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Why Iceland Voted 'No" to the Diktats of the Creditor Banks

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About 75% of Iceland's voters turned out on Saturday to reject the Social Democratic-Green government's proposal to pay $5.2 billion to the British and Dutch bank insurance agencies for the Landsbanki-Icesave collapse. Every one of Iceland's six electoral districts voted in the "No" column – by a national margin of 60% (down from 93% in January 2010).

The vote reflected widespread belief that government negotiators had not been vigorous in pleading Iceland's legal case. The situation is reminiscent of World War I's Inter-Ally war debt tangle. Lloyd George described the negotiations between U.S. Treasury Secretary Andrew Mellon and Stanley Baldwin regarding Britain's arms debt as "a negotiation between a weasel and its quarry. The result was a bargain which has brought international debt collection into disrepute … the Treasury officials were not exactly bluffing, but they put forward their full demand as a start in the conversations, and to their surprise Dr. Baldwin said he thought the terms were fair, and accepted them. … this crude job, jocularly called a 'settlement,' was to have a disastrous effect upon the whole further course of negotiations …"

And so it was with Iceland's negotiation with Britain. True, they got a longer payment period for the Icesave payout. But how is Iceland to obtain the pounds sterling and Euros in the face of its shrinking economy. This is the major payment risk that is still unaddressed. It threatens to plunge the krona's exchange rate.

The settlement proposal did lower the interest rates from 5.5% to 3.2%, but it included running interest charges on the bailout since 2008. It even included the extra-high interest charges that led depositors to put their funds in Icesave in the first place. Icelanders viewed these interest premiums as compensation for risks – that were taken and should be lost by the high-interest Internet depositors.

So the Icesave problem will now go to the courts. The relevant EU directive states that "that the cost of financing such schemes must be borne, in principle, by credit institutions themselves." As priority claimants Britain and the Netherlands will indeed get the lion's share of what is left from the Landsbanki corpse. That was not the issue before Iceland's voters. They simply aimed at saving Iceland from an open-ended obligation to take the bank's losses onto the public balance sheet without a clear plan of just how Iceland is to get the money to pay.

Prime Minister [Johanna Sigurdardottir]() warns that the vote may trigger "political and economic chaos." But trying to pay also threatens this. The past year has seen the disastrous experience of Greece, Ireland and now Portugal in taking reckless private sector bank debts onto the public balance sheet. It is hard to expect any sovereign nation to impose a decade or more of deep depression on its economy inasmuch as international law permits every nation to act in its own vital interests.

Attempts by creditors to persuade nations to bail out their banks at public expense thus is ultimately an exercise in public relations. Icelanders have seen how successful Argentina has been since it imposed a crew haircut on its creditors. They also have seen the economic and political disruption in Ireland and Greece resulting from trying to pay beyond their means.

Creditors did not give accurate advice when they told Ireland that it could pay for its bank failures without plunging the economy into depression. Ireland's experience stands as a warning to other countries about trusting overly optimistic forecasts by central bankers. In Iceland's case, in November 2008 the IMF staff projected yearend-2009 gross external public and private debt at 160% of GDP – but observed that an exchange rate depreciation of 30% would push the ratio to 240% of GDP, which would be "clearly unsustainable." But the most recent IMF staff report (January 14, 2011) shows end-2009 gross external debt at 308% of GDP, and estimates end-2010 gross external debt at 333% – even *before* taking the Icesave and other debts into account!

The main problem with Iceland's obligation to Britain and the Netherlands is that foreign debt is not paid out of GDP. Apart from what is recovered from Landsbanki (now with the help of Britain's Serious Fraud Office), the money must be paid in exports. But there has been no negotiation with Britain and Holland over just what Icelandic goods and services these countries would be willing to take in payment. Already in the 1920s, John Maynard Keynes pointed out that the Allied creditor nation had to take some responsibility just how Germany could pay its reparations, if not by exporting more to these countries. In practice, German cities borrowed in New York, turned the dollars over to the Reichsbank, which paid Britain and France, which paid the money back to the U.S. Government for their Inter-Ally Arms debts. In other words, Germany tried to "borrow its way out of debt." It never works over time.

The normal practice would be for Iceland to appoint a Group of Experts to lay out the strongest possible case. No sovereign nation can be expected to acquiesce in imposing a generation of financial austerity, economic shrinkage and forced emigration of labor to pay for the failed neoliberal experiment that has dragged down so many other European economies.

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