

Monthly Macroeconomic Review

October 1, 2009

- **Current indicators of economic activity** provided a mixed picture over the last month, although most reinforced the estimates of a positive turnaround in real activity. Imports and exports of goods and incoming tourism increased in August. Tax revenues were relatively high, though lower than in the preceding month. However, the industrial production index and the trade and service sectors revenue index weakened in July.
- **The International Monetary Fund** raised its global growth forecast for 2009 to negative 1.1 percent, and its forecast for 2010 to 3.1 percent.
- Israel's **balance of payments** showed a large surplus in the current account in the second quarter as well.
- **The consumer price index** rose by 0.5 percent in August.
- **The Bank of Israel interest rate** remained unchanged. Despite the fact that the BOI stopped its daily purchases of foreign currency last month, it continues to intervene in foreign-currency trading according to its own (non-transparent) considerations.
- The unlinked government **bond yield curve** fell, all across the curve, in September.
- **World equity markets** posted gains in September. The MSCI World index rose by 4 percent, the S&P 500 index rose by 4 percent, the NASDAQ index rose by 6 percent, and the MSCI Emerging Markets index rose by 9 percent. The TA-100 index rose by 5 percent, or 6 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.

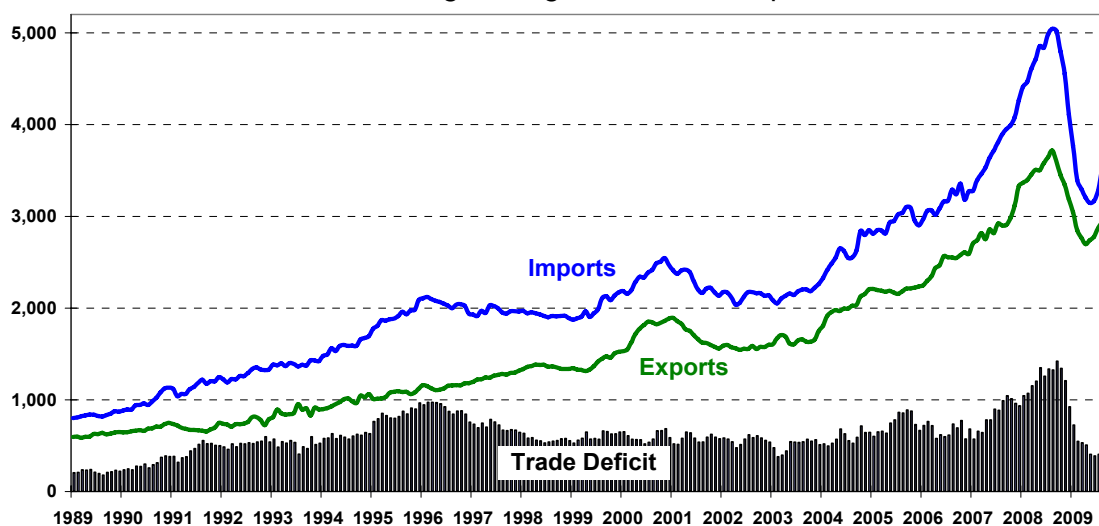


A. Developments in the Israeli Economy

Current indicators of economic activity provided a mixed picture over the last month, although most reinforced the estimates of a positive turnaround in real activity. Imports and exports of goods and incoming tourism increased in August. Tax revenues were relatively high, though lower than in the preceding month. However, the industrial production index and the trade and service sectors revenue index weakened in July.

Foreign-trade data for August indicate continued recovery in exports and imports of goods, and expansion of the trade deficit. **Exports of goods** (excluding diamonds, ships, and aircraft; in dollar terms) increased by 5 percent in August and decreased by 16 percent in the twelve months ended in August. **Imports of goods** grew by 7 percent in August and fell by 25 percent in the twelve months ended in August.

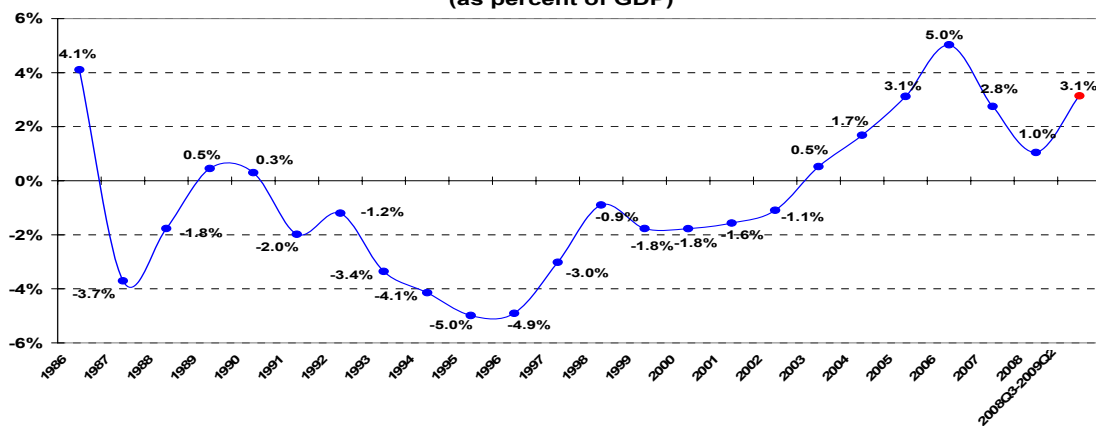
Exports and imports of goods & the trade deficit
(excl. diamonds, ships and aircraft)
3-month moving average, US\$ millions per month



The monthly **trade deficit** rose to USD 0.7 billion in August, the highest level this year. The deficit expanded in recent months, after a low of USD 0.2 billion recorded in May, but remains low in comparison to August 2008, when the deficit reached USD 1.4 billion.

The balance of payments showed a large surplus in the current account in the second quarter of 2009 as well, at USD 2.1 billion, versus USD 2.3 billion in the first quarter and an average of USD 0.6 billion each quarter in 2008. The sharp declines in exports and imports of goods and services were arrested in the second quarter this year, but left imports lower than exports, so that the surplus in the current account remained similar to the first quarter. Investments in tradable securities overseas by residents of Israel grew by USD 3.4 billion in the first half of 2009, reaching the high level of early 2007.

The Current Account (as percent of GDP)



State tax revenues totaled ILS 14.5 billion in August. In light of the revenue figures for July and August and the upward revision of the growth forecasts, the tax revenue target for 2010 in the state budget (ILS 183.1 billion) appears to be reasonable, or even slightly conservative.

