China Economic Insight

2015

Contents

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Executive Summary

A. Recent Developments

- **Real GDP growth eased to 7.4% in 2014 (7.7% in 2013)** due to a slowdown in investment spending, lower consumption growth and weak global demand for Chinese exports
- **Inflation slowed to 2.0% in 2014 (2.6% in 2013)** as weaker global commodity prices led to lower food prices and as falling real estate prices pulled down rent inflation
- **The current account surplus rose to 2.1% of GDP (1.9% in 2013)** as lower global commodity prices reduced the import bill, which more than offset the impact of weak global growth on exports
- **Capital outflows increased in Q4 2014,** with corporates paying down external debt as the US dollar (USD) strengthened ahead of potentially higher US interest rates
- **The budget deficit widened to 1.8% of GDP in 2014 (0.9% in 2013)** as the authorities implemented a robust fiscal stimulus to meet their growth targets
- **The central bank loosened monetary policy** to stimulate the economy and alleviate tighter liquidity
- **Bank deposit growth eased** (9.1% in 2014) as economic growth slowed, **while credit growth rose** (16.2%) as shadow-bank loans were shifted to regulated banks, leading to a rise in non-performing loans (NPLs) and lower return on equity (17.6% at end-2014)

B. Macroeconomic Outlook (2015-17)

- **China will continue to shift towards a consumer-led economy**, implying an investment slowdown; real GDP growth is expected to reach the government's official target of 7.0% in 2015, but then slow gradually to 6.0% by 2017 as the authorities act to shift away from investment in favour of private consumption
- **Inflation may ease in 2015** (0.7%) as falling real estate prices lead to lower domestic inflation and falling global food prices slow foreign inflation; **in 2016-17, we expect monetary stimulus and higher global food prices to lift inflation to an average 1.8%**
- **The current account surplus may widen** (3.0% of GDP in 2015) on lower commodity prices; we expect a narrower surplus by 2017 (1.8%) as global commodity prices recover
- **Capital outflows are expected to continue in 2015** as corporates pay down USD debt ahead of higher expected US interest rates; outflows are expected to continue with capital account liberalisation in 2016-17
- **The budget deficit is expected to widen** (2.5% of GDP in 2015 to 2.9% by 2017) with increased spending on affordable housing and high-speed railways
- **Low inflation provides room for the central bank to inject liquidity into the economy** and cut interest rates and reserve requirement ratios (RRR) to further stimulate growth
- **Deposit growth is likely to ease (8%-9% in 2015-17)** as economic growth slows; lending growth is expected to be higher as shadow bank loans continue to be absorbed into regulated banks; profitability is likely to be lower as shadow bank loans push up NPLs and provisioning

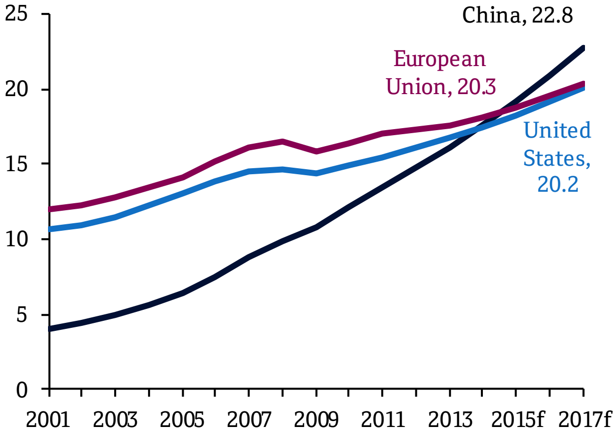
Background

China became the world's largest economy in 2014 and the predominant contributor to global growth

China has transformed over the last 30 years from a predominantly agrarian economy into the world's factory, lifting 500m people out of poverty in the process. It is the most populous nation (1.37bn people), the largest contributor to global growth, the largest exporting nation, and the world's largest economy on a purchasing power parity (PPP) basis. Nevertheless, China remains a middle income country per capita: GDP per capita was just under USD13k in 2014, compared with USD55k in the US. To achieve higher per capita income, China plans to enact a new transformation from an investment–led to a consumer-led economy. China currently has one of the world's highest private savings rates at 49% of GDP. Encouraging people to spend more of these savings to drive the economy forward is the main challenge for the future.

