

Weekly Macroeconomic Review

May 5, 2009

	Expectations derived from the capital market	Our forecast
Inflation in the coming months		1.2% in April 0.2% in May
Future cumulative inflation – next 12 CPIs (through March 2010)		1.9%
Inflation through May 2010 CPI (average annual rate)	2.4%	2.8%
Bank of Israel interest rate, 6 months ahead	1.10% (up 0.60)	0.75%
Fed interest rate, 6 months ahead	0.30% (up 0.05)	0.25%
Yield on Israeli Government 10-Year bond, 6 months ahead	5.37% (up 0.29)	5.50%
Yield on US Treasury 10-Year bond, 6 months ahead	3.36% (up 0.19)	3.50%
Dollar exchange rate, 6 months ahead	NIS 4.14 (unchanged)	NIS 4.22 (up 2.0%)

Israel

The Bank of Israel's **Companies Survey** indicates a low of negative 39 points in the first quarter of 2009, down from a negative 29 points in the preceding quarter, and about a negative 30 points at the peak of the last recession in 2001-2002. The Companies Survey joins other indicators all showing highly negative growth in the first quarter. Official growth data are scheduled for publication on May 17.

The government has approved the Ministry of Finance's proposal for additions to the budget in 2009 and 2010. The proposal encompasses a moderate increase of 1.7 percent each year in real government expenditures, with a massive budget deficit of 6.0 percent of GDP in 2009 and a similar deficit of 5.5 percent of GDP in 2010. The planned deficit for 2010 represents a compromise between those who support budgetary discipline and those promoting budgetary expansion to cope with the economic crisis.

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The deficits for both years, 2009 and 2010, will total an immense amount of approximately ILS 88 billion, and the government will have to finance most of this sum through the domestic bond market. As a reminder, the BOI has announced that it would buy government bonds for ILS 15 to 20 billion in the coming months, and some of the deficit will be financed abroad through the use of US government guarantees. Even without these two components, the Finance Ministry will still be obliged to borrow a large net amount of about ILS 60 billion from the public in Israel and overseas over the course of 24 months.

However, the main problem is that based on Finance Ministry estimates, the government will need to carry out a **deep cutback of ILS 14 billion in the state budget for 2010** in order for the budget not to exceed 5.5 percent of GDP. Unpopular measures will be necessary on the revenue side as well – cancellation of tax exemptions and increases in indirect taxes – but at this stage the Finance Ministry has not yet quantified the required amounts.

The Prime Minister and the Minister of Finance can expect intense struggles in the government and Knesset in the coming weeks to pass the deep cutbacks in the 2010 budget. If they fail, the budget deficit and the massive government bond offerings required to finance the deficit will be even higher, and may cause an increase in the fiscal risk premium and in the long-term interest rate.

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.

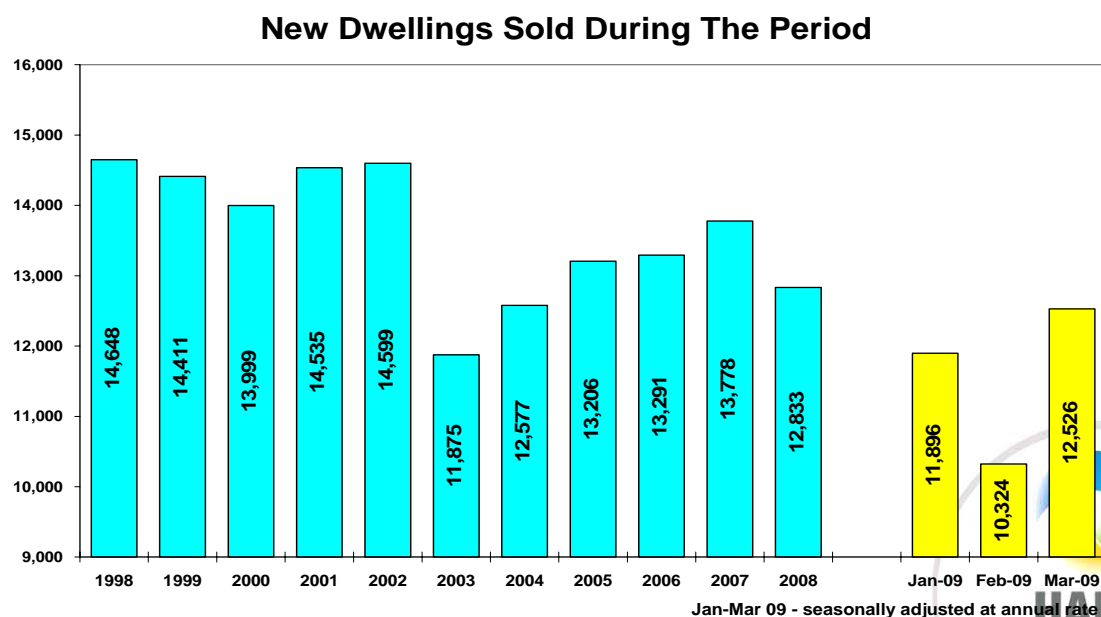


We have estimated for some time now that the forecast by the BOI and other economists of zero or negative inflation in 2009 would not materialize, as these estimates referred to the economic recession and the decline in demand, but ignored the aggressive monetary policy applied by the BOI in recent months. 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.

