

Middle East Association Annual Lunch

Speech by Stephen K Green
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Good Afternoon Ladies and Gentlemen. It is a great honour and privilege, as well as somewhat intimidating for me to address so many real experts on Middle East affairs.

At our headquarters building we have what we call a history wall. It is a huge installation on the ground floor: seven metres high and 35 long with 3,700 images. It is in effect a pictorial history of HSBC's life and times.

It is a constant reminder of where we have come from, and the institutions which make up our DNA.

The Wall runs chronologically and if you go back to 1889, you can find a picture of a share certificate of the Imperial Bank of Persia which was founded by Baron Julius de Reuter who also founded the eponymous news agency.

At 1890, you can see the first Persian banknotes, 1895 a photo of the Shiraz branch and staff. As you move through the early 20th century there are photos of what was by then the Imperial Bank of Iran.

After the Second World War it was renamed the British Bank of the Middle East and was the first bank in Dubai, in Oman and in Kuwait.

At one time or another over the years we have operated in most Middle East countries. These days, with some 120 offices in the Gulf, Levant and Egypt, we are the largest international bank in the region. We operate in most of the Gulf and Levant as HSBC Bank Middle East Limited, and we have a 40 per cent stake in The Saudi British Bank. We also have an Egyptian subsidiary, HSBC Bank Egypt, which is steadily growing, particularly in the retail market.

We have a significant investment banking capacity in the region, based in Dubai. Furthermore we have a global Group business actually based in the Middle East, namely HSBC Amanah Finance. Amanah designs and structures our Islamic compliant financial services for Group members, and has been remarkably successful in its five years of existence pioneering such products as Sukuk - or sovereign - bonds, mortgages and a range of personal financial services compliant with Shariah law tailored to today's needs of Moslem clients around the world. And in December 2003 we applied for a licence to operate in Iraq.

Our business in the Middle East is also part of the world's most international banking Group. We have over 9,500 offices in 79 countries and territories. Unlike most of our competitors, no one territory makes up the majority of our profits. And our business is also deeply rooted in each country with its specific characteristics, culture and history.

As an international bank we look to invest our shareholders' savings in economies where we see potential for growth. Which is why we are delighted to have such a strong presence in the Middle East.

Let me share our house view with you. To begin with the short term, the economic outlook for the Middle East economies is broadly positive this year. In September the International Monetary Fund forecast that the economy of the region would grow by 4.5 percent in real terms in 2004.

This represents a slight slowdown from 2003, when the growth rate was estimated at 5.1 percent, driven mainly by higher oil output

and prices.

The region's production of oil is expected to fall in 2004, in line with cuts in quotas from OPEC.

The factors affecting economic growth differ significantly from country to country in the Middle East. In particular, the oil-producing Gulf states have different economic dynamics from those of North Africa and the Levant. However, most of the countries in the region will display broad convergence in 2004. Non-oil factors will be the main drivers of real GDP growth in the region.

In the oil-producing economies, a combination of government and private spending will sustain economic growth, despite the expected decline in oil output. Oil prices and output have been relatively high since early 2000. Oil revenues have financed a boom in public spending in the Arab Gulf states and generally high levels of liquidity have fuelled consumer spending, investment spending, corporate profitability and stock market performance.

A virtuous circle of economic activity has emerged that is likely to be sustained throughout 2004, against a background of world economic growth driven especially by the US and Asia.



**virtuous
circle**

Tourism recovered strongly in the second half of 2003. The recovery of tourism is likely to continue in 2004 and should benefit Egypt, Jordan, Lebanon and the UAE in particular.

Similarly, foreign investment, and to a lesser extent domestic investment, picked up in the second half of 2003, after slowing down before and during the period of hostilities in Iraq. This investment momentum is likely to be sustained through 2004. There are, of course, significant risks in this forecast – some political, some economic.

