



Building a strong foundation for the future



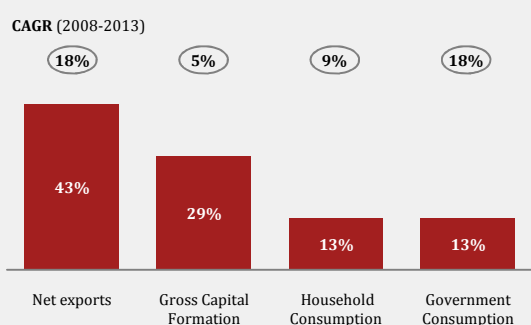
Stephen Anderson, Managing Partner, PwC Qatar

Qatar has enjoyed significant economic growth with real GDP increasing by 10.7% per annum since 2008, and it is now one of the richest nations in the world with GDP per capita exceeding \$100,000 at PPP (Purchasing Power Parity) exchange rates. The nation has weathered global economic instability by taking advantage of its vast natural gas reserves, producing the highest levels in the GCC at 159 bn cubic metres in 2013, and becoming the biggest LNG exporter in the world. Furthermore, Qatar has managed to contain domestic price pressures by setting over \$300bn of export revenues aside in its growing sovereign wealth funds and managing a proactive interest rate policy.

Qatar's reliance on gas exports, and the decoupling of gas and oil prices in the aftermath of the Japanese earthquake of 2011, suggest that it is likely to be one of the best placed GCC nation to weather the current fall in oil prices. That said, Qatar is not immune, and the medium term prognosis for global gas supply will likely place downward pressure on prices with increases in supply from both Australia and the US in particular. Even though we project inflation to remain at manageable levels going forward, inflation volatility remains a threat due to the unprecedented investment programme related to the 2022 FIFA World Cup which may lead to domestic bottle necks. Also, securing governmental revenue beyond hydrocarbons has proved difficult for Qatar and going forward, diversification of the revenue base should be a key focus area.

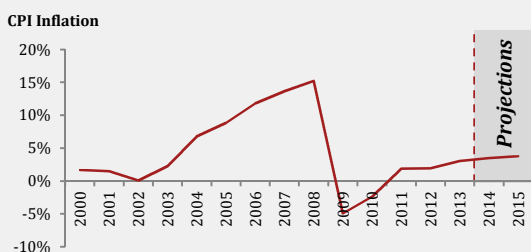
To meet these challenges and create a thriving investment environment we recommend that the authorities strengthen macro-fiscal capabilities in three areas: first, by accelerating the deepening of Qatar's capital markets and sources of funding; second, expanding the government's revenue base; and finally, managing government expenditure efficiently. These measures will help to achieve the desired AAA credit rating, develop a business environment attractive to private and international investors, diversify the economy, and ensure prudent management of governmental expenditure. We see the outlook for the coming years as moving to a more sustainable level of growth, tighter fiscal discipline and continued diversification of the economy.

Fig 1: 2013 GDP components (% of GDP)



Source: Qatar Ministry of Finance

Fig 2: Inflation expectations



Category	Food	Clothing	Housing services	Household Items	Health care	Transport & Commis	Culture	Other
CPI weights	13	6	32	8	2	20	11	7
Avg. CPI ('10-'14)	2.7	2.4	-1.6	4.0	2.2	2.9	4.3	2.1

Source: IMF WEO October 2014, QSA

Economic outlook

We expect real GDP to grow by 6.0% in 2014, by 6.5% in 2015, and to average around 6.2% per annum between 2016 and 2019 aided by:

- strong growth in the working age population – the population is projected to grow by an additional 10% per year, reaching 2.5m in 2018 due to the continuous influx of immigrant workers;
- a resilient oil & gas sector due to Qatar's leading position in the LNG market and new gas sector developments;
- substantial growth in the non-oil & gas sector which should outpace hydrocarbons, driven by government expenditure which we expect to continue growing strongly following a 18% average annual growth rate between 2008 and 2013 (see Fig 1); and
- stable inflation running at around 4.0% over the next 5 years, resulting from low oil prices partially balancing upward pressure brought on by the planned investment programme.

