

Breadbasket or basketcase?

-A foreign investor's perspective on Iceland-

Three letters to the Prime Minister of Iceland

Letter One

Credit is due not just literally

Outsiders are often blind to the complexity of a nation's problems, but sometimes, a fresh set of eyes, however myopic, can see the wood from the trees. As an Englishman living in the third most densely populated island in the world, Hong Kong, I seem to have become very attached to the third least densely populated country in the world. I have been visiting Iceland regularly for 5 years as an investor, not a financial wizard making mysterious alchemy with currency and derivative trades, but investing in real businesses. Gradually I am beginning to get a feel for the economic potential, even if the culture and much of the country remains a mystery.

Before I start, I want to say immediately that my prognosis, for what it's worth, is extremely positive, and I'm excited about the island's future. But this optimism is tempered by the hope that brave decisions are made to unblock bottlenecks, to not take financial short cuts, and to play to Iceland's strengths.

When I tell people overseas that I am a keen investor in Iceland, most of them think I am reckless. They still perceive Iceland as the basketcase and backwater of Europe. So perhaps it would be appropriate to revisit the much debated financial crisis from a foreigner's perspective. The main theme of this article is playing to one's strengths, of which Iceland has many. So I found myself scratching my head as to why Iceland thought it was ideally placed to become a big player in the financial markets? Notwithstanding the insanity that followed, credit is due not just literally.

Without going into the details, the most profligate lenders, several of them banks in Germany and France, are desperate for borrowers to accept bailouts or other forms of negotiated refinancing rather than bankruptcies, and they are using their clout in Brussels to push these through. This is not out of heartwarming concern for the profligate borrowers, but because lenders and borrowers are two sides of the same coin. If Deutsche Bank, with its 1.5% capital to lending ratio were to fairly value its EUR2.2 Trillion balance sheet today, it would be bankrupt many times over. The bank uses several schemes to hide the fact that their balance sheet, two thirds of the size of Germany's entire GDP, has shrunk by more than their total equity. Firstly they create off balance sheet vehicles and 'sell' assets at cost to that vehicle so they don't register any loss on the books. Secondly they avoid selling assets that would trigger revaluations of a broad category of assets in the same class. But the most important technique of all is refinancing to avoid recognizing losses. The other three biggest banks in Germany, and many others throughout Europe, are in the same position. Imposed restructurings, while ensuring the lender's survival, are a slow and painful death for the borrower.

Iceland's swift suicide followed by the opportunity of rebirth is absolutely the right choice, to disconnect itself from the umbilical cord of a debt ridden global economy. I feel the handling of the Icesave

deposits, particularly your president's veto, was the correct approach, and the government, as the main shareholder of the three banks needs the courage to ignore the pressure from Brussels, which is really simply indirect pressure from the large banks in Europe, and do the same with the Glacier Bonds. As a private equity investor I am very familiar with risk discounted returns. This means that for every 1% above the risk discounted return the risk of losing part or all of your money goes up. The carry trade was and remains a risky pyramid scheme and participants should accept counterparty risk as well as the exchange rate risk. When I buy an oil derivative the counterparty is JP Morgan and possibly the US government as a final backstop, I understand I am taking on the risks inherent in the oil trade and the risk of JP Morgan going bust. In the carry trade the counterparty risk were Icelandic banks with the most overly geared balance sheets in banking history and the backstop of a government of a nation of 320,000 people. The idea that the Icelandic government or the Icelandic people should be honor bound to take on that counterparty risk is absurd.

The carry trade is the product of Japan's financial problems. Japan's public debt is 20x the government's revenue. To put this in perspective Portugal, Spain, and Ireland's ratios are between 4x and 6x. The only two reasons Japan is not bankrupt today is because nearly all that debt is locally owned and, more importantly interest rates have been kept artificially low at below 1% for many years. With a global fiat currency it is easy for central banks to manipulate interest rates. In the old days there was the headache of the gold standard. Now all the Central bank of Japan needs to do is buy Japanese government debt and this can then be shown as an asset on the bank's balance sheet. The old asset column required before 1971 was something real called gold which now only represents 0.2% of the Bank of Japan's assets. Japan simply can't afford to have higher interest rates no matter what the economic situation, at 2% interest the Japanese government would default. So, over the past decade a big spread has developed in interest rates between Japan and other parts of the world, and the carry trade was born. This baby grew voraciously into a multi-trillion dollar monster. Eating yen and depositing other currencies and its problem elsewhere. The Icelandic government must not honor this counterparty risk and burden Iceland with decades of payments to effectively finance Japan's government debt.

