Monthly Macroeconomic Review February 1, 2010

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- Based on these economic indicators, **growth** in the fourth quarter and full year of 2009 seems to have been lower than the initial estimate by the Central Bureau of Statistics. **In our opinion**, the Bank of Israel's forecast of 3.5 percent growth in 2010 is somewhat over-optimistic.

- **The budget deficit in 2009** totaled 5.15 percent of GDP, versus 6.0 percent of GDP in the planned budget.

- **The surplus in the current account of the balance of payments** expanded to USD 7.2 billion (3.7 percent of GDP) in 2009, following a surplus of USD 2.1 billion (1.0 percent of GDP) in 2008.

- **The consumer price index** remained unchanged in December, lower than forecast.

- **The BOI interest rate** remained unchanged, as expected.

- **Government bond yields** decreased over the entire curve in January, especially in the medium range, due to lessened expectations of an increase in the BOI interest rate and the decrease in US yield curves.

- **Equity markets** posted declines in January. The MSCI World index fell by 4 percent, the S&P 500 index lost 4 percent, the NASDAQ index fell by 5 percent, and the MSCI Emerging Markets index fell by 6 percent. The **TA-100 index** fell by 1 percent (a 1 percent increase, in dollar terms).

This review contains five chapters:

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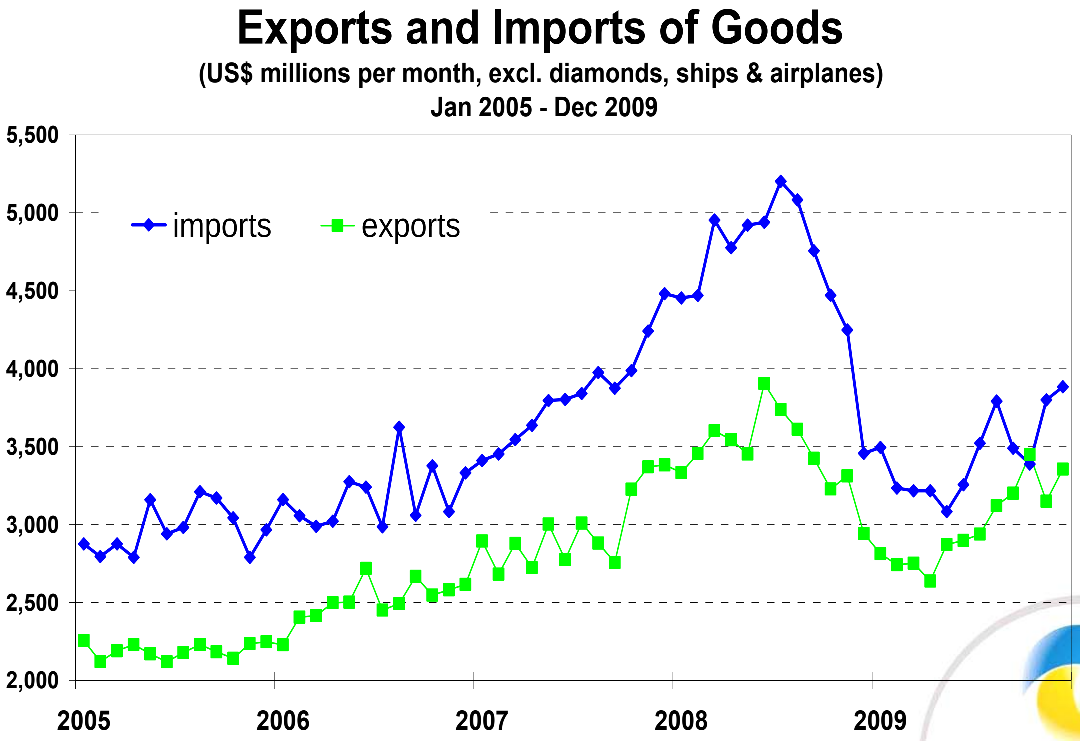
A. Developments in the Israeli Economy

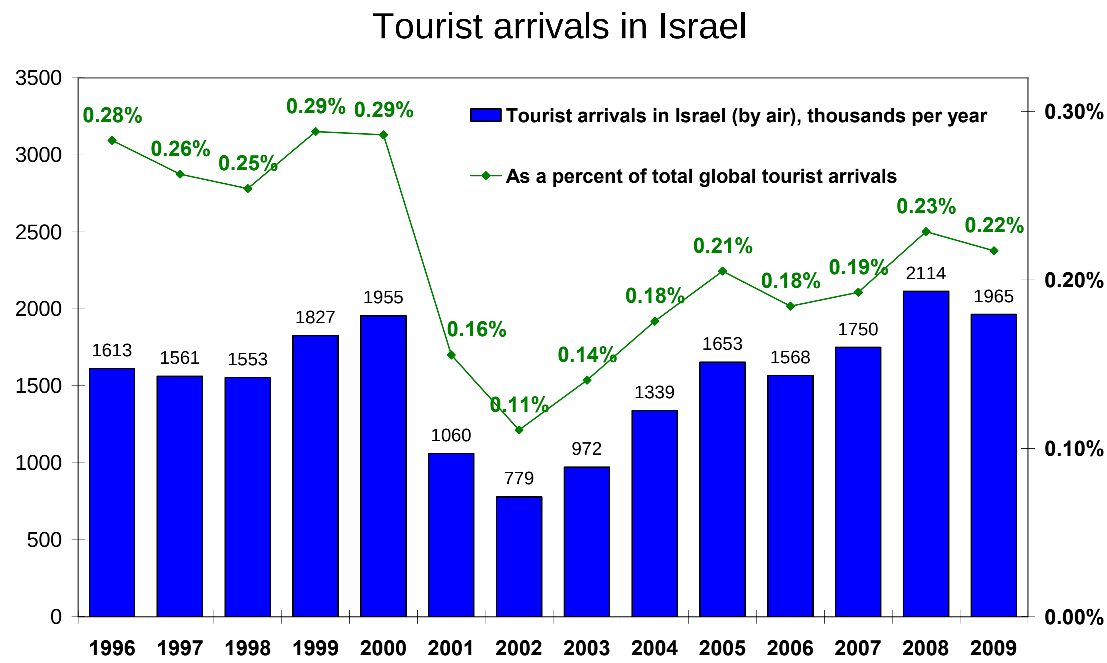
Current indicators of economic activity painted a mixed picture over the last month. Imports and exports of goods increased in December, and tax revenues were slightly higher than expected. By contrast, incoming tourism decreased. The industrial production index and the trade and service sectors revenue index declined in November.

Based on these economic indicators, **growth** in the fourth quarter and full year of 2009 seems to have been lower than the initial estimate by the Central Bureau of Statistics. **In our opinion**, the Bank of Israel's forecast of 3.5 percent growth in 2010 is somewhat over-optimistic. **The International Monetary Fund** (IMF) also predicts a modest growth in Israel of 2.5 percent in 2010

Exports of goods (excluding diamonds, ships, and aircraft, in dollar terms) grew by 7 percent in December and by 14 percent in the last twelve months. **Imports of goods** grew by 2 percent in December and by 12 percent in the last twelve months.

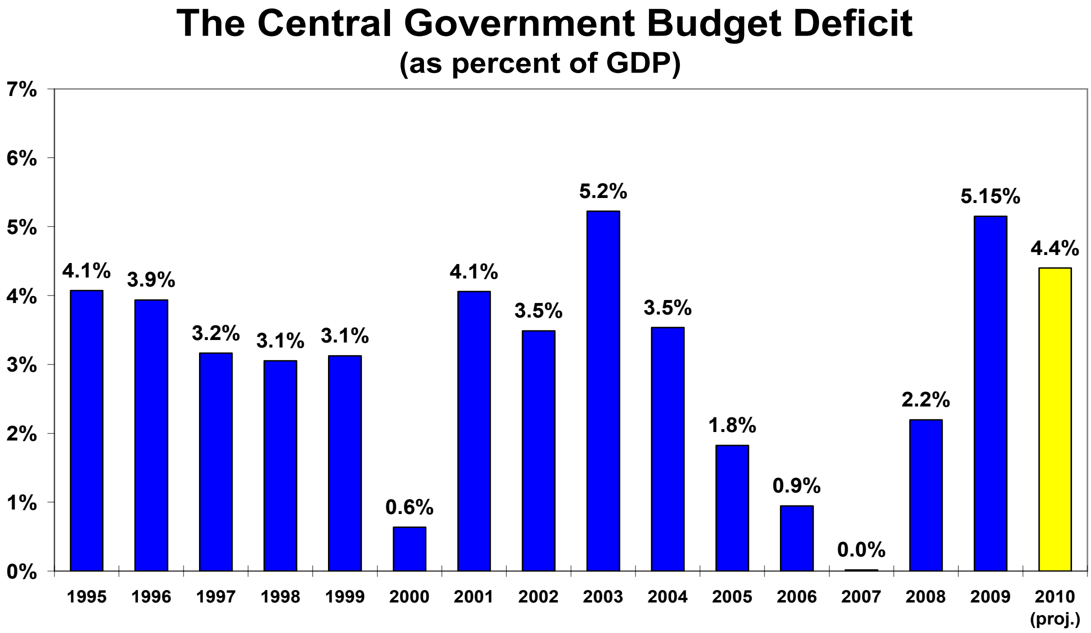


The number of incoming tourists by air decreased by 12 percent in December. This figure declined by 7 percent **in 2009**. The global recession and the military campaign in Gaza in late 2008 contributed to the decrease in incoming tourism. In an international comparison, Israel maintained approximately the same share of total global tourism.