On the political side, the main concerns, obviously, are civil conflict and terrorism. Terrorist attacks in Saudi Arabia have already affected investors' interest in the Kingdom. In Iraq, hostilities officially ended on May 1, 2003, but the unstable security situation has constrained the work of redevelopment. A major escalation of hostilities in Iraq, or between Israel and Palestine, or terrorist strikes, would damage investors' confidence in the region, as well as the prospects for tourism. Conversely, any improvement in the security situation would have a beneficial economic effect.

On the economic side, the main risk is from a decline in oil prices – which we see as an increasing possibility in 2005. We expect world economic growth to slow as a result of the effect of structural imbalances; this will affect demand for oil. And on the supply side, there is a risk that increased supply from Russia, Africa and Iraq – coupled with relatively weak growth of demand in the industrialised countries – could drive prices lower.

This would be a good point to come back to Iraq. We at HSBC had a long history in the country prior to the Saddam era, and we feel that the country remains potentially one of the major economies of the region. When it emerges from the current difficult phase, we can see a vital role for it in the region's economy. Iraq is a sizeable country with a population of over 20 million; it has the world's second-biggest proven oil reserves; and it has a commercial and trading history. There are obvious uncertainties and risks, but the potential is clearly there.

Saudi Arabia has also had its share of mixed publicity in the past year or more. We have had strong ties to the Kingdom for many years, in more recent times through our shareholding in The Saudi British Bank. Though questions undoubtedly remain about the course of the country's development, the Saudi government have committed themselves to a range of reforms that we believe will help the country to meet the economic and social challenges ahead. Privatisation is gathering

momentum; capital markets' reform is underway; and foreign investment is coming into gas exploration.

For our part we feel that this is a key regional market and we are currently finalising an investment which will establish a joint investment banking venture with Saudi British Bank and local partners to benefit from the growth and development of the Kingdom's capital market and project finance opportunities. Such opportunities are going to multiply in the region's largest single economy.

In Jordan, trade liberalisation and other economic reforms have brought a return of confidence to the country.

Elements such as the rise of share prices by more than 50 per cent last year, the continuing surge in exports, increasing remittances from overseas Jordanians, and a more settled regional environment suggest Jordan can grow at 5 per cent this year. The Free Trade Agreement and increasing business with the US will only help this.

As for Iran, the Iranian economy has performed well over the past three years, particularly in the non-oil sector, and declines in unemployment and external debt and improvements in official reserves and key social indicators all tell a positive story. These all stem from structural reforms which have included the opening up of the

economy to international trade and foreign direct investment, exchange rate unification and the general overhaul of the financial system. But Iran still has unemployment problems and it is clear that there are plenty of uncertainties ahead.

It is early days yet, but I should add that Libya's reforms and their recent overtures to the international community bode well. The removal of UN sanctions is a positive step. Libya too, has a growing indigenous labour force, but seems committed to liberalisation and to the reduction of the role of the state in the economy. Directly or indirectly, I would hazard a guess that Libya's contribution to the region's economy in the medium to longer term will be significant.

The UAE is a great story, and one in which HSBC has played a significant part over more than half a century. You only need to see how much growth and sheer activity is going on there, in Dubai in particular, to understand what kind of potential the region actually holds.

From the famous Palm Island projects to the world's tallest building Burj Dubai, due for completion in 2006; from Dubailand to the World Island project, the Hydropolis underwater hotel and a seemingly never-ending list of golf courses being developed,

structural reforms

the vision of Dubai's architects seems without limits. Such dynamism does not come without its risks. But one has to admire those who are driving these projects forward.

Dubai has rivals for the role of regional service centre, of course. Bahrain is working to establish itself as a regional centre for Islamic banking expertise. And Qatar, now developing rapidly on the basis of the world's third-largest natural gas reserves, is beginning to see itself as an active competitor.

The key economic event for Egypt in the past year was undoubtedly its decision to float the Pound. Though it has led to sharp increases in local inflation, it has had a tangible effect on the competitiveness of the country's exports as well as strengthening the country's foreign currency earning sources.

The investment climate has improved significantly, as witnessed by the return of institutional investors as well as the improvement in the daily trading volumes of stocks, and local listings by such companies as Vodafone Egypt.

