Indonesia Economic Insight
2015

Contents

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Editorial closing: September 30, 2015

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Executive Summary

Recent Developments

- Concerns about growth and tighter US monetary policy led to **capital outflows and a weaker exchange rate in 2013-15**

- **Real GDP growth has slowed progressively** from 6.4% in 2010 to an average of 4.7% in the first half of 2015, reflecting a broad-based slowdown of consumption, investment and exports

- **Inflation rose in 2015** to 7.5% as cuts to fuel subsidies and import tariffs pushed up prices

- **The current account deficit narrowed from 3.0% of GDP in 2014 to 1.8% of GDP in the first half of 2015**, mainly as imports have fallen from 23% of GDP in 2014 to 18% of GDP in the first half of 2015

- **Expenditure fell after fuel subsidy cuts, but the deficit has still widened** to 2.2% of GDP due to weak revenue

- **Infrastructure investment has picked up** due to rising government disbursements and reforms

- **Bank loan growth has been squeezed by the slowing economy**, but deposit growth has been stable and the sector remains highly profitable

Macroeconomic Outlook (2015-17)

- **Real GDP growth is expected to be held back by tight financial conditions related to capital flight and weakening external demand**, particularly from China; growth should recover from 4.5% in 2015 to 5.0% in 2016 on infrastructure investment, and then to 5.5% in 2017 as financial conditions begin to ease

- **We expect the fiscal deficit to widen slightly** to 2.3% of GDP by 2017, mainly because of rising public investment

- **We expect the current account deficit to widen** as the infrastructure investment programme gets underway, which should lead to higher imports of capital goods

- **Inflation will remain high at as the currency weakens, but should ease** to 5.8% in 2016 and 4.8% in 2017 as the impact of fuel subsidy cuts and import tariffs dissipates

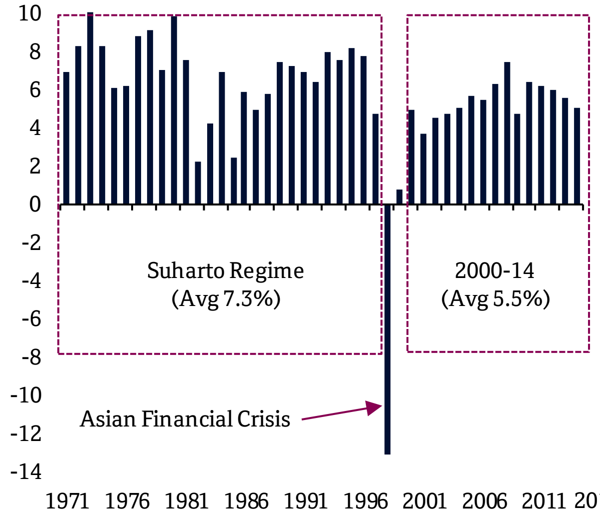
- **Deposit growth is expected to slow** in 2016-17, with falling inflation and lower nominal GDP growth; **loan growth could be constrained in 2015-16 due tight financial conditions but should recover by 2017**

Background

Since 1971, the Indonesian economy has been transformed from agrarian to a global force

Indonesia has maintained consistently high real GDP growth since 1971, only interrupted by the Asian Financial Crisis in 1997–98. In the process, the economy has been transformed from mainly agrarian to one of the fastest growing emerging markets (EMs) through industrialisation. During the Suharto regime (1967–98), rising oil prices created windfall export revenue, which attracted large foreign direct investment. However, strong growth during that period masked structural weaknesses, such as rising public debt, protectionism, and current account deficits. This left Indonesia exposed to the 1997–98 Asian Financial Crisis as large capital outflows led to a depreciation of the Indonesian rupiah (IDR) and high inflation. As a result, real GDP fell 13.1% in 1998 and only rose by 0.8% in 1999. Since then, the economy has grown robustly at an average of 5.5%.

Real GDP Growth
(%)

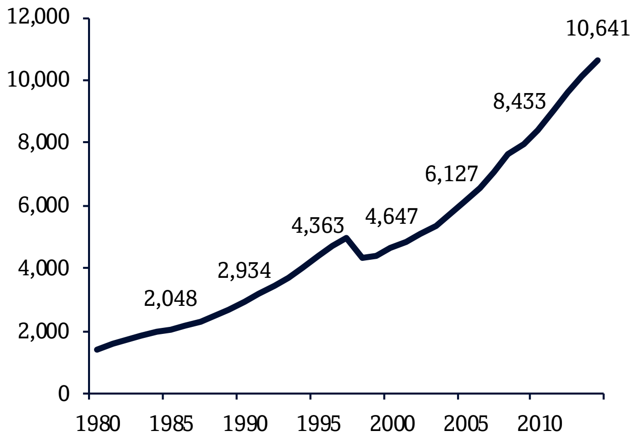


Sources: International Monetary Fund (IMF) and QNB Economics

Rising wealth and a young population are driving the rapid emergence of a large middle class

