

# Leumi Review

Issue No. 159 | August 2011

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# Leumi Review

## Israel: Macroperspectives

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# Economic Activity in the First Half of 2011

## The Bank of Israel's interest rate remains unchanged for August

On July 25 2011, the Bank of Israel (BoI) announced that the interest rate for August-2011 would remain unchanged at 3.25%. Several factors were behind this decision:

