Iceland's debt repayment limits will spread

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Can Iceland and Latvia pay the foreign debts run up by a fairly narrow layer of their population? The European Union and International Monetary Fund have told them to replace private debts with public obligations, and to pay by raising taxes, slashing public spending and obliging citizens to deplete their savings.

Resentment is growing not only towards those who ran up the debts - Iceland's bankrupt Kaupthing and Landsbanki, with its Icesave accounts, and heavily geared property owners in the Baltics and central Europe - but also towards the foreign advisers and creditors who put pressure on these governments to sell off the banks and public companies to insiders. Support in Iceland for joining the EU has fallen to just over a third of the population, while Latvia's Harmony Centre party, the first since independence to include a large segment of the Russian-speaking population, has gained a majority in Riga and is becoming the most popular national party. Popular protests in both countries have triggered rising political pressure to limit the debt burden to a reasonable ability to pay.

This political pressure came to a head over the weekend in Reykjavik's parliament. The Althing agreed a deal, expected to be formalised on Monday, which would severely restrict payments to the UK and Netherlands in compensation for the cost of bailing out their Icesave depositors.

This agreement is, so far as I am aware, the first since the 1920s to subordinate foreign debt to the country's ability to pay. Iceland's payments will be limited to 6 per cent of growth above 2008's gross domestic product. If creditors thrust austerity on the Icelandic economy there will be no growth and they will not get paid.

A similar problem was debated 80 years ago over Germany's first world war reparations. But many policymakers remain confused over the distinction between squeezing out a domestic fiscal surplus and the ability to pay foreign debts. No matter how much a government may tax its economy, there is a problem turning the money into foreign currency. As John Maynard Keynes explained, unless debtor countries can export more, they must pay either by borrowing or by selling off domestic assets. Iceland today has rejected these self-destructive policies.

There is a limit to how much foreign payment an economy can make. Higher domestic taxes do not mean a government can translate this revenue into foreign exchange. This reality is reflected in Iceland's position on its Icesave debt - estimated to amount to half its entire GDP.

In taking this stand, Iceland promises to lead the pendulum swing away from the ideology that debt repayments are sacred.

In the post-Soviet economies the problem is that independence in 1991 did not bring the hoped-for western living standards. Like Iceland, they remain dependent on imports. Their trade deficits have been financed by the global property bubble - borrowing in foreign currency against property that was free of debt at independence. Now the bubble has burst and it is payback time. No more credit is flowing to the Baltics from Swedish banks, to Hungary from Austrian banks or to Iceland from Britain and the Netherlands. Unemployment is rising and governments are slashing healthcare and education budgets. The resulting economic shrinkage is leaving large swathes of property in negative equity.

Austerity programmes were common in developing countries from the 1970s to the 1990s, but European democracies have little tolerance for such an approach. As matters stand, families are losing their homes and emigration is accelerating. This is not what capitalism promised.

Populations are asking not only whether debts should be paid, but - as in Iceland - whether they can be paid. If they cannot be, then trying to pay will only shrink economies further, stopping them becoming viable.

Will Britain and the Netherlands accept Iceland's condition? Trying to squeeze out more debt service than a country could pay requires an oppressive and extractive fiscal and financial regime, Keynes warned, which in turn would inspire a nationalistic political reaction to break free of creditor-nation demands. This is what happened in the 1920s when Germany's economy was wrecked by the rigid ideology of the sanctity of debt.

A pragmatic economic principle is at work: a debt that cannot be paid, will not be. What remains an open question is just how these debts will not be paid. Will many be written off? Or will Iceland, Latvia and other debtors be plunged into austerity in an attempt to squeeze out an economic surplus to avoid default?

The latter option may drive debt-laden countries in a new direction. Eva Joly, the French prosecutor brought in to sort out Iceland's banking crisis, warned this month that Iceland would have little left but its natural resources and strategic position: "Russia, for example, might well find it attractive." The post-Soviet countries are already seeing voters shift away from Europe in reaction to the destructive policies the EU supported.

Something has to give. Will rigid ideology give way to economic reality, or the other way round?

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