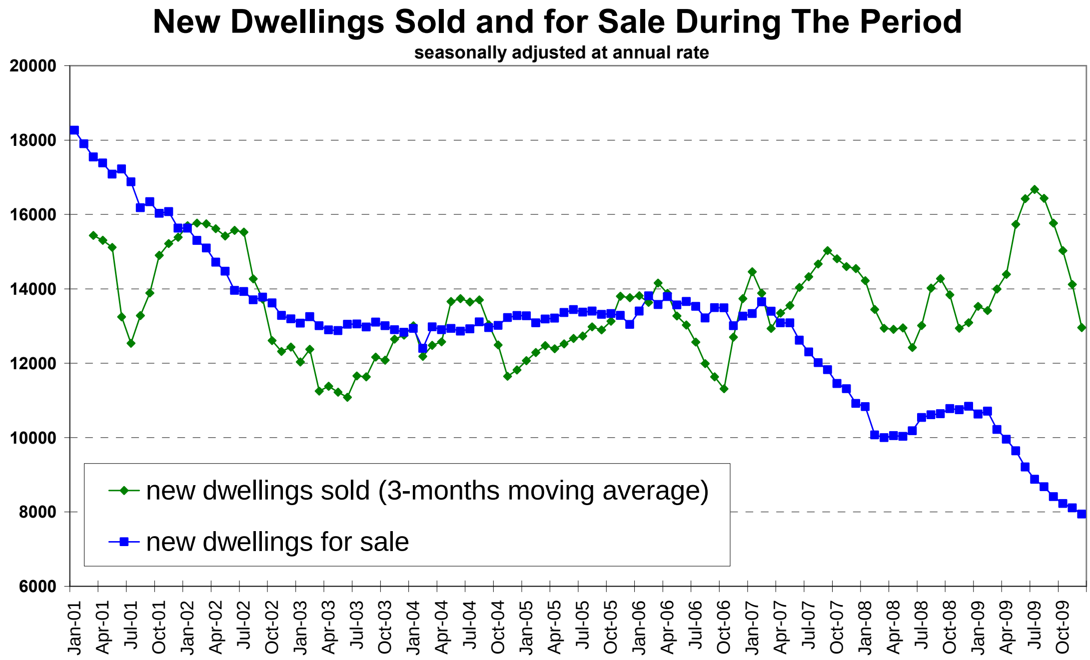
State tax revenues totaled ILS 14.8 billion in December and ILS 177.7 billion in the full year of 2009, 0.6 percent of GDP above the planned budget. Our estimate in recent months was a surplus of about 0.5 percent of GDP.

The budget deficit totaled 5.15 percent of GDP, versus the budget plan of 6.0 percent of GDP, due to higher tax revenues than in the original planned budget. Government expenditures appear to have been significantly increased in December, with expenses moved from 2011 to 2010.

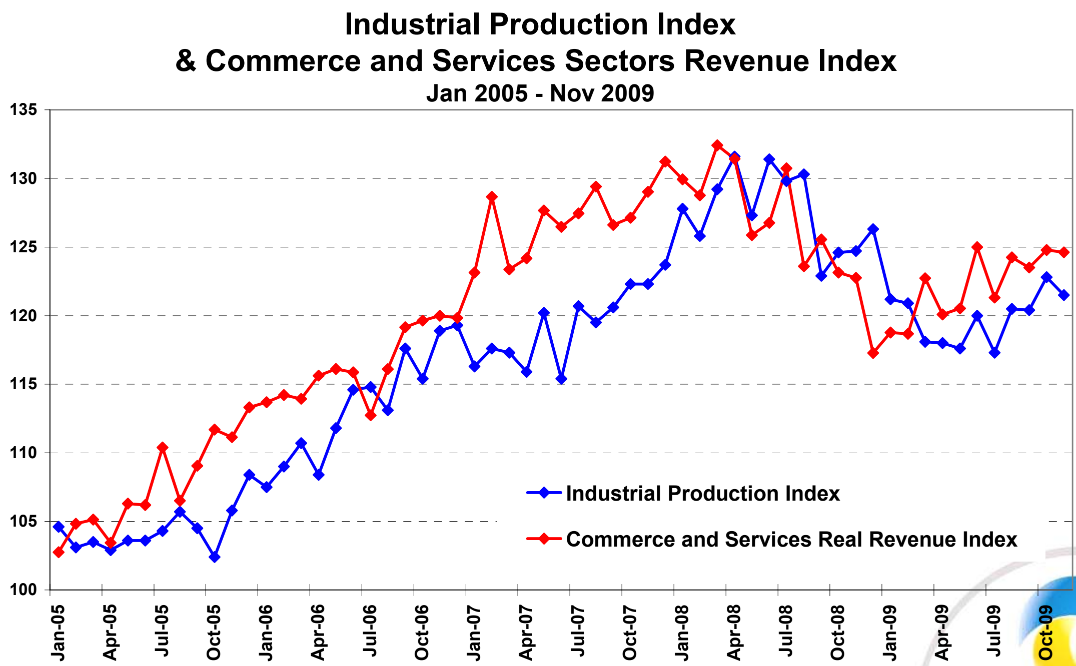


According to our estimates, the deficit in 2010 will reach 4.5 percent, about 1 percent of GDP less than the objective in the state budget. The government has declared a budget deficit target of 3.0 percent in 2011; based on the current trajectory of government expenditures (a real increase of 1.7 percent) and expected revenues (including the future tax cut), the deficit will be higher, at around 4.5 percent. Budget talks will begin soon; in order to comply with the deficit target, the government will need to cut back the state budget for 2011 (less than 1.7 percent growth in expenditures) and/or postpone the planned tax reductions. A third option is to raise the deficit target, though this makes no economic sense, in our view. A fourth possibility, the worst option in terms of desirable policy, is to present an unrealistic revenue forecast, so that the forecast deficit meets the target and no policy steps are necessary.

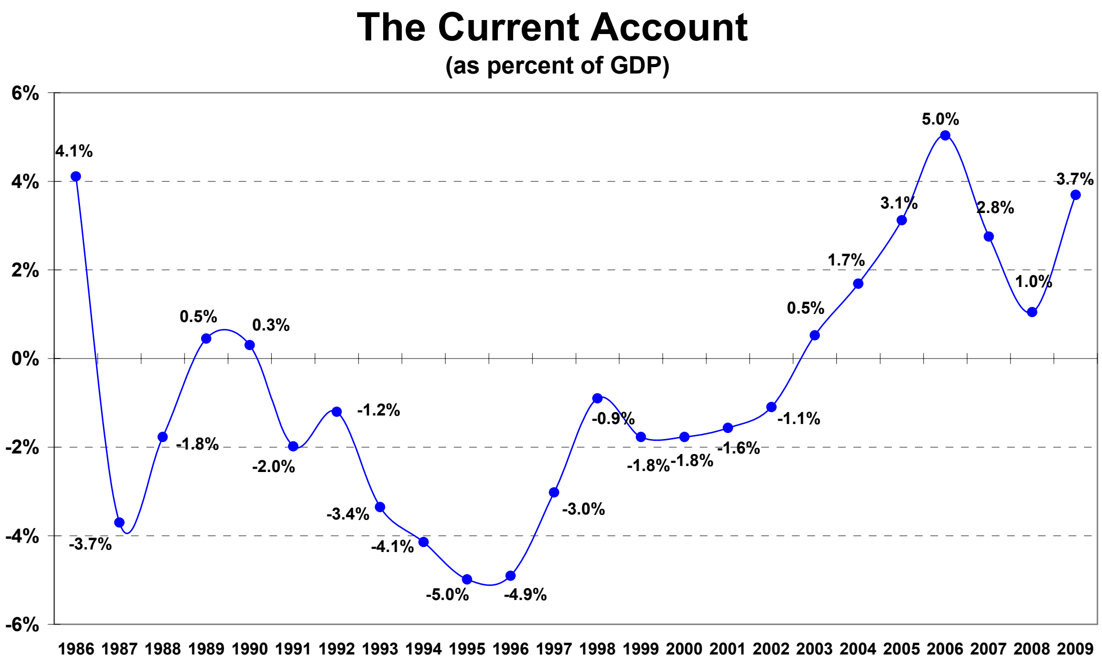
The number of new homes sold decreased by 11 percent in December and by 12 percent in the twelve months through December. The supply of homes for sale decreased by 2 percent, reaching a new low.



The industrial production index decreased by 1.1 percent in November and by 2.6 percent in the twelve months ended in November. **The trade and service sectors revenue index** fell by 0.1 percent in November and rose by 1.5 percent in the twelve months ended in November.



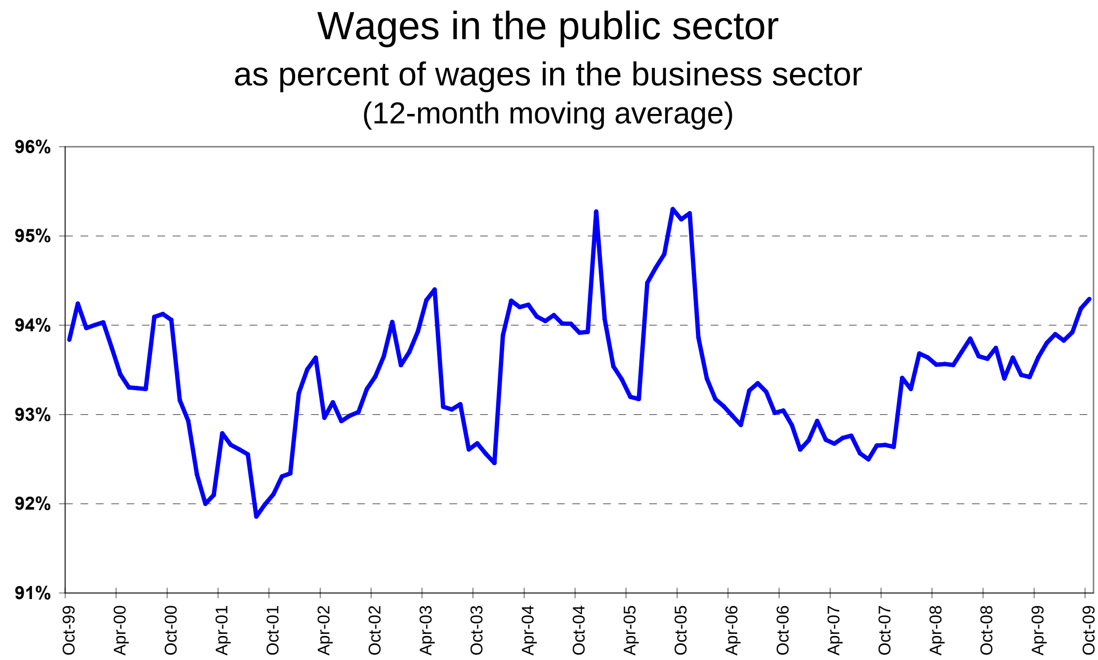
The surplus in the current account of the balance of payments expanded to USD 7.2 billion (3.7 percent of GDP) in 2009, following a surplus of USD 2.1 billion (1.0 percent of GDP) in 2008, due to factors including a larger decrease in imports than in exports.



