QNB

India Economic Insight
2017

Contents

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Editorial closing: November 30, 2016

Executive Summary

Recent Developments

- **Real GDP growth has slowed** from 7.6% in 2015/16 to 7.3% in the first half of 2016/17, mainly owing to a contraction in investment on lower government capital spending and weaker private investment

- **Inflation has trended down** from 9.4% in 2013/14 to 3.4% year-on-year in December 2016 due to slower food price inflation and lower oil prices

- **The current account deficit narrowed** from 1.1% of GDP in 2015/16 to 0.3% of GDP in H1 2016/17, mainly due to low oil prices as India is a net importer of crude oil

- **The general budget deficit narrowed** from 6.9% of GDP in 2015/16 to an expected 6.7% in 2016/17 thanks to revenue growth from higher excise duties on fuel products and hikes in services tax rates

- **Banking sector growth has slowed** as state banks have struggled with rising nonperforming loans

- **The Indian government has embarked on a remarkable demonetisation experiment** by removing 86% of cash from circulation—economic activity was disrupted, but should rebound

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Macroeconomic Outlook (2017-20)

- **Growth should pick up** from 6.9% in 2016/17 to 7.4% in 2017/18 as spending rebounds from the shock of demonetisation; in 2018/19 to 2019/20 growth would fade slightly on fiscal consolidation

- **Successful implementation of important reforms should support investment growth**—for example higher public capital spending and a new harmonised goods and services tax

- **Inflation is expected to pick up** to average 5.2% in 2017/18 on rising food and energy prices and should then stabilise at 5.0% in 2018/19 to 2019/20

- **The current account deficit should widen gradually** from 0.7% of GDP in 2016/17 to 1.2% in 2019/20 as global oil prices rise; the capital account surplus should stabilise at 2% of GDP as high growth prospects attract FDI offsetting possible portfolio outflows

- **Fiscal consolidation is set to continue** with the deficit narrowing from 6.7% of GDP in 2016/17 to 5.8% by 2019/20 due to current spending restraint, especially on wages and subsidies, income disclosure schemes and the goods and services tax

- **Credit growth should rise** from 6.5% in 2016/17 to 8.8% in 2017/18 as the demonetisation shock fades and as banks are recapitalised and should then stabilise at around 9% in 2018/19 to 2019/20

Background

The liberalisation of the Indian economy in 1991 improved economic performance in the subsequent two decades

India's economic reforms in 1991 led to a significant improvement in its economic performance. The reforms came in the middle of an acute balance of payments crisis which left India with reserves barely sufficient to fund oil imports for two weeks. In response, the government devalued the currency, reduced regulation, dismantled bureaucratic control over licensing, opened up the economy to foreign investments and cut trade tariffs. The results were startling. India's annual real GDP growth rose from an average of 4.1% in the four decades prior to 1991 to 6.8% in the subsequent two decades. This made India one of the growth engines for the global economy. Income per capita increased more than fivefold to USD6.7k today on a purchasing power parity (PPP) basis. The share of people living below poverty (defined as USD1.9 per day on a PPP basis) was halved from 45.9% in 1993 to 21.2% in 2011. Life expectancy increased from 58 years in 1990 to 68 in 2013.

As the impact of the 1991 liberalisation dissipated, the need for a new round of reforms became apparent

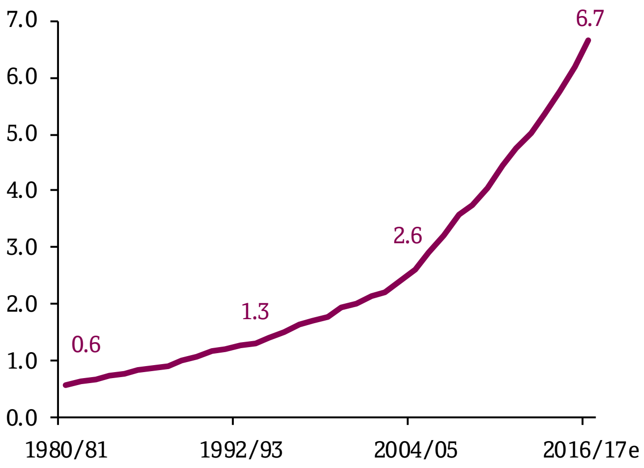
Two decades after 1991, the Indian economy was crippled by supply bottlenecks in the form of weak transport infrastructure and power shortages. India's ranking in the World Bank's Ease of Doing Business Index deteriorated from 120 out of 189 in 2007 to 140 in 2013, lagging behind Sri Lanka, Nepal, Bhutan and Pakistan. The persistent inflation problem, a result of supply bottlenecks, was further exacerbated by government policies aimed at increasing rural wages and easy monetary policy. India lost competitiveness and the current account balance deteriorated from a surplus of 2.3% of GDP in 2003 to a deficit of 4.8% in 2012. The weaknesses were exposed in the taper tantrum of 2013, when the tapering of US quantitative easing led to capital flight from emerging markets (EMs). India was among the worst-hit countries and was in need of a new wave of reforms to address its vulnerabilities and reinvigorate growth.

