

Monthly Macroeconomic Review

May 3, 2009

- Indicators of economic activity in March show moderation of the negative trend: a slight decrease in **imports of goods**, versus a slight increase in **exports of goods** and **incoming tourism**. The **index of trade and service sector revenues** decreased somewhat in February, while the **industrial production index** remained unchanged.
- The **Bank of Israel** lowered its **growth forecast for 2010** from 2.3 percent to 1.0 percent. The **International Monetary Fund** lowered its **growth forecast for 2010** to just 0.3 percent. In other words, both expect the recession to persist in 2010, though not at the intensity of 2009.
- The **consumer price index** rose by 0.5 percent in March, more than expected. March CPI and composition data reinforce our estimate, as emphasized in recent months, that inflation in 2009 will be within the target range of 1 to 3 percent rather than below target.
- The **unlinked government bond yield curve** rose over its entire length in April.
- **Global equity markets** posted gains in April. The MSCI World index rose by 11 percent, the S&P 500 index rose by 10 percent, the NASDAQ index rose by 12 percent, and the MSCI Emerging Markets index rose by 17 percent. The TA-100 index rose by 12 percent, or 13 percent in dollar terms.

This review contains five chapters:

- A. Developments in the Israeli Economy.
- B. Additional Tax Cuts – Is This the Right Time?
- C. Developments in the Capital Market.
- D. Developments in Inflation and Monetary Policy.
- E. Developments in the Global Economy.

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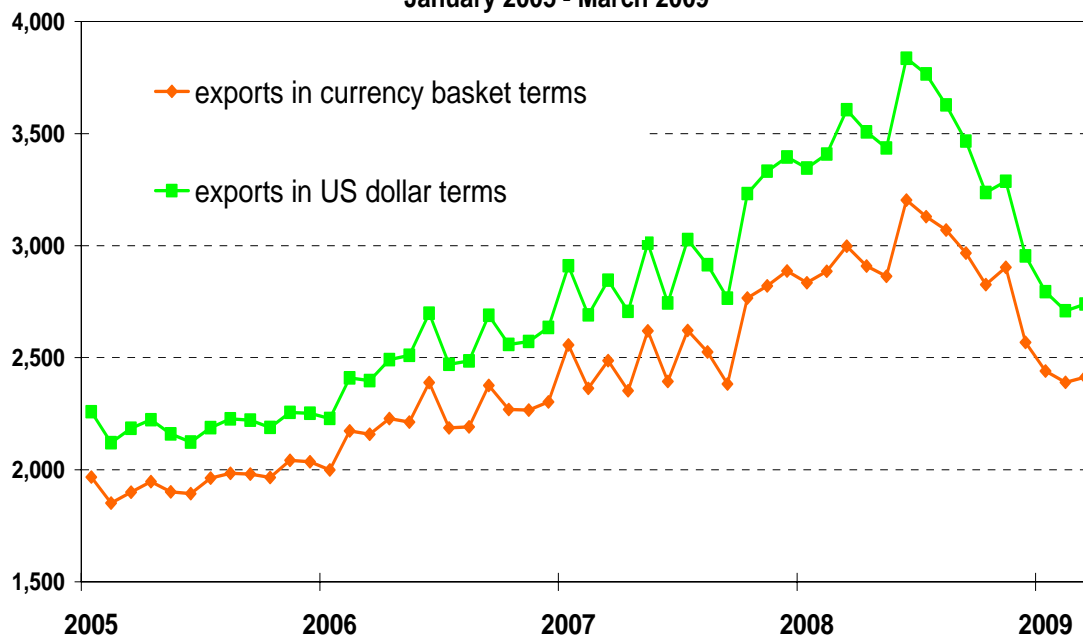
A. Developments in the Israeli Economy

Indicators of economic activity in March show moderation of the negative trend: a slight decrease in imports of goods, versus a slight increase in exports of goods and incoming tourism. The index of trade and service sector revenues decreased somewhat in February, while the industrial production index remained almost unchanged.

Exports of goods (excluding ships, aircraft, and diamonds; in dollar terms) increased by 1 percent in March, but decreased by 24 percent in the twelve months ended in March. Exports of goods decreased by 13 percent in the first quarter of 2009 as compared to the preceding quarter.

Exports of Goods

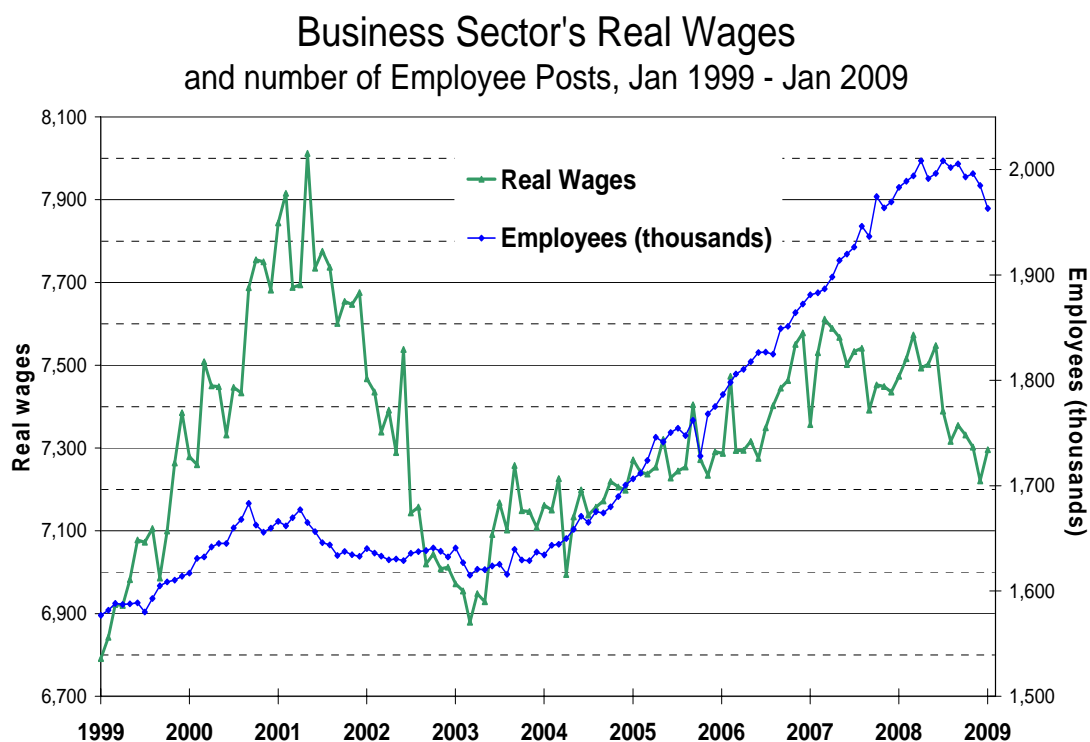
(millions per month, excl. diamonds, ships & airplanes)
January 2005 - March 2009



Imports of goods decreased by 1 percent in March and by 35 percent in the twelve months ended in March. In the first quarter of 2009, imports of goods decreased by 19 percent compared to the preceding quarter. The sharp decline in imports led to a decrease in the trade deficit in March, to just USD 0.5 billion.

Incoming tourism increased by a slight 0.6 percent in March, based on data net of seasonal effects, and decreased by 19 percent in the twelve months ended in March. The Pope's planned visit should support tourism in the next few months.