With over 250m people, Indonesia is the world's fourth most populous country with the largest Muslim population. Its total population is expanding by 3.5m people every year (1.4% annual growth). The population is youthful (~37% under 20), which should drive labour force growth and provide a demographic dividend into the 2020s. Economic development has led to steadily–rising affluence. GDP per capita has grown by an average 6.2% since 1980, with a rapidly–growing middle class, and reached USD10.6k in 2014 on a purchasing power parity basis (PPP). With nominal GDP of USD889bn, Indonesia was the 17th largest economy globally up from 28th in 2000.

GDP per Capita
(USD on a PPP basis)

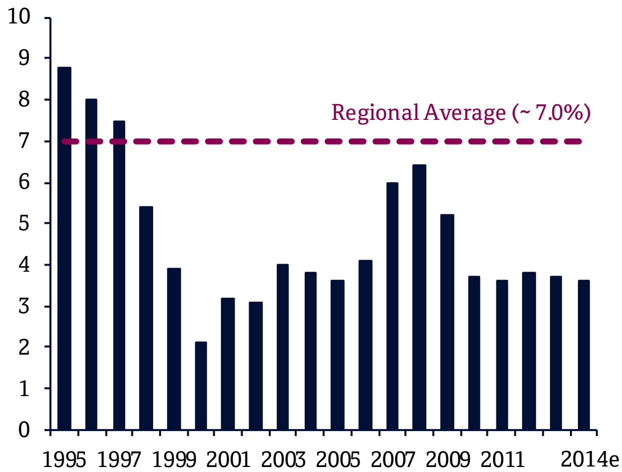


Sources: IMF and QNB Economics

Underinvestment has led to a crippling infrastructure gap, which the new government hopes to close

Indonesia is an archipelago of ~18,000 islands, making it hugely challenging to maintain the infrastructure for a rapidly expanding economy. Government investment faded after the Asian Financial Crisis, and Indonesia's infrastructure has fallen into a dilapidated state, failing to keep up with the demands of the growing population. Underinvestment and geography have created significant logistical challenges: it is 4–5 times more expensive to ship a container from Jakarta to West Sumatra than to Singapore; cement is ten times more expensive in Papua than Jakarta. Poor infrastructure creates crippling supply bottlenecks: heavy road traffic, congested transport networks and widespread power and water shortages. As a result, growth is sub-par and inflation and interest rates are high. However, Jokowi, the new president elected in October 2014, hopes to turn the situation around by revitalising investment in infrastructure.

Infrastructure Investment
(% GDP)



Sources: World Bank (WB) and QNB Economics estimates
*Regional average comprises China, Thailand and Vietnam

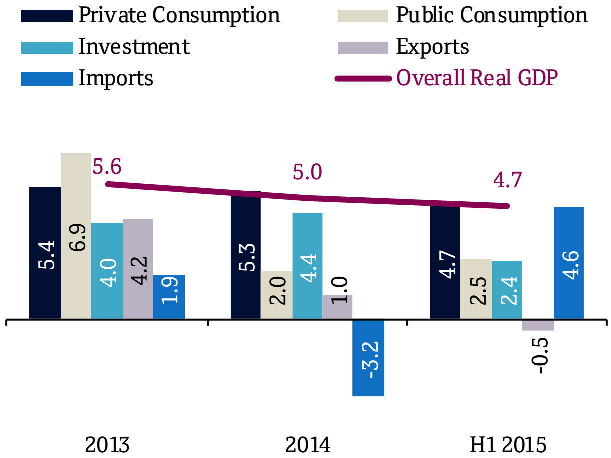
Recent Developments

The economy is undergoing a broad-based slowdown

Real GDP growth slowed from 6.4% in 2010 to 4.7% in H1 2015 as per our last forecast ([Indonesia Economic Insight 2014]). Financial conditions tightened and under-investment led to supply bottlenecks. Delays to public infrastructure plans slowed investment growth from 4.4% in 2014 to 2.4% in H1 2015. Delays to passing the revised budget and lower expenditure have dragged on public consumption. Export growth has slowed due to government export restrictions (see below) and weak external demand, particularly from China as its economy slows (a 1% slowdown in China leads to ~0.6% slower growth in Indonesia). Growth was supported by lower imports (which adds to GDP) as weaker IDR depressed domestic demand. Weak activity slowed private consumption growth (55% of real GDP) from 5.3% in 2014 to 4.7% in H1 2015.