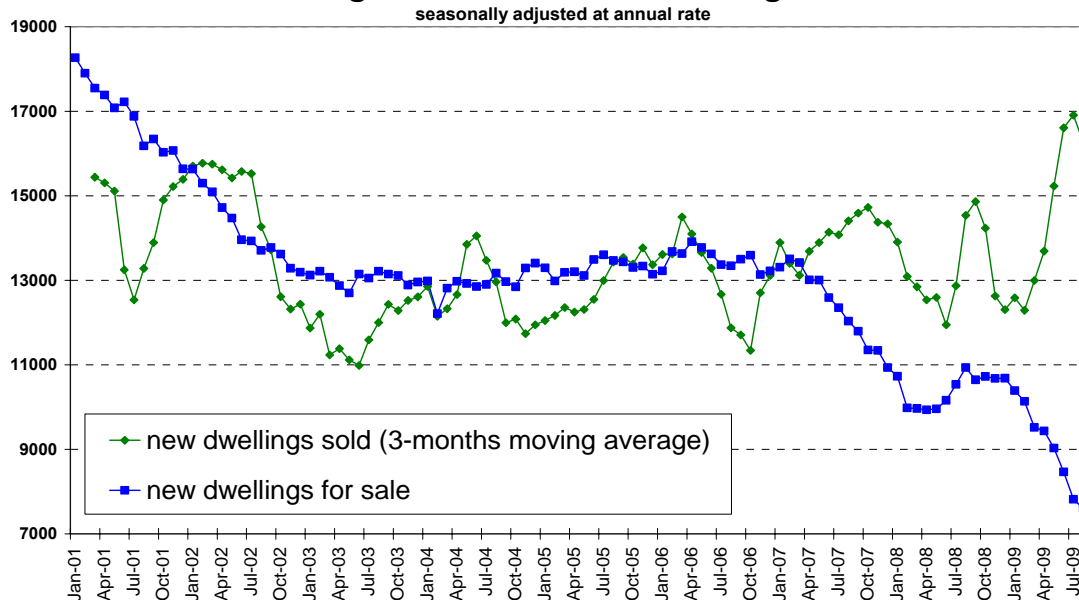
The number of **incoming tourists** by air grew by 2 percent in August, reaching a similar level to that of August last year.

Tourist Arrivals (thousands per month)



The number of new homes sold decreased by 16 percent in August and by 18 percent in the twelve months ended in August. The supply of homes for sale also fell, reaching a new low. This may signal further upward pressures on housing prices.

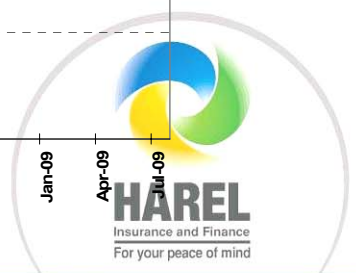
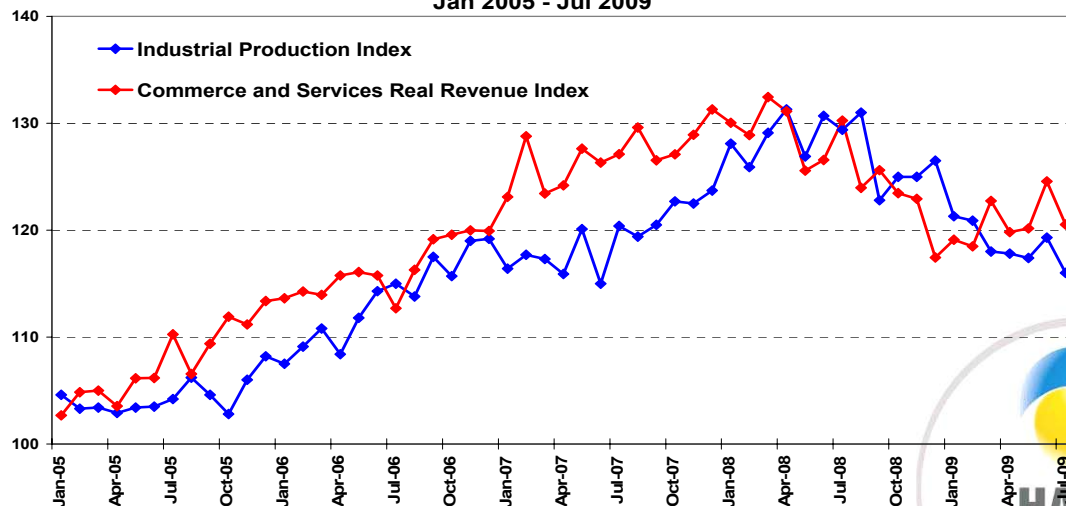
New Dwellings Sold and for Sale During The Period



Indices of real activity in July were weak. The industrial production index decreased by 2.8 percent, and by 10 percent in the twelve months ended in July. The trade and service sectors revenue index was down by 3.2 percent, and by 7 percent in the twelve months ended in July.

Industrial Production Index & Commerce and Services Sectors Revenue Index

Jan 2005 - Jul 2009



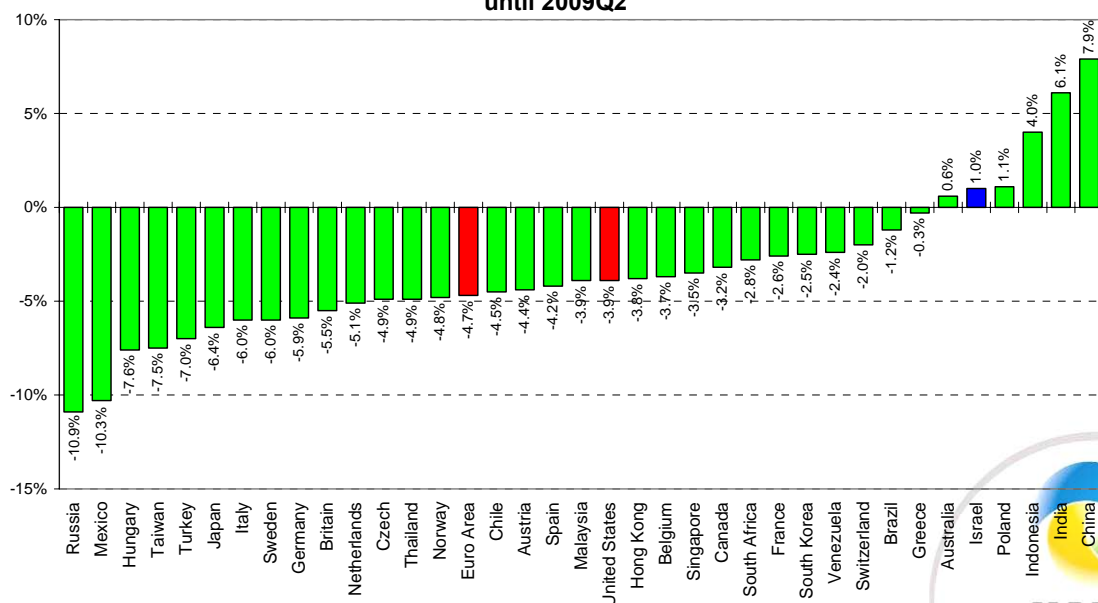
The Bank of Israel's composite index rose by 1.3 percent in August, mainly due to strong foreign-trade data.

