



# Global View



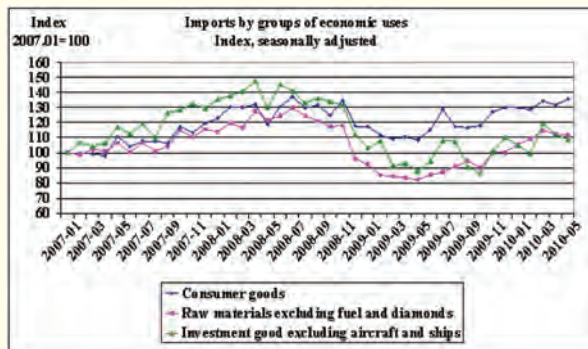
## Economic Review 3<sup>rd</sup> Quarter 2010 | No. 22



Israel

### **An increase in the trade deficit in the second quarter (April-May data)**

May was characterized by a slight decline in the import of goods to Israel (compared with April, according to data excluding seasonality) and by a more substantial drop in exports of goods from Israel. Thus there was a certain increase in the trade deficit in Q2 (according to April-May data) compared with Q1. If this trend continues, then the decline in the surplus in the current account of the balance of payments in Q1 2010 will be seen as the beginning of a downward trend in this area also in the remainder of 2010, together with a decline in the annual surplus compared with 2009.



When analyzing the foreign trade data, it is important to remember that this analysis is based on data denominated in US dollars; while in May there was a substantial strengthening of the dollar vis-à-vis the euro and the UK sterling, such that it is possible that the fall in Israeli exports in dollar terms does not reflect an equal

fall in quantitative terms. When looking at the trend of imports according to goods categories (see graph) one notable category that returned to levels from before the crisis is that of consumer goods (which reflects growing demand on the part of households), while the import of raw materials and investment products is still low compared with the peak levels of 2008.

It thus appears that the business sector (in particular manufacturing) has still not returned to the level of production that characterized this sector during 2008, despite the rapid economic growth in recent quarters.

### **Economic growth in the first quarter of the year – slowdown or acceleration?**

On June 16 the Central Bureau of Statistics (CBS) published its second estimate of economic growth data for the first quarter of this year. This publication included an upward revision of first quarter GDP growth data from 3.3% to 3.6%. Furthermore, a breakdown of the various GDP components indicated substantial changes. For example, export, which according to the previous estimates registered a decline of 7.3% in its annualized rate, now shows in the latest figures an increase of 7.4%.

Similarly, investment in the economy that previously showed a decline now shows an increase in the updated figures. Also private consumption, which in the previous estimates expanded by a moderate rate of



1.6%, increased according to the current estimate by 4.0%, in annualized terms.

These updated figures are in line with various indicators on developments in the economy that were published in recent months. Yet, when analyzing economic developments over the long term, it can be seen that across GDP data a slowdown was registered in the first quarter. However, when analyzing GDP excluding the impact of the start-up companies component, which tends to be complex and very volatile, it can be seen that the rate of growth in the economy actually accelerated in the first quarter of the year (a similar phenomenon was seen also in business sector output), and it is similar to the rate of growth in 2007 and the beginning of 2008, prior to the crisis.

Against this backdrop, the first quarter of the year now appears to be a quarter in which most activity in the economy actually indicated an acceleration and not a slowdown in the rate of expansion, as was originally indicated in the first estimates of the CBS.

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The outlook for the Eurozone economy is particularly clouded as the future depends on the individual policies and dynamics in each and every member state. It seems however, safe to state that the simultaneous restrictive financial policy in almost all euro countries will have a dampening effect on the economy. While the weak euro should offset some of the negative dynamism, it will mostly benefit export-oriented economies. Moreover, the most pressing problem; weak private consumption, will be stressed. Eventual economic growth is becoming solely dependent on exports. Given the enormous fiscal challenge some countries encounter, social unrest or political unwillingness to adhere to these measures are quite probable. Questions also remain about the ultimate willingness and capability of Germany to finance the rest of Europe. The probability of a renewed debt crisis will strongly depend on the solidity of the financial

system. We expect the Financial Stabilization Facility to be tested at a certain point – with a negative outcome. A double-dip scenario for the Eurozone seems probable.

For some time we have been wondering why the terminology “peripheral” is still used when addressing the problems of the Eurozone: the economic core has long been reached and with this, also the “heart” of the European ideology. The crisis demonstrated that national interests are at the forefront. It also revealed that the powers of the ECB have its limits, particularly due to its impotency to influence fiscal policies in the member states. Consequently, the viability of the euro can be questioned.