Financial independence is the product of a trade surplus and a locally financed government debt. Iceland has achieved the first and the second is within reach. Iceland is then small enough and far enough away from the financial chaos elsewhere to cast off and set sail alone, without too many people noticing.

Letter Two

Half of Iceland's economy is still underwater

So let's talk about the future. This means switching the focus to Iceland's strengths. When I choose a country to invest in, I first have three boxes to tick; governance; balance of trade; energy and food security. Call me old fashioned, but a decade in private equity has confirmed that long term growth is impossible without these ingredients. I will not analyze in detail where Iceland sits on governance, but having spent most of my career investing in China, India, and Eastern Europe, I can say Iceland's governance is adequate.

Iceland's exports per capita put it in the top 20 nations in the world, in the company of great desert gas exporters such as Qatar, trading hubs such as Singapore, and manufacturing giants like Germany. Iceland's figures get lost in the lists because of the tiny population. Total exports are 4 billion EUR, 42% of which are from sustainable fishing, and 36% processed aluminum, is chunky money for a nation with a population smaller than the town of Cardiff in Wales. Importantly, in 3 out of the last 4 years, Iceland's exports have exceeded imports. Long may this continue, with no return to the old habits of deficits. Positive trade balances are critical to so many other aspects of a healthy economic community, not least of all, employment, currency stability, and future access to debt markets.

Lastly, in the buzz of modern life we forget you can't eat a grain derivative and that the iPad will be an expensive cheese board once the battery runs out. Iceland has the dual blessing of being parked on top of the Mid-Atlantic Ridge, up against the seesaw between the Icelandic and Aleutian Lows. The Ridge blesses Iceland with vast amounts of heat to convert to energy, and the Icelandic Low is the perfect environment for plentiful marine life.

Despite guzzling through a record 88 kilos of fish per capita, Iceland still has 97.5% of its fish catch for export. The fact that the fish industry only employs 7000 people is deceptive, while just 11% of direct GDP, when supporting industries are included, this climbs to 25%. Once you also include the fact that fish exports allow Iceland to import an equivalent quantity of goods, 40% of all imports, without currency depreciation. Make no mistake half of Iceland's economy is still underwater. It would be wise not to tinker with a system that is the envy of many nations. The value of wild fish, long term, will continue to strengthen globally and Iceland is very well positioned to take advantage of it. Don't mess with it if it's working.

As everyone knows, Icelandic electricity prices, below half those of the EU, are currently leveraged by one industry, aluminium. Again while this offers a meaninglessly low number of local jobs and almost no local ownership or tax revenues, Icelanders benefit from the differential between aluminium raw material imports and finished product exports, which still amount to a chunky EUR900M, or 30% of Iceland's non-Bauxite imports. This is currently the sole, but very significant benefit, of these foreign owned plants.

Lessons from Detroit should sound a warning on the importance of diversification. In 1929 Detroit had a population of 1.6 million with 160,000 employed in car factories. Today the population is 700,000 and

the city is tottering on the edge of bankruptcy. They focused on one industry. There are a number of engineered materials and composites that could, in the next 50 years put pressure on aluminium smelting and Iceland would do well to find other sources of revenue from its geothermal strength. Aluminium processing makes economic sense because 35% of the process costs are electricity, so half price electricity gives the companies a 17% margin to play with, much of which is traded away by the disadvantages of being based in Iceland. There have been several reviews of other energy intensive industries to introduce to Iceland such as chlorine and caustic soda production, but in most cases the logistical disadvantages of Iceland are greater than the energy saving.

50% of the costs of data centres are electricity and cooling. Iceland is well aware that it seems like an ideal location for this activity. The two bottlenecks here have been Iceland's lousy network connections to Europe and the Americas and the signal latency demands of many customers, these appear to have driven Google to build the 400,000sqm datacenter at the Node Pole, aka tiny Lulea in Sweden. Many global internet companies will keep dual data centres in Europe and the US to avoid the micro-second delays of the Atlantic crossing. The Icelandic government is, understandably, loath to pump more money into upgrading the cable network as it already loses millions on the current network. The link to Emerald Technologies' cross-Atlantic cable will significantly improve the data capability. As an outsider I think the investment to draw in a first big name foreign anchor client would be worthwhile, go to Google and ask them what they need in bandwidth to consider Iceland, then build it. Even while the cable networks would always lose money, the spin-offs for encouraging other data clients and related IT industries would more than compensate for this.

The out and out export of electricity offers the lowest benefits for Iceland, simply further access to foreign currency. Energy independence is a holy grail. Let's hope that some oil is found offshore to plug the gaping hole of jet fuel, marine diesel, and petrol that Icelanders consume. As with being comfortable with killing the animal you eat, if you burn oil, you should also be comfortable with living with the environmental dilemmas of extracting it.