Real GDP

(% change, year-on-year)

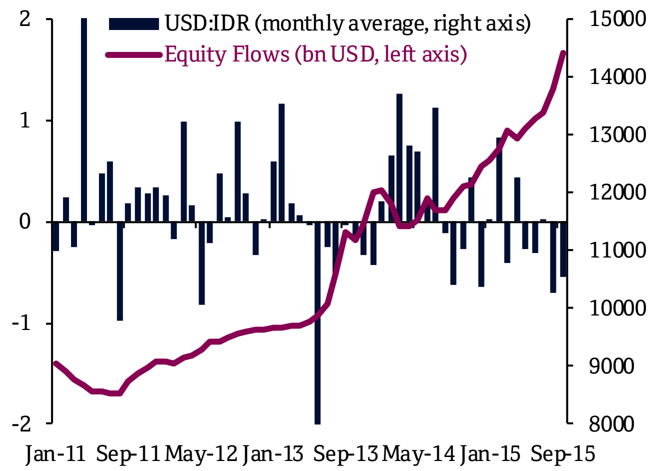


Sources: BI and QNB Economics

Concerns about both growth and tighter US monetary policy led to capital outflows and a weaker IDR

Indonesia has faced repeated bouts of capital outflows since 2013 as a number of developments concerned investors. First, slowing growth (see above). Second, the shift from a current account surplus to a persistent deficit due to weak external demand and lower prices for key commodities. Third, tighter monetary policy in the US following the announcement of potential QE tapering in May 2013. Capital outflows persisted in 2014-15 on weaker commodity prices and rising expectations for the Fed to start hiking interest rates. As a result, the exchange rate weakened by 48% from an average of IDR9,759 per USD in May 2013 to IDR14,423 in September 2015, a further 21% since our last report in September 2014.

Capital Flows and the Exchange Rate



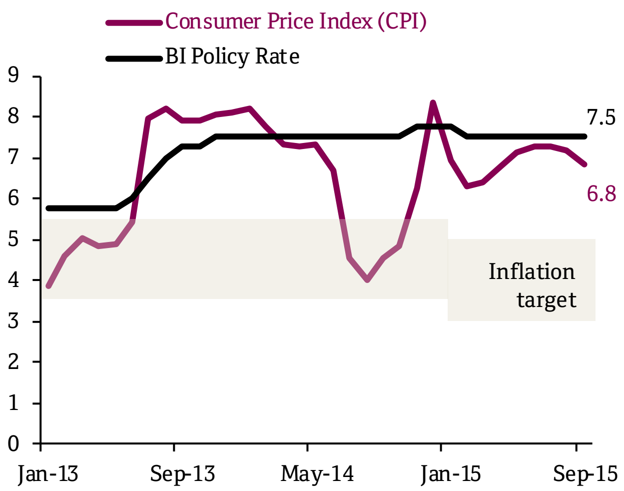
Sources: Bank Indonesia (BI), Institute of International Finance (IIF) and QNB Economics

Inflation has risen in 2015 as cuts to fuel subsidies and import tariffs pushed up prices

CPI inflation rose from 6.4% in 2014 to 6.9% on average so far this year. Cuts to fuel subsidies in 2014 and January 2015 have pushed up the price of fuel. The weak IDR and higher import tariffs imposed in June and July (on products including luxury goods, cars, food and beverages) have also pushed up prices. Food prices rose 9.8% in the year to August, even though global food prices have fallen substantially. Domestic inflation is also rising on a lack of investment and supply bottlenecks (see Background section above on under-investment). For example, inflation in transportation and housing/utilities rose 10.0% and 7.4% respectively (year-on-year on average in H1 2015). BI increased its policy interest rate by 25bps to 7.75% in November 2014 in response to government increases in fuel prices, but cut rates back to 7.5% in February as growth slowed. BI's inflation target is well below current levels and was lowered to 3%-5% in January.

