

Weekly Macroeconomic Review

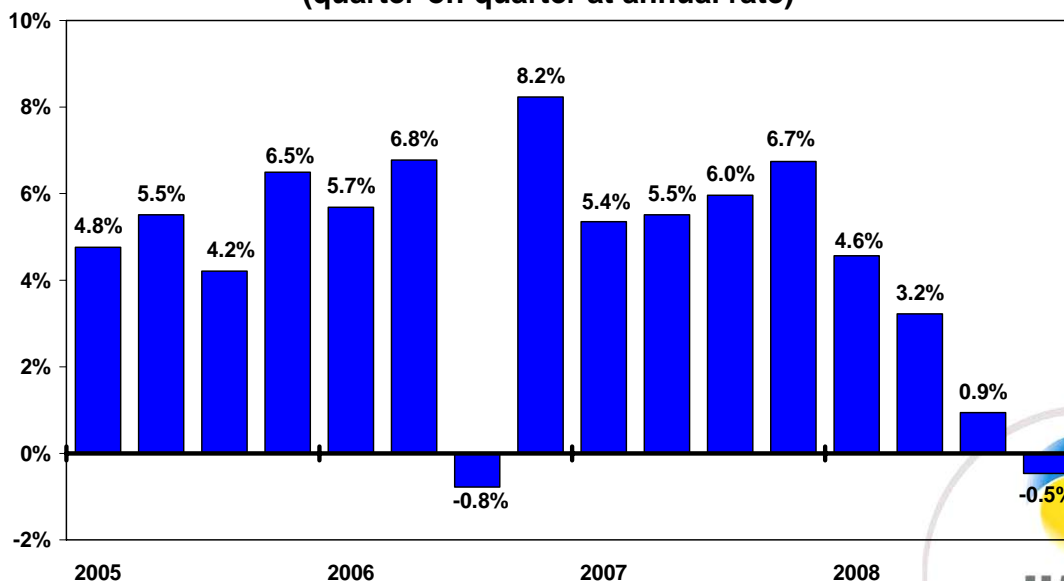
February 24, 2009

	Expectations derived from the capital market	Our forecast
Inflation in the coming months		0.2% in February 0.4% in March
Future cumulative inflation – next 12 CPIs (through January 2010)		2.1%
Inflation through May 2010 CPI (average annual rate)	0.3%	2.5%
Bank of Israel interest rate, 6 months ahead	0.90% (up 0.15)	0.75%
Fed interest rate, 6 months ahead	0.35% (up 0.10)	0.25%
Dollar exchange rate, 6 months ahead	NIS 4.15 (unchanged)	NIS 4.24 (up 2.2%)

Israel

GDP in the fourth quarter of 2008 decreased at an annualized rate of 0.5 percent; the third-quarter growth rate was also adjusted downward, to just 0.9 percent. **Business GDP** contracted by 1.2 percent in the fourth quarter, while **per-capita GDP** decreased by 2.3 percent.

GDP Growth
(quarter-on-quarter at annual rate)



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GDP increased by 3.9 percent in the **full year** of 2008, following 5.4 percent growth in 2007. Business GDP grew by 4.3 percent, following 6.2 percent growth in 2007. Per-capita GDP grew by 2.0 percent, following an increase of 3.5 percent in 2007.

The composition of growth paints a very negative picture of the fourth quarter. **Exports of goods and services** decreased sharply, at an annualized rate of 43.6 percent. **Imports of goods and services** decreased by 21.4 percent. **Private consumption** decreased by 3.6 percent. By contrast, **public consumption expenditures** grew by 19 percent.

We estimate that as a result of the slowdown in the global economy and the continuing crisis in the capital markets, growth in the first quarter of 2009 will be even more negative, including an additional decline in imports, exports, and private consumption.

The Bank of Israel reduced the interest rate by only 0.25 percentage point, while most economists expected a 0.5-point cut. The BOI also announced that it would focus on additional tools to attain monetary expansion. The interest-rate announcement explains why monetary expansion is necessary, but does not provide any reasons for the BOI's decision to reduce the interest rate by only 0.25 point.