Macroeconomic hurdles

1. Inflation volatility

Inflation has been subdued in the past 5 years due to a period of relatively stable oil prices and Housing Services prices (which contribute 32% of the CPI basket) declining 1.6% annually between 2010 and 2014 reflecting a market correction in real estate (see Fig 2). We expect inflation to pick up further to 3.8% in 2015 and to average around 4% in the medium term, but to remain manageable.

Key risks to this outlook include: the influence of volatile oil prices; a sharper than expected recovery in the housing market; and potential supply bottle necks arising from the unprecedented investment plan.

This is reflected in the dispersion of inflation projections, which range from the Qatari Ministry of Finance which expects 3% in 2014 and 3.4% in 2015 to HSBC projecting 3.8% and 4.5% over the same period.

The exchange rate peg to the US Dollar limits the ability of the Qatar Central Bank, QCB, to use interest rate policy to manage inflation. Nevertheless, the QCB has been able to engineer a spread of around 4 percentage points between lending and deposit rates. Similar to Oman, the QCB has installed ceilings on the amount commercial banks can deposit and lend from the QCB, which act as an informal capital control.

Going forward the QCB should accelerate the deepening of capital markets and develop its liquidity framework to increase the potency of monetary policy to combat the threat of potentially rising and volatile inflation.

2. Diversification of governmental revenue

Qatar's diversification agenda and National Vision 2030 set a target to fund 100% of government expenditure with non-hydrocarbon revenues by 2020. The size of the diversification task is immense: government revenue from non-hydrocarbon sources has grown at an impressive rate of 12% a year in the period 2008-2013, but is still dwarfed by revenue from hydrocarbons which have grown by 20% a year over the same period. This has limited the revenue diversification and the non-hydrocarbon fiscal balance is projected to be -46% and -44% for 2014 and 2015 respectively.

To fund government expenditure fully through non-hydrocarbon sources in 2012-13, the economy would have needed to double its non-hydrocarbon revenue. For the next 2 years the gap equates to \$62.5bn or 21% of QIA's, Qatar Investment Authority's, assets under management. Given this gap, Qatar will need to consider reforms to its revenue base to diversify the revenue sources.

3. Management of governmental expenditure

In addition to the contracted projects for the 2022 World Cup, there is over \$100bn of infrastructure pre-execution contracts waiting to be awarded over the next 3 years, according to MEED the Middle Eastern infrastructure project tracker.

Based on our analysis, the government can expect to finance at least 40% of these new contracts. To manage investments on this scale, Qatar needs to develop best in class forecasting and expenditure management capabilities to avoid the cost overruns typically associated with infrastructure projects. Big infrastructure projects are notoriously subject to substantial cost overruns, for example, Dubai's city metro final costs overshoot contracted expenditure by 75%, and the UK government does factors in a 66% cost contingency for complex infrastructure projects.

With the remaining 60% of contracts having the potential to be privately financed, the Qatar Government needs to be able to properly incentivise the private sector to effectively finance and monitor these projects.

Box 1: Focus on Natural Gas

Natural gas as the Qatari answer to depressed oil prices

Like most economies in the GCC, the Qatari government has traditionally derived most of its revenue from oil (52% of hydrocarbon revenue in 2013). With the oil price down more than 40% since June 2013, our analysis indicates that if oil prices remain depressed, natural gas revenues will become the government's main source of revenue from the fiscal year 2014/2015. With a continuous strong demand from its main LNG export partners in Asia and new gas field developments, LNG has the potential to partially offset the impact of a prolonged period of low oil prices on the Qatari economy.

Our assessment is driven by three key factors:

- (1) Qatar's dominant global position in the LNG market, being the largest exporter as of 2013 and having the 3rd largest proven reserves (see Fig 5),
- (2) the decoupling of natural gas prices from oil prices, starting in 2008/09 with the US shale gas revolution (see Fig 6) and more recently in the LNG market,
- (3) and increasing popularity of natural gas over other fossil fuels due to its lower carbon emissions.

Significance of LNG in Natural Gas market

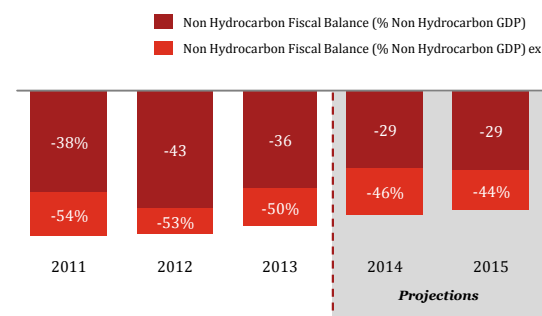
Natural gas prices mirrored oil prices until the shale gas revolution. Since then the natural gas market split into three regional markets:

- the US domestic market;
- the European pipeline market; and
- the LNG market targeting mainly Asian demand.

