Monthly Macroeconomic Review January 3, 2010

- **The initial CBS estimate of growth in 2009** stands at 0.5 percent, slightly higher than advance estimates. Third-quarter growth has been adjusted to 3.0 percent in annualized terms, from 2.2 percent in the previous estimate.

- **Current indicators of economic activity** painted a positive picture over the last month. Imports of goods increased significantly in November, and tax revenues were in line with expectations. However, exports of goods, incoming tourists, and new homes sold decreased. In October, the industrial production index and the trade and service sector revenues index showed gains. In our opinion, given the economic indicators published so far, growth in the fourth quarter of 2009 is likely to have accelerated.

- The Minister of Finance has announced a reduction in the rate of **VAT**, by 0.5 percentage points, to 16 percent.

- **The current account of the balance of payments** reached a surplus of USD 1.3 billion in the third quarter of 2009. In the first three quarters of 2009, the surplus totaled USD 5.0 billion. We estimate that this surplus will decrease considerably in 2010, due to the expectation of a faster increase in imports than in exports.

- **The consumer price index** rose by 0.3 percent in November, in line with our forecast.

- **The Bank of Israel interest rate** rose by 0.25 percentage points, to 1.25 percent.

- **The government bond yield curve** rose, across the entire curve, in December, supported by the increase in US government bond yields and the increase in the short-term interest rate in Israel.

- **Global equity markets** posted gains in December. The MSCI World index rose by 2 percent, the S&P 500 index rose by 3 percent, the NASDAQ index rose by 6 percent, and the MSCI Emerging Markets index rose by 4 percent. The **TA-100 index** rose by 6 percent (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

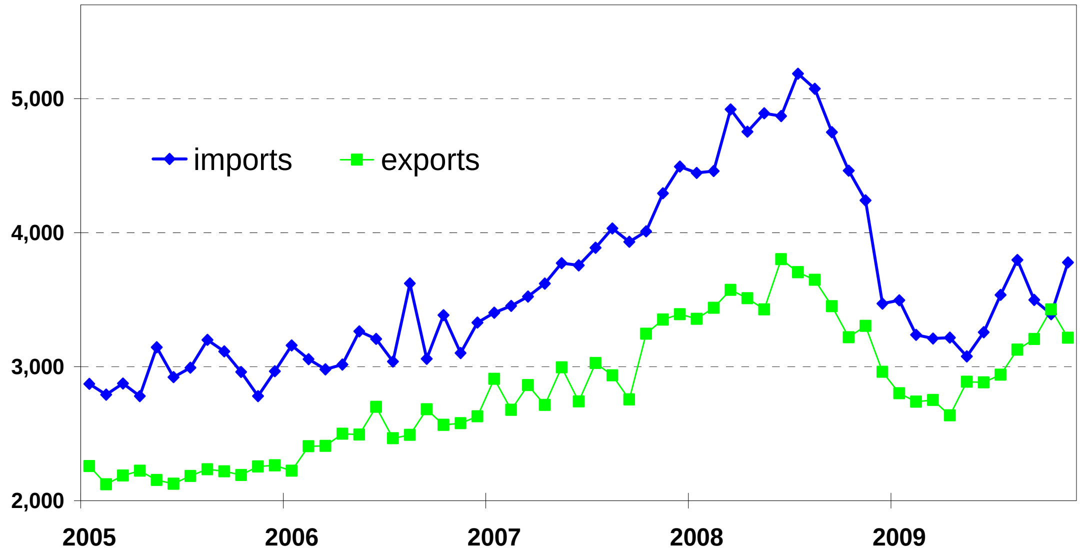
The initial estimate of growth in 2009 by the Central Bureau of Statistics stands at 0.5 percent, slightly higher than advance estimates. Third-quarter growth has been adjusted to 3.0 percent in annualized terms, from 2.2 percent in the previous estimate.

Current indicators of economic activity painted a positive picture over the last month. Imports of goods increased significantly in November, and tax revenues were in line with expectations. However, exports of goods and incoming tourists decreased. In October, the industrial production index and the trade and service sector revenues index showed gains. In our opinion, given the economic indicators published so far, growth in the fourth quarter of 2009 is likely to have accelerated.

Exports of goods (excluding diamonds, ships, and aircraft, in dollar terms) decreased by 6 percent in November, following a steep increase at a similar rate in October. Exports contracted by 3 percent over the twelve months ended in November. By contrast, **imports of goods** grew by 11 percent in November and decreased by 11 percent in the twelve months ended in November. As a result, a significant **trade deficit** formed again in November.

Exports and Imports of Goods

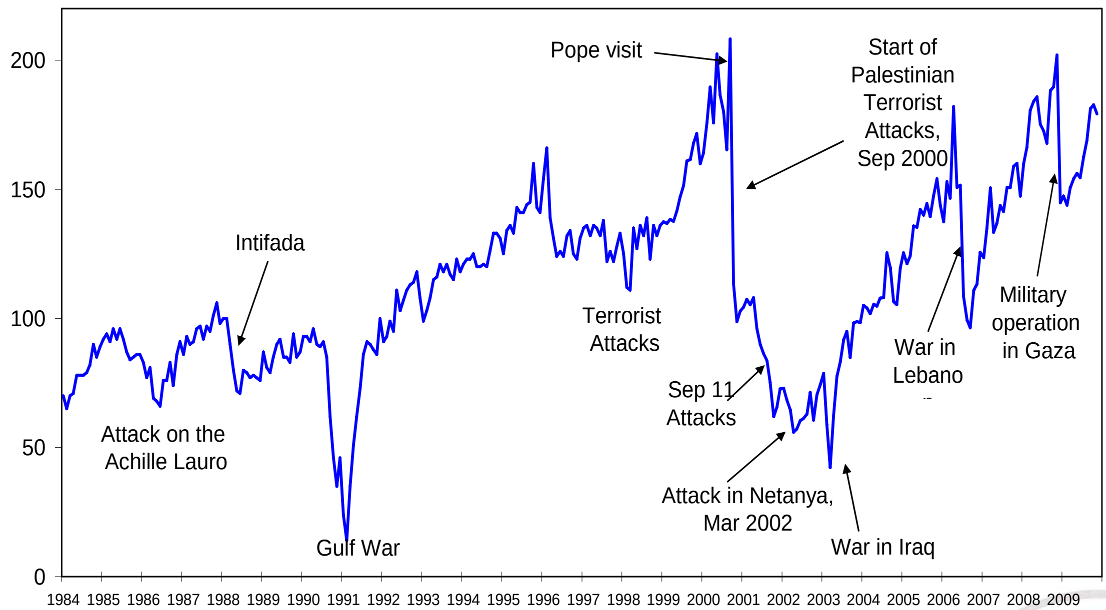
(US$ millions per month, excl. diamonds, ships & airplanes)
Jan 2005 - Nov 2009



The number of **incoming tourists** by air, based on data net of seasonal effects, shrank by 2 percent in November, after a consecutive four months of increases.

Tourist Arrivals

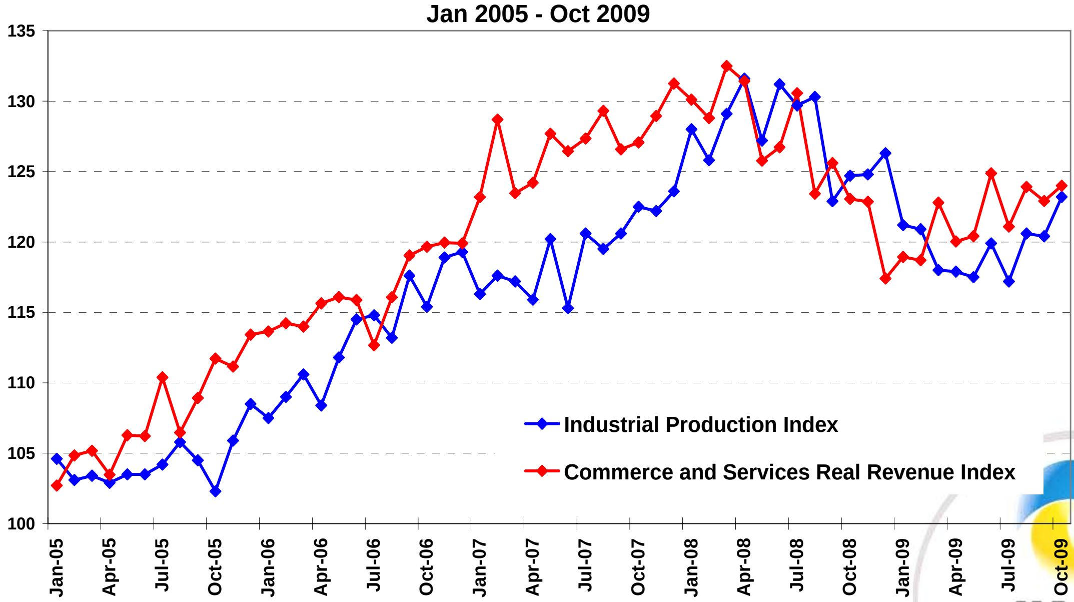
(thousands per month)



