Global View

Economic Review

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Israel

Macroeconomic Developments in the Israeli Economy during 2008 and the Implications for the Credit Market

The gross national product – According to estimates by the Central Statistics Bureau, the gross national product is expected to increase by approx. 4.5% during 2008 while in the business sector, product is expected to increase by 5.2% (these official estimates by the Central Statistics Bureau for 2008 are very similar to the Leumi forecast from December 2007). The moderation in the growth rate during 2008, compared with previous years, reflects the great weight of the positive "extreme influences" of 2007 and the continued growth in the Israeli economy during H1/08 on the 2008 product. The slowdown in the growth rate began affecting economic activity data for H2/08, with a decrease in the growth rate from approx. 5% during H1/08 to approx. 3% during the H2/08.

What characterizes the various components of economic activity?

The public consumption growth rate began to moderate during the past year and the rate of increase in public consumption is expected to reach approx. 4.4% during 2008, compared with 6.7% in 2007. Inter alia, the reduction in the growth rate is related to the public's financial well-being (just on the share price declines, for example) as well as on the noticeable increase in the degree of economic and financial uncertainty with which the public has to deal when making consumption decisions.

Regarding investments in fixed assets (motorcars, equipment and construction): after a number of years of substantial reduction in the field of investments, during 2006-2007, a relatively sharp rise was recorded. This rapid rise did not continue into 2008 and, pursuant to the forecast, the increase in investments in fixed assets is expected to reach approx. 5.3%, compared with 15.5% during 2007.

A slowdown in the growth rate of commodities and services exports was recorded – Exports are still expected to increase by 5.8% in 2008. The relative moderation in the growth of exports during 2008, despite the global economic crisis, reflects the positive contribution made by the branches benefiting from the global commodities price hikes (chemicals, mining and quarrying and base metals). Additional factors that contributed to the continuing growth of exports, despite the moderation in the

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increase in the volume of global trading and the real appreciation of the shekel, include tourism exports, which grew rapidly this year, and high-tech services exports.

Commodities and services imports – During 2008 there was a slight slowdown in the trend of increasing volumes of imports against the background of global price hikes.

The balance of payments – In the wake of the global commodity price hikes, especially that of crude oil, and the worsening of Israel's trading conditions, the relatively large surplus in the current account of the balance of payments is expected to decrease during 2008. During 2008, a surplus of 2.3 percent of the product, compared with approx. six percent of the product in 2006 and 3.2 percent of the product in 2007 is expected.

The crisis in the capital markets and the economic slowdown have gained expression in the credit market. According to Bank of Israel (BoI) data, during the first nine months of 2008 an increase of approx. 2.7% in banking credit (approx. NIS 18 million, including mortgage banks), annualized to approx. 3.6% was recorded. During the 12 months ending in September 2008, the rate was higher, reaching approx. 4.5%. In contrast to the moderate development of banking credit, in the extra-bank credit field, there was a sharp trend change, which has characterized this market over recent years. The volume of bond issues, which could be used as an alternative to banking credit, amounted to approx. NIS 10-12 billion during the first nine months of 2008 (pursuant to estimates based on the stock exchange data) a sharp decline compared with a volume of close to NIS 70 billion issued during 2007.

During this period, in Israel, there has been a change in large institutional investor (pension funds, provident funds and insurance companies) activity, which forms a leading factor in extending extra-bank credit. Following a number of years of accelerated growth in the volume of credit that they extended to companies in the corporate sector, both by means of acquiring negotiable and non-negotiable bonds and by extending direct loans to companies, there has been a significant slowdown in this activity. Consequently, the weight of banking credit in the total credit extended to the corporate sector, which decreased over recent years to approx. 51.3% at the end of 2007, increased slightly to approx. 51.8% at the end of March 2008 (the last figure published) and it is likely to continue increasing over the forthcoming period.