In our opinion, the main reason for the BOI's minimal rate cut is essentially technical. First, the BOI is apparently not convinced that it can effectively control a near-zero overnight rate. Second, the BOI may fear a decrease in the public's deposits with banks if the interest rate is too close to zero; in that case, a further rate cut would reduce the amount of money instead of increasing it. Based on the experience of the next few weeks, the BOI may decide to lower the interest rate by 0.25 percentage point again at the end of March. Yet the BOI may also decide at that time that the minimum interest rate it can control is 0.75 percentage points; in that case, there will be no further rate cuts in the coming months.

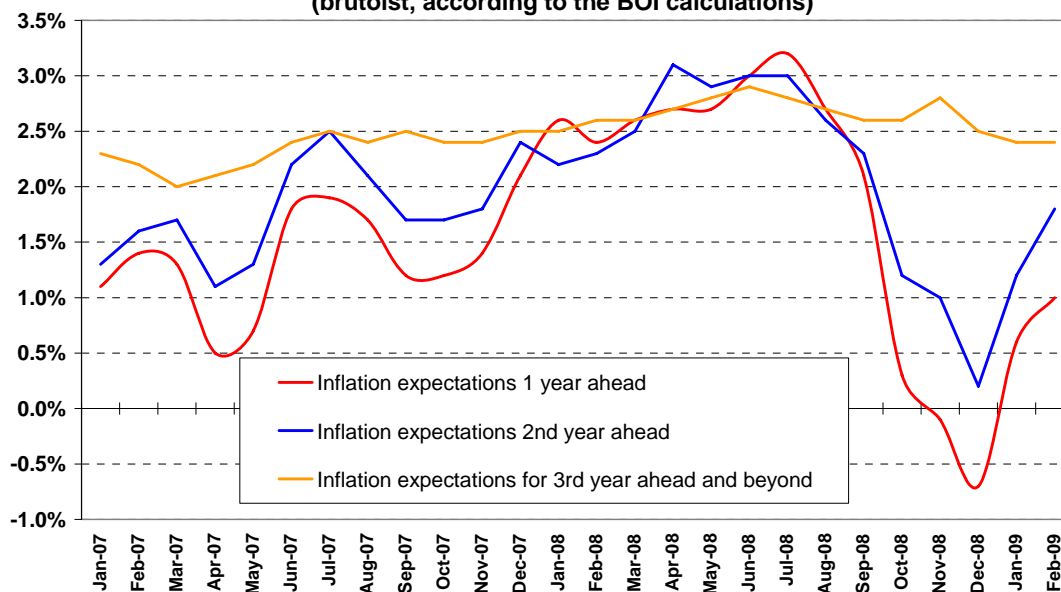
The BOI concurrently reduced the **spread for commercial banks** (the corridor around the BOI interest rate) to just 0.25 percentage point, from 0.5 percentage point before this decision and 1 percentage point a few months ago. This move was aimed at increasing credit and liquidity in the market, by increasing commercial banks' incentive to receive credit from the BOI and reducing their incentive to deposit funds with the BOI.



The BOI's statement that it would focus on **the use of additional tools** to create monetary expansion may hint at further purchases of foreign currency, although the BOI has refrained from explicitly saying as much at this stage. A decision on this subject will probably be reached over the course of the next month, as foreign-currency balances are very near the target set by the BOI at the time. Another option is the use of new tools, such as direct intervention in the credit market, e.g. in the corporate-bond market or through the encouragement of non-bank institutions to increase credit granting to the business sector.

Inflation expectations rose moderately over the last few weeks. According to calculations by the BOI, inflation expectations have increased slightly, to an average of 0.8 percent for the first year and 1.5 percent for the second year between mid-January and mid-February, in contrast to the expectations of negative inflation for the first year in November-December. Expectations for the third year and beyond remain at 2.4 percent.