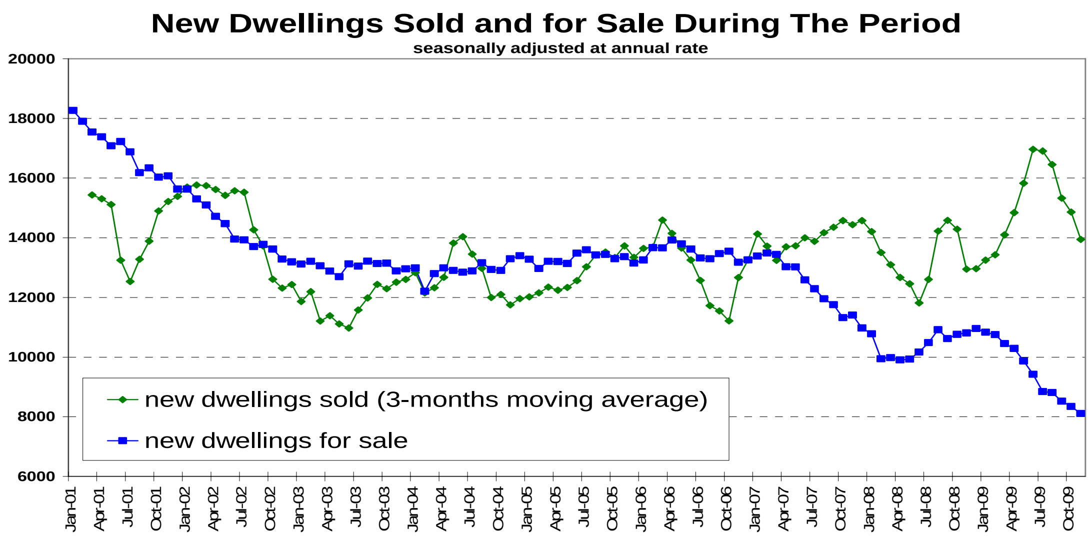
State tax revenues totaled ILS 16.3 billion in November. Due to the improvement in state tax revenues in recent months and the public criticisms of the increase in water prices, the Minister of Finance decided to lower the rate of **VAT** by 0.5 percentage points. In our opinion, this step will not contribute to strengthening Israel's economy. Although the budget deficit in 2010 is expected to be lower than forecast in the state budget (5.5 percent of GDP), it will nonetheless be very high. Moreover, a substantial effort will be required in order for the government to meet the deficit target for 2011 (3 percent of GDP). Under these circumstances, we think it would have been better to reduce the budget deficit, rather than decreasing VAT revenues. The argument that this move will help disadvantaged population groups and reduce inequalities is also not necessarily correct. If the VAT cut forces the government to make greater reductions (or smaller expansions) of budgetary spending in 2011, the overall impact of both moves could be to increase inequalities.

The index of trade and service sector revenues rose by 0.9 percent in October and by 1 percent in the twelve months ended in October. **The industrial production index** rose by 2 percent in October, and fell by 1 percent in the twelve months ended in October.

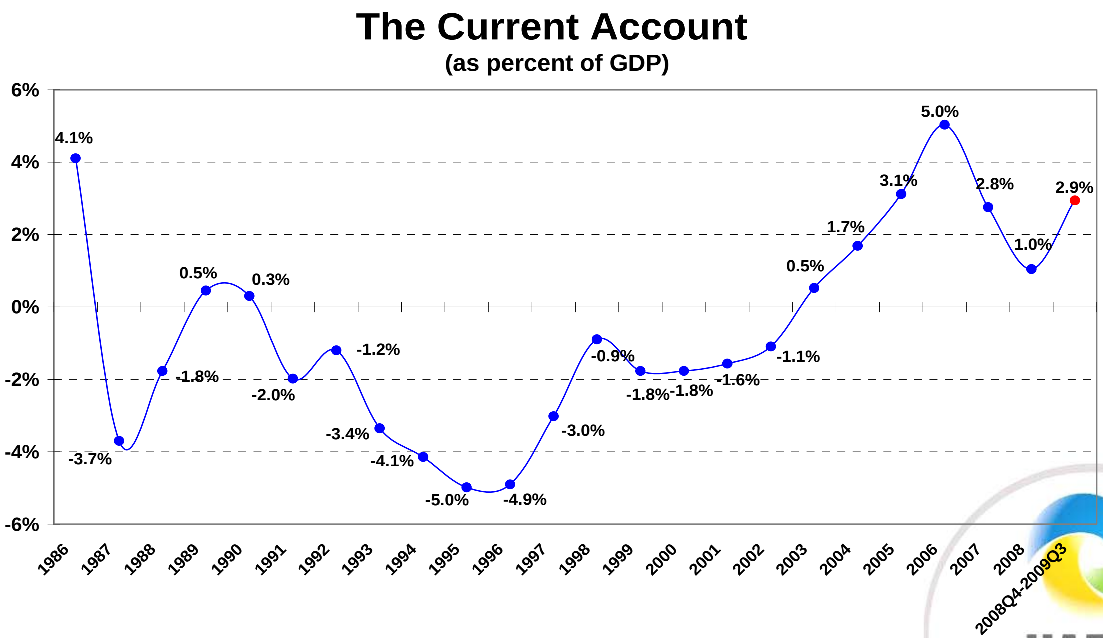
Industrial Production Index & Commerce and Services Sectors Revenue Index
Jan 2005 - Oct 2009



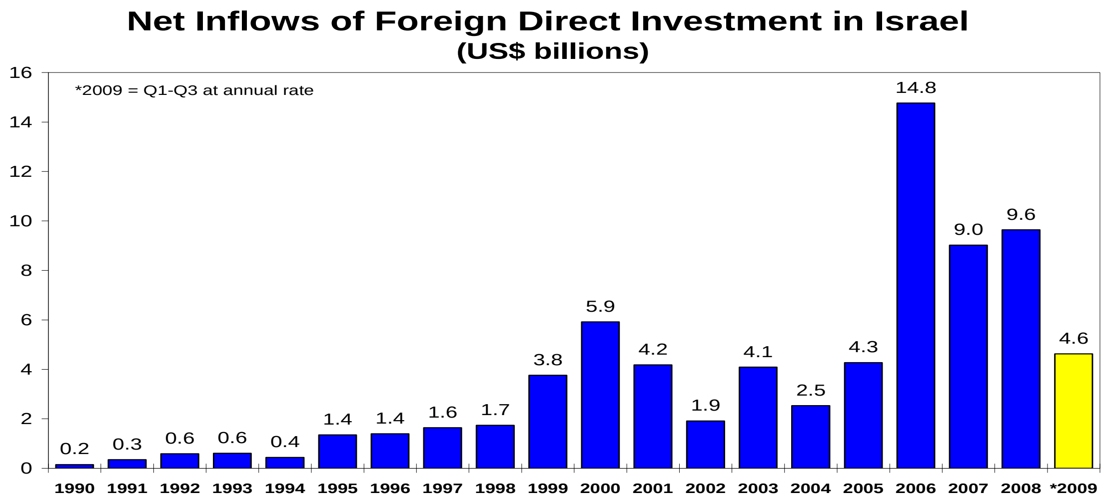
The number of new homes sold decreased by 18 percent in November and by 5 percent in the twelve months ended in November. **The supply of homes for sale** decreased by 3 percent, reaching a new low.



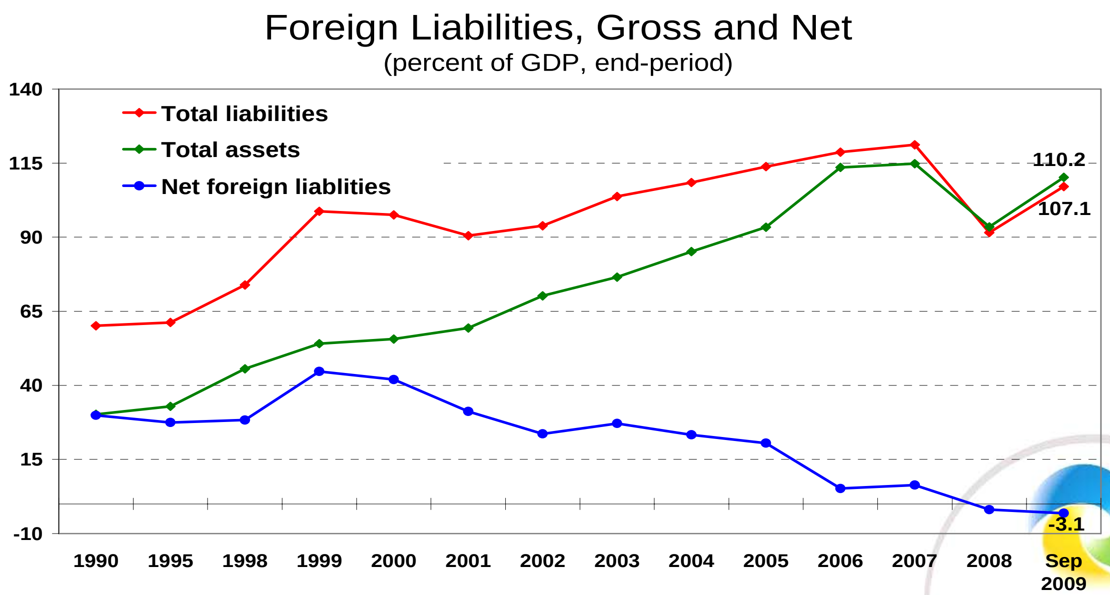
The current account of the balance of payments reached a surplus of USD 1.3 billion in the third quarter, similar to the surplus in the preceding quarter, following a surplus of USD 2.5 billion in the first quarter. The cumulative surplus in the current account in the last four quarters totaled 2.9 percent of GDP, but we expect the surplus to decrease considerably in 2010, due to an expectation of faster growth of imports than of exports.



The increase in foreign direct investments in Israel in the third quarter amounted to USD 1.5 billion, following increases of USD 0.7 billion and USD 1.3 billion in the first and second quarters. The decrease in these investments this year was more moderate than the decrease in direct investments overseas by Israelis.



The balance of assets and liabilities of the Israeli economy (the international investment position) reached a surplus of assets over liabilities of USD 4.9 billion (3.1 percent of GDP) at the end of September 2009. This amount is based on overseas assets in the amount of USD 210.7 billion, offset by overseas liabilities of the Israeli economy in the amount of USD 205.8 billion.