GDP of the World's Largest Economies

(USD tn adjusted for PPP, 2017 value shown)



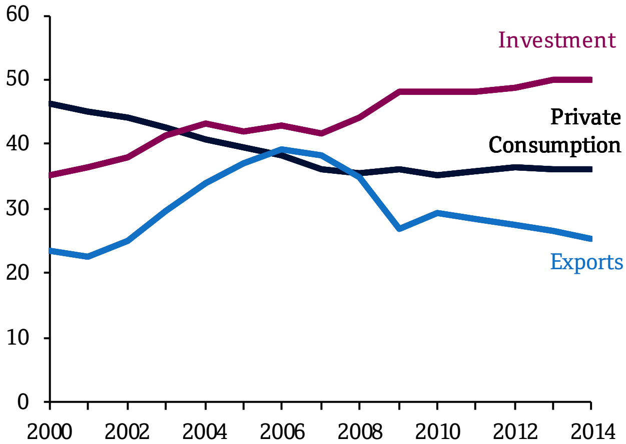
Source: International Monetary Fund (IMF)

Strong investment drove growth over the last 30 years, but China is now transitioning to consumption-led growth

Investments in infrastructure and manufacturing and a focus on the external sector have been the main drivers of growth up to 2012. In the 2000s, privatisation, low labour costs and opening up to foreign investment drove economic expansion. In 2008, an USD600bn stimulus (mainly infrastructure projects) further boosted investment growth as exports slowed due to the global recession. This growth model has now become unsustainable: over-investment and weak global demand have led to excess capacity in manufacturing and infrastructure and high levels of credit to the economy (205% of GDP at end-2014) from traditional and shadow banks. As a result, the authorities aim to shift the economy towards services and innovation as well as stimulating domestic consumption to guide the economy onto a more sustainable growth path.

Consumption, Investment and Exports

(% of GDP)



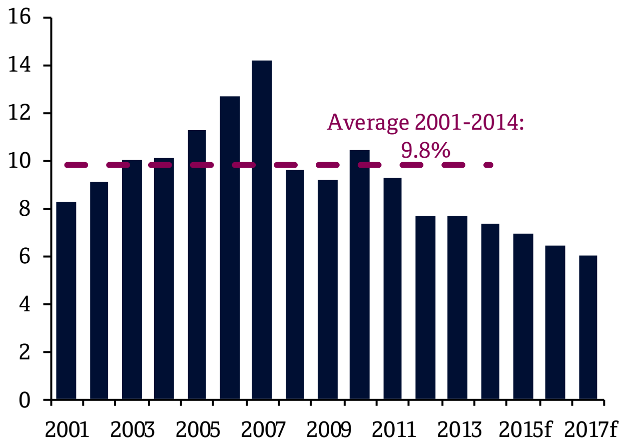
Sources: IMF and QNB Economics estimates

The transition means growth is expected to ease from previous high levels

China grew by an average annual rate of 9.8% in 2001-14. The transition to a more consumer-led economy entails a gradual easing. Growth peaked at 14.2% in 2007, but has slowed since, although it remains one of the highest in the world at 7.4% in 2014 and is expected to remain above 6.0% through 2017. China's new leadership has taken action to enhance growth (financial liberalisation; tax breaks for small companies; fiscal stimulus; and monetary easing) and rein in corruption and shadow banking. Further reforms are expected to increase openness and trade links and encourage private sector development. Reforms will also need to address medium term challenges, such as rising pollution, driving innovation and reorienting export-oriented cities towards economic diversification.

Real GDP Growth

(%)



Source: National Bureau of Statistics (NBS)

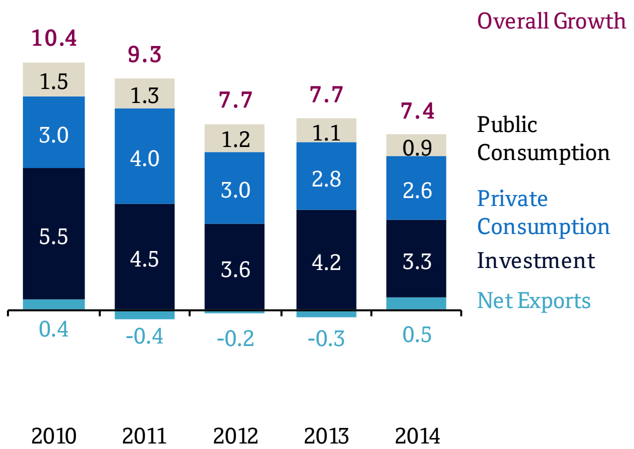
Recent Developments

Chinese GDP growth eased in 2014 as the economy shifted away from investment driven growth

Real GDP growth eased to 7.4% in 2014 from 10.4% in 2010, mainly due to a slowdown in investment. The contribution of investment to real GDP growth has been volatile, but it eased to 3.3 percentage points (pps) in 2014, due to excess capacity in the economy, notably in the real estate sector, as well as government efforts to direct the economy away from investment. The contribution of private consumption to real GDP growth slowed to 2.6pps as reforms to boost consumption take time to gain traction. We estimate that net exports made a small positive contribution to growth in 2014.

