

## Monthly Macroeconomic Review

February 1, 2009

- Mounting signs point to a **significant real crisis in the global economy** in 2009. Growth estimates in most advanced countries range from negative 1 percent to negative 2 percent. By contrast, following the brisk action taken by governments and central banks around the world, signs of the financial crisis and liquidity crisis are lessening.
- **Local indicators of economic activity** show continuation of the negative trend: sharp declines occurred in **December** in exports and imports of goods, in incoming tourism, and in state tax revenues. The industrial production index and the trade and service sectors revenue index declined in **November**.
- **The Bank of Israel** has sharply lowered its **growth forecast** for 2009, from 1.5 percent to a negative 0.2 percent, with steep declines in business GDP, exports, imports, and investments.
- **The consumer price index** decreased by just 0.1 percent in December, above forecasts. Inflation in 2008 totaled 3.8 percent, higher than the inflation target.
- **The BOI interest rate** was lowered by 0.75 percentage points to 1.00 percent, due to the deepening and lengthening of the global crisis and the BOI's estimates of a low point in real domestic activity in 2009.
- **The unlinked-bond yield curve** fell in the short and medium-term ranges during January, due to the interest-rate cuts by the BOI. Yields in the long-term range rose, due to factors including the grim forecast for the government deficit in the coming years.
- **In world equity markets**, the MSCI World index fell by 9 percent in January, the S&P 500 index lost 9 percent, the NASDAQ index lost 6 percent, and the MSCI Emerging Markets index lost 6 percent. By contrast, the TA-100 index gained 6 percent (but lost 1 percent in dollar terms).



This review contains four chapters:

- A. Developments in the Israeli Economy.
- B. Developments in the Capital Market.
- C. Developments in Inflation and Monetary Policy.
- D. Developments in the Global Economy.

## A. Developments in the Israeli Economy

Almost all indicators of economic activity point to a negative trend.

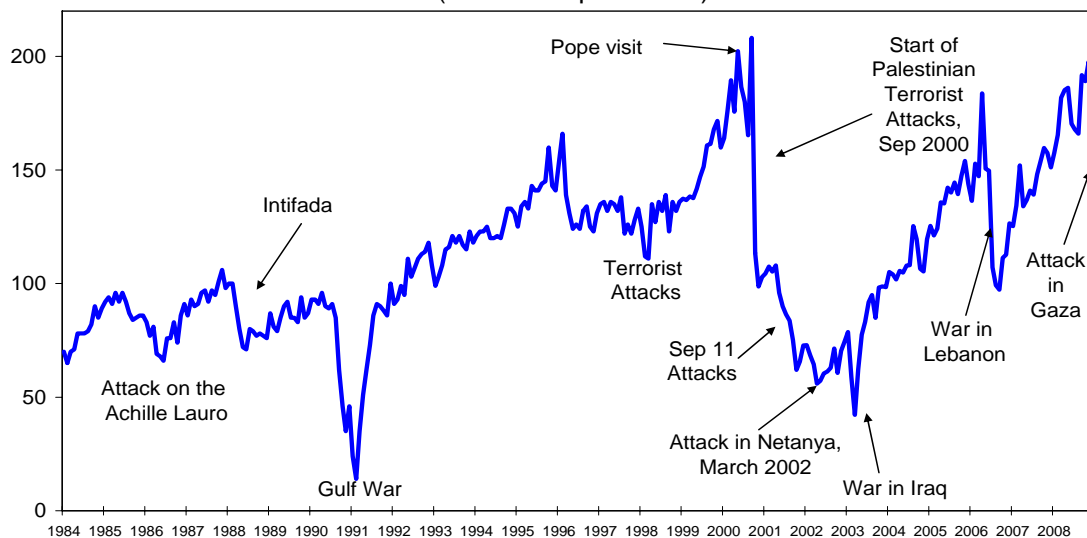
Exports and imports of goods dropped sharply in December. **Exports of goods** (excluding ships, aircraft, and diamonds; in dollar terms) declined by 5 percent in December, and by 8 percent in the fourth quarter of 2008 as compared to the third quarter. **Imports of goods** fell by 19 percent in December and by 17 percent in the fourth quarter as compared to the third quarter. These data indicate a significant downturn in economic activity.



**State tax revenues** were exceptionally low in December, at ILS 12.7 billion. The **budget deficit** for 2008 totaled 2.1 percent of GDP, versus the planned 1.6 percent. These figures reinforce our estimate that **a severe budgetary problem will arise in 2009**. Following the data for December, we estimate a tax revenue shortfall of ILS 35 billion, or 4.5 percent of GDP, in 2009.

**Incoming tourism by air** decreased by a steep 23 percent in December, based on data net of seasonal effects, and increased by 1 percent in the last twelve months. The decline in incoming tourism in December was affected by the fighting in Gaza in the final third of the month, but probably also reflected a downturn in global tourism as a result of the worsening recession in the advanced countries.

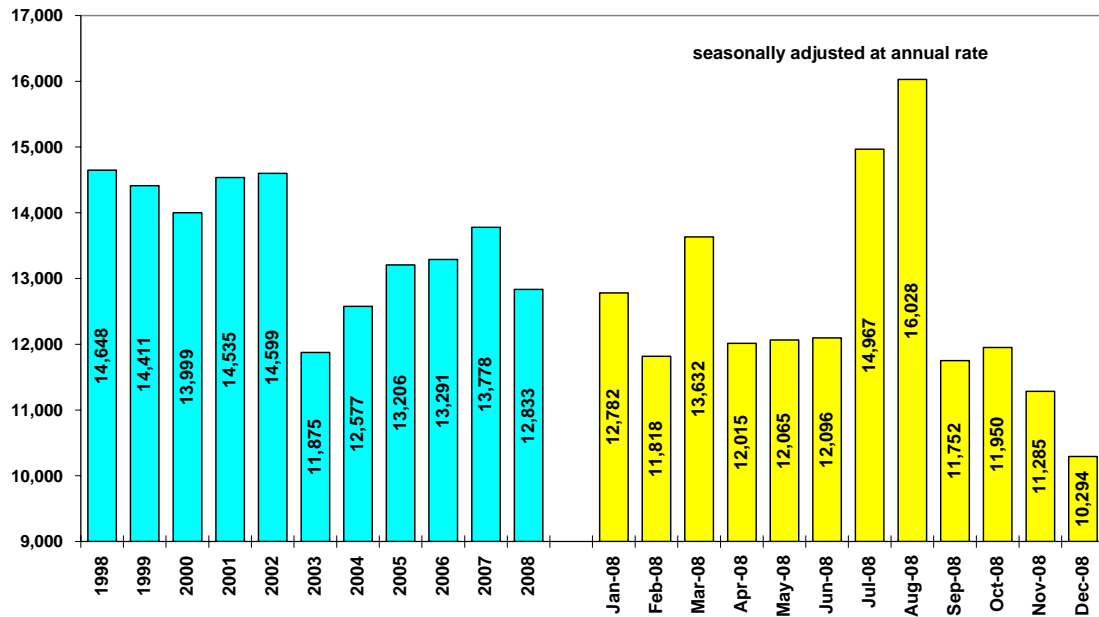
### Tourist Arrivals (thousands per month)



**Tourists' hotel stays** dropped sharply by 30 percent in December, based on data net of seasonal effects, and remained almost unchanged in the last twelve months.

**The number of new homes sold** decreased by 8.8 percent in December. Overall in 2008, 12,800 new homes were sold in Israel, down 7 percent from 2007.