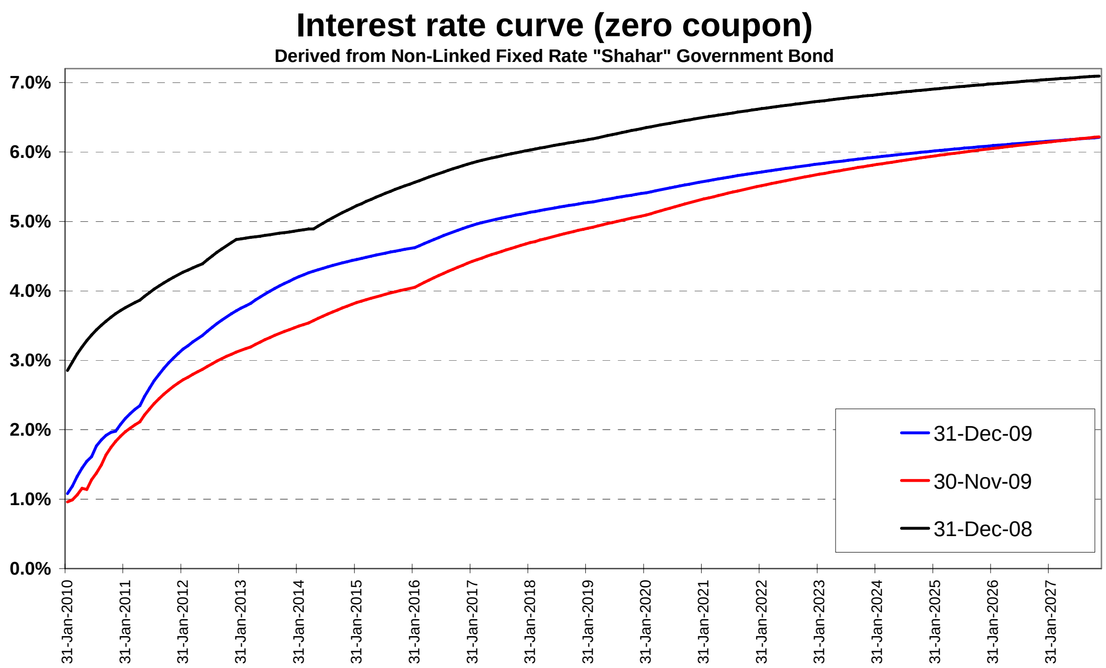


In the labor market, the number of employee positions of Israeli workers increased at a moderate rate of 0.2 percent in September and decreased by 1.2 percent in the twelve months ended in September. **Average nominal wages for employee positions** of Israelis remained almost unchanged in September, and rose by 0.7 percent in the twelve months ended in September (a real decrease of 2.0 percent).

B. Developments in the Capital Market

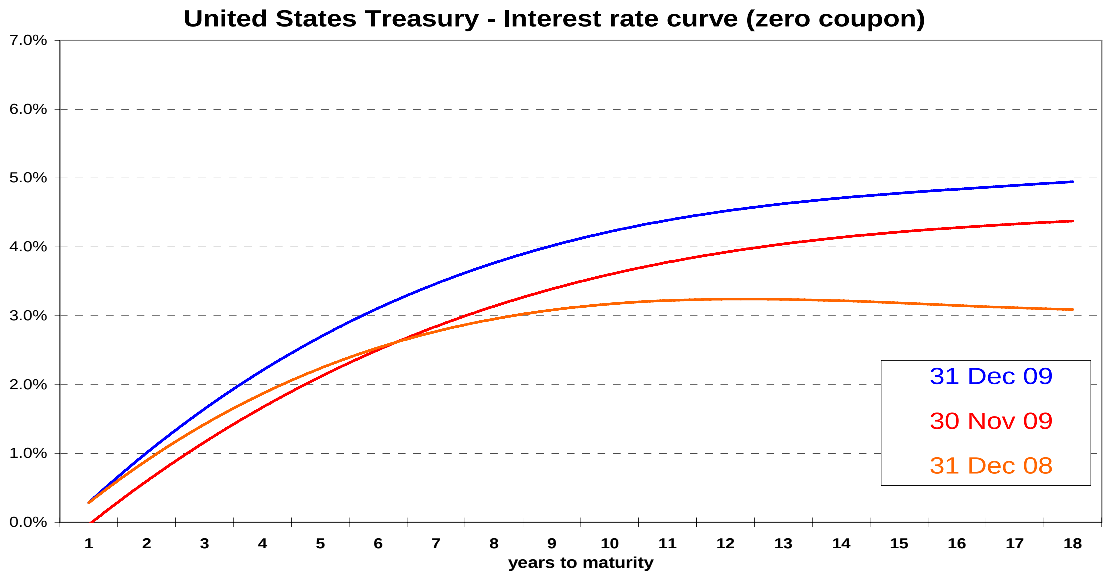
Bond Market

The government bond yield curve rose, across the entire curve, in December, mainly in the medium-term range, supported by the increase in US government bond yields and the increase in the short-term interest rate in Israel.



In 2009 the curve dropped sharply across the board, due to the interest-rate cuts by the Bank of Israel and the relatively strong performance of the Israeli economy during the crisis.

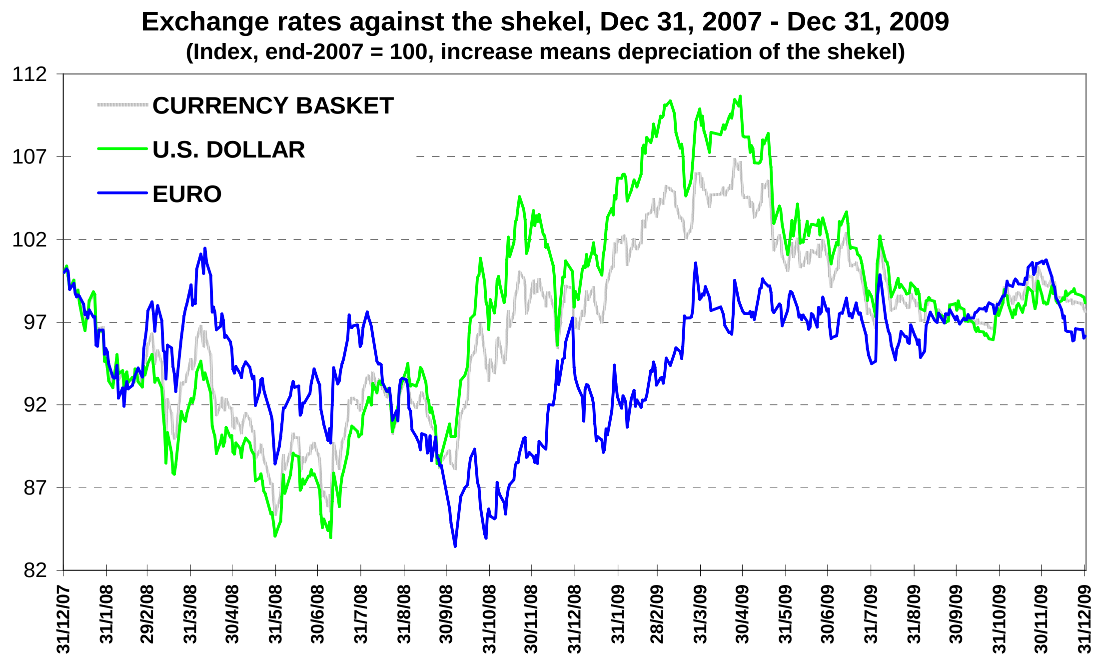
The US government bond yield curve showed increases along its entire length in December.



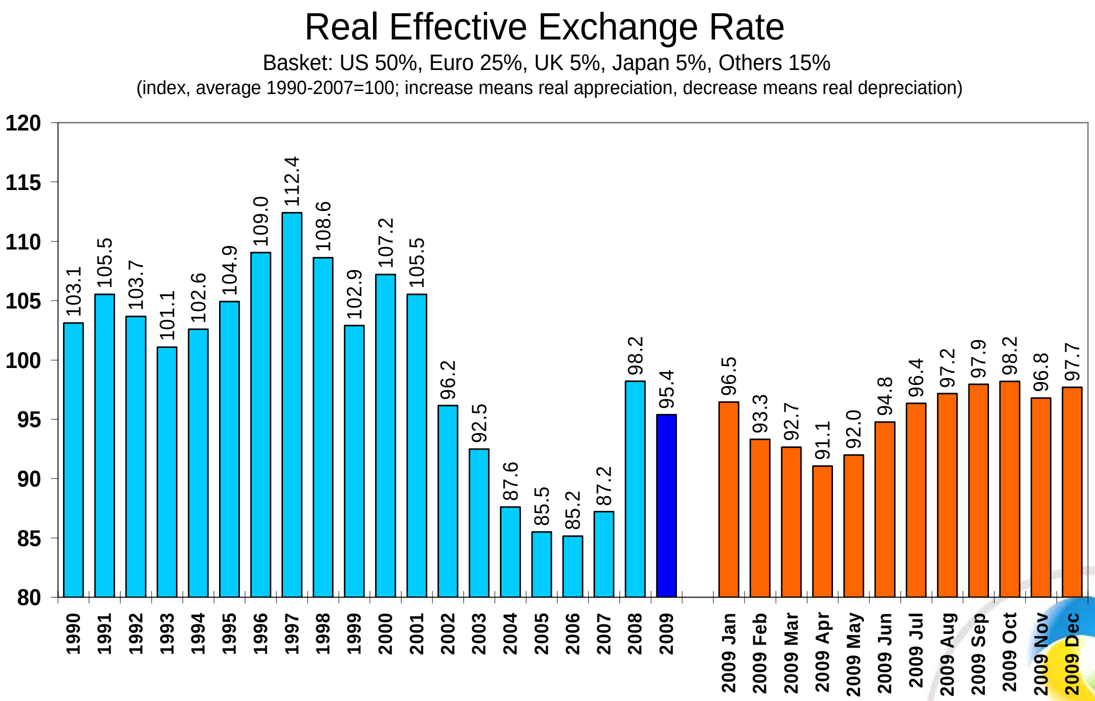
The curve rose sharply in 2009, supported by the improved growth forecast for the US and globally, which led to the redirection of funds from "safe" assets such as government bonds, and by the immense deficit of the US government.