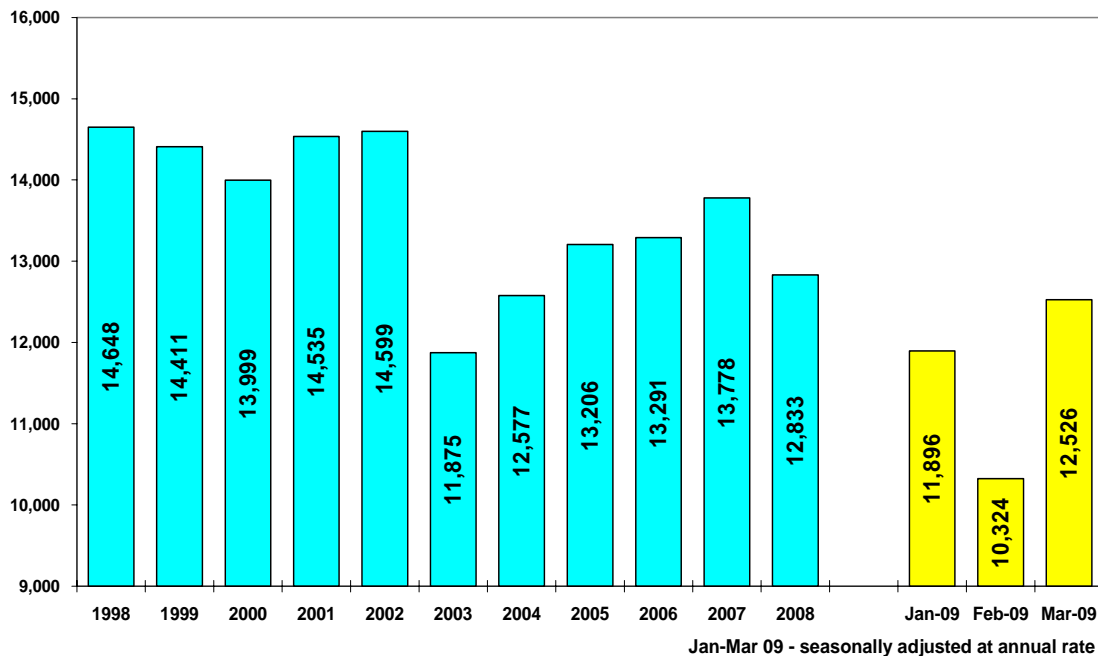
A sharp decline in employee positions of Israelis in January: **The number of positions of Israeli employees** decreased by 1.1 percent in January and by 0.5 percent in the twelve months ended in January. Average nominal wages for employee positions of Israelis rose by 1.9 percent in January, but by only 1.5 percent in the twelve months ended in January, while real wages decreased by approximately 2 percent (net of the consumer price index). In the **business sector**, the number of employee positions (including non-Israelis) decreased by 1.1 percent in January, while real wages increased by 1 percent.



The **number of new homes** sold rose by 12 percent in March, and decreased by 8 percent in the twelve months ended in March.



New Dwellings Sold During The Period



Indicators of economic activity in February showed relative stability. The **industrial production index** remained unchanged in February and decreased by 2 percent in the twelve months ended in February. The **index of trade and service sector revenues** decreased by 0.5 percent in February and by 10 percent in the twelve months ended in February.

State tax revenues totaled ILS 14.7 billion in March. This figure is consistent with our expectations, and reinforces our estimate that a shortfall in tax revenues is expected this year relative to the budgetary planning of ILS 35 to 40 billion, or approximately 5 percent of GDP.

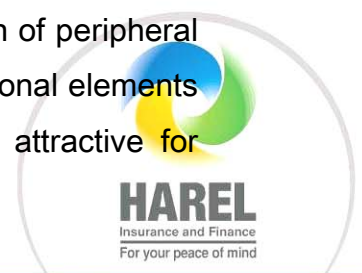
The Ministry of Finance has introduced a package of economic measures designed to cope with the economic slowdown. In our opinion, the plan as presented is missing several key elements, at this stage. For example, it is unclear how the government intends to finance the tax cuts included in the plan.



Key points of the economic plan presented by the Prime Minister and the Minister of Finance:

- **Expanding credit and encouraging exports.** The state plans to provide guarantees for insurance against risks arising from the crisis. Planned measures include: doubling guarantees for capital raising to the banking system, from ILS 6 billion to ILS 12 billion; establishing funds for new non-bank credit at a volume of ILS 2 billion, mainly for high-tech industries; state-guaranteed aid packages for exports worth ILS 6 billion; and doubling of the fund for mid-sized businesses, to ILS 2.6 billion.
- **Structural reforms.** These measures focus on land, ports, and electricity, and on strengthening urban security.
- **Curbing unemployment and promoting employment.** The government plans to reduce the number of foreign workers, in order to free jobs for Israelis. Another measure is the expansion of the 'Orot Lataasuka' (Employment Lights) program and the negative income tax program to the entire country. In addition, a fund will be established in collaboration with the 'Histadrut' and with employers to support factories in peripheral regions, and professional training programs will be promoted.
- **Tax policy.** The plan includes a gradual reduction of tax rates from 2009 to 2016, the elimination of tax distortions, and improvement of the collection system. The maximum marginal tax rate now stands at 46 percent; this rate is planned to fall gradually to just 39 percent in early 2016. Corporation tax will decrease to 18 percent, from 26 percent today.
- **Physical infrastructures and human capital.** These measures mainly concern transportation, in order to support the connection of peripheral regions – the Negev and Galilee – to central Israel. Additional elements are investments in tourism and in making Israel more attractive for tourism.

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According to **the IMF's estimates**, the Israeli economy is expected to contract by 1.7 percent in 2009 and grow by only 0.3 percent in 2010; inflation will reach annual averages of 1.4 percent in 2009 and 0.8 percent in 2010; while unemployment reaches 7.5 percent in 2009 and 7.7 percent in 2010. The IMF's estimates for growth in Israel are more pessimistic than our forecasts and those of the Bank of Israel, though its estimates concerning unemployment are relatively optimistic.

The BOI has published its annual report and reduced its **growth forecast for 2010** from 2.3 percent to just 1.0 percent. In other words, the BOI expects the recession to continue in 2010, though at a lesser intensity than in 2009.

In addition, **the BOI is clearly opposed to the initiative of continued tax cuts** in the Israeli economy. The BOI not only does not support further tax reductions; it proposes considering a **postponement of the cuts planned for 2010**, the last phase of the reform approved several years ago.

B. Additional Tax Cuts – Is This the Right Time? ¹

The multi-year tax reduction plan approved several years ago concludes in 2010, with the reduction of the maximum marginal tax rate to 44 percent and corporation tax to 25 percent. On April 23, the Prime Minister and the Minister of Finance announced their intention to carry out additional tax cuts over the coming years, so that by 2016 the maximum marginal tax rate will be 39 percent, while corporation tax reaches 18 percent. This ambitious plan, which would substantially reduce the tax liability of individuals and companies, is controversial due to factors including the economic crisis globally and in Israel and the considerable increase in the budget deficit.

¹ This chapter was prepared by Michael Sarel.



Supporters of deeper tax cuts mention the positive effects of the tax cuts begun in 2003, at the height of the last recession. It is true that the macro-economic developments of 2003-2008, concurrent with the tax reduction process, were highly impressive: rapid growth, low and stable inflation, a surplus in the current account of the balance of payments, and in particular an increase in tax collection (despite the lower tax rates), which contributed to the reduction of the budget deficit and the ratio of public debt to GDP. There were certainly other factors leading to this macro-economic success, such as the rapid growth of the global economy and international trade, the gradual weakening of Palestinian terrorist attacks following the peak in 2002, and the guarantees received by Israel from the US government in 2003; but there is no doubt that the tax cuts had an important role in these achievements.