Economic and banking reforms have been gaining momentum over the past six months, and the black market is now being reined in. Egypt's removal from the FATF list of non-co-operative countries is also evidence of the improvement in its local financial management.

So, overall, the short to medium-term view for the region – although not without risks – is broadly positive. But what about the medium term strategic perspective?

The circumstances are different in each country. For example, we are seeing a transition in ownership models from state and from traditionally dominant families to more open structures, such as public joint stock companies or mixed public/private enterprises. But the rate of progress is not uniform, nor is the progress always smooth.

There are a number of long-term challenges, which will decide how smoothly that progress actually is. The region has obviously come a long way; but income growth and job creation remain of paramount importance. It is worth noting that average per-capita income has been virtually static over the last two decades.

Let me first focus on job creation. It is crucial for the governments in the Middle East to ensure that the quality of their own, home-grown talent is as good as it can be in a world of increasing global competition for manufacturing and services. Some Middle Eastern countries can deliver growth without

jobs; others cannot. And in any event, income growth without jobs is insufficient from a social perspective. We are all aware of the destabilising potential of unemployment, particularly amongst educated urban young people.

Rapid population growth – 116 million in 1975 rising to over 250 million last year – makes it one of the world's fastest-growing regions. And it is estimated that by 2015 around a quarter of the Middle East's population will live in urban areas of 750,000 inhabitants or larger. The challenge for government education programmes posed by these rapid changes is obvious.

And in this, there is a long way to go. A number of governments in the region have invested significantly in education – Saudi Arabia, for example, has invested more per head than Korea, China or India. However, in terms of the requirements for competitive success in a globalised world, there is clearly some way to go. The region has only 18 personal computers per thousand inhabitants, compared to a world average of 78.

Only about 2 per cent of regional households have internet access, compared with over 35 per cent in East Asia. High rates of illiteracy persist, and R&D spending and employment in science and engineering are well below global averages.

The next ingredient for success is relatively easier to deal with: access to capital. Firstly, the region will continue to receive significant oil and gas earnings for the foreseeable future. Secondly, there is no reason to believe that Foreign Direct Investment – which is perhaps the best form of investment, bringing a long-term commitment as well as expertise and know-how along with capital – will not flow in response to appropriate regulatory and market environments. Countries that encourage FDI will benefit their economies, and could well benefit others by providing the channel for attracting foreign companies and their capital to the region. And, of course, banks like HSBC play a role in this bringing access to capital markets and expertise to the region.

What about the long-term future of the oil market? While demand for oil has seen pauses, notably in the mid-seventies and early eighties, the overall trend has been upwards from the 1930s until today. There is no reason to believe that alternative sources of energy will have a material impact on demand for oil; nor that the major G7 countries are going to become materially more efficient in their consumption of oil.

On the supply side, of the 64 significant oil-

banking reforms

producing countries, 52 of them have now reached or passed their peak production. Countries such as the US, the UK, China, Mexico and Norway fall into this category. Meanwhile, a third of world production of oil is being met by Middle East producing countries.

And furthermore, demand for gas is rising. Expressed in terms of energy content, demand for gas is now equal to 60 per cent of world petroleum consumption – good news for Iran and Qatar, which have the world's second and third-largest natural gas reserves respectively.

My main conclusion is straightforward. In the coming two or three decades, the world is likely to rely on Middle East oil, and gas for that matter, to an extent never seen before. This demand provides a fantastic opportunity, but also an immense

responsibility, for the governments, planners and corporations of the region.

So I can finish on an optimistic note. The Middle East has changed over the last generation in a way no-one could have envisaged 50 years ago. It will continue to change. As always, there are risks – but the potential is immense.

Over the next few decades, countries of this region have more opportunity than most other parts of the world to invest in education and skill development, in infrastructure, and in their future. It is a unique window of opportunity, and one which creates enormous opportunities for us all. We at HSBC are committed to the region and look forward to contributing to the realisation of that potential in the coming years.