Exchange Rates

The shekel appreciated by 2 percent against the currency basket in December, while remaining unchanged against the dollar and gaining 4 percent against the euro.



The effective real exchange rate of the shekel weakened by 3 percent in 2009, due to the intervention of the BOI through purchases of foreign currency, following real appreciation of the shekel by 13 percent in 2008.



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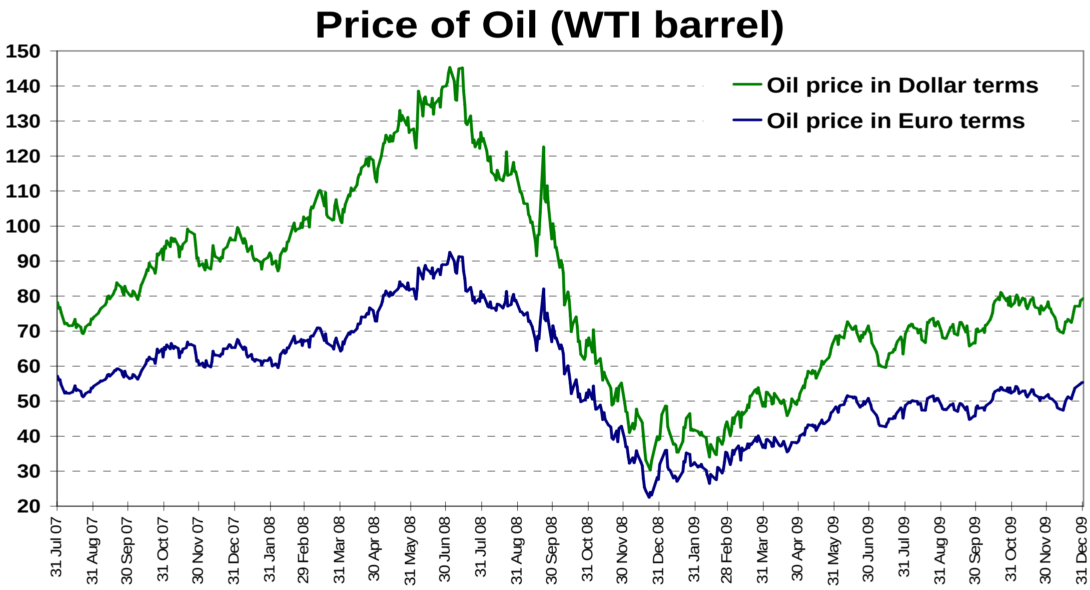
Energy prices

The price of a WTI oil barrel rose by 3 percent in **dollar** terms, and rose by 7 percent in **euro** terms. The price of **natural gas** increased by 32 percent in dollar terms during the same period.

During 2009, the price of a WTI oil barrel rose by approximately 102 percent (from USD 39 to USD 79), following the steep drop in oil prices during the second half of 2008.

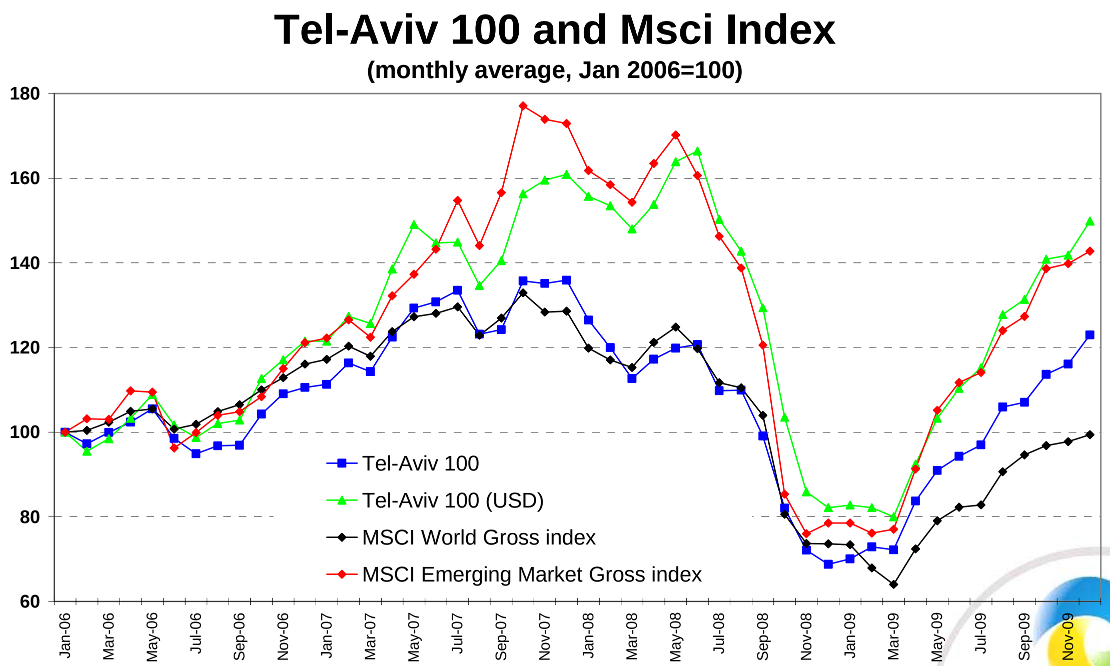


Stock Markets

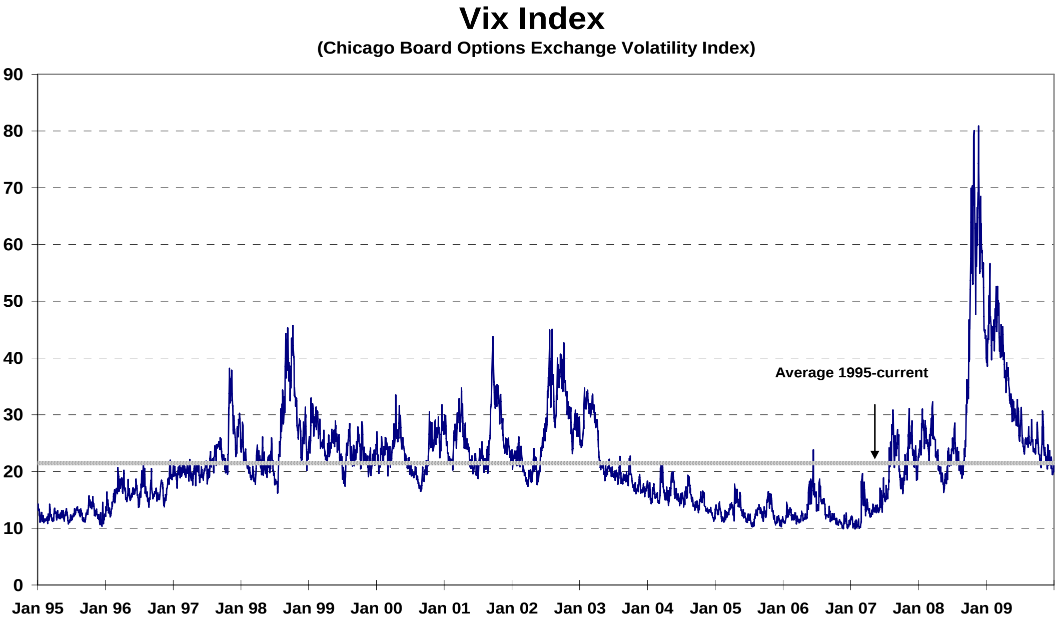
Global equity markets posted gains in December. The MSCI World index rose by 2 percent, the S&P 500 index rose by 3 percent, the NASDAQ index rose by 6 percent, and the MSCI Emerging Markets index rose by 4 percent. The **TA-100 index** rose by 6 percent (6 percent in dollar terms).

2009 was the best year of the last decade for the majority of the world's stock markets; 2008 was the worst.