Estimated Contributions to Real GDP Growth

(pps and %)



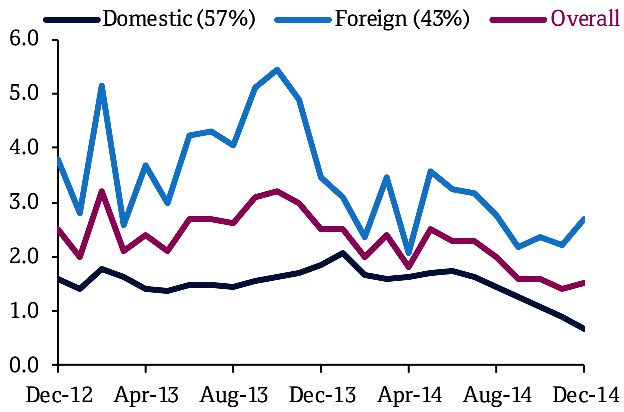
Sources: NBS and QNB Economics estimates

A decline in real estate prices and lower global commodity prices pulled inflation down

Consumer Price Index (CPI) inflation slowed to 2.0% in 2014 (2.6% in 2013) as falling real estate prices pulled down domestic inflation and weaker global commodity prices led to lower foreign inflation.[1] Rents are estimated to constitute the highest weight in the overall CPI basket (17.6%). Falling real estate prices drove down rents and domestic inflation in 2014. Lower global food and commodity prices have kept foreign inflation relatively low, dragging overall inflation further down. Inflation fell further to an average 1.1% in the first two months of 2015, mainly driven by lower domestic inflation.

CPI Inflation

(% change; weights given in brackets)



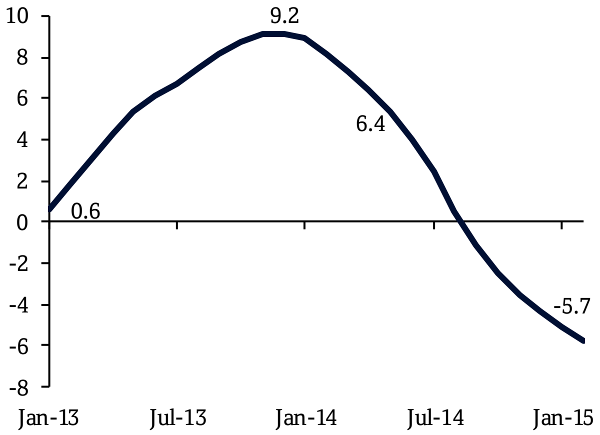
Sources: NBS and QNB Economics estimates

Falling real estate prices are increasing the risk of deflation, but the government has sufficient resources to absorb this potential shock

Residential property prices fell 5.7% in the twelve months to February 2015 as the housing market has become heavily oversupplied. High investment and leverage in real estate has driven economic growth in recent years through residential construction and other household-related sectors. Local governments, property developers, investors and individuals are exposed to real estate. However, public debt is relatively low (41% of GDP) and the authorities have substantial resources (USD3.8tn in international reserves) to absorb any potential shock from the real estate sector.

Newly Built Residential Buildings Prices

(70 major cities, simple average, % change, year on year)



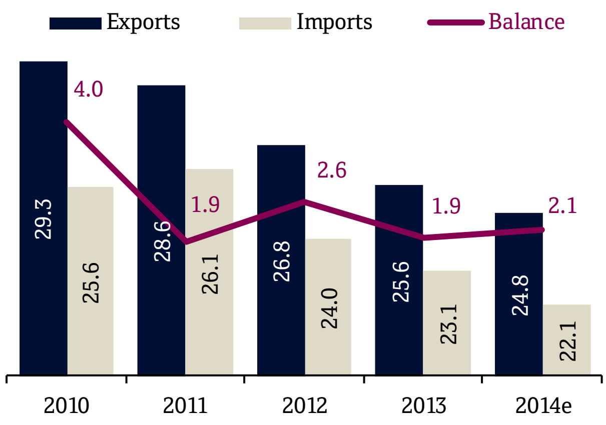
Source: NBS and Bloomberg

[1] Domestic inflation comprises of residence, recreation, education and culture articles, transportation and communication, health care and personal articles, household facilities, articles and services. Foreign inflation includes food, tobacco, liquor, articles and clothing.

The current account surplus rose in 2014 as lower global commodity prices reduced the import bill

The current account surplus rose to 2.1% of GDP in 2014 (1.9% in 2013) as lower global commodity prices reduced the import bill, which more than offset the negative impact of weak global demand on exports. Exports continued to fall as a share of GDP (from 25.6% in 2013 to 24.8% in 2014) on weak global demand. A sizable portion of imports are tied to exports as manufacturing inputs are sourced abroad, mainly from other Asian countries such as Indonesia, Philippines, Thailand and Vietnam. Therefore, import growth fell alongside export growth. Additionally, the sharp fall in oil prices and lower global commodity prices drove the import bill down, a trend that has continued in early 2015 with year-on-year imports plunging an average 20.1% from a year earlier in the first two months of the year.