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



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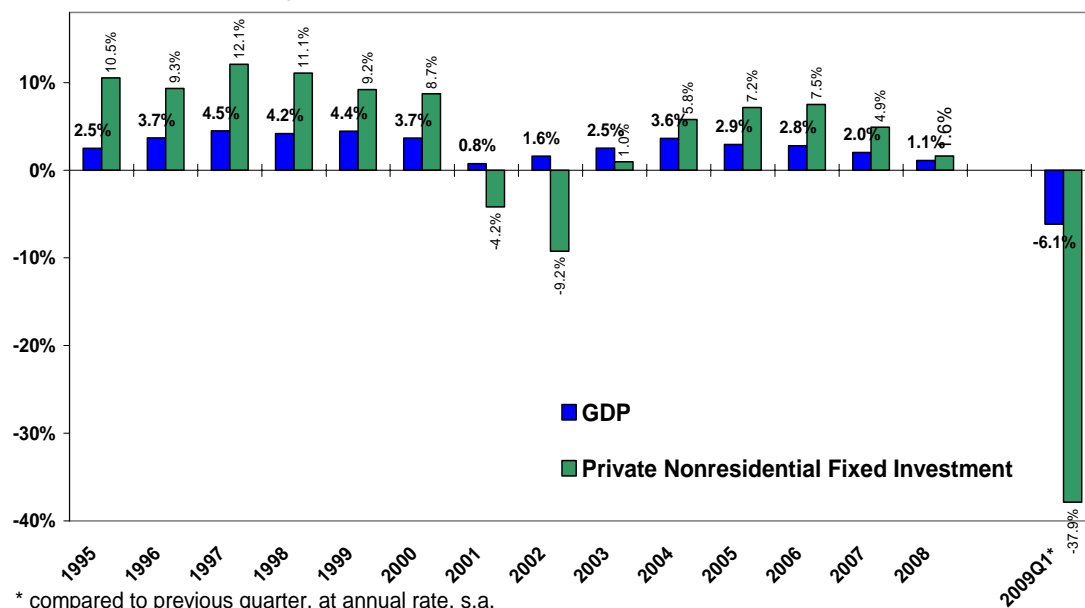
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United States

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.

The U.S. Economy, 1995-2009
Real growth rates of GDP and business investment



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.

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. In March, the Fed announced purchases of government bonds. Immediately following the announcement, **yields of ten-year bonds** fell from 3.00 percent to 2.55 percent. This yield now stands at 3.16 percent, higher than the level prior to the Fed's announcement.

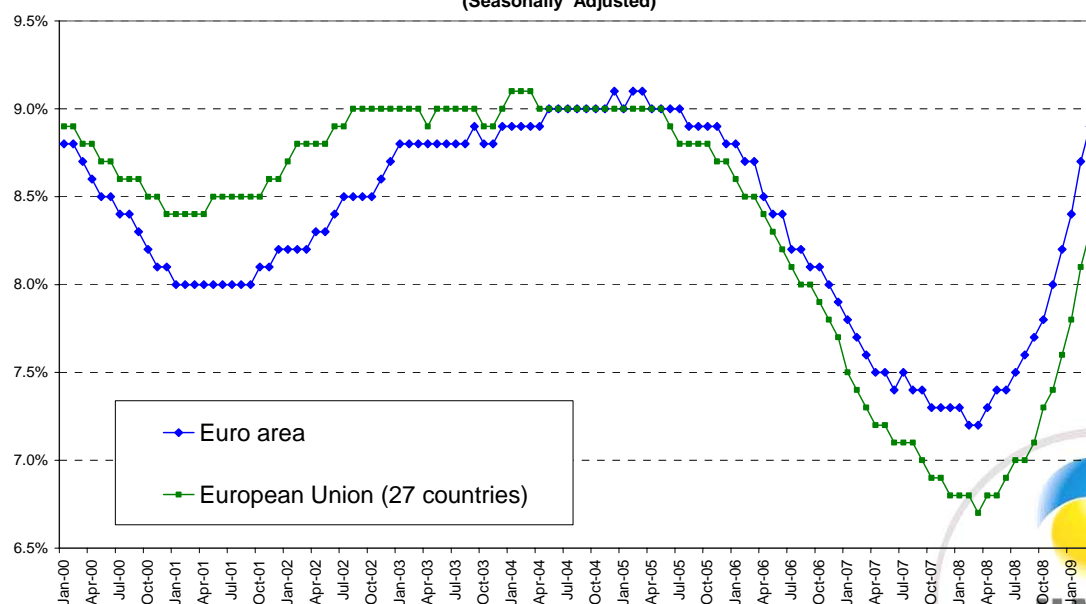
The University of Michigan's **consumer confidence index** rose to 65.1 points in April, from 57.3 points in March, higher than expected.

The ISM manufacturing sector index stood at 40.1 points in April, above expectations.

Euro Area

Unemployment in the euro zone continues to rise rapidly, as in the United States, reaching a higher-than-expected 8.9 percent in March, versus 8.7 percent in February and 7.3 percent in March 2008.

Euro area and Eu27 Unemployment rates
(Seasonally Adjusted)



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

Important Announcements in the Coming Week

- Data on employee positions and average wages will be published in Israel, and the ISM service sector index will be published in the United States, on Tuesday, May 5.
- Data on retail sales and the final purchasing managers' index will be published in the euro zone on Wednesday, May 6.
- Interest-rate decisions will be announced in the UK and in the euro zone on Thursday, May 7.
- The employment report will be published in the US on Friday, May 8.

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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