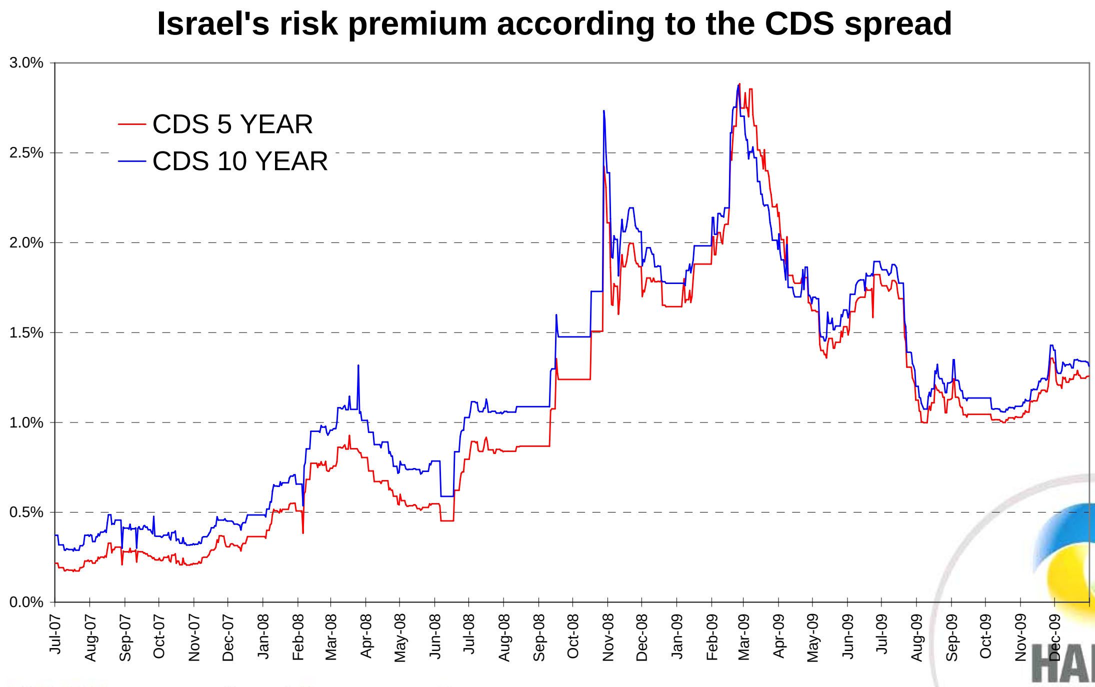
	MSCI World (gross)	MSCI EM (gross)	Tel-Aviv 100 (in shekel terms)	Tel-Aviv 100 (in dollar terms)
2005	10%	35%	29%	21%
2006	21%	33%	12%	22%
2007	10%	40%	25%	37%
2008	-40%	-53%	-51%	-50%
2009	28%	70%	78%	78%
December 2009	2%	4%	6%	6%
Average annual return in the last 10 years	3%	18%	15%	17%



The VIX index, a popular measure of short-term implied volatility in the equity market as reflected in S&P 500 index option prices, declined consistently during 2009. At the end of December, the index was 73 percent lower than the record level of November 2008, and close to its multi-year average.



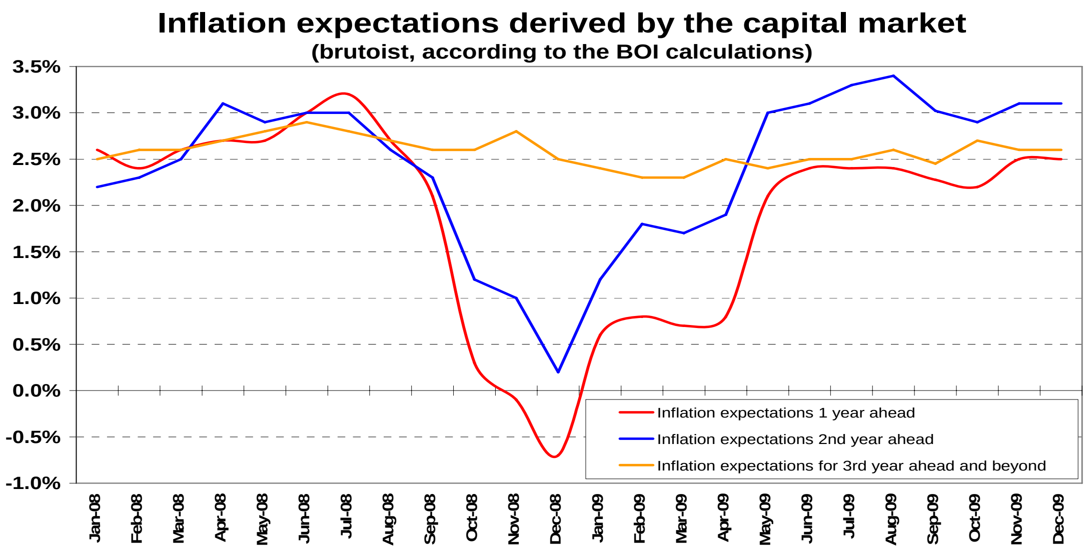
Israel's risk premium, based on the 10-year CDS spread, was 1.3 percent at the end of December, similar to the preceding months.



C. Developments in Inflation and Monetary Policy

The consumer price index rose by 0.3 percent in November, in line with our estimate and slightly higher than the average forecast. Twelve-month **inflation** now stands at 3.8 percent, far above the government's target. We estimate that the tax hikes of recent months contributed nearly 1.5 percentage points to the inflation. **In our opinion**, twelve-month inflation will rise to 4.8 percent in January-February, then fall gradually, not converging into the price stability range of 1-3 percent until July 2010.

Inflation expectations, according to calculations by the BOI, remained stable, reaching an average level between mid-November and mid-December of 2.5 percent for the first year, 3.1 percent for the second year, and 2.6 percent from the third year forward.

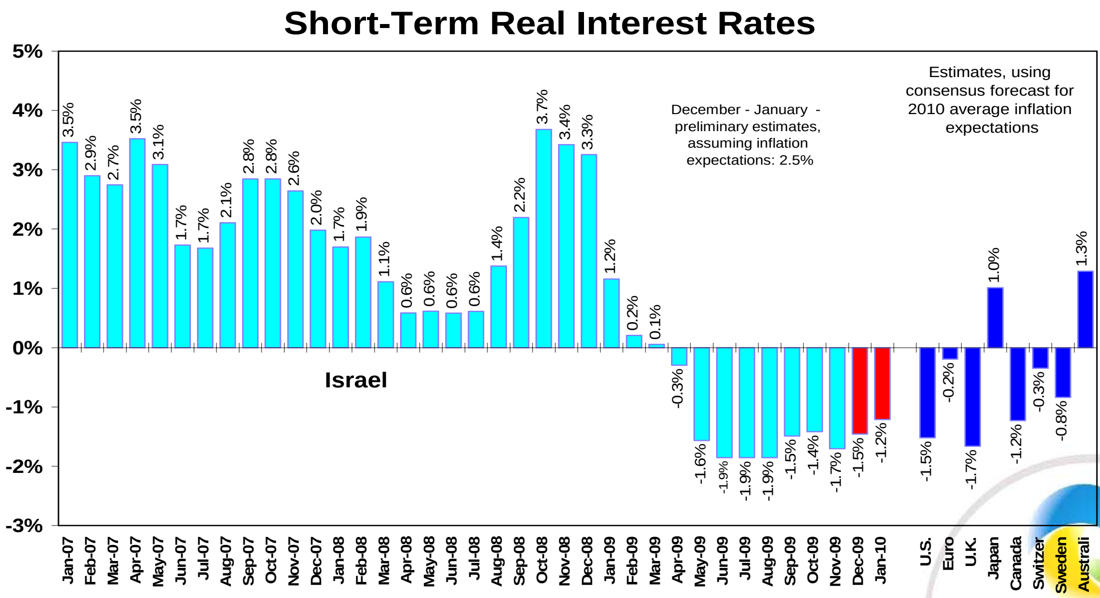


Means of payment (M1) increased by 0.5 percent in November and by 58 percent in the twelve months ended in November.

The Bank of Israel interest rate rose by 0.25 percentage points to 1.25 percent; we and most economists had seen the decision as borderline, with less than a 50 percent probability of an increase. In contrast to its earlier announcement, the BOI cited the increase in property prices, including housing, as one of the main factors affecting its decision.

In addition, we note that the BOI decided to raise the interest rate despite the appreciation of the shekel since its last decision; the shekel has been stable against the dollar, but has gained 4 percent against the euro. This indicates that the prevention of appreciation of the shekel has fallen in importance in the full spectrum of the BOI's considerations, due to the improvement in exports, growth, and employment in recent months.

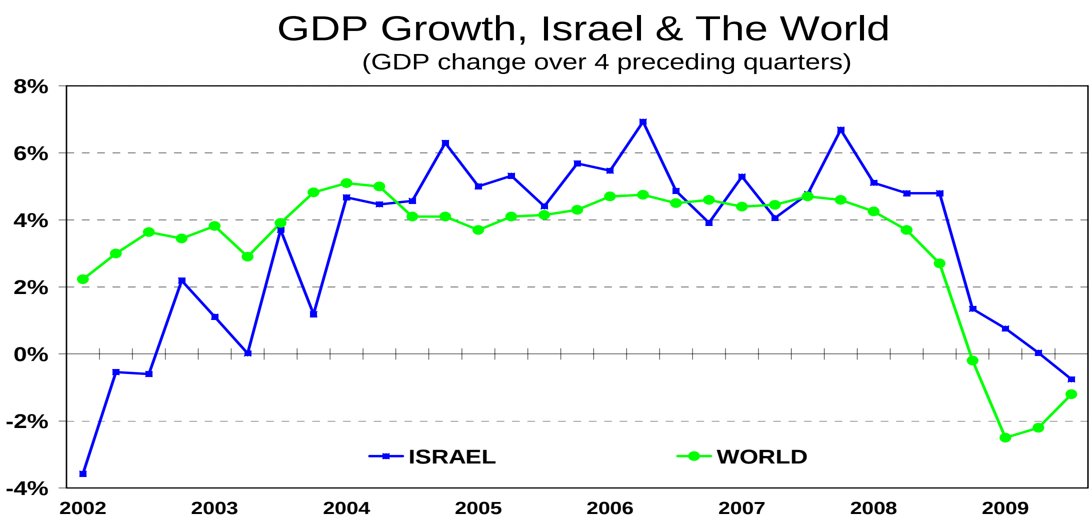
Despite this increase in the interest rate, the rate remains very low; if it remains this low over a long period, it will lead to the formation of significant inflationary pressures within one or two years. The BOI's announcement indicates that the current interest-rate hike is part of a gradual process of returning the interest rate to the "normal" level, but the pace of the increase will depend, as always, on local and global growth, inflation, and the pace of interest-rate increases by other central banks.



Our estimate is that the BOI will continue to raise the interest rate gradually, once every two months on average, by 0.25 points each time, unless there are significant changes in the exchange rate or in other macro-economic variables. In addition, the BOI's announcement indicates that the pace of interest-rate hikes in the coming months will also depend on developments in the equity market and in housing prices.