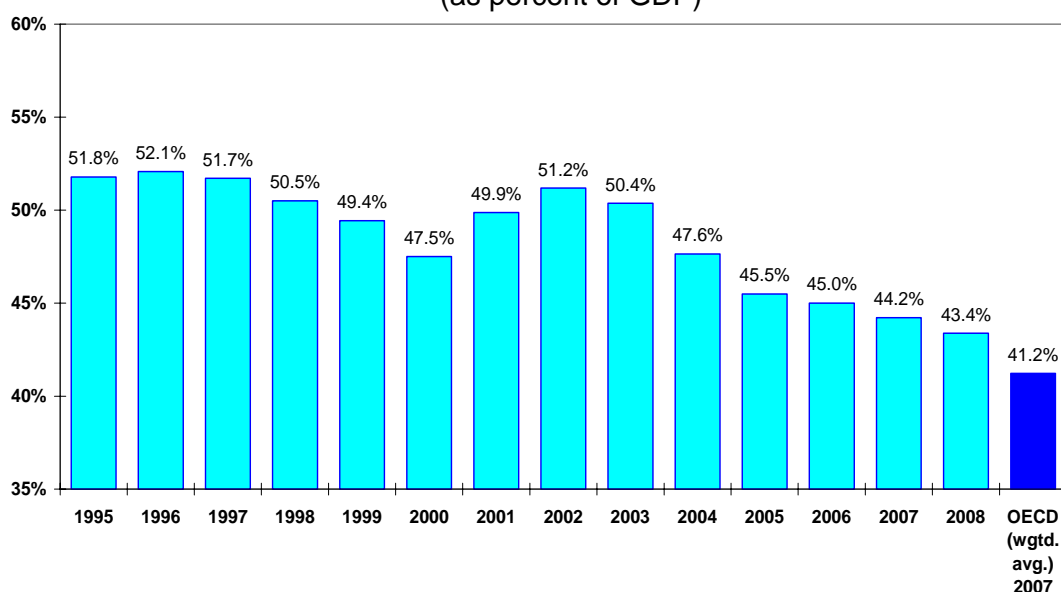
However, in examining the possibility of a reduction in tax rates eventually leading to an increase in tax revenues – or at least no substantial decrease in revenues – the starting point must be specified accurately. When tax rates are initially high, both in absolute terms and in a global comparison, a reduction of tax rates is likely to lead to a significant change in behavior on the part of workers and firms: they may work harder, invest more, prefer activity in Israel over activity overseas, and reduce the volume of tax evasions and tax planning. Thus, it is quite possible that a reduction of tax rates will cause an increase in workforce participation, investments, and growth, and no damage to tax revenues.

By contrast, when tax rates are low (in absolute terms as well as in comparison to other countries), the potential for behavioral change of workers and firms in response to the reduction in tax rates is quite limited; a reduction in tax rates is likely to be accompanied by a significant decrease in tax revenues.

The starting point today is far different from the situation in 2002. Current tax rates are much lower than in 2002, when the maximum marginal tax rate was 60 percent and corporation tax was 36 percent, both among the highest in the world. Thus, in contrast to the tax cuts begun in early 2003, cutting taxes today may cause a decrease in tax revenues. This decrease will lead to an increase in the budget deficit, unless it is offset by a significant decrease in government expenditures as a percentage of GDP.

Substantial decreases in government expenditures are far harder to achieve today than in the past. In 2002, broad government spending was at a peak of 51 percent of GDP; this figure fell gradually starting in 2003, as a result of continuous budgetary restraint, reaching just 43 percent of GDP by 2008; the weighted average in thirty OECD countries is estimated at 41 percent of GDP.

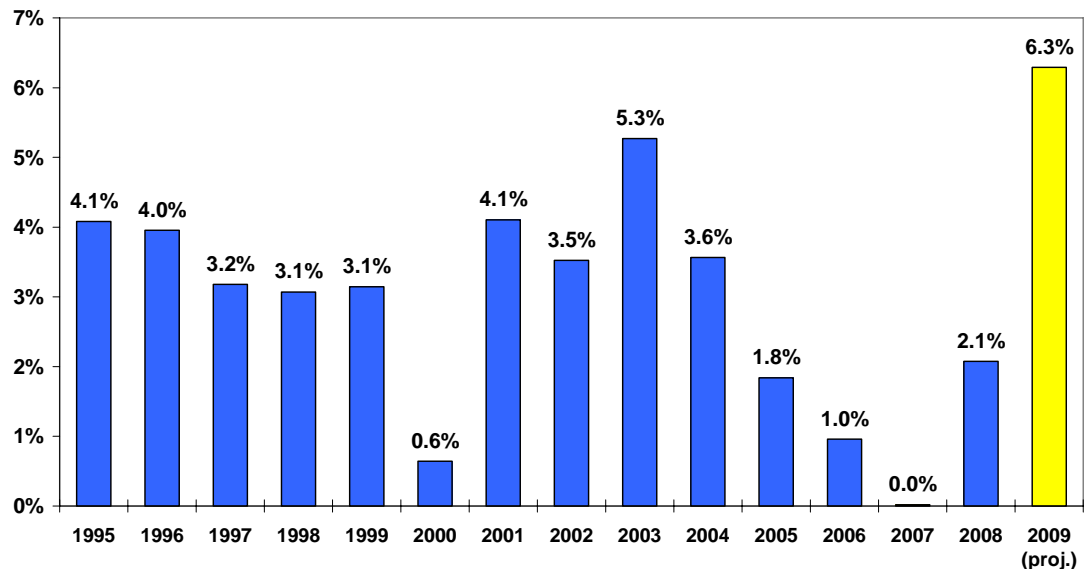
General Government Expenditure (as percent of GDP)



In other words, "excess" government expenditures, in comparison to common practice in the advanced countries, have been significantly reduced over recent years, to almost zero. It is very difficult to believe that under these conditions another substantial reduction in the ratio of government expenditures to GDP can be attained.

Thus, the tax cuts will lead to an increase in the budget deficit. The problem is that this deficit has already expanded to troubling dimensions, expected to reach over 6 percent of GDP in 2009, the highest level since the stabilization plan of the mid-1980s.

The Central Government Budget Deficit (as percent of GDP)



Moreover, the forecast deficit in the subsequent years, after 2009, assuming slow and gradual recovery in growth globally and in Israel starting in 2010, does not look much better; the increase in the ratio of public debt to GDP is likely to continue for at least several years.

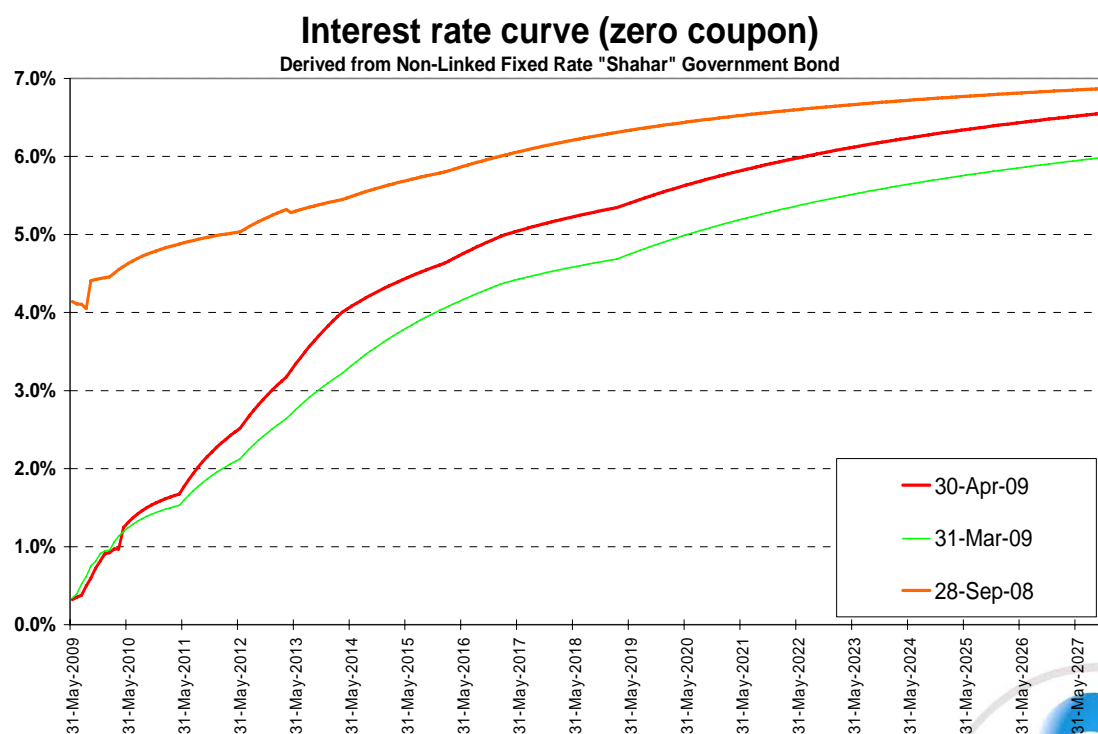
A further increase of the deficit as a result of tax cuts may lead to an increase in the fiscal risk premium, a downgrade of the rating of government debt, an increase in the long-term interest rate, and damage to investments, private consumption, and growth in the Israeli economy. If such a process occurs, it will lead to a further decline in tax revenues and additional growth of the budget deficit, with still greater damage to growth and to macro-economic stability. In that case, the financial and real crisis now affecting the Israeli economy may be joined by a third, far more severe crisis – a fiscal crisis.

