



LEUMI REVIEW

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Economic Developments in 2007 and Forecast for 2008

The Israeli economy has been growing rapidly for a number of years now - at a rate of more than 5% per year.

The composition of growth over the last two years has encompassed domestic demand as well as exports: private consumption continues to grow; residential construction has slightly recovered following a moderate first half of 2007; investment in various sectors of the economy continued to grow rapidly; and expenditure on public consumption (excluding security imports) increased as well. Published fourth quarter 2007 data indicates that the trend of rapid growth continues.

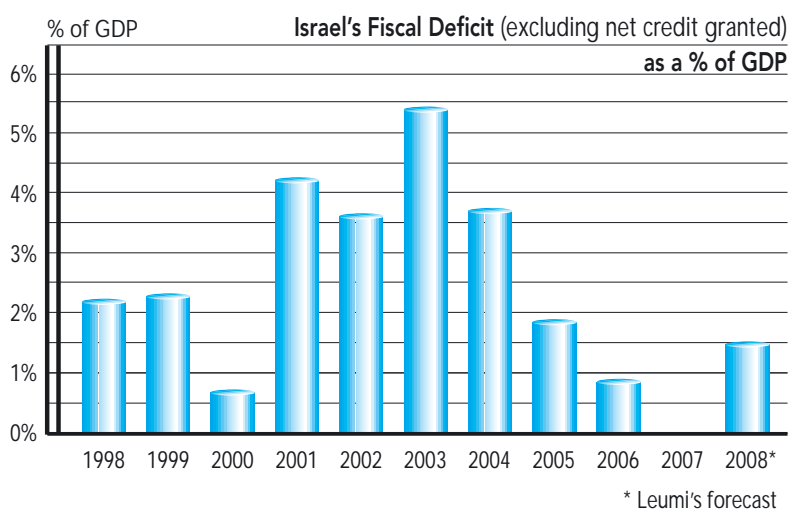
The strong economic growth has resulted in a decrease in the unemployment rate, which at the end of the fourth quarter was 6.7%, 1.1 percentage point lower than in the same period last year. The continuing downward trend in the rate of unemployment is due to a 4.9% increase in the number of employed labor in the third quarter of 2007, compared to the third quarter of 2006. There has been a notable increase in the number of part-time employees (mostly women).

Israel's credit rating was raised to 'A'

At the end of November 2007, Standard & Poor's, the international credit rating agency, raised Israel's long-term foreign currency rating from (A-) to (A). At the same time, the agency kept its credit outlook on Israel at "Positive".

In early February 2008, Fitch, also raised Israel's long-term foreign currency rating from (A-) to (A) with a "stable" outlook.

The main consequence of Israel's credit rating upgrade will be that international investment institutions as well as business organizations that may have previously been prevented from investing in Israel and doing business in the country will now be able to do so. The same goes for Israeli companies who may now be eligible for investment opportunities or business activity that previously was blocked to them. In other words, better credit worthiness will "open doors" for the Israeli economy to overseas opportunities, primarily in all areas related to strengthening interest on the part of foreign investors.



A low fiscal deficit, coupled with rapid growth, contributed to a significant reduction in Israel's debt/GDP ratio, one of the key factors determining the country's credit rating.

Fiscal performance in 2007

2007 ended with a balanced budget and no deficit. This compares to a planned budget deficit of NIS 18.7bn (2.9% of GDP) for all of 2007. The fact that the government undershot its deficit target had a significant impact on the local capital market, and especially on the bond market. This is because the State did not need to raise large amounts of capital, and therefore, greatly reduced its activity in the market in order to finance its deficit.

Box: The Construction Sector

The main disappointing development in Israel's economy is the decline in residential construction starts since the beginning of the year. The rate comes to approximately 30,000 housing construction starts in annualized terms, compared to an increase of 40,000-50,000 new households in Israel each year.

The decline in the number of housing construction starts can be seen as well as in data on new apartments sold within the private construction sector. The data shows that at the end of October only approximately 10,500 housing units remained available for sale. The months of supply stood at only nine, by the end of October. This is the lowest level seen in recent years, as the central region (excluding Tel Aviv) continues to stand out as the region with the lowest number of months of supply. (Months of apartments supply are defined as the number of months until the current inventory of available housing units for sale is depleted, based on sales in the same month).

This is the result of an insufficient level of construction during a period in which demand for housing is increasing, against the backdrop of an improvement in the background macro-economic conditions in Israel and an increase in real estate purchases in Israel by foreign residents.

The consequences of an insufficient level of construction starts

The impact of surplus demand in the face of relatively low supply in the housing market can already be seen and is causing an increase in housing prices (in particular in areas of high demand). This is consequently having a significant effect on the consumer price index (CPI), which rose by 3.4% in 2007. Without the moderating effect of the strengthening of the shekel vis-à-vis the US dollar, the rise in housing prices would have led to a more pronounced deviation from the price stability target range of 1-3%. Such a situation may occur in the future if there will not be a significant increase in the housing supply. Another weak point in Israel's economy is the low amount of investment infrastructure.

The consumer price index (CPI): the Bank of Israel failed to achieve its price stability target

The CPI increased 3.4% in 2007, slightly above the upper 3% limit of the BOI target range.

The increase in prices in 2007, despite the appreciation of the shekel vis-à-vis the US dollar, reflects the buoyant demand and the willingness to pass on to the consumer the price hikes coming from the supply side. In particular, there have been significant impacts to the surge in energy prices, as well as other raw materials which pass through different components of the CPI. Additionally, there has been continuing price increases in residential real estate, especially in areas of high demand.

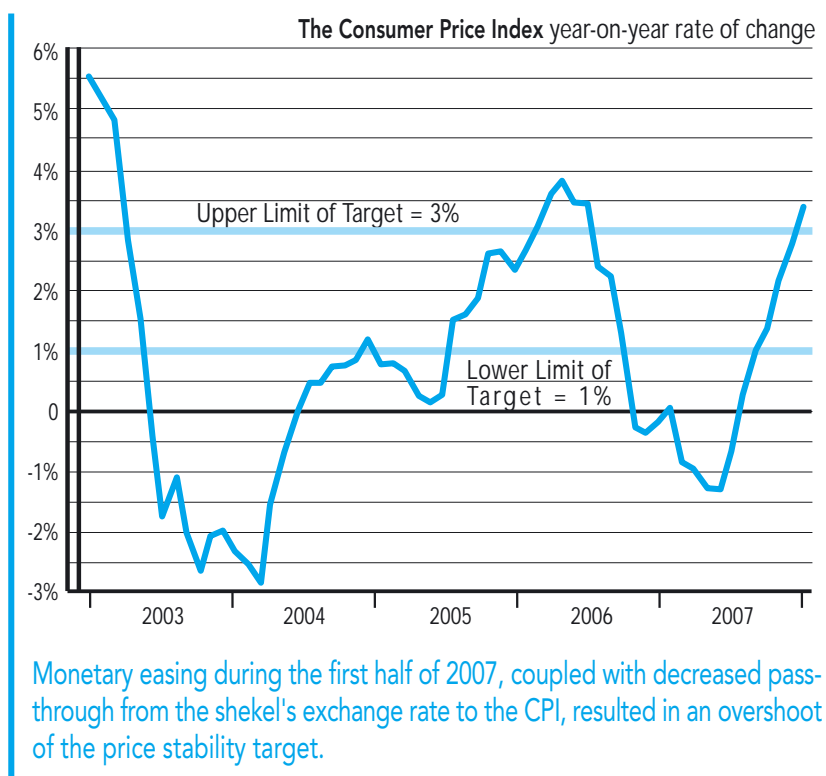
A turnaround in developments of the exchange rate of the shekel from appreciation to depreciation, will likely lead to a further deviation of inflation from the price stability target in a short period. Such development, should it occur, will likely lead to an upward adjustment in the interest rate of the Bank of Israel (BoI).

