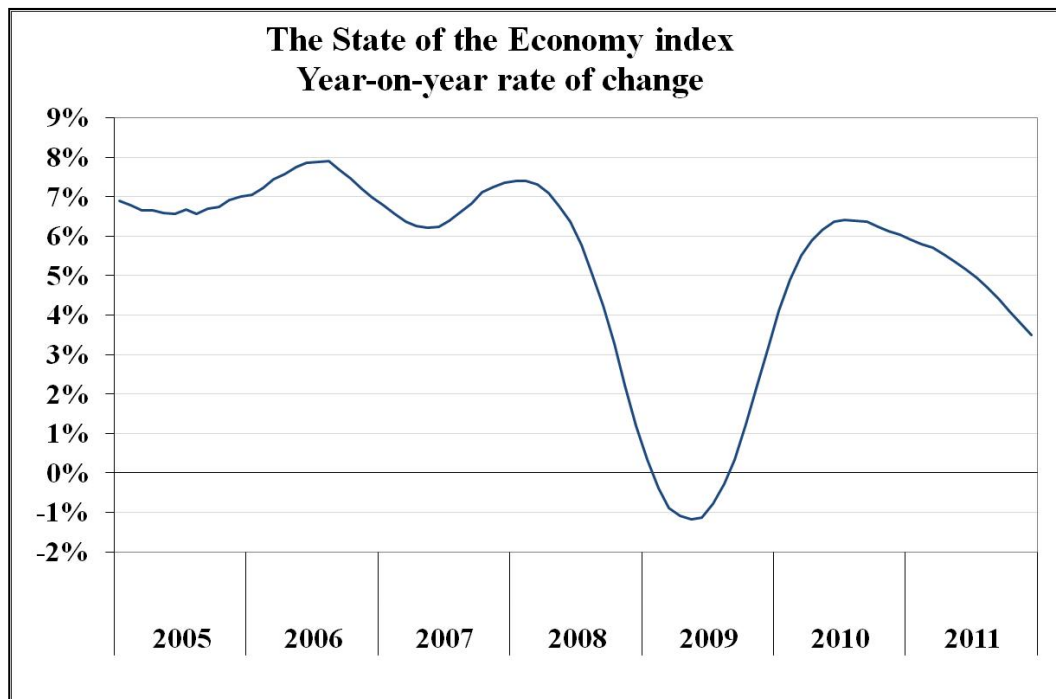


Leumi Economic Weekly

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The slowing trend in the rate of increase in the composite state-of-the-economy index is continuing

The composite state-of-the-economy index increased 0.2% m/m in December 2011, while the increase over the past year totaled 3.5%. As can be seen in the accompanying diagram, the rate of increase in this index since the end of 2010 has been in a downward trend, which has intensified recently. This testifies to the continuing slowdown in economic activity in Israel. This slowdown has still not been reflected in the unemployment rate in the economy, as the unemployment rate continues to be low, equaling a stable rate of 5.4% in recent months according to updated estimates by the Central Bureau of Statistics (CBS).



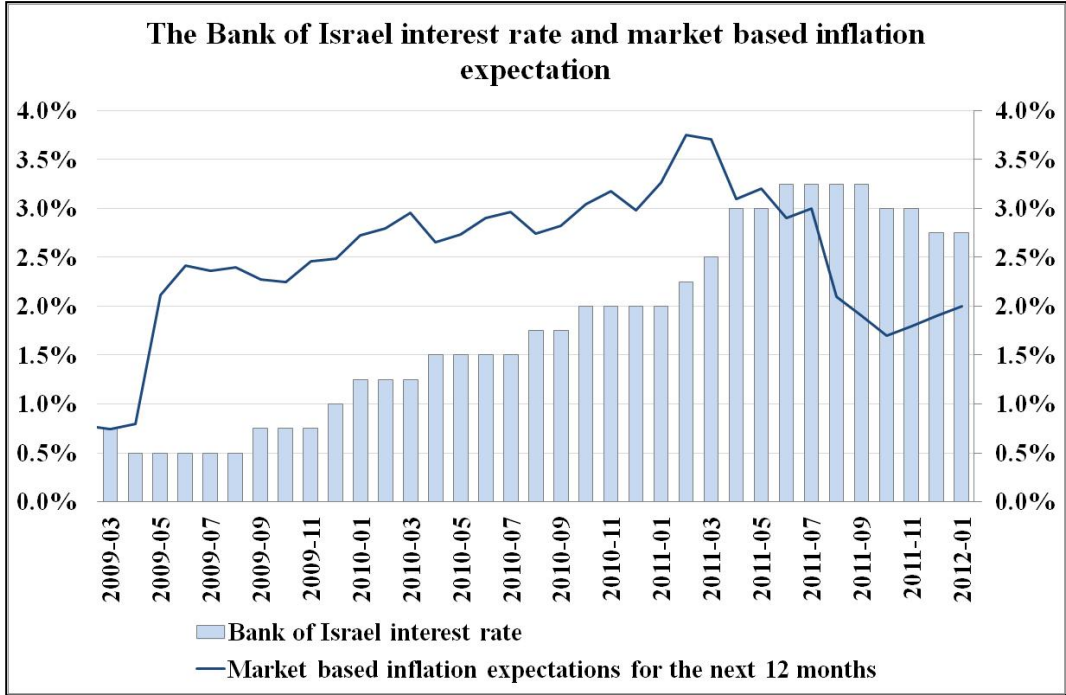
Against the backdrop of the slowdown in economic growth, there is a notable weakness in Israeli export, which has been hurt by the situation in the global economy, particularly in Europe. On this regard, it is worthwhile to note the downward revision the International Monetary Fund (IMF) made to its forecasts on January 24.

