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Why Don't States Default?

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Presented in partial fulfilment of the requirements for the degree of
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Abstract

This paper demonstrates how traditional rationalist theories failed to prevent a default-like event during the 2008-13 Icesave dispute. Evidence is presented to suggest that classic deterrents were not present or otherwise non-effective during the dispute and as such failed to prevent default. Furthermore, it will be posited that the repayment agreement referendum results were best explained by constructivist theories of international relations. Finally, it will be concluded that the result of the Icesave dispute occurred due to the unique circumstances that invalidated traditional deterrents and brought constructivist incitements to the fore.

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0.1 List of Figures

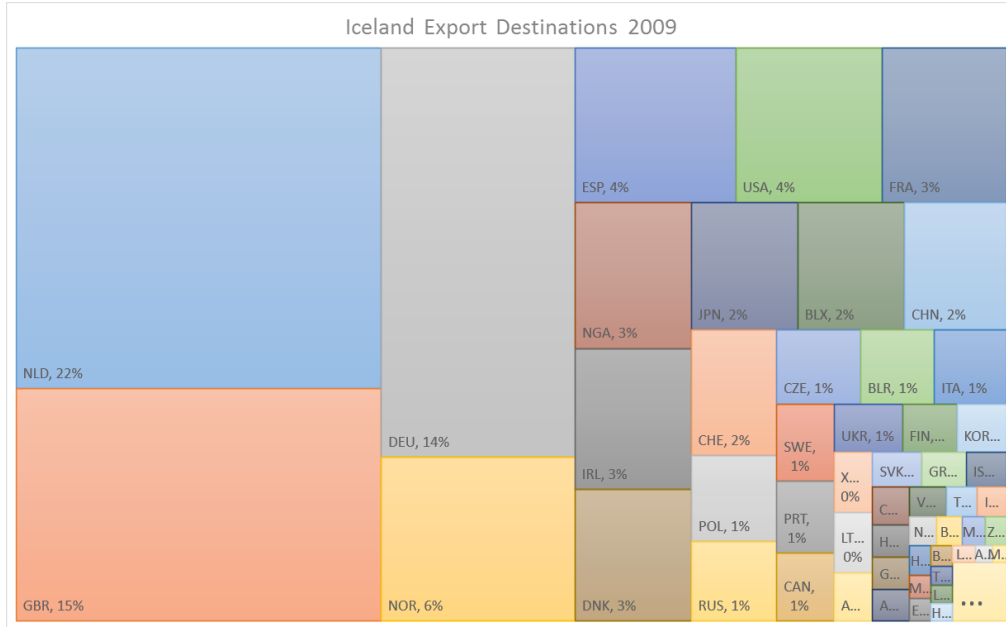


Figure 1: (OEC 2009)

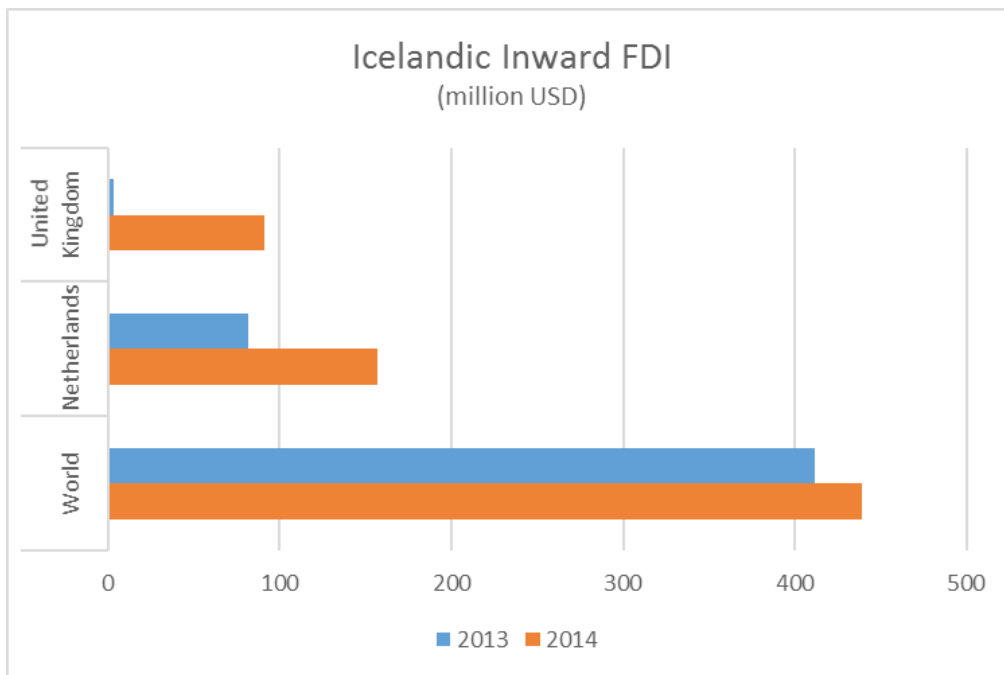


Figure 2: (OECD 2017)

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Agency	Rating	Outlook	Date
Moody's	A3	Stable	Sep 01 2016
Moody's	Baa2	Positive Watch	Jun 10 2016
S&P	BBB+	Stable	Jan 15 2016
Fitch	BBB+	Stable	Jul 24 2015
S&P	BBB	Stable	Jul 17 2015
Moody's	Baa2	Stable	Jun 29 2015
Fitch	BBB	Positive	Jan 30 2015
S&P	BBB-	Positive	Jul 18 2014
S&P	BBB-	Stable	Jan 24 2014
S&P	BBB-	Negative	Jul 26 2013
Fitch	BBB	Stable	Feb 14 2013
Moody's	Baa3	Stable	Feb 07 2013

Agency	Rating	Outlook	Date
Fitch	BBB-	Stable	Feb 17 2012
S&P	BBB-	Stable	Nov 23 2011
Fitch	BB+	Stable	May 17 2011
S&P	BBB-	Negative	May 17 2011
S&P	BBB-	Negative Watch	Apr 13 2011
Moody's	Baa3	Negative	Jul 29 2010
Moody's	Baa3	Stable	Apr 23 2010
Moody's	Baa3	Negative	Apr 06 2010
S&P	BBB-	Negative	Mar 30 2010
Fitch	BB+	Negative	Jan 05 2010
S&P	BBB-	Negative Watch	Jan 05 2010
Agency	Rating	Outlook	Date
S&P	BBB-	Stable	Dec 31 2009
Fitch	BBB-	Negative	Dec 23 2009
Moody's	Baa3	Stable	Nov 11 2009
Moody's	Baa1	Negative	Dec 04 2008
S&P	BBB-	Negative	Nov 24 2008
Fitch	BBB-	Negative Watch	Oct 08 2008
Moody's	A1	Negative Watch	Oct 08 2008
Moody's	A1	Stable	Oct 08 2008
S&P	BBB	Negative	Oct 06 2008
Moody's	Aa1	Negative Watch	Sep 30 2008
Fitch	A-	Negative Watch	Sep 30 2008
S&P	A-	Negative Watch	Sep 29 2008
Moody's	Aa1	Stable	May 20 2008
S&P	A	Negative	Apr 17 2008
S&P	A+	Negative Watch	Apr 01 2008

Agency	Rating	Outlook	Date
Fitch	A+	Negative	Apr 01 2008
Moody's	Aaa	Negative	Mar 05 2008
S&P	A+	Negative	Nov 20 2007
Fitch	A+	Stable	Mar 15 2007
S&P	A+	Stable	Dec 22 2006
S&P	AA-	Negative	Jun 05 2006
Fitch	AA-	Negative	Feb 21 2006
S&P	AA-	Stable	Feb 10 2005

Table 1: (Icelandic Central Bank 2016)

Chapter 1

Introduction

This paper starts with a simple question; why don't states default? If we were to apply this question to individuals and their personal finances then the answer would be that lending institutions have a recourse in law, backed by the government, to force repayment of errant loans. This could be in the form of collateral or a visit from the bailiffs but no matter the method, banks usually get their money back. Under the international system, there is no higher authority that can force states to repay their loans in the same way that a government does for private citizens. Yet despite this lack of an overarching leviathan demanding repayment, states rarely default. We are not left with a 'Market for Lemons' (Akerlof 1970) style situation as, for the most part, states borrow freely on international markets.