Inflation

(% year-on-year)

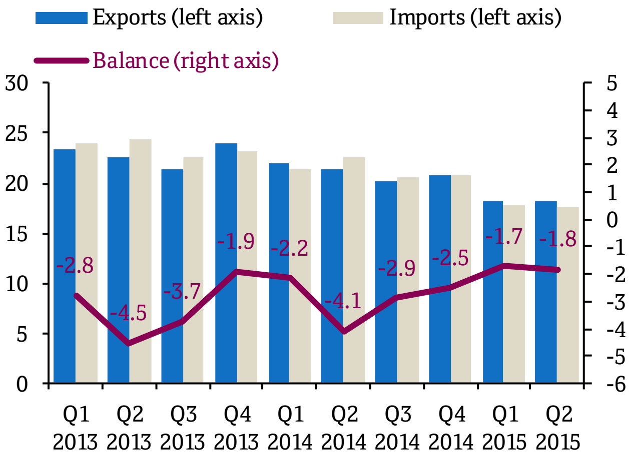


Sources: Statistics Indonesia (SI) and QNB Economics

The current account deficit narrowed in 2015 as imports fell more than exports

The current account deficit narrowed from 3.0% of GDP in 2014 to 1.8% of GDP in the first half of 2015, mainly as imports fell from 23% of GDP to 18%. Imports fell for a number of reasons. First, delays in government plans for infrastructure investment have reduced demand for imported capital goods. Second, domestic demand has moderated with the slowing economy. Third, the weaker exchange rate and import tariffs have made foreign goods and services more expensive. Finally, Indonesia is a net oil importer and lower oil prices have reduced imports. Exports fell from 22% of GDP in 2014 to 18% in H1 2015 due to weak external demand for Indonesia's manufactured goods, particularly from China and the region, as well as lower commodity prices (the main Indonesian exports are coal, gas, palm oil and crude oil).

Current Account
(% of GDP)

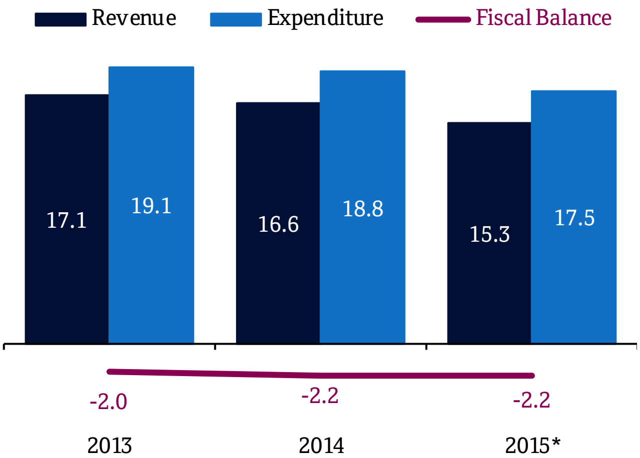


Sources: BI and QNB Economics

Expenditure has fallen after fuel subsidy cuts but weaker revenue has led to a wider budget deficit

Expenditure has fallen due to lower fuel subsidies and delays to infrastructure investment. The government took advantage of falling oil prices to cut fuel subsidies in 2014 then virtually eliminate them from the beginning of 2015. On average, fuel subsidies cost 3.5% of GDP in 2011-14; they are only expected to cost 0.6% of GDP in 2015. Fuel subsidies cuts were intended to free public spending for investment in infrastructure, however, this expenditure has been slow to materialise. Only 25% of the USD21bn infrastructure budget was disbursed in the first eight months of the year due to parliamentary delays and issues with land acquisition. The fiscal deficit still widened in 2014-15 as weakening economic activity and falling commodity prices held back government revenue and as fuel subsidy cuts were accompanied by increased social welfare payments to protect lower income segments.

Fiscal Deficit
(% of GDP)



Sources: BI and QNB Economics; * based on revised budget

Infrastructure investment is behind schedule, but has begun to pick up on rising government disbursements and reforms

Weak public infrastructure spending in H1 2015 (10.9% of the USD21bn infrastructure budget) has begun to pick up (10.7% of this budget was spent in August alone). The infrastructure budget allocation increased by more than USD7bn in 2015 and the draft 2016 budget is 8% higher. Additionally, the new government has introduced key reforms to support infrastructure (particularly related to land acquisition, which has delayed projects in the past). For example, regulations became effective at the start of 2015 clarifying the timeframe and processes to settle land acquisition disputes for public infrastructure projects. Additionally, reforms in March 2015 made it easier for the private sector to acquire land for public projects and also improved the terms for public-private-partnerships in infrastructure.

Infrastructure Budget Cumulative Spending

	% of infrastructure budget spent
Jan-15	0.0
Feb-15	0.5
Mar-15	1.4
Apr-15	3.1
May-15	6.1
Jun-15	10.9
Jul-15	14.3
Aug-15	25.0

Sources: CEIC and Barclays

Infrastructure spending will be concentrated in oil refining, power and transport projects

One major project has moved forward in recent months, signalling that spending on other projects could begin to pick up. Construction started at the end of August at the USD4bn Batang power plant after four years of delays due to land acquisition issues. There are a number of other major projects that could begin soon. Five refineries are being upgraded with assistance from foreign partners—a memorandum of understanding was signed with Sinopec, Saudi Aramco and JX Nippon Oil and Energy in December 2014. Thirty three hydroelectric power projects were meant to be tendered this year, but none have been yet. Upgrades to a number of airports are underway, land is being acquired for a third runway at Jakarta's main international airport and, finally, 10 regional airports are planned.