The number of employee positions of Israeli workers remained almost unchanged in June, and fell by 1 percent in the twelve months ended in June. Average nominal wages for employee positions of Israelis rose by 3 percent in June, following a sharp decrease in May. In the twelve months ended in June, average nominal wages remained almost unchanged, while real wages decreased by 3 percent.

Gross domestic product, according to the update, grew at an annualized rate of 1.0 percent in the second quarter of 2009, with a 1.3 percent increase in business product. Growth in the second quarter was similar to the initial estimate, but the composition of growth looks far better, with exports and imports adjusted significantly upward.

Growth in Israel over the last four quarters stood at 1.0 percent. This was lower than the growth rate in China and India, but much higher than in most other countries, especially the US and the euro zone. These figures highlight the fact that the recession in Israel over the last year was quite weak compared to the rest of the world.

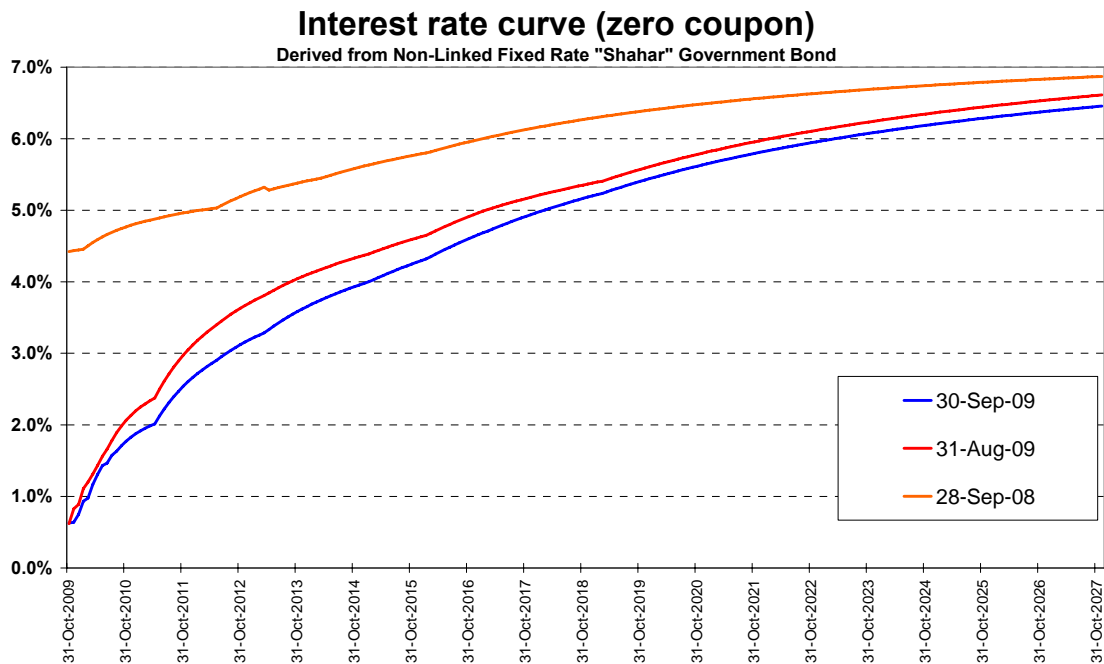
GDP change over 4 preceding quarters until 2009Q2



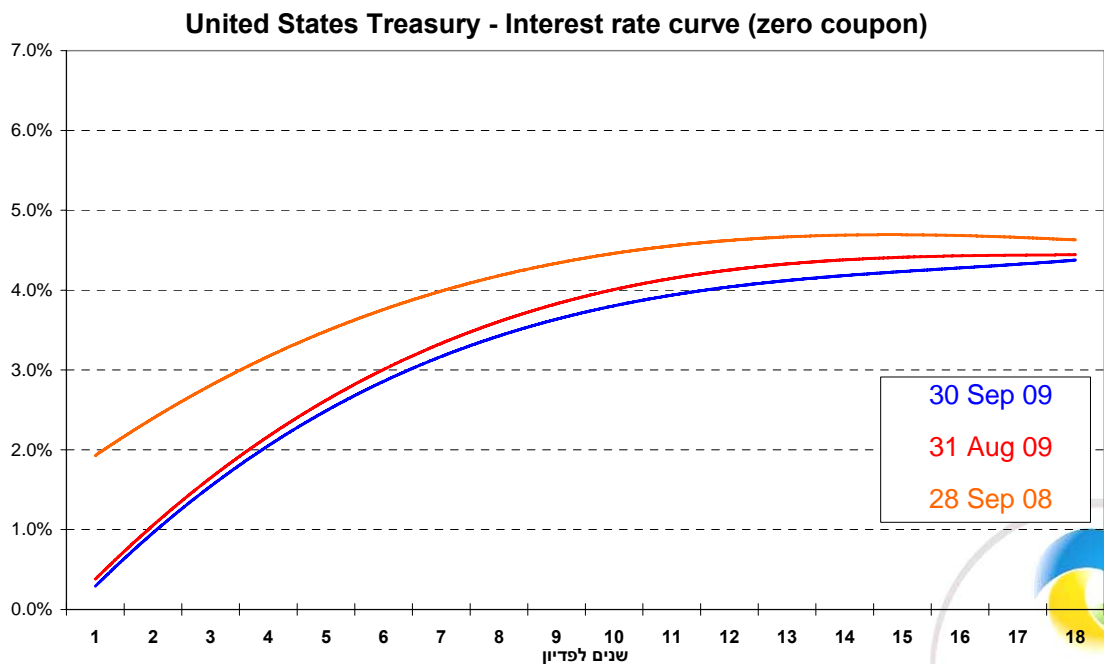
B. Developments in the Capital Market

Bond Market

The unlinked government bond yield curve fell, all across the curve, in September, in line with our estimates. Expectations of a future increase in the BOI interest rate decreased during the month.