Prime Minister Modi and the Reserve Bank of India (RBI) have kick-started a new wave of reforms

Since being elected in 2014, the Modi government has implemented an array of reforms. Restrictions on foreign investment have been lifted, ease of doing business has improved, a bankruptcy law was enacted to expedite insolvency resolution and a constitutional amendment was passed to allow for the implementation of the Goods and Services Tax (GST). The RBI has also pushed through reforms, adopting a coherent monetary policy framework based on inflation targeting and introducing measures to help banks more easily restructure stressed assets. The reform drive has made India one of the rare bright spots among EMs and boosted its 2016 rankings in ease of doing business (World Bank) and global competitiveness (World Economic Forum). But further reforms are needed to address labour market inflexibility, land acquisition laws which inhibit investment and impaired banking assets.

Nominal GDP Per Capita

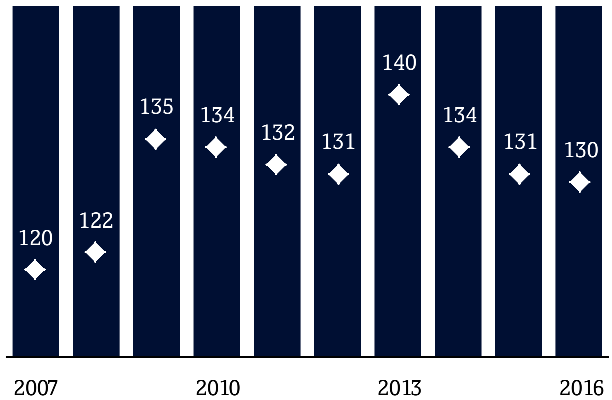
(k USD Purchasing Power Parity)



Sources: International Monetary Fund (IMF), Haver Analytics and QNB Economics

Ease of Doing Business Ranking

(1: most business-friendly, 189: least business-friendly)



Sources: World Bank, Haver Analytics and QNB Economics

Key Reforms

Reform	*Impact*	*Date*
Central Government		
Energy Subsidy Cuts	Narrower fiscal deficit	Oct 2014
Easing Foreign Direct Investment	Narrower fiscal deficit; Higher GDP	Mar 2015, Jun 2016
Goods & Services Tax Amendment*	Narrower fiscal deficit; Higher GDP	Sep 2016
Bankruptcy Law	Improved banking system; Higher GDP	May 2016
Central Bank		
Inflation targeting	Low and stable inflation	Feb 2015
Increased banking competition	Higher GDP	Jun 2015
Debt Restructuring	Improved banking system; Higher GDP	Jun 2016

Source: QNB Economics

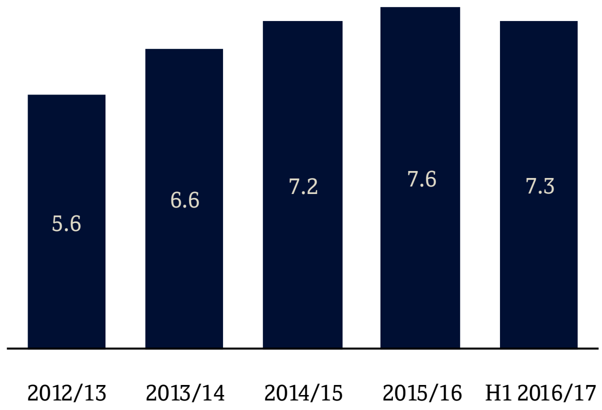
* Implementation of the GST is expected in mid-to-late 2017

Recent Developments (2015-16)

Growth has slowed owing to a contraction in investment

India's real GDP growth rose steadily from 5.6% in 2012/13 to 7.6% in 2015/16. Private consumption was the largest contributor to growth, benefiting services sectors and manufacturing. Investment also contributed significantly. However, in the first half of 2016/17, year on year growth slowed to 7.3%, mainly on a 5.7% contraction in investment and slightly weaker private consumption. The investment slowdown was a result of the government cutting back on capital expenditure to meet fiscal deficit targets, while private investment also remained weak due to stress in the banking system as well as a lack of regulatory approvals, such as land acquisition and environmental clearances. A number of factors offset weaker investment, including stronger government consumption on the back of higher current expenditure, a recovery in exports, mainly due to robust demand for Indian services, and weaker imports, related to the slowdown in investment.