According to the new forecasts, the euro region economy is expected to shrink 0.5% in 2012, following positive growth of 1.6% in 2011. This is a downward revision compared to the previous forecast of 1.6 percentage points. However, according to this forecasts, Germany and France are expected to continue to grow, albeit by a negligible rate, which is significantly

lower than their growths in 2011. Regarding the American economy, the IMF expects a growth rate of 1.8%, similar to the growth in 2011. These updated forecasts do not do anything to change our forecasts regarding growth in Israel, and we still expect 2.7% GDP growth in 2012.

The interest rate of the Bank of Israel is cut to 2.5%

On January 23 the Bank of Israel (BoI) announced a 25bps cut to its interest rate for February, bringing it to 2.5%. The inflation data facing the decision makers indicate a rate of increase in prices that is within the price stability target range of 1% - 3%. Inflation expectations and various forecasts are also within the price stability target range, and as can be learned from the accompanying graph, the real expected interest rate (the difference between the nominal rate and inflation expectations) is at a positive level of less than one percent and reflects expansionary monetary policy. This is because under “regular” economic conditions (stable growth and in line with the potential, etc.) the real interest rate is expected to be 2% - 3%. Incidentally, the expected real interest rate in the US is negative, at a level of 2% - 3%.



The policy of cutting interest rates being implemented by the BoI stems primarily from the slowdown in economic activity in Israel. In addition to the data on the composite state-of-the-economy index and the situation around the world, both of which we detailed above, the BoI also noted the companies survey for the fourth quarter of 2011, which is published by the central bank but still has not yet been released, according to which the responses of companies indicate that business activity continued to moderate in the last quarter of 2011.

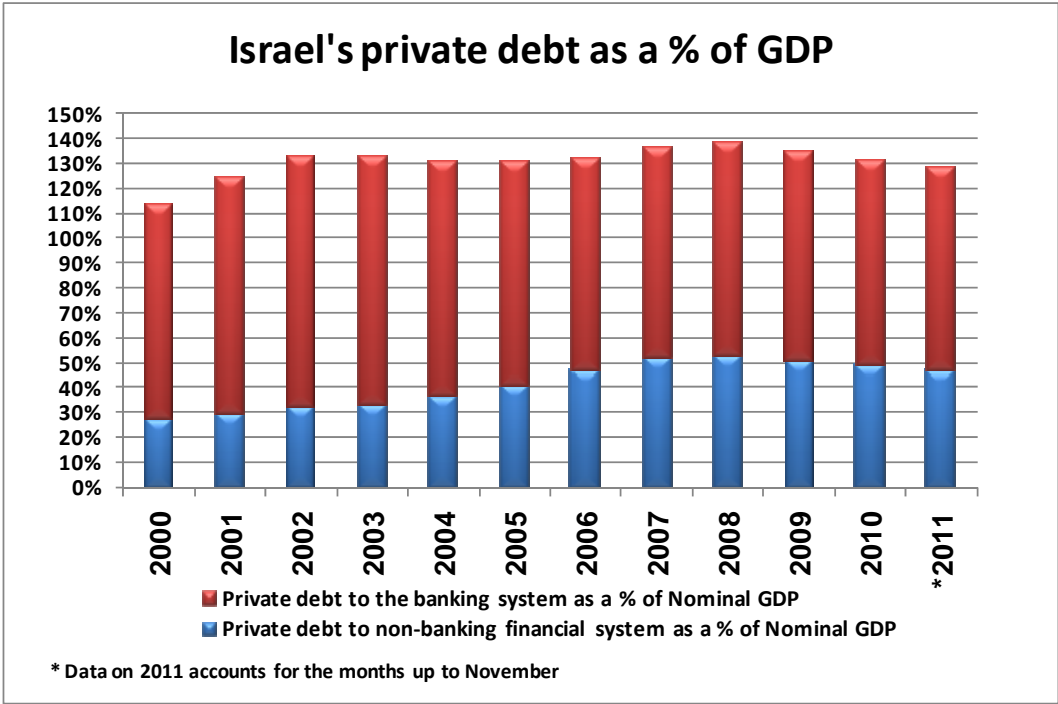
Also noted in the interest rate announcement was the low level of interest rates overseas and the fact that the markets are not pricing in an interest rate hike by any of the central banks in the large developed countries. Retrospectively, the announcement by the US central bank on January 25 declaring the US interest rate will remain at its near-zero level at least until the end of 2014 (representing a delay compared to the previous target date which was at least until mid-2013) was also a supporting factor in the interest rate decision that was accepted.