D. Developments in the Global Economy

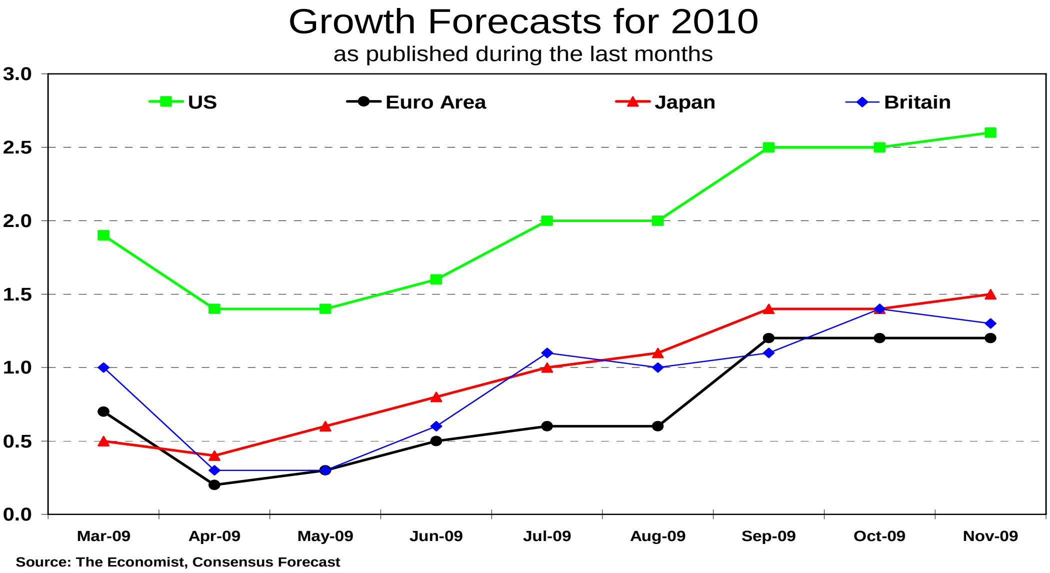
Global GDP decreased by 1.2 percent over the four quarters ended in the third quarter of 2009, according to *Economist* data – an improvement relative to the second quarter. These figures were strongly influenced by growth in China and India. Excluding those countries, the decrease in global GDP was far more severe. Growth data in Israel for the last four quarters were good compared to the rest of the world, even excellent in comparison to the advanced countries.



Data of world's growth is based on The Economist's calculations.

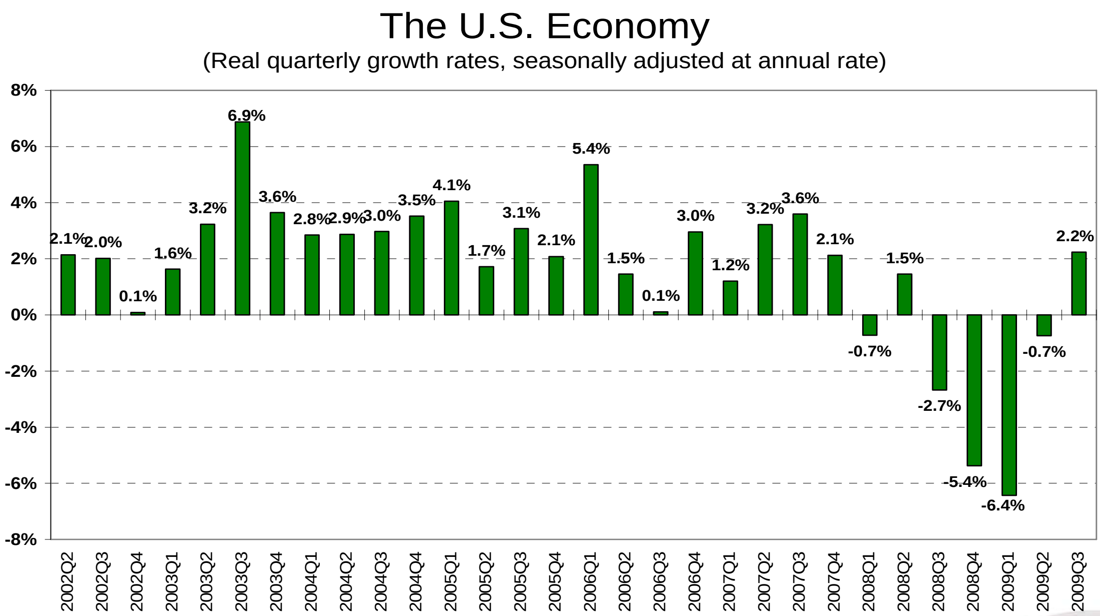
Growth forecasts for advanced economies

The Economist published its **monthly Consensus Forecast** of growth rates in developed countries. No significant changes were recorded in the forecasts, similar to the last 3 months.

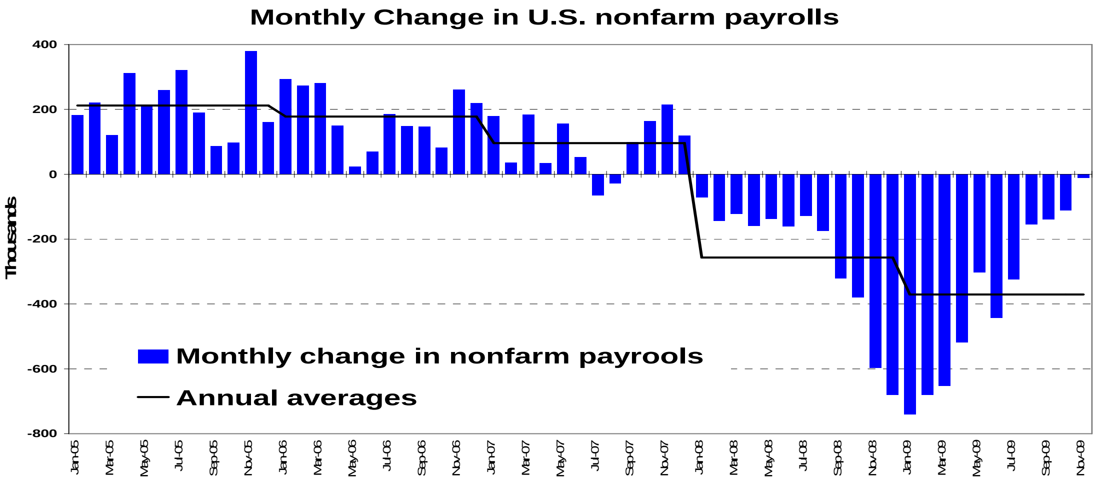


United States

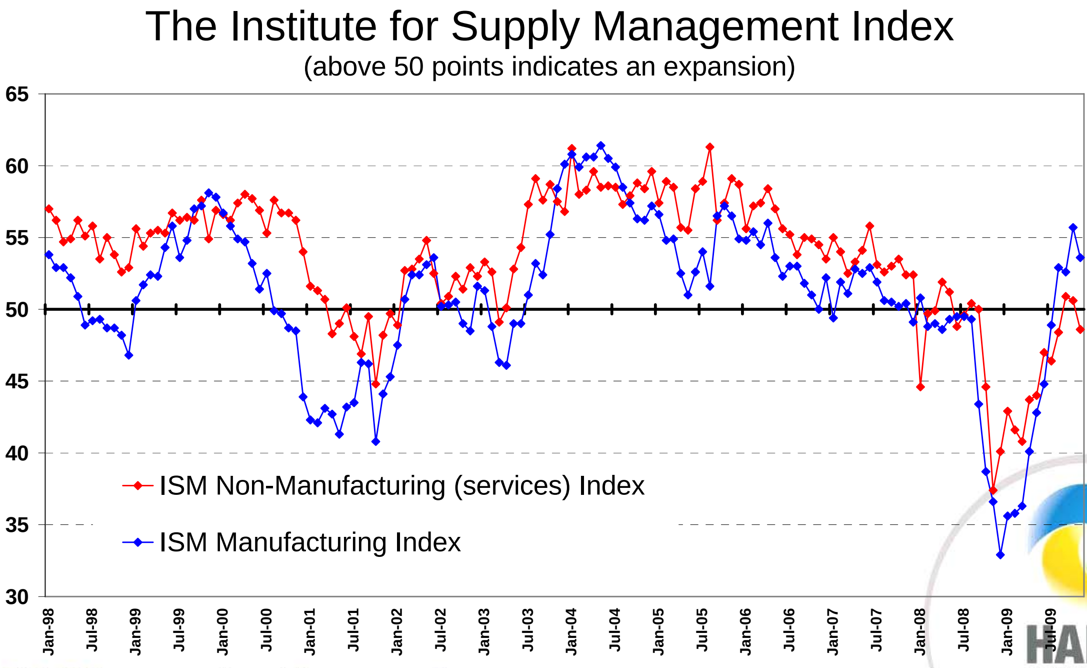
Most **current indicators of economic activity** showed a positive picture over the last month. However, according to the most recent estimate, real **GDP** grew at an annualized rate of 2.2 percent in the third quarter of 2009, below expectations and lower than the previous estimate.