Infrastructure Projects

Oil Refining	bn USD	Period
Upgrading 5 refineries	25.0	2014-21
Bontang Refinery	9.0	2015-19
Power		
33 Hydroelectric Projects	32.7	2015-19
Cilacap Coal Power Plant	7.5	2015-21
Batang Power Station	4.0	2015-19
Other	17.8	
Transport		
Airport Developments	5.4	2015-20
Improvements on 5 Ports	4.2	2015-19
Priot Port	2.5	2014-16

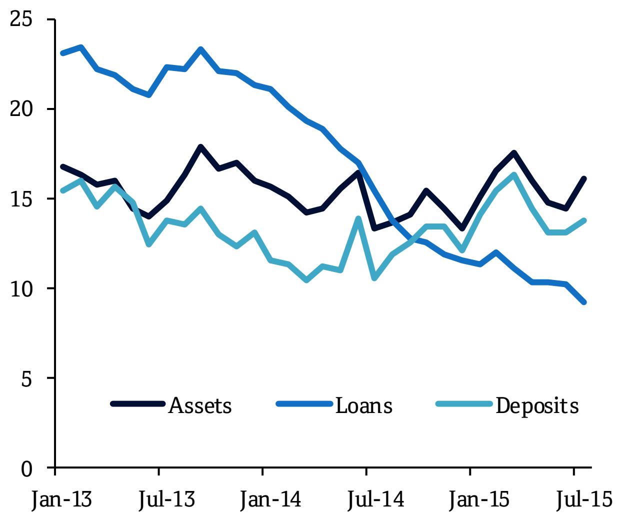
Source: Jakarta Post and QNB Economics

Bank loan growth has been squeezed by the slowing economy, but the sector remains highly profitable

Deposit growth has been stable compared with loan growth since 2013, despite the slowdown in the economy, due to population growth and rising inflation. However, loan growth has slowed due to lower credit demand as the economy has eased as well as tight financial conditions. As a result, the loan-to-deposit ratio has dropped from a peak of 92.2% in July 2014 to 88.5% in July 2015. In response, to support credit growth, BI relaxed rules in July on loan to deposit limits (banks can now include debt securities as deposits) and loan to value on property and cars. The banking sector remains highly profitable. Return on average equity is over 20% at the four largest banks, and ~17.1% across the sector. High net interest margins (~500bps) help support banks' profitability. Asset quality is moderate, but deteriorating as the economy slows. NPLs were 2.7% at the end of July 2015, compared with 2.2% in July 2014. The capital adequacy ratio remains high and rising at 20.8% in July 2015.

Banking Sector Assets, Loans and Deposits

(% change in IDR terms, year-on-year)



Sources: BI and QNB Economics

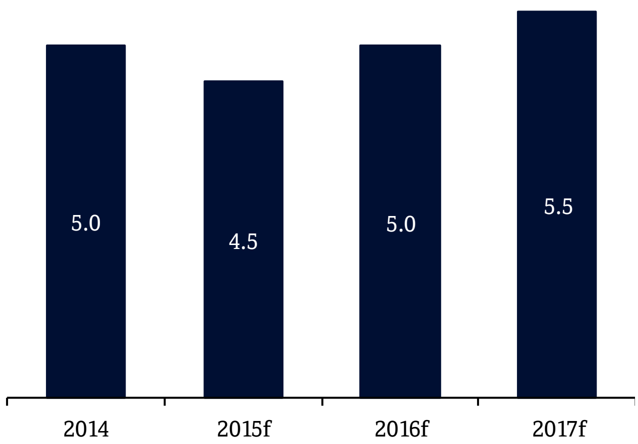
Macroeconomic Outlook (2015–17)

Growth should recover by 2017 on infrastructure investment and easier financial conditions

Real GDP growth is expected to slow further in H2 2015. Tighter financial conditions could drag on growth: credit growth is slowing, interbank interest rates are rising (7.5% at end-August) and capital outflows may continue as the Fed raises interest rates. Consumption may slow as a weaker exchange rate depresses domestic demand. Government spending may be constrained due to weak revenue and as the deficit nears the 3% legal limit. Exports are also expected to weaken on a slowing Chinese and global economy. In 2016, progress with infrastructure plans should add to investment growth. By 2017, financial conditions should begin to ease as the Fed nears the end of its tightening cycle, adding to growth through healthier capital flows along with a more stable IDR. A slowing Chinese economy and low commodity prices will continue to weigh on growth throughout 2016-17.