Real GDP Growth
(%, year on year)

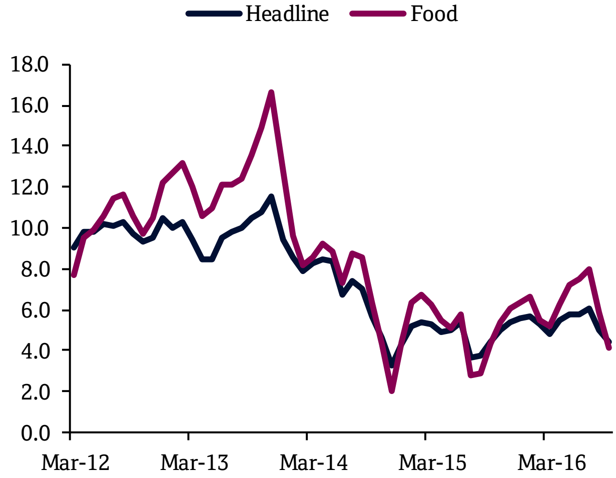


Sources: Central Statistical Office (CSO), IMF, Haver Analytics and QNB Economics

Inflation has trended down primarily on lower commodity prices

Inflation has trended down over the last few years, falling from 9.4% in 2013/14 to 3.4% in December 2016 within the Reserve Bank of India's (RBI) inflation target (4% +/-2%). Lower inflation has been mainly owing to lower commodity prices. First, food inflation has fallen steadily, driving down the headline given the 45.9% weight of food in the CPI basket. This in turn has been driven by a number of factors including the release of surplus grain buffers and good monsoon rains starting June 2016 following two consecutive years of drought. Second, low global oil prices have helped bring down inflation. Although falling commodity prices have played an important role in reducing inflation, the decline was more broad-based. Core inflation, which excludes food and energy, has fallen from 8.2% in 2013/14 to 4.9% in December 2016.

CPI Inflation
(%, year on year)

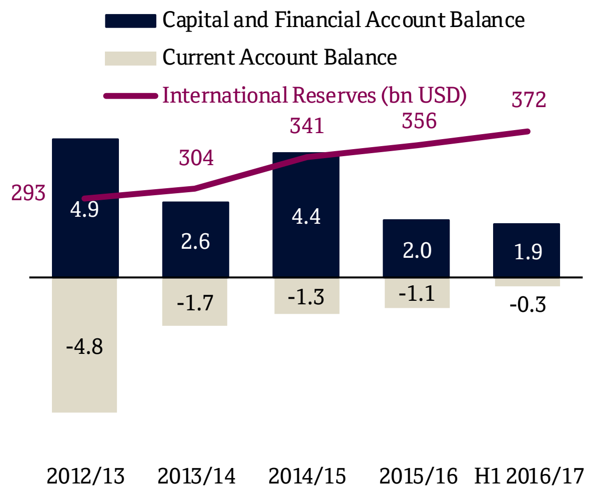


Sources: Ministry of Statistic & Programme Implementation (MOSPI), Haver Analytics and QNB Economics

External balances improved in H1 2016/17

The current account deficit narrowed to 0.3% in H1 2016/17 from 1.1% of GDP in 2015/16 mainly due to low oil prices and India's position as a net crude oil importer as well as on reduced gold imports as headline inflation has trended downward. At the same time, the capital and financial account surplus narrowed slightly to 1.9% of GDP in H1 2016/17 from 2.0% in 2015/16, as lower investment spending caused corporates to raise fewer funds in overseas borrowing. In absolute terms however, this was outweighed by net foreign direct investment (FDI), which at USD21.3bn (2.0% of GDP), stood as the country's most favourable H1 recording ever. Other than strong economic growth, FDI has been helped by eased restrictions on foreign ownership across several major sectors. Portfolio inflows were also strong, supported by delays in US interest rate hikes. With a widened balance of payments surplus, international reserves rose to USD372bn (8.4 months of import cover) at the end of H1 2016/17 from 8.1 months at end 2015/16.