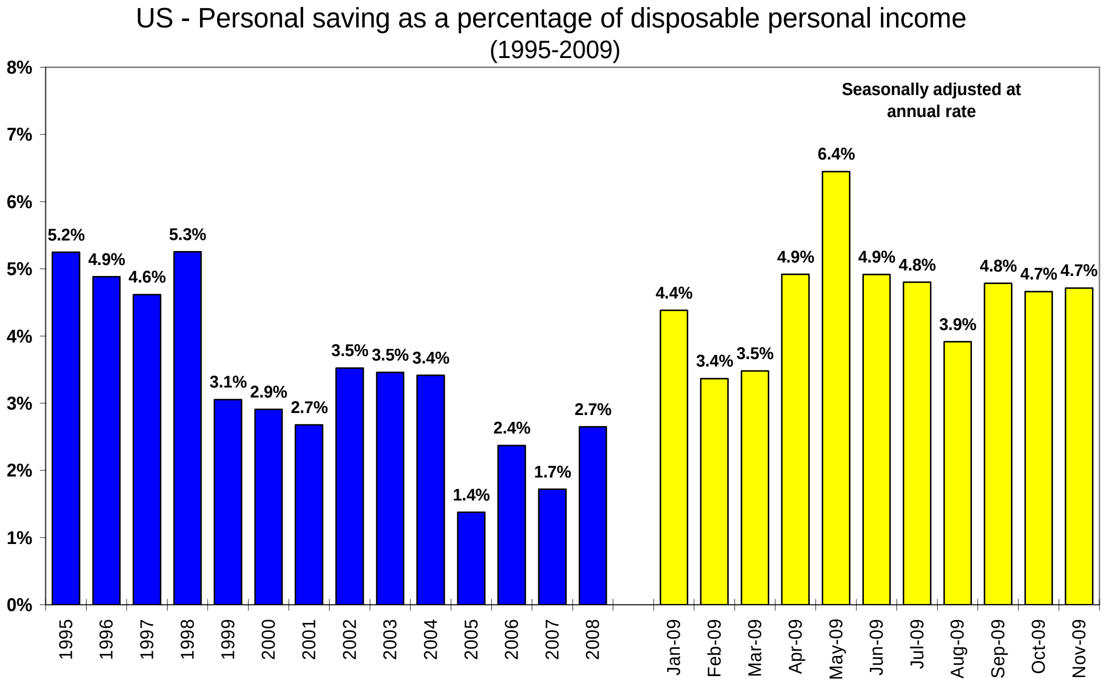
The employment report for November was surprisingly positive. The decrease **in the number of employed persons** was very moderate (a decrease of 11,000 employed persons, versus an expected decrease of 120,000), with data for the preceding months adjusted upward. **The unemployment rate** surprisingly decreased by 0.2 percentage points to 10.0 percent, with a decrease in the participation rate.



The ISM manufacturing sector index stood at 53.6 points in November, above 50 points but lower than expected. **The ISM services sector index** reached 48.7 points in November, also below expectations.



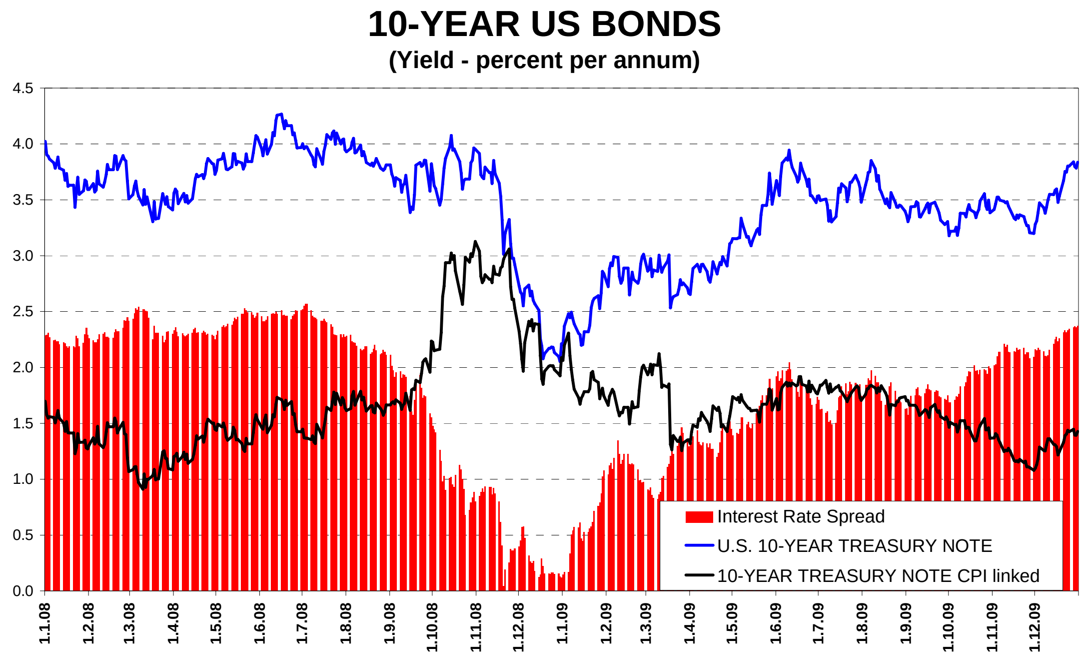
Private income and consumption data for November were positive. **Real private income and real private consumption** grew by 0.2 percent (2-3 percent in annualized terms). Households' rate of savings stood at 4.7 percent, similar to the preceding months.



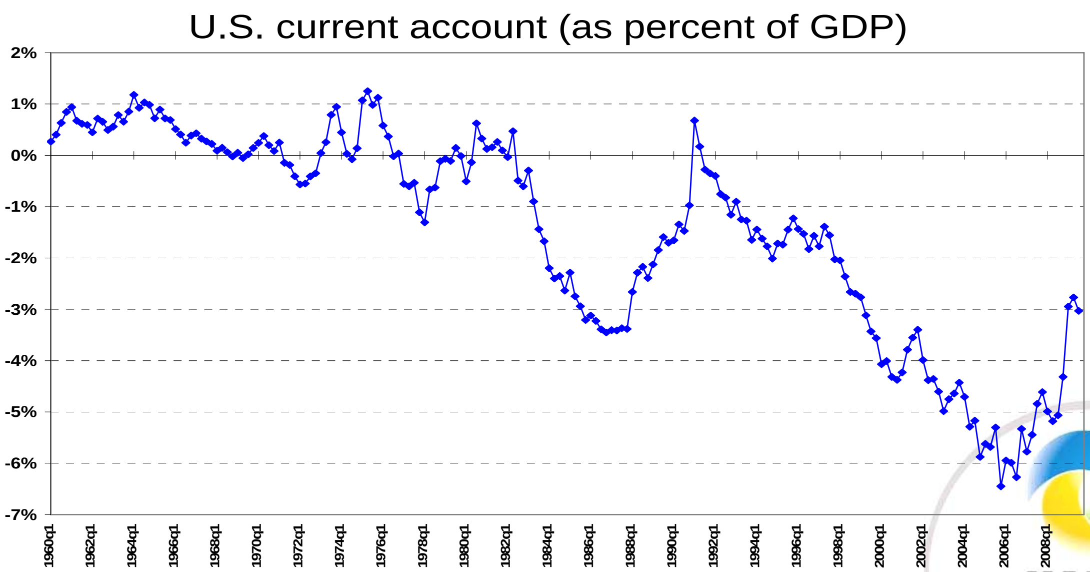
Retail sales figures for November were surprisingly positive with an increase of 1.3 percent.

The Fed left the interest rate unchanged at 0-0.25 percent, as expected. The press release stated that the Fed believes inflation will remain moderate for some time, and the interest rate is likely to remain low for a long period, despite the signs that the economy is beginning to recover. It was also noted that in light of the improvement in the functioning of the financial system, the Fed has decided to allow most of the aid programs to end as planned (towards the end of the first quarter of 2010).

Yields of ten-year US government bonds increased to 3.8 percent in December, versus a low of 2.05 percent in December 2008.



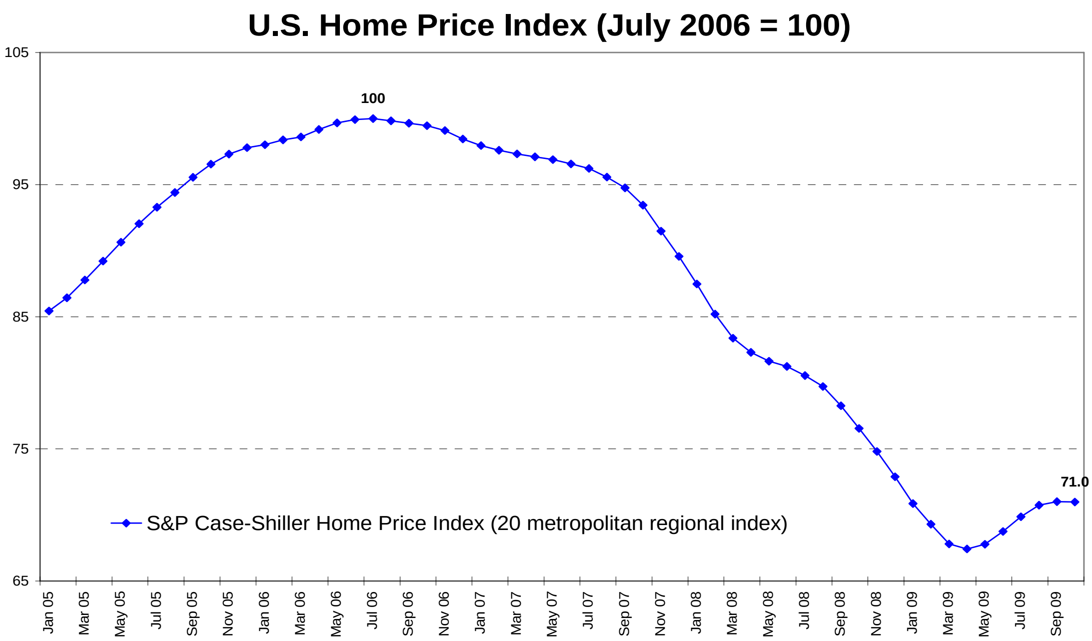
The deficit in the current account of the balance of payments expanded to 3.0 percent in the third quarter of 2009, versus 2.8 percent in the preceding quarter and 5.1 percent in the same quarter last year. We estimate that the deficit will expand in the coming years, unless the dollar weakens against other major currencies.



