures than Ireland or Greece, as they cannot expect EU help. The paradox that big debtor countries must fend for themselves, while small ones can expect bailout has broadly been confirmed by recent events. Spain and Italy have not faced anything like the market attacks against Greece and Ireland, but nonetheless they have slashed pay for public employees, reformed pension systems and aggressively raised taxes without much external pressure from the EU.

Ireland's new government should realise that it has a stronger hand than Spain or Italy — and should exploit its position to escape debt servitude.