We estimate that the surplus in the current account will contract considerably in 2010.

In the job market, The number of employee positions of Israeli workers remained almost unchanged in October, and decreased by 0.8 percent in the twelve months ended in October. **Average nominal wages for an employee position** of Israelis rose by 0.8 percent in October and by 2 percent in the twelve months ended in October (a real decrease of 0.8 percent).

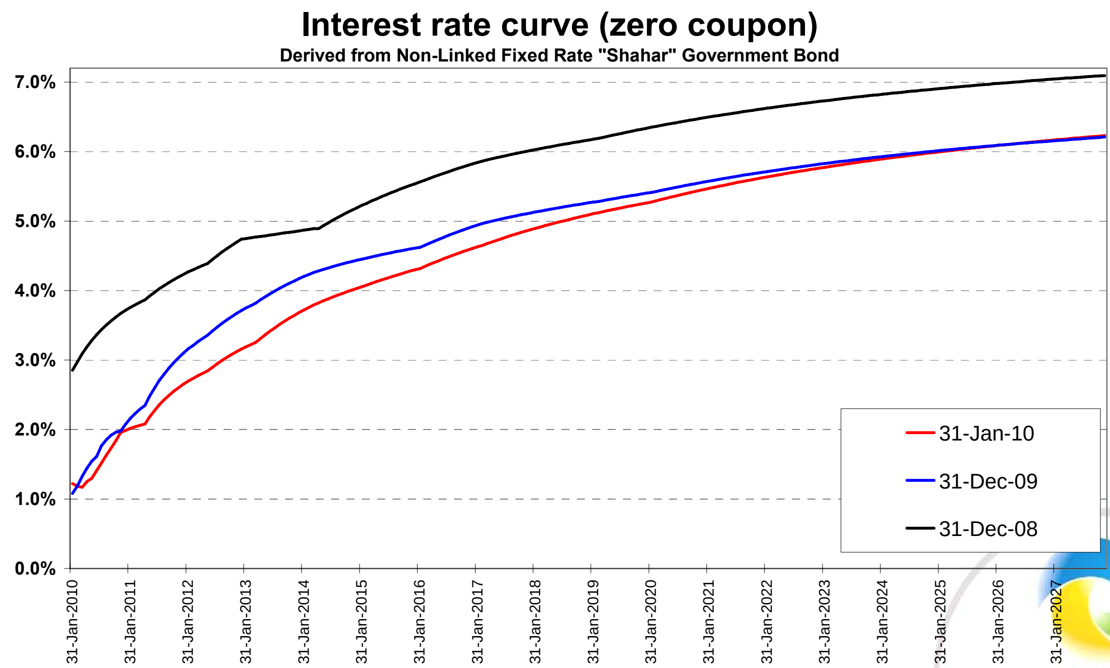
Wages in the public-service sector increased over the last year at a greater rate than in the **business sector**, in which the impact of the global economic crisis and the increase in the unemployment rate in Israel were strongly felt.



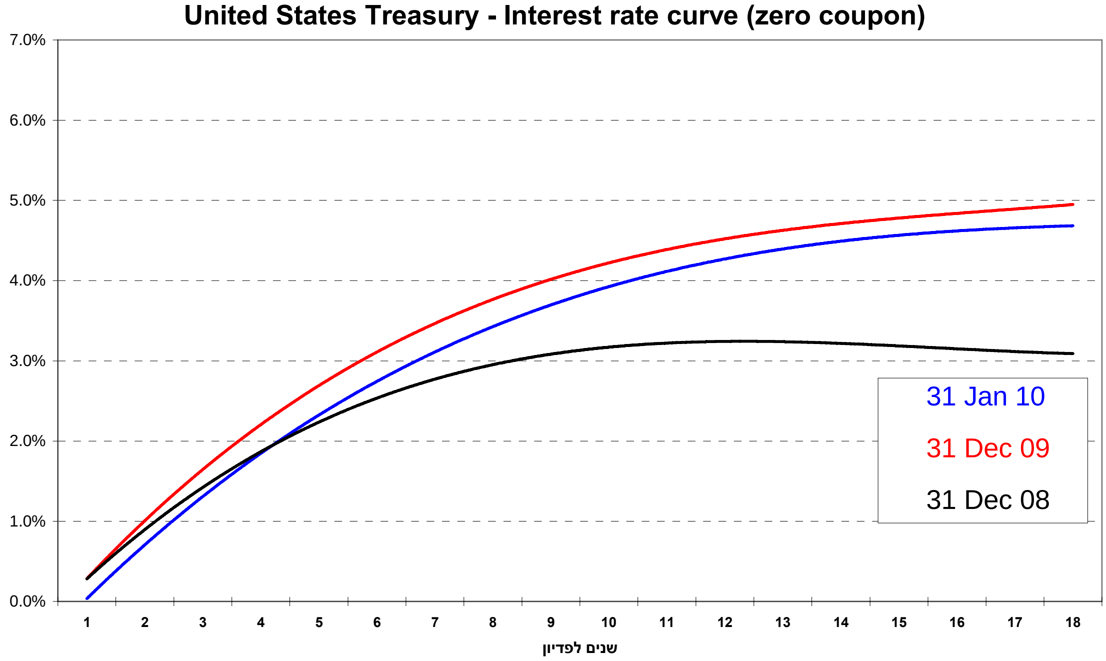
B. Developments in the Capital Market

Bond Market

Government bond yields decreased over the entire curve in January, especially in the medium range, due to lessened expectations of an increase in the BOI interest rate and the decrease in US yield curves.

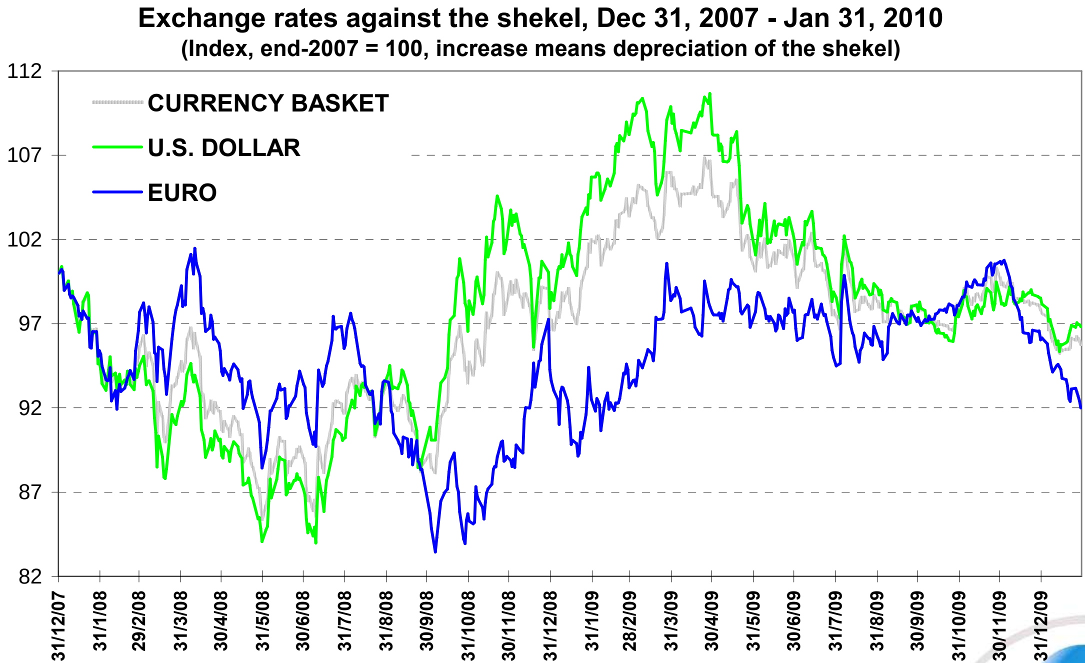


US government bond yields decreased over the entire curve in January.



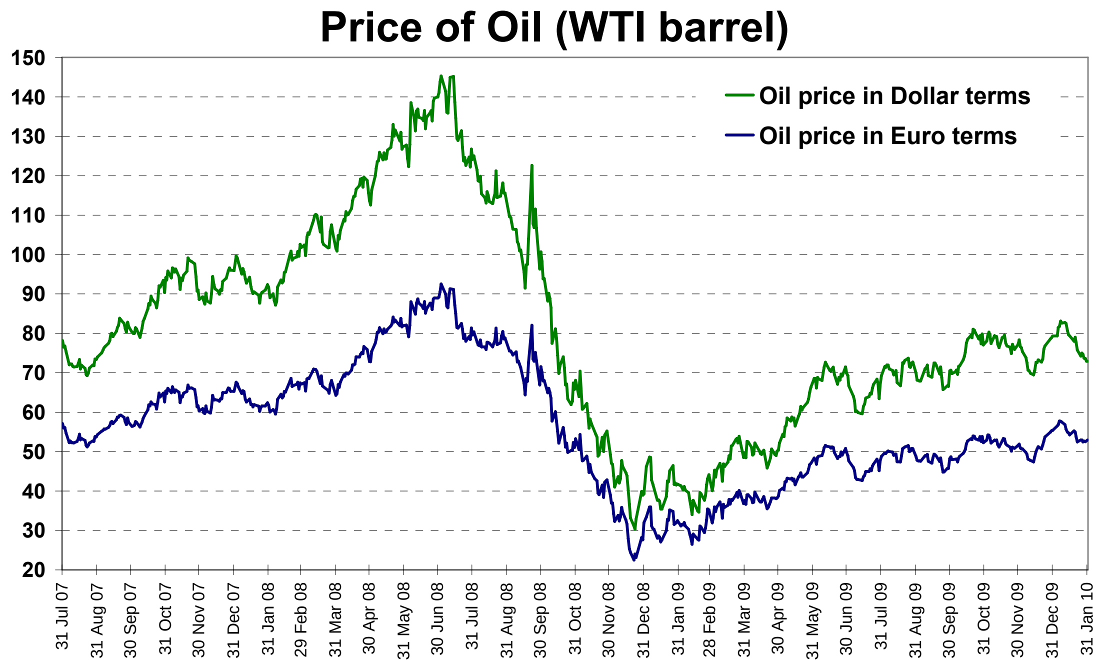
Exchange Rates

In January, the **shekel** appreciated by 2 percent against the currency basket, by 1 percent against the dollar, and by 4 percent against the euro.