Real GDP

(% change, year-on-year)



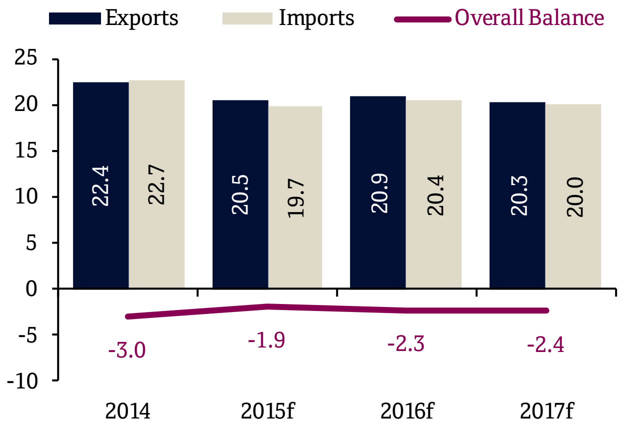
Sources: BI and QNB Economics forecasts

The current account deficit may widen as infrastructure investment boosts imports

In late 2015 and during 2016-17, we expect the current account deficit to widen as the infrastructure investment programme gets underway, which should lead to higher imports of capital goods. Exports are likely to be held back by restrictions on the export of certain raw materials (coal, gas, nickel, bauxite, chromium, gold, silver and tin), which are designed to support the development of domestic manufacturing industries. However, slightly stronger exports are expected in 2016-17 than in 2015 due to a weaker IDR, which should boost competitiveness, as well as government policies to support manufacturing exporters (for example a new tax holiday for key growth industries, such as chemicals, machinery, maritime transport and downstream oil and gas).

Current Account

(% of GDP)



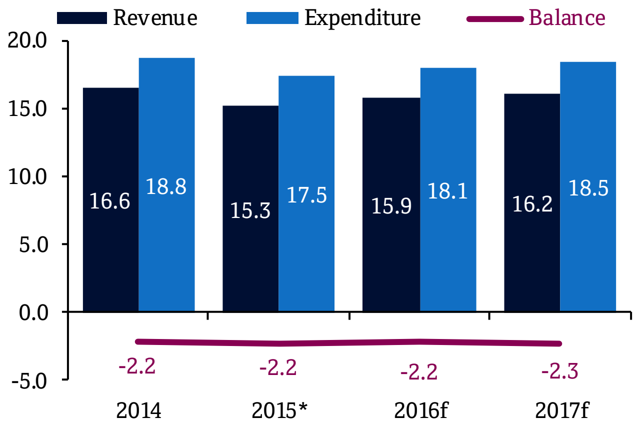
Sources: BI and QNB Economics forecasts

The fiscal deficit is expected to widen marginally as public investment in infrastructure rises

We expect the fiscal deficit to widen slightly to 2.3% of GDP in 2017, mainly because of rising public investment. Hold-ups to parliamentary approval of the revised budget for 2015 delayed infrastructure disbursals. However, we expect fiscal spending to rise going forward as investment gets underway this year and as budget allocations for infrastructure are higher in the 2016 draft budget. Meanwhile, revenue should recover with economic growth in 2016-17, partially offsetting higher expenditure. The government is constrained by a legal limit for the budget deficit of 3% of GDP. Therefore, the current deficit of 2.2% of GDP, and the risk that revenue could be weaker than expected, leave minimal room for stronger spending to support GDP growth.

Fiscal Balance

(% of GDP)



Sources: BI and QNB Economics forecasts; * based on revised budget

Inflation will remain high as the currency weakens, but should ease as the impact of fuel subsidy cuts and import tariffs dissipates

We expect the IDR to continue to weaken in 2015-17 as the current account deficit is forecast to widen and as the Fed is expected to increase US interest rates, leading to further capital outflows, especially in 2016. As a result, inflation is expected to continue rising during the remainder of 2015. However, inflation should ease in 2016-17 as the one-time base effects of cuts to fuel subsidies (mainly initiated from January 2015) and the introduction of import tariffs dissipate. Nonetheless, weakening IDR will keep inflation high in comparison to the rest of the world in 2016-17. The upper end of BI's inflation target is 5%, so policy rate cuts are unlikely until 2017 at the earliest.