Balance of Payments
(% of GDP)



Sources: CSO, RBI, Haver Analytics and QNB Economics

The budget deficit narrowed, but remains elevated

The general government deficit narrowed to 6.7% of GDP in 2016/17 from 6.9% in 2015/16, primarily due to higher revenue, which rose as a result of higher excise duties, mainly on fuel products, and continued hikes in services tax rates. In addition, the government launched successful schemes that permit the disclosure of previously undeclared income at various tax and penalty rates during the year. Expenditure rose slightly from 28.0% of GDP to 28.1%. Current expenditure grew 16% in April to November 2016 compared with the same period in 2015 driven by wage increases in the 7th pay commission as well as increases in other rural and social spending, such as healthcare and education. However, this was partially offset by a 10% drop in capital expenditure as public investment was cut to keep fiscal consolidation on track. Public debt as a share of GDP fell to an expected 68.5% in 2016/17 from 69.1% in 2015/16 owing to high nominal GDP growth of around 10.7%.

Banking sector growth has slowed as state banks have struggled with bad assets

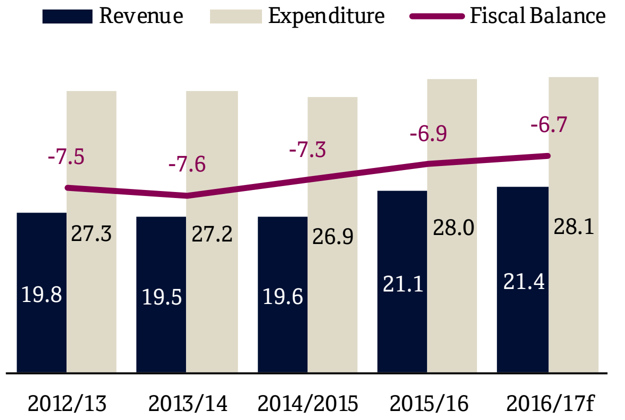
The banking sector in India slowed in 2015/16, and despite a pick-up in the twelve months to September 2016, growth remained subdued and below historical norms. Both asset and credit growth have slowed due to poor asset quality of state banks (which hold around 70% of total banking assets), hurting their capital position and making them averse to extending loans. Weak credit growth has hit deposit growth as banks have become less aggressive in chasing funding. Non-performing assets rose to 9.1% in September 2016, up from 7.8% in March. If restructured loans are also included, then the overall share of stressed assets stood at 12.3% in September 2016. This has impacted profitability, with return on equity merely reaching 5.0% in September 2016. To address the problems of bad assets, slow insolvency resolution and low recovery rate of debt, India passed a bankruptcy law in May 2016. In addition, the government announced plans to inject capital into state banks, although the amount earmarked (USD10.4bn through March 2019) may well fall short of capital

The Indian government embarked on one of the most remarkable monetary experiments ever: demonetisation

On 8 November 2016, the prime minister unexpectedly announced a ban on using the highest denominated 500 and 1000 rupee notes. Holders of these notes had until the end of 2016 to replace them with deposits at banks. The amount of deposits allowed to be withdrawn in the form of cash was restricted as the central bank faced logistical constraints in replacing old notes with new ones. Three reasons were behind the government's decision to take such an extraordinary measure. First, the government aimed to reduce reliance on cash in transactions as India stands out as one of the most cash-dependent large economies. Second, the government wanted to eliminate the black market, which is heavily cash-based. This would boost its revenue by increasing the tax base and reducing tax evasion. Third, the government wanted to tackle the counterfeiting of Indian notes. The government's demonetisation policy led to an immediate removal of 86% of cash from circulation.

Fiscal Balance*

(% of GDP)