## New Dwellings Sold During The Period



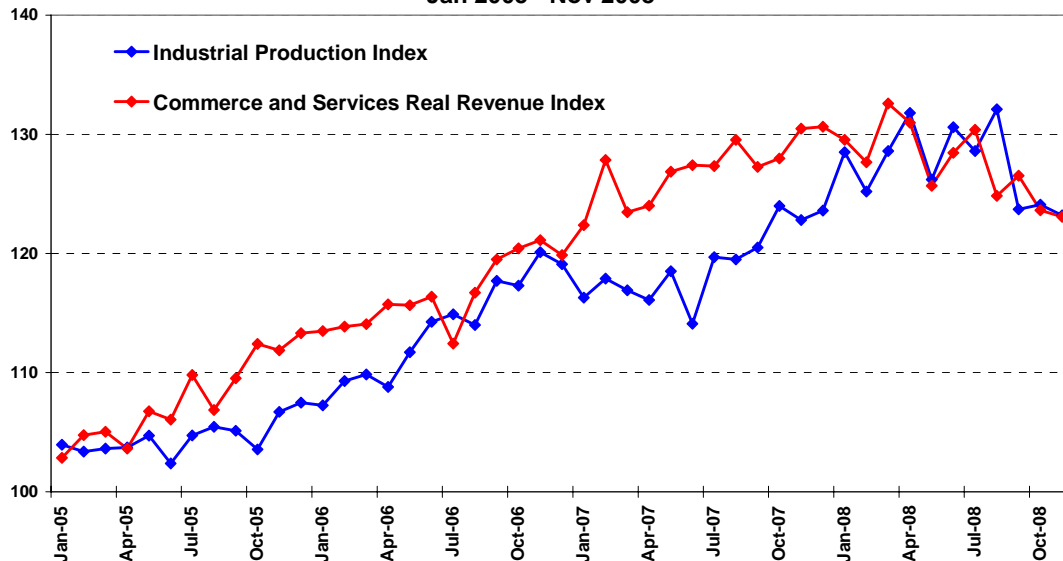
The supply of homes for sale decreased again, to a record 10.7 months of sales. The decrease in the supply of homes creates upward pressure on prices, which may balance the downward pressures arising from the economic slowdown and the decline in demand for housing.

The BOI has sharply reduced its **growth forecast** for 2009, from 1.5 percent to a negative 0.2 percent, with steep drops in business GDP, exports, imports, and investments; only a moderate increase in private consumption, with a decrease in per-capita private consumption; and a sharp increase in unemployment, to an annual average of 7.6 percent. According to the BOI's forecasts, growth in 2010 is expected to reach 2 to 2.7 percent.

We believe that the BOI's 2009 forecast is pessimistic, but given the macro-economic uncertainty globally and in Israel, it is certainly possible. For this forecast to materialize, growth in the US and in the other advanced countries would have to be worse than today's prevalent estimates. Furthermore, even if annual growth is near zero, the unemployment rate is unlikely to reach an annual average of 7.6 percent, but should be far lower. By contrast, the forecast for the deficit in the government budget, at 4.1 percent of GDP, is highly optimistic. If the BOI is correct in its macro-economic forecast, we fear that the deficit may be much larger. The BOI's forecasts for 2010, at 2.7 percent growth and an average annual unemployment rate of 7.6 percent, seem reasonable.

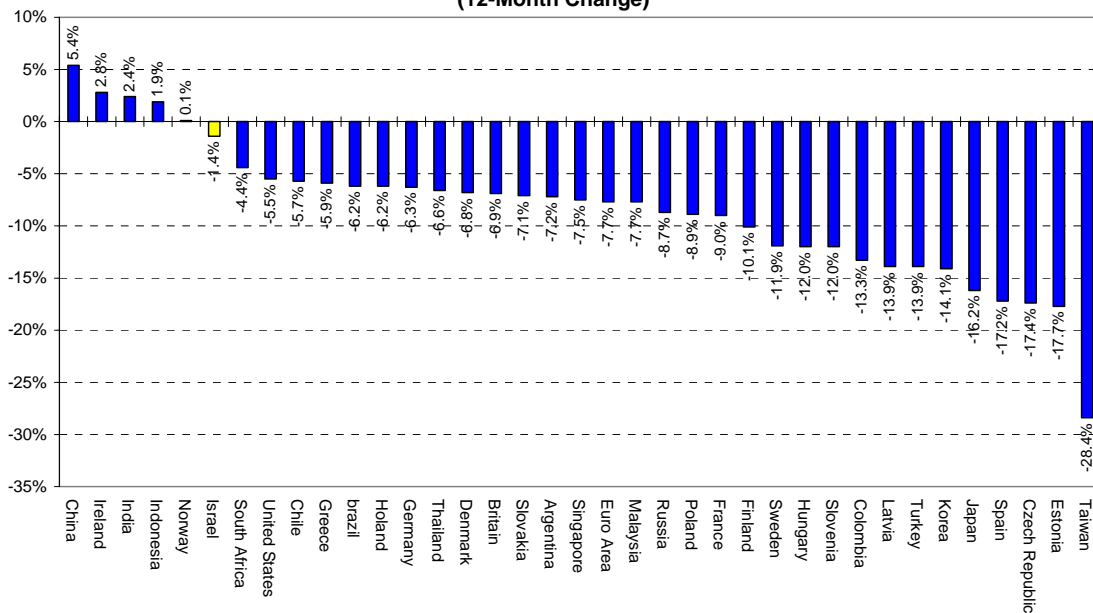
Indicators of economic activity in November were negative. The **industrial production index** fell by 0.7 percent in November, and remained unchanged in the last twelve months. The **trade and service sectors revenue index** lost 0.4 percent in November and 6 percent in the last twelve months.

**Industrial Production Index  
& Commerce and Services Sectors Revenue Index**  
Jan 2005 - Nov 2008



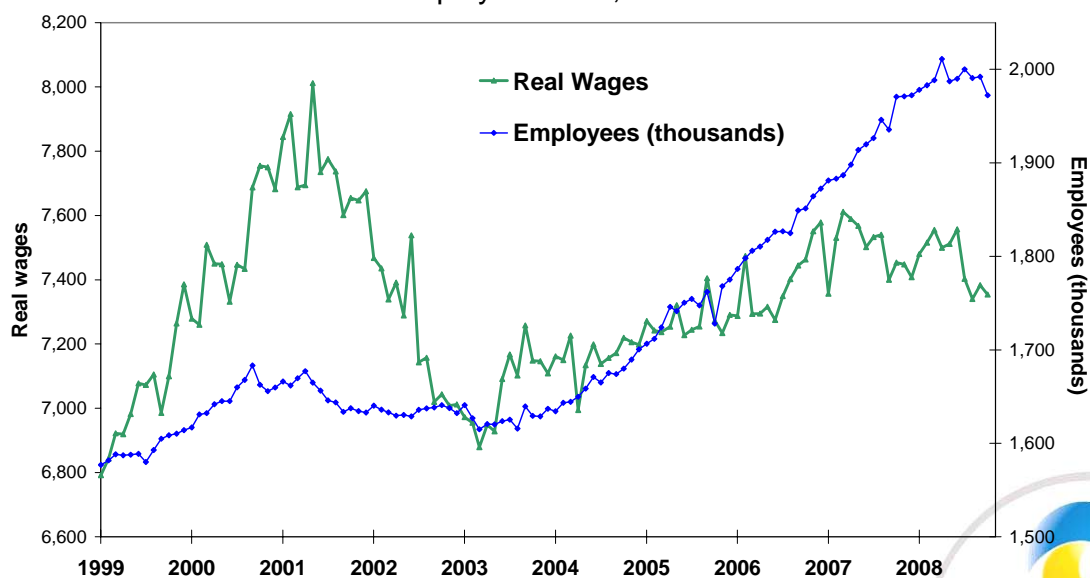
In most countries, one of the main sectors severely hurt by the economic crisis over the last year has been the **industrial sector**. This sector reacts strongly to declines in demand for private consumption, fixed investments, and especially reduced inventories by firms. An **international comparison** of changes in industrial production from November 2007 to 2008 shows a notable sharp decline in production in a majority of countries, particularly in Eastern Asia and Eastern Europe. In China too, where industrial production is still rising, the growth rate was much lower than in previous years. However, in **Israel** the damage to industrial production has been quite minor so far – a decrease of 1.4 percent in original data, or an actual increase of 0.3 percent in data net of seasonal effects.

