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Embargo on Qatar: Manageable for the time being, but not perennially

On June 5, 2017 Saudi Arabia, the United Arab Emirates, Egypt and Bahrain (known as the quartet) announced they were breaking diplomatic ties with Qatar, due to the country's relations with Iran and accusations that it supports extremism. The quartet has suspended all air and sea travel links with Qatar, while Saudi Arabia has closed its borders with the country. This means that overland imports of food and other suppliers to Qatar are blocked. Sanctions have had diverse impacts, particularly on trade, capital and human flows. Nevertheless, Qatar, the world's largest exporter of liquefied natural gas, has been able to soften the effect of the crisis so far, thanks to its reserves of cash and gold. The government has taken immediate and effective measures which, along with rising energy exports, have been able to mitigate the challenges arising from the crisis. Against this backdrop Coface expects the Qatari economy to grow by 3.4% in 2017 and by 3% in 2018 - although this is far below the real annualised growth of 13% recorded between 2005 and 2014.

Impacts of the embargo on the Qatari economy: Under control so far

Growth figures indicate a slowdown in the Qatari economy but this is mainly due to the floundering oil sector and subdued energy prices. Real GDP increased by 0.6% yoy in the second quarter, a slow down from the 2.4% yoy recorded in the first quarter. However, on a quarterly basis, the economy expanded by 0.5% in the second quarter of 2017 – a recovery from the contraction of -1.5% in the first quarter (although figures only cover the first month of the embargo). The lacklustre oil sector was the main reason for the annual slowdown in the economy. The mining and quarrying sector, which accounted for almost half of GDP on constant prices, shrank by 2.7% year on year in the second quarter of 2017, following a contraction of -0.4% year on year during the first three months. The OPEC agreement, which includes production cuts by major oil producers, has negatively affected the sector. In the second quarter of the year, Qatar's crude oil production fell to 613 thousand barrels per day (tb/d), down from 656 tb/d in 2016 and 663 tb/d in 2015[1]. Non-oil sectors showed a growth of 3.9% year on year in the second quarter of 2017, decelerating from 5.2%. On a quarterly basis, non-oil activity remained flat, indicating that the economy has been affected by the Gulf crisis. Manufacturing output expanded by 1.2% from the previous quarter.

1 - *Monthly Oil Market Report, September 2017, OPEC*

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The main impacts of the crisis have been felt in the construction, retail trade and transportation sectors which contracted on a quarterly basis by 4.1%, 2.6% and 7% respectively, in the April-June period. The embargo has temporarily interrupted Qatar's imports, which may have resulted in shortages of certain construction materials and caused delays in some construction projects.
The closing of Saudi Arabia's border and the ban on Dubai as a trans-shipment hub have forced Qatar to reorganise its shipping lines. The transportation sector has visibly suffered from this situation and the retail sector (like the rest of the Qatari economy) is heavily dependent on imports. The figures indicate that imports dipped by 8% in the second quarter of 2017 compared to the previous quarter.
A continued crisis will drag down the pace of growth, as it will negatively weigh on consumer and investor confidence. Certain non-hydrocarbon sectors, such as tourism and transportation, will particularly suffer from the sanctions. Growth in the tourism sector is expected to slow, as nearly 40% of tourist arrivals into the country originate from the Gulf region. After declining by 10% in 2016, Qatar's international tourism receipts are expected to fall by a further 11.8% in 2017, with an annual revenue of $10.1 billion (equivalent of 6% of GDP[2]). The imposition of land, air and sea blockades from the quartet is believed to have cost Qatar Airways 50 flights a day and 18% of its total seating capacity[3]. The termination of direct flights between Qatar and the quartet is also weighing on reciprocal trade and service flows.
Lower confidence could also affect private consumption. Real growth in household consumption (which was already hit by fiscal consolidation) could slow to as low as 3% in 2017, after rising by 6% in 2016[4]. The fact that headline inflation has remained subdued so far can be considered as a positive development which should prevent household consumption from slowing further. In August, overall consumer prices in Qatar fell by 0.4%. During the same month, food and beverage prices rose by 2.8% on an annual basis, after jumping by 4.5% in July - their highest increase since 2014 when they were affected by economic sanctions. Disrupted trade routes due to the sanctions could present challenges for Qatar's external balance. In July 2017, imports dropped by 35% compared to a year earlier, amid the sanctions imposed by the quartet. In August, imports continued to decline, although at a slower pace, by 7.8%. Over the upcoming period, imports could continue to recover due to the re-routing of trade flows. The fall in imports could be temporary, as Qatar will continue to import the construction materials and machinery it needs for its large scale infrastructure projects - although at higher prices. Coupled with lower earnings from energy exports due to low prices, it will be difficult for the country to attain the levels of its former double-digit current account surpluses.
According to the IMF, the current account balance is only expected to reach 0.7% of GDP in 2017 and 0.6% in 2018, figures which are far below the 21.2% average between 2005 and 2014.
The crisis has also affected the banking system. Qatari banks are beginning to have increased funding needs in the aftermath of the crisis, due to the withdrawal of deposits by GCC residents deposits from the Qatari banking system. In July, the balance sheets of commercial banks shrank by 10.6 billion riyals, a fall of 0.8% compared to May just before the embargo. Deposits from overseas customers dropped to 148.97 billion riyals in August, down from 170.6 billion riyals in June. During the same period, foreign bank deposits and borrowings fell to 169.8 billion riyals, down from 192.7 billion riyals.