Energy prices

The price of a WTI oil barrel fell by 8 percent in **dollar** terms and by 4 percent in **euro** terms. The price of **natural gas** fell by 10 percent in dollar terms over the same period.



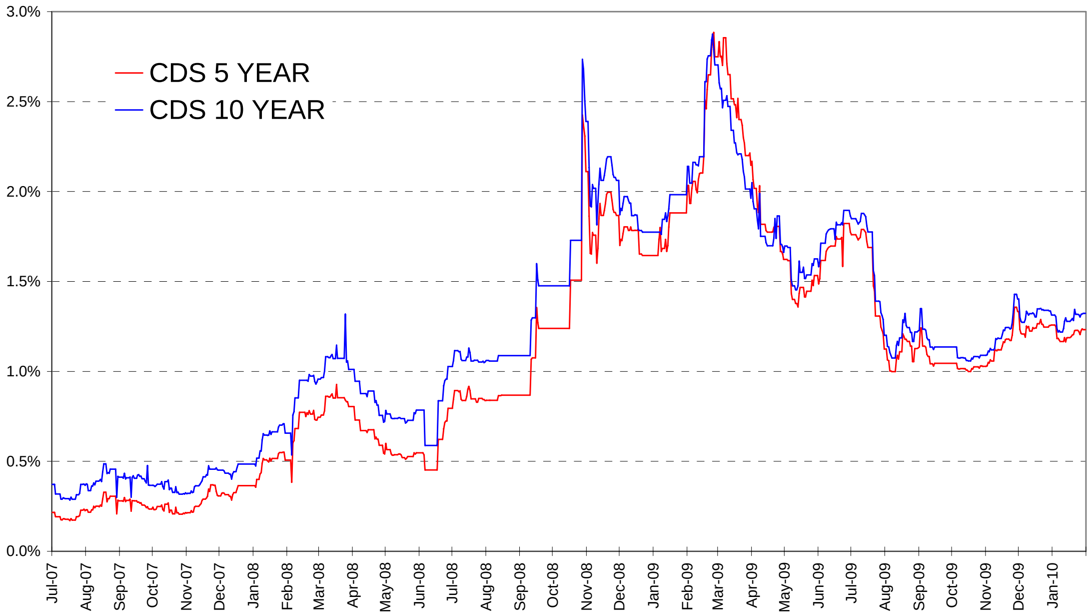
Stock Markets

Equity markets posted declines in January. The MSCI World index fell by 4 percent, the S&P 500 index lost 4 percent, the NASDAQ index fell by 5 percent, and the MSCI Emerging Markets index fell by 6 percent. The **TA-100 index** fell by 1 percent (a 1 percent increase, in dollar terms).

	MSCI World (gross)	MSCI EM (gross)	Tel-Aviv 100 (in shekel terms)	Tel-Aviv 100 (in dollar terms)
2005	10%	35%	29%	21%
2006	21%	33%	12%	22%
2007	10%	40%	25%	37%
2008	-40%	-53%	-51%	-50%
2009	28%	70%	78%	78%
January 2010	-4%	-6%	-1%	1%

Israel's risk premium, based on the 10-year CDS spread, was 1.3 percent at the end of December, similar to the preceding months.

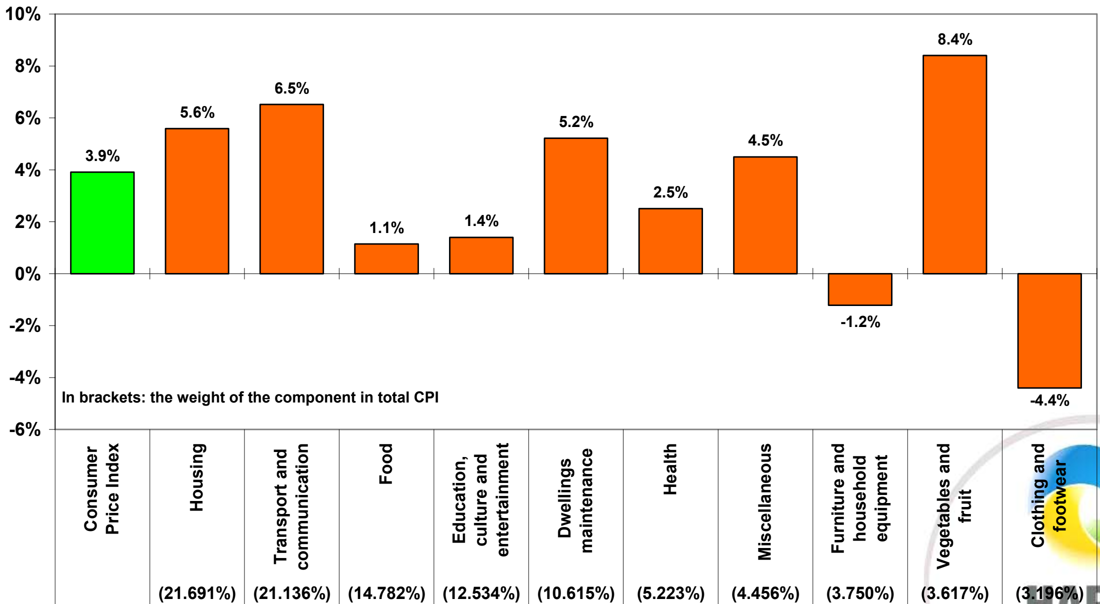
Israel's risk premium according to the CDS spread



C. Developments in Inflation and Monetary Policy

The consumer price index remained unchanged in December, below expectations. The surprisingly low figure mainly stemmed from **the housing item**, which decreased by 0.6 percent.

Changes in the CPI and its components during the last 12-months (until Dec 2009)



Inflation expectations, according to calculations by the BOI, between mid-December and mid-January stood at an average level of 2.5 percent for the first year, 3.1 percent for the second year, and 2.5 percent for the third year forward, similar to the preceding month. **The amount of means of payment** decreased by 1.2 percent in December, and the annual growth rate decreased to 51 percent. This rate is high compared to previous years, but significantly lower than the peak rate of 65 percent seen in August 2009.

The Bank of Israel has revised its growth forecast for 2010 to 3.5 percent, from 2.5 percent previously. The BOI estimates unemployment in 2010 at 7.1 percent, down from the previous estimate of 8.3 percent.

The Bank of Israel interest rate remained unchanged at 1.25 percent, in line with our expectations and those of most economists. It is quite clear that after a month in which the shekel appreciated (despite significant intervention by the BOI), stock indices fell, expectations for the US interest rate moderated, the amount of means of payment decreased, and the CPI was 0.3 percentage points lower than expected, the BOI was obliged to pause the increases in the interest rate.

D. Developments in the Global Economy

The International Monetary Fund (IMF) has adjusted its global growth forecast upward. The revised forecast predicts **global growth** of 3.9 percent in 2010, following negative growth of 0.8 percent in 2009, with 2.1 percent growth in the advanced countries, including **2.7 percent in the US and 1.0 percent in the euro zone.** These estimates are slightly lower than the average forecast in the *Economist* survey for 2010 (2.8 percent in the US and 1.4 percent in the euro zone).

The IMF expects global growth in 2011 to reach 4.3 percent, with the growth rate in the US slowing to 2.4 percent and euro-zone growth reaching 1.6 percent. The inflation forecast for the advanced countries stands at an annual average of 1.3 percent in 2010 and 1.5 percent in 2011.

World Economic Outlook Update Projections (annual percent change)