Outlook for 2008

What is expected to happen to economic growth in the coming year?

Despite rapid economic growth in 2007, economic growth is expected to moderate in 2008 due to the fact that Israel is a small open economy and the degree of sensitivity to economic developments around the world is relatively high. This means that the main growth driver of exports is significantly impacted by external developments.

However, it is very important to note that domestic demand in Israel is very strong and



thus the economy has other growth drivers. Domestic demand is expected to mitigate the effect of a US lead slowdown, resulting in a higher growth rate than that of other developed countries in 2008.

Does the deterioration in the US economy represent the main risk factor for growth in the Israeli economy in 2008?

It would appear that the first question to be asked relating to economic growth in Israel regards the degree of slowdown in the US economy and its demand for Israeli goods and services in 2008. We estimate there will be a significant slowdown in the US economy in 2008 that will impact also private consumption as well as the business sector. The average US consumer in recent years, consumed over and above his financial means. Therefore, the crisis in the US housing market is not expected to be restricted only to the financial sector, affecting liquidity and risk assessments in the markets, but is also

expected to cause changes in consumer preferences and to reduce private consumption, which is the main driver of the US economy. As mentioned previously, Israeli export is exposed to a higher degree relative to other markets to changes in demand in the US market.

Does the mortgage crisis in the US also threaten Israel?

The shocks in the US mortgage market raise questions on the degree of risk of similar shocks occurring also in Israel. In general, the answer to the question is that no contagion is expected in the Israeli mortgage market. In order to try to justify this response it is helpful to characterize the main differences between the Israeli and the US mortgage markets.

Within this framework we point out the main differences.

1. The rates of financing are very high in the US -- In the US it is acceptable to take out a mortgage also for current consumption expenditures and not only to finance the purchase of a home. This practice is much less widespread in Israel. In the case of Israel, the relatively low degree of dependence of households on mortgage credit as a source for financing current consumption is notable also in the relatively high degree of savings of Israeli households (from their disposable income), which is close to 30% compared to less than only one percent in the US. Part of the explanation for this phenomenon stems also from the different structure of the financial system and the accepted institutional savings arrangements in Israel compared to the US.

2. The high degree of ease of obtaining credit in the US -- The financial system in the US is based on the use of borrower credit

ratings from agencies that assess households. In contrast to this "automatic" tool, in Israel the lenders do a much more thorough check of the borrowers' ability to pay back the loan as a condition for granting credit for purchasing a home.

3. The relatively sharp increase in housing prices in the US and in investment in construction there - Whereas in the US the prices of housing units rose at a relatively rapid pace over the last few years and the investment in residential construction reached high levels relative to GDP, the upward trend in these variables in Israel was relatively moderate and began only recently. Furthermore, the rate of expansion of the housing supply in Israel has been moderate in recent years, and the fear of the creation of an excess surplus in the near future (especially in the areas of high demand) is very low. In other words, the real estate market in the US grew at too fast rate in recent years, which is not the case in the Israeli market.

Overall, in light of the different structures of the markets and the institutional arrangements, it appears as though the degree of vulnerability of the Israeli mortgage market is lower than that of the US market. Furthermore, past experience has shown that the trend of housing prices in Israel is not sensitive to parallel trends in the US and in England. Thus there is not much concern that the fall in housing prices in the US and other places around the world will affect prices in Israel as well.

The shekel has demonstrated great strength this year over the US dollar; will this trend continue?

The strength of the shekel vis-à-vis the US dollar reflects first and foremost the weakness

of the dollar in global markets. Nonetheless, there were factors that, in recent years, supported the strengthening of the shekel, specifically the significant inflow of investments into Israel from overseas and positive export performance.

Even so, throughout 2007 there already began a slowdown in the inflow of foreign financial investment (net) to the Tel Aviv Stock Exchange (TASE), especially investments in bonds. At the same time, the capital outflows of overseas investments by Israeli institutional investors (i.e. pension funds, insurance companies etc.) increased slightly throughout 2007, as a result of the desire of these bodies to diversify to a greater degree their investments abroad. As a result, the non-banking private sector moved from a state of equilibrium in capital flows to and from Israel in 2006 to a surplus of outgoing capital over incoming capital to Israel in 2007.

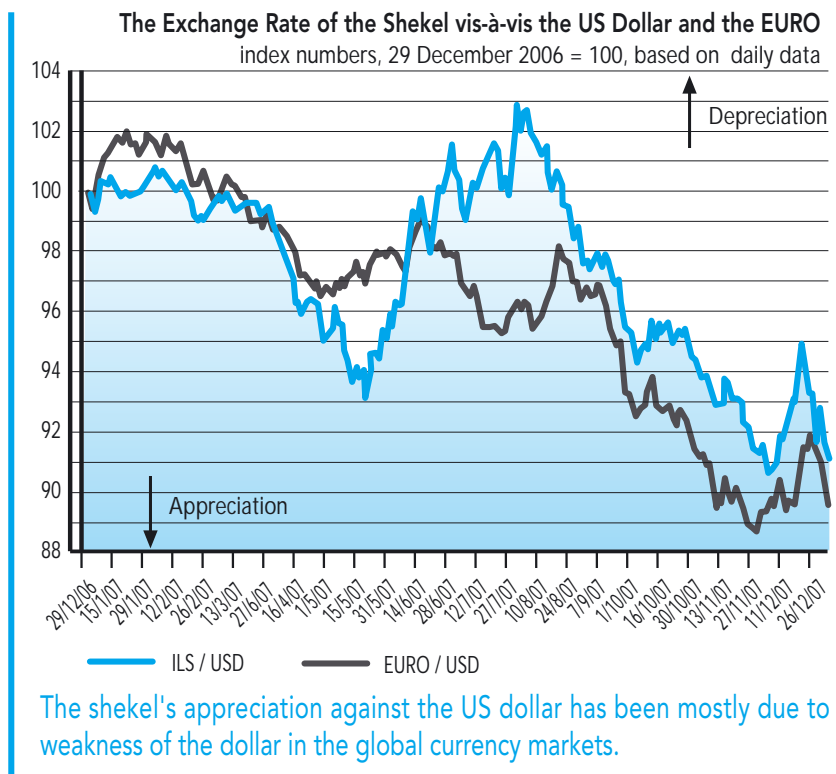
In our opinion, this trend of a modest weakening of the very strong fundamentals supporting the shekel will continue also throughout 2008. At the same time, the impressive surplus in the current account of Israel's balance of payments began to narrow throughout 2007 from its peak level. These developments, that include the net outflow of capital from Israel and the narrowing of the surplus in the current account of the balance of payments, are likely to result in a decreasing potential for an additional significant appreciation in the shekel vis-à-vis the basket of currencies of Israel's leading trading partners.

However, an appreciation of the shekel vis-à-vis a specific currency, as what happened this year quite notably in the exchange rate of the shekel vis-à-vis the US dollar, may occur in the event there will be additional

strong volatility in the exchange rates of currencies around the world, and especially if there will be renewed weakness in the dollar in global markets.

Monetary and Inflation outlook

Despite the appreciation of the shekel vis-à-vis the US dollar over the past year we have seen the build-up of inflationary pressures. These pressures are expected to continue throughout 2008. In the event the shekel will weaken against the dollar, then this may be a factor that will also lead to an acceleration in the rate of inflation towards the upper border of the price stability target range - 3 percent - or perhaps even above this border.