The price difference between these regional markets exacerbated following the 2011 Earthquake in Japan which led to the closure of the majority of its nuclear power plants. Asia now accounts for 73% of world LNG imports and pays up to \$18/mBtu, compared to \$10-\$12/mBtu in Europe and around \$4/mBtu in the US market. Qatar benefits from these price differentials with 62% of its LNG exports directed to Japan, South Korea, India and China alone (see Fig 7).

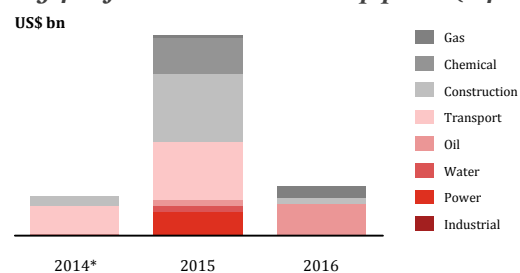
While the LNG market is characterised by long-term contracts which reduce price sensitivity to changes in demand, a lift of gas export bans in the US and new capacity build up in Australia, that some forecasters expect to overtake Qatar as the biggest LNG exporter by 2019, are likely to lower the price difference. Going forward, Qatar will need to consider whether it wants to maintain its 32% market share by lifting its moratorium on the North Field and bringing on stream new projects such as the Barzan field.

Fig 3: non-hydrocarbon Fiscal Balance



Source: IMF

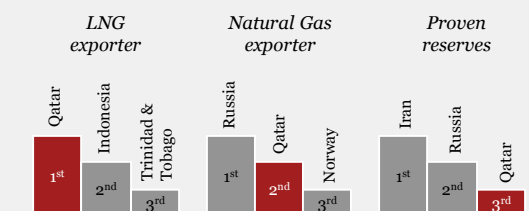
Fig 4: Infrastructure contracts pipeline ('14-'16)



Source: MEED, PwC Analysis, *only December 2014

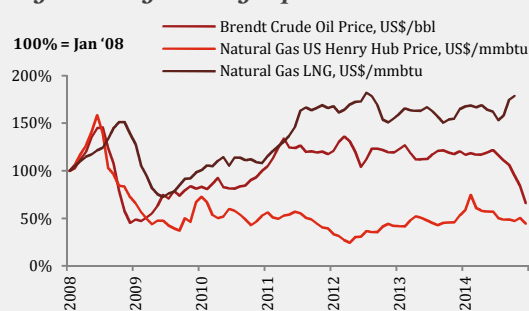
Fig 5: Qatar's position in the natural gas market

Based on 2013 data



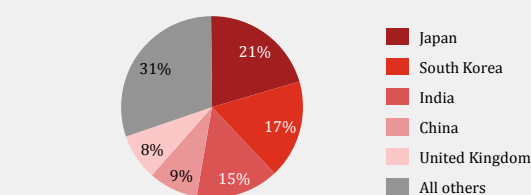
Source: BP 2014 Statistical review of World Energy

Fig 6: Divergence in gas prices



Source: World Bank, Thomson Reuters Datastream
(Latest values: Oil: 16/12/2014, US Henry Hub: 16/12/2014, LNG: Oct 2014 Avg)

Fig 7: Qatar LNG export destinations (2013)



Source: BP 2014 Statistical review of World Energy

Strengthening macro-fiscal capabilities

"I stress that the waste, extravagance, mishandling of state funds, lack of respect for the budget, reliance on the availability of money to cover up mistakes are all behaviours that must be disposed of, whether oil prices are high or low."

– HH The Emir Sheikh Tamim bin Hamad Al-Thani

at the 43rd session of the Qatar Advisory Council, 25th November 2014

Qatar should take advantage of its current position by building its macro-fiscal capabilities to meet the 2030 National Vision. Building this capability will aid Qatar's goal of achieving an AAA credit rating, help to develop a business environment attracting private and international investors, diversify the economy and ensure prudent management of the budgetary process. We believe to achieve these outcomes, authorities should focus on three distinct issues.