**Industrial Production November 2008**  
(12-Month Change)



The number of employee positions of Israelis decreased by 1.8 percent in October and by 0.2 percent in the last twelve months. Average wages for Israelis' employee positions rose by 0.8 percent in October and by 4.5 percent in the last twelve months. In the business sector, employee positions including non-Israelis decreased by 1 percent in October, while real wages decreased by 0.4 percent.

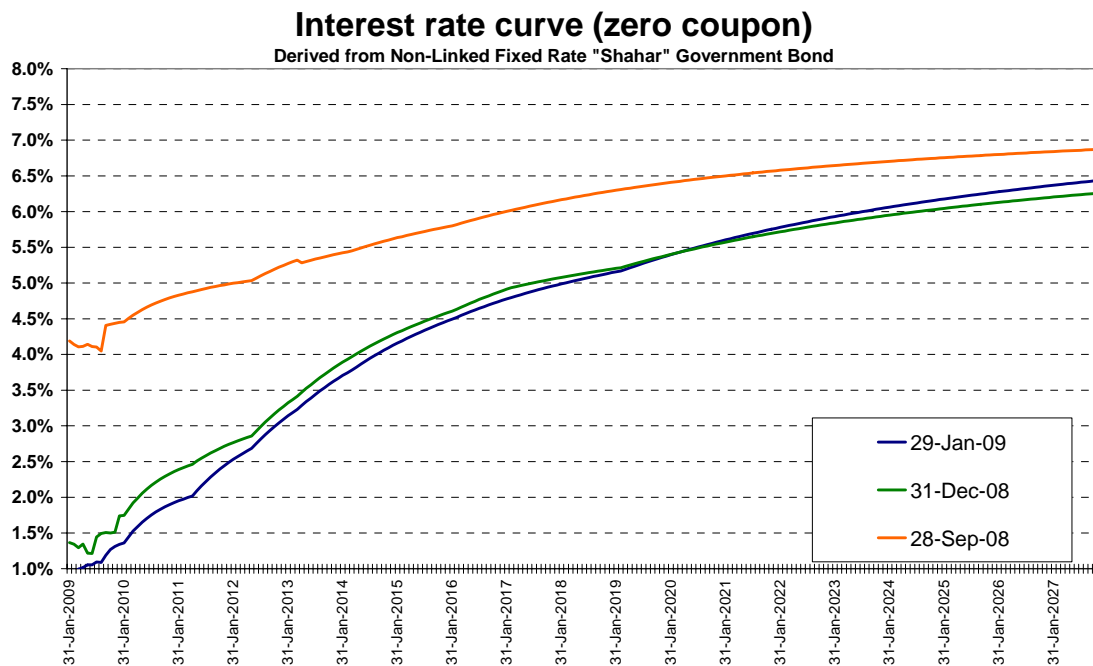
**Business Sector's Real Wages**  
and number of Employee Posts, Jan 1999 - Oct 2008



## B. Developments in the Capital Market

### Bond Market

The unlinked-bond yield curve fell in the short and medium-term ranges during January, due to the interest-rate cuts by the BOI. Yields in the long-term range rose, due to factors including the grim forecast for the government deficit in the coming years.

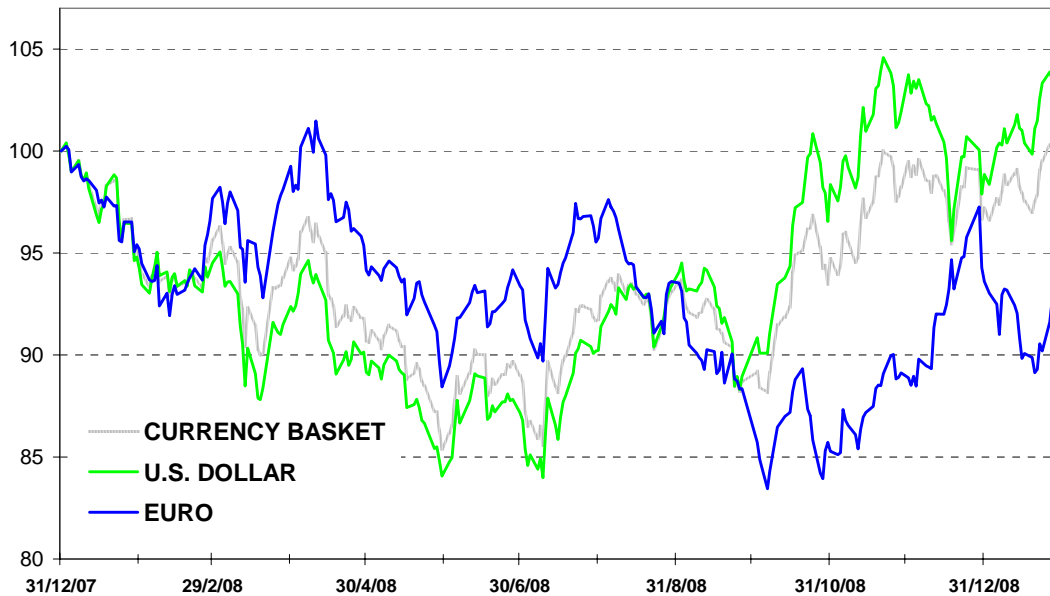


**Inflation expectations** derived from the capital market through the May 2010 CPI (the gap between the unlinked and linked government-bond yield curves) was at zero at the end of January. **We estimate** that inflation during this period will be far higher.

### Exchange Rates

In January, the **shekel** weakened by 5 percent against the currency basket and by 7 percent against the dollar, and strengthened by 1 percent against the euro.

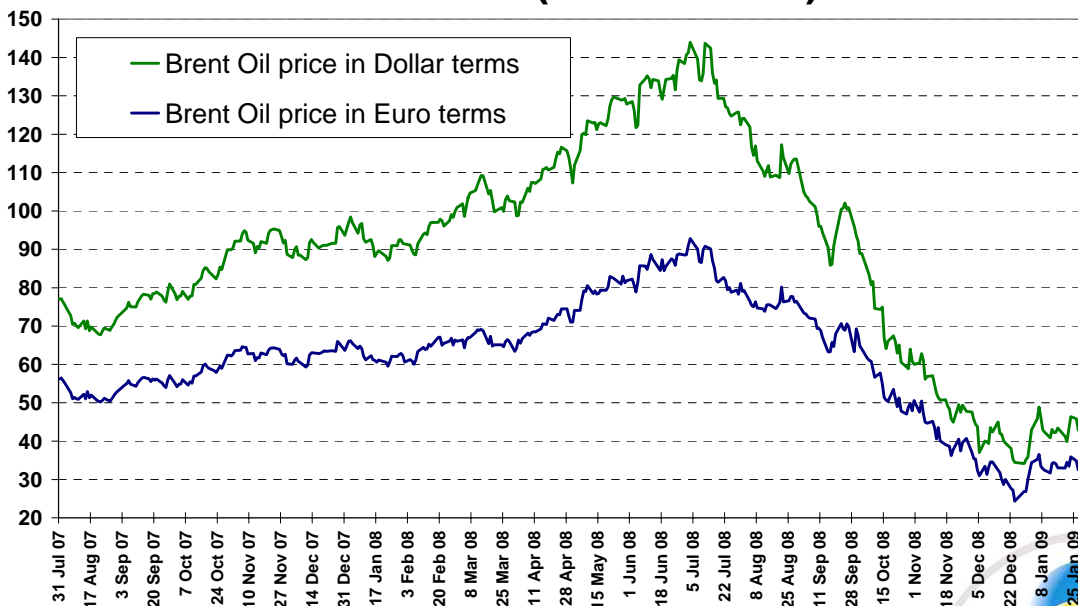
Exchange rates against the shekel, Dec 31, 2007 - Jan 30, 2009  
(Index, end-2007 = 100, increase means depreciation of the shekel)



## Oil Prices

The price of a Brent oil barrel rose by 25 percent in January, in dollar terms, and by 17 percent in euro terms, following several consecutive months of declines.