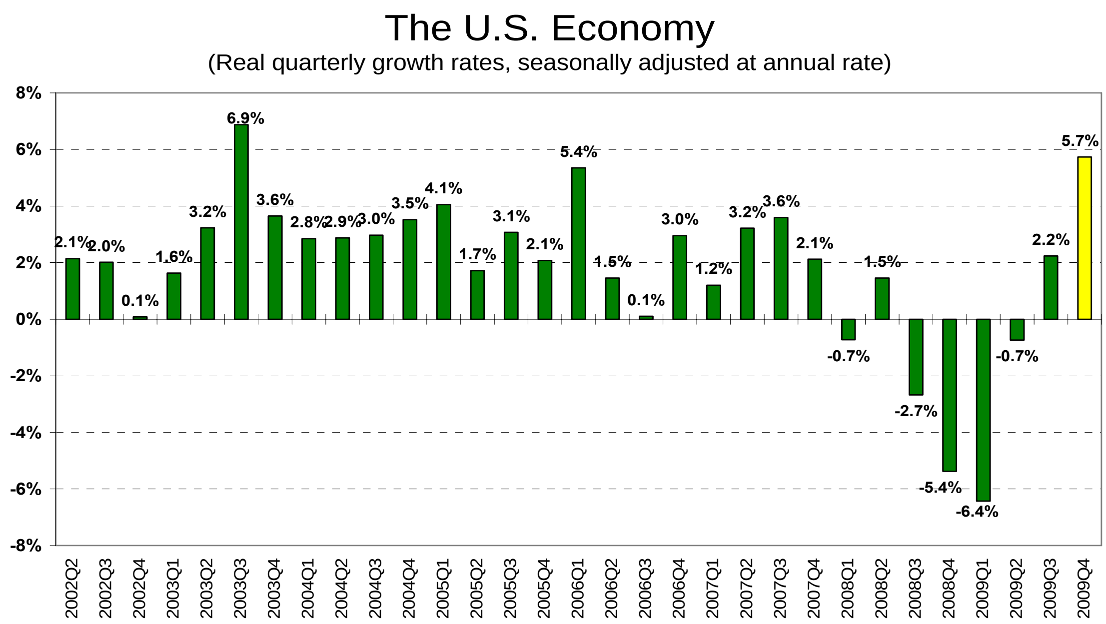
	2007	2008	2009	2010	2010 previous est.	2011	2011 previous est.
World growth	5.2	3.0	-0.8	3.9	3.1	4.3	4.2
Advanced economies	2.6	0.5	-3.2	2.1	1.3	2.4	2.5
United states	2.1	0.4	-2.5	2.7	1.5	2.4	2.8
Euro zone	2.7	0.6	-3.9	1.0	0.3	1.6	1.3
Germany	2.5	1.2	-4.8	1.5	0.3	1.9	1.5
France	2.3	0.3	-2.3	1.4	0.9	1.7	1.8
Japan	2.3	-1.2	-5.3	1.7	1.7	2.2	2.4
United kingdom	2.6	0.5	-4.8	1.3	0.9	2.7	2.5
Canada	2.5	0.4	-2.6	2.6	2.1	3.6	3.6
Developing economies and emerging markets	8.3	6.1	2.1	6.0	5.1	6.3	6.1
Africa	6.3	5.2	1.9	4.3	4	5.3	5.2
central and eastern Europe	5.5	3.1	-4.3	2.0	1.8	3.7	3.8
Russia	8.1	5.6	-9	3.6	1.5	3.4	3
Developing Asia economies	10.6	7.9	6.5	8.4	7.3	8.4	8.1
China	13.0	9.6	8.7	10.0	9	9.7	9.7
India	9.3	7.3	5.6	7.7	6.4	7.8	7.3
Middle east	6.2	5.3	2.2	4.5	4.2	4.8	4.6
South and central America	5.7	4.2	-2.3	3.7	2.9	3.8	3.7
Brazil	5.7	5.1	-0.4	4.7	3.5	3.7	3.5
Mexico	3.3	1.3	-6.8	4.0	3.3	4.7	4.9

United States

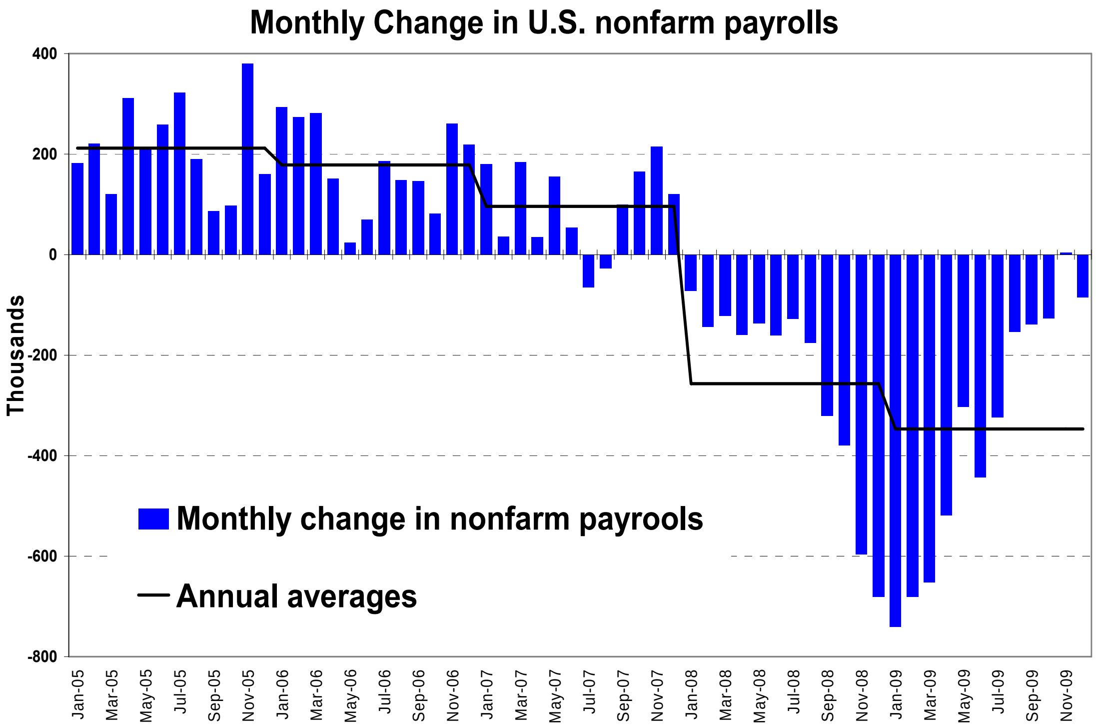
The US government has published a plan to reduce risks in the financial system, the key element of which is a limit on banks' ability to invest their own funds in high-risk instruments. Following publication of the plan, stock markets worldwide recorded sharp declines.

In our opinion, increased regulation of financial institutions, including limits on risk-taking and a requirement to increase capital, is a natural outcome of the conclusions drawn from the financial crisis. Regulation is likely to increase in the coming years, as economic conditions improve and financial institutions' profits grow.

According to an initial estimate, the **US economy grew** at an annualized rate of 5.7 percent in the last quarter of 2009, far above earlier estimates. However, the increase in inventories, which is not expected to recur in the coming quarters, had a decisive contribution to the high growth rate. Excluding this element, the growth rate was only 2.2 percent.



The employment report for December was weak relative to advance estimates. The **number of employed persons** decreased by 85,000, versus expectations of stability. The previous month's data were adjusted upward slightly. The **unemployment rate** remained at 10.0 percent.



During 2009, the number of employed persons in the United States decreased by an average of 347,000 each month, further to an average monthly decrease of 257,000 during 2008. In order to maintain a stable unemployment rate over time, the American economy needs a monthly increase of about 100,000 employed persons, assuming a constant participation rate. The weak employment figures led to a slight reduction in **expectations of an increase in the Fed interest rate**.

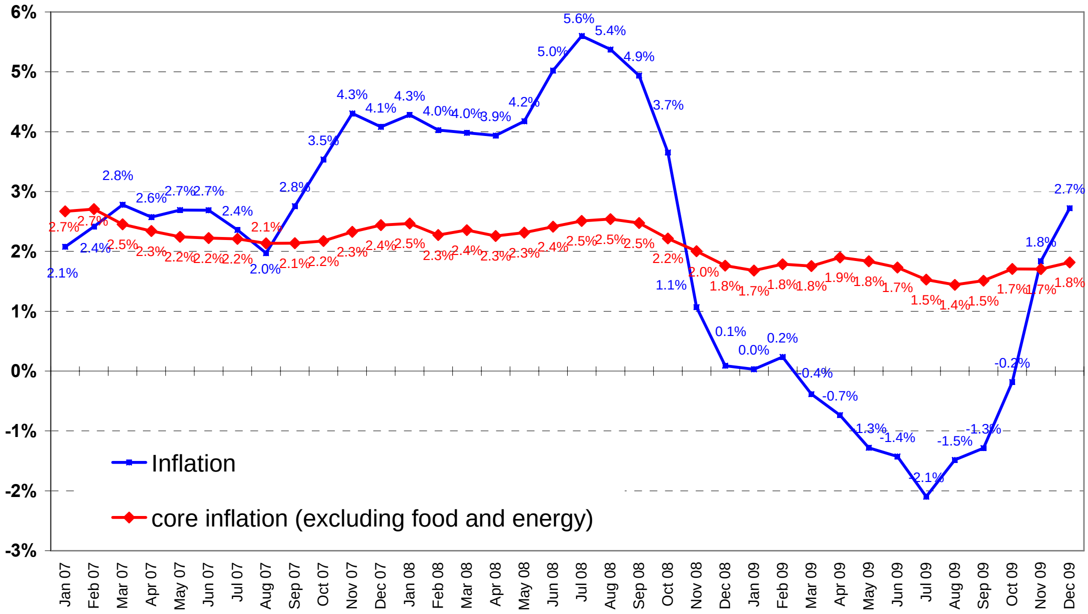
The ISM manufacturing sector index stood at 55.9 points in December, above expectations. This is the fifth consecutive month that the index shows an increase in activity. **The ISM services sector index** stood at 50.1 points in December, in line with expectations.

Retail sales declined by a surprising 0.3 percent in December, and increased by 5.4 percent in the last twelve months.

The Fed left the interest rate unchanged at 0-0.25 percent, as expected.

Inflation reached 2.7 percent in December, while **core inflation** was 1.8 percent, with an increase of 0.1 percent in the core index, in line with expectations.

