Macroeconomic outlook

Qatar: Growth to improve in 2017 but GCC dispute weighs on outlook.

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Overview and outlook

- Growth is expected to pick up to 2.5% in 2017 from 2.2% in 2016 on higher oil and gas output and further expansion in the construction, financial services and transportation sectors.
- A second consecutive, albeit narrowing, fiscal deficit is expected in 2017 (-5.1% of GDP), amid fiscal restraint and higher oil/gas revenues.
- Public debt reached 67% of GDP in 2016 as the government ramped up bond issuance and expanded its demand for credit.
- Private sector credit growth remains weak at 5% y/y in April.
- Liquidity has improved with higher energy prices and bond issuance; bank deposit growth is outpacing credit growth.
- The banking system is highly exposed to foreign funds (38% of total liabilities), a key concern in the current diplomatic crisis.
- Borrowing costs are up, CDS spreads have widened, equities are down.
- The currency is under pressure in the forwards market, but no de-peg.

Headline growth slows in 2016 on a contraction in oil and gas output and government fiscal consolidation

Economic growth moderated to 2.2% in 2016 from 3.5% in 2015 on a contraction in oil and gas output (-1%) and a slowdown in non-hydrocarbon sector activity (5.6%). (Charts 1 & 2.) In the former, maturing oil fields, maintenance of LNG facilities and delays prevented the Barzan gas processing plant from reaching full capacity and stymied potential output growth. Over in the non-hydrocarbon sector, while construction (15.4% y/y), financial services (7.9% y/y) and real estate (6.8% y/y) were the major contributors to growth, the economy felt the negative effects of government fiscal consolidation, tighter liquidity and private sector credit, and generally lower consumer confidence. Last year's GDP growth rate was the slowest since 2002.

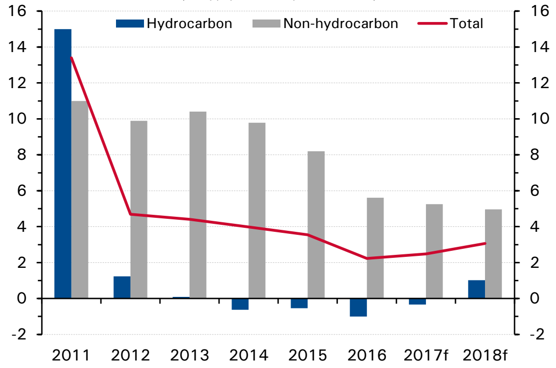
Table: Key economic indicators

		2015	2016	2017f	2018f
Nominal GDP	$ bn	164.6	152.4	169.9	183.9
Real GDP	% y/y	3.5	2.2	2.5	3.1
- Oil	% y/y	-0.5	-1.0	-0.3	1.0
- Non-oil	% y/y	8.2	5.6	5.3	5.0
Consumer price inflation	% y/y	1.8	2.7	1.5	3.0
Budget balance	% GDP	-1.9	-9.0	-5.1	-3.5

Source: Official sources, NBK estimates

Chart 1: Real GDP growth

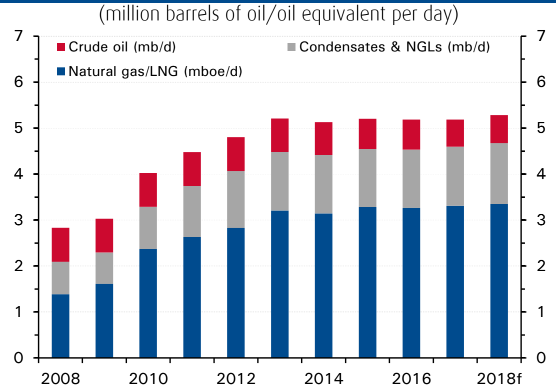
(% y/y, base year 2013)



Source: Ministry of Development Planning & Stats (MDP&S), NBK est.