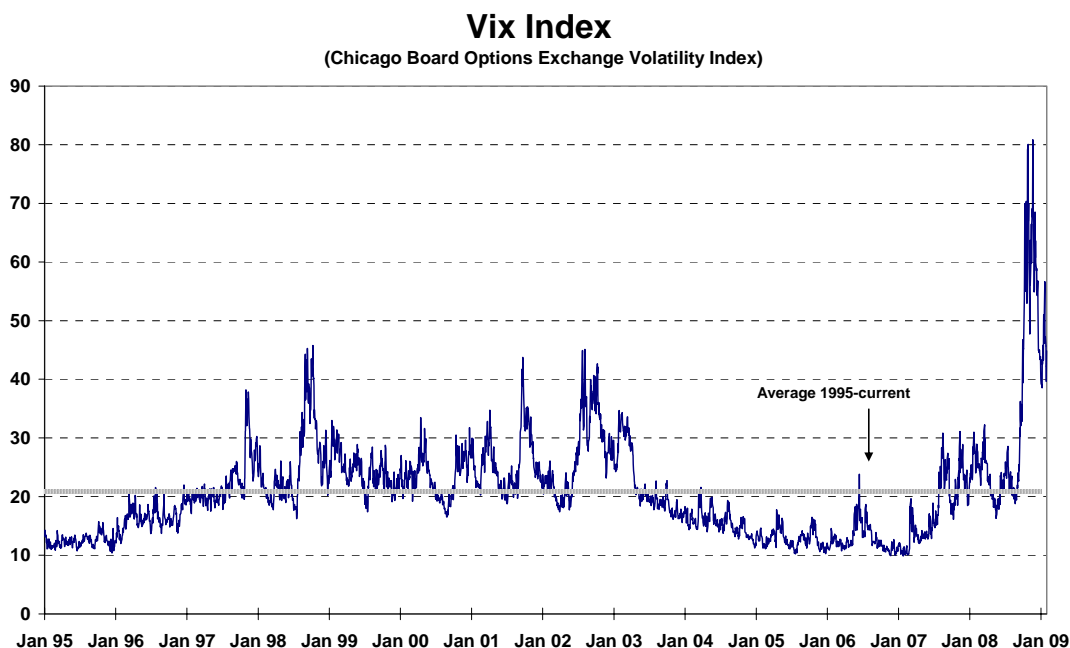
## Price of Oil (Brent barrel)



## Stock Markets

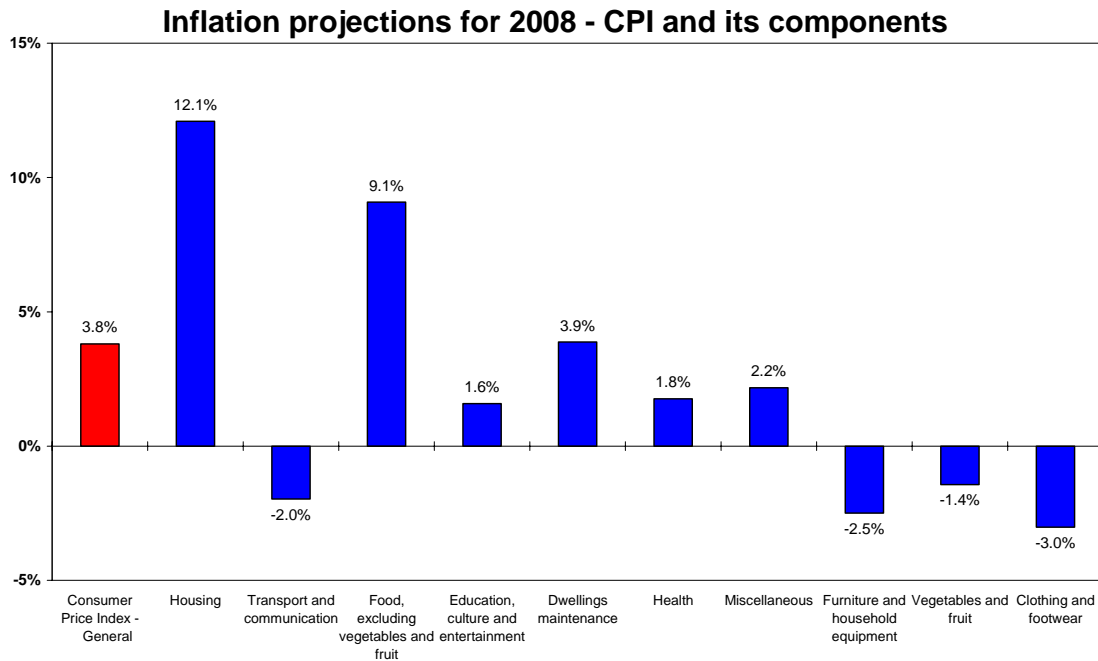
In world equity markets, the MSCI World index fell by 9 percent in January, the S&P 500 index lost 9 percent, the NASDAQ index lost 6 percent, and the MSCI Emerging Markets index lost 6 percent. By contrast, the TA-100 index gained 6 percent (but lost 1 percent in dollar terms).

The VIX index (a popular measure of implied volatility in the equity market in the short term, based on tracking prices of S&P 500 index options) rose by 12 percent in January, but was still 44 percent lower than its October peak.



## C. Developments in Inflation and Monetary Policy

The **consumer price index** decreased by only 0.1 percent in December, higher than expected. Inflation in 2008 totaled 3.8 percent, above target. Notable in 2008 was an increase in prices of housing and food, excluding fruits and vegetables. By contrast, prices of transportation and communications, furniture and home equipment, fruits and vegetables, and clothing and footwear decreased.



**Housing prices** also rose steeply in December, by 2.2 percent, and by 13.4 percent in the last six months. Housing prices have now corrected the great erosion of the preceding period, which resulted from the linkage of rent prices to the dollar and the decrease in the dollar exchange rate. In our opinion, this correction is nearly complete, and the increase in housing prices will be much more moderate in the coming months.

**Inflation expectations** calculated by the Bank of Israel were at negative 0.1 percent for the first year and positive 0.7 percent for the second year, on average between mid-December and mid-January – still low, but up significantly from the average in December. Expectations from the third year forward remained at 2.5 percent. Concurrently, the **amount of means of payment** rose sharply, by 4.0 percent in December and 17.5 percent in the last twelve months.

The **Bank of Israel** lowered the interest rate for February by 0.75 percentage points, to just 1 percent; this followed a sharp reduction in the BOI's **growth forecast** for 2009, from 1.5 percent to a negative 0.2 percent, with steep drops in business GDP, exports, imports, and investments, and a dramatic increase in unemployment.



