Like Iceland, Ireland can refuse to pay up

It is in our long-term interest to get the best value from countries deep in debt. So let them go bankrupt

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Two months ago I started an article on this page with a joke about two bankrupt countries, a joke that has suddenly become even more relevant than I expected, after the people of Iceland voted by a 60-40 margin to repudiate the debt deal that their Government had painstakingly negotiated with Britain and the Netherlands.

What was the difference between Ireland and Iceland, I asked? One consonant and about six months.

The link between the economic fates of these two tiny North Atlantic countries should be no laughing matter either for financial markets or politicians in Europe — and perhaps across the world. The Icelandic voters' overwhelming rejection of a deal to settle the banking losses created in Britain and the Netherlands by the collapse of Icelandic banks during the 2008 financial crisis is likely to inspire demands for a similar referendum in Ireland, a country with a strong constitutional tradition of referendums on all sorts of issues, ranging from the revision of EU treaties to abortion, child protection and even competition policy.

The possibility of an Irish debt referendum is dismissed by European financial authorities as completely fantastic, in much the same way that the suggestion of government defaults in Greece and Portugal used to be ridiculed as "science fiction". One is told that Ireland, unlike Iceland, is a member of the European Union and the euro. It has already committed itself to a long-term bailout. The Irish people had a chance to pass judgment on this plan at their recent general election and chose politicians who were as committed to the European financial protectorate as those who were ignominiously voted out.

Most importantly, the Irish are told that There Is No Alternative (Tina). To follow Iceland would be an act of

Default by Portugal used to be ridiculed as 'science fiction'

economic suicide and national humiliation, other European countries would retaliate, the ECB would withdraw support for Irish banks — the country might even be expelled from the EU.

But will Tina intimidate Irish public opinion for ever? Tina was a favourite slogan of Margaret Thatcher, but it has been used by all governments on the brink of devaluations, defaults and U-turns. Events in Iceland should logically revive the democratic and nationalist forces demanding a referendum in Ireland.

The per capita debt burden of €20,000 imposed by the EU on Ireland is almost double the estimated debt of €12,000 rejected by Iceland. Indeed, Ireland's debt now appears to be bigger, in relation to its economy, than the reparations imposed on Germany after the First World War. When this comparison was recently suggested at a gathering of economists, a German banker indignantly riposted: "But let us not forget that the Irish debts were different from the Versailles reparations: they were the consequence of genuine financial sins." Everyone round the table drew breath as the banker suddenly realised what he had implied.

In short, the permanent debt burden imposed on the Irish State implies a constraint on political freedom and loss of national sovereignty more serious than those that Ireland initially rejected in the Lisbon treaty.

The people of Iceland had been similarly warned of the impact of rejecting the debt deal, but they nevertheless dared to do this. And within hours of Saturday's "no" vote it became obvious that the consequences would actually be rather mild.

The British and Dutch governments, instead of imposing new financial sanctions, simply announced that they would now transfer their dispute with Iceland to an obscure European court, the EFTA Tribunal, where a final judgment could not expected for several years. The European Commission, instead of declaring a trade war or threatening to expel Iceland from the European Free Trade Association, merely announced that Iceland's default would "complicate" negotiations on possible EU membership, a prospect which in any case Icelandic citizens now find less appealing.

Meanwhile, the Icelandic Government, after issuing dark prophecies that a "no" vote would cause Iceland's volcanoes to erupt in unison, suddenly made an astonishing

They said a 'no' vote would cause volcanoes to erupt in unison

discovery after the referendum was lost. Having predicted throughout the referendum campaign that the ultimate costs to the nation would be vastly increased if the dispute with Britain and the Netherlands went to court, the Finance Ministry announced on Monday that the country's obligations were actually much smaller than expected — and indeed that the Government might not end up paying anything, once all the assets and liabilities were added up and offset against one another by the courts.

In fact, Iceland's experience conforms to a long pattern of government debt restructurings through the ages, from the US states in the 19th century, and Latin America in the 1930s and again in the 1980s, to Poland in the 1980s, Russia in the 1990s, and Greece, Spain and Portugal throughout their histories. The costs of government default have usually turned out to be quite modest — and almost invariably much lower than predicted by creditor countries and banks on the eve of a default.

Financial markets, far from putting defaulters into some kind of economic quarantine or treating them permanently as pariahs, normally resume lending with gusto once an unsustainable burden of national debt has been removed, allowing a country to return to normal financial conditions and economic growth.

In this sense, government defaults through the ages have been similar to corporate bankruptcies in modern times. Since the abolition of debtors' prisons, the purpose of corporate bankruptcies has not been to punish the profligate or act as a warning to other debtors but rather to extract the greatest possible long-term value from a business that has gone wrong, apportioning the inevitable losses among all stakeholders in a fair and reasonable way. With Ireland, Greece and Portugal now effectively bankrupt — and their debts privately acknowledged by officials at the IMF to be far beyond any plausibly sustainable level — this is clearly the kind of procedure that Europe now requires.

In Iceland, this period of debt servitude now appears to be over and a robust economic recovery should soon begin. The same will happen in Ireland if its people have the courage to ignore their politicians and take the trouble to think for themselves.