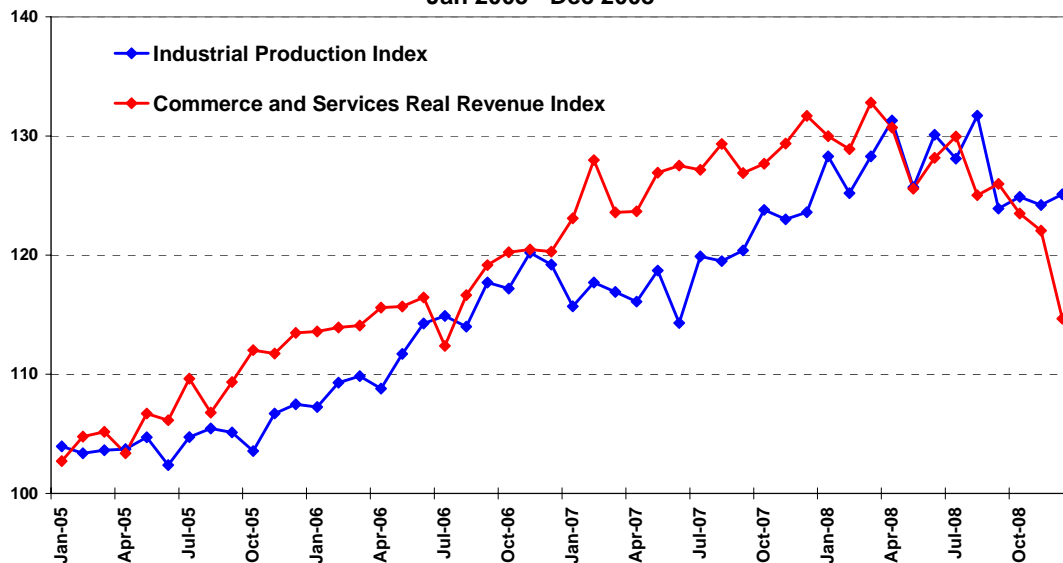
Inflation expectations derived by the capital market
(brutoist, according to the BOI calculations)



The quantity of means of payment continued to grow rapidly, rising by 4 percent in January and by 24 percent in the last twelve months.

Indicators of economic activity in December were weak. The **industrial production index** rose by 1 percent, both in December and in the last twelve months. The **trade and service sectors revenue index** fell sharply, by 6 percent in December and 13 percent in the last twelve months.

Industrial Production Index & Commerce and Services Sectors Revenue Index Jan 2005 - Dec 2008



United States

The US Treasury Department has announced a bailout plan for the real-estate sector, in addition to the fiscal incentive plan (USD 800 billion) and the financial-sector bailout plan.

Industrial production decreased by 1.8 percent in January, below expectations. **Construction starts and permits** decreased by 17 percent and 5 percent respectively in January, lower than expected.

The consumer price index rose by 0.3 percent in January, with a 0.2 percent increase in the core index, both in the highest gains of the last five months. The general index remained unchanged in the last twelve months, with the 20 percent decline in energy prices; the core index rose by 1.7 percent.

The Fed has issued its forecasts for the US economy in the coming years. The key forecast calls for negative 1 percent growth in 2009 (4Q vs. 4Q), 3 percent in 2010, 4 percent in 2011, and long-term growth potential of 2.6 percent. This forecast is more pessimistic than the IMF's estimates for 2009, but more optimistic for 2010. With regard to **inflation**, the new element is the establishment of a forecast of change in private consumption prices (the PCE deflator) in the long term, at 1.7 percent to 2.0 percent; this forecast essentially constitutes an unofficial inflation target of the Fed.

Important Announcements in the Coming Week

- The Central Bureau of Statistics (CBS) will release the employment report for the fourth quarter of 2008, including the unemployment rate, on Wednesday, February 25th.
- Data on sales of existing homes will be published in the United States on Wednesday, February 25th.
- The CBS will publish data on sales of new homes on Thursday, February 26th.
- The growth rate for the fourth quarter of 2008 will be published in the United States on Friday, February 27th.
- The consumer price index and the unemployment rate will be published in the euro zone on Friday, February 27th.
- Private-consumption data will be published in the United States on Monday, March 3rd.

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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