The **interest-rate announcement** notes that the BOI will continue to closely monitor developments in the Israeli and global economy, and if necessary it will use other tools at its disposal to achieve its goals, thereby supporting the stability of the financial system and encouraging employment and growth. The main new element here is the words "other tools," which seem to indicate that the BOI intends to use means other than interest-rate reductions. Such tools may include additional foreign-currency purchases and/or other means of increasing liquidity and credit in the economy. **In our opinion**, if there is no substantial depreciation of the shekel in the next month, there is a strong probability of an additional interest-rate cut by the BOI next month.

The BOI has also released its quarterly **Inflation Report**. According to the central scenario of the BOI's econometric models, inflation in 2009 will total 0.0 to 0.3 percent, with the interest rate to fall to zero by the end of 2009, then rise to 1.5 to 2.0 percent by the end of 2010.

## D. Developments in the Global Economy

### Growth forecasts for advanced economies

The **IMF** expects negative 1.6 percent growth in the United States in 2009, negative 2.0 percent in the euro zone, negative 2.6 percent in Japan, and negative 2.8 percent in the UK.

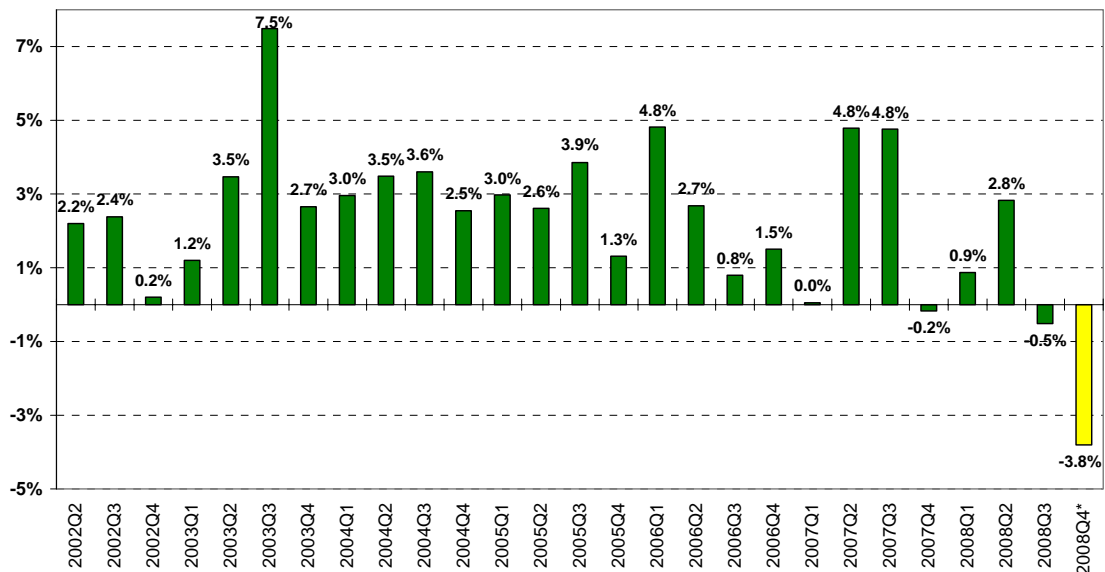
The Economist's **monthly Consensus Forecasts** point to growth rates of negative 1 percent to negative 2 percent in most of the advanced countries.

### United States

According to the initial growth estimate, **GDP** decreased by an annualized 3.8 percent in the fourth quarter of 2008, following a 0.5 percent decrease in the third quarter. This was the sharpest decline in GDP in the US since the early 1980s, though still more moderate than expected.

## The U.S. Economy

Real quarterly growth rates, at annual rate

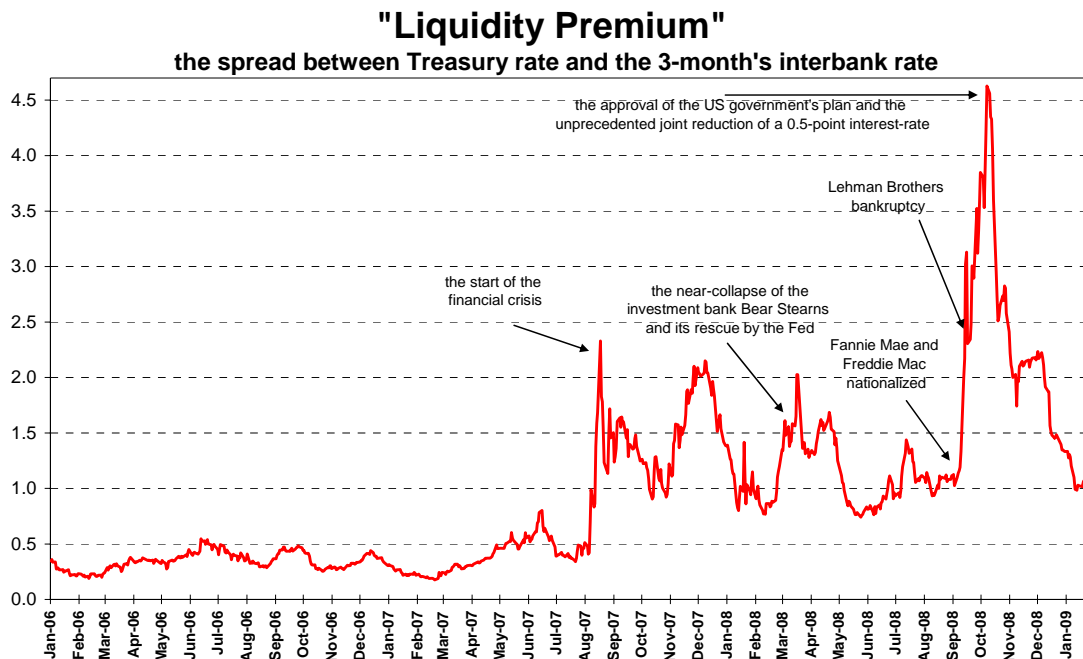


While the Fed's interest-rate decision came as no surprise, there were several interesting aspects to its announcement:

- The Fed declared an uncompromising war on deflation.
- The Fed announced that it would increase its involvement in the credit markets.
- The Fed stated that it would be willing in principle to buy government bonds, but would only do so under very special circumstances.

The Obama administration has presented its **plan to cope with the economic crisis**, at a total cost of USD 825 billion over the next two years (In addition to the USD 350 billions remaining from the TARP). The plan includes tax cuts, increased investments in national road infrastructures, renovation and modernization of government buildings, increased investments in alternative energy aimed at doubling output, health-care reform, and education reform with improvements to the learning environment. The plan is likely to undergo changes before being approved by Congress.

Although **worries over bankruptcies of major banks** reemerged this month as Citigroup and Bank of America requested further government aid, the liquidity crisis continued to wane. The risk premium expressed in the difference between the interbank interest rate and the interest rate on three-month government bonds decreased to 1.0 percentage points.