Thus, under the current budgetary conditions, immediate additional tax cuts and legislation on future tax cuts – even if the intention is gradual implementation of the reductions over the coming years – should both be avoided. Such legislation will not be perceived as serious by consumers and investors, and may hurt the credibility of economic policy. At this stage, additional tax cuts are better left as a vision for the future.

C. Developments in the Capital Market

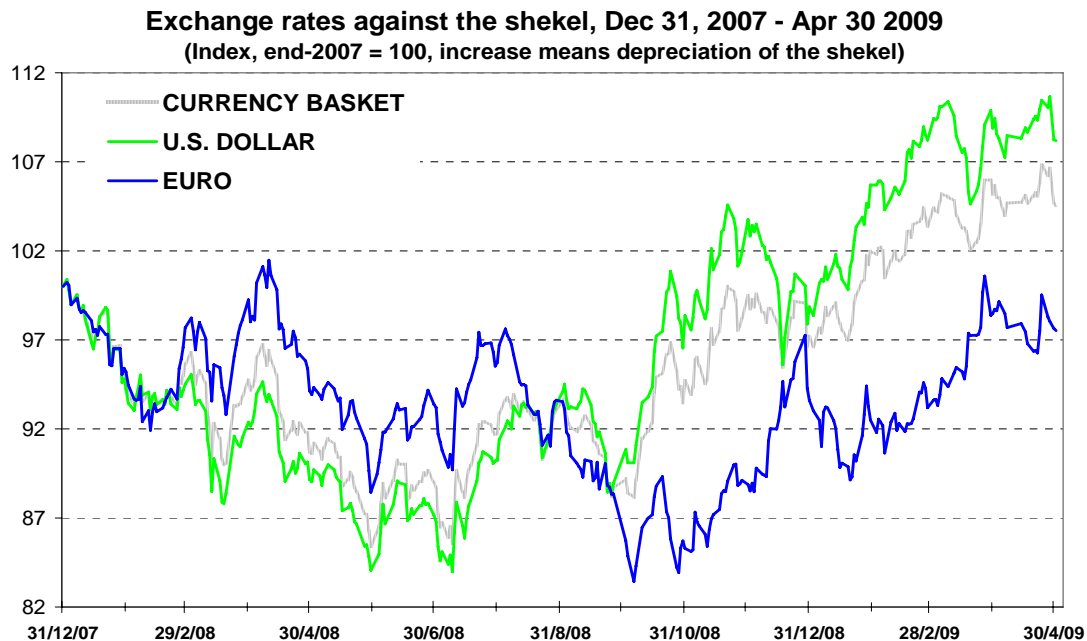
Bond Market

The unlinked government bond yield curve rose over its entire length in April. After the BOI's announcement on March 25 of an increase of the volume of its purchases of government bonds, the entire curve decreased moderately. Later, in line with our estimates, the curve returned to the level prior to the BOI's announcement, then continued to rise.



Exchange Rates

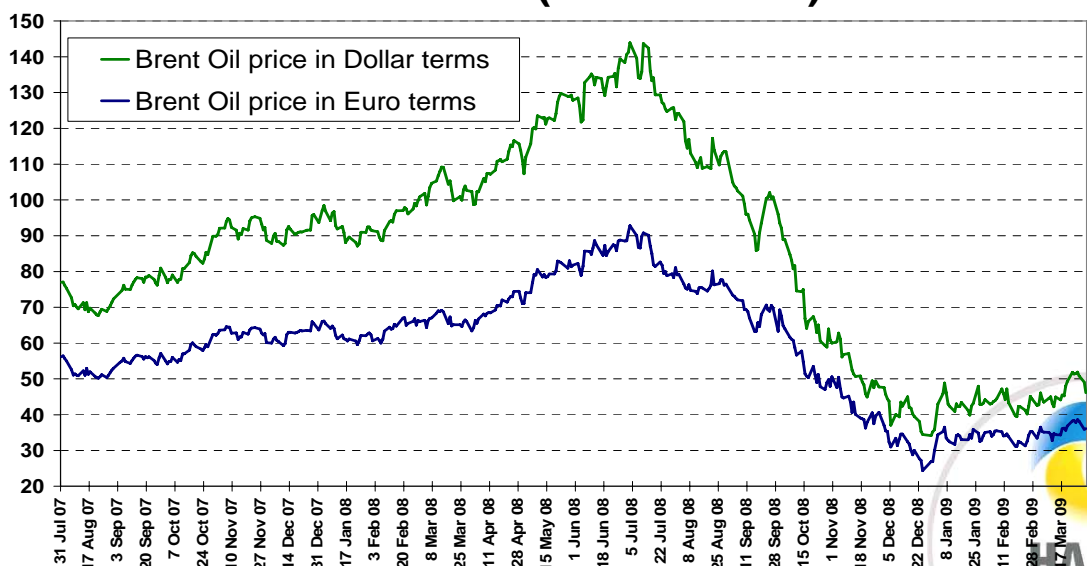
The shekel appreciated by 1 percent against the currency basket, the dollar, and the euro in April.



Oil Prices

The price of a Brent oil barrel rose by 6 percent in dollar terms and by 3 percent in euro terms in April.

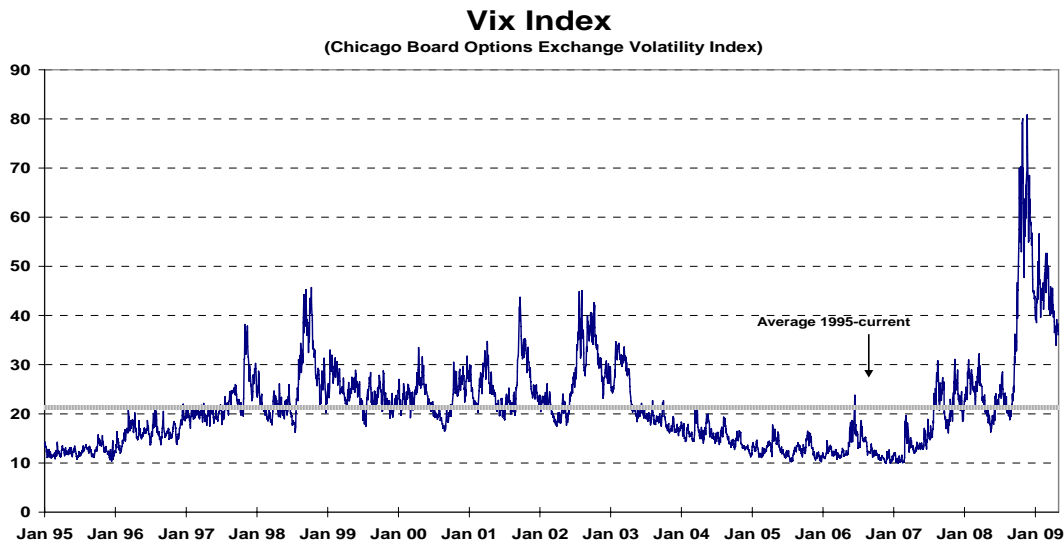
Price of Oil (Brent barrel)



Stock Markets

Global equity markets posted gains in April, following March gains. The MSCI World index rose by 11 percent, the S&P 500 index rose by 10 percent, the NASDAQ index rose by 12 percent, and the MSCI Emerging Markets index rose by 17 percent. The TA-100 index rose by 12 percent, or 13 percent in dollar terms.