GDP grew a modest 0.2 % q-q at the beginning of the year. Private consumption declined

0.1 % q-q with automotive sales accounting for most of the drag following the phase-out of scrapping programs for older vehicles. Retail sales data indicates subdued consumer activity in 2Q. The prospects of consumption deteriorated even further due to the planned austere fiscal consolidations, which will additionally pressure already elevated employment rates. Consumer confidence started to deteriorate. Surprisingly, net exports subtracted half a point of GDP. This is mainly explained by imports growing 4%, while exports rose 2.5%. Normally, strong import activity would point to a healthy domestic demand. In this case, strong imports rather involved intermediate goods, which would feed into the production process. This would also explain the large inventory contribution of 0.8 % to GDP. Germany's exports rose 2.6 % in 1Q, continuing to benefit from the ongoing recovery of global trade. Close to 50 % of Germany's exports are destined to other Eurozone countries and 5 % are delivered to China. Given the weak consumption profile in the Eurozone and increasingly cautious capital expenditures by companies, exports will represent the key engine of growth. While export activity will remain healthy for the short-term, we expect the pace of export and imports to slow down, which could also cause inventory contribution to flatten out.

Gross fixed capital formation declined 1.1 %. While factory orders and production expectations would point to increasing capital spending, the sovereign crisis appears to have already negatively affected business sentiment, thereby deteriorating the prospect of positive impulses from this segment. Government expenditures rose 0.3 % in 1Q. In light of the planned cuts in state expenditures, growth prospects seem limited. In total, 2Q GDP growth

should accelerate as some adverse effects from 1Q will be unwound and exports look strong, but the expansion will increasingly face headwinds, particularly in 2011.

The rise in inflation over recent months reflects higher energy prices. Changes in commodity prices could lead to further slight increases in HICP inflation during the second half of 2010. Looking further ahead, inflation rates should overall remain moderate. Increases in taxes and administered prices may lead to some additional inflation pressure. Importantly, inflation expectations over the medium to longer term continue to be firmly anchored.

Monetary developments revealed some positive trend in bank loans to the private sector for several months. Loans to non-financial corporations remained negative, which seems however normal, given the lagging nature of this component. The ECB extended the full allotment for its 3-m operation until September by means of a fixed rate tender. This additional liquidity for banks represents a slight extension of the measure decided in the beginning of March and does not represent a major change. The ECB remained quite vague in respect to the controversial bond purchases. Mr. Trichet, Central Bank president, was keen to emphasize that these purchases were sterilized on a week by week basis using one week term deposits and that the bond purchases were a temporary measure. Rising yields for Spanish, Italian, Portuguese and Irish bonds demonstrate that investors are questioning the ECB's response to the crisis. By purchasing government bonds, Mr. Trichet, is trying to win time for governments to gain credibility in their thrust to tackle their indebtedness and/or deficits. The president is also trying to prevent Europe's monetary union from tearing apart. Bond purchases may however be interpreted as bail-out of Eurozone states, which is not foreseen in the Eurozone constitution. It may also raise inflation pressures, particularly if sterilization should no longer be successful. Even more problematically, several Governing Council members openly opposed bond purchases.

European finance ministers agreed on the structure of a EUR 440 billion European Financial Stability Facility (EFSF), which represents the main part of the EUR 750 billion rescue package announced on May 10, to counter the crisis. The additional assistance to countries in need is therewith provided via a special purpose vehicle rather than the bilateral loans used in the Greece drama. The allocation reveals that Germany as the main economic power in the Eurozone will contribute EUR 122.8 billion,

representing 5.1 % of national GDP, followed by France with EUR 92.3 billion, representing 4.8 % of national GDP. Place three and four, Italy and Spain, however demonstrate the inherent problem with this Facility: Some of the largest contributors are in fact the ones, which may most likely need assistance. What amount could ultimately be available? What rating will be attributed to the EFSF? Will Germany eventually have to contribute even more? This brings us right to the point of the German position within the Eurozone. Admittedly, Germany has been, through exports, a main beneficiary of the spending-keen Southern countries for years. Restrictive financial policies in almost all euro countries transform Germany into a major financier. Given the fact that Germany was more than hesitant in offering support to Greece, which required the provision of bilateral loans of EUR 8 billion in the first year, equaling to 0.3 % of Germany's GDP, how willingly will Germany really deploy EUR 122.8 billion, or 5.1 % of their national GDP? Furthermore, the help would go to countries, which comfortably lived beyond their means, enjoying their lives, whereas Germans at the same time took wage hits to finance the reunification with former East Germany. Public opposition is fierce, which has already led to changes in the political landscape. Remarks by some German ministers pointing to the direction of certain member states leaving the EMU have damaged credibility even more. Uncertainty about the political commitment remains extremely high and the true efficiency of the EFSF is therefore questionable. When could the EFSF be activated? A failed auction might be sufficient for a member state to ask for borrowing. The relatively "smooth" auctions may indicate that the ECB was involved out of fear that alternatively the EFSF would be tested.