Government support is key to dealing with the challenges

The government's support has so far helped the Qatari economy to deal with the negative impacts of the crisis. The government has notably deposited billions of dollars into the local banking system to prevent liquidity from drying up, as Gulf residents have started to withdraw their deposits. According to the central bank data, Qatar pumped 29.1 billion riyals ($8 billion) into the banking system in August, increasing public deposits to 302.6 billion riyals (up from 273.5 billion riyals in July). In June when the crisis began, public deposits stood at 249.8 billion riyals. In August 2017, the central bank's international reserves and foreign currency liquidity increased to $38.3 billion, up from as low as $35.4 billion in July. In addition, the Qatar Investment Authority (QIA) has $300 billion in reserves that it could liquidate. According to Thomson Reuters data[5], the QIA sold 4.4 million shares in jeweler Tiffany & Co, reducing its stake from 13% to 9.5%, just weeks after it reduced its stakes in Credit Suisse Group.
Another measure has been to reorganise supply chains, in cooperation with other regional and international actors. Turkey has been delivering food to Qatar by air and sea. Turkey's exports to Qatar increased by 42.3% in June and by 170.2% on an annual basis in July. Qatar and container lines have established new shipping services via Oman, Kuwait and the Indian subcontinent, due to the ban of Dubai as a trans-shipment port. In August, Turkey announced plans to use a land route through Iran to export goods to Qatar. The new trade line is expected to reduce the transportation costs of food products by nearly 80% compared to air freight charges. Qatar is also looking to speed up the completion of its new Hamad Port, with the aim of expanding shipping routes to India, Oman, Turkey and Pakistan. This would allow Qatar to import more food, construction materials and other products. Securing food supplies is also on the government's agenda, as it is dependent on imports for over 90% of its supplies.
Before the blockade was imposed, Qatar imported most of its food needs through the Abu Samra crossing, on the Saudi border. On August 23, the Qatar Islamic Bank provided $440 million of financing to build food processing and storage facilities at Hamad Port. These measures are aimed at countering possible inflationary pressures resulting from food prices affected by higher import costs.
Qatar's hydrocarbon exports are continuing to soar. The country exports both oil and piped gas, but its biggest role is in the liquefied natural gas (LNG) market, where it accounts for one third of global trade. During the first half of 2017, Qatar's natural gas exports rose by 19.3% from a year earlier, while its oil exports jumped by 31.6% in the same period. The country exports all of its LNG through the Strait of Hormuz and the transit passage through the Strait is protected by international laws. Qatar's LNG exports within the GCC region are limited (accounting for only around a tenth of its total LNG exports), which means that any measures from the boycotting countries would have relatively low impacts. The authorities have announced that the diplomatic crisis has not affected the country's long-term energy contracts. Qatar has long-term supply contracts with over 15 countries and the UK, Korea, Japan and India remain its biggest clients. Qatar's dry natural gas production is expected to increase by 1.1% in 2018 compared to a year earlier, after inching down by 0.3% in 2017[6].
Annual growth in the construction sector, which accounts for nearly 9% of GDP, is continuing to support the economy. Construction activities jumped