The Vix index, a popular metric of implied volatility in the equity market in the short term based on tracking of S&P 500 index option prices, decreased by 17 percent in March, and was 54 percent below the October peak.



D. Developments in Inflation and Monetary Policy

The consumer price index rose by 0.5 percent in March, more than expected. The housing item rose by 1.6 percent, while the index of wholesale prices, excluding fuels, rose at a high rate of 0.9 percent. March CPI and composition data reinforce our estimate, as emphasized in recent months, that inflation in 2009 will be within the target range of 1 to 3 percent, rather than zero or negative, as predicted by many economists, including the BOI.



The quantity of means of payment continued to grow very rapidly, by 8 percent in March and 41 percent in the twelve months ended in March. Growth rates this high were last recorded prior to 1991, when inflation was in the double digits. Although this does not necessarily indicate an increase in future inflation, such a rapid increase in the amount of money constitutes a warning sign for monetary policy.

Inflation expectations between mid-March and mid-April, according to calculations by the BOI, remained stable at 0.7 percent for the first year and 2.4 percent for the second year. After the publication of the March CPI, inflation expectations derived from the capital market rose to an annualized rate of 1.7 percent for the coming fourteen months (through the May 2010 CPI). This is a substantial increase in these expectations, relative to the zero or negative inflation expected several months ago; however, in our opinion this level is still slightly too low.

The BOI left the interest rate unchanged at 0.5 percent, in line with our expectations and those of most economists. The BOI's announcement stated, "The chance of the economy moving into deflation has decreased; under the current conditions it has become more likely that inflation will converge into the target range by the end of the year." This is a significant change from the forecast released following the last interest-rate decision, in which the BOI predicted negative 0.6 percent inflation in 2009.

We have estimated for some time now that the forecast by the BOI and other economists of zero or negative inflation in 2009 would not materialize, as these estimates referred to the economic recession and the decline in demand, but ignored the aggressive monetary policy applied by the BOI in recent months. This policy has caused a considerable increase in the amount of money, and supports depreciation of the shekel, balancing the decrease in inflationary pressures due to the recession.

It now appears that the BOI as well as the capital markets have changed their estimates regarding expected inflation. The trend of the last two weeks continued in the government bond markets, with yield spreads between the unlinked and linked curves expanding throughout the curves.

The BOI's announcement hints, though it does not say so explicitly, that no further steps towards monetary expansion are in store in the near future. In our opinion, the next significant move by the BOI is likely to be a decision to stop foreign-currency purchases. This decision will be made in the event of rapid depreciation of the shekel, and/or a further increase in inflation expectation.

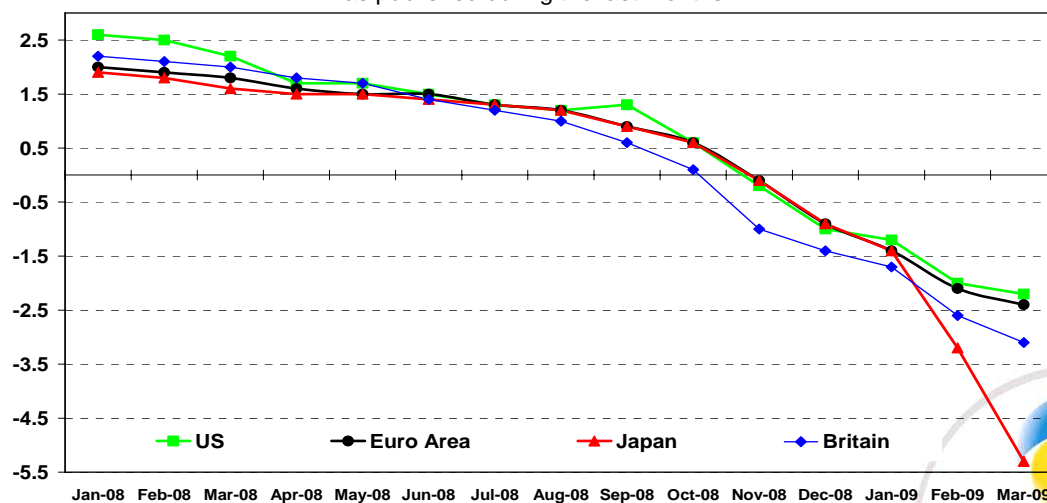
E. Developments in the Global Economy

Growth forecasts for advanced economies

The *Economist* has published its monthly Consensus Forecast of growth rates in the advanced countries: Growth forecasts for 2009 continued to fall, especially for **Japan** (negative 5.2 percent). Estimates for growth in 2010 are positive but moderate, at 1.9 percent in the US and 0.7 percent in the euro zone.

Growth Forecasts for 2009

as published during the last months

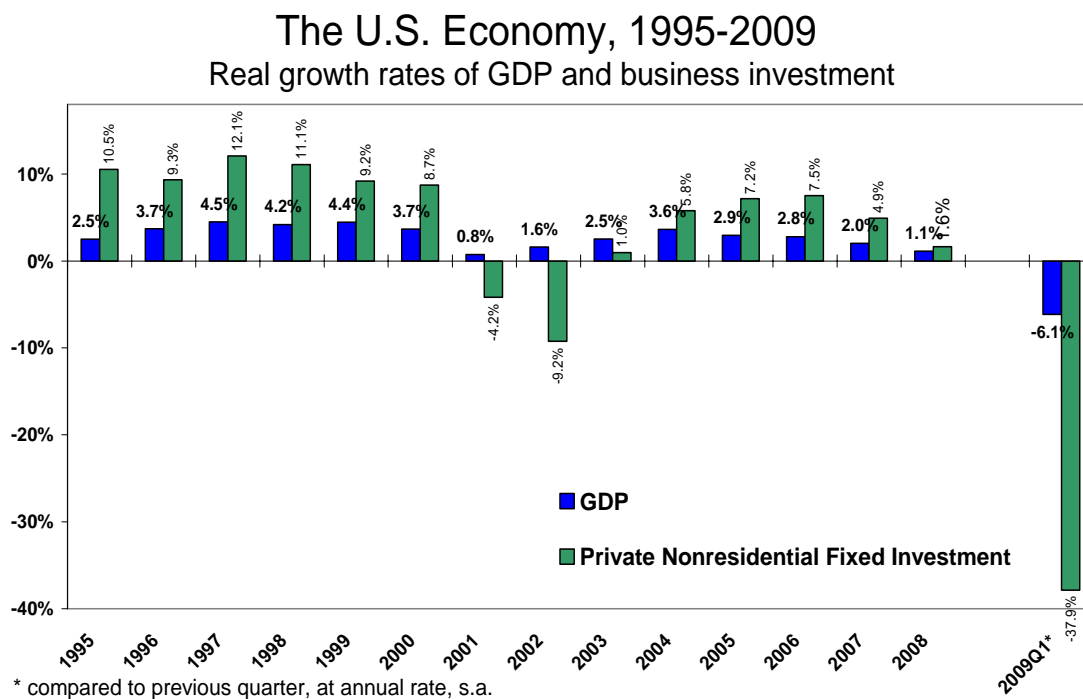


Source: The Economist, Consensus Forecast

United States

GDP in the United States contracted at an annualized rate of 6.1 percent in the first quarter of 2009, according to initial estimates, a sharper-than-expected decline, following 6.3 percent contraction in the last quarter of 2008.