Economic and Financial Indicators of Israel

	updated to:	Last three months		2007	2006	2005
		compared to the previous period*	compared to the corresponding period*			
ECONOMIC ACTIVITY						
			real percent change			
Industrial output	Nov	2.4	3.7	4.9	3.6	3.8
Revenue of trade and services sectors	Nov	-0.3	6.9	8.6	6.1	7.4
State of the economy index	Dec	3.0	9.6	8.3	3.8	4.8
ECONOMIC SECTORS						
			real percent change			
High-technology industrial output	Nov	1.7	-1.3	4.7	6.1	5.7
Sales of new dwellings in private construction	Nov	-1.6	9.5	2.2	11.1	0.6
Hotel person nights	Dec	1.6	11.8	7.0	1.5	12.5
of which: tourists	Dec	8.2	55.5	22.1	44.2	45.2
FOREIGN TRADE						
			percent change (current US\$ prices)			
Export of goods (ex. ships, aircrafts and diamonds)	Dec	12.4	27.7	18.5	14.4	7.1
of which: manufacturing (ex. diamonds)	Dec	11.8	27.4	18.2	14.9	6.9
agricultural	Dec	28.6	37.6	30.5	0.5	12.7
Import of goods (ex. ships, aircrafts and diamonds)	Dec	6.7	30.8	20.6	9.2	11.2
of which: raw materials (ex. diamonds and fuels)	Dec	7.0	23.2	17.1	9.5	4.5
investment goods (ex. ships and aircrafts)	Dec	6.6	35.9	23.8	6.2	3.2
consumption goods	Dec	4.2	36.0	29.1	10.6	7.1
LABOR MARKET						
			real percent change			
Employee posts - Israeli workers	Oct	0.8	4.1	3.8	4.9	3.2
Average wage per Israeli employee	Oct	-0.6	1.2	2.0	0.9	1.3
		Last 3 months**	The corresponding period**	2007	2006	2005
GOVERNMENT BUDGET						
			percentage of GDP			
Total revenues and grants	Dec	36.1	38.8	34.3	37.5	36.3
Total expenditure and credit allocated	Dec	40.8	43.7	33.8	37.9	37.8
Deficit (-) / Surplus (+)	Dec	-4.7	-5.0	0.4	-0.5	-1.5
of which: deficit (-) / surplus (+) ex. credit (net)	Dec	-5.2	-5.7	-0.1	-1.0	-2.0
Domestic borrowing (net)	Dec	4.6	0.6	-0.7	-0.8	-0.4
Loans from abroad (net)	Dec	-0.5	2.3	-1.0	-0.4	1.1
		Last 3 months	Last 12 months	2007	2006	2005
PRICES, EXCHANGE RATES AND TOTAL YIELD INDICES						
			percent change (end of period)			
Consumer price index	Dec	1.1	3.4	3.4	-0.1	2.4
Wholesale price index of manufacturing output	Dec	5.0	11.4	11.4	2.1	5.2
Price index of input in residential building	Dec	-0.2	3.1	3.1	5.9	5.9
NIS/US\$ exchange rate	Jan 08	-9.2	-14.9	-7.7	-8.1	6.8
NIS/EURO exchange rate	Jan 08	-6.1	-2.4	1.7	2.1	-7.3
NIS/trade-weighted exchange rate	Jan 08	-7.2	-7.0	0.0	5.3	1.7
Tel-Aviv 100 index	Jan 08	-15.4	4.7	26.3	12.0	29.4
Tel-Aviv 25 index	Jan 08	-13.6	11.6	32.3	12.5	33.3
Tel-Tech index	Jan 08	-31.3	-23.2	-2.3	-2.3	-4.8
		The last month	The corresponding month			
INTEREST RATES						
			average of the last month (%)			
Bank of Israel interest rate	Feb 08	4.25	4.25	4.00	5.00	4.50
Non-linked treasury bill ("MAKAM") - 1yr yield to maturity	Jan 08	4.77	4.54	4.6	5.0	5.2
Non-linked government bond ("SHACHAR") - 10yrs real yield to maturity	Jan 08	6.05	5.58	6.0	5.7	6.2
CPI-linked government bond ("GALIL") - 10yrs real yield to maturity	Jan 08	3.50	3.43	3.5	3.6	3.7
Federal Reserve rate	Feb 08	3.00	5.25	4.50	5.25	4.25

* Seasonally adjusted. ** As % of GDP (estimate)

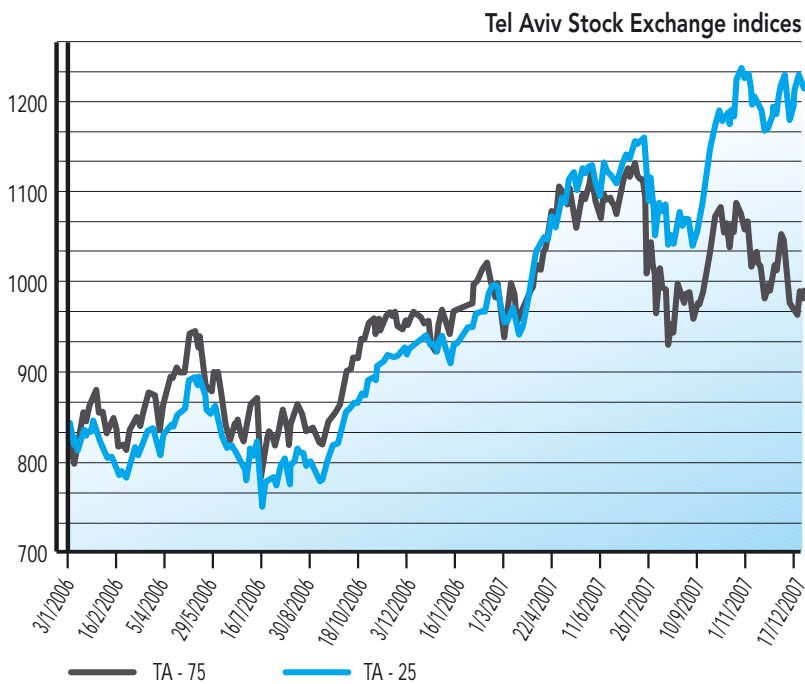
Review of the Local Stock Market in 2007

The local stock market opened 2007 with a wave of optimism, continuing the positive trend seen during the four preceding years. Contributing to the upbeat atmosphere in the market was Israel's forecast rating upgrade - from 'stable' to 'positive' - by international credit rating company "Standard & Poors" in February (after credit rating companies "Fitch" and "Moody's" did the same in 2006), and also Israel's receiving of approval in May to initiate the proceedings for joining the OECD. Cuts in the local interest rate, implemented by the Bank of Israel (BoI), from 5.0% at the end of 2006 to 3.5% by June 2007, contributed to the optimism in the local stock market. However, despite the positive atmosphere, the first signs of difficulties started to arise already in the first half of 2007. Looking back, these signs, hinted at what was to come. An example of one of these signs was the "mini crisis" in the Shanghai stock market at the end of February, which was expressed in a sharp one-day drop of 8.8% in the value of Chinese stocks. Concerns that events in China would develop into a wider crisis led to price declines in global stock markets, including in Israel. Approximately one month later, the US mortgage market, began to show signs of trouble which, in July, ultimately transformed into a crisis. This crisis was reflected in sharp falls in prices in stock markets around the world from the end of July through mid-August. In the local stock market the prices of the 100 most highly

capitalized stocks (the TA-100 index) fell more than 12.0% during this period.