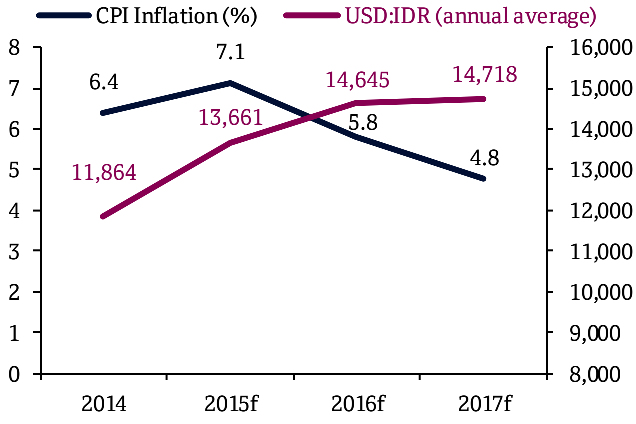
External debt is expected to rise to finance the current account deficit

We expect the current account deficit to average 2.2% of GDP in 2015-17, while net capital inflows will only amount to 1.3% of GDP on average. The deficit in the balance of payments will be partly financed by higher external debt and partly by running down international reserves, which, in line with recent BI policy, will help support the currency. As a result, we expect external debt to rise from USD304bn at the end of July 2015 to around USD353bn at the end of 2017. Meanwhile, international reserves are expected to fall from USD105bn at the end of August 2015 to around USD90bn at the end of 2017. The drop in international reserves in terms of import cover will be even more pronounced as we expect imports to rise significantly due to the infrastructure investment programme.

Banking sector growth may be constrained by tight financial conditions until 2017 at the earliest

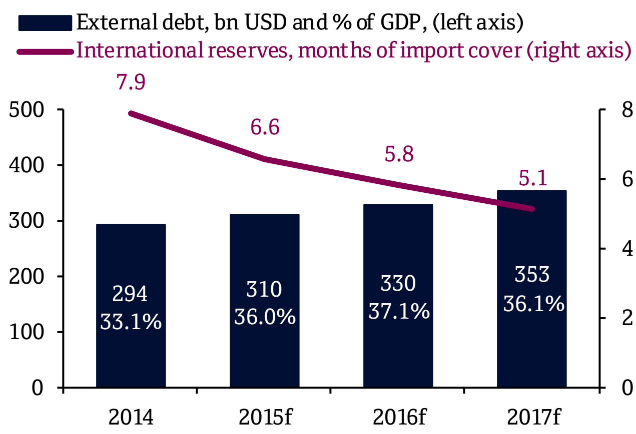
In 2016-17, deposit growth is expected to slow from high levels in line with falling inflation and lower nominal GDP growth. Loan growth could be constrained in 2015-16 due to rising interest rates, depressed capital flows and higher NPLs. From 2017, loan growth should pick up gradually as credit demand recovers (on higher economic growth and investment) and as financial conditions ease for a number of reasons. First, BI could lower interest rates by 2017 if inflation subsides and the currency stabilises. Second, BI is likely to use regulation to support credit growth as it did in mid-2015 (see above). Third, by 2017, the Fed should be near completing its tightening cycle, helping capital inflows to recover. Fourth, NPLs should stabilise by 2017 on higher economic growth.

Inflation and the Exchange Rate



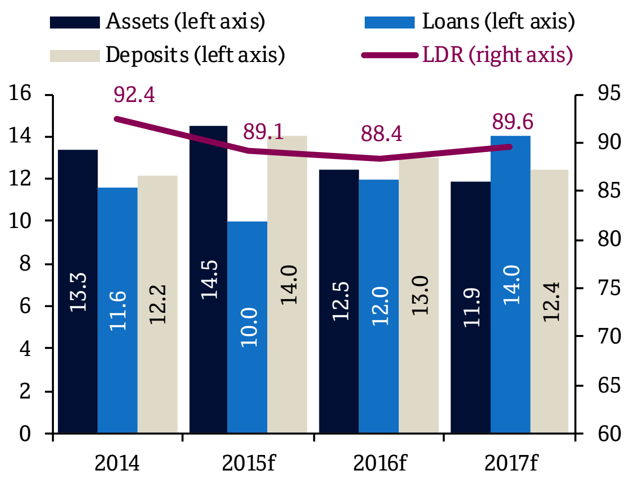
Sources: BI, SI and QNB Economics forecasts

International Reserves and External Debt
(end of period)



Sources: BI and QNB Economics forecasts

Banking Sector Assets, Loans and Deposits
(% change in IDR terms, year-on-year, end of period)



