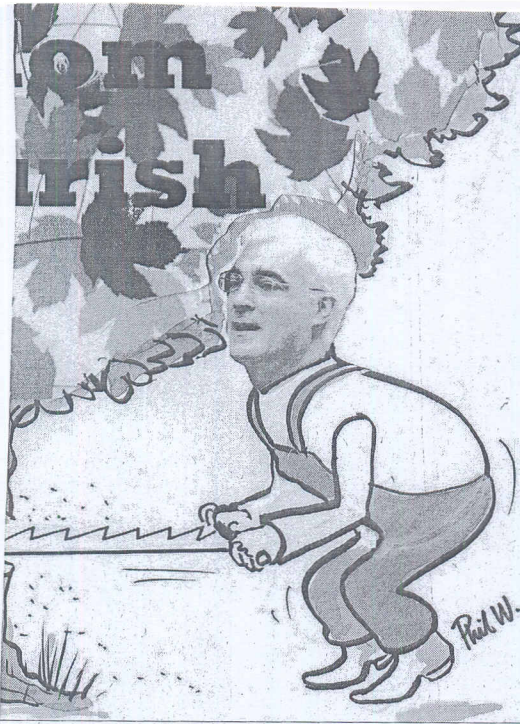
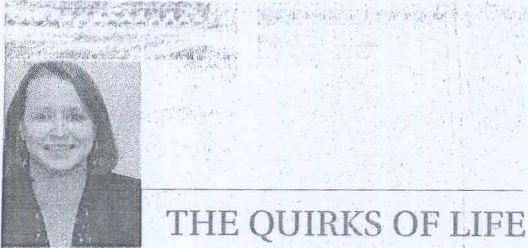


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Paying for mistakes

JONATHAN SMALLEY

HAVE pity for Icelanders.

Iceland's economy and inhabitants' lives have been destroyed because Icelandic banks' debts and deposits grew too large for the economy. Generations of Icelanders will pay for these mistakes. The Icelandic Government's immediate concern is to keep the local economy going and supplied with food and oil.

I am concerned about banks owing depositors and bondholders multiples of their home countries' GDP. In such cases can their country as lender of last resort credibly rescue their banking system? Iceland's government couldn't.

Where are these profligate countries? Iceland, Ireland and Britain have public and bank debt in excess of 300 per cent of GDP. They are first, third and fourth in the Western world's league of shame.

Governments as lenders of last resort are credible. They can raise future taxes and in the last resort print money. That credibility reduces if the tax base is rapidly shrinking (it's harder to raise money on a shrinking tax base) and the printing press alternative creates inflation. The position is much worse if the debt is in foreign currency.

The banks in Ireland are in recapitalisation crisis talks, notwithstanding the government's comprehensive guarantee. There remains a real risk of failure, but ultimately the Euro countries are likely to bail out Ireland.

Britain is vulnerable which is why Britain rushed to recapitalise its banks and why the value of sterling has sunk 25 per cent in three months. There is a real risk that the recapitalisation was not enough and more capital may be needed. Britain has the added problem that total foreign currency liabilities are nearly five times its GDP, nearly as big as Iceland's problem.

I hope that Britain can muddle through the coming recession, but nothing is certain.

How are we doing in the Isle of Man? In 2006-07 the Manx GDP rose to £1.8 billion. Bank deposits were £66 billion, with £22 billion in non-sterling deposits. That places us above Iceland in the league of shame.

The Manx Government has reserves of £1.3 billion, which sounds great until you realise public service pension liabilities come to £1.2 billion. The Treasury has just agreed to act as lender of last resort over the next 12 months for the new Depositors' Compensation Regulations. Conceding the principle of financial support may in the long run prove much more onerous than the £150 million bill it is likely to pick up for Kaupthing. Manx banks are too big for our economy to support.

Our real protection is not the government's balance sheet, but the FSC not making the same mistakes it did with Kaupthing. If the British and Irish banks' problems overwhelm their capital and their lenders of last resort, the Manx economy is doomed unless the FSC acts in a timely and decisive manner. It is a daunting task facing the FSC as our last line of defence. Are they up to it? If the worst happens, generations of Islanders could pay for their mistakes.

Have pity for Islanders.

Jonathan Smalley is a leading island lawyer and a partner in Douglas-based Stuart Smalley and Co.