USA: Inflation rate during the past 12 month

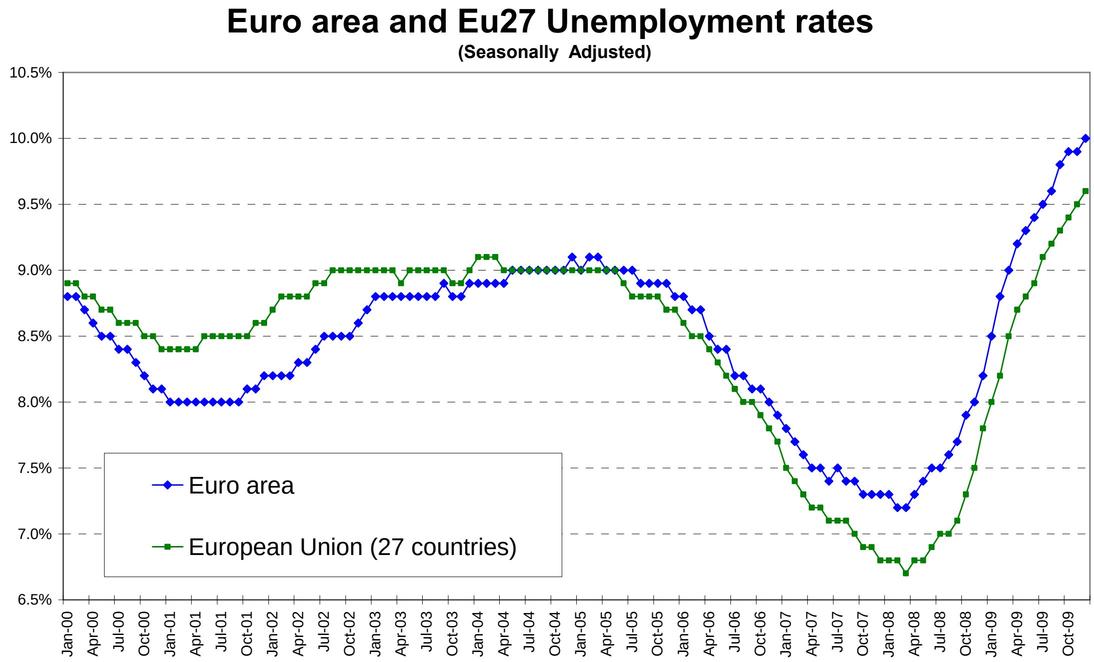


Housing-market figures that were published in the last month were mostly negative. **Construction permits** increased by a surprising 11 percent in December, but **construction starts** were disappointing, with a 4 percent decrease, **sales of new homes** declined sharply by 16.7 percent and sales of exciting home fell by 8 percent.**The Case-Shiller index of housing prices** in twenty major cities fell slightly in November, below expectations.

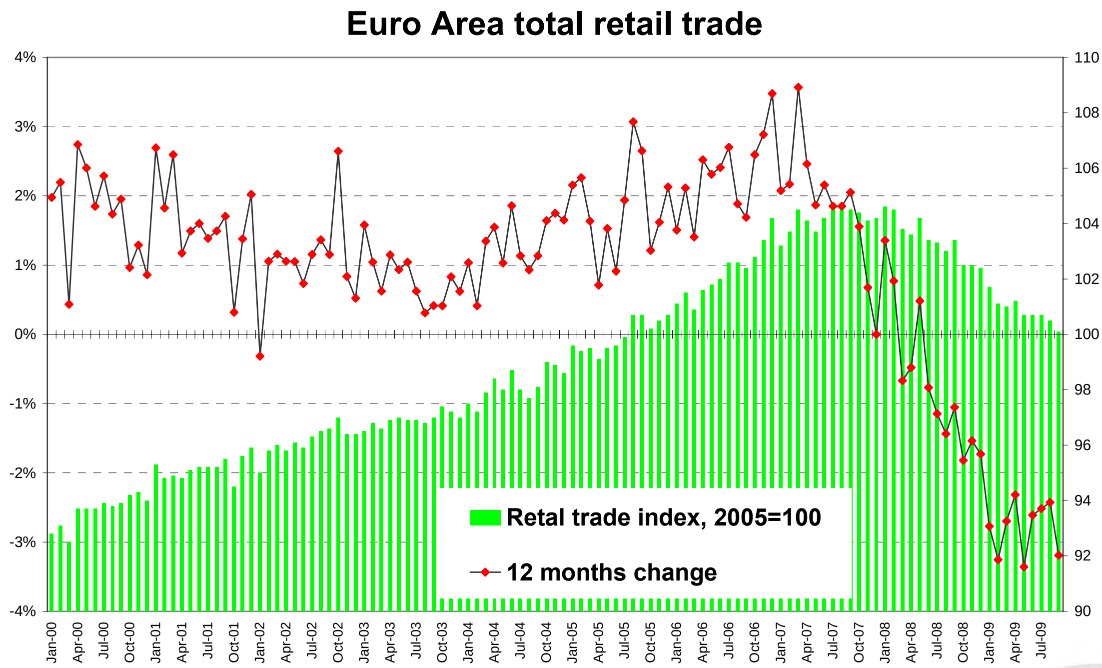
Euro zone

Twelve-month **inflation** reached 1.0 percent in December (according to the initial estimate), slightly lower than expected. The **ECB** kept the interest rate unchanged at 1.0 percent, in line with expectations.

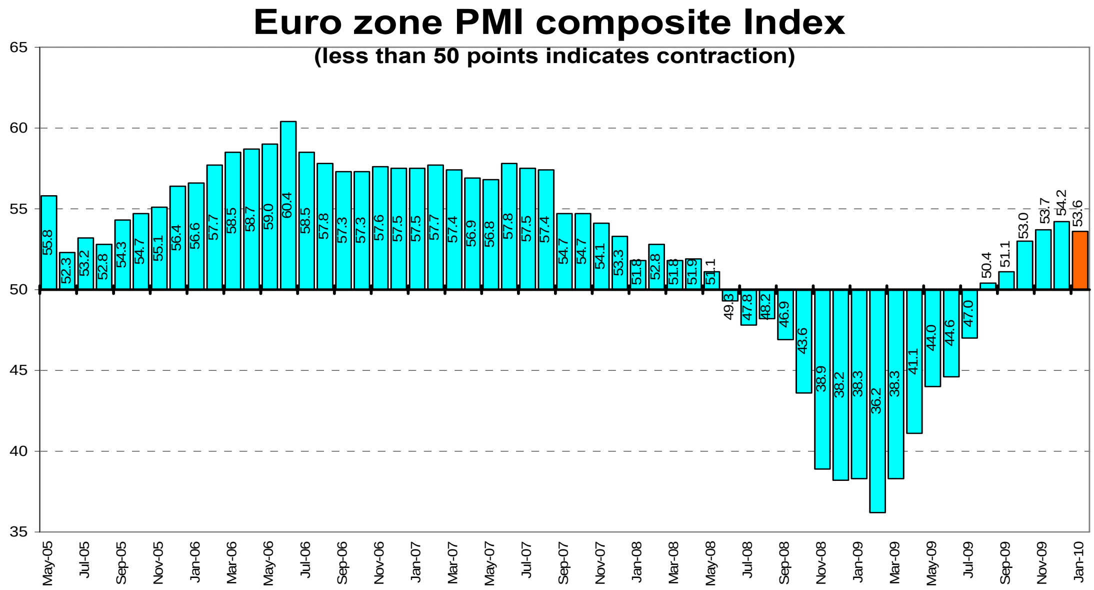
Unemployment in the euro zone was 10.0 percent in December, up from 8.2 percent in December 2008.



Retail sales decreased by a sharper-than-expected 1.2 percent in November.



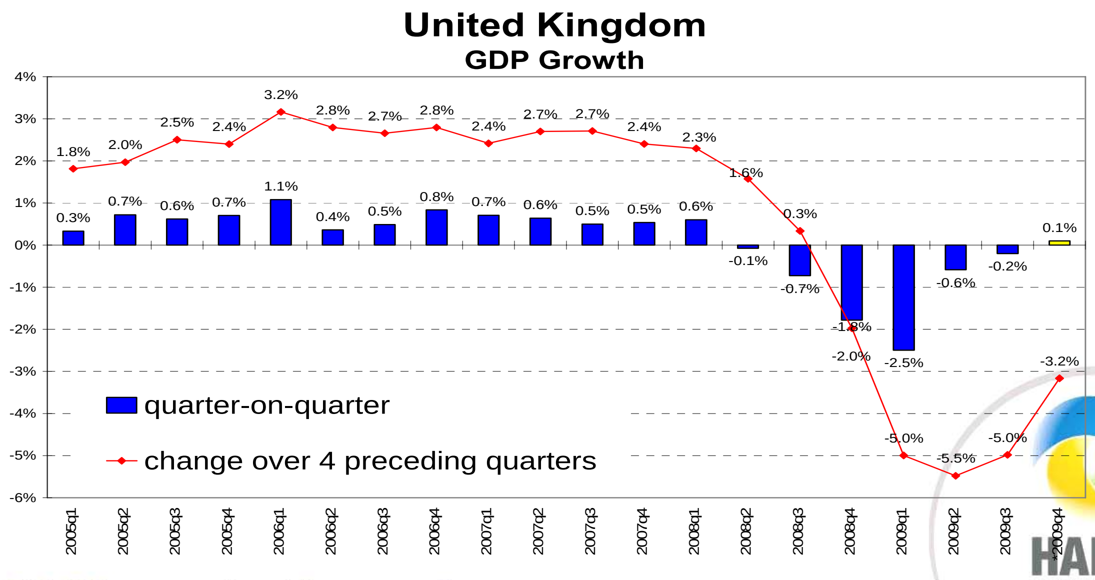
According to the initial estimate, the **euro zone purchasing managers' index** stood at 53.6 points in January, lower than expected.



United Kingdom

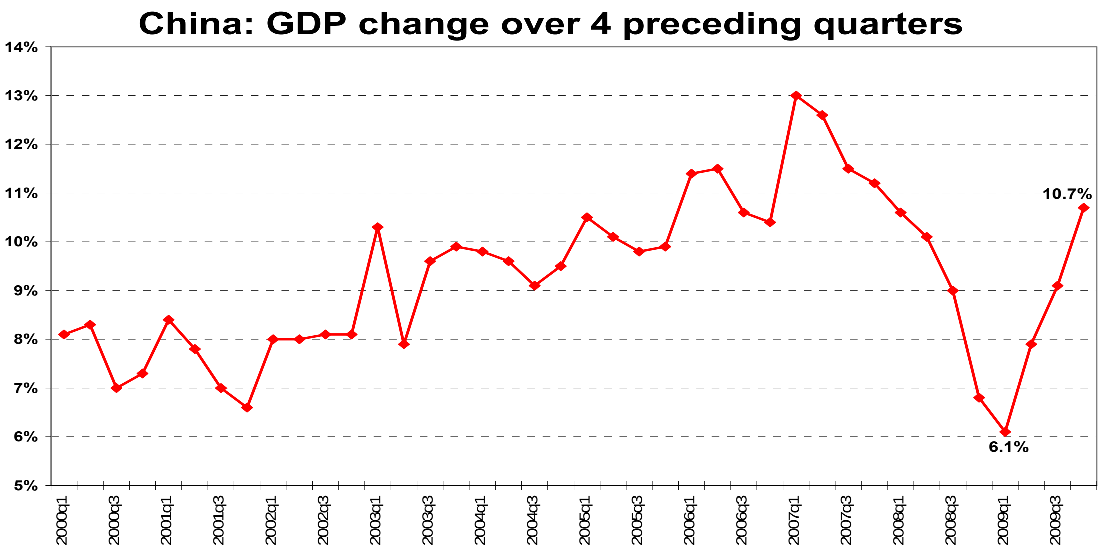
The central bank left the interest rate unchanged at 0.5 percent, as expected, with no change to the quantitative expansion plan.