1. Continue to deepen capital markets

One of the prerequisites for an effective monetary policy is a deep and liquid local capital market and active sovereign debt market.

Qatar's equity market is the third largest by market capitalisation in the GCC and has attracted more trading volumes following its graduation into the emerging countries group by MSCI in May 2014. However, the number of equities listed on the stock exchange is low at 43 with only one IPO in the last 4 years (see fig 8) suggesting a scope for further growth.

Compared to the UAE, the majority of outstanding debt in the market is sovereign. The Qatari government has been the most active within the GCC to deepen the sovereign debt market in recent years by issuing bonds with a range of maturities in an effort to build a yield curve.

Development of the sovereign debt market in particular has allowed Qatar to gain international credit ratings of Aa2 from Moody's and AA from S&P, but in order to gain the top credit ratings held by nations such as Singapore, further measure must be taken (see the box on right for key lessons from Singapore).

With sovereign debt amounting to 34% of GDP in 2013, and expected to decline below 20% over the next 3 years, Qatar has plenty of room to support the growth of the sovereign market further. Qatar's focus should also shift to assessing any barriers for issuance of more corporate debt and perception of the effectiveness of Qatari institutions by investors and companies themselves compared to the UAE. This should lead to four identified benefits:

- 1) smooth and lengthen the yield curve;
- 2) increase interest in Qatar from external investors;
- 3) accelerate the professionalism of government through exposure to external analysts; and
- 4) smooth lumpy investments.

Together with a push to strengthen domestic institutions such as legal courts and commercial disputes settlements, Qatar will be well positioned to achieve its AAA rating goal.

2. Expand the revenue base

To meet the nation's non-hydrocarbon financing goal, a larger non-hydrocarbon revenue base is required. This can be achieved by shaping incentives around key focus areas. For example, like other GCC countries, Qatar is at risk from high obesity and diabetes levels. By shaping incentives to reduce consumption of unhealthy foods by introduction of new taxations the government can support its 2030 vision of a sustainable healthy society, while also raising non-hydrocarbon revenues.

When building this revenue base it is important levies are enacted in ways consistent with certain principles. These may include:

- introducing incentive shaping measures on a small and gradual scale in order to not provoke extreme reactions;
- levying areas of issue consistent with achieving Qatar's National Vision; and
- considering distinctions and cultural differences between Qataris and non-Qataris.

3. Performance based budgeting

Increased governmental expenditure and growth in governmental services are key to the diversification efforts of the Qatari government. In order to manage expenditure efficiently and avoid inflation volatility, performance metrics should be introduced into the budgeting processes by linking budgeting of funding with national strategy and planning.

Ministries and the QCB have a leading role in the implementation of performance based budgeting. This involves a move from annual to multi year budgets, implementing accruals accounting rather than cash, utilising an appropriate IT system to monitor and measure performance through specific indicators more effectively. To implement this, the Ministries will need to build their capabilities in forecasting, budgeting, accounting and measuring performance.

The budget reform process should be inspired by international best practises and standards, but adapted to the specific context, strategy and capabilities of the State of Qatar.

Fig 8: Equity markets and outstanding debt in the GCC

	Market capitalisation (\$bn)	# of equities	IPOs '10-'14	Outstanding Debt (\$bn)	Maturing pre 2020 (\$bn)
KSA	540	164	27	31	18
UAE	266	124	6	118	78
Qatar	201	43	1	86	51
Kuwait	101	204	0	4	3
Oman	25	123	11	5	5
Bahrain	20	38	1	20	12

■ Public ■ Private

Source: Capital IQ, PwC Analysis

Box 2: Deepening the sovereign debt market – Lessons from Singapore

Singapore has an economy with a fiscal surplus and managed exchange rate, similar to Qatar and has:

- Built a deep sovereign debt market and corresponding yield curve,
- Gained international credit ratings of Aaa, AAA and AAA from Moody's, S&P and Fitch respectively.

It achieved this through disciplined debt management:

- Monetary Authority of Singapore issues, reopens and introduces new bonds,
- Whilst accumulating gross debt of 103% of GDP, net debt is 0% due to investment of proceeds through its sovereign wealth funds.