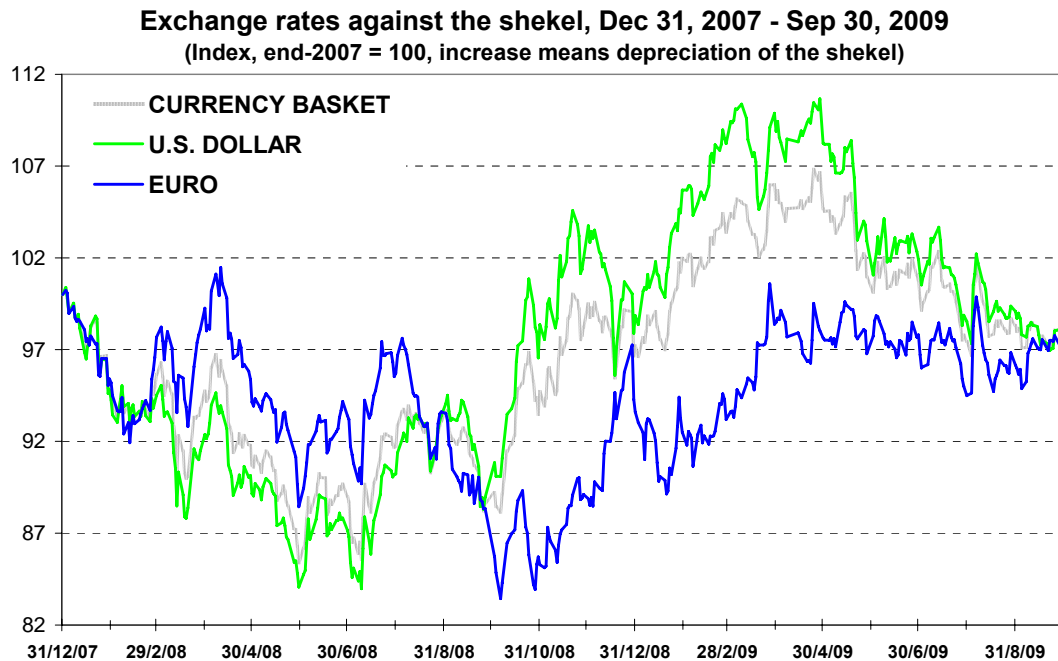


The US government bond yield curve fell in the medium and long range during September.



Exchange Rates

The shekel strengthened by 1 percent against the currency basket and the dollar and weakened by 1 percent against the euro in September.

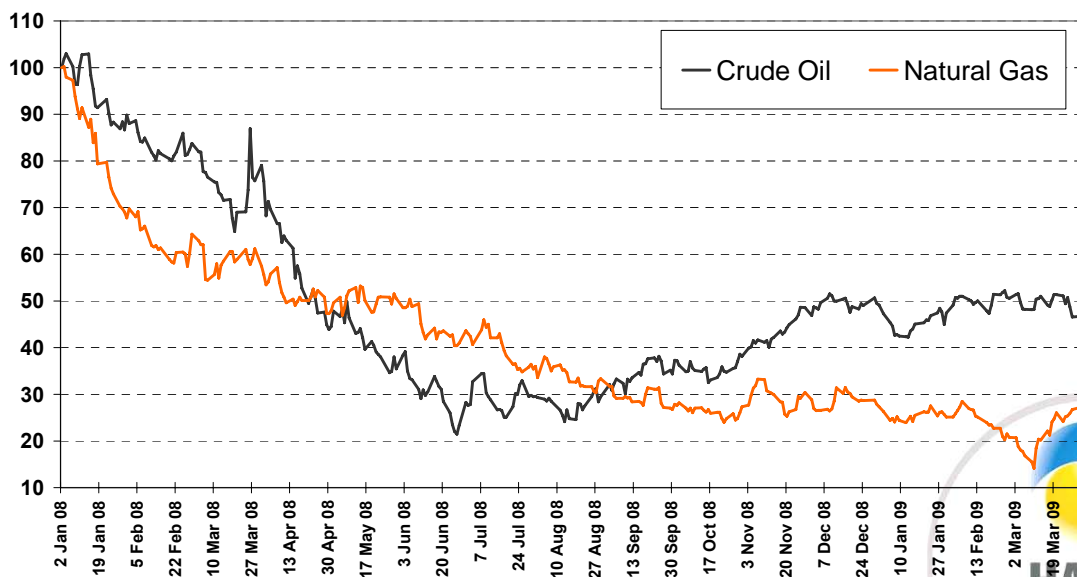


Energy prices

The price of natural gas rose by 37 percent in September, while the price of WTI crude oil rose by 1 percent.

Oil and Gas prices

Jul 2008 = 100



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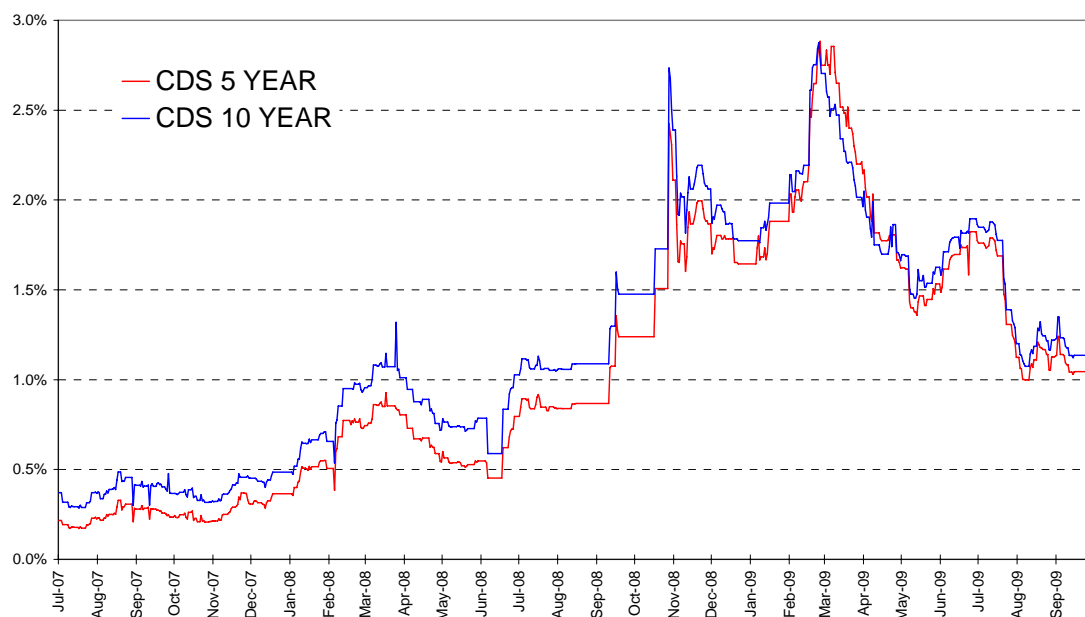
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Stock Markets

World equity markets posted gains in September. The MSCI World index rose by 4 percent, the S&P 500 index rose by 4 percent, the NASDAQ index rose by 6 percent, and the MSCI Emerging Markets index rose by 9 percent. The TA-100 index rose by 5 percent, or 6 percent in dollar terms.