As time progressed, throughout September and October, indeed there was a downward correction recorded in most share indices in the local market; however, despite this it could not be said at the time that it was a turning point in the market. This is because the crisis in the US led to an increase in the level of risk associated with investment in stock markets in general, and in emerging markets in particular. As a result, the trends seen in the local stock market changed from upward moving prices in the first half of 2007, to non-movement in the best cases, and to declines in the not-so-good cases in the second half of the year. This is due to the fact that during this period the local stock market operated primarily in the shadow of events occurring overseas, that, as mentioned, were dictated by the increase in the level of risk aversion around the world.

In addition, the local stock market was affected in the second half of 2007 by expectations for a slowdown in the US economy in 2008, and then, towards the end of the year, there were voices heard claiming the "landing" of the US economy will be even harder than what was originally thought. Also the hike in the BoI interest rate from 3.5% in mid-2007 to 4.0% by the end of the year, and expectations that this upward trend in rates would continue in 2008, burdened the local stock market in the second half of the year.



Since the turmoil in financial markets started, investors have become more selective. The TA-25 index has managed to maintain an upward trend whilst the TA-75 index has been trading at levels similar to those seen during the summer.

Overall in 2007 the TA-25 index of blue chip shares increased 31% in value, while the TA-75 index of second-tier stocks rose only 7.7%. This is because real estate shares, which are heavily represented in the TA-75 index, registered only a moderate 4.8% increase during the year. Bank shares were also relatively weak in 2007, as their share prices increased only 7.5% throughout the entire year. The poorest performing sector of 2007 was the technology sector, which in the fourth quarter of the year registered a sharp decline that consequently led the sector to register a 3.5% decline for the entire year. In contrast, the best performing sector in the local stock market in 2007 was the chemical sector, which showed a consistent upward trend throughout the whole year, reflecting the sharp rise in prices of chemical products around the world - and in particular chemicals used in agriculture. Thus, the chemical sector registered an impressive 53.3% increase in 2007.

The sole sector that registered a cumulative decline in its index in 2007 was, as mentioned above, the technology sector. However, we note that from the beginning of the year up until the sub-prime crisis in the US in July, technology shares increased in value by 21%. Due to the crisis, which was among the factors that led to a downward correction in economic growth forecasts for the US, the main target market for Israeli high-tech exports, there appears to be a certain change for the worse in the way investors relate to Israeli technology shares. This negative relationship worsened further in the fourth quarter of the year when the scenario of a "hard landing" of the US economy began to be more widely accepted. In the local stock market these developments were seen in, among other ways, price declines in the shares of technology companies, due to

concerns that the expected slowdown in the US will hurt these companies' business results. Thus, in the last three months of 2007 these shares declined approximately 18.7% in value.

The local insurance sector also suffered from the consequences of the US sub-prime crisis. However, in contrast to the impact of the crisis on Israeli technology shares, which is related to the slowdown in economic growth, the insurance sector was affected by the sub-prime crisis primarily via the impact on the financial markets. This is due to the fact that the profits of insurance companies are dependent to a relatively high degree on the yield on their portfolio of financial investments as the source of their activities. The shares of insurance companies declined approximately 15% within a period of 15 trading days from the time the crisis erupted in the US. However, in contrast to most of the leading stock market indices that returned after approximately two months to their pre-crisis price levels, the correction in the stock prices of insurance companies stretched out over a longer period - approximately three months. In addition, it appears as though the level of volatility in the stock prices of insurance companies has increased since the crisis began. Overall the insurance sector increased only 1.1% in 2007.

Bank shares were characterized by a high degree of volatility throughout all of 2007. Throughout the year the trends in these shares, which are among the most actively traded shares by foreign investors, were affected primarily by the atmosphere of global stock markets. This influence from abroad strengthened even more so after the US sub-prime crisis erupted. Therefore, it seems that the positive financial results that

most local banks published in 2007 had a limited impact on their stock prices. Thus, the trends seen throughout most of 2007 in the shares of Israeli banks mimicked closely the trends seen in the US S&P500 index. However, it is important to note that in contrast to the banks overseas, some of which registered large write-downs as a result of the sub-prime crisis, the exposure of Israeli banks to the US mortgage market was, in most cases, small.

Just as in the case of most stock indices in the local market, real estate shares were also affected by the US sub-prime crisis. However, in the second half of the year these companies also had to deal with an additional factor that made things more difficult for them - the hike in local interest rates. We recall that a rise in interest rates increases the attractiveness of investing in a risk-free asset, which consequently leads investors to reduce their investments in stocks and other instruments that are characterized by a higher level of risk. Therefore interest rate hikes have a negative impact on the stock market as a whole. However, real estate companies have a higher sensitivity to a hike in interest rates since these companies are characterized by a relatively high degree of leverage. Thus, in the first five months of 2007, when the interest rate of the Bol was cut 1.25 percentage points, real estate shares increased 29% in value. After approximately one and a half months of stability, these shares fell sharply, by approximately 18%, with the eruption of the crisis in the US. However, in contrast to the prices of most stock indices in the local market, in which the sharp declines were completely erased by the start of the fourth quarter of the year, the upward trend seen in real estate shares was stopped half way to the peak levels seen

at the beginning of May. It appears as though this is connected to the hike in local interest rates in the second half of 2007 and to the expectation for a continuation in interest rate hikes in 2008.

Furthermore, the sole sector that continued its upward trend even after the eruption of the US mortgage market crisis, was the chemical sector (including rubber and plastics). In addition, the declines registered in the share prices of chemical companies as a result of the crisis at the end of July and in the first half of August were relatively moderate, falling 7.0%, in contrast to the relatively sharp decline of 13.0% in the prices of the other stock indices in the local market. The strength of the chemical sector in 2007 is attributed to the improvement in the state of the agro-chemical market, and the return of the sector's profitability to a growth trend after an erosion in profitability in 2006. In addition, the positive trend in prices of

chemical shares reflects the sharp increase in the prices of the output of the sector throughout the past year and the increase in the dollar value of the sector's exports.

In summary, it can be said that the main factors that negatively affected the local stock market in 2007 were the sub-prime crisis in the US and the turnaround in the path of interest rates from a downward trend in the first half of the year to an upward trend in the second half. These developments created difficulties for the local stock market, just like they did for other stock markets around the world in the second half of 2007. Nevertheless, most stock indices on the local market finished the year with a positive return, which reflects, despite everything that happened, the strength of the local market, supported by positive macro-economic data that continues to be published.

Communication Products Sector - Review of the Third Quarter of 2007

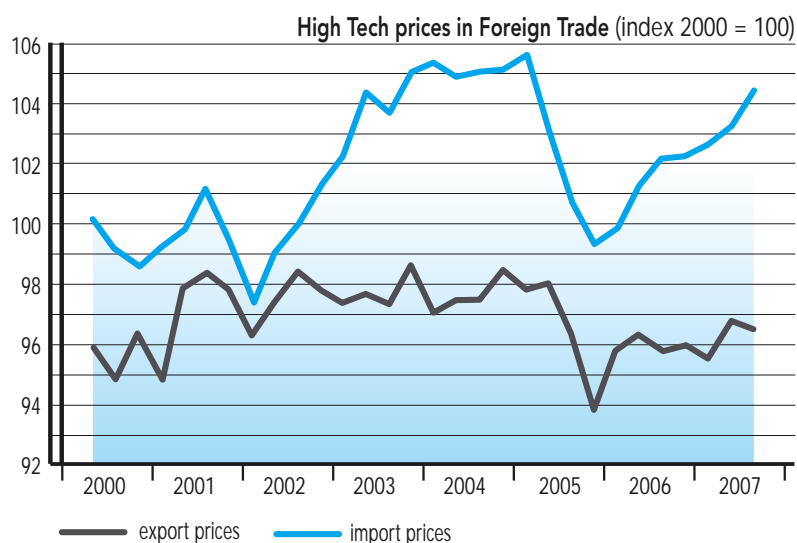
Economic background

The communication equipment sector includes products that are used for internet communication, military communication systems, satellite communication systems, solutions for transporting electricity across data networks, and more. The larger companies within this sector include 'E.C.I. Telecom', 'Gilat Satellite Networks', 'AudioCodes' and 'Alvarion'. The manufacturing activity of a large part of the companies in the sector takes place in Israel as well as overseas. In addition, domestic production is intended for the most part for the export market.