The crisis in the global capital markets, which damaged the Israeli market, has resulted in an increase in the credit risk, which was underpriced in the past and enabled issues with margins that expressed a low credit risk. Apparently, consequently, at this time of global crisis the "appetites" for taking risks of institution investors has decreased substantially and the sharp rise in the yields to maturity of corporate bonds during September and October 2008, meaning substantial capital losses, is likely to result in these institutions rethinking their manner of risk management.

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Euro Zone

Today's extraordinary market circumstances, which have started to seriously impact economic growth, worked wonders: European leaders collaborated. They agreed to a coordinated approach with the following aims: ensuring appropriate liquidity conditions for financial institutions, facilitating the funding of banks, providing financial establishments with additional capital resources and allowing for an efficient recapitalization of distressed banks to avoid failures. Importantly, they also called for sufficient flexibility in the implementation of accounting rules for financial and non-financial organizations. Accordingly these institutions will value their assets consistently with risk-of-default assumptions rather than market value, which in illiquid markets may no longer be appropriate. Governments had to walk the talk probably sooner and with more vigor than they had hoped. Most of the largest financial institutions in Europe have experienced some sort of intervention by now. Support was also finally offered by the ECB, but rather reluctantly. Just one week before it joined other central banks in cutting benchmark rates, Jean-Claude Trichet still emphasized that upside risks to price stability had not disappeared at it was crucial to keep inflation expectations firmly anchored. The persistent plunge in commodity prices, the fall in Eurozone labor costs in Q2 to 2.7% from a revised 3.5% in Q1 and the notion that inflationary pressures should subside in an environment of an economic slowdown likely facilitated the decision process.

In fact, Q2 GDP showed considerably slower growth than the previous quarter, as suspected. It was characterized by a perceptible weakness in investments and a rare decline in final consumption. Exports fell by 0.4%. Data points for Q3 hint to another negative quarter. Leading indicators, such as the PMI Manufacturing, PMI Services and PMI Retail all remained below the 50-threshold, thereby signaling a contraction. Retail sales y-y continue to decrease. The ECB hopes that the plunge in oil prices will help strengthen real disposable income, supporting consumption. However, given softening trends in the labor market we expect the consumer to remain cautious. Due to the global economic slowdown further contraction in exports should be anticipated. The slowdown in industrial production and orders as well as the continuous fall in business sentiment are strong indications of persisting weakness in corporate capital expenditures. In light of the late reaction in monetary policy in this increasingly difficult economic environment, we expect sub-par growth until the end of 2009.

Given the increasingly recessionary environment in the Eurozone and softening trends in inflation, we expect the ECB to continue its easing of monetary policy. We still see some potential

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China Syndrome (Financial Style)

Following well-publicized nuclear power plant accidents in the late 1970's and mid-1980's, the threat of nuclear contamination from a possible meltdown of a reactor core became a global fear. Events of the recent past represents the financial equivalent of the China Syndrome in which the unraveling of "toxic" financial material (SIV's, ABCP, CDO's, sub-prime, etc.), magnified by the use of reckless leverage, threatened a meltdown of the global financial system.