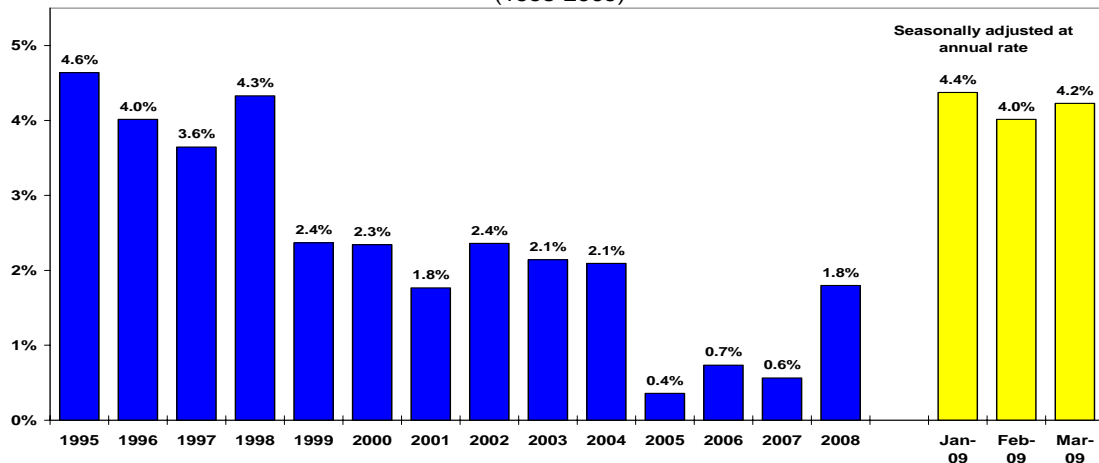
This is the third consecutive quarter in which the US economy has contracted. The composition of growth in the first quarter included very sharp declines of 30 percent in **exports** and 50 percent in **investments**, and a steep drop in **inventories**. A sharp decrease in **investments by firms**, at an annualized 38 percent, was notable. By contrast, **private consumption** rose by 2.2 percent, following steep declines in the preceding two quarters.



Monthly data on **real private consumption** indicate a 0.2 percent decrease in March, following a 0.1 percent increase in February. The **rate of households' savings** out of disposable income reached 4.2 percent in March, similar to January and February and far higher than the average in previous years.



US - Personal saving as a percentage of disposable personal income
(1995-2009)

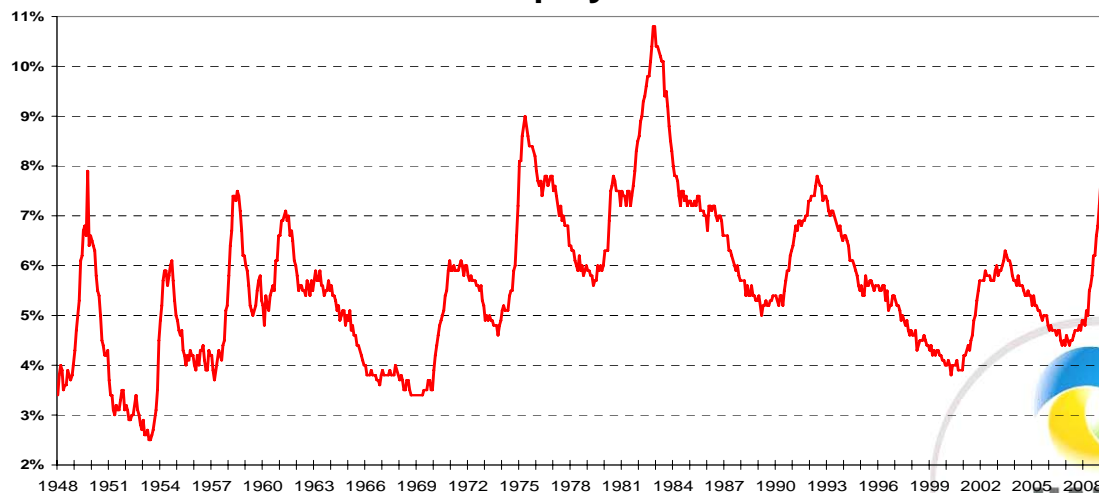


The University of Michigan's **consumer confidence index** rose to 65.1 points in April, from 57.3 points in March, higher than expected.

The Fed left the interest rate unchanged at 0-0.25 percentage points, as expected. The press release stated that the economy had continued to contract but at a lower rate, and that economic forecasts had improved over recent weeks. The Fed announced that it would continue its plan of purchasing government bonds and mortgage-backed bonds.

The **employment report** for March was poor, but in line with expectations. The economy lost approximately 660,000 jobs in March, and the unemployment rate rose to 8.5 percent, a 25-year record, from 8.1 percent in February and 5.3 percent in March 2008.

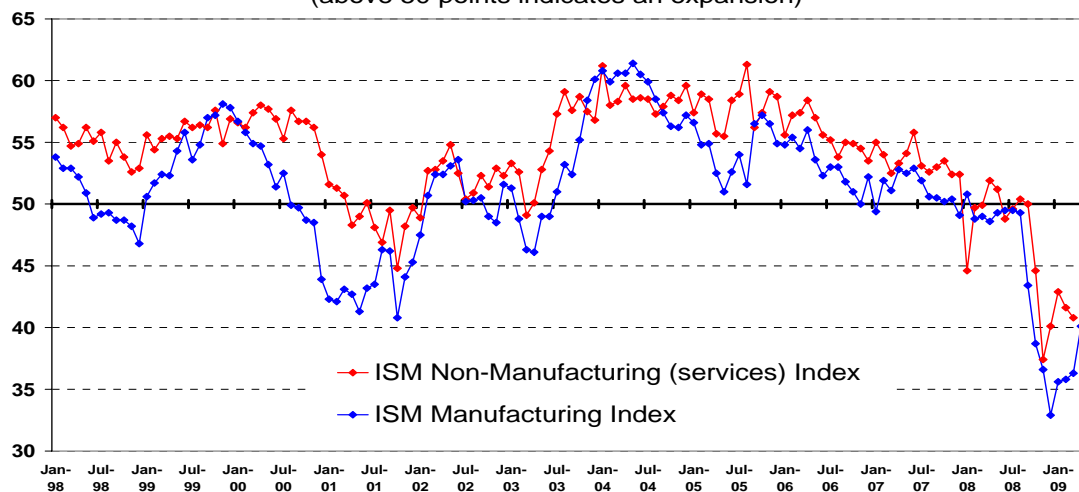
U.S. Unemployment rate



Retail sales decreased by 1.1 percent and industrial production decreased by 1.5 percent in March, both falling more than expected after encouraging gains in February.

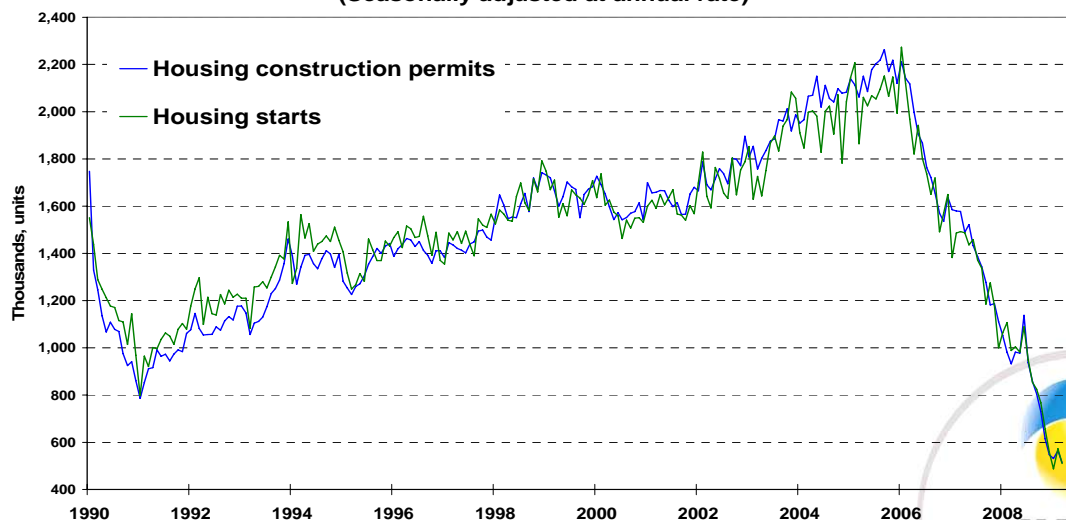
The ISM manufacturing sector index stood at 40.1 points in April, above expectations. The ISM service sector index was 40.8 points in March, versus 41.6 points in February, lower than expected. According to the ISM indices, economic activity in the United States continued to contract in January, February, and March, but at a more moderate rate compared to December.