2 - Qatar Tourism report, Q4 2017, BMI Research
3 - The GCC Crisis and Qatar Airways, 13/08/2017, International Policy Digest
4 - Qatar Country Report, Q3 2017, BMI Research
5 - Qatar sovereign wealth fund cuts stale in Tiffany & Co, 14/09/2017, Reuters News
6 - Qatar Oil & Gas Report, Q4 2017, BMI Research

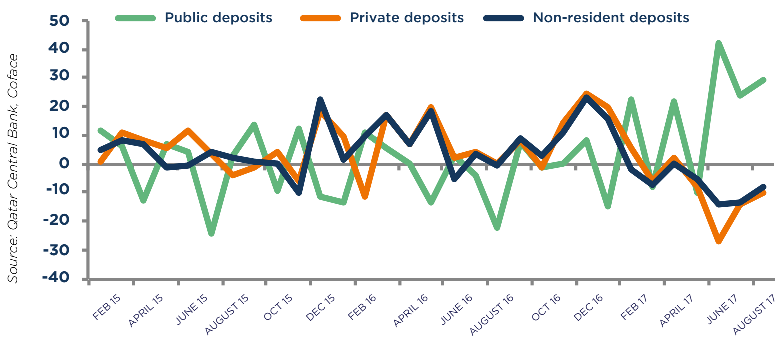
by 15.3% year on year in the second quarter of 2017, after growing by 15.9% in the first quarter. This solid expansion is backed up by the government's strategy of economic diversification and investments driven by the 2022 FIFA World Cup organisation. Even before the blockade, the Qatari government was taking the necessary steps to secure the supply of building materials. In 2006, Qatar Primary Materials Co (QPMC) was established to safeguard supplies of these materials. The country usually imports large stocks of materials, able to ensure sufficient supplies for another few months. The country imports some materials from the blockade. China remains a major supplier of tiles and wood. Steel and cement are among the most important building materials needed by local constructors. In order to prevent a potential bottleneck, Qatar's government had been stockpiling cement. In January 2017, the QPMC announced that it would inaugurate its new cement storage silos project during the first quarter of 2017, to ensure the sustainability of cement supplies. According to a statement from the company, the project will comprises two cranes, two conveyor belts and 12 concrete silos – each with a storage capacity of 5,000 tonnes, to give a total of 60,000 tonnes. Iran will also continue to play an important role in Qatar's cement supply and it provided 1.2 million tonnes of the 1.5 million tonnes of cement imported by Qatar in 2015. All in all, the construction industry is expected to grow by 11.6% in 2017 and 10.1% in 2018 – although there are downward risks if the diplomatic rift lasts longer[7].

Banks show resilience, thus far, to higher funding pressures...