A number of possible deterrents exist within the literature but, as we will discover, they sometimes fail to operate effectively; especially in certain fringe cases like the Icesave dispute of 2008-13. With reference to the Icesave case, this paper sets out to explain how constructivist thinking also offers a relevant insight into why the deterrents proposed by competing theories failed to prevent an Icelandic default-like event. An argument will be made for how the historic animosity between Iceland

and its creditors was exacerbated during the dispute and how this lead to the rejection of multiple repayment agreements. In doing so, evidence of the failure of rationalist theories to deter the default will be offered.

The debate over the causes of default fits into the wider debate between the traditional rationalist theories of International relations and more modern constructivist theories. The obvious economic element appeals to the rationalist tradition but this paper contends that in fact, constructivist elements also play an important part in forming an answer to “Why don’t states default?”

Chapter 2

Literature Review

In order to discover why states choose to avoid or embrace default, it makes sense to look at the positives and negatives of defaulting on sovereign debt. Starting with the benefits, the most obvious is the removal of the debt. The state in question, should it choose to default, no longer has to pay money from its own treasury to a foreign entity and can instead spend that money furthering its own interests. Whether those interests be aligned with the interests of citizens, state or both lies beyond the scope of this paper. What may perhaps be forgotten when one reads the headline “State A has defaulted on £Xm” is that the total amount saved is potentially a much greater sum when one considers the future interest payments that the state will no longer have to make. Given that in many developing countries interest rate payments can be the difference between budget surplus and deficit (Jochnick & Preston 2006), the importance of this distinction cannot be understated. With so much to gain from choosing to default, it is perhaps a wonder why more states don’t choose to default on at least some of their debts if not all.

2.1 Military Intervention

It makes sense then, that there is a reason why states try to avoid default. Historically, this has been the threat of military retaliation. As Wendt (Wendt 2001) writes “military intervention to collect sovereign debts was legitimate in the nineteenth century”. Citing the 1902 blockade of Venezuela by Britain, Germany and Italy, Wendt argues that this was a successful use of Military force by the European powers to protect bond holders from a Venezuelan default. Like thugs in the employ of a loan shark, the military of the European states pressured an indebted state into repayment through the use of violence. Further examples of states acting in this way are few and far between however. This is likely because states are very aware of their relative military capabilities and so, in the case that a borrower state is obviously weaker, they attempt to avoid default, therefore no actual military action is required; the threat of military deployment is sufficient. Conversely, a state is unlikely to engage in a military action it does not deem likely to succeed and therefore, is unlikely to attempt to use its military to encourage repayment if doing so is unlikely to succeed or its success would be too costly. The absence, therefore, of examples of military retaliation does not mean that states do not respond to the threat of military retaliation.

The use of the Venezuelan crisis of 1902 as evidence for military retaliation as a factor in default decisions has been subject to a number of criticisms, particularly by Tomz (Tomz 2011). Firstly, the timing of the intervention, particularly by the British, was odd if intervention on behalf of private bond holders was the primary motivation. Venezuela had been in a state of default for 34 of the last 55 years when British and German ships arrived in 1902 (Tomz 2011). This begs the question as to why the British decided to retaliate in 1902, and not, for example, between 1847

and 1862 when Venezuela was also in a period of default. Indeed, a British Foreign Office official claimed in 1871 that “the [private bondholders] must not expect forcible measures, such as reprisals, and still less any of a more decidedly warlike character, will ever be resorted to by Her Majesty’s government in support of their claims” (Tomz 2011). Furthermore, once Venezuela had been brought to the negotiations table the European victors ranked their claims. For both Britain and Germany, the claims of private bond holders were ranked last behind other concerns (Forbes 1978). Therefore, the argument that military force was used as a deterrent against default faces some, not insignificant, criticism.

Furthermore, the argument that the lack of military actions in response to default is not evidence that the threat of military action is not an effective means of ensuring repayment lacks credibility. Take, for example, the country of Switzerland, famed for both its banking sector and its neutrality. Switzerland’s military is incapable of waging a foreign war against military powers such as the UK, the US or China. Nevertheless, Swiss banks hold sovereign bonds of all three nations. Given their inability to use force to guarantee repayment, were military retaliation the only factor in preventing default then the UK, the US and China would have defaulted on Swiss held bonds long ago. The inability to use their military for retaliatory purposes would, even if military retaliation were just one factor of many in the default decision, increase the risk of buying sovereign bonds. With a universal price, the demand for sovereign bonds should fall given these circumstances but this is not observed. Switzerland is the 6th highest holder by value of US Treasury securities ahead of the UK, France and Germany (Federal Reserve Bank 2017). It is therefore, at least in the modern era, probably not the case that the threat of military retaliation is a significant factor in why states attempt to avoid default.

2.2 Trade Sanctions

A second reason given for why states choose to avoid defaulting is the threat of trade sanctions. It would do a state no good to erase their debt and then find its exports drying up as a result of punishing embargoes and tariffs. This could lead to a budget deficit as tax revenues fall and so the state would have to re-borrow the debt they had just defaulted upon. This effect would be most prominent in cases where one country is particularly dependent on another's market. This doesn't appear to happen in practice however, as an example cited by Tomz proves (Tomz 2011). During the Argentinian debt crisis of the early 1920s, Argentina was very reliant on exports of beef (its biggest industry) to the UK. There were also a sizeable number of US bondholders at the time but trade relations with the US were much more hostile. Trade sanction theory would suggest Argentina would prioritise British bonds to avoid sanctions but in reality the opposite happened. This ties in a study by Martinez and Sandleris, which found that there is little evidence of any impact on bi-lateral trade between a recently defaulted nation and its creditors (Martinez & Sandleris 2011). These circumstances suggest that the threat of trade sanctions are unlikely to be the deciding factor in whether a state chooses to default or not.

Instead of focussing on the possibility of trade sanctions, Argentine law makers instead argued over the damage that defaulting would do to their ability to borrow in the future and their reputation as borrowers (Tomz 2011). The cost of borrowing, or the interest rate, faced by states is a very important factor in their ability to finance a budget deficit. States with large budget deficits must borrow money, usually by issuing government bonds, in order to supply public services at their current level. The interest rate they borrow at is determined by the market as a

function of the risk that the loan won't be paid back. US government bonds have had historically very low interest rates because the US has consistently paid back their loans on time. A state that the market perceives to have a higher risk of default will face larger interest rates as borrowers want compensation for the increased risk. A country that has recently defaulted has shown itself to be a high risk proposition for potential investors and so therefore would face sizeable interest rates.

Furthermore, as a state at risk of default will be operating at a budget deficit, defaulting may not actually help the state financially in the medium to long term. Should a state with a budget deficit default then they will have to continue borrowing at a now increased interest rate to finance their deficit, assuming that there are no cuts to services, tax increases or other budget affecting policies to otherwise bring the budget into surplus. Therefore, the state will quickly accrue new debt, this time at a higher cost, thereby landing the state back into the situation it started in. This is all assuming that the defaulting state will still have access to credit markets following default. If a state with a budget deficit is excluded from the market then it must face severe austerity measures or partake in inflationary monetary policy to survive in its current form. States therefore face a calculation as to which path is more costly; continuing to service its current debt or defaulting and facing a higher interest rate.

2.3 Economic Rationalism

Eaton and Gersovitz portray this relationship between lender and borrower as a purely rational game where each actor seeks to maximise their own outcome (Eaton & Gersovitz 1981). Eaton and Gersovitz claim that in the instance of a single loan, states face no incentive to repay and

consequently, lenders refuse to lend as the rate of default is too high at 100%. In reality, they claim, a typical state is unlikely to be a one-time borrower. As states' fortunes ebb and flow with the business cycle, so does their demand for loans. An example given is the case of crop failure. Economic and social damage due to crop failure in one growing season can be mitigated with a loan to be repaid in the next season when fortunes hopefully change for the better. Should the state fail to repay that loan, then it will be unable to borrow in the next instance of crop failure as lenders punish it and the state will therefore have to suffer the consequences of a budget deficit. States must therefore calculate whether the benefit accumulated through default is greater than the cost of not being able to borrow in the future. This model does fail to capture why states that have defaulted in the past, like Mexico and Argentina, are still able to borrow. Assuming Eaton and Gersovitz' model is accurate, neither Mexico nor Argentina would be able to borrow any more as credit markets punish them for past defaults. This clearly is not the case and so a less narrow picture of sovereign credit markets is required.