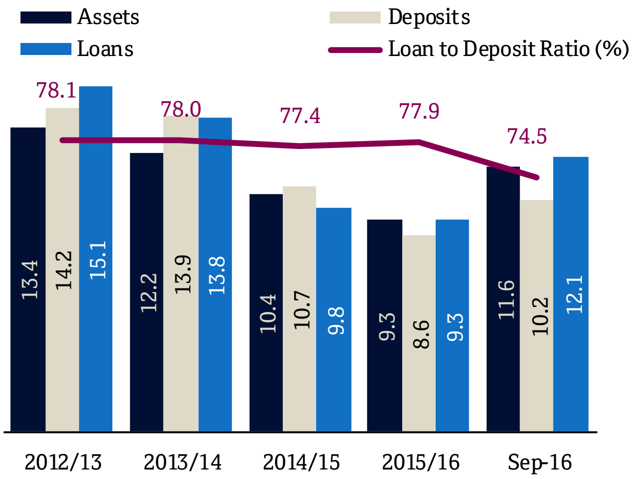


Sources: IMF, Ministry of Finance, Haver Analytics and QNB Economics

* General government including central and state budgets

Banking Sector Growth

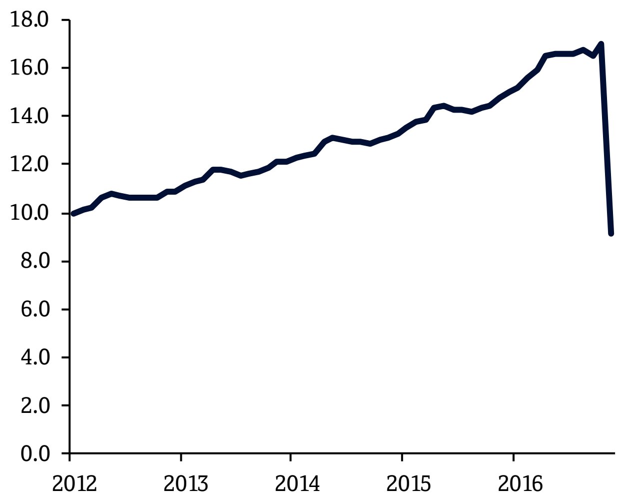
(%, year on year)



Sources: RBI, Haver Analytics and QNB Economics

Indian currency with the public

(tn rupees)



Sources: RBI, Haver Analytics and QNB Economics

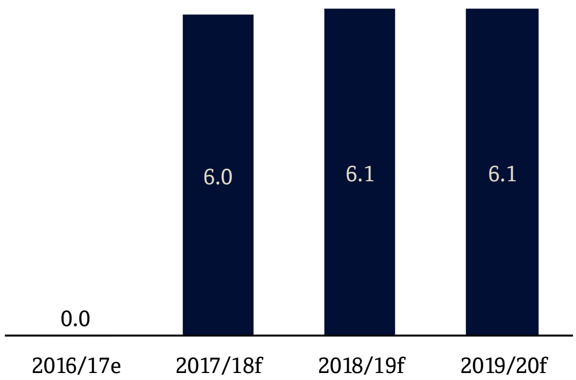
Macroeconomic Outlook (2017-20)

Reforms should support investment growth

Successful implementation of important reforms, namely higher public capital spending and the GST in 2017, are expected to lift investment. The key hurdles to GST implementation were overcome in 2016 with the passage of a constitutional amendment and approval from 50% of India's state legislatures. The GST will increase the tax base and boost internal trade, raising India's long-term economic potential and attracting higher capital inflows. However, a number of other reforms remain bogged down by political opposition. Progress has been elusive on the creation of public asset reconstruction agency aimed at cleaning up banks' balance sheets and boosting lending; lifting foreign ownership limits in certain sectors; enacting labour laws to make it easier for firms to hire and fire; and passing a land acquisition law. Overall, we expect public and foreign investment to revive investment growth to 6.1% per year from 2017/18 to 2019/20.

Real Investment Growth

(% year on year)



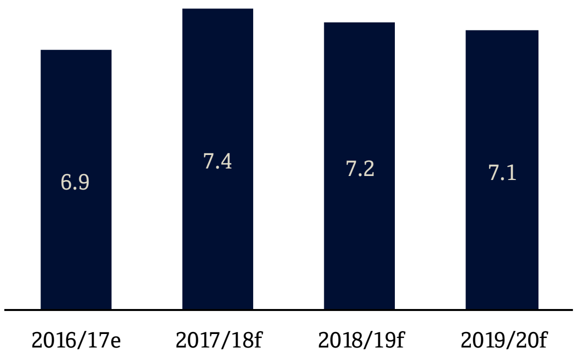
Sources: CSO, IMF, Haver Analytics and QNB Economics forecasts

Growth should pick up as spending rebounds from the shock of demonetisation, but then fade on fiscal consolidation

We expect that demonetisation lowered real GDP growth from 7.6% in 2015/16 to 6.9% in 2016/17 as cash shortages delayed purchases. In 2017/18, growth should recover to 7.4% as the cash shortage is alleviated and spending bounces back. Additionally, the introduction of GST will improve internal trade and attract FDI, supporting growth. Although the government is carrying out fiscal consolidation, the growth impact in 2017/18 will be offset by a shift towards higher quality capital spending and more progressive taxes that reduce the burden on lower income earners who tend to have a higher propensity to consume. Higher prices of oil and other commodities will hold back growth. In 2018/19 to 2019/20, we expect growth to fade slightly to 7.2% and 7.1% respectively as fiscal consolidation is likely to re-emerge as a drag although this will be partly offset by a continued boost from the GST.