As previously mentioned, public deposits remain a key source of funding for Qatari banks. This is another indicator of the importance of government support to overcoming the impact of the diplomatic crisis on the economy The share of public deposits in all customer deposits rose to 38% in August, up from 32% in June, as the government pumped money into the banking system to offset the decline in external funding. The country's substantial financial buffers are helping to maintain funding pressures at manageable levels. Higher public deposits will be more than sufficient to compensate for the funding needs caused by fleeing non-residents' deposits. Funding from the Qatar Central Bank (QCB) to commercial banks is also playing an important role in sustaining liquidity in the banking system. Funds due to the QCB rose as high as 38.9 billion riyals in July, up from 3.4 billion riyals at the end May, before easing to 28 billion riyals in August. Over the upcoming period, funding pressures are expected to continue as outflows will persist due to the unsolved diplomatic crisis. Nevertheless, the asset quality of the Qatari banking system is high. Banks are backed by the government's immense capital buffers, which maintain liquidity at comfortable levels.

Qatari banks' exposures to GCC countries are limited, accounting for around 20% of total external liabilities[8]. Qatari banks enjoy funding from other regions as well, such as Asia and Europe, which is helping them to offset sanctions. In July, the Qatar National Bank applied for a license in Hong Kong. The bank has also said that it will convert its China representative office into a branch[9]. According to some media experts, Qatari banks are said to be considering funding options such as loans, private placement or dollar bonds in Asian markets. Non-performing loans are low, at 1.2% of total loans. Banks remain well capitalised. The overall capital adequacy ratio stood at 15.7% in 2016, compared to the required ratio of 12.5%. Thanks to all of these liquidity supports from the government and the central bank, along with the opening of new trade routes, new suppliers and solid growth from the gas and infrastructure sectors, the Qatari economy has so far performed quite well and maintained a bright outlook. Nevertheless, with no quick solution to the crisis and ongoing tensions, risks are rising.

CHART 1
Monthly change in Qatari commercial bank deposit (bln riyals)



Higher challenges in the medium-term

The possibility that the crisis lasts more than few months is the biggest threat to Qatari economy. The quartet has refused to negotiate on a list of 13 demands to Qatar, which include scaling down ties with Iran, shutting down the Turkish military base, closing down news outlets funded by Qatar and stoping the funding of extremism. Qatar has stated that the blockading countries are being stubborn on their policies and that their sanctions are against international laws. If the parties take longer than a few months to come to an agreement, Qatar's import costs will escalate further. This would impede growth in the construction sector and would push prices up, due to the higher costs of building materials. Qatar's tourism revenues would also decline further in the face of continued tensions. This would dampen the country's growth performance, despite interventions from its government to reduce financial and fiscal risks. Growth would primarily be hit by lower growth in non-hydrocarbons. Subdued energy prices have already put the country under pressure in terms of budget expenses. Without public support, non-hydrocarbon sectors, which accounted for 51% of GDP as of the second quarter of 2017, would show weak growth performance. Furthermore, continued political uncertainty would drag down investments. This, combined with tighter monetary policy (due to the currency peg to the US dollar) and lower public support, would moderate the growth of non-hydrocarbon sectors.

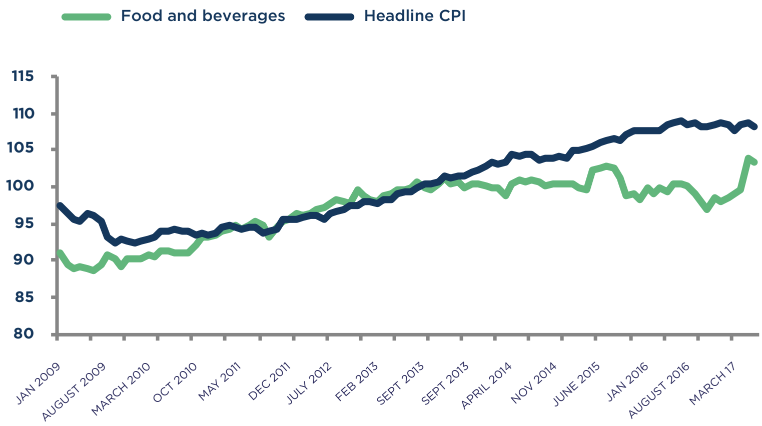
As the crisis continues, uncertainties will rise, which could also negatively affect the government's goal of economic diversification. Qatar is endevouring to diversify its economy away from the hydrocarbon sector, by building up a domestic industrial and manufacturing infrastructure. However, investments into these areas would be hampered due to greater uncertainties, lower corporate profitability on reduced regional trade volumes and higher logistical costs.