Chart 2: Oil and gas production

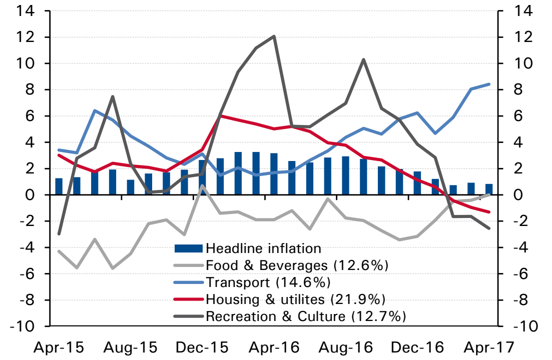
(million barrels of oil/oil equivalent per day)



Source: JODI, BP, OPEC, NBK estimates

Chart 3: Consumer price inflation

(% y/y, weights in brackets)



Source: MDP&S

Looking ahead, we expect growth to accelerate slightly this year and next to 2.5% and 3.1%, respectively, thanks to gains in LNG, natural gas and condensates output on the hydrocarbon side. Crude output is expected to average 30,000 b/d less in 2017 as per Qatar's obligations under the terms of last November's OPEC production cut agreement. Continued growth in construction, services and transportation should contribute on the non-hydrocarbon side. The government's $200 billion public infrastructure program, which it is executing as part of its Vision 2030 diversification strategy and FIFA World Cup 2022 plan, will underpin growth in this sector, even while the government continues to keep a tight rein on current expenditures.

Of course, the recent diplomatic rift between Qatar and its neighbors, in which air, transport and even financial links have been severed or limited, does have the potential to significantly alter the equation and affect the outlook. Depending on how long the crisis lasts—two weeks and counting so far—the impact on the flow of goods and services, people and capital could be substantial, with negative repercussions for Qatari trade, tourism, labor and banking sector liquidity. These are all key components of Qatar's diversification strategy; limitations imposed on any one of these would cause headline growth to suffer. Inflation would almost certainly spike, as consumer goods and materials are rerouted, while the banking system, with its elevated share of foreign liabilities, could experience outflows and rising costs.

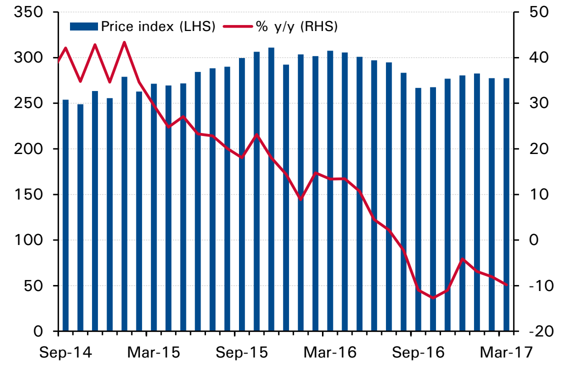
Headline inflation to ease in 2017 on moderating rental costs and as the impact of 2016's fuel/utility price hikes recedes

Inflation averaged 2.7% in 2016, increasing from 2015's headline figure of 1.8% due to price hikes which were associated with the removal of energy and utility subsidies. This also came despite a 2% decline in food prices that year. As of April 2017, inflation was 0.8% y/y, brought lower by declining rental prices (-1.3% y/y) and falling costs in the recreation and culture category (-2.6% y/y). (Chart 3.) Rent inflation, which feeds into the largest CPI contributor—the housing and utilities category—turned negative in February for the first time in 5 years. The supply of properties exceeds demand, and real estate prices, as measured by the real estate price index, were down almost 10% y/y in March. (Chart 4.) We expect inflation to ease to 1.5% in 2017 before rising to 3% next year on slowly rebounding international food prices and improving economic growth. Of course, were the diplomatic dispute to drag on for several months, with the supply of food and goods entering Qatar either affected or subjected to costlier reroutes, then the impact on consumer prices could be profound.