Israel's risk premium, based on the 10-year CDS spread, was 1.1 percent at the end of September, similar to the end of the preceding month.

Israel's risk premium according to the CDS spread

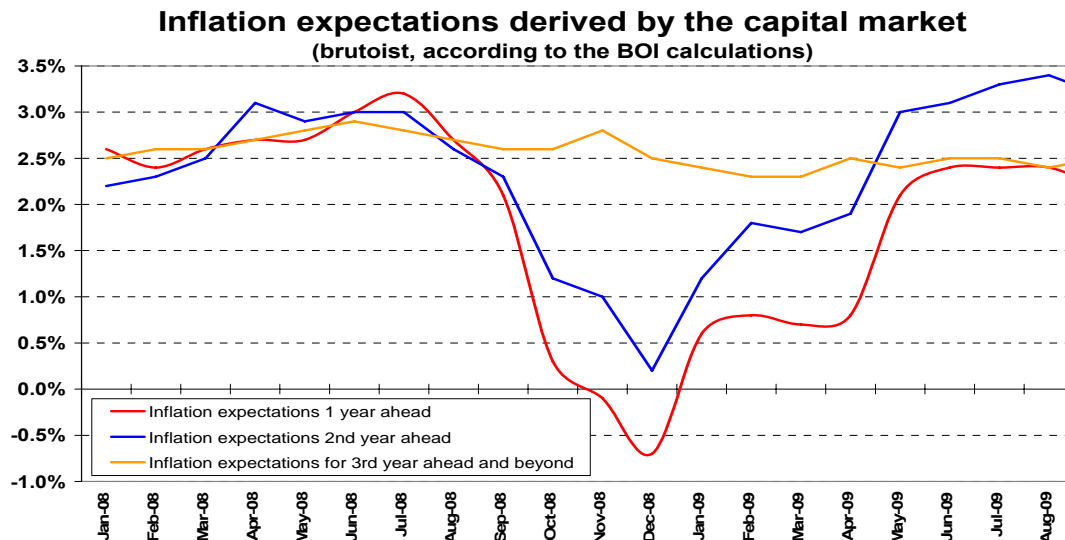


C. Developments in Inflation and Monetary Policy

The consumer price index increased by 0.5 percent in August, within the forecast range. The Drought Levy imposed on July 15 should have affected the July and August CPIs equally, but the CBS actually calculated a contribution of 0.26 percent in July and only 0.10 percent in August, likely due to its decision to revise downward the overall impact of the levy on water prices for consumers. No significant surprises appeared in the other items. Inflation in the twelve months ended in August totaled 3.1 percent, but included the effect of the increase in indirect taxes in recent months, which we estimate added about 1.3 percent to the general index.



Inflation expectations between mid-August and mid-September, according to calculations by the BOI, stood at 2.2 percent on average for the first year and 3.2 percent for the second year, a slight decrease compared to the preceding months.



Given the **Bank of Israel's non-transparent intervention in the foreign-currency market** in August, the monthly report on foreign-currency balances was eye-opening. The BOI reported that during the month of August it bought USD 4.1 billion, and that total foreign-currency balances at the end of August reached USD 56.4 billion. The amount of foreign currency purchased in August was almost double that of the preceding months, despite the transition from daily intervention to occasional intervention. The shekel exchange rate remained almost unchanged overall in August, although volatility during the month was high. The extent of the BOI's intervention in September is unclear, but it seems that massive involvement on the scale of USD 4 billion in a month cannot be sustained for long.

The **Bank of Israel interest rate** remained unchanged, in line with our estimate; other estimates ranged from no change to a 0.25-point rate hike. The BOI's announcement gave no hint of future interest-rate policy.



The BOI noted three main reasons for its decision:

- Inflation, excluding seasonal effects and the effects of indirect taxes, has been in the middle of the target range in recent months; inflation expectations are also within the target range.
- The economic recovery continues in Israel and globally, but a negative GDP gap and a relatively high unemployment rate are still tempering inflationary pressures.
- The interest rates of the central banks in the leading economies are low, and are expected to remain so in the coming few months.

From our perspective, all three factors were already true last month (when the BOI raised the interest rate), remain true today (when the BOI made no change to the interest rate), and will still be true in the next few months (when the BOI may or may not raise the interest rate).

The point is that the BOI needs to continue to raise the interest rate in the near future, but at a moderate pace. Thus, an increase of 0.25 percentage point at an average frequency of once every two months, or possibly slower, seems reasonable given the economic conditions, the considerable increase in money supply, world monetary policy, and the goal of preventing pressures towards rapid appreciation of the shekel.

D. Developments in the Global Economy

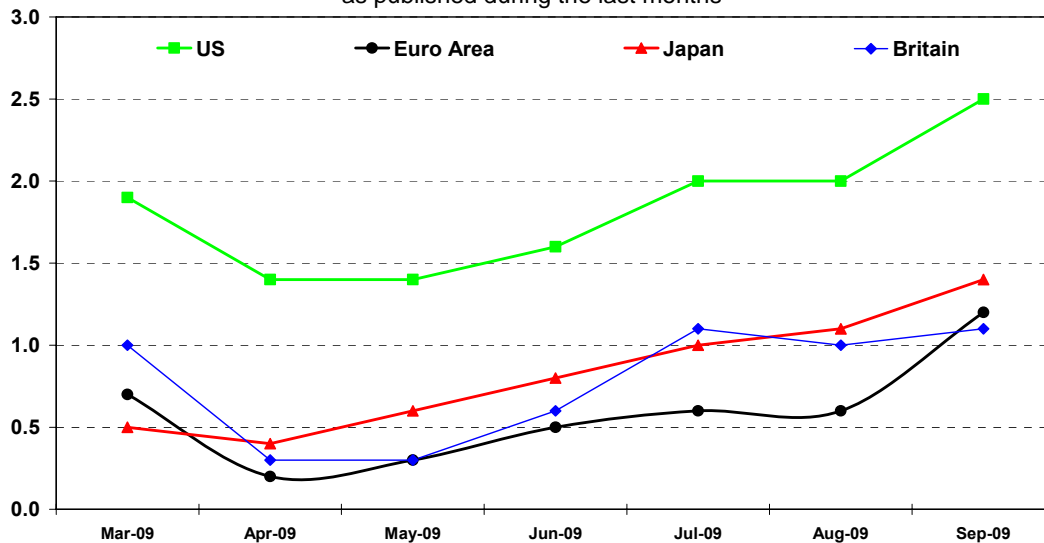
Growth forecasts for advanced economies

The *Economist* has published its monthly Consensus Forecast of growth rates in the advanced countries. Growth forecasts for 2010 rose significantly, and inflation estimates for the US and the euro zone increased.