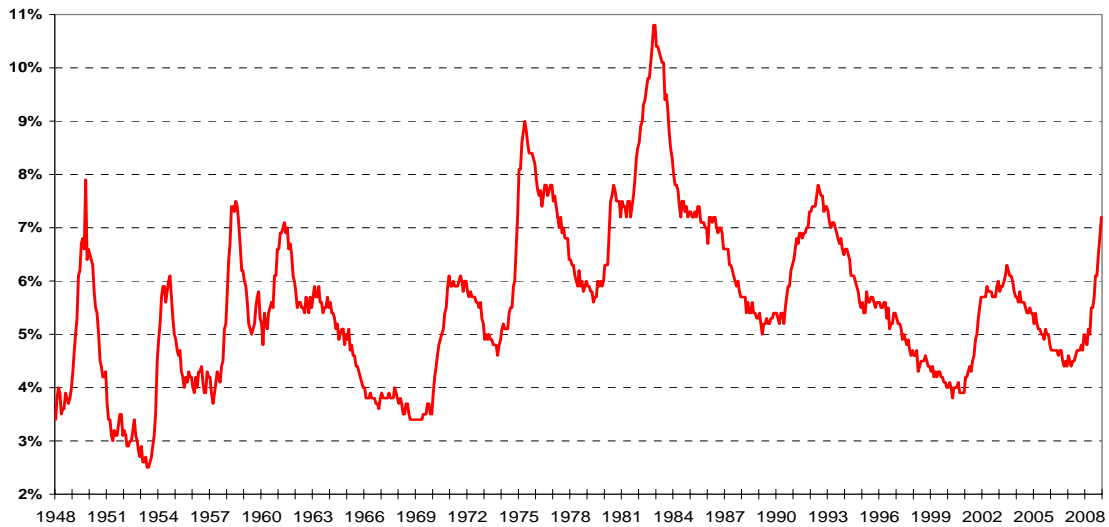
One reason for this development was the growing estimates that following the Lehman Brothers bankruptcy and the consequent shocks to the financial system, the US government will not allow another major bank to fail, preferring to nationalize the bank at risk. Nationalization would erase the value of the bank's shares, but allow liabilities to the bank's business partners to be met.

**Yields of US government ten-year bonds** rose to 2.85 percent in January, following the December low, in line with our advance estimates.

The deterioration in the labor market worsened in December. The number of **jobs** decreased by 520,000, similar to November, while data for previous months were adjusted downward. In 2008, the American economy lost an average of about 220,000 jobs each month.

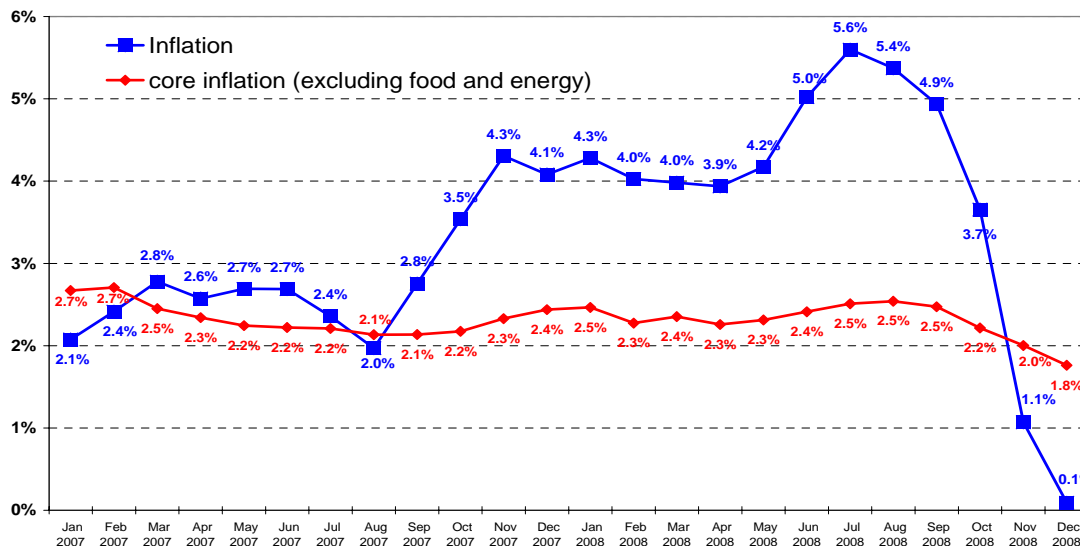
The **unemployment rate** rose by 0.4 percentage points to 7.2 percent, the highest level since 1993, but still much lower than the peak of 10.8 percent in 1982.

### U.S. Unemployment rate



The consumer price index decreased by 0.7 percent, versus an expected 0.9 percent decrease. The core index remained unchanged, versus estimates of a 0.1 percent increase. Inflation in the last twelve months dropped sharply to just 0.1 percent in December, from 4.9 percent in September.

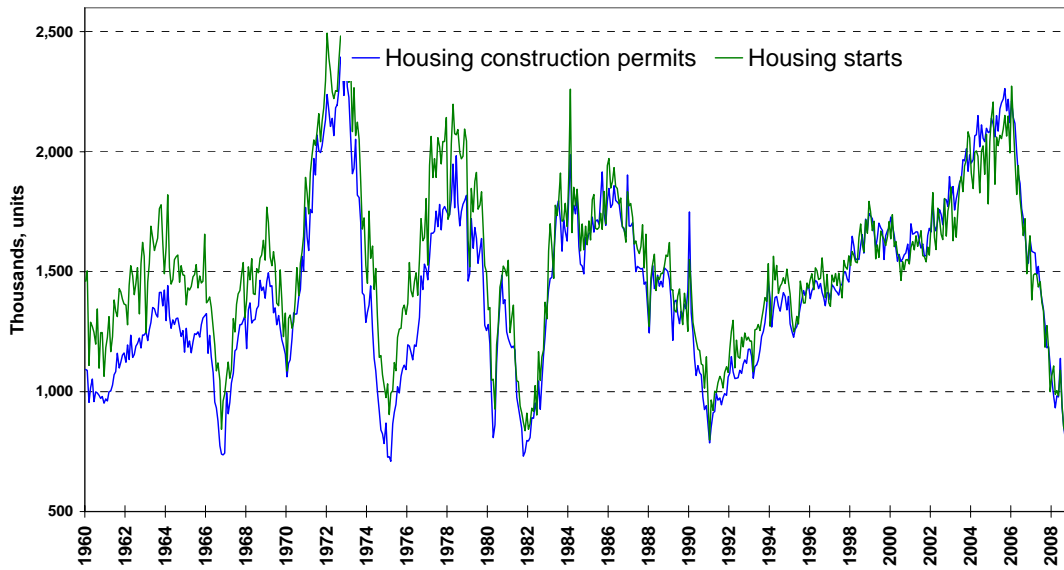
### USA: Inflation rate during the past 12 month



Construction starts and permits decreased by 16 percent and 11 percent, respectively, in December, in a sharper-than-expected decline, reaching a historic low.