Current Account
(% of GDP)

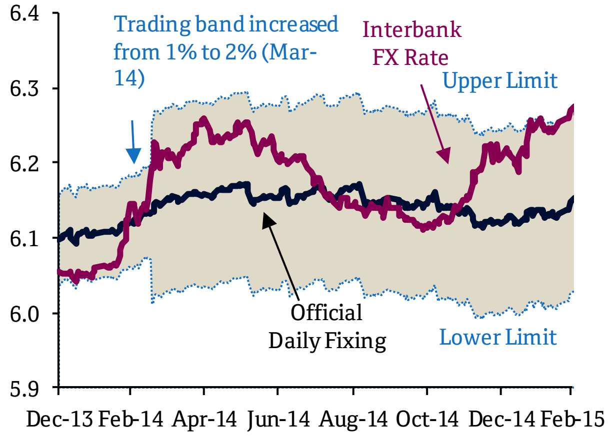


Sources: NBS, IMF and QNB Economics estimates

Capital outflows weakened the CNY against the USD

Capital outflows increased in Q4 2014 as corporates paid down external debt as the USD strengthened and ahead of expected higher US interest rates, leading to a weaker CNY. The People's Bank of China (PBoC) sets an official fixed exchange rate for the currency on a daily basis. The interbank exchange rate is permitted to deviate from the daily fixing by +/- 2%, creating a trading band for the currency with an upper and lower limit. Since late 2014, the authorities have weakened the official exchange rate against the USD (through a higher daily fixing) to support growth by maintaining export competitiveness. The interbank exchange rate is currently trading close to the upper limit of the trading band, probably as a result of downward pressures from capital outflows.

Exchange Rate
(USD:CNY)

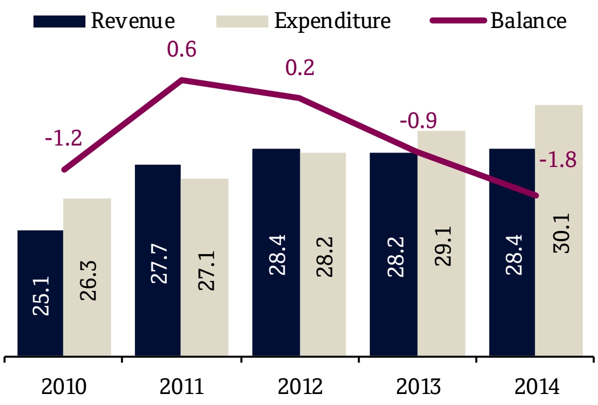


Source: Bloomberg

The budget deficit widened as the authorities implemented a fiscal stimulus to meet growth targets

The budget deficit widened to 1.8% of GDP in 2014 (0.9% in 2013) as the authorities implemented a robust fiscal stimulus to meet growth targets. Most of the stimulus was provided through higher spending, which rose from 29.1% of GDP in 2013 to 30.1% of GDP in 2014. Current expenditure was increased as well as investment in high-speed railways and affordable housing. The government has recently introduced new measures to deal with rising, but still low, public debt (41.2% of GDP at end-2014): rating the performance of officials based on financial soundness not growth; introducing reforms to increase transparency and reduce corruption; encouraging the development of a local government bond market; and initiating a debt swap plan (see below).

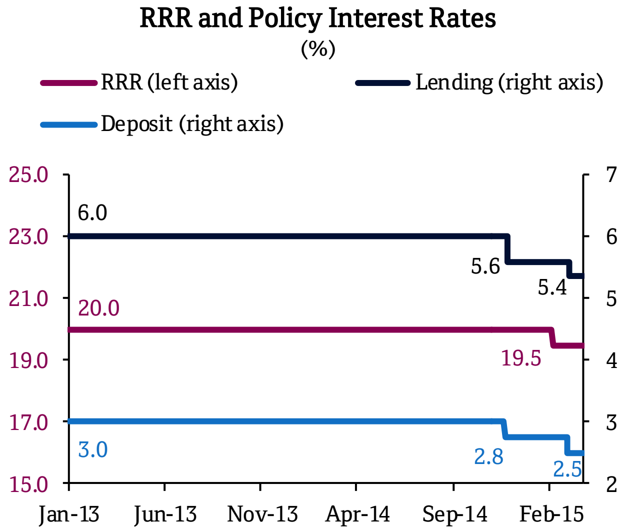
General Government Budget
(% of GDP)