A more complete representation, is Tomz's Reputation Theory (Tomz 2011). Tomz argues that there are three kinds of borrower and that at any one time, a lender has an idea of which type of borrower they are dealing with. There are lemon governments who may default in both good times and bad times, stalwart governments who will endeavour to repay regardless of circumstance and fair weather governments who will repay provided conditions are favourable. Which type of government a state has is determined by the value that government places on future loans. As with the previous model, states attempt to borrow in multiple periods and as such must account for the fact that a default in the present period will lead to ramifications in future periods, in this case, interest rates will rise and the state may be locked out of credit markets

in extreme circumstances. If a government places a high value on future loans relative to the immediate cost of servicing the debt then they will aim to repay even in bad times, such states are stalwarts. If a government places a low value on future loans they are unlikely to repay even in good times, they are lemons. Somewhere in between these two are fair-weather governments who value future loans but not enough to outweigh the immediate benefits of default during bad times. This means that during good times when growth is positive, fair-weather states will repay but during economic downturn, the state thinks more short term and defaults. Lenders use contextual inference to determine which type of borrower each borrower is, and offer an interest rate or refuse to serve them as their inference dictates. Lenders' adjust their expectations of borrower behaviour based upon prior behaviour. A country that maintains payments even during economic hardship, for example, will increase its standing in the eyes of creditors and consequently will be offered more favourable rates in the future. States weigh up the benefits of this increased reputation against the benefit of defaulting on a current loan. Such a system necessitates an uncertainty premium for newcomers to the market as lenders must hedge more against the possibility of being wrong in their estimations of the newcomer's nature. Other phenomena include market seasoning (rewards for consistent payers), market exclusion (for undisguised lemons) and market re-entry (when excluded lemons offer compensation in return for previous misdeeds).

Tomz' model formalises what many international financiers likely hold to be self evident, states have a reputation for credit worthiness and the interest rate they are able to achieve on their loans is dependent on that reputation. Indeed, one might as well substitute 'reputation' for credit rating as that is, in practice, what represents it. The so called 'Big Three' credit ratings agencies of Moodys, Fitch, and Standard & Poors

set credit ratings for all manner of financial securities including sovereign bonds (Investopedia 2017). Credit ratings agencies give states a rating denoting how risky their sovereign bonds are. Where these agencies differ from Tomz' default model is that, ostensibly, they do not take into account whether a country has a reputation for default. Instead, many economic indicators such as the economic policy of the government, the exposure of domestic industry to international fluctuations and the stability of the domestic banking system are considered when producing their rating: the credit rating as set by the credit ratings agencies is determined by future prospects rather than by past actions. That is not to say that the past cannot influence the credit rating, indeed if a head of state demonstrated in the past that they consider default a reasonable approach to dealing with debt and they remain in a position of power then naturally the credit rating will reflect that. However, other factors are taken into account. If, for example, a state is dependent on oil revenues for a large part of its income then predictions as to the future price of oil will impact upon that state's credit rating. Tomz' Reputation Theory is therefore somewhat incomplete as a method of determining credit worthiness yet remains useful in demonstrating why states seek to avoid default in order to maintain credit worthiness and so not increase borrowing costs in the future.

2.4 Constructivism

It would be easy to reduce the decision whether or not to default down to a simple cost/benefit analysis as the models presented thus far do. In both models, the decision to default is based upon a comparison between the monetary gain of refusing to pay back loans to the future monetary loss caused by increased borrowing costs or market shut-out. Devolving

the decision to default as a simple cost/benefit analysis fails to portray law makers as real people with ideas and bias. How states perceive each other is likely to be important to default decision. Opposing states are likely to be less disposed towards making decisions beneficial to each other, like servicing debt, than states with good relations. A history of colonisation by foreign powers may result in an anti-colonial sentiment towards previously colonial powers for example. The most common example of how social factors impact international relations is US policy on North Korea's nuclear arsenal compared to Britain's or France's. While both Britain and France have nuclear capabilities well exceeding North Korea's both numerically and technologically, the US perceives North Korea as a much greater nuclear threat than the UK or France. Constructivist thought such as this can provide valuable insight into why states do or do not choose to default.

For example, a reason for default that falls outside the rationalist analysis of the Tomz and Eaton models is the concept of odious debt (Jayachandran & Kremer 2006). Often, following a change in regime, a state will default on its loans claiming that there is no obligation for the new regime to pay the debts of the old. The debts taken on by the old regime are seen as unjust as they were supposedly taken on against the will of the people. These debts are therefore the debts of the old regime and its rulers and so the new regime has no obligation to service them. An example of this in practice would be the default by Iran on debts relating to the purchase of US surplus military property at the conclusion of World War II (Jayachandran & Kremer 2006). Iran claims that those contracts were imposed by the US as subjugation debts and so the post-revolution Islamic Republic of Iran was not liable for them. Therefore, states may default if they feel that the debts they are charged with are not theirs to pay, even if doing so may incur costs in the future.

Chapter 3

Methodology

To tackle the question of why states don't default, we will examine the case of Iceland and the Icesave dispute of 2008-13. The use of a single case study to research this issue may attract criticism. However, in this instance, the use of a single case study is acceptable for a number of reasons (Della Porta 2013). While every sovereign default is unique, the Icesave case is even more so in that it was not a traditional default. The errant debt was not extended by Iceland but rather a private bank that later came under Icelandic control and furthermore, the debt was later ruled to have never existed in the first place. The various theories as to why states don't default, that are present in the literature, may work in the majority of cases but, in this case, they obviously failed to prevent Iceland's default. It is the fringe nature of the Icesave case that makes it an interesting candidate for discovering where the mainstream theories break down. The Icesave dispute presents an exception to the rule and therefore warrants the in depth analysis only a single case study can provide. That is not to say that other such exceptions do not exist however, as there certainly are many other cases of default that also warrant investigation. Unfortunately, time constraints are an issue here and so this paper will neglect to investigate those cases.

One might also criticise the use of the Icesave dispute for investigating sovereign default as, as previously mentioned, it is not a typical case of sovereign default. This fact, while being true, does not necessarily disqualify the Icesave case from study. It could be claimed that since it was ruled that Iceland did not owe the UK and the Netherlands anything, the Icesave dispute was not an example of sovereign debt. However, without an overarching authority to mandate the honouring of contracts, sovereign debt is ever a mere ‘gentleman’s agreement’. If an investor chooses to purchase government bonds, they do so on the belief that the issuing state will honour that agreement as the investor has no power, typically, to force repayment. Therefore, sovereign debt is ever one actor’s word against another’s: One’s claim that money is owed against another’s that it isn’t. Therefore, when both the UK and the Netherlands, two ostensibly more powerful nations, made claims upon Iceland, Iceland entered into a debt that they chose to default on. It was only five years after the incident that the UK and the Netherlands agreed to follow the EFTA ruling and relinquish their claims. For the period between 2008 and 2013, Iceland faced a decision of whether to pay the UK and the Netherlands the amount it was claimed they owed or to default. Furthermore, until the EFTA court ruling, all three nations were acting as if the debt was real and so therefore, their behaviour is analogous to states reacting to more traditional debts. The Icesave dispute was therefore a valid choice for investigation because of its uniqueness as a fringe case rather than in spite of it and because despite that uniqueness, the motivations of the states involved should, in theory, mimic that displayed in other cases.

To answer the question of ‘Why states don’t default?’, we will use mostly document evidence from reputable sources such as the OECD, to assess why the deterrents identified in the literature failed to prevent

Iceland's rejection of the claims resulting from the failure of Icesave.