The export of **high-tech equipment**, that is to say communication equipment, industrial equipment for control and supervision, medical equipment, control equipment, measurement and navigation instruments and optical equipment - all together accounted for approximately one-quarter of the total export of goods from Israel in 2006 (excluding polished diamonds). According to our estimates, the export of communication equipment accounts for close to 30% of the total export of high-tech equipment. Similarly, the proportion of communication equipment out of the total output of Israeli high-tech equipment, most of which is intended for export, is approximately 27%. The export of high-tech equipment has been in an upward trend in the last four years, and as a result in the third quarter of 2007 it was 65% higher than its

level registered at the end of 2003 (in US dollar terms, seasonality adjusted data). In quantitative terms there has been a similar increase, since the export prices of high technology equipment remained stable from the second half of 2001 through the third quarter of 2005, when prices recorded a moderate gradual decline of approximately 2%. From that period until the last quarter surveyed prices have remained stable.

The sharp increase in the export of Israeli high-tech equipment in recent years is related to the increase in demand for technology in the US, the main target export market for Israeli high-tech. The increase in the demand for technology in the US is expressed by the development of the "Tech Pulse" index, published by the Federal Reserve Bank of New York. Since 2003 this index grew by double-digit annual rates (in real terms), and in the last five years it has more than doubled. In the first 11 months of 2007 this index was 16.5% higher than its level in 2006. The strong correlation between the export of Israeli high-tech equipment and the demand for technology in the US, which contributed to the strength in local high-tech companies in recent years, will likely be an obstacle to Israeli high-tech firms in the near future, due to the expectations for a slowdown in US economic growth. Indeed, the scenario of a 'soft landing' for the American economy is widespread; however, the scenario of a 'hard landing' is gaining momentum, and if this scenario is realized then it is likely to cause significant



Terms of trade have weakened in the High Tech sector. Export prices have been stable while prices of imported inputs increased.

damage to Israeli high-tech companies.

The import of raw materials to the **overall electronics industry** has also been in an upward trend since the second half of 2005, after a year in which it remained stable (in US dollar terms, seasonality adjusted data).

In the third quarter of 2007 imports of inputs to the local high-tech industry were 8.6% higher compared to the same period in the preceding year. In quantitative terms there was a 6.3% increase, since input prices in the sector increased approximately 2.3% during the same period. This quantitative increase in the import of raw materials for the sector indicates the optimism on the part of manufacturers in the sector regarding expected activity in the near future. However, the increase in input prices, alongside stability in the export prices of Israeli high-tech equipment since the beginning of 2006, are factors that will make it difficult for local high-tech companies, including companies in the communication equipment sector, which recorded a gradual decline in their gross profits in 2007.

The foreign trade of the local high-tech sector is affected by manufacturing activity of **the communication equipment sector**. Note that the output and export of the communication equipment sector accounts for approximately 30% of the total output and export of the local high-tech sector. The manufacture of communication equipment registered an upward spike of 35.6% in 2006 (seasonality adjusted data), and as a result, in the last quarter of the same year it was 20% higher than its level registered in the second quarter of 2000, when the "high-tech bubble" was at its peak. Although there was a further expansion of output in the sector in the first 9 months of 2007, output remained stable at the high levels registered in 2006.

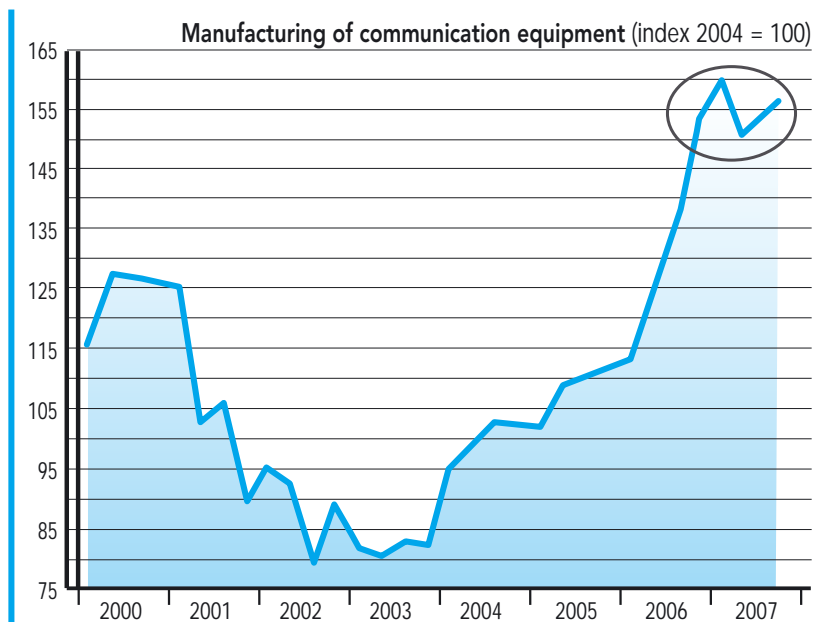
The number of employees in this sector has been increasing since the second half of 2004. This follows the sharp drop recorded during 2000-2003, after the high-tech bubble "burst". The increase in the number of employees over the last two years was slower than the rate of increase of output in the sector. Thus, in the third quarter of 2007 the number of employees in the sector was 4.4% higher compared to the same period in the preceding year, whereas the output of the sector increased by a sharper rate of 14.6%. This development implies an increase in productivity in the sector. Despite this, real wages of those employed in the communication equipment industry were stable from the end of 2003 through the third quarter of 2006. As a result, salary expenditure per unit of production fell during the same period, a development which indicates that companies active in the sector were operating more efficiently. In the final quarter of 2006 the trend changed and real wages of those employed in the sector began to rise. Thus, real wages in the sector were 5% higher in the third quarter of 2007 compared to the same period in the preceding year. As a result, the fall in salary expenditure per unit of production moderated, and in the third quarter of 2007 it was only 1.5% below what it was in the same period of 2006.

Recently there has been a notable trend in which communication equipment companies have been penetrating additional markets, in particular Russia. One example of this is the company "Alvarion", which was chosen by local companies in Nigeria, Taiwan and Russia to upgrade and expand communication systems in each country. "Gilat Satellite Networks" has deepened its market presence in Russia, and so has "Ceragon", the solutions of which were

chosen by a Russian telecom company for use in its communication network.

In summary, the data portray mixed signals. In addition, the sector is burdened by expectations for a moderation in the US economy, the main target market for Israeli high-tech exports.

The analysis presented below, that focuses on the financial results of public companies active in the sector, also shows dissimilar trends in the development of the financial ratios used to analyze the sector. We note that the financial results also include the activities of Israeli public companies overseas, which account for a wide portion of activity in the communication equipment sector, while the macro data presented include only the activity of the sector in Israel.



The expansion of the communication equipment manufacturing since the beginning of 2004 stopped in the first three quarters of 2007 but remained at a higher level than it was when the "high tech bubble" was at its peak.