Fiscal restraint to continue this year but the deficit should narrow on higher oil and gas revenues

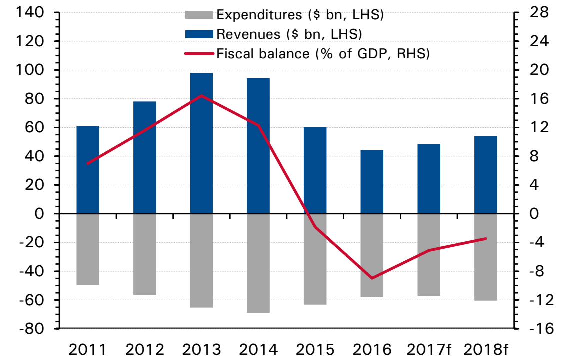
Qatar recorded its second consecutive fiscal deficit in 2016, at -9% of GDP. (Chart 5.) Lower oil and gas revenues as a result of the oil price downturn have significantly affected the government's finances. In response, the authorities embarked on fiscal consolidation, cutting current expenditures through freezes in public sector pay, reductions in expatriate employees and in the number of ministries. Fuel and utility subsidies were cut, and non-essential infrastructure scaled back, as in other GCC states. This year should see further fiscal restraint, but with spending targeted to a greater extent at infrastructure projects, many of which need to be completed in time for the FIFA World Cup in 2022. The deficit is expected to narrow to -5.1% of GDP in 2017 and to -3.5% of GDP in 2018, thanks largely to an expected improvement in energy prices.

Chart 4: Real estate price index



Source: Ministry of Justice (MOJ), Qatar Central Bank (QCB)

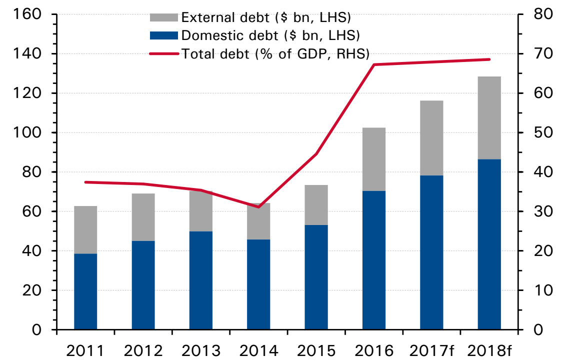
Chart 5: Fiscal balance



Source: QCB, NBK estimates

Chart 6: Central government debt (gross)

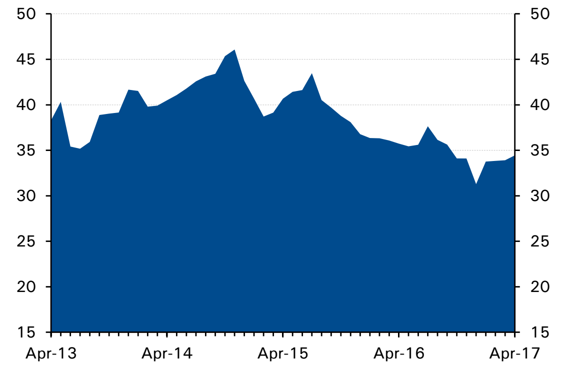
($ billion)



Source: QCB, NBK estimates

Chart 7: International reserves

($ billion)



Source: QCB, NBK estimates

The government has increasingly tapped the debt markets to finance the deficit, leading to a sharp rise in public debt

Qatar sold more than $17 billion in bonds and sukuk in 2016, $14.5 billion of which was raised from international investors. This included a $9.0 billion triple-tranche USD-denominated international bond last May. Consequently, central government debt (gross) increased significantly in 2016 to 67.2% of GDP from 44.6% in 2015. (Chart 6.) Recourse to the debt markets has helped Qatar's finances and injected much-needed liquidity into the banking system.