While this presents a risk of misinterpretation of data leading to incorrect conclusions, this will be minimised by using each individual data set only to add evidence to an overarching claim rather than as the sole justification for any individual conclusion. Secondly, as the data was collected by a third party, there is limited scope for verifying the accuracy and validity of the data. However, as mentioned previously, the data will be collected from well respected institutions with a historic precedent for providing data for research use. This will assuage most concerns about the reliability of the data the conclusions drawn are based on.

While this approach is limited in scope and so cannot hope to provide a definitive, general answer to 'Why states don't default?', it can shed some light on where the existing theories break down. Studying the exceptions to general rules can help to produce better general rules in the future as fringe cases can demonstrate weaknesses in the established theories regarding scenarios that may become more common. This particular case, for example, shows one of the downsides of our ever more interconnected, international financial system and as banks continue to expand internationally, similar cases to the Icesave collapse may become more and more common. Therefore, the study of the Icesave dispute in regards to sovereign default adds to the wider knowledge base on sovereign default and can help to provide a better understanding of the phenomenon, even if in isolation it is unable to provide a conclusive answer to the question 'Why don't states default?'

Chapter 4

Case Study

As an investigation into why states default, we will look at the Icesave dispute of 2008-13. As 93% of the Icelandic banking sector went into administration in October 2008, British and Dutch depositors in Icesave, the foreign operating branch of Icelandic 'big three' bank Landsbanki, stood to lose a total of £3.4bn (EFTA Court 2013). Despite protecting Icelandic deposit holders the Icelandic Government refused to guarantee the deposits held by foreigners in the UK and the Netherlands. Believing this to be in violation of EEA regulations that forbid discrimination between EEA citizens regardless of nationality, both the British and Dutch governments guaranteed their own depositors before approaching Iceland for the money. What followed were lengthy negotiations, finally resulting in a court ruling by EFTA in Iceland's favour (EFTA Court 2013). Why and how Iceland was able to avoid paying the UK and the Netherlands will provide insight into the broader question of why states default. As will be described, the Icelandic case is quite complex and so therefore, it is of benefit to lay out the events of the Icesave dispute before applying tests to confirm the failure of rationalist deterrents to prevent default.

The foundations for the Icesave dispute were laid in 2006 when

Iceland suffered the so called ‘Geyser Crisis’. Caused by an overheated economy, the Icelandic banking sector suffered from a severe liquidity crisis, despite other indicators being very healthy (Zeissler et al. 2014). A Fitch report in February 2006 showed concerns about Iceland’s future and Fitch later downgraded Iceland’s economic outlook to negative (Zeissler et al. 2014). To deal with the liquidity crisis, the big three Icelandic Banks, Glitnir, Kaupthing and Landsbanki, expanded abroad to garner new deposits. Landsbanki bypassed its own subsidiary branch Heritage Bank to begin operating in the UK as the online bank Icesave in October 2006 (EFTA Court 2013). Due to the large interest rates set in Iceland to cool down its overheated economy, Icesave was able to offer the highest interest rate in the UK for the first 9 months of operation (Zeissler et al. 2014). Naturally this resulted in rapid growth both from standard depositors and professional money movers borrowing at low interest rates in places like Switzerland and depositing in the higher interest rate Icesave. The Icesave scheme is a huge success in attracting capital and continues to do well in the UK and a Dutch branch was opened on the 29th May 2008.

During the latter half of 2008, concerns about the stability of the banking sector begin to circulate with the collapse of Northern Rock in the UK. When Lehman Brothers went bankrupt on 15th September, the interbank lending markets seized up as waves of uncertainty rippled through financial sectors the world over. This proves to be the death knell for the Icelandic banks as, unable to borrow to meet their large commitments, their reserves are used up at an alarming rate. By the 6th of October, Icesave deposit holders are unable to access their funds online and the FME (Icelandic financial authority) stops trading in Landsbanki stocks while other banks freeze all fund transactions to Landsbanki (EFTA Court 2013). The following day, Landsbanki enters administration

and control is passed to the FME using emergency legislation passed a few days prior. The Icelandic government guarantees 100% of the deposits held in Landsbanki by Icelanders but not those held in branches abroad. Considering this a breach of EEA non-discrimination legislation, the British government enacts the 2001 anti-terrorism act to freeze all Landsbanki assets as well as any funds relating to Landsbanki held by the FME or the central bank of Iceland (EFTA Court 2013). They also, along with the Dutch government, began reimbursing their respective citizens up to the amount supposedly guaranteed by the Icelandic government's deposit guarantee scheme. Using the 2001 Anti-terrorism act the British government then froze Landsbanki assets and put Landsbanki on a list of other frozen regimes that included Iran, North Korea and Zimbabwe among others. The move was met with much criticism, both on the part of Icelandic politicians from all parties and the Icelandic general public who did not appreciate being labeled as terrorists (indefence.is 2009).

Meanwhile, the Icelandic economy was collapsing. With the bankruptcy of Glitnir, Kaupthing and Landsbanki, 93% of a banking sector worth many times Iceland's GDP had failed (EFTA Court 2013). After some resistance, Iceland finally succumbed and agreed to join an IMF emergency program on the 25th October that, over several installments, would provide \$2.1bn of relief to Iceland (EFTA Court 2013). Negotiations continue between Iceland, the Netherlands and the UK but are hampered somewhat by the Icelandic governing coalition being removed from power in January 2009. A left leaning coalition led by Jóhanna Sigurðardóttir assumed power and continued to negotiate with the British and Dutch governments leading to the UK freezing order being lifted on the 9th June 2009.

The first Icesave bill, as the repayment agreement was called, enacted on the 2nd September 2009 was not accepted by the British and Dutch

governments as it included a clause whereby repayment obligations upon Iceland were to be canceled in 2024 (Zeissler et al. 2014). This clause was removed in the second Icesave bill and it was passed by the Icelandic Parliament on the 4th January 2010. However, in an unprecedented move, the Icelandic President refused to sign the bill into law. The president position in Iceland is largely ceremonial, similar to the British Monarch, and in general once a bill is passed in parliament, it is considered a formality for the President to sign it into law. In this case however, President Ólafur Ragnar Grímsson announced he would not sign the bill into law after receiving a petition signed by a quarter of the Icelandic electorate urging him to refuse the bill, thereby triggering the first of two Icesave referendums. In conclusive fashion, the bill was rejected by 98% of the vote on the 6th March 2010 forcing the authorities back into renegotiation. After a further period of negotiation, the matter was passed to the electorate once again in April 2011 and was again rejected, although this time with only 60% of the vote (EFTA Court 2013).

With success seeming unlikely, the British and Dutch finance ministers both announced they would be seeking a resolution from EFTA. On the 28th January 2013, the EFTA court cleared Iceland of any wrongdoing (EFTA Court 2013). On the first count, that Iceland had failed to provide a sufficient deposit guarantee scheme, it was found that the unforeseen size of the Icelandic financial collapse allowed for a *force majeure* defence. The unprecedented scale of the Icelandic banking crisis meant, as the court decided, that no guarantee scheme would have been able to deal with the fall out and, furthermore, to attempt to do so might be potentially destructive, therefore Iceland was cleared of the charge of failing to provide sufficient guarantees for depositors. The second charge, that Iceland had discriminated between depositors was also found to be false. Following Landsbanki's collapse, the Icelandic deposits were moved,

as part of a greater, government led restructuring of the Icelandic banking system, to New Landsbanki, a new bank. It was only after these deposits had been moved that the FME decided deposit guarantees were not to be paid out to depositors of 'old' Landsbanki. As these depositors were all foreigners, there was no discrimination between depositors in Landsbanki, the depositors who would be receiving guarantees were now all depositors in New Landsbanki. Therefore, the court found that there was no discrimination (EFTA Court 2013). Iceland was therefore cleared on all counts and the UK and the Netherlands were ordered to pay Iceland's legal costs. This ruling effectively ended the dispute and Iceland is under no further obligation to pay Britain and the Netherlands. Payments have been made however, without interest, from the estate of Old Landsbanki to the total paid by the UK and the Netherlands leaving both countries only out of pocket for the five years of missing interest and the legal costs.