Sources: NBS, IMF and QNB Economics estimates

The PBoC loosened monetary policy to support growth

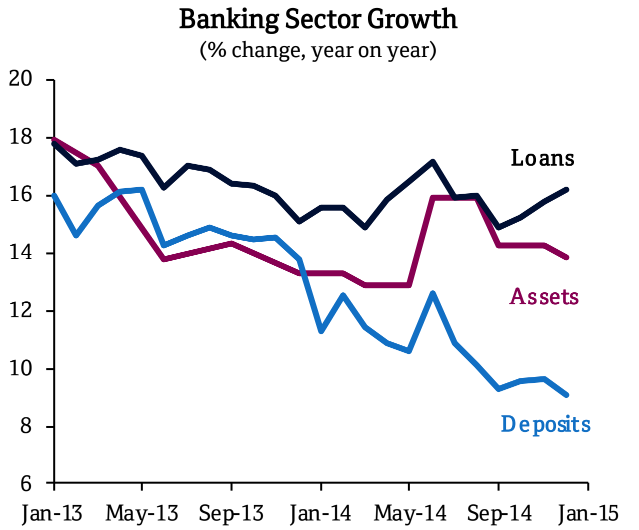
The PBoC has loosened monetary policy to stimulate the economy and alleviate tighter liquidity. A series of cuts in policy interest rates began in November 2014 as the PBoC reduced one-year lending rates by 40 basis points (bps) to 5.6% and one-year benchmark deposit rates to 2.75% (a 25bps cut). In early February 2015, the PBoC cut the RRR, which stipulates the share of deposits commercial banks must hold as cash, by 50bps to 19.5%, while both the lending and deposit policy rates were cut by an additional 25bps to 5.4% and 2.5% respectively. Additionally, to alleviate tight liquidity, the PBoC reportedly injected CNY500bn into the banking system in September 2014 and a further CNY200bn in October.



Source: People's Bank of China (PBoC)

Policy measures were introduced to restrict shadow banking, which accelerated credit growth in the regulated sector

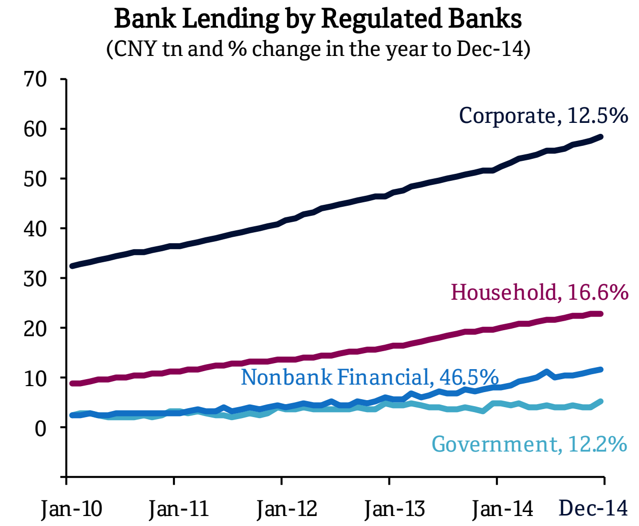
Deposit growth eased to 9.1% in 2014 (13.8% in 2013) as the economy slowed and as capital leaked out of the country. Local government financing vehicles (LGFVs) were central to driving the rapid growth of shadow banking in recent years. In 2014, the authorities limited borrowing through LGFVs, ending in their outright ban in October, which then pushed local governments towards regulated loans instead of shadow banking. Therefore, credit growth rose to 16.2% (15.1% in 2013) as reforms pushed shadow-bank loans into the regulated segment. With loans growing faster than deposits, the loan to deposit ratio rose to 94.6% at end-2014, from 88.8% at end-2013. As lower quality assets from the shadow banking system were brought back onto the balance sheets of regulated banks, NPLs rose slightly to 1.3% at end-2014, compared with 1.0% at end-2013. As a result, provisioning increased, which had a negative impact on profitability. Return on average equity fell to 17.6% in 2014 from 19.2% in 2013. Banks remained well capitalised, with the average capital adequacy ratio at 13.2% at end-2014.



Source: NBS and PBoC

Lending to households is growing rapidly, which is supporting consumption growth

Growth in domestic credit remains relatively high (16.2%), boosted by restrictions on shadow banking. Credit to households has been growing faster than credit to corporates. Around 65% of loans to households are for consumption and this should, therefore, support the economic shift to a consumer-led economy. There has also been high growth in mortgage loans (17.6% in 2014 and 21.0% in 2013) as a more affluent middle-class has bought properties in urban areas. Lending to nonbank financial companies rose 46.5% in the year to December 2014, although from a low base, as the government relaxed restrictions on consumer finance companies.



Source: NBS

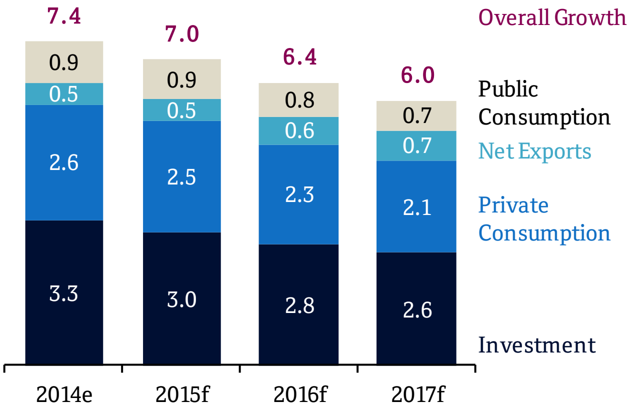
Macroeconomic Outlook (2015-17)