Real GDP Growth

(% year on year)



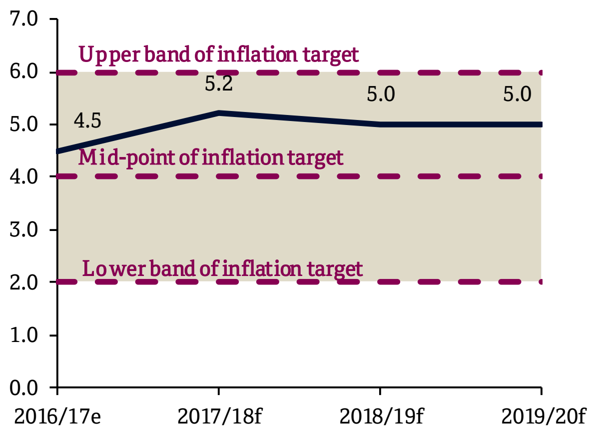
Sources: CSO, IMF, Haver Analytics and QNB Economics forecasts

Higher oil prices should drive inflation higher

We expect headline inflation to reverse its recent downward trend and accelerate to 5.2% in 2017/18. This is due to the projected normalisation of food prices following an exceptionally good monsoon season in 2016/17, as well as rising global energy prices. At the same time, we do not expect the impact of demonetisation to spill over into 2017/18 as the RBI is set to replace all old currency notes by April 2017. Despite the higher inflation forecast, inflation should remain within the RBI's inflation target of 4 +/- 2%. The RBI changed its policy stance in February 2017, from accommodative to neutral, potentially with an eye out to rising inflation. In 2018/19, we expect inflation to fall to 5.0% as food inflation slows and as oil prices, whilst still forecast to rise, do so at a slower pace. Beyond this, we forecast inflation to stabilise at 5.0% in 2019/20.

Inflation

(%)



Sources: MOSPI, RBI, Haver Analytics and QNB Economics forecasts

The current account deficit should begin to widen as global oil prices rise

Higher oil prices should see the current account deficit widen in the second half of the fiscal year. Overall, we expect a 2016/17 current account deficit of 0.7% of GDP. Higher oil prices will continue to dominate the outlook on the current account over the forecast period, with the impact only slightly softened by India's ongoing fiscal consolidation which will reduce demand for imports. We expect the capital and financial account to stabilise at 2% of GDP. India's long-term growth prospects and ongoing investment reforms should continue to attract FDI flows. Offsetting this to some extent are higher US interest rates which increase the risk of portfolio outflows, although it appears that India is less vulnerable to outflows relative to other EMs on the back of its low external debt, small current account deficit and still strong headline growth. Overall, we expect the balance of payments to remain in surplus and a further accumulation of foreign reserves.

Fiscal consolidation is set to continue

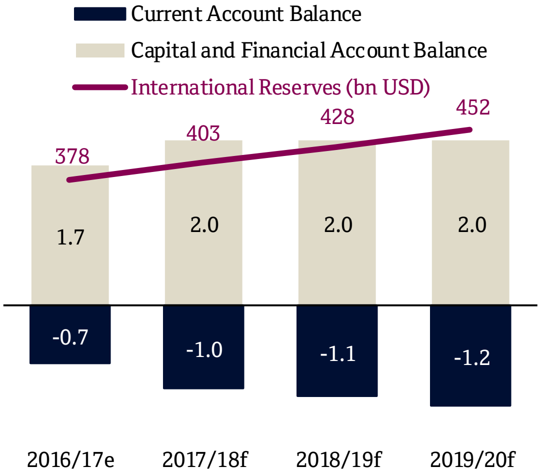
We expect the fiscal deficit to narrow from 6.7% of GDP in 2016/17 to 5.8% by 2019/20. In February, the central government budget for 2017/18 targeted a deficit of 3.2% of GDP compared with 3.5% in 2016/17. However, state budgets should partly offset this consolidation as the states have already met their deficit targets and due to higher transfers from central government, which allows them to raise spending. As a result, the general government deficit will narrow slightly to 6.6% of GDP. In 2018/19-2019/20 fiscal consolidation is set to continue with the aim of eventually reducing public debt to 60% of GDP from 68.5% currently. Ambitious privatisation targets should help reduce debt. Consolidation will be achieved through current spending restraint, especially on wages and subsidies, income disclosure schemes and GST. Although GST will keep the average tax rate unchanged, it is expected to lead to higher inter-state trade, increasing the tax base and raising overall government revenue.