In contrast to expectations, the UK economy grew, at a minimal rate, in the fourth quarter of 2009, following six consecutive quarters of contraction. According to the initial estimate, **GDP** grew by 0.1 percent, or an annualized 0.4 percent.

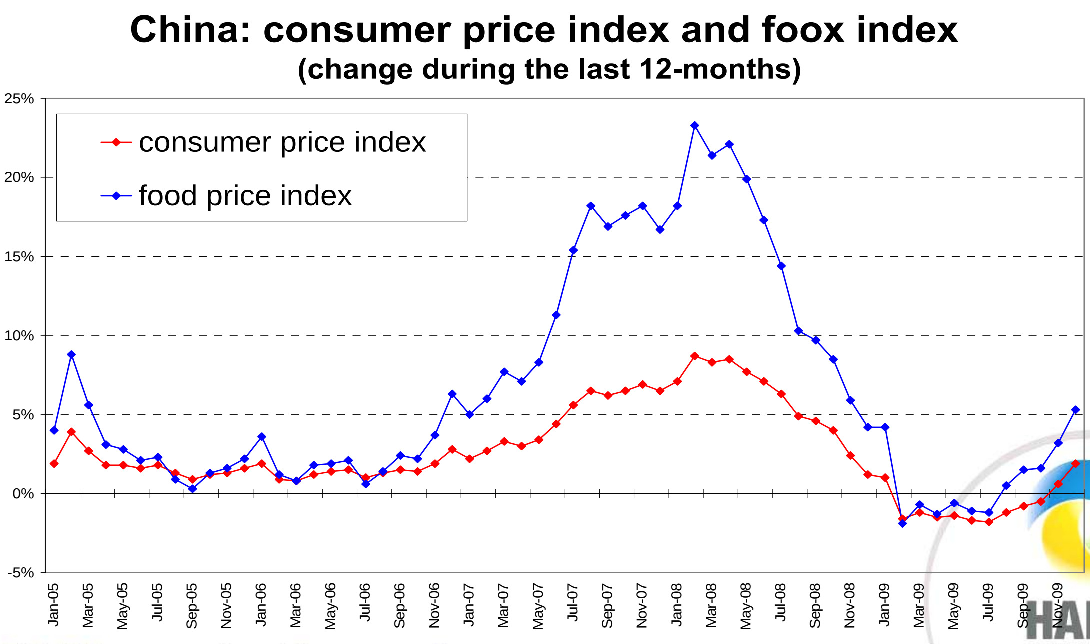


China

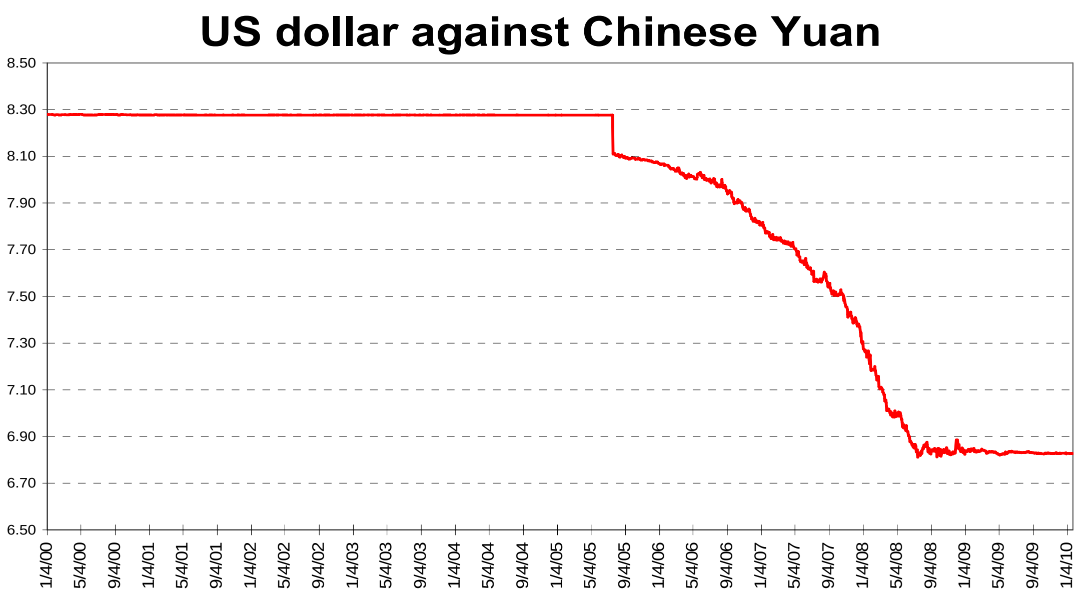
The Chinese economy grew at a steep rate of 10.7 percent in the four quarters up to the last quarter of 2009. Industrial production grew by 18.5 percent, while retail sales increased by 17.5 percent, supported by the government's incentive program and tax cuts.



The consumer price index rose by 1.9 percent in the twelve months ended in December, mainly due to an increase in food prices; food prices comprise about one-third of the CPI in China, more than in the advanced countries. Excluding food prices, inflation stood at 0.2 percent.



A year ago, there were concerns in China over a sharp increase in unemployment and deflation, as inflation reached a negative 1.8 percent in July 2008. Today, inflation is rising and very rapid GDP growth has resumed. An increase in growth and inflation will cause the central bank to begin raising the interest rate during 2010, and create pressure on the government to allow the local currency (the yuan) to strengthen, in order to rein in inflation. Last year, the authorities explained the need for a stable and relatively weak yuan due to the decrease in exports, the slowdown in growth, and negative inflation. These arguments now sound weak, and support **future appreciation** of the yuan.

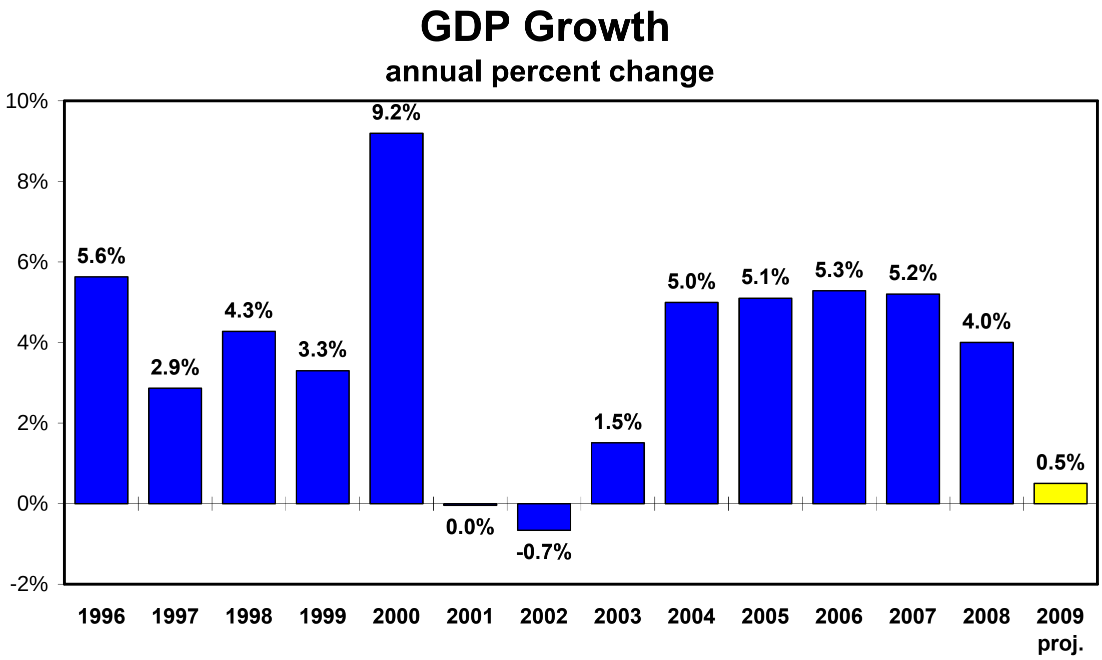


E. Israel's Growth Potential in the Coming Years – The Unpleasant Arithmetic[1]

One of the key factors determining Israel's future, its economic and social character, and possibly even its security and diplomatic situation is the expected growth rate of its economy over the coming years.

[1] This section was prepared by Michael Sarel.

Israel's last recession persisted from late 2000 to mid-2003. After the recession ended, the Israeli economy attained impressive growth rates of 5.0 to 5.3 percent for four consecutive years. In the last two years, due to the global economic crisis, the growth rate decreased to 4.0 percent in 2008 and only approximately 0.5 percent – meaning recession in terms of per-capita GDP – in 2009.



Recently, there have been many claims that in the coming years, as it recovers from the recession, the Israeli economy will be able to achieve impressive performance again, as in the years prior to the recession, and that the predicted growth rate during these years will revert to an average level of 5 percent or more.