Recent Chronology of Events

A partial time-line of events shows the downward spiral that Central Banks and governments around the world are trying to reverse. June 20: the Dow closes below 12,000. July 11: Indy Mac, the second-largest U.S. independent mortgage lender is seized by the FDIC. Aug. 12: Switzerland's UBS AG announces plans to separate its investment banking and wealth management units following $45 billion of write downs. Aug 31: Germany's Commerzebank AG agrees to buy Dresdner Bank. Sept. 7: the U.S. government takes over Fannie Mae and Freddie Mac. Sept. 15: Lehman Brothers files the largest bankruptcy in history and Merrill Lynch runs into the arms of Bank of America. Sept. 16: the Fed extends an $85 billion loan to AIG (the world's largest insurance company) and the government takes control. One of the oldest and largest money market funds breaks the buck on bad investments and freezes redemptions. Sept. 18: Lloyds Bank agrees to buy the U.K.'s largest mortgage lender, HBOS. Sept. 19: The treasury guarantees $3.4 trillion of money market funds in order to stem massive consumer liquidations. Sept. 21: Goldman Sachs and Morgan Stanley become commercial banks. Sept. 26: Washington Mutual is seized by the FDIC and its branches and assets are sold to JPMorgan-Chase in the biggest U.S. bank failure; bondholders are not protected. Sept. 28: Fortis, the largest Belgian financial firm, receives an 11 billion euro rescue from the Benelux countries. Sept. 29: the U.S. House of Representatives rejects a $700 billion treasury rescue plan. The Dow suffers its biggest point drop ever of 778 points and closes below 11,000 at 10,365. Sept. 30: Ireland says it will guarantee its banks deposits and debt for two years. Oct. 1: the U.S. Senate approves a revised rescue plan. Oct. 3: The U.S. House approves the revised $700 billion rescue plan. Oct. 6: the Fed says it will double its auction for cash to banks to $900 billion. The Dow falls below 10,000. Oct. 7: The Fed announces a program to support the commercial paper market. Oct. 8: In an unprecedented move, Central Banks announce coordinated rate cuts of 50 bps. Oct. 9: Wells Fargo beats out Citigroup in the acquisition of Wachovia for about $15 billion. The Dow falls below 9,000. Oct. 10: the Dow dips below 8,000 but closes around 8,500. Oct. 11: Treasury Secretary Paulson says that pumping capital into banks is a priority. Oct. 12: European leaders agree to guarantee bank borrowing and use government funds to prevent big bank failures. Oct.13: The Fed leads other central banks in an attempt to flood the system with as many dollars as wanted as they try to help governments instill confidence and get money market rates (LIBOR or EURIBOR) lower. Royal Bank of Scotland, HBOS and Lloyds TSB get a £37 billion capital infusion from the U.K. government and Germany says it will provide up to €500 billion in loan guarantees and capital to its banking system. Oct. 14: Treasury announces that it will invest $250 billion into banks with the first $125 billion going to the largest players. Oct. 15: the Dow falls 733 points or 7.9% to 8,578 for its biggest daily percentage drop.

Market Freeze

As the above events unfolded, the financial system became more dysfunctional. Not only did the fixed income market stop functioning, but the short term money market stopped functioning as banks stopped lending to each other except for very short periods and on a very selective basis. This was despite the fact that Central Banks were flooding the system with liquidity. Three month LIBOR rose from 2.82% in mid-September to 4.82% by October 10 as banks hoarded the liquidity being pumped into the system. Hopefully, in a sign that the coordination of liquidity injections, capital infusions, and government guarantees of bank deposits and debt might begin to be working, 3 month LIBOR fell over the past five days to 4.42%. Additional easing of LIBOR rates in the days, weeks and months ahead will be a positive sign that the system is returning to some semblance of normalcy. In the meantime it is expected that the Fed will continue to cut rates to at least 1.0% by year end and that the ECB and the BOE will also reduce rates to fend off weakening economies.

Global Recession

Now that the financial crisis has been attacked with measures akin to "shock and awe", participants confront the specter of the financial crisis spreading to the real economies. In many of the major economies, housing weakness is spreading to commodities and the industrial sector. A lack of lending and plunging consumer expenditures will throw the U.S. and others into a period of very weak growth for at least the next several quarters. U.S. GDP will probably register little to no growth in Q3 before falling into negative 1-2% territory for Q4 and Q109. One countervailing positive is the sharp decline in oil prices to $70 from the July high of around $145. Lower energy prices will act as a much needed tax cut for consumers. Nevertheless, indicators point to growing economic weakness and a recession that will be deeper and longer than we have experienced over the past 25 years. To counter this, it is increasing likely that the government will enact additional fiscal stimulus measures to aid consumers and business. Needless to say, the U.S. budget deficit is set for an unprecedented swelling on top of the record 2008 deficit of $455 billion. Many are estimating that the fiscal 2009 budget deficit will reach $800 billion or about 5.5% of projected 2009 nominal GDP of $14.4 trillion.

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