The Icesave dispute therefore represents an interesting avenue for the study of why states default. There are a number of factors as to why Iceland may have chosen to reject the repayment plans presented at both referendums. Investigations can be made into why the possibility of the extension of military or trade sanctions from much greater military and economic powers were ineffective at persuading the Icelandic public. The opinions of the Icelandic public on Britain, the Netherlands and the financial industry may have also played a part and so a look into past relations between these once-colonial powers and a once-colonised country could also provide insight. These possibilities deserve further scrutiny.

Chapter 5

Investigation

To demonstrate the failure of traditional deterrents to prevent the outcome of the Icesave dispute and to predict the behaviour of the nations involved, we will contrast the actual events of the crisis with what the rationalist theories predict. As will be shown, there are significant discrepancies between theory and reality in this particular case.

To demonstrate the failure of rationalist deterrents to prevent Iceland's default we will apply the theories presented in the literature with the actual events of the crisis. Once we have established that Iceland could indeed pay the amount demanded, we will show that each of the traditional deterrents, starting with military threats, failed to operate effectively in the Icesave case. We will then proceed to present the case for constructivist incentives for Iceland's default.

Before establishing how traditional deterrents failed to prevent an Icelandic default, it is important to establish whether Iceland had the capability to pay or not. If Iceland lacked the capability to pay then investigating Iceland's decision makes little sense. Iceland is one of a number of European countries that has yet to adopt the Euro as its currency. Instead, the Icelandic Central Bank issues its own currency, the Icelandic Krona (ISK). The Icelandic Central Bank control the supply of

ISK and can therefore choose to print more if it so desires. The Icelandic deposits guarantee program disputed by the UK and the Netherlands guaranteed deposits in ISK and so if non-discrimination was to be followed as the UK and the Netherlands claimed, payouts to British and Dutch depositors would also be in ISK. The Icelandic government could therefore, conceivably, print ISK to pay off the depositors. To do so would deflate the ISK and cause damage to Icelandic businesses reliant on imports but nevertheless, it remained an option. As will be shown later, the decision to comply with British and Dutch demands in this case had economic concerns regardless and so we will consider Iceland able to comply should it have wished.

5.1 Military Threat

As already established, traditional theories point to the threat of punitive military action acting as a deterrent upon default. Given that Iceland did not pay the amount demanded, then there must have been no credible military threat from either demanding nation should the theory hold. To demonstrate why the military threat deterrent failed in this instance we will first look into the military capabilities of the three nations and draw conclusions as to what the outcome of a punitive, military action would be. This will determine whether Britain, the Netherlands or an alliance thereof would have the capability to force Iceland to act in a way they find favourable. Secondly, we will look into the ability of the UK and the Netherlands to issue a threat, either implied or explicit. Lastly, we will investigate whether the UK or the Netherlands did indeed issue any threat. The finding of these enquiries should paint a picture as to why the threat of military retaliation failed in this instance to induce compliance.

While an exact comparison of munitions and equipment is difficult, a

straight comparison of military strength by active personnel is quite straightforward and strongly in the favour of the UK and the Netherlands. Iceland lacks a standing military although it does have an armed coast guard of roughly 200 people (Icelandic Coast Guard 2017). This paltry force pales in comparison to the military of either the UK or the Netherlands. The UK's 194,000 active personnel is over half of Iceland's total population (European Defence Agency 2008). The Dutch military is also sizeable at roughly a quarter the size of the British armed forces (European Defence Agency 2008). Military spending by both countries also dwarfs Iceland's coast guard budget to the point of irrelevancy. At this point, it would be normal to carefully evaluate the ability of the involved forces to mobilise and then operate in the given combat zone. However, given the vast difference in military strength between the Netherlands and the UK and Iceland, it seems unnecessary. The British military has operated in Icelandic waters in a combat role previously during the Cod Wars of the 20th century and still can, given the two states relative closeness. It is therefore clear that the UK and the Netherlands both individually have a military strength that far outstrips Iceland's. In a straight conflict with just one of these aggressors, Iceland would undoubtedly come up short. Nevertheless, Iceland continued to disregard the threat posed by the large disparity in armed forces strength between them and the other parties. They therefore thought that the threat of military action was not credible, that much is clear. As to why it wasn't a credible threat, there are a number of possibilities.

One such possibility is that the UK and the Netherlands were engaged in operations in the Middle East and so therefore, did not have the troops available to effectively strike at Iceland. This is unlikely however, as in 2008, the UK had almost 12,000 personnel situated in Iraq and Afghanistan (BBC 2008) while the Netherlands had less than 2000

personnel in Afghanistan(BBC 2010). While significant deployments, these instances represent very much the minority of British and Dutch forces with plenty left over to attack Iceland should the order be given. Even if one takes into account that those troops deployed overseas but not involved in an active conflict, like for example those deployed on training exercises in Canada, would be delayed in responding to any call to readiness, enough personnel would remain to overwhelm Iceland's paltry coast guard forces. Therefore, it was clearly not a question of capability that lead Iceland to conclude that the threat of military retaliation was not credible.

However, perhaps discussing capability is getting ahead of ourselves. There are, after all, many factors that influence the decision to engage in military action, otherwise, states with large militaries like the US or China would be in a state of perpetual conquest. One such factor, is that all three countries are members of NATO and are therefore allies. This has not prevented conflict in the past, as the Cod Wars prove, but it has prevented escalation(Steinsson 2016). During the 1950s to 1970s, Britain and Iceland engaged in a series of small scale conflicts over fishing rights in the North Atlantic. The conflicts were mostly non-violent and casualties were limited to one individual but they ended in an Icelandic victory despite the overwhelming military advantage held by the British. Facing the risk of escalation from a small scale conflict involving little actual weaponry use to a war against one of the strongest military powers in the world, Iceland decided to take the diplomatic route to secure its objectives. Levering both the US and western Cold War fears against the UK, Iceland threatened to withdraw from NATO and eject the US from Keflavik airbase (Steinsson 2016). With pressure from the US and the threats of the Cold War ever present, Britain conceded to Icelandic demands. The NATO alliance between the competing nations does

present a formidable barrier to the use of force against each other to the point that the utilization of military assets in this instance would be supremely unlikely. It is true that geopolitical conditions have changed since the 1970s, the cold war has ended and the USAF no longer permanently operates out of Keflavik, but NATO has shown little to no symptoms of collapse.

Ultimately then, the use of force by the UK and the Netherlands was constrained by NATO, even though they had the capability to inflict retribution upon Iceland. Nevertheless, Iceland refused to allow the scheduled British NATO deployment to Keflavik airbase in December 2008. Since the US withdrawal from Keflavik airbase in 2006, NATO members have taken turns garrisoning Keflavik and patrolling Icelandic airspace. Following the use by the UK of the 2001 Terrorism Act to Freeze Landsbanki assets, the Icelandic Prime minister states that it would not be appropriate for the UK to deploy RAF personnel to Keflavik Airbase as had been arranged (Sigurdardottir 2008). One possible reason for Iceland to decline British forces access could be signalling that Iceland was willing to move away from NATO to get what they want. This had worked in the past for Iceland and so the possibility of Iceland using the same strategy to strengthen their bargaining position is there. An alternate explanation is that Iceland believed there was, at the very least, an implicit threat from the UK that resulted in Iceland preventing British troops deploying. In which case, it would make sense to decline them access to Icelandic Military assets. In truth though, it is far-fetched to believe that the UK or the Netherlands seriously considered military action as a possible recourse in this instance and the literature agrees (Bulow & Rogoff 1989). The large expense, the public outcry that would result and the potential negative diplomatic ramifications of military action makes it an untenable response to what is a relatively

small scale dispute.

A second possibility is that the UK and the Netherlands reasoned that the cost of going to war was too expensive for the default to justify. Should the monetary cost of deploying troops to Iceland be large relative to the amount they could hope to recoup, it would not make sense to utilise the military. This is unlikely to be the reason why the UK and the Netherlands did not resort to military action however and as such is only mentioned for completeness. A much more likely reason is the diplomatic circumstances previously mentioned.

Military threat theory therefore failed to deter Iceland on two counts. Firstly, that despite the overwhelming difference in military strengths between the 'lender' states and the 'borrower' state, the borrower state did not feel threatened enough to prevent default. Secondly, in the pursuit of repayment, the stronger 'lenders' did not attempt to use their military to induce repayment. Therefore, in this instance, the threat of military action was not an effective deterrent against Iceland's default.