Increasing debt issuance has not stemmed the decline in the country's international reserves, however, which fell to $34.4 billion in April, a y/y decline of 3.6%. (Chart 7.) April's figure also represents a fall of $11.6 billion, or 25%, from the country's all-time high reserve level of $46 billion in November 2014. Import cover is still around 6.6 months, however, which is more than twice the 3 months recommended by the IMF for fixed exchange-rate regimes.

Increased government borrowing driving credit growth, but lending to the private sector remains soft

In 2016, total credit growth rebounded from the single digit lows of early 2015 to come in at a robust 12.1%, driven by public sector lending. By the end of April, credit growth was ranging around 9% y/y, with public and private sector lending growth at 15.9% y/y and 5.1% y/y, respectively. (Chart 8.) Private credit growth is below where it needs to be to get the private sector fully engaged in the country's development plan. Real estate lending is especially lackluster, while demand from industry, contractors and retail consumers remains soft.

Deposit growth rebounds in 1Q17 but increased foreign liabilities amid Qatar's diplomatic dispute prompts a ratings downgrade

Meanwhile, the banking system has witnessed double-digit deposit growth since last December as oil prices firmed over that period. Total deposits rose by 16.4% y/y by the end of April. (Chart 9.) Both public and private sector deposits have led the way, rising by 0.3% y/y and 12.1% y/y, respectively. Meanwhile, non-resident deposits, though still increasing at the rate of 56% y/y, are not doubling as they were last year.

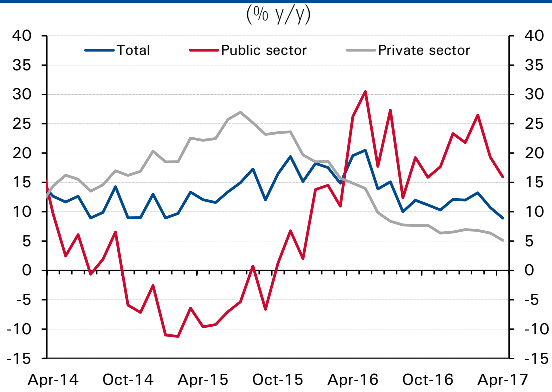
The improvement in liquidity is reflected in the banking sector's loan-to-deposit ratio (LDR), which has fallen since the start of the year as deposit growth has outpaced credit growth. As of April, it stood at 111.6%, having been as high as 119.9% in February 2016.

The decline in government deposits (-11.1%) last year and anemic private deposit growth (0.9%) hastened commercial banks reliance on foreign funds and led to an increase in overseas liabilities. Net foreign liabilities reached QR 182.5 billion ($50.1 billion) in April, up 28% y/y. (Chart 10.) Almost all of the liabilities are non-resident deposits, interbank funds and debt securities. They are also largely short-term in nature i.e. less than 12 months.

Most of the funds raised from overseas have been directed towards local lending, a significant portion of which is financing for the government's infrastructure projects, which tend to be long term. This large foreign currency mismatch plus the extent of the banking system's reliance on foreign funds—38% of total bank liabilities and 167% of foreign assets as

Chart 8: Credit growth

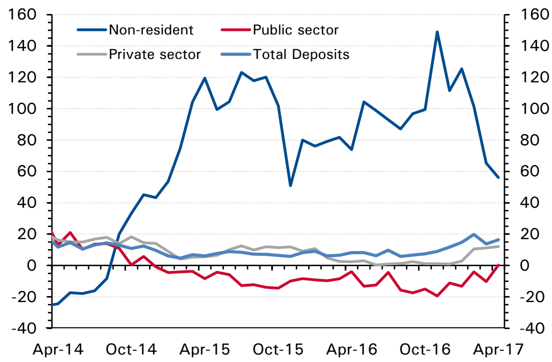
(% y/y)