Profitability

The operational profitability of the sector is in a downward trend, and in the last four quarters of the surveyed period the sector showed an operating loss. This is due to a gradual decline in the gross profitability of the sector alongside an increase in operating and R&D expenditures in the first three quarters of 2007 compared to the same period in the preceding year. Also, return-on-equity (ROE) in the sector indicates a low level of profitability.

Gross margins in the sector stood at 39.6% in the third quarter of 2007, a high rate compared to the average in other industrial sectors. However, gross profits in the sector showed a gradual decline from around 41% of total sales in the first three quarters of 2006 to approximately 39-40% in the first three quarters of 2007. It appears as though this is related to, among other things, stability

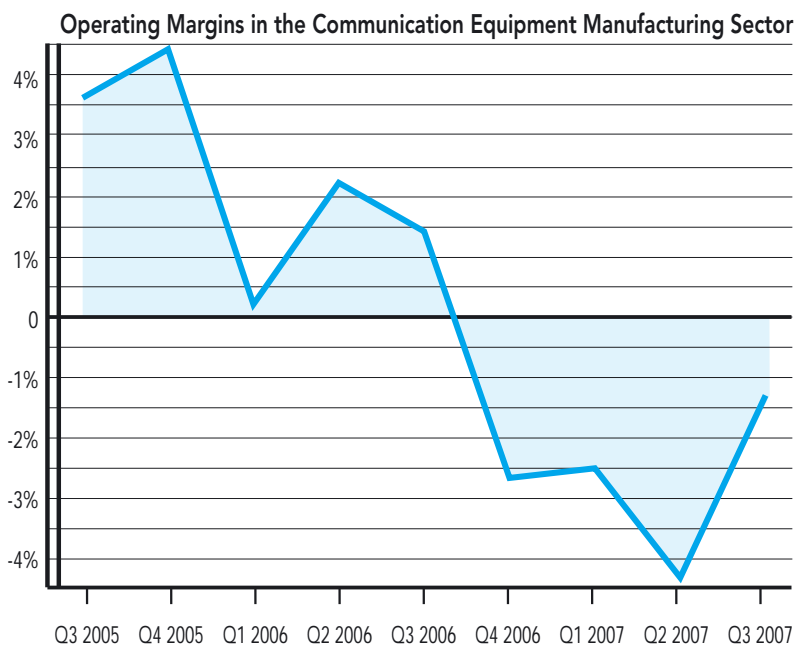
in the export prices of the sector while at the same time input prices increased since the beginning of 2006.

Despite the high level of gross profitability that characterizes the sector, the sector has registered an operating loss since the last quarter of 2006. In the third quarter of 2007 the operating loss stood at 1.3% of revenues; this is compared to an operating profit of 1.4% of total sales in the third quarter of 2006. The transformation from operating profit to loss, that occurred in the fourth quarter of 2006, stems primarily from the gradual decline registered in the gross profitability of the sector. In the second quarter of 2007 the operating loss of the sector reached a two-year high of 4.3% of sales. It is still too early to determine if the improvement in operating profitability of the sector in the last quarter of the surveyed period denotes a change in the trend, or if it is merely temporary upward volatility.

The significant difference between the high level of gross profitability of the sector and its low operating profitability is attributed to the high level of operating and R&D expenditures associated with the sector.

The ratio of operating expenses as a percentage of sales of the sector stood in the first three quarters of 2007 at 27.4% on average per quarter, compared to a rate of 26.4% on average per quarter in the parallel period in 2006. This increase in operating expenditures as a percentage of total sales contributed to the gradual decline registered in the operating profitability of the sector in 2007 versus 2006.

The communication equipment sector is characterized by relatively high research and development (R&D) costs. In the third quarter of 2007 these amounted to



The operating profit of the sector has been on a downward trend over the last two years, and in the fourth quarter of 2006 it transformed into loss. This is primarily due to the gradual decline registered in the gross profitability of the sector during the same period.

approximately 14.0% of total sales. Similar to the development of operating expenses in the sector, R&D expenditures also registered a gradual increase of approximately 1% in the first three quarters of 2007 compared to the same period in the preceding year. This development indeed damages the operating profitability of the sector in the short-term; but such expenditures should benefit the sector in the future, in light of the rapid technological advancements that characterize communication equipment. Therefore, it is advisable that the manufacturers in the sector will work to improve their profitability by increasing their gross profitability and by reducing operating expenses, and not by cutting back on R&D expenditures.

In spite of the negative trends in the gross and operating profitability of the sector, the ROE in the sector has been in a general upward trend since the beginning of 2006. This is primarily due to two quarters in which significant sums were recorded in the "other income / expenses" line of the sector's aggregate profit and loss (P&L). Excluding this single component of the P&L, the ROE of the sector was volatile, and in the third quarter of 2007 stood at 0.5%, a low level compared to the average of the other industrial sectors. This compared to 2.5% in the same quarter of the preceding year, and minus 2.6% in the preceding quarter. These data indicate that during most of the surveyed period the ROE was higher than the operating profitability of the sector. This is a result of relatively high financial income earned in the sector. We will further expand on this below.

Liquidity

The communication equipment sector is characterized by a high level of liquidity, which improved during the covered period.

The current ratio of the sector in the third quarter of 2007 stood at 2.67, a figure that reflects a high level of liquidity. Compared to the third quarter of 2006, the more recent figure represents an improvement from 2.31, which is also considered high.

The acid test of the sector stood at 2.23 in the third quarter of 2007, representing an increase of 0.33 compared to the same quarter in the preceding year. The sector's quick ratio also reflects a high level of liquidity.

Financial stability

All the parameters that measure the financial stability of the sector indicate a high level, which strengthened during the covered period.

The proportion of shareholders' equity out of total assets of the sector in the third quarter of 2007 was 58.8%, a high level that reflects a high degree of financial stability. Compared to the third quarter of 2006, the more recent figure reflects an increase of five percentage points. This development indicates an improvement in financial stability.

The narrowing of the financial leverage in the sector stems primarily from a decline in short-term liabilities. Thus, in the third quarter of 2007 the proportion of short-term liabilities out of the total aggregate balance sheet of the sector was 24.1%, compared to 27.7% in the third quarter of 2006. In contrast, the proportion of long-term liabilities out of the total aggregate balance sheet stood in the last quarter of the surveyed period at 5.6%, reflecting a decline

of only 0.7 percentage points compared to the same period in the preceding year. This development indicates a strengthening of the financial stability of the sector in the third quarter of 2007 compared to the same period of 2006, as the short-term liabilities of the sector are generally more expensive and more risky than the long-term liabilities, since they must be redeemed in the coming year.

Developments in the financial burden show an improvement in the financial stability of communication equipment companies, and a high level. Throughout the entire surveyed period the sector registered financial income. In the third quarter of 2007 financial income in the sector amounted to 1.8% of sales, a figure that reflects a high level of financial stability. Compared to the third quarter of 2006, the most recent figure represents a slight increase of 0.2 percentage points; however, a longer term look backwards, of two years, shows a sharp increase in financial income in the sector from a level of around 0.3%-0.4% in the second half of 2005 to approximately 1.8% in the first three quarters of 2007.

Summary

The available data hint that the sector is at a turning point. The macro-economic data show that the expansion in the output of the sector has stopped at a higher level than what it was at 2000, when the "high-tech bubble" was at its peak; the productivity in the sector has increased, but also employee salaries in the sector are starting to increase after years of decline. Looking forward, the expected moderation in the US economy, the main export market of the sector, is likely to make things difficult for the sector, as

most of its output is intended for the export market. However, the trend in which companies in the sector are penetrating additional markets around the world is likely to slightly moderate the negative impact of the expected slowdown in the US market.