5.2 Trade Sanctions

Trade sanctions and embargoes have frequently been used to punish the actions of 'rogue' states. If trade sanction theory holds in this instance, then it can be assumed that Iceland did not feel that the possible sanctions outweighed the benefits of rejecting British and Dutch demands. This could be because Britain and/or the Netherlands lacked the capabilities to enact sanctions or that any sanction they could enact were of little consequence compared to the savings from refusing to pay the debt. The arguments presented here will show that the 'lender' states lacked the ability to enact meaningful sanctions and so Iceland was left without a deterrent based on trade.

The UK and the Netherlands are two of Iceland's biggest export markets and so the threat of trade sanctions by either or both states upon Iceland represented a grave threat to an economy already in deep trouble as Iceland's was in 2008/9. As the chart below shows, in the year of the dispute, the Netherlands and the UK together made up over a third of Iceland's exports. Following the GFC, Iceland experienced a period of trade surplus (OEC 2009) which, for a country seeking to recover from recession, it would be desperate to maintain. It should follow then that Iceland would seek to avoid damaging trade relations between itself and its two biggest importers, the UK and the Netherlands. Were either 'lender' state able to enact sanctions it would have severely damaged Iceland's trade balance and so therefore both states had the influence to potentially enact sufficiently damaging trade sanctions.

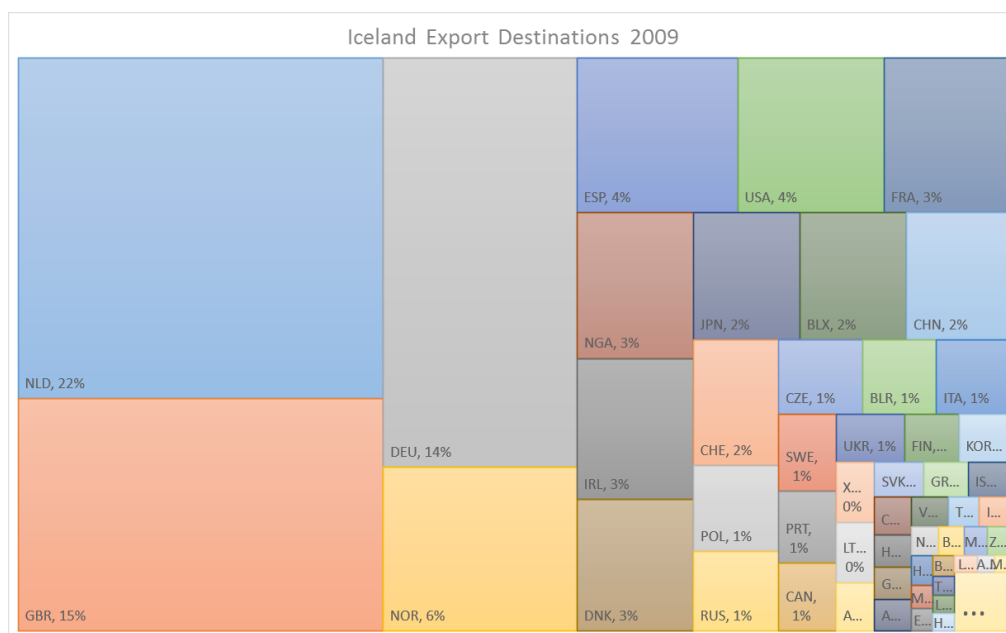


Figure 5.1: (OEC 2009)

Sanctions were not enforced however, as Iceland, although not being part of the EU, is part of the European Economic Area (EEA) along with

the UK and the Netherlands (EFTA 2017). Therefore, the UK and the Netherlands were not able to implement trade sanctions as a means of punishing Iceland without falling afoul of EEA legislation. In order to enact trade sanctions upon a fellow EEA member, the UK or the Netherlands would have to leave the EEA and by extension the EU. The costs of doing so would likely far outweigh the benefit of Iceland paying out, should the sanctions convince them to. Furthermore, leaving the EU would represent a constitutional change and therefore require a large public debate. This would far exceed what could be considered a pragmatic approach to encouraging payment. Therefore, Iceland would have seen it as very unlikely that either the UK or the Netherlands would have used formal trade sanctions against them in order to secure payment and so the threat of trade sanctions failed to be an effective deterrent against default.

While direct, traditional trade sanctions may have been impossible, the use of indirect measures to harm the Icelandic economy may have been present. It is possible to consider the use of the 2001 Anti-Terrorism act by the UK in this way as it would have prevented some trade (Financial Markets Law Committee 2009). Icelandic Businesses with deposits held in Landsbanki would have been unable to trade with businesses who held their own funds in British based banks due to the freezing of funds. There was a great deal of uncertainty when the act was used as to what was and wasn't legal with regards to moving money that came into contact with Landsbanki, the FME or the Icelandic Central Bank and, as a result it would theoretically be quite difficult to carry on as normal if you were an export based business who used Landsbanki services (Financial Markets Law Committee 2009). That being said, the collapse of the 'big three' Icelandic banks would mean that little international trade was happening in the immediate aftermath anyway as

there would be some delay before government guarantees were paid out. As the Icelandic central bank was quickly removed from the terrorism list, normal business activities could resume and so the effect of the 2001 Anti-Terrorism Act as a trade sanction was minimal and it would not have acted as an effective deterrent.

While Iceland escaped punishment via trade sanctions, it is possible that they may have been subject to a decrease in Foreign Direct Investment (FDI) as British and Dutch investors were scared away by the lack of will demonstrated by the Icelandic government to guarantee foreign deposits. Unfortunately, the data doesn't exist to compare FDI flows from the UK and the Netherlands to Iceland before and during the Icesave dispute. This is of little consequence as it would be impossible to separate the drop in FDI over the 2008-9 period from that which was caused by the Icesave dispute and that caused by the wider, vicious recession that Iceland entered into. What can be looked at however, is the difference in FDI from before and after the EFTA ruling in 2013. The table overleaf shows (fig 5.2) the FDI flows into Iceland from the UK and the Netherlands over that period.

As the table demonstrates, although total inward FDI to Iceland only increased by just over 6%, FDI from the UK and the Netherlands increased by much, much more. Dutch FDI into Iceland almost doubled while British FDI increased by a factor of 30 (OECD 2017). This could be due to the EFTA verdict clearing Iceland of wrongdoing and thereby restoring the trust of British and Dutch investors. The resolution of the dispute therefore likely had a positive effect upon the levels of FDI from the UK and the Netherlands. Furthermore, this being the case, it is also likely that the onset of the dispute had a negative impact on FDI. Therefore, Iceland did suffer as a result of its decision to contest the repayment yet this was obviously not enough of a deterrent against

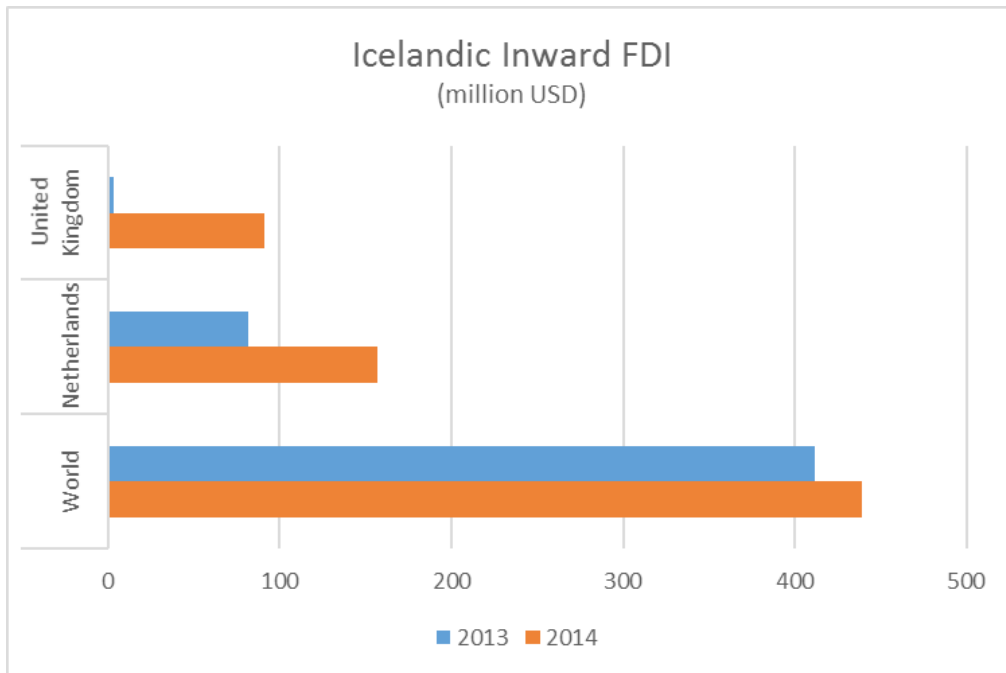


Figure 5.2: (OECD 2017)

default given that Iceland chose to default anyway.