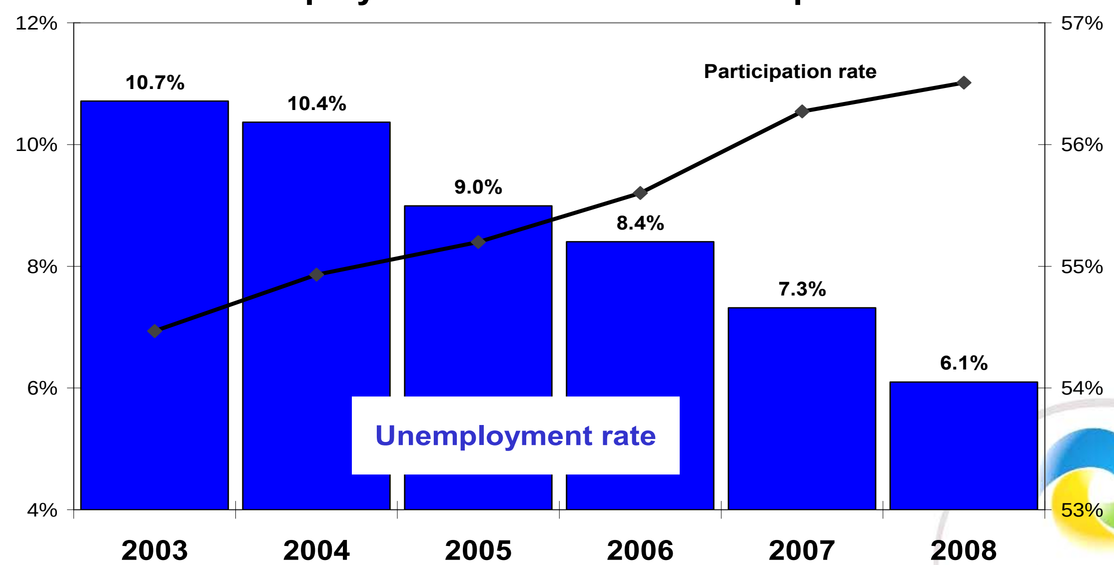
We believe differently. Our opinion is based on a simple calculation demonstrating that the rapid growth during the five years preceding the global economic crisis occurred against the background of several processes of a nonrecurring nature, which are not expected to repeat themselves in the coming years. These processes account for a substantial part of the rapid growth in Israel in the pre-crisis years.

In the five years from the emergence from the previous recession to the beginning of the global economic crisis (from the third quarter of 2003 to the third quarter of 2008), **GDP per adult (age 15+) grew at an average annual rate of 2.81 percent** – relatively rapid growth. For comparison, GDP per capita (as well as GDP per adult) in the advanced countries has grown at an average annual rate of about 2 percent in the last few decades.

During that period, **the number of Israeli workers grew at an average annual rate of 3.66 percent, while the number of adults (age 15+) grew at an average annual rate of 1.78 percent**. In the long term, when workforce participation rates and unemployment rates are stable, both figures would be expected to be the same: the number of workers would grow at the same rate as the number of adults. However, during the period in question there was a significant difference between these rates, as noted.

The gap between these two numbers (representing average annual growth of 1.85 percent) is the result of a **substantial increase in the participation rate**, from 54.90 percent to 56.61 percent of the total population aged 15+, and a **significant decrease in the unemployment rate**, from 11.58 percent to 6.45 percent. The increase in the participation rate explains about one-third of the gap, while the decrease in the unemployment rate accounts for about two-thirds of it.

The Unemployment Rate and the Participation Rate



In other words, this period saw an exceptional increase in the number of employed persons in Israel, at an average annual rate of 1.85 percent. The increase was exceptional in the sense that it was above and beyond the natural growth in the number of employed persons in proportion to population growth.

We can calculate the contribution of the exceptional growth in the number of employed persons to the increase in GDP per adult. Based on the conservative assumption that the average productivity of new employees joining the labor market as a result of the increase in participation and the decrease in unemployment is only about half the average productivity of the previous employees, this contribution amounts to 0.92 percent, on annual average. **Excluding this contribution, GDP per adult would have grown at an average annual rate of just 1.9 percent, instead of 2.8 percent.** In other words, without the exceptional impact of the increase in participation and the decrease in unemployment, the growth rate in Israel would have been similar to the average in the advanced countries in recent decades.

Unfortunately, it is quite likely that the increase in participation and decrease in unemployment were one-time phenomena resulting from special circumstances in the years following 2003.

- **The unemployment rate** peaked at over 11 percent in 2003, due to the deepest and longest recession ever experienced by the Israeli economy. Today, after the global economic recession and the (relatively short and mild) recession in Israel, the unemployment rate is less than 8 percent. The difference between the current unemployment rate and the "natural" unemployment rate expected in the long term is small, in contrast to the situation in 2003. Thus, we cannot expect the absorption of unemployed workers into the job market to contribute significantly to an increase in the number of employed Israelis, as was the case after 2003.

- **The participation rate**, which had been stable in the preceding period, rose rapidly in the years following 2003. This leap resulted from two factors:
    - o The economic plan to revitalize the economy formulated in mid-2003 raised the retirement age by two years. As a result, the participation rate among those older than 60 increased.
    - o The same plan greatly reduced child allowances and income support benefits. As a result, the participation rate among those with low earning capability increased, especially among families for whom entering the labor market was not worthwhile prior to 2003, as their loss from becoming ineligible for the income support benefit would have been greater than their potential wages.

Today, as noted and in contrast to the period following 2003, there is no particular reason to anticipate a substantial decrease in unemployment or a significant increase in the participation rate.

On the contrary: There are concerns that demographic processes may actually cause a decrease in workforce participation. According to demographic forecasts by the CBS (derived from Table 3 and Table 16 in the last annual statistical publication), the number of adults (age 15+) will grow at an average annual rate of 1.75 percent from 2010 to 2015. However, the number of adults at the primary work ages (25-64) will grow at an average annual rate of only 1.32 percent during the same period. As a consequence, the participation rate may not only fail to increase in the coming years; it may actually decline.

Another cause for pessimism lies in the growth forecasts for the advanced countries, which are lower than the growth rates in these countries during the years before the crisis. For example, the average annual growth rate during the four years of 2004-2007 was 2.9 percent in the US and 2.4 percent in the euro zone.

Most forecasts indicate that both of these rates will be approximately 0.5 percentage points lower in the coming years. Of course, lower growth in the economies serving as the destination for the large majority of Israeli exports will adversely affect Israel's growth potential as well.

Based on these considerations, our estimate is that the growth potential of the Israeli economy in the coming years is approximately 3.5 percent – under the optimistic assumptions of stability in the area of security and avoidance of significant mistakes in the management of economic policy.

Nonetheless, in the longer term it is possible to increase Israel's workforce participation rate significantly, thereby also raising its growth potential. Achieving this will depend on a substantive change in government policy, in particular a structural change in the education system and the removal of cultural and other entry barriers to the labor market. These changes will enable large sectors of the Israeli population, primarily ultra-Orthodox Jews (*Haredim*) and Arabs, to obtain suitable education and knowledge and to realize their potential for participation in the Israeli job market. Such a policy would not only serve to increase the growth rate of the economy but also contribute to the reduction of social inequalities.

Important Announcements in the Coming Month

Title	date	Day	Time	Link
US, Private income and consumption	Feb 1	Mon	15:30	www.bea.gov
US, ISM manufacturing index	Feb 1	Mon	17:00	www.ism.ws
Euro zone PMI index	Feb 3	Wed	11:00	www.markiteconomics.com
Euro Zone, Retail sales	Feb 3	Wed	12:00	www.ec.europa.eu/eurostat
US, ISM Services index	Feb 3	Wed	17:00	www.ism.ws
UK, interest rate decision	Feb 4	Thu	14:00	www.bankofengland.co.uk
Euro zone, interest rate decision	Feb 4	Thu	14:45	www.ecb.int
US, employment report	Feb 5	Fri	15:30	www.bls.gov
Israel, average wages	Feb 7	Sun	13:00	www1.cbs.gov.il/reader
Israel, incoming tourists	Feb 9	Tue	13:00	www1.cbs.gov.il/reader
Israel, foreign trade	Feb 10	Wed	13:00	www1.cbs.gov.il/reader
US, retail sales	Feb 11	Thu	15:30	www.census.gov/svsd/www/adseries.html
US, Q4 GDP initial estimate	Feb 12	Fri	12:00	www.ec.europa.eu/eurostat
Israel, CPI	Feb 15	Mon	18:30	www1.cbs.gov.il/reader
Israel, Q4 GDP initial estimate	Feb 16	Tue	13:00	www1.cbs.gov.il/reader
US, housing stars and permits	Feb 17	Wed	15:30	www.census.gov/pub/const
Israel, Industrial production index and trade and service sectors revenue index	Feb 18	Thu	13:00	www1.cbs.gov.il/reader
US, CPI	Feb 19	Fri	15:30	www.bls.gov
Israel, BOI interest rate decision	Feb 22	Mon	17:30	www.bankisrael.gov.il
US, Case-Shiller index	Feb 23	Tue	16:00	http://www2.standardandpoors.com
Israel, New dwelling sold in private sector	Feb 23	Tue	13:00	www1.cbs.gov.il/reader
US, new home sales	Feb 24	Wed	17:00	www.census.gov/const/www/newressalesindex.html
UK, Q4 GDP estimate	Feb 26	Fri	11:30	www.statistics.gov.uk
Euro zone, CPI	Feb 26	Fri	12:00	www.ec.europa.eu/eurostat
US, Q4 GDP estimate	Feb 26	Fri	15:30	www.bea.gov
US, Sales of existing homes	Feb 26	Fri	17:00	www.realtor.org/Research.nsf/Pages/EHSdata
US, Michigan University consumer confidence index	Feb 26	Fri	17:00	www.sca.isr.umich.edu
Israel, house starts and completions	Feb 28	Sun	13:00	www1.cbs.gov.il/reader
Israel, labor force survey	Feb 28	Sun	13:00	www1.cbs.gov.il/reader

This review is posted online at www.harel-finance.co.il/macro in Hebrew

and at www.harel-finance.co.il/macro/ENG in English.

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