The Institute for Supply Management Index (above 50 points indicates an expansion)



Construction starts and permits decreased by a sharper-than-expected 11 percent and 9 percent, respectively, in March.

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

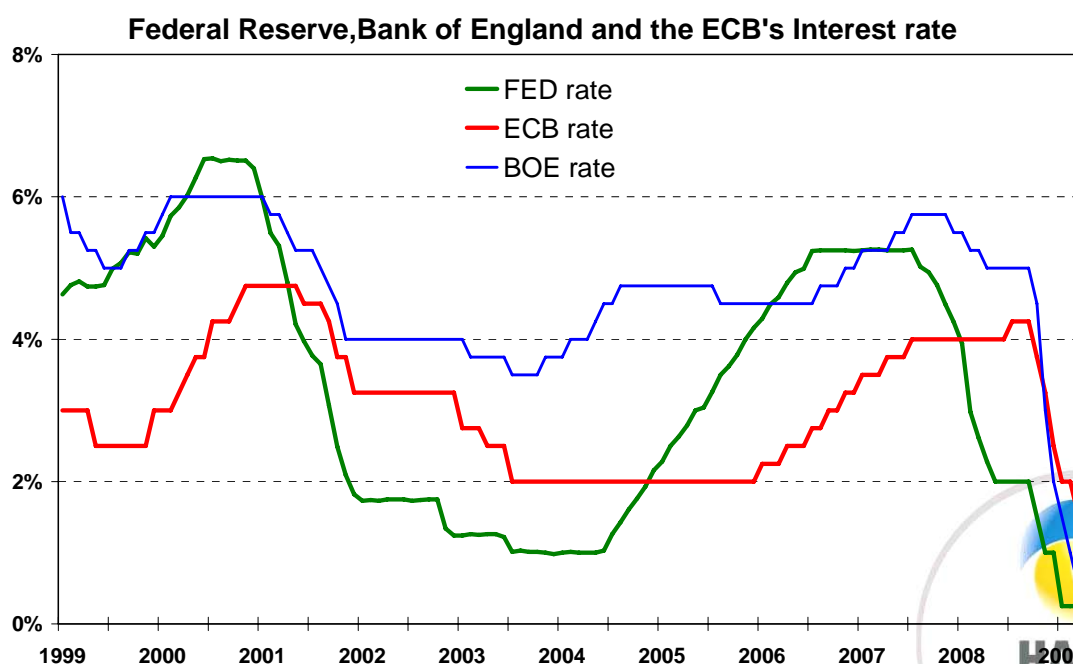


Sales of existing homes decreased in March, following the increase in February. However, the **median price** of homes sold rose for the second consecutive month. These figures, from the Realtors' Association, are quite volatile, but may show a significant movement towards stabilization and possibly an increase in housing prices. In addition, **sales of new homes** totaled 356,000 homes in March, in annualized terms, higher than expected, with figures for the last two months adjusted upward. The **S&P Case-Shiller index** of housing prices in twenty major US cities decreased by 18.6 percent in the twelve months ended in February.

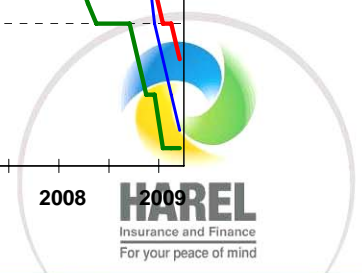
The **consumer price index** decreased by 0.1 percent in March, but core prices rose by 0.2 percent, for the third consecutive month.

Europe

The **European Central Bank** lowered the interest rate by 0.25 percentage points to 1.25 percent, in contrast to estimates of a 0.5-point cut. The ECB President hinted at a press conference that the interest-rate reduction process had not ended. The **UK's central bank** left the interest rate unchanged at a low of 0.5 percent, as expected.

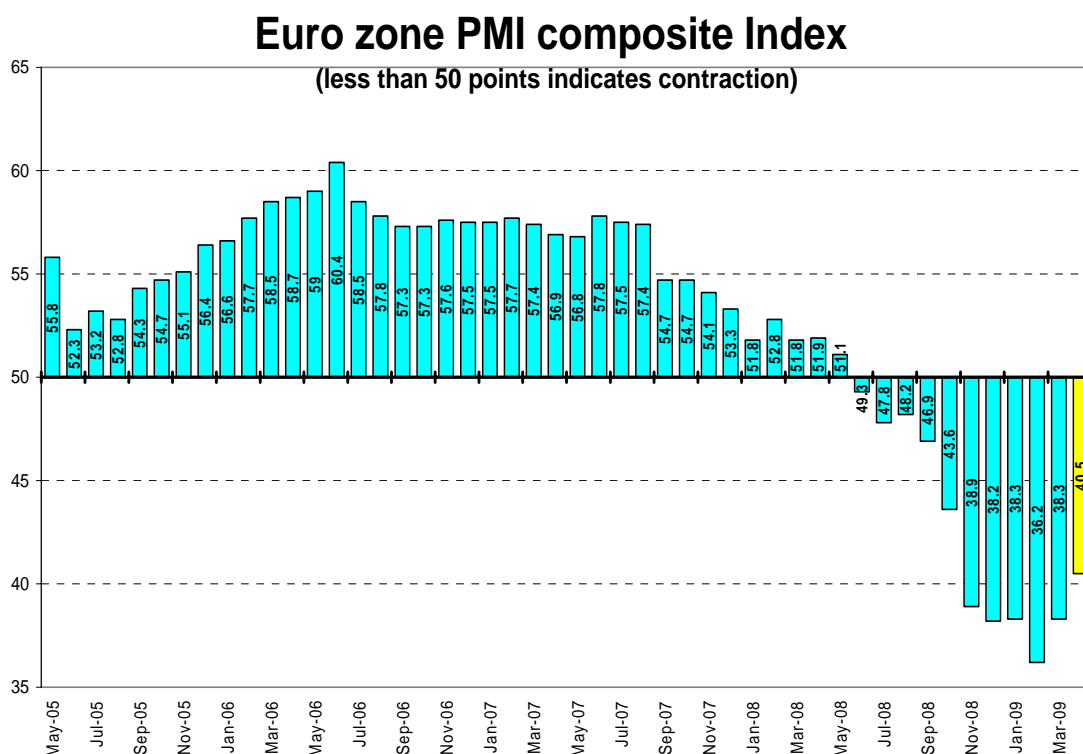


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Inflation was 0.6 percent in April, according to an initial estimate, similar to the rate in March.

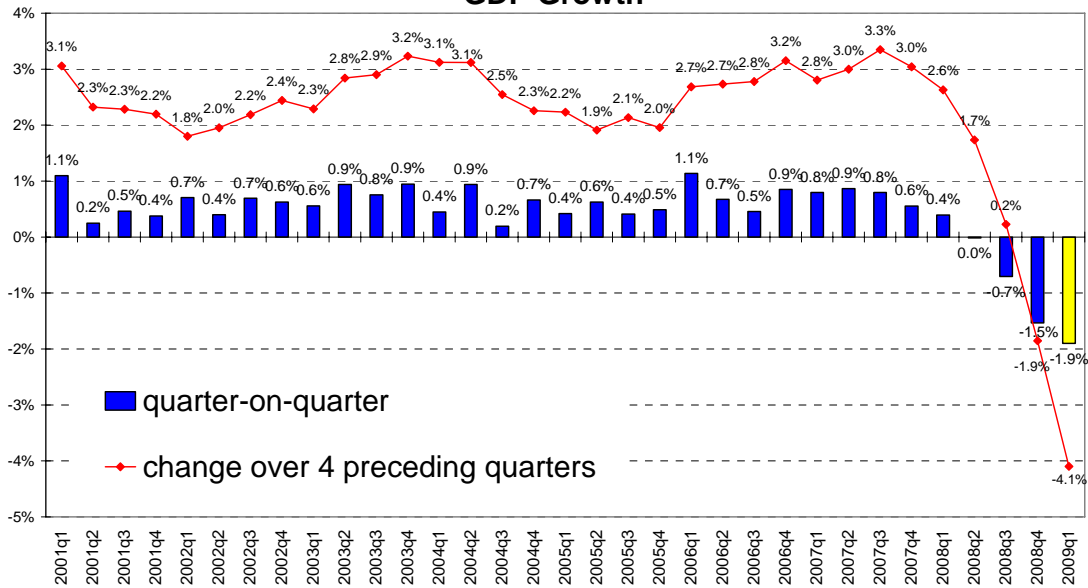
The euro zone **purchasing managers' index** reached 40.5 points in April, according to an initial estimate, higher than expected. This figure indicates continuation of the recession, but at lesser strength.