Credit should rise as confidence improves with the demonetisation shock fading and bank recapitalisation

We forecast credit growth to rise to 8.8% in 2017/18 from 6.5% in 2016/17 as the demonetisation shock fades and as an injection of over USD8bn improves public banks capitalisation (80% of the government's recapitalisation programme). Credit will also be aided by higher nominal GDP growth and past measures to aid debt resolution (bankruptcy law, debt restructuring). In 2018/19, slower nominal GDP growth is expected to keep credit growth flat offsetting additional bank recapitalisation (USD1.9bn). Credit growth should rise slightly in 2019/20 as nominal GDP picks up. In terms of deposits, growth should slow in 2017/18 as withdrawal limits on banks' deposits are relaxed. Thereafter, deposit growth should be stable as improvements in the credit cycle are offset by slower nominal GDP growth. We expect the loan-to-deposit ratio to fall to 73.9% by 2019/20. NPLs should decline in the medium term as banks clean up their balance sheets, helping to improve profitability.

Balance of payments

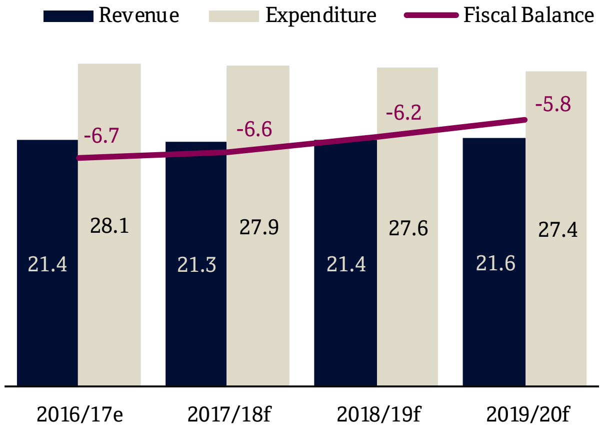
(% of GDP)



Sources: CSO, RBI, Haver Analytics and QNB Economics forecasts

Fiscal Balance*

(% of GDP)

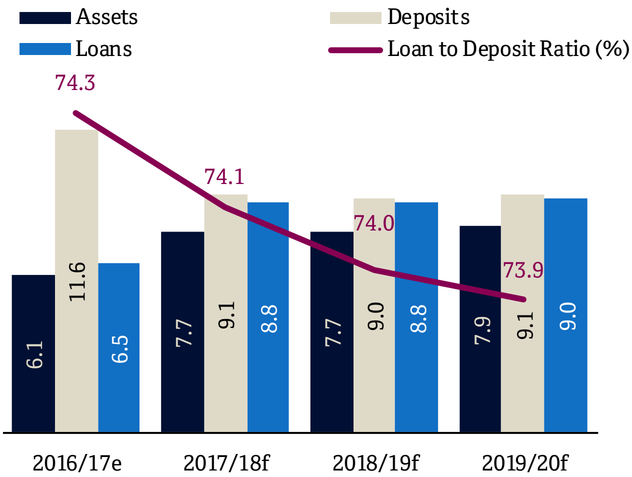


Sources: IMF, Ministry of Finance, Haver Analytics and QNB Economics forecasts

* General government including central and state budgets

Banking Sector Growth

(% year on year; unless otherwise mentioned)