It is therefore unclear what the impact of trade upon the Icesave dispute was. While the fact that Iceland suffered no threat of traditional sanctions due to its membership of the EEA, there is some evidence that at least FDI did suffer negatively regardless. Trade Sanction theory claims that states leverage their trade power to induce repayment however in this case it is impossible to tell whether the ‘lender’ states would have done so were they not restrained by the EEA. Furthermore, Iceland did suffer negative impacts upon trade as a result of its actions and yet still defaulted. Therefore, trade sanction theory can not be applied adequately to this unusual case and even if you were to apply it, the impact of trade upon the decision would surely have been minimised by the competing forces pushing Iceland both towards and away from default. Because of this, the threat of damage to trade did not operate as an effective deterrent.

5.3 Reputation

Reputation theory claims that a belief in the importance of maintaining or gaining a reputation as a safe borrower is often enough to prevent default. While Iceland wasn't a borrower in the traditional sense, as the government nationalised a bank with debts (EFTA Court 2013). The response to the Icesave dispute would undoubtedly affect the perceptions of reputation held by future investors. Therefore, by examining how Iceland's response to the dispute affected perceptions of Iceland as a borrower, we can ascertain why the threat of the market punishing Iceland in the future was not enough to prevent an Icelandic default in the present. The data will show that Iceland did indeed suffer damage to its reputation yet this did not work effectively as a deterrent. Therefore either reputation did not matter to Iceland or, more likely, greater situational factors played an important role in shaping Iceland's response.

Credit Ratings set by the 'Big Three' ratings agencies offer a suitable proxy for reputation. Credit ratings represent a perception of the risk investors feel they will face should they choose to invest into, in this case, a country (Preston 2011). Therefore, credit ratings should adjust alongside reputation thereby making a metric based on perception quantifiable. The table below amalgamates credit ratings from the 'Big Three' ratings agencies to show how Iceland's credit rating changed over the last decade. As is shown in the table, Iceland's credit rating was heavily damaged by the events of the GFC and only recently has Iceland's rating returned to pre-crisis levels. This period includes the Icesave dispute however it is important to remember that during the crisis, 93% of the Icelandic banking sector collapsed and as a result the Icelandic economy suffered a severe hit (EFTA Court 2013). The large decrease in Iceland's credit rating cannot therefore, be solely, or even mostly, credited

to the Icesave dispute in the presence of these other factors.

Agency	Rating	Outlook	Date
Moody's	A3	Stable	Sep 01 2016
Moody's	Baa2	Positive Watch	Jun 10 2016
S&P	BBB+	Stable	Jan 15 2016
Fitch	BBB+	Stable	Jul 24 2015
S&P	BBB	Stable	Jul 17 2015
Moody's	Baa2	Stable	Jun 29 2015
Fitch	BBB	Positive	Jan 30 2015
S&P	BBB-	Positive	Jul 18 2014
S&P	BBB-	Stable	Jan 24 2014
S&P	BBB-	Negative	Jul 26 2013
Fitch	BBB	Stable	Feb 14 2013
Moody's	Baa3	Stable	Feb 07 2013
Fitch	BBB-	Stable	Feb 17 2012
S&P	BBB-	Stable	Nov 23 2011
Fitch	BB+	Stable	May 17 2011
S&P	BBB-	Negative	May 17 2011
S&P	BBB-	Negative Watch	Apr 13 2011
Moody's	Baa3	Negative	Jul 29 2010
Moody's	Baa3	Stable	Apr 23 2010
Moody's	Baa3	Negative	Apr 06 2010
S&P	BBB-	Negative	Mar 30 2010
Fitch	BB+	Negative	Jan 05 2010
S&P	BBB-	Negative Watch	Jan 05 2010
Agency	Rating	Outlook	Date
S&P	BBB-	Stable	Dec 31 2009
Fitch	BBB-	Negative	Dec 23 2009

Agency	Rating	Outlook	Date
Moody's	Baa3	Stable	Nov 11 2009
Moody's	Baa1	Negative	Dec 04 2008
S&P	BBB-	Negative	Nov 24 2008
Fitch	BBB-	Negative Watch	Oct 08 2008
Moody's	A1	Negative Watch	Oct 08 2008
Moody's	A1	Stable	Oct 08 2008
S&P	BBB	Negative	Oct 06 2008
Moody's	Aa1	Negative Watch	Sep 30 2008
Fitch	A-	Negative Watch	Sep 30 2008
S&P	A-	Negative Watch	Sep 29 2008
Moody's	Aa1	Stable	May 20 2008
S&P	A	Negative	Apr 17 2008
S&P	A+	Negative Watch	Apr 01 2008
Fitch	A+	Negative	Apr 01 2008
Moody's	Aaa	Negative	Mar 05 2008
S&P	A+	Negative	Nov 20 2007
Fitch	A+	Stable	Mar 15 2007
S&P	A+	Stable	Dec 22 2006
S&P	AA-	Negative	Jun 05 2006
Fitch	AA-	Negative	Feb 21 2006
S&P	AA-	Stable	Feb 10 2005

Table 5.1: (Icelandic Central Bank 2016)

When one of the Ratings Agencies revises a state or organisation's credit rating or outlook they release a brief outline of the reasoning behind the decision for the sake of transparency. From these press

releases we can ascertain whether the IceSave dispute played a part in influencing Iceland's credit rating over the period from when Landsbanki collapsed through to the court ruling of 2013.

In the years preceding the global financial crisis of 2008, only Standard & Poor's (S&P) drew attention to the large amounts of external debt held by Icelandic banks, although it stopped short of mentioning Landsbanki specifically (S&P's 2005). At the peak of the crisis, when the 'big three' Icelandic banks toppled in quick succession, all three agencies downgraded credit ratings in response to the large liquidity injection by the government and the massive burden on public spending it entailed (S&P's 2008). Again, Icesave is not specifically mentioned at all during this time. This is not to say that the Icesave dispute, which was in its infancy during this time, did not influence the decision but, more likely, that it was seen as a minimal secondary factor compared to Iceland's greater problems. It is only by late 2009 when the Credit Ratings agencies, starting with Moody's (Moody's 2009), begin to explicitly mention the Icesave dispute as having a direct effect on Iceland's financial outlook. From then on until the resolution of the dispute in 2013, all three ratings agencies refer to the resolution of the Icesave Dispute as an "important step towards the normalisation of relations with international creditors" (Fitch 2011). Furthermore, with the EFTA court ruling in 2013, Moody's upgraded Iceland's credit rating citing the ruling explicitly as the main reason (Moody's 2013). It is therefore clear that the Icesave dispute had a clear negative effect on Iceland's sovereign credit rating. This begs a question as to why the credit rating damage did not act as an effective deterrent against default.