The consumer price index rose by 0.4 percent in November and the core index remained unchanged, both in line with expectations. Twelve-month **inflation** now stands at 1.8 percent. **The wholesale price index** rose sharply in November, by 1.8 percent, versus an expected increase of only 0.8 percent.

Housing-market figures that were published in the last month were mixed. **Construction starts and permits** increased by 9 percent and 6 percent, respectively, in November, as expected. Housing-market data were mixed. **Sales of existing homes** were surprisingly positive, with a 7 percent increase, but **sales of new homes** fell by 11 percent.

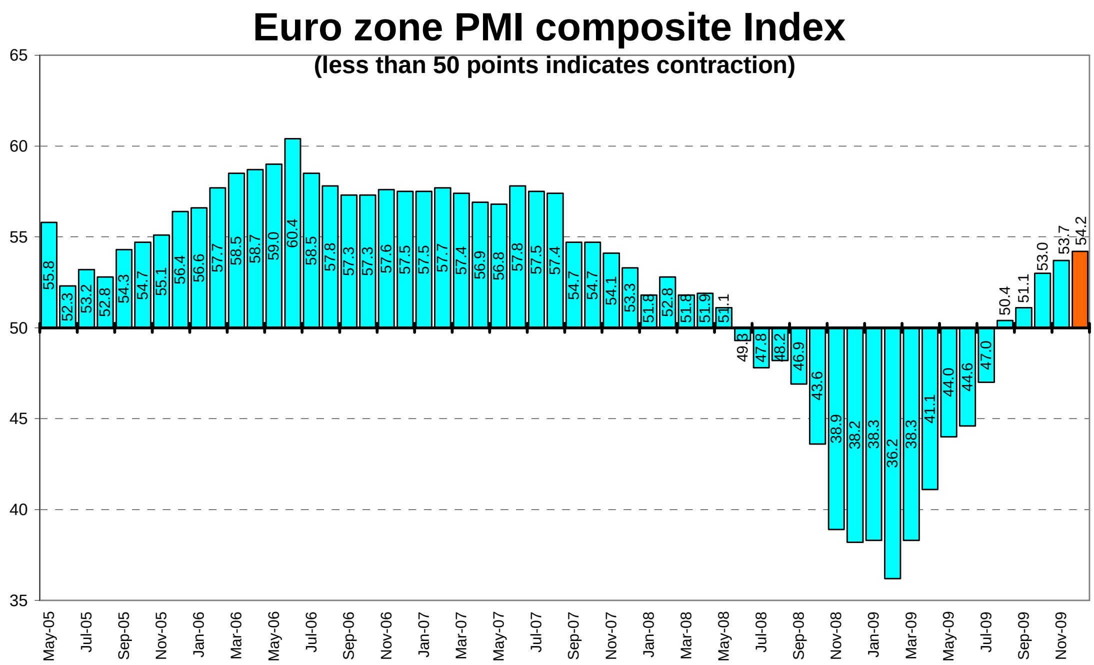
The Case-Shiller index of housing prices in twenty major cities remained almost unchanged in October, below expectations, with prices down by 29 percent from the peak level of 2006.



Euro zone

The ECB maintained the interest rate unchanged at 1.0 percent, as expected. The President of the ECB also announced that the ECB's last round of loans to banks would take place in mid-December. Like other central banks worldwide, the ECB flooded the market with liquidity by providing extensive credit to banks in the euro zone. The banks took loans from the central bank and used the liquidity to purchase government bonds and other safe assets, thereby strengthening their balance sheets, continuing to offer credit to firms and households, and avoiding insolvency. With the economic recovery, the central bank has decided to curb the expansion of liquidity.

The euro zone purchasing managers' index was at 54.2 points in December, according to an initial estimate, above expectations.



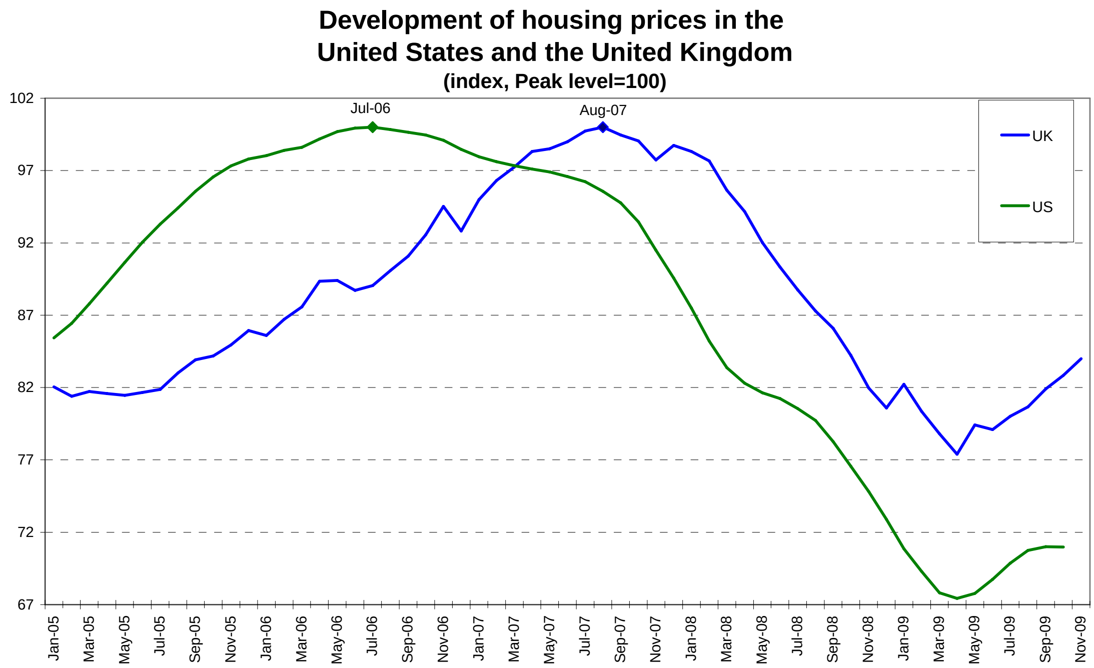
The unemployment rate in the euro zone remained unchanged at 9.8 percent in October, in line with expectations, versus 7.9 percent in October 2008.

Retail sales remained unchanged in October, below expectations.

United Kingdom

In line with expectations, **the central bank left the interest rate unchanged** at 0.5 percent and made no change to the **quantitative expansion plan**.

The UK's Halifax house price index rose by 1.4 percent in November, more than expected, for the fifth consecutive month. 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
US, ISM manufacturing index	JAN 4	Mon	17:00	www.ism.ws
Euro zone, CPI estimate	JAN 5	Tue	12:00	www.ec.europa.eu/eurostat
Israel, average wages	JAN 5	Tue	13:00	www1.cbs.gov.il/reader
US, ISM Services index	JAN 6	Wed	17:00	www.ism.ws
Euro zone PMI index	JAN 6	Wed	11:00	www.markiteconomics.com
Euro Zone, Retail sales	JAN 7	Thu	12:00	www.ec.europa.eu/eurostat
UK, interest rate decision	JAN 7	Thu	14:00	www.bankofengland.co.uk
Euro zone, Q3 GDP	JAN 8	Fri	12:00	www.ec.europa.eu/eurostat
Euro zone, unemployment	JAN 8	Fri	12:00	www.ec.europa.eu/eurostat
US, employment report	JAN 8	Fri	15:30	www.bls.gov
Israel, foreign trade	JAN 12	Tue	13:00	www1.cbs.gov.il/reader
Israel, incoming tourists	JAN 12	Tue	13:00	www1.cbs.gov.il/reader
Euro zone, interest rate decision	JAN 14	Thu	14:45	www.ecb.int
US, retail sales	JAN 14	Thu	15:30	www.census.gov/svsd/www/adseries.html
Euro zone, CPI	JAN 15	Fri	12:00	www.ec.europa.eu/eurostat
US, CPI	JAN 15	Fri	15:30	www.bls.gov
Israel, CPI	JAN 15	Fri	18:30	www1.cbs.gov.il/reader
Israel, Q3 GDP	JAN 17	Sun	13:00	www1.cbs.gov.il/reader
Israel, Industrial production index and trade and service sectors revenue index	JAN 19	Tue	13:00	www1.cbs.gov.il/reader
US, housing stars and permits	JAN 20	Wed	15:30	www.census.gov/pub/const
US, Sales of existing homes	JAN 25	Mon	17:00	www.realtor.org/Research.nsf/Pages/EHSdata
Israel, BOI interest rate decision	JAN 25	Mon	17:30	www.bankisrael.gov.il
UK, Q4 GDP initial estimate	JAN 26	Tue	11:30	www.statistics.gov.uk
US, Case-Shiller index	JAN 26	Tue	16:00	http://www2.standardandpoors.com
US, new home sales	JAN 27	Wed	17:00	www.census.gov/const/www/newressalesindex.html
US, interest rate decision	JAN 27	Wed	21:15	http://www.federalreserve.gov
Israel, New dwelling sold in private sector	JAN 28	Thu	13:00	www1.cbs.gov.il/reader
Euro Zone, employment report	JAN 29	Fri	12:00	www.ec.europa.eu/eurostat
Euro zone, CPI estimate	JAN 29	Fri	12:00	www.ec.europa.eu/eurostat
US, Q4 GDP initial estimate	JAN 29	Fri	15:30	www.bea.gov
US, Michigan University consumer confidence index	JAN 29	Fri	17:00	www.sca.isr.umich.edu

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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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