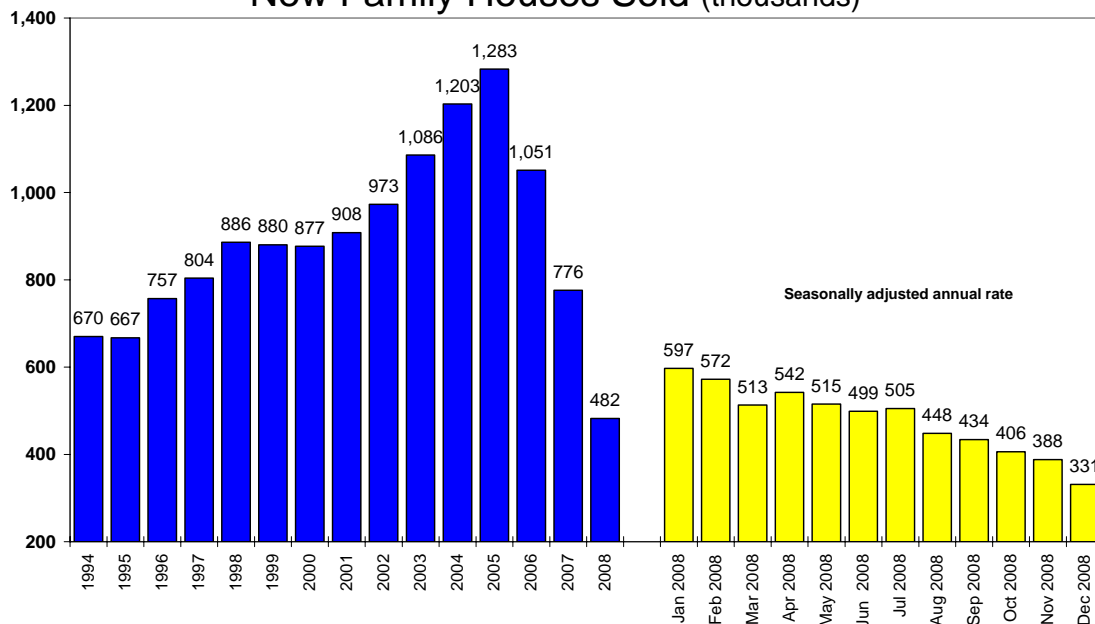


### US housing permits and housing starts (Seasonally adjusted at annual rate)



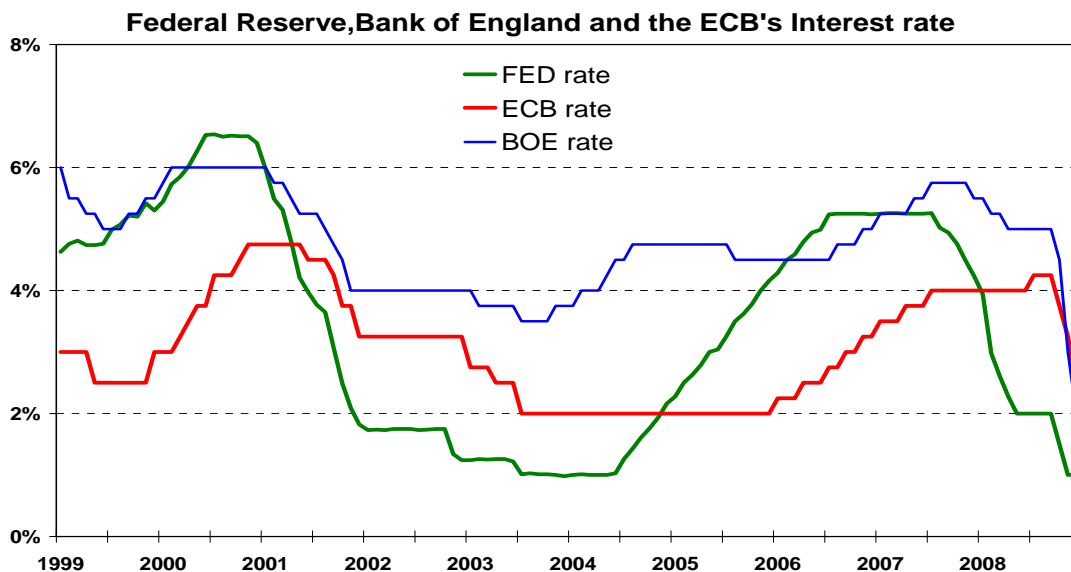
Sales of new homes decreased by 15 percent in December, while figures for previous months were adjusted downward. Sales of new homes declined by a total of 38 percent in 2008, following a decrease of 27 percent in 2007.

### New Family Houses Sold (thousands)

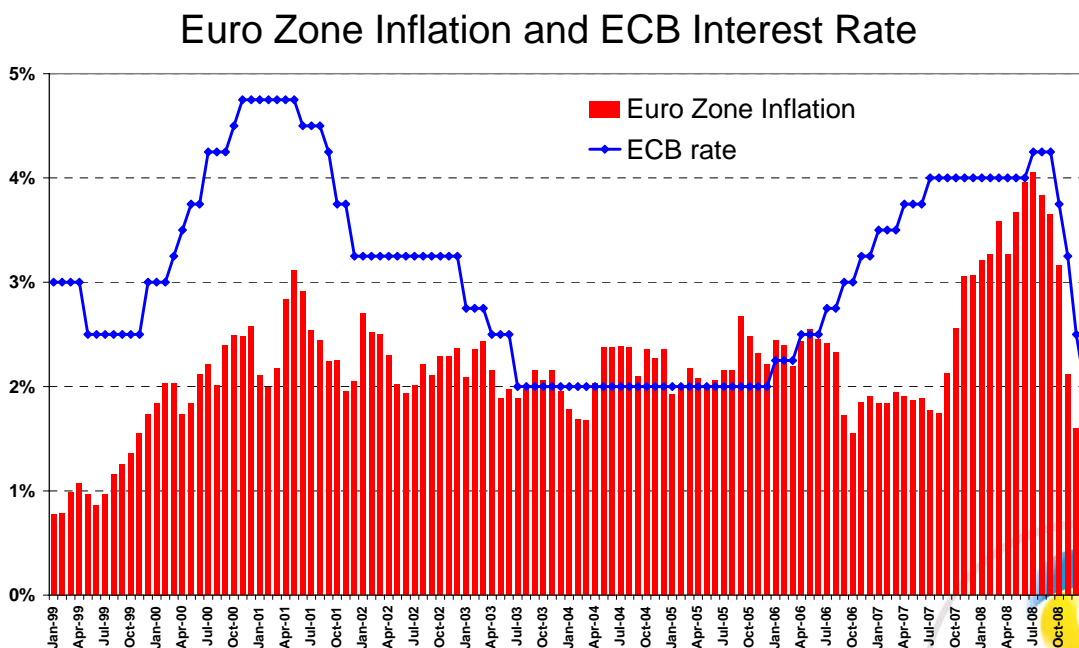


## Europe

Central banks in Europe and the UK continued to lower interest rates, due to the worsening economic slowdown and the considerable reduction in inflationary pressures. The **ECB** lowered the euro-zone interest rate by 0.5 percentage points to 2.0 percent, while the **BOE** lowered the UK rate by 0.5 points to 1.5 percent.



**Inflation** in the euro zone was 1.1 percent in December, according to an initial estimate, lower than expected.

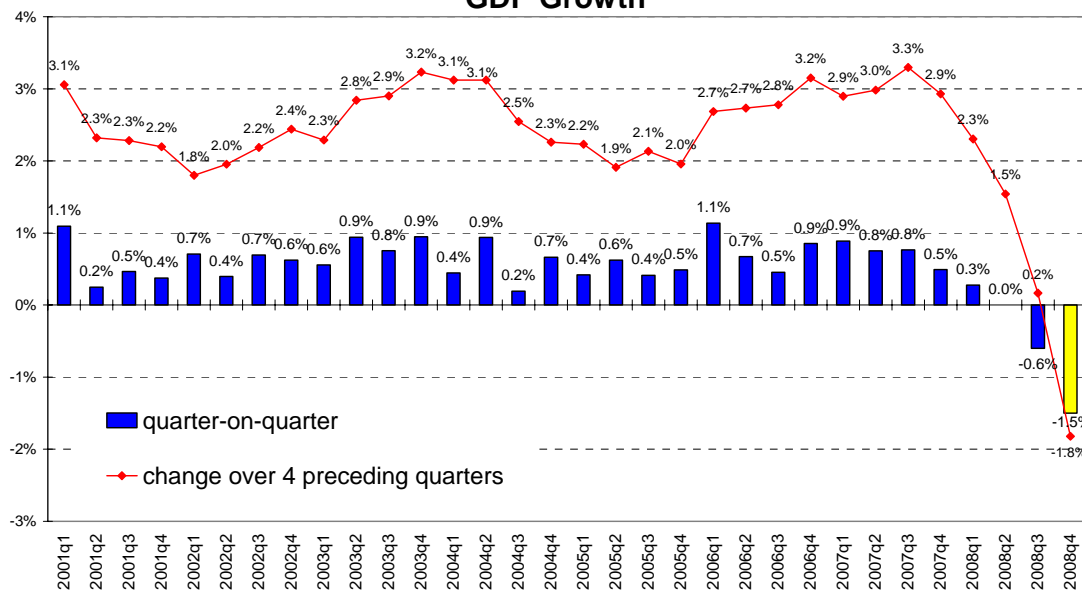


**GDP** in the euro zone contracted by 0.2 percent in the third quarter of 2008, or 0.8 percent in annualized terms, similar to the second quarter and in line with expectations.