Letter Three

The bestest

I love trees, and the first half a dozen times I visited Iceland I felt a sensation verging on panic, as I scanned the horizons for hours looking for a lonely pine. Fishing in August the temperature was 7C and, with wind shear, it was close to freezing. Why would anyone come to this barren, windy, godforsaken place? Eventually though, I've had to concede that Iceland is stunning, and its macabre lunar landscapes add to its allure. My young children ranked their holiday in the Western Fjords as their 'bestest of all time', so I find myself being dragged back there again this summer at their insistence. The tourism figures show my kids are not unique in their views. Every year the tourism figures climb another whopping 20%.

Of course the cheaper Krona has played a big part in these climbing numbers. But my Icelandic friends tell me about the hippies in the 70's, who stopped many of the old colourful corrugated buildings downtown being cleared. Many of those crusaders are now senior executives, with their ponytails replaced by balding pats. But they should feel immense pride in having saved Reykjavik from being turned into a faceless architectural mess. Just, and only just enough charm has been maintained. There are a few streets, or parts of streets, that tourists enjoy strolling through. These should not only continue to be protected, but buildings on the key roads between the cathedral and docks should be enhanced wherever possible, particularly the two main town squares. Some of the most offensive eyesores should be replaced in partnership with a government tourism fund. Reykjavik totters precariously on the border between a bland suburban town and somewhere that, with a mixture of creativity and preservation, could become a destination.

Icelanders keep sending us foreigners to the Golden Circle. Having gained the trust of a few locals they eventually suggested I explore other parts of the island. I was amazed. There are all these magnificent fjords, rugged majestic mountains, and bays full of islands, yet you are corralling all the foreigners into this duller area south of Reykjavik. I have to assume this is done intentionally, to keep foreigners away from where the Icelanders want to holiday. Alternatively, if you can bare our company, there are opportunities to open up several other more stunning Circles to entice tourists to the country.

There is a complete lack of funky places to stay, something the likes of KEX and Icelandair hotel are successfully setting right. This good example needs to spread around the countryside like an eclectic virus, mutating earth houses and urban chic into uniquely Icelandic designs. In desperation I have rented two mobile homes this summer.

As an amateur historian the Icelandic government's choice of the name Portus for the company running Harpa intrigued me. Was the choice of name representing the folly of the roman engineers in thinking they could overcome the silt pouring down the Tiber with Rome's first man-made harbour? Or did it represent the sinking of Caligula's folly for a more practical use, the foundations for Portus' lighthouse? Either way, on the surface, this expensive to build and expensive to run building appeared to be more

like Caligula's barge, destined for a similar fate. That was until I was flying to Iceland in February, expecting to be one of half a dozen people on the flight at that bleak time of year. Instead I found myself on a packed flight wedged between the thighs of members of a strange tribe that spoke a language I could not recognize. It was not until I reached Iceland that I realized this was the tribe of Eve Online, on their annual pilgrimage to Reykjavik. 5000 digital nomads filled the Harpa, and more importantly the hotels, and all my favorite restaurants, during the quietest of all months in Iceland's tourism season. I asked for a tour of Harpa, and as a regular visitor to the Sydney Opera House was impressed by the technical quality of the facility. It's first class. I could see that Iceland's location, floating nicely between the Americas and Europe makes it a perfect venue for conferences with 2000 to 8000 attendees from both sides of the pond. There is no coincidence as to why Ronald Reagan met Gorbachev there. It's neatly 4000km from each of the President's homes. The spin off revenues for Iceland of regular international conference traffic will be massive. I was disappointed to see that the Harpa schedule for April to June showed no international events, but its early days and this will hopefully change in the coming years.

It's wonderful to read the numbers for those pioneers of whale watching. In their first year with 300 clients I imagine many of the fishermen snorted into their beers at their friends' foolish idea. But now with more than 175,000, I wonder who does the snorting. A few more 'anchor' activities need to be created for tourists. This does not mean crass Viking theme parks or fake volcanoes. The next anchor is already taking form, with a staggering number of international music festivals throughout the year. Every effort needs to be made to get the word out about these events overseas and around town, to get people to fly in from the US and EU, again with cool affordable places to stay, drink, and eat. Iceland's incredibly successful musical fusion of your rimur heritage and modern eclectic tastes are another strength that should be fostered with support and coordination. You have the potential to be a music capital of Europe. Keeping it cheap to get to, and stay in Iceland is critical.

I'm sure all this is old news to you. Perhaps it's nice to have your views reconfirmed by a foreigner or for your views of foreigners reconfirmed. Iceland is unique and should be very wary about becoming a small and irrelevant part of the EU, and focus on the strengths that its isolated position provide.