The transition to a consumer-led economy may take time to materialise on falling house prices and the risk of deflation

Real GDP growth is expected to continue slowing from 7.0% in 2015 to 6.4% in 2016 and 6.0% in 2017 as the authorities act to restrain investment in favour of private consumption. Our projection for real GDP growth in 2015 is in line with the government's official growth target. The contribution of investment to real GDP growth is expected to fall to 3.0pps in 2015, down from an estimated 3.3pps in 2014. Government plans to stimulate private consumption may struggle to gain traction with falling house prices undermining confidence and spending. A slow recovery in the global economy and world trade mean net exports are only likely to make a minor growth contribution. A further investment slowdown and moderate private consumption growth may lead to a further growth slowdown to 6.4% in 2016 and 6.0% in 2017.

Contributions to Real GDP Growth

(pps and %)



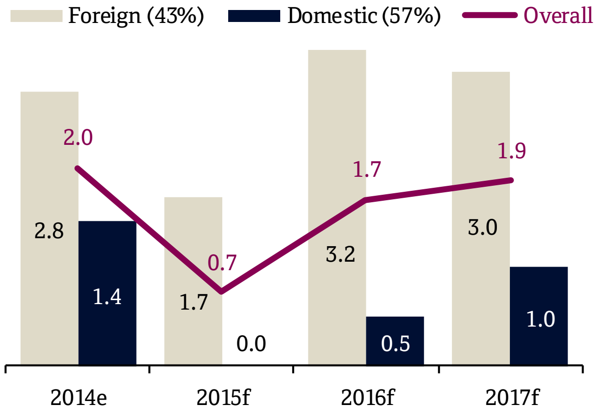
Sources: NBS and QNB Economics estimates and forecasts

CPI inflation is expected to fall in 2015 on lower rents and global food prices, before recovering in 2016-17

Inflation is expected to ease to 0.7% in 2015 as the weak real estate market halts domestic inflation and falling global food prices lead to low foreign inflation. In 2015, falling house prices are likely to stall rent inflation, which could be exacerbated by government plans to build more homes. Furthermore, producer prices are falling (-4.8% in the year to February) and some lower costs may be passed on to consumers this year. Therefore, inflation in 2015 is likely to be well below the PBoC's 3% target, so more interest rate and RRR cuts are likely. In 2016-17, looser monetary policy should help lift domestic inflation. Additionally, a recovery in global commodity prices and a weaker exchange rate should raise foreign inflation.

CPI Inflation

(% change; weights given in brackets)



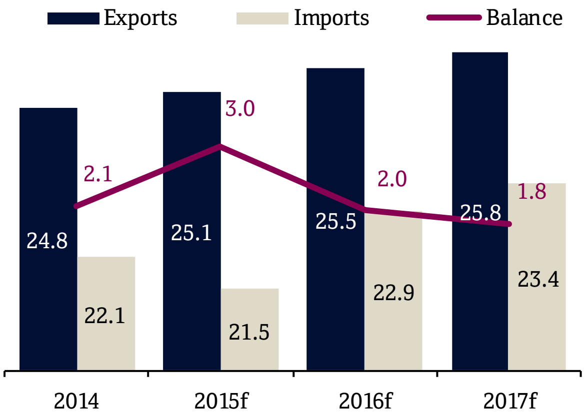
Sources: NBS and QNB Economics estimates and forecasts

The current account surplus may grow in 2015 on lower commodity prices, but this could reverse in 2016-17

In 2015, the current account surplus is expected to widen as the terms of trade improve on lower commodity prices. China's import bill should fall further in 2015 on lower global commodity prices. Meanwhile, export prices should be stable and helped by a moderate recovery in global demand. In 2016-17, we expect a narrower surplus as a recovery in global commodity prices increases the import bill, despite the trend for more inputs into Chinese goods being produced domestically. We expect some recovery in exports thanks to a more competitive USD:CNY (see below) and rising productivity. However, gains could be limited by weak global trade, rising Chinese wages and as the exchange rates of competitors are also weakening (notably other Asian currencies and the euro).

Current Account

(% of GDP)