Projections: January 2015

Economic Indicators

Indicator	2013	2014p	2015p	2016-19p (Avg)
GDP (real annual % growth)	6.5%	6.0%	6.5%	6.2%
Inflation	3.1%	3.5%	3.8%	4.0%

Sector GDP composition and growth (real average growth)

Sector (% of 2013 GDP**)	2012	2013	2014*	Key issues/trends
Agriculture & Fishing (0.1%)	4.6%	5.9%	9.6%	Agriculture continues to expand with the aid of government subsidies as part of the National Food Security Plan established in 2011.
Oil & Gas (Mining & Quarrying) (54.4%)	1.4%	0.2%	-2.2%	The Moratorium imposed on further gas exploration in the North Field coupled with maturing gas sources and lower oil prices have served to contract the sector in 2014.
Manufacturing (9.9%)	11.1%	5.8%	3.4%	Sector growth continues to be fuelled by downstream facilities for oil and gas. Strategic investments in other industrial segments will help the nation meet its diversification target.
Electricity & Water (0.5%)	10.3%	6.6%	11.7%	Forecasts suggest demand will outstrip supply by 2020. This has prompted efforts to attract more private investment and in particular expand alternative energy sources such as solar production.
Building & Construction (4.8%)	9.0%	13.6%	14.5%	Construction has seen large growth in 2014 so far due to the large number of projects undertaken for the 2022 World Cup as well as other infrastructure initiatives.
Trade, Restaurants & Hotels (6.1%)	6.1%	12.6%	11.1%	Business tourism remains the main driver of the sector, but growing numbers of leisure visitors reflect the investment made in cultural, outdoor and sports tourism projects.
Transport & Communications (3.3%)	5.8%	9.7%	11.8%	Investment in the nation's ports, airport and public transit infrastructure as well as a new national 4G network have contributed to the sectors significant growth and will benefit other sectors logistically going forward.
Finance, Insurance, Real estate and Business Services (12.3%)	12.0%	13.4%	16.6%	The sector has seen high growth in 2014 with a greater number of Sharia compliant lenders enlarging the market. Strong population growth and a mandatory health insurance scheme will aid expansion of the insurance industry.
Government Services (9.4%)	12.3%	15.5%	9.3%	Rapid expansion in higher education opportunities, with many university partnering schemes, and healthcare investment aim to grow the sector in line with the National Development Strategy. State expenditure has increased annually at 21.8% between 2008 and 2013 and is projected to increase in the coming year.

Excludes: Social Services, Imports duties, Household services and Imputed bank services charges

*YoY % change based on latest available data,** Based on 2013 Nominal GDP, shares do not add to 100% due to excluded sectors

Source: IMF, Qatar MDPS, PwC Analysis

Equity market performance

Stock Market Index	2011	2012	2013	2014*
Qatar SE All Share (annual % change)	24.0%	9.4%	16.2%	37.2%
MSCI GCC (annual % change)	2.0%	1.5%	11.2%	27.2%

Monetary policy rates

Rate	Current Value	Previous Value	Last Changed
Deposit	0.75%	1%	August 2011
Lending	4.5%	5%	August 2011
Repurchase	4.5%	5%	August 2011

* Latest available data (16/12/2014)

Source: Qatar Central Bank, Thomson Reuters Datastream, PwC Analysis



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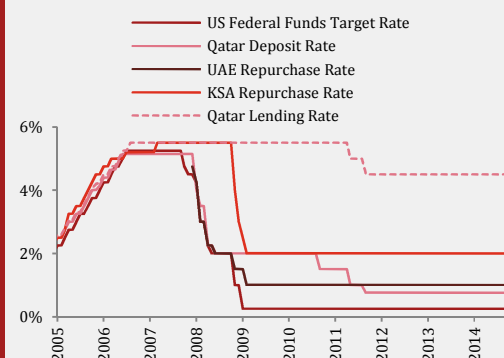
Milos Bartosek

The future evolution of Qatar's monetary policy

Going forward we expect the Federal Reserve to instigate contractionary policy implying a rise in the Federal Funds Target Rate.

This will narrow the policy wedge that has widened following the outbreak of the financial crisis and was maintained by the QCB to manage monetary policy more actively despite the continuous peg to the US Dollar.

Fig 9: Selected Policy rates 2005-2014 (M10)



Source: Thomson Reuters Datastream

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