**Unemployment** in the euro zone reached 8.0 percent in December, higher than expected.

According to an initial estimate, **GDP in the UK** contracted by 1.5 percent, or 6 percent in annualized terms, in the last quarter of 2008, following a decrease of 0.6 percent in the third quarter. A more moderate decrease of 1.2 percent was expected. The main contributing factor to the decrease was a 4.6 percent decline in industrial production.

### United Kingdom GDP Growth

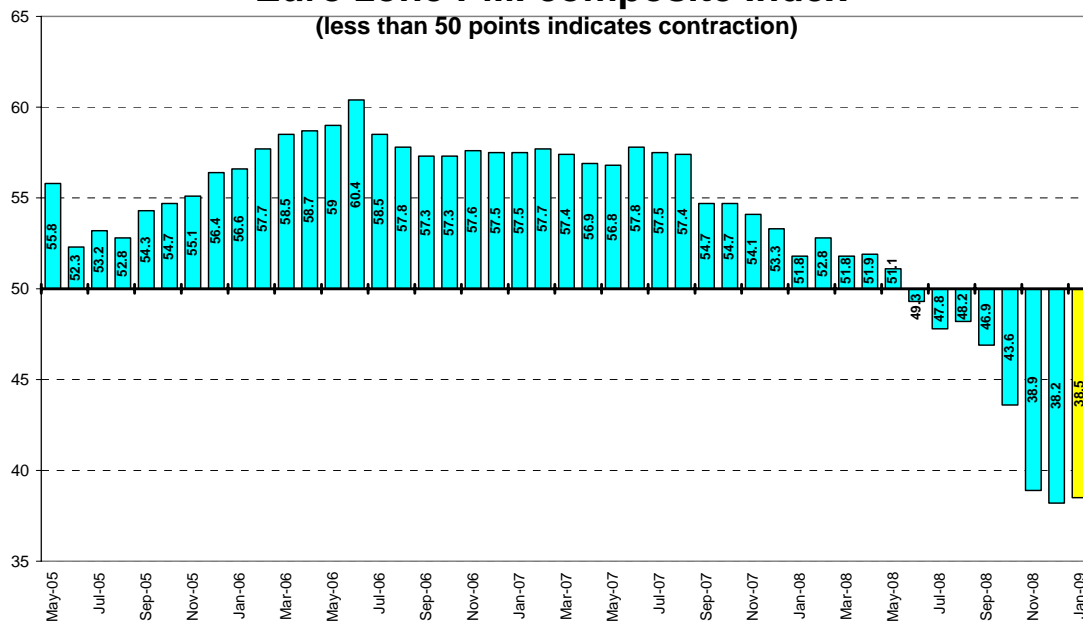


As we have noted before, the effect of the global financial crisis is especially pronounced in the UK due to the bubble formed in real-estate prices there, the large debts of households, and the large weight of the banking and financial sector in the economy.

The **purchasing managers' index** was 38.5 points in January according to the initial estimate, still under 50 points but higher than expected.



## Euro zone PMI composite Index (less than 50 points indicates contraction)



**Housing prices in the UK** continued to fall. Prices dropped 2.2 percent in December and 19 percent in the last twelve months, and were down by 20 percent from the peak of August 2007.

## Important Announcements in the Coming Month

Title	Publication date	Day	Time	Link
Private income and consumption data, US	2 February	Mon	15:30	<a href="http://www.bea.gov">www.bea.gov</a>
ISM manufacturing sector index, US	2 February	Mon	15:30	<a href="http://www.ism.ws">www.ism.ws</a>
Final PMI (purchasing managers' index), euro zone	4 February	Wed	11:00	<a href="http://www.markiteconomics.com/">http://www.markiteconomics.com/</a>
Retail sales, euro zone	4 February	Wed	12:00	<a href="http://www.ec.europa.eu/eurostat">www.ec.europa.eu/eurostat</a>
ISM service sector index, US	4 February	Wed	15:30	<a href="http://www.ism.ws">www.ism.ws</a>
Interest-rate decision, UK	5 February	Thu	14:00	<a href="http://www.bankofengland.co.uk">www.bankofengland.co.uk</a>
Interest-rate decision, euro zone	5 February	Thu	14:45	<a href="http://www.ecb.int">www.ecb.int</a>
Average wages	5 February	Thu	12-14	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
Employment report, US	6 February	Fri	15:30	<a href="http://www.bls.gov">www.bls.gov</a>
Inflation report, UK	11 February	Wed	12:30	<a href="http://www.bankofengland.co.uk">www.bankofengland.co.uk</a>
Foreign trade, Israel	12 February	Thu	12-14	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
Retail sales, US	12 February	Thu	15:30	<a href="http://www.census.gov/svsd/www/adseries.html">http://www.census.gov/svsd/www/adseries.html</a>
Growth estimate, euro zone	13 February	Fri	12:00	<a href="http://www.ec.europa.eu/eurostat">www.ec.europa.eu/eurostat</a>
CPI, Israel	15 February	Sun	12-14	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
Incoming tourists, Israel	16 February	Mon	18:30	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
CPI, UK	17 February	Tue	11:30	<a href="http://www.statistics.gov.uk">www.statistics.gov.uk</a>
Construction starts and permits, US	18 February	Wed	15:30	<a href="http://www.census.gov/pub/const">http://www.census.gov/pub/const</a>
Industrial production index and trade and service sectors revenue index	19 February	Thu	12-14	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
CPI, US	20 February	Fri	15:30	<a href="http://www.bls.gov">www.bls.gov</a>
Retail sales, UK	20 February	Fri	11:30	
Publication of national accounting and growth data, 4Q 2008	23 February	Mon	12-14	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
Interest-rate decision, BOI	23 February	Mon	17:30	<a href="http://www.bankisrael.gov.il/">http://www.bankisrael.gov.il/</a>
Hotel stays	24 February	Tue	12-14	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
Manpower survey, 4Q 2008	25 February	Wed	12-14	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
Sales of existing homes, US	25 February	Wed	17:00	<a href="http://www.realtor.org/Research.nsf/Pages/EHSdata">http://www.realtor.org/Research.nsf/Pages/EHSdata</a>
Sales of new homes, US	26 February	Thu	17:00	<a href="http://www.census.gov/const/www/newressalesindex.html">http://www.census.gov/const/www/newressalesindex.html</a>
Sales of new homes	26 February	Thu	12-14	<a href="http://www1.cbs.gov.il/reader">http://www1.cbs.gov.il/reader</a>
4Q growth rate, US	27 February	Fri	15:30	<a href="http://bea.gov/">http://bea.gov/</a>
Michigan University consumer confidence index	27 February	Fri	17:00	<a href="http://www.sca.isr.umich.edu">www.sca.isr.umich.edu</a>
CPI, euro zone	27 February	Fri	12:00	<a href="http://www.ec.europa.eu/eurostat">www.ec.europa.eu/eurostat</a>
Unemployment rate, euro zone	27 February	Fri	12:00	<a href="http://www.ec.europa.eu/eurostat">www.ec.europa.eu/eurostat</a>

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