Unemployment in the euro zone rose to 8.9 percent in March, higher than expected, from 8.7 percent in February and 7.3 percent in March 2008.

GDP in the UK contracted by 1.9 percent in the first quarter of 2009, or a negative 7.4 percent in annualized terms, according to an initial estimate, in a greater-than-expected decrease. This was the sharpest drop in GDP in the last thirty years, with 6.2 percent contraction (23 percent annualized) in the industrial sector.

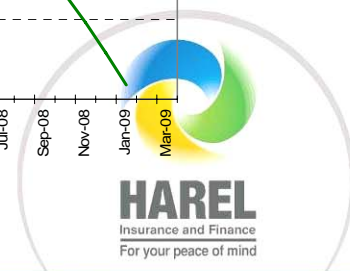
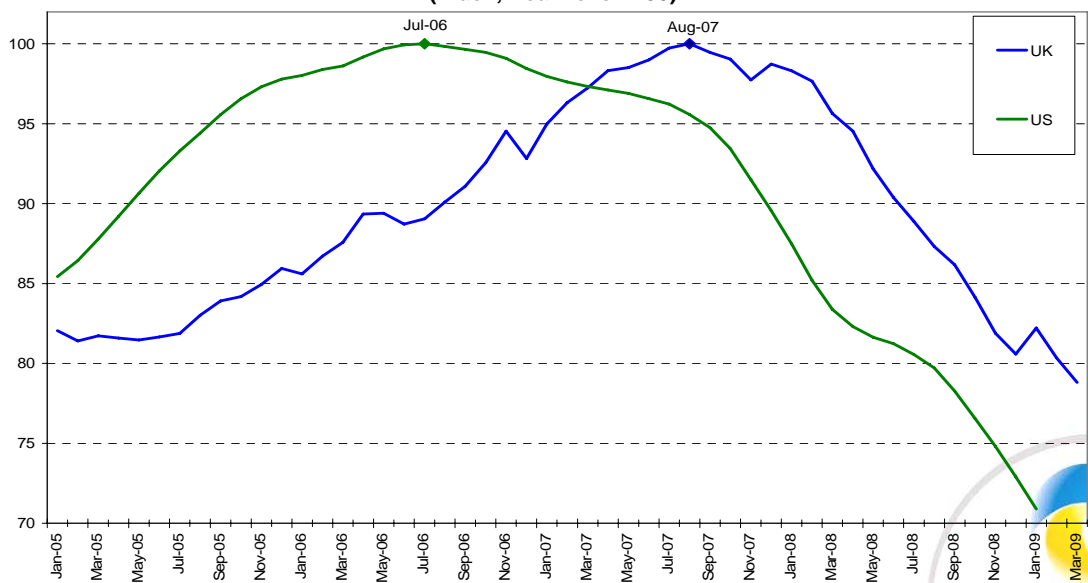
United Kingdom GDP Growth



Despite the growth data, **retail sales** in the UK rose by a surprising 0.3 percent in March, versus expectations of a decline at a similar rate.

The UK's Halifax house price index fell by 1.9 percent in March, and was 21 percent below the peak of August 2007. The rate of decline in housing prices in the UK is similar to the rate in the US, but occurring about one year later.

Development of housing prices in the United States and the United Kingdom (index, Peak level=100)



Japan

The Tankan survey of business confidence in Japan indicated a decline to the lowest level since the survey began in the mid-1970s. Japan's economy has been the hardest hit by the global crisis among the advanced economies; estimates currently indicate negative 6 percent growth in 2009. Japan did not suffer from a real-estate bubble or credit problems like the US and some European countries, but its exports, which flourished in recent years thanks to a cheap local currency and the US consumption bubble, were severely damaged by the sharp decline in global demand in general, and in the demand for cars and electronics in particular.

Inflation was negative at 0.2 percent in March, lower than expected, as was core inflation at a negative 0.6 percent. The **central bank** left the interest rate unchanged at 0.1 percent, as expected.

G20 summit

Leaders of the world's twenty largest economies are meeting in London to discuss various measures related to the global crisis. The G-20 decided on the need to increase supervision and regulation of the capital markets.

In addition, a decision was made to increase the budget of the International Monetary Fund (IMF) by USD 1 trillion, mainly in order to provide aid to developing countries at risk of collapse as a result of the global crisis, particularly in Eastern Europe. The US did not succeed in persuading the European countries to significantly increase fiscal incentives, similarly to the incentive programs in the US.

Important Announcements in the Coming Month

Title	Date	Day	Time	Link
Average wages	5 May	Tue	12-14	http://www1.cbs.gov.il/reader
ISM service sector index, US	5 May	Tue	17:00	www.ism.ws
PMI (purchasing managers' index), euro zone	6 May	Wed	11:00	http://www.markiteconomics.com/
Retail sales, euro zone	6 May	Wed	12:00	www.ec.europa.eu/eurostat
Interest-rate decision, UK	7 May	Thu	14:00	www.bankofengland.co.uk
Interest-rate decision, euro zone	7 May	Thu	14:45	www.ecb.int
Employment report, US	8 May	Fri	15:30	www.bls.gov
Foreign trade, Israel	13 May	Wed	12-14	http://www1.cbs.gov.il/reader
Retail sales, US	13 May	Wed	15:30	http://www.census.gov/svsd/www/adseries.html
CPI, euro zone	15 May	Fri	12:00	www.ec.europa.eu/eurostat
CPI, Israel	15 May	Fri	14:00	http://www1.cbs.gov.il/reader
CPI, US	15 May	Fri	15:30	www.bls.gov
National accounting and growth data, 1Q 2009	17 May	Sun	12-14	http://www1.cbs.gov.il/reader
Construction starts and permits, US	19 May	Tue	15:30	http://www.census.gov/pub/const
Incoming tourists, Israel	19 May	Tue	12-14	http://www1.cbs.gov.il/reader
CPI, UK	19 May	Tue	11:30	
Industrial production index and trade and service sectors revenue index	20 May	Wed	12-14	http://www1.cbs.gov.il/reader
Retail sales, UK	21 May	Thu	11:30	http://www.statistics.gov.uk
1Q growth rate estimate, UK	22 May	Fri	11:30	http://www.statistics.gov.uk
Interest-rate decision, BOI	25 May	Mon	17:30	http://www.bankisrael.gov.il/
Hotel stays	26 May	Tue	12-14	http://www1.cbs.gov.il/reader
New dwelling sold in private sector	27 May	Wed	12-14	http://www1.cbs.gov.il/reader
Manpower survey, 1Q 2009	27 May	Wed	12-14	http://www1.cbs.gov.il/reader
Sales of existing homes, US	27 May	Wed	17:00	http://www.realtor.org/Research.nsf/Pages/EHSdata
Sales of new homes, US	28 May	Thu	17:00	http://www.census.gov/const/www/newressalesindex.html
CPI estimate, euro zone	29 May	Fri	12:00	www.ec.europa.eu/eurostat
Unemployment rate, euro zone	29 May	Fri	12:00	www.ec.europa.eu/eurostat
1Q growth rate estimate, US	29 May	Fri	15:30	http://bea.gov/
Michigan University consumer confidence index	29 May	Fri	17:00	
House starts and completions, 1Q 2009	31 May	Sun	12-14	http://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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