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### Greece is the word

Not talking here about the 1970's Broadway musical "Grease" and follow-up movie starring John Travolta and Olivia Newton-John.

That story, as most of you will recall, dealt with the angst of teenage life in 1950's America. No, those "Happy Days" are long gone and what we are talking about here is the profligate ways of an ancient culture that tried (not too hard) and failed (spectacularly) to reinvent itself in order to obey the rules of its newly adopted parents; the Maastricht Treaty and the ECB. However, just like a mischievous child who borrowed the family car and then drove it headlong into a ditch, the parents felt compelled to come to the rescue.

And so they did; with the EU and IMF arranging a European multi-national bailout fund designed to prevent the errant ways of the naughty child from spreading bad consequences to its siblings. The €750 billion rescue package (€110 billion allocated to Greece) will allow Greece to fund itself for the next three years. The package is also designed to subdue liquidity contagion into Portugal, Ireland, Italy and Spain (which along with Greece are known as the PIIGS). The debts of the PIIGS to each other, as well as the huge sums owed to Germany, France and the UK, are primarily held by the same European banks that are still struggling with bad assets from the CDO meltdown of 2008.

Fears that a default by Greece would lead to defaults in other weak EU sovereigns caused banks to stop lending to each other. This new liquidity crisis, reminiscent of the dark days following the collapse of Lehman, imperiled Europe and forced the EU to defend the union and protect the EUR which had fallen 17% from earlier in the year to around 1.20 before rebounding to 1.23 at quarter end. However, while the rescue package quelled the liquidity crises and avoided disaster for the European single currency, it is generally acknowledged as only a short term solution. To be successful, profligate EU members must follow through on hard political and social decisions designed to significantly reduce deficit spending. Unfortunately, the imposition of fiscal discipline during a period of economic weakness raises the likelihood of meager economic growth for an even longer period. This will act to further complicate the task of debt reduction and argues for the continuation of low policy rates.

### U.S. Economy Stumbles

The economy suffered a loss of momentum as the quarter progressed, especially data released in June that primarily covered May economic performance. GDP growth in the first quarter of 2010 was revised down to 2.7% compared to the initial report of a 3.2% advance and many analysts are revising down their GDP forecasts to 3.0% and lower for the rest of 2010. The lack of meaningful private job growth is weighing down consumer income and confidence. After jumping 240,000 in April, private job growth slowed to just 33,000 in May and 83,000 in June. True, the economy has created 600,000 jobs so far this year

through June but this is pittance compared with the 8.5 million job losses registered in 2008 and 2009. And while the June unemployment rate is now 9.5% (versus the 10.1% high of October and 9.7% in May) much of this modest improvement is the result of statistical gyrations in the size of the labor force. Lackluster job growth, plus the uncertainties surrounding U.S. energy policy following devastation from the BP oil spill has resulted in mixed consumer confidence measures with the Conference Board measure falling to 52.9 in June from 63.3 in May. There is also renewed concern over the health of the housing market which has seen sales tumble and inventory increase following the end of government tax incentives for home buyers.

Tacit acknowledgement of the loss of economic momentum was evident in the policy statement released at the end of the June 23rd FOMC meeting. Given the low level of resource utilization, stable to declining current inflation and subdued inflation expectations, no one was surprised by the continuation of the 0-25 bps federal funds rate target and the "exceptionally low for an extended period" language. However, other portions of the statement showed that the Fed is disappointed with pace of the recovery, worried about the downside risks and not too concerned about inflation, for now. Fed watchers know that it is the construction and nuance of each Fed statement, viewed in progression, that one can get a sense of how close the Fed may be to a policy action. In this light, the June statement is being interpreted as a downgrade of the current environment. Of particular concern was the changing assessment of financial conditions which went from being "supportive of economic growth" to "have become less supportive of economic growth on balance, largely reflecting developments abroad." Given what we know now, markets are generally not expecting any change in Fed policy until mid 2011 at the earliest.

### Markets

Concern over European sovereign credit risk and slower U.S. economic prospects helped to push rates lower. By late June, two year t-note yields had fallen to a record low of 0.59% while the 10 year yield reached 2.95%, the lowest in 14 months. While treasury prices could decline briefly (pushing yields up towards 3.20%) from current overbought level, there does not seem to be a sustainable reason that would push rates significantly higher in the period ahead.

Equity prices, meanwhile, fell for a second consecutive month. After falling 8.2% in May following the outbreak of the European debt crises, the S&P 500 fell an additional 5.4% in June. Measured from the late April high at 1220, the S&P has fallen 15.5% to the June close at 1031. A level we are watching is 1008 which, if it holds, could lead to a 7.0% rebound back up to the 200 day moving average around 1100-1110. If economic data continues to disappoint and the index breaks 1008, we think the next support is at 980 and then 944. But since our outlook is for a weak recovery and not a double dip, we don't think that the market will trade below 944.

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