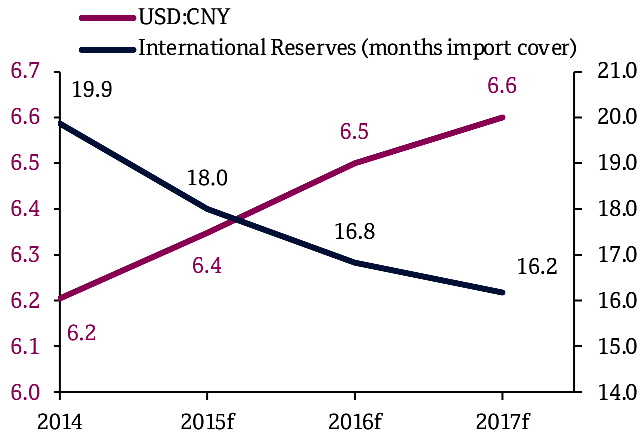


Sources: NBS, IMF and QNB Economics forecasts

The CNY is expected to weaken owing to capital outflows

Capital outflows are expected to persist, leading to a weaker CNY during 2015-17. Chinese corporates are likely to continue paying down USD external debt in 2015 ahead of the expected US interest rate hikes. Meanwhile, the authorities are pushing hard for capital account liberalisation. This could increase outflows in 2015-17 as China's large domestic savings are increasingly invested overseas, particularly if China's economic slowdown reduces returns on domestic assets. Capital outflows and a narrowing current account surplus mean the exchange rate is likely to weaken further. To offset this trend, the authorities are likely to use international reserves to provide support for the currency. We therefore expect international reserves to fall to 16.2 months of import cover by end-2017, from an estimated 19.9 months at end-2014.

Exchange Rate



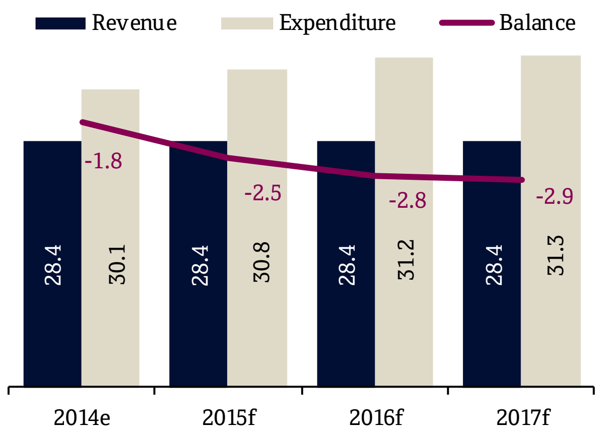
Sources: Bloomberg and QNB Economics forecasts

The budget deficit is expected to widen moderately as the government increases spending to stimulate the economy

The government plans to raise spending on education, health, housing and high speed railways. Revenue is expected to remain flat as a share of GDP—reforms of the business tax (replacing it with VAT in certain sectors) should be offset by tax breaks for small companies. Higher spending and flat revenue are expected to lead to a small increase in the fiscal deficit from 2.5% in 2015 to 2.9% in 2017. The government has introduced a debt swap plan, which will lengthen the tenor and lower the interest rate on RMB1trn (USD160bn) of local government debt in order to smooth the financing of the general government budget deficit.

General Government Budget

(% of GDP)



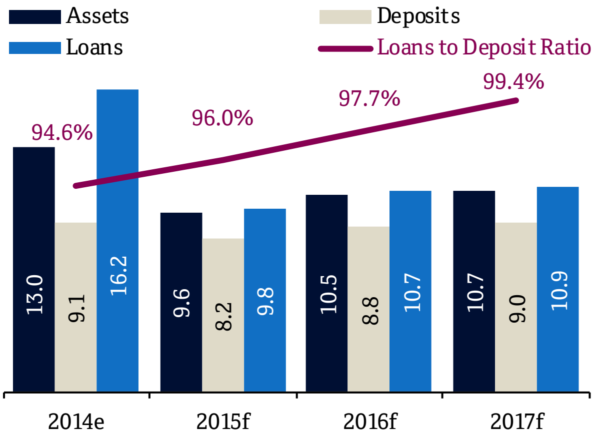
Sources: IMF and QNB Economics estimates and forecasts

Banking sector growth is expected to ease with the economy

Deposit growth is expected to slow in 2015 as the economy cools and inflation falls. It should then recover in 2016-17 as a cap on bank deposit rates is expected to be removed and inflation rises. Lending growth should outpace deposit growth as curbs on shadow banking lead to higher loan growth in the regulated sector and as deposits may leak abroad in search of higher yields. Government efforts to stimulate lending, particularly to consumers and SMEs, and looser central bank monetary policy (interest rate and RRR cuts are expected) should also elevate loan growth. As a result, the loan to deposit ratio is expected to rise steadily. Profitability may be negatively impacted as the increase in shadow bank loans in the regulated sector are likely to push NPLs and provisioning higher. Profits could also be squeezed by narrower net interest margins owing to the expected removal of the deposit cap and the opening of the banking sector to competition.