Source: QCB

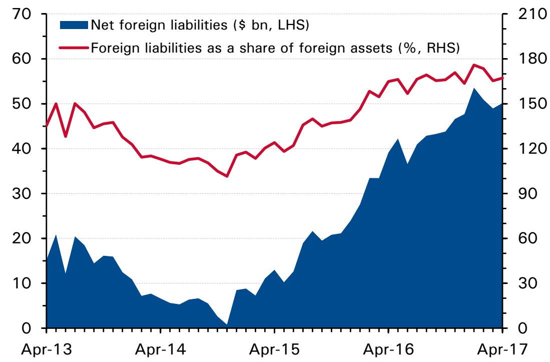
Chart 9: Deposit growth

(% y/y)



Source: QCB

Chart 10: Banks' net foreign liabilities



Source: QCB

Chart 11: Interbank rates

(%, 3-month rate)

Source: Thomson Reuters Datastream

of April—are part of the reason that Qatar found its long term sovereign rating lowered. S&P cut it by one notch to AA- recently, following the country's diplomatic isolation by Saudi Arabia and its other neighbors.

All its ratings (including the country's four largest banks) were placed on negative credit watch, a move that was also echoed by Fitch. The key concern is the potential for outflows of external funds should the crisis continue unresolved.

The UAE central bank, for example, is reportedly already preparing instructions for UAE entities to unwind their exposure to Qatar, while SAMA, the Saudi central bank, has told banks not to process Qatari riyal-denominated payments and to limit exposure to Qatar.

And while Qatari banks' exposure to GCC-sourced funds is no more than 8% of total foreign liabilities (QR 75 billion or $26 billion), the potential for non-GCC funds to depart in the event of a crisis escalation is acute; foreign entities may decide that exposure to Qatar is just not worth the risk. Recognizing this, Qatari banks are reportedly raising their deposit rates in response by as much as 100 bps over LIBOR. This compares with an average differential of 20 bps before the crisis.

Markets moved immediately to re-price Qatari risk, with borrowing costs up, spreads widening and equities falling.

The impact on the markets has been pronounced, with strong re-pricing of Qatari risk: borrowing costs have already spiked, with interbank rates rising 29 bps to 2.21% over the last week; CDS spreads have widened from 58 bps before the crisis to 92.5 bps as of 12 June; yields on Qatari bonds (2021) are up 35 bps; and the QE index, the main equities index, is down 7% ytd at 9,135, having been in positive territory in early June. (Charts 11-13.)

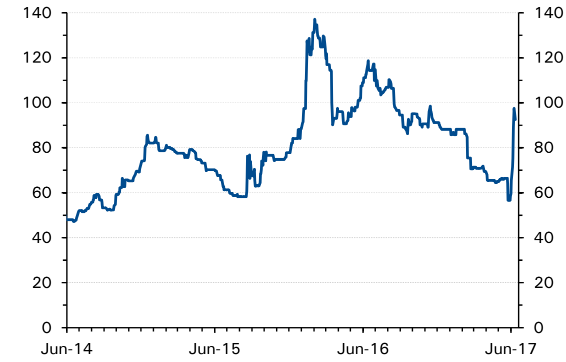
The riyal is also under pressure in the forwards market, with speculation increasing that a total financial boycott by Qatar's neighbors would lead to financial outflows and tighter credit conditions and force the Qataris to abandon the US dollar peg. (Chart 14.) We view this as highly unlikely, however. The authorities are steadfast in their commitment to the peg with more than enough resources to defend it.

The authorities, with $335 billion in sovereign wealth fund assets with the Qatar Investment Authority (QIA), as well as $34 billion in central bank international reserves, would have ample financial resources to weather a financial dislocation of this sort (asset coverage of Qatari banks' GCC exposure would stand at 14 times).

Furthermore, the political and economic costs of a de-peg would dwarf any potential benefit to Qatar.

Chart 12: 5-yr CDS

(bps)



Source: Thomson Reuters Datastream

Chart 13: Qatar Exchange (QE)

(index)

Source: Thomson Reuters Datastream

Chart 14: 12-month forward exchange rate

(QR:USD)

Source: Thomson Reuters Datastream

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