Sources: RBI, Haver Analytics and QNB Economics forecasts

Key Macroeconomic Indicators

	2012/13	2013/14	2014/15	2015/16	2016/17e	2017/18f	2018/19f	2019/20
Real sector indicators								
Real GDP growth (%)	5.6	6.6	7.2	7.6	6.9	7.4	7.2	7.1
Nominal GDP (bn USD)	1,829.0	1,863.2	2,042.4	2,073.7	2,251.9	2,485.1	2,748.1	3,038.2
Growth (%)	0.3	1.9	9.6	1.5	8.6	10.4	10.6	10.6
GDP per capita (k USD, PPP)	5.0	5.4	5.8	6.2	6.7	7.2	7.9	8.6
Consumer price inflation (%)	9.9	9.4	5.9	4.9	4.5	5.2	5.0	5.0
Budget balance (% of GDP)	-7.5	-7.6	-7.3	-6.9	-6.7	-6.6	-6.2	-5.8
Revenue	19.8	19.5	19.6	21.1	21.4	21.3	21.4	21.6
Expenditure	27.3	27.2	26.9	28.0	28.1	27.9	27.6	27.4
Public debt	69.1	68.0	68.3	69.1	68.5	66.9	66.1	66.1
External sector (% of GDP)								
Current account balance	-4.8	-1.7	-1.3	-1.1	-0.7	-1.0	-1.1	-1.2
Goods and services balance	-7.1	-4.0	-3.3	-3.3	-3.1	-3.2	-3.0	-2.9
Exports	24.7	25.2	23.2	22.9	21.2	22.2	21.1	19.8
Imports	-31.9	-29.2	-26.6	-26.2	-24.3	-25.4	-24.2	-22.7
Income balance	-1.2	-1.2	-1.2	-0.8	-0.5	-0.4	-0.4	-0.5
Transfers balance	3.5	3.5	3.2	3.0	2.8	2.6	2.4	2.2
Capital and Financial account balance	4.9	2.6	4.4	2.0	1.7	2.0	2.0	2.0
International reserves (months of import cover)	6.4	6.7	7.5	7.8	7.2	7.3	7.4	7.6
External debt	22.4	23.9	23.3	23.4	24.2	23.5	22.9	22.3
Monetary indicators								
M3 growth	13.8	13.6	11.0	10.0	12.4	12.3	12.3	0.0
Policy Rate (%)	7.5	8.0	7.5	6.8	n.a.	n.a.	n.a.	n.a.
Exchange rate USD:INR (av)	54.4	60.5	61.1	65.5	67.2	68.5	69.5	70.5
Banking indicators (%)								
Return on equity	13.8	10.8	9.6	6.3	n.a.	n.a.	n.a.	n.a.
NPL ratio	3.2	3.8	4.2	7.4	7.6	n.a.	n.a.	n.a.
Capital adequacy ratio	13.9	12.9	12.8	12.7	n.a.	n.a.	n.a.	n.a.
Asset growth	13.4	12.2	10.4	9.3	6.1	7.7	7.7	7.9
Deposit growth	14.2	13.9	10.7	8.6	11.6	9.1	9.0	9.1
Credit growth	15.1	13.8	9.8	9.3	6.5	8.8	8.8	9.0
Loan to deposit ratio	78.1	78.0	77.4	77.9	74.3	74.1	74.0	73.9
Memorandum items								
Population (m)	1235.0	1251.0	1267.0	1283.0	1298.4	1313.8	1329.6	1345.5
Population Growth (%)	1.2	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Average Brent Crude (USD/b)	110.2	107.6	85.5	47.3	47.6	55.7	58.4	60.0

Sources: CSO, Ministry of Finance, MOSPI, RBI, Bloomberg, IMF, Haver Analytics and QNB Economics forecasts

QNB Group Publications

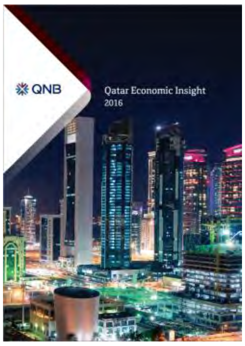
Recent Economic Insight Reports

Indonesia 2016

Vietnam 2016

India 2016

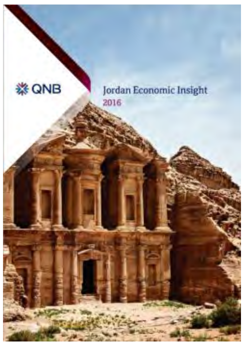
China 2016



Qatar - Sep 2016

Kuwait 2016

Qatar - Jun 2016



Jordan 2016

Oman 2013

UAE 2013

Qatar Reports

Qatar Monthly Monitor

Recent Economic Commentaries

China growth targets imply more debt-fuelled fiscal stimulus
Fed more likely to use rates than balance sheet to tighten policy
Oil after OPEC — range-bound at USD55-60
China chooses yuan stability over growth to stem outflows
India's fiscal consolidation to have minimal impact on growth
Trump and Trade
IMF tinkers with forecasts but is still too optimistic
Capital flows to EMs improved in 2016, but prospects are subdued
Qatar's GDP to recover in 2017-18
India's growth to dip on demonetisation
Qatar's fiscal deficit set to decline in 2017
The US economy in 2017 – 2 percent growth and 2 rate hikes
Could the divergence in global growth continue?
What to expect in 2017: five key themes
Oil price forecasts up on OPEC agreement, but implementation key
As Euro Area tailwinds fade, fiscal policy is left to support growth
Reforms should raise investment and growth in Indonesia
Economic implications of Trump's win
What is behind the global productivity slowdown?
Reforms should lift Indonesia's investment and growth

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** Dormant*

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