Whether the effect of the crisis upon Iceland's credit rating can be considered a symptom of reputation damage is unclear however. Following the first Icesave referendum, S&P predict that if negotiations

breakdown, a downgrade would be likely (S&P's 2010). Additionally, from 2009 onwards, Moody's makes continued claims that Iceland's recovery is threatened by delays in resolving the Icesave dispute (Moody's 2009). The ratings agencies claimed that should Iceland be forced to pay the UK and the Netherlands then, without a generous repayment plan, the debt will significantly harm Icelandic recovery efforts. This reasoning seems to suggest that rather than Iceland's reputation as a reputable borrower being damaged by the dispute, the damage to Iceland's credit rating was more to do with the additional debt responsibility hindering Iceland's ability to repay. Ultimately though, reputation is not an arbitrary characteristic; it is created by a number of factors with financial situation being one of them. After all, even if your friend Jeff is a great guy, his inability to keep up his mortgage payments would make you hesitant to lend to his new business venture. Therefore, it is fair to include capability to pay under the greater heading of reputation in this case.

Iceland's credit rating changes over the period therefore shows that they did suffer as a result of the actions taken during the Icesave dispute. However, this did not act as an effective deterrent against default. One possibility for this could be that Iceland had already taken such a large hit to its rating from the wider financial crisis that the potential damage caused by defaulting was insignificant by comparison. Iceland's credit-worthiness was already facing a long period of repair and so the benefit gained by rejecting repayment outweighed the potential damage caused to its credit rating. In this way, the unique circumstances of the Icesave dispute rendered reputation damage as an ineffective deterrent against default for a financially ruined Iceland.

5.4 Constructivist Contributions

The theories tested so far have been mostly rationalist in approach. They have treated Iceland as a single, materialist, self-serving entity and assumed it has acted as such. This approach fails to acknowledge the important role the Icelandic people played in this dispute. Twice, repayment agreements were put in front of the Icelandic electorate and twice they were rejected, thereby forcing the parties involved to seek independent adjudication. Unit-level constructivists such as Katzenstein (Reus-Smit 2013) would argue that the internal bias' that arise from Icelandic culture and history will affect Icelandic foreign policy especially, as was the case here, if the foreign policy was dictated by a referendum. Constructivism may therefore offer insight into how Iceland was pushed towards default in a way that the rationalist deterrents failed to prevent.

The UK and Iceland have had a number of armed incidents during the past century. During World War II, Britain invaded and occupied Iceland in order to prevent Germany from doing the same. With the breakout of World War II, Iceland declared neutrality, hoping to stay out of the conflict (Miller 2005). Following the conquest of Denmark by Germany in 1940, Britain asked Iceland to join the allies in return for protection of her independence. Iceland refused and soon thereafter Britain invaded and occupied Iceland. Although there were no casualties on either side as a result of this, there remains some ill will towards the Britain for violating Iceland's sovereignty.

As alluded to earlier, Britain and Iceland have also engaged in conflict since World War II. In three separate disputes between 1958 and 1976, collectively referred to as the Cod Wars, Iceland sought to expand its territorial waters and establish fishing rights for a larger area (Steinsson 2016). British fishermen trawled the waters now claimed by

Iceland and Iceland attempted to forcibly expel them. Taking issue with this behaviour, the UK began escorting its fishermen with a small Royal Navy force. In the end, Iceland succeeded in its aims despite possessing the weaker numbers and arsenal of the two sides by threatening to withdraw from Nato (Steinsson 2016). Nevertheless the atmosphere during the conflicts was indisputably nasty and it is certainly possible that some ill will remains towards Britain for what Iceland viewed as Britain's unjust actions during the conflict. There have been no similar disputes between Iceland and the Netherlands in recent memory however. The possibility therefore exists that some animosity remains between Iceland and the UK as a result of the conflicts of the 20th Century. This may have played into the referendum results as Britain may be seen by Icelanders as 'the old enemy' and so they acted to punish Britain by refusing to accept the repayment agreements. Therefore, the two referendums could be seen as a vote *against* Britain rather than a vote *for* rejecting the agreements. Although no such history exists between Iceland and the Netherlands, the Netherlands were British allies in the dispute and so had aligned themselves against Iceland as well.

The use of the 2001 Anti-Terrorism act by the UK against the Icelandic central bank and all assets of Landsbanki could also have played a role in turning Icelandic public perception against the UK. Following the use of the Anti-Terrorism act, there was public outcry in Iceland both from the people and from politicians. One example of this was an online petition signed by over 80,000 people accompanied by pictures of Icelandic signatories holding signs printed with variants of "I am not a terrorist Mr Brown" (indefence.is 2009). Over 25% of all Icelanders signed this petition which is a clear indicator of just how unpopular Britain's move was. Unfortunately for the UK, the placement of Icelandic banks on a list alongside regimes like North Korea fed into the Icelandic cultural

narrative of the UK as a bully, unjust in its relations with less powerful nations. This almost certainly helped push the Icelandic electorate towards ‘punishing’ the UK at the ballot box.

A further reason for the Icelandic people to vote against the UK and the Netherlands’ interests is post-colonial nationalism. As Bergmann argues, the ‘colonial experience was instrumental in shaping Icelandic national identity’ (Bergmann 2014). Iceland was, for many years a colony of Denmark, a period oft referred to as that of national shame. Many Icelandic politicians tap into nationalist narratives of Icelandic rebirth, where Iceland no longer has to bow to foreign imperial powers (Bergmann 2014). Both the Netherlands and the UK have histories of imperialism that could have influenced the referendum outcomes. While neither the UK or the Netherlands ever included Iceland within their empires, the anti-imperial narrative of Iceland’s post-colonial nationalism could very much still include them. While a certain rivalry with Denmark is maintained, Bergmann argues that Icelandic nationalism is more focused on Iceland throwing off the yoke of an unaligned oppression rather than any specific nation (Bergmann 2014). This contrasts perhaps with Scottish nationalism which seeks to secure independence from the “English” government. With the UK and the Netherlands heavily pressuring Iceland to concede to their demands, it stands to reason that voting against the Icesave agreements could be seen by the electorate as a moral stance against foreign oppression of Iceland. Rejecting the Icesave agreements was seen as rejecting a return to domination by foreign powers. Therefore, Icelandic post-colonial nationalism, a facet of Icelandic culture, could have influenced the referendum results and by extension, Icelandic foreign policy.

The concept of odious debt could possibly apply in the Icesave case for two reasons. Firstly, the Icesave debt was originally ‘caused’ by the

failure of a bank to operate with sufficient liquidity. Therefore, the debt may not be seen as belonging to the state and so therefore, it is unjust for the state to be held responsible for it. It should be mentioned that this is a question of the perception of who is responsible for the debt rather than who is responsible by law (Jayachandran & Kremer 2006). Secondly, the government which chose to reject repayment in the initial instance did not survive to make further negotiations. In January 2009, the government was replaced by a new one led by Johanna Sigurðardóttir who then took a leading role in negotiations with the UK and the Netherlands. Therefore, a new regime was negotiating repayment for a debt incurred under an old regime by a private entity. While no revolution occurred, as is normally the case with odious debt cases, the large disconnect between the debt incurred and the party held responsible makes the odious debt justification for non-payment very strong. Therefore, the odious debt justification could have further fueled the fires of discontent among Icelandic voters and pushed the referendum results towards rejection.

Chapter 6

Conclusions

The Icesave case is an interesting one. Traditional deterrents against default failed to apply or be effective against Iceland's 'default-like' behavior. The threat of military action to enforce compliance never materialised as the nations involved were long standing allies. Trade sanctions were also similarly constrained by the states' membership of the EEA, although some private sector punishment in the form of reduced FDI does seem to have occurred. The GFC overshadowed the dispute making the normal punishment mechanism of credit rating damage insufficient as a deterrent. In this fringe case, the traditional rationalist deterrents failed to be effective. Furthermore, a number of constructivist default inducements were present. A pattern of animosity both before and during the dispute between the UK and Iceland encouraged a certain amount of spite in the Icelandic electorate. Similarly, Icelandic anti-colonialism also pushed the Icelandic voter away from 'bowing' to foreign once-colonial powers. Lastly, the nature of the debt itself, once private but now public, and the change in government likely resulted in its classification as odious in the eyes of Iceland. Therefore, Iceland was as much pushed by constructivist factors as pulled by the failure of rationalist deterrents towards its default like behavior. Further study into

other fringe cases where rationalist deterrents fail to prevent default is the logical continuation of this work. Although this paper was constrained by its methodology, with further case studies, a clearer picture of why states default can be drawn.

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