The sector has been dealing with rising input prices since the beginning of 2006, while sales prices of its output have remained stable. These developments are reflected in a downward slide in the sector's gross profitability in the first three quarters of 2007, compared to the same period in 2006. In addition, the sector has recorded an increase in operating and R&D costs, which has led to a decline in operating profitability. The level of profitability of the sector presented by the operating profit margins and ROEs is low compared to other sectors.

On the other hand, the level of liquidity in the sector is high compared to other sectors, and it continued to increase during the surveyed period. The sector is also characterized by a high level of financial stability, which strengthened during the surveyed quarters. This is reflected in the decline in financial leverage seen in the sector, which was accomplished through a decline in short-term liabilities. Also the increase in financial income indicates an improvement in financial stability in the sector and indicates its high level.

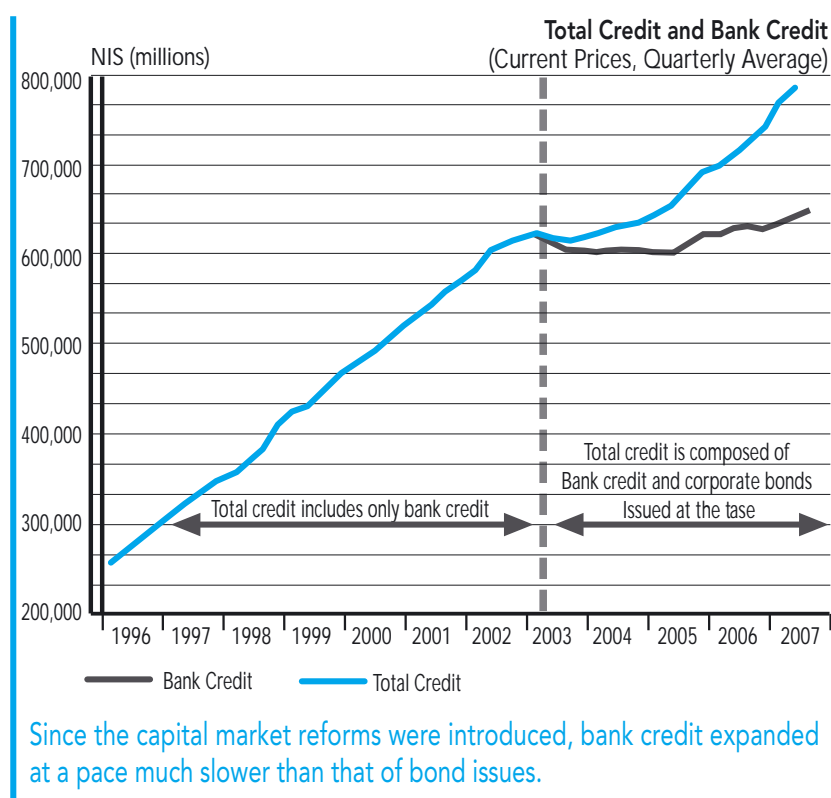
Looking forward, we estimate that the risk associated with this sector will increase due to, among other things, the expected moderation in economic activity in the US. Macro-economic data and the financial parameters used in analyzing profitability of the sector already indicate such a change in the trend.

The Impact of Capital Market Reforms on Credit in the Economy

A series of reforms that were implemented in the Israeli capital market¹ in recent years have led to a structural change in the credit market. In addition to bank credit, the business sector is now able to raise financing through issuance of corporate bonds thus substituting bank credit. This article will evaluate the impact of the recent reforms on the development of total credit in the economy (bank and non-bank), as well as the degree of linkage between the development of total credit and business turnover in the economy.

The demand for credit stems from a wide variety of sources. Credit for households is, among other things, affected by growth in the population as well as average salary levels, while credit to the businesses sector is affected by current and future business activity as reflected by the level of investment in the economy. In order to get an overall picture of the total amounts of credit in the economy we gathered data on bank credit granted in the economy that is published by the monetary department of the Bank of Israel (BoI), and data on corporate bond issues on the local bond market, which could be viewed as a substitute to bank credit.

The accompanying chart portrays the



¹ These reforms include the Pension Reform [2004], the Bachar Committee Reforms for increasing competition in the capital market [2005], and the Control of Financial Services (Provident Funds) Law [2005].

development of bank credit and total credit in the economy during the period 1996-2007. Data in the chart are split into two periods: the period preceding the implementation of capital market reforms (1996-2002), and the period after the reforms were introduced (2003-2007). We composed the estimate of total credit in the economy in the period following the introduction of reforms by adding the sum of corporate bond issues on the bond market to the total of bank credit.

The chart on page 20 shows that total bank credit remained almost completely unchanged in the years following the introduction of capital market reforms. However, non-bank credit expanded strongly. From a macro-economic viewpoint, it appears as though the development of a corporate bonds market, in combination with an expansion in business activity in the economy and low levels of government capital raising, all led to a sharp rise in total credit granted in the economy.

Needless to say, the entire picture is more complex, being influenced as well by a series of changes that occurred at the microeconomic level. For example, the groups of large borrowers for whom the Supervisor of Banks limited the volume of bank credit granted, applied for credit outside of the banking system by means of issuing bonds on the capital market. Despite this, the actual development of total credit indicates a strengthening of the correlation between changes in business activity and the rate of increase of total credit in the economy. Our findings show that the impact of business turnover on the amount of credit in the economy has increased. The rate of increase of credit from the year 2003 onwards has been greater than the rate of GDP

growth. This phenomenon, in which the supply of credit to the public has expanded, testifies to the competition that was created among the bodies that grant credit to the public: banks, institutional bodies, and mutual funds.

If we take a look at the composition of bond issues on the stock market, we discover that the mix of bonds issued through 2004 was different than the bond mix issued in the years following. In the period 2002-2003, the clear majority of bonds issued on the Tel-Aviv Stock Exchange (TASE) were of investment grade quality or better (a rating of 'A' or better). Beginning in 2004, the proportion of bonds with low credit ratings of 'A-' or lower, or bonds not rated at all (hereinafter, 'speculative bonds') out of total tradable bonds continuously increased. In the first half of 2007, the proportion of speculative bonds accounted for approximately 34% of total issues of tradable bonds.

There are a number of explanations for this phenomenon. Before the credit market went through its structural changes, the supply of bank credit and credit margins were a result of equilibrium in a market characterized by few competitors. The reforms introduced new players to the supply side and thus increased the level of competition between credit grantors. This competition cannot be defined as perfect competition because the players do not compete on equal terms. Whereas the banks benefit from information they have accumulated over the years on those requesting credit and on the means of pricing credit risks, non-bank grantors of credit do not benefit from similar information. Alternatively, the banks are subject to strict supervision over their activities, while the mechanisms for supervising non-bank credit

have still not been fully determined. This combination of circumstances has allowed the expansion of loans granted by non-banking entities; and in retrospect it appears as though at the same time the quality of the credit portfolio within the banking system has improved.

Looking at total credit in the economy from 2002 onwards, it appears as though, as already mentioned, that total bank credit did not increase significantly. However, the quality of the bank credit portfolio improved.

The main explanation for the improvement in the quality of the credit portfolio and the decline in the amount of problem debt is the improvement in the performance of the

economy following the economic slump during 2001-2002. The exit from the slowdown led to an increase in the ability of borrowers to maintenance their debt. Therefore, some of the loans categorized during the years of economic slowdown as problematic debt because the borrowers had trouble making payments, are now fully functioning loans with payments being made on the principle and the interest. In addition, in light of the increase in the number of speculative bond issues, against the moderate increase in total bank credit, we therefore conjecture that credit risk was partially transferred from the banks to purchasers of bonds with low credit ratings.