Banking Sector

(% change, year on year)



Sources: PBoC and QNB Economics estimates and forecasts

Macroeconomic Indicators

	2010	2011	2012	2013	2014	2015f	2016f	2017f
Real sector								
Real GDP growth (%)	10.4	9.3	7.7	7.7	7.4	7.0	6.4	6.0
Nominal GDP (USD tn)	5.9	7.3	8.4	9.5	10.3	10.8	11.4	12.2
Growth (%)	16.5	22.9	14.7	12.9	8.3	5.2	5.7	6.7
GDP/capita (USD k, PPP)	9.0	10.0	10.9	11.9	12.8	13.4	14.1	15.1
Consumer price inflation (%)	3.3	5.4	2.6	2.6	2.0	0.7	1.7	1.9
Domestic (57%)	0.6	3.3	0.7	1.6	1.4	0.0	0.5	1.0
Foreign (43%)	6.6	10.1	4.2	4.1	2.8	1.7	3.2	3.0
External (% of GDP)								
Current account balance	4.0	1.9	2.6	1.9	2.1	3.0	2.0	1.8
Trade balance (goods and services)	3.7	2.5	2.8	2.5	2.7	3.6	2.6	2.4
Exports	29.3	28.6	26.8	25.6	24.8	25.1	25.5	25.8
Imports	25.6	26.1	24.0	23.1	22.1	21.5	22.9	23.4
Income, transfers and omissions	0.2	-0.6	-0.2	-0.6	-0.6	-0.6	-0.6	-0.6
Capital and financial account balance	4.8	3.6	-0.4	3.4	-1.9	-2.3	-1.3	-0.8
International reserves (import cover)	17.9	18.9	18.1	20.2	19.9	18.0	16.8	16.2
External debt	9.4	9.5	8.8	9.1	8.2	7.6	7.0	7.2
Exchange rate USD:CNY (av)	6.8	6.5	6.3	6.2	6.2	6.4	6.5	6.6
Fiscal (% GDP, general government)								
Budget balance	-1.2	0.6	0.2	-0.9	-1.8	-2.5	-2.8	-2.9
Revenue	25.1	27.7	28.4	28.2	28.4	28.4	28.4	28.4
Expenditure	26.3	27.1	28.2	29.1	30.1	30.8	31.2	31.3
Public debt	36.6	36.5	37.4	39.4	41.2	43.5	45.3	46.8
Monetary								
M2 growth	21.2	16.5	13.9	13.7	12.2	9.6	10.1	10.3
Interbank interest (%, 3 months, eop)	4.6	5.5	3.9	5.6	5.1	n.a.	n.a.	n.a.
Banking (%)								
Return on equity	19.2	20.4	19.8	19.2	17.6	n.a.	n.a.	n.a.
NPL ratio	1.1	1.0	1.0	1.0	1.3	1.5	1.8	2.0
Capital adequacy ratio	12.2	12.7	13.3	12.2	13.2	n.a.	n.a.	n.a.
Asset growth	18.7	18.3	17.5	14.1	13.0	9.6	10.5	10.7
Deposit growth	20.2	12.7	13.4	13.8	9.1	8.2	8.8	9.0
Domestic credit growth	18.8	17.1	17.1	15.1	16.2	9.8	10.7	10.9
Domestic credit (% GDP)	145.8	145.6	152.2	158.0	169.2	172.6	176.6	180.7
Loan to deposit ratio	81.8	85.0	87.8	88.8	94.6	96.0	97.7	99.4
Memorandum items								
Population (bn)	1.34	1.35	1.35	1.36	1.37	1.37	1.38	1.39
Growth (%)	0.48	0.48	0.50	0.50	0.50	0.50	0.50	0.50
Unemployment (%)	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1

Sources : Bloomberg, China Banking Regulatory Commission, IMF, PBoC, NBS and QNB Economics estimates and forecasts

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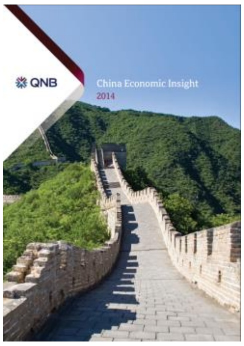
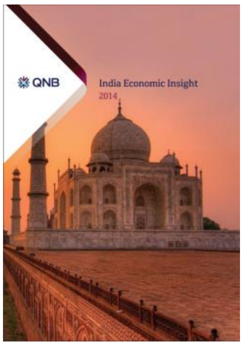
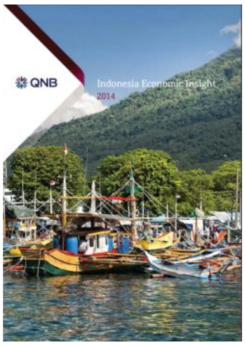


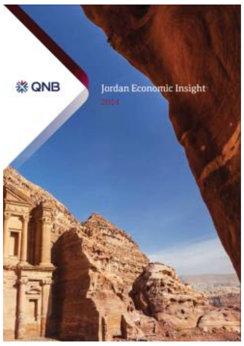
China 2014



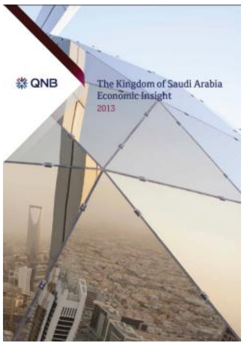
India 2014



Indonesia 2014



Jordan 2014



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