Sources: BI and QNB Economics forecasts

Macroeconomic Indicators

	2010	2011	2012	2013	2014	2015f	2016f	2017f
Real sector indicators								
Real GDP Growth	6.4	6.2	6.0	5.6	5.0	4.5	5.0	5.5
Nominal GDP (bn USD)	755	893	919	913	889	861	890	977
GDP per capita (USD, PPP)	8,433	9,009	9,587	10,129	10,641	11,135	11,756	12,515
CPI Inflation	5.1	5.3	4.0	6.4	6.4	7.1	5.8	4.8
Budget balance (% GDP)	-1.2	-0.6	-1.6	-2.0	-2.2	-2.2	-2.2	-2.3
Revenue	15.6	17.1	17.2	17.1	16.6	15.3	15.9	16.2
Expenditure	16.9	17.7	18.8	19.1	18.8	17.5	18.1	18.5
Public Debt	24.5	23.1	23.0	24.9	25.0	26.1	26.1	26.1
External sector (% GDP)								
Current Account Balance (% GDP)	0.7	0.2	-2.7	-3.2	-3.0	-1.9	-2.3	-2.4
Exports	22.1	23.9	23.0	22.5	22.4	20.5	20.9	20.3
Imports	19.3	21.2	23.2	23.2	22.7	19.7	20.4	20.0
Invisibles Balance	-2.1	-2.5	-2.5	-2.5	-2.6	-2.7	-2.7	-2.7
Capital & Financial Account Balance	3.5	1.5	2.7	2.4	5.0	0.5	1.7	1.8
FX Reserves (mths prospective imports)	6.1	6.2	6.4	5.9	7.9	6.6	5.8	5.1
External Debt	26.8	25.2	27.5	29.2	33.1	36.0	37.1	36.1
Monetary indicators								
Broad Money Growth	15.4	16.4	15.0	12.8	11.9	14.0	13.0	12.4
Policy Rate (%)	6.5	6.5	6.0	5.8	7.5	n.a.	n.a.	n.a.
Exchange Rate USD:IDR (av)	9,088	8,774	9,375	10,438	11,864	13,661	14,645	14,718
Banking Indicators (%)								
Return on Average Equity	25.9	25.4	25.3	24.5	21.3	n.a.	n.a.	n.a.
NPLs	2.5	2.1	1.8	1.7	2.1	3.0	3.0	2.9
Capital Adequacy Ratio	16.2	16.1	17.3	19.8	18.7	n.a.	n.a.	n.a.
Asset Growth	n.a.	21.4	12.7	16.0	13.3	14.5	12.5	11.9
Loan Growth	35.8	24.7	23.1	21.4	11.6	10.0	12.0	14.0
Deposit Growth	37.0	18.7	15.6	13.1	12.2	14.0	13.0	12.4
Loan to Deposit Ratio	77.4	81.3	86.6	92.9	92.4	89.1	88.4	89.6
Memorandum items								
Population (m)	237.6	241.0	244.5	248.0	251.5	255.1	258.7	262.4
Population Growth (% change)	2.9	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Unemployment	7.1	6.6	6.1	6.3	6.1	5.8	5.6	5.5

Sources: BI, Bloomberg, SI, IMF and QNB Economics forecasts

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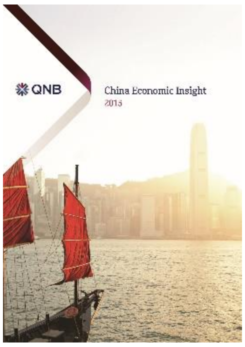
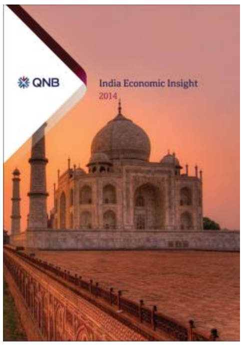
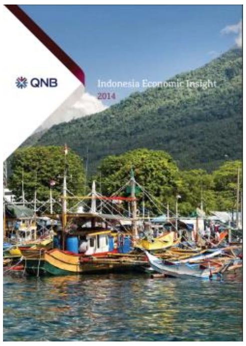
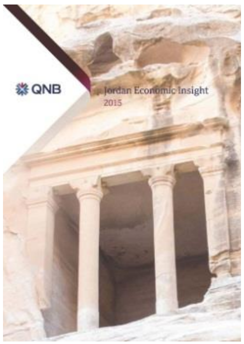
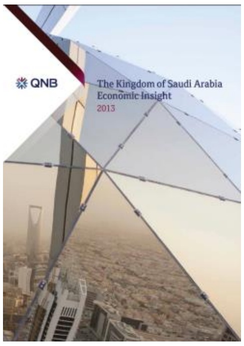

China 2015


India 2014


Indonesia 2014


Jordan 2015


KSA 2013


Kuwait 2015


Oman 2013


Qatar – Sep 2015


Qatar - Feb 2015


UAE 2013

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Capital Outflows from China: Causes and Consequences
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