Bank Leumi le-Israel B.M. and subsidiaries

Condensed Consolidated Balance Sheet as at 30 September 2007 (NIS millions)

Reported amounts

	30.9.2007 (Unaudited)	30.9.2006 (Unaudited)	31.12.2006 (Audited)
ASSETS			
Cash and deposits with banks	45,661	39,651	47,609
Securities	46,355	45,869	46,375
Securities borrowed or purchased under agreement to resell	246	—	—
Credit to the public	196,327	180,448(A)	183,800
Credit to governments	701	905	1,020
Investments in companies included on the equity basis	1,855	1,237	1,251
Buildings and equipment	3,226	3,020	3,056
Other assets	7,636	6,276(A)	6,230
Total assets	302,007	277,406	289,341

(A) Restated.

Condensed Consolidated Statement of Profit and Loss for the Periods Ended 30 September 2007 (NIS millions)

Reported amounts

	For the Three Months Ended 30 September		For the Nine Months Ended 30 September		For the Year Ended 31 December
	2007 (Unaudited)	2006 (Unaudited)	2007 (Unaudited)	2006 (Unaudited)	2006 (Audited)
Net interest income before provision for doubtful debts	2,265	1,718	5,867	5,159	6,922
Provision for doubtful debts	79	282	128	668	933
Net interest income after provision for doubtful debts	2,186	1,436	5,739	4,491	5,989
Operating and other income					
Operating commissions	834	736	2,487	2,219 (A)	3,013 (A)
Profits from investments in shares, net	9	14	234	100	128
Other income	66	188	309	579	740
Total operating and other income	909	938	3,030	2,898	3,881
Operating and other expenses					
Salaries and related expenses	1,104	1,129	3,135	3,570	4,552
Building and equipment maintenance and depreciation	313	298	907	872 (A)	1,201 (A)
Other expenses	368	358	1,031	1,049 (A)	1,514 (A)
Total operating and other expenses	1,785	1,785	5,073	5,491	7,267
Operating profit before taxes	1,310	589	3,696	1,898	2,603
Provision for taxes on operating profit	471	343	1,367	981	1,320
Operating profit after taxes	839	246	2,329	917	1,283
Equity in after-tax operating profit of companies included on equity basis	62	45	146	143	171
Minority interest in after-tax operating losses (profits) of subsidiaries	—	5	(3)	3	—
Net operating profit	901	296	2,472	1,063	1,454
After-tax profit from extraordinary items	109	674	368	1,397	2,080
Net profit for the period	1,010	970	2,840	2,460	3,534

Basic earnings per share

(NIS)

Net operating profit	0.64	0.21	1.75	0.75	1.03
After-tax profit from extraordinary items	0.08	0.48	0.26	0.99	1.47
Total	0.72	0.69	2.01	1.74	2.50

Diluted earnings per share

(NIS)

Net operating profit	0.62	0.21	1.73	0.75	1.03
After-tax profit from extraordinary items	0.08	0.48	0.26	0.99	1.47
Total	0.70	0.69	1.99	1.74	2.50

(A) Reclassified.

Eitan Raff
Chairman of the
Board of Directors

Galia Maor
President and
Chief Executive Officer

Zeev Nahari
Senior Deputy Chief
Executive Officer
Head of Finance and
Economics Division

The complete quarterly report for the periods ended 30 September 2007 including condensed financial statements, directors' report and management review is available for public inspection at all branches of the Bank. A copy of the said report will be provided on request. The representative exchange rate against the dollar on 30 September 2007, according to which the financial statements have been prepared, was NIS 4.013.

(A) The retained earnings at the end of the period include:

- Adjustments from translation of the financial statements of autonomous foreign subsidiaries, amounting to NIS (408) millions (30 September 2006 - NIS (377) millions, 31 December 2006 - NIS (403) millions).
- Adjustments in respect of presentation of securities available for sale at fair value in a net amount of NIS 616 millions (30 September 2006 - NIS 275 millions, 31 December 2006 - NIS 623 millions).

(B) Reclassified.

LIABILITIES AND EQUITY CAPITAL	30.9.2007 (Unaudited)	30.9.2006 (Unaudited)	31.12.2006 (Audited)
Deposits of the public	236,929	221,996	231,823
Deposits from banks	10,197	5,453	5,241
Deposits from governments	1,632	2,239	2,146
Securities loaned or sold under agreement to repurchase	185	—	—
Debentures, bonds and subordinated notes	16,872	16,050	15,622
Other liabilities	15,540	12,997(A)	16,866
Total liabilities	281,355	258,735	271,698
Minority interest	121	150	152
Shareholders' equity	20,531	18,521	17,491
Total liabilities and equity capital	302,007	277,406	289,341

**Condensed Consolidated Statement of Changes in Shareholders' Equity
for the Periods Ended 30 September 2007 (NIS millions)**

Reported amounts

For the Three Months Ended 30 September (Unaudited)

	2007			2006		
	Capital and capital reserves	Retained earnings	Total Shareholders' equity	Capital and capital reserves	Retained earnings	Total Shareholders' equity
Balance at the beginning of the period	7,493	12,155	19,648	7,262	10,089	17,351
Net profit for the period	—	1,010	1,010	—	970	970
Benefit in respect of shares based payment transactions	55	—	55	76(B)	—(B)	76
Adjustments in respect of presentation of securities available for sale at fair value	—	(327)	(327)	—	251	251
Related tax effect	—	125	125	—	(91)	(91)
Translation adjustments for companies included on equity basis	—	23	23	—	(36)	(36)
Loans to employees for purchase of the Bank's shares	—	(3)	(3)	—	—	—
Balance at the end of the period	<u>7,548</u>	<u>12,983(A)</u>	<u>20,531</u>	<u>7,338</u>	<u>11,183(A)</u>	<u>18,521</u>

For the Nine Months Ended 30 September (Unaudited)

	2007			2006		
	Capital and capital reserves	Retained earnings	Total Shareholders' equity	Capital and capital reserves	Retained earnings	Total Shareholders' equity
Balance at the beginning of the period	7,405	10,086	17,491	7,010	8,990	16,000
Net profit for the period	—	2,840	2,840	—	2,460	2,460
Benefit in respect of shares based payment transactions	143	—	143	328(B)	—(B)	328
Adjustments in respect of presentation of securities available for sale at fair value	—	(16)	(16)	—	362	362
Related tax effect	—	9	9	—	(133)	(133)
Translation adjustments for companies included on equity basis	—	(5)	(5)	—	(35)	(35)
Loans to employees for purchase of the Bank's shares	—	69	69	—	(461)	(461)
Balance at the end of the period	<u>7,548</u>	<u>12,983(A)</u>	<u>20,531</u>	<u>7,338</u>	<u>11,183(A)</u>	<u>18,521</u>

For the Year Ended 31 December 2006 (Audited)

	Capital and capital reserves	Retained earnings	Total Shareholders' equity
Balance as at 1 January 2006	7,010	8,990	16,000
Net profit for the year	—	3,534	3,534
Proposed dividend	—	(2,500)	(2,500)
Benefit in respect of shares based payment transactions	395	—	395
Adjustments in respect of presentation of securities available for sale at fair value	—	876	876
Related tax effect	—	(299)	(299)
Translation adjustments for companies included on equity basis	—	(61)	(61)
Loans to employees for purchase of the Bank's shares	—	(454)	(454)
Balance as at 31 December 2006	<u>7,405</u>	<u>10,086(A)</u>	<u>17,491</u>

28 November 2007

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