Growth Forecasts for 2010

as published during the last months



Source: The Economist, Consensus Forecast

United States

GDP contracted at an annualized rate of just 0.7 percent in the second quarter of 2009, versus an earlier estimate of 1.0 percent, in a smaller-than-expected decrease.

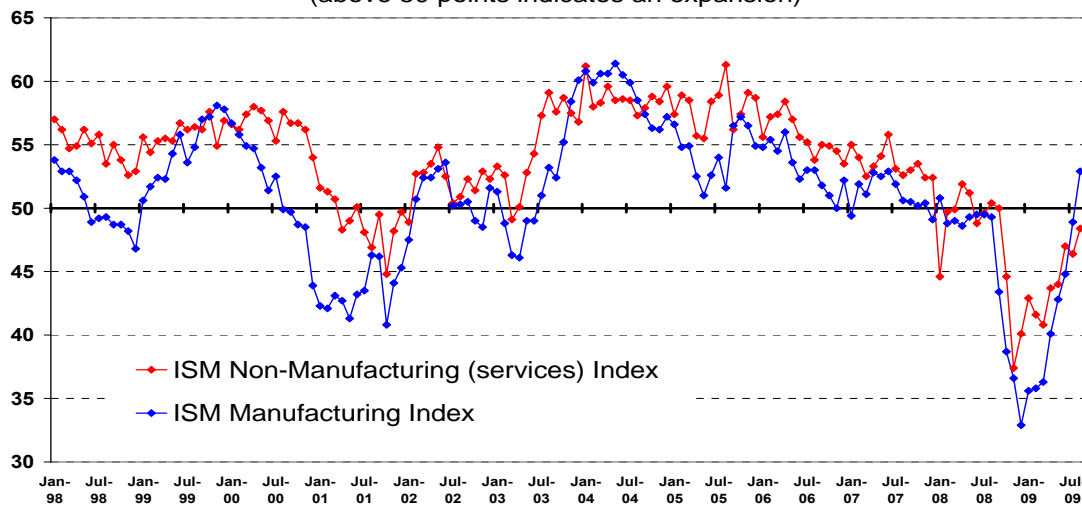
In line with advance estimates, **the Fed left the interest rate unchanged** at 0.00-0.25 percent. The Fed's press release showed confidence in the pace of the economy's recovery and emphasized that the very low interest rate would remain in place for a long period. The Fed also announced the continued purchase of mortgage-backed securities, though at a slower pace.

The ISM service sector index reached 48.4 points compared to 46.4 points in July. In contrast to the manufacturing sector, the service sector is still experiencing mild contraction, mainly due to the banking and insurance industries which were badly hurt by the crisis.



The Institute for Supply Management Index

(above 50 points indicates an expansion)



Retail sales figures for August were surprisingly positive, with a 2.9 percent increase, versus expectations of more moderate growth. This figure, combined with the optimistic speech by the Fed Chairman, contributed to stock-market gains and increases in government bond yields.

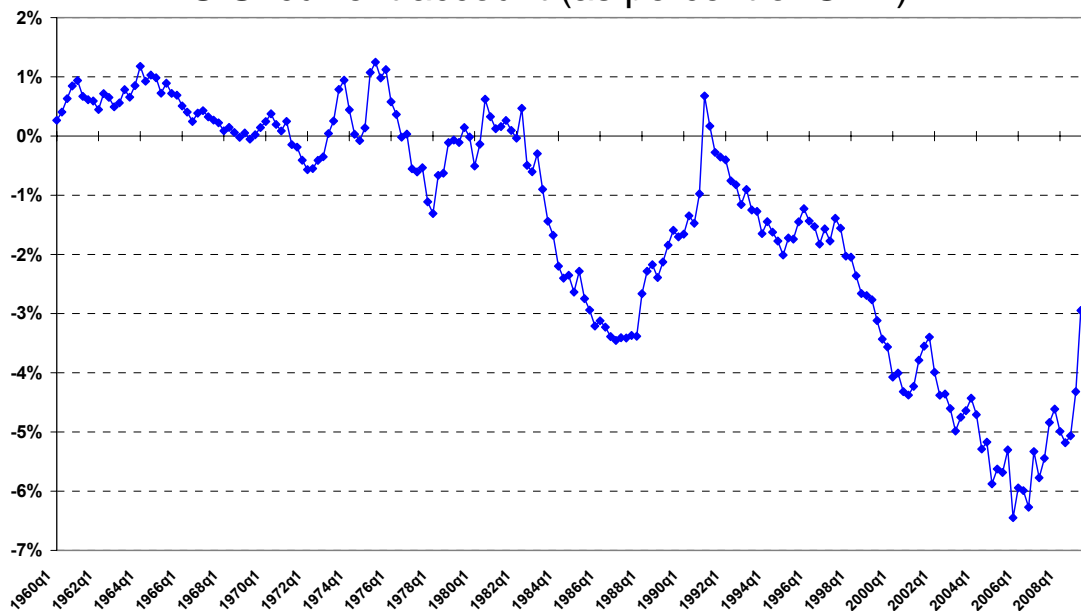
The employment report for August contained no major surprises. The **number of employed persons** fell by 216,000 (a slightly smaller-than-expected decline), and the **unemployment rate** rose to a 26-year high of 9.7 percent.

Construction starts increased by 2 percent in August, while **construction permits** increased by 3 percent, in line with estimates. **Sales of existing homes** decreased, surprisingly, by 2.7 percent in August. The median **price** of homes sold also fell slightly, according to data from the Realtors' Association. Figures for **New home Sales** were also a disappointment as they hardly rose in August. The **S&P Case-Shiller index** of housing prices in twenty major US cities rose by 1.2 percent in August, above expectations.

The consumer price index rose more than expected in August, and **inflation** in the twelve months ended in August stood at a negative 1.5 percent. **Core inflation** was 1.4 percent, as expected, with a 0.1 percent increase in August.