7 - *Qatar Infrastructure Report, Q3 2017, BMI Research*
8 - *State of Qatar Ratings Affirmed At 'AA-/A-1+'; Outlook Negative, 25/08/2017, S&P Global Ratings*
9 - *Qatar's Biggest Bank Turns to Asia to Offset Saudi-Led Sanctions, 13/09/2017, Bloomberg*

The banking system would also be affected by weaker economic conditions, lower investor sentiment and deposit outflows. High competition for funding (in an environment where the Qatari Central Bank is already increasing its rates following the US Federal Reserve) will force banks to accept higher borrowing costs. This situation would weigh on banks' margins and limit their profitability.

Qatar's fiscal strength would also be affected by the disputes. If the crisis is prolonged, further fiscal consolidation could dampen growth performance. The budget balance, already under pressure from low energy prices, is expected to record deficits of 3.1% of GDP in 2017 and 0.6% in 2018[10], dragged down by the ongoing diplomatic rift. Aiming at cutting extra spending, the government has already announced that it will cut the world cup budget by almost half (to between $8 billion and $10 billion). The government's efforts to mitigate additional costs to the economy through the above mentioned measures should delay the budget balance from leaving the positive zone. The introduction of value-added tax (VAT) in 2018, as a part of the fiscal consolidation measures, may not have a noticeable impact on the budget performance, as at 5% it will be small and many essential food and service items will be exempt.

CHART 2
Qatar headline and food CPI (Index, 2013=100)



The liquidity of the Qatari banking system will continue to be an important topic to monitor. Low energy prices and deposit outflows will push banks to rely more heavily on government funding and extra-regional funds. This could represent a challenge, as international investor confidence could rapidly be hurt by higher volatility in energy prices or an escalation in diplomatic uncertainties. Qatar's substantial financial buffers should be able to help mitigate these risks, but it should be noted that Qatari authorities have already warned banks to tap international markets for raising funds, rather than over-relying on public funding[11].

In August 2017, non-resident deposits fell to 149 billion riyals, down by 19.3% from their May level. If the outflows continue at this pace until the first year anniversary of the embargo, in June 2018 non-resident deposits will have fallen below 80 billion riyals ($21.6 billion). This would mean a decline of around $20 billion in the banking system's liquidity between August 2017 and June 2018, equating to almost half of the central bank's current international reserves and foreign currency liquidity. Although this is a very unlikely scenario, such a development would not be tolerated by the government and it would continue to pour liquidity into the banking system, by using its huge financial buffers to avoid a squeeze on liquidity.

Higher imports from countries other than the GCC region would create additional costs to businesses, as Qatar imposes a 5% ad valorem tariff on the cost, insurance and freight (C.I.F.) invoice values of most imported products from non-GCC countries, including food products. In 2016, Qatar's imports from the GCC stood at 16% of its total imports, at nearly $5 billion. The government may continue to absorb the additional costs resulting from the change of origin of supplier countries, but this would be at the expense of using its financial reserves.

To summarise, any deterioration in the current situation would result in additional costs for the Qatari economy. These negative impacts could be mitigated if energy prices continue to recover. On the other hand, increasing feedstock from the Barzan would allow lifting the production of refined products, petrochemicals and fertilizers. Expansion in the construction sector and further infrastructure projects would also sustain momentum in other manufacturing activities. These developments would be supportive of growth in non-hydrocarbon sectors.

10 - World Economic Outlook, April 2017, IMF
11 - Qatar to Tell Banks to Seek Overseas Funding as Gulf Spat Drags On, 17/08/2017, Bloomberg

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