Looking forward, it appears the interest rate in Israel will continue to decline slightly in the near-term, this in the absence of any extraordinary events and/or new negative information on the state of the Israeli economy and around the world.

Debt (bank and non-bank) as a percentage GDP in the Israeli economy is in a downward trend, and is low in an international comparison

Data on debt (bank and non-bank) in the Israeli economy for the month of November 2011 were published this week. From the data it arises that between February and November 2011¹ overall bank credit in the economy expanded 5.0%. It arises from the data that among households, credit for housing increased 10.8%, and this is despite steps implemented by the BoI to limit the rise in mortgages in the economy.

It also arises from the data that non-housing credit to households increased 7.1% from the beginning of 2011. Regarding the business sector, in February - November 2011 the balance of bank debt increased 1.5%; while the balance of non-bank debt (excluding banks and insurance companies) increased 2.8%.



Looking back historically, when we analyze the level of leverage of the Israeli economy (according to the index of the ratio of debt/GDP) in the past decade, a very encouraging picture arises, in particular when analyzing the level of private debt in the economy, which includes the debt of households and the business sector. Whereas the past decade was characterized by a substantial increase in the level of leverage of the private sector in many economies around the world, Israel was notable for its stability.

¹ Last July there was a revised update of the debt data for 2011 as a result of new orders by the Supervisor of Banks regarding provisions for credit losses. Data on the debt of the business sector to banks fell substantially as a result of the erasure of defective debt according to the new regulation. In addition, also credit to the public (non-housing) was revised downwards for 2011, albeit by lower rates. Therefore, the report on the rates of change from the beginning of the year (end of December 2010) is a biased report, and therefore the report of the balance of debt in this document relates to the end of January 2011 instead of the end of December 2010.

As evidence, in 2011, according to IMF data, the estimate of the rate of average private debt in relation to GDP in the euro zone stands at 208%, in the US at 182%, in Japan at 220%, in Britain at 219%, while in Ireland and Spain, which are countries in crisis, the estimate of private debt is notable at 368% and 279%, respectively. In contrast, the estimate of private debt of Israel in 2011 stands at only 128% of GDP², a rate that is substantially below the level of leverage that exists today around the world.

When analyzing the development of the debt in the Israeli economy over the past decade (see diagram), it can be seen that starting from 2002 the level of private debt in the economy has consistently been between 130% - 140% of GDP, while significant change has occurred in the composition of the debt over the years. As a result of structural changes in the financial markets, including the Bachar Committee reforms, it can be seen that the level of bank debt out of total debt has been in a downward trend, while on the other hand the level of non-bank debt has been in an upward trend.

The important point is that the Israeli economy has succeeded to achieve a high level of economic growth over the years without an increase in the overall leverage, but instead only through a change in the composition of the debt, this in contrast to the growth engines that characterized other economies around the world in recent years. We also note that starting in 2008, the year of the global financial crisis, the level of leverage of the economy has been in a downward trend, from 139% of GDP down to 128% in 2011, as mentioned. The decline in the level of debt relative to GDP means that in the above-mentioned period the rate of increase in the level of debt was more moderate than the rate of increase in the nominal GDP of the economy (which over time is supposed to be a source for the return of the debt that was taken).

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² The estimate of annual debt is based on the average of monthly data (data from the end of the period, nominal) that are published by the BoI. The GDP data – the annual nominal gross domestic product.