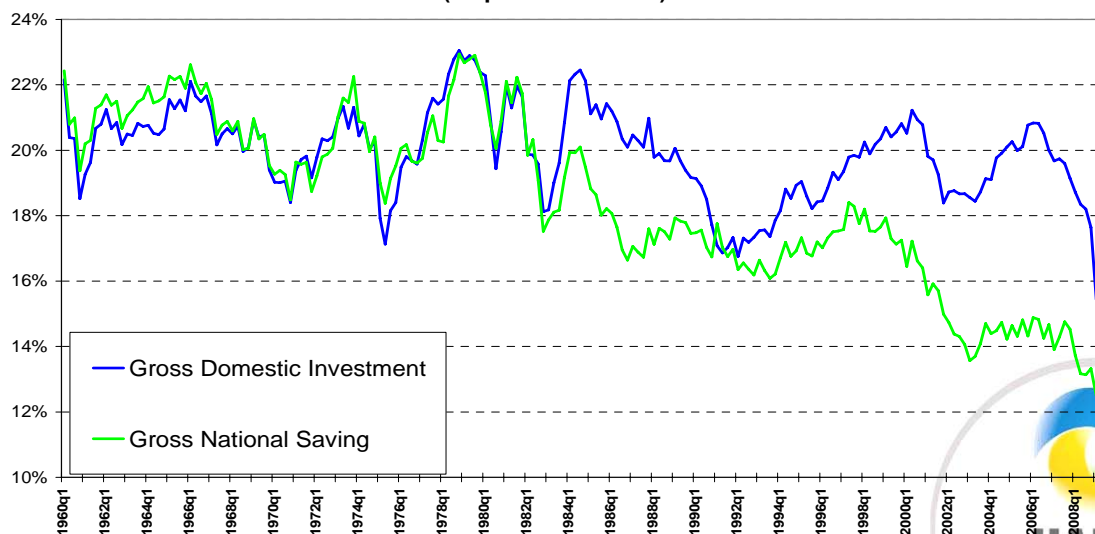
The deficit in the current account of the balance of payments contracted to 2.8 percent of GDP in the second quarter of 2009, from 2.9 percent in the preceding quarter and 5.2 percent in the same quarter last year.

U.S. current account (as percent of GDP)



However, the improvement in the US current account in recent quarters derives from a sharp decrease in domestic investments, rather than an increase in national savings. This may indicate that the decrease in the deficit is only temporary, due to the heavy recession in economic activity and the accompanying decline in investments; but the deficit may swell again with the anticipated recovery in activity.

US Savings and Investment (as percent of GDP)

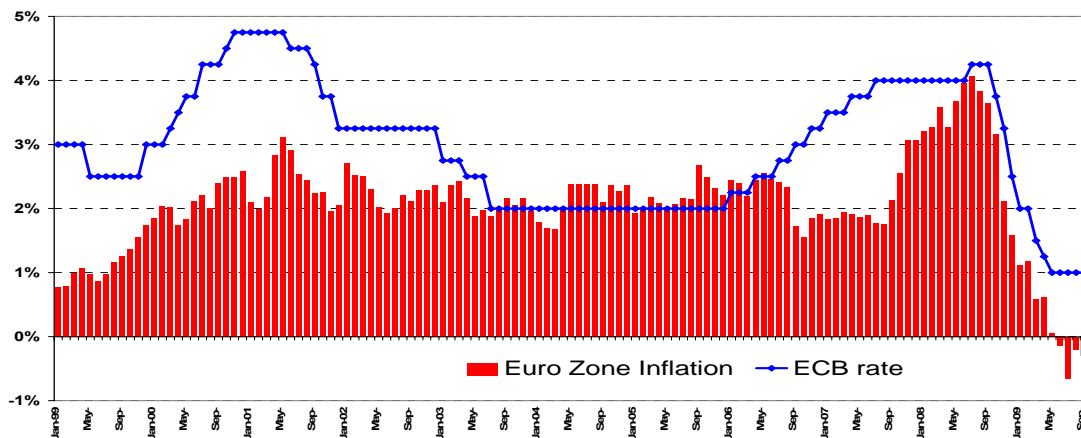


Euro Zone

The ECB left the interest rate unchanged at 1.0 percent, as expected. ECB President Jean-Claude Trichet said that signs of stabilization in economic activity had multiplied. The sharp correction in economic activity has ended, and the euro-zone economy is now entering a period of stability and moderate recovery.

Inflation stood at a negative 0.3 percent in September according to the initial estimate, below expectations.

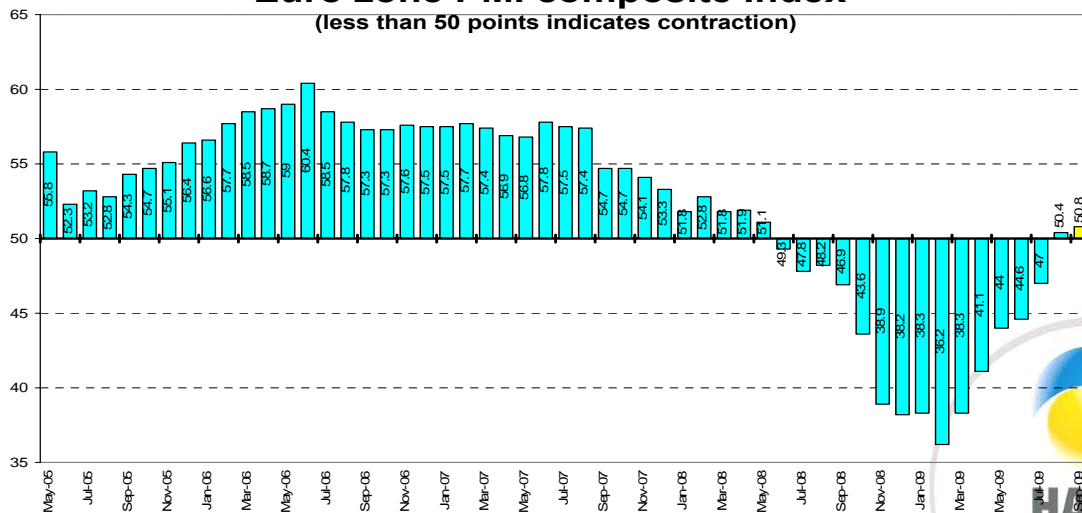
Euro Zone Inflation and ECB Interest Rate



GDP contracted by 0.1 percent in the second quarter of 2009, or 0.4 percent annualized, like the initial estimate.

The euro zone purchasing managers' index was at 50.8 points in September, according to an initial estimate, below expectations.

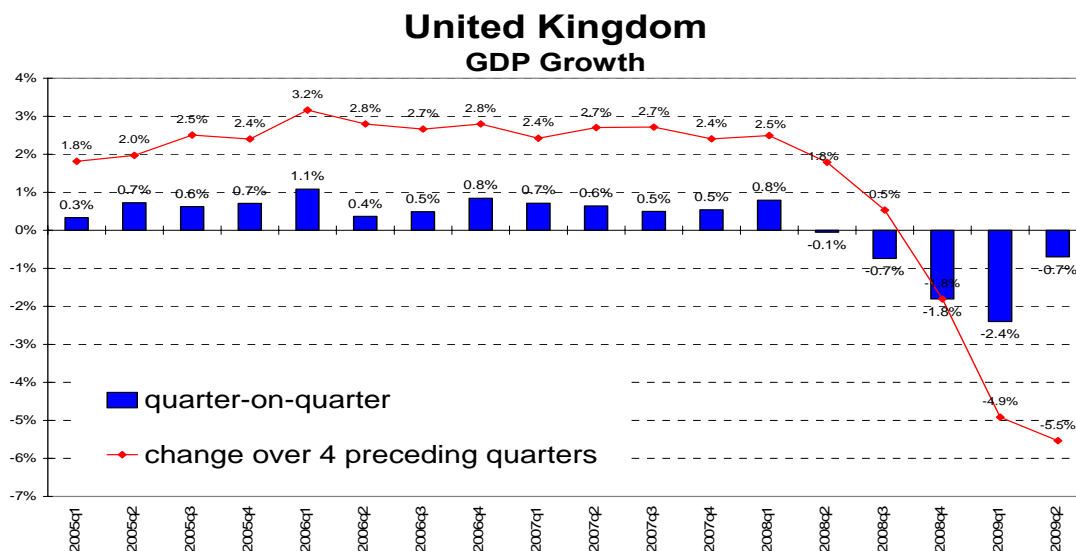
Euro zone PMI composite Index
(less than 50 points indicates contraction)



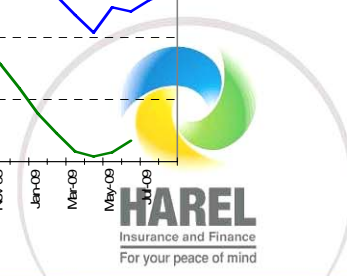
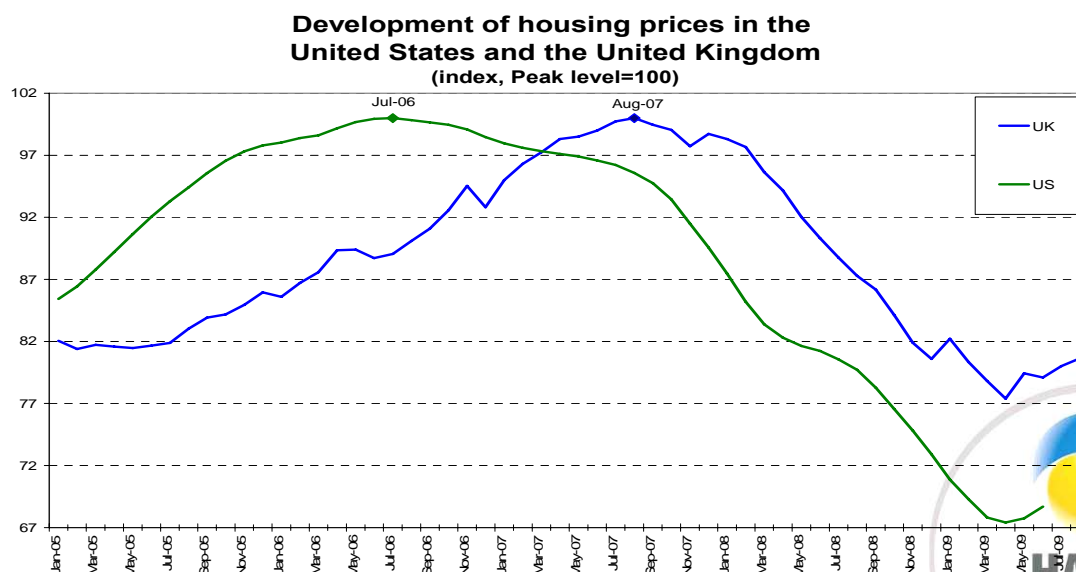
United Kingdom

The central bank left the interest rate unchanged at 0.5 percent, as expected.

The UK economy contracted by 0.7 percent in the second quarter of 2009, or an annualized rate of 2.8 percent, higher than the initial estimate, but as expected. The decrease stemmed from factors including the contraction in industrial output and financial services.



The UK's Halifax house price index rose by 0.8 percent in August, following the 1.2 percent increase in July. Assuming the recovery in housing prices continues, it would appear that the price decline in the UK was shorter and milder than in the US.



Important Announcements in the Coming Month

Title	date	Day	Time	Link
TANKAN survey, Japan	1 Oct	Thu	01:50	http://www.boj.or.jp/en/theme/research
Private income and consumption data, US	1 Oct	Thu	13:30	www.bea.gov
ISM manufacturing sector index, US	1 Oct	Thu	16:00	www.ism.ws
Employment report, US	2 Oct	Fri	14:30	www.bls.gov
PMI (purchasing managers' index), euro zone	5 Oct	Mon	10:00	www.markiteconomics.com
Retail sales, euro zone	5 Oct	Mon	11:00	www.ec.europa.eu/eurostat
ISM service sector index, US	5 Oct	Mon	16:00	www.ism.ws
Interest-rate decision, UK	8 Oct	Thu	13:00	www.bankofengland.co.uk
Interest-rate decision, euro zone	8 Oct	Thu	13:45	www.ecb.int
Average wages	12 Oct	Mon	13:00	www1.cbs.gov.il/reader
Retail sales, US	14 Oct	Wed	14:30	www.census.gov/svsd/www/adseries.html
CPI, euro zone	15 Oct	Thu	11:00	www.ec.europa.eu/eurostat
Tourists arrivals	15 Oct	Thu	13:00	www1.cbs.gov.il/reader
CPI, US	15 Oct	Thu	14:30	www.bls.gov
CPI, ISRAEL	15 Oct	Thu	18:30	www1.cbs.gov.il/reader
Foreign trade, Israel	18 Oct	Sun	13:00	www1.cbs.gov.il/reader
National accounting and growth data, 2Q 2009	18 Oct	Sun	13:00	www1.cbs.gov.il/reader
Construction starts and permits, US	20 Oct	Tue	14:30	www.census.gov/pub/const
Industrial production index and trade and service sectors revenue index	22 Oct	Thu	13:00	www1.cbs.gov.il/reader
3Q growth rate estimate, UK	23 Oct	Fri	10:30	www.statistics.gov.uk
Sales of existing homes, US	23 Oct	Fri	16:00	www.realtor.org/Research.nsf/Pages/EHSdata
Interest-rate decision, BOI	26 Oct	Mon	17:30	www.bankisrael.gov.il
Sales of new homes, US	28 Oct	Wed	16:00	www.census.gov/const/www/newressalesindex.html
New dwelling sold in private sector	29 Oct	Thu	13:00	www1.cbs.gov.il/reader
3Q growth rate estimate, US	29 Oct	Fri	14:30	www.bea.gov
CPI estimate, euro zone	30 Oct	Fri	12:00	www.ec.europa.eu/eurostat
Unemployment rate, euro zone	30 Oct	Fri	12:00	www.ec.europa.eu/eurostat
Private income and consumption data, US	30 Oct	Fri	14:30	www.bea.gov
Michigan University consumer confidence index	30 Oct	Fri	16:00	www.sca.isr.umich.edu

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.

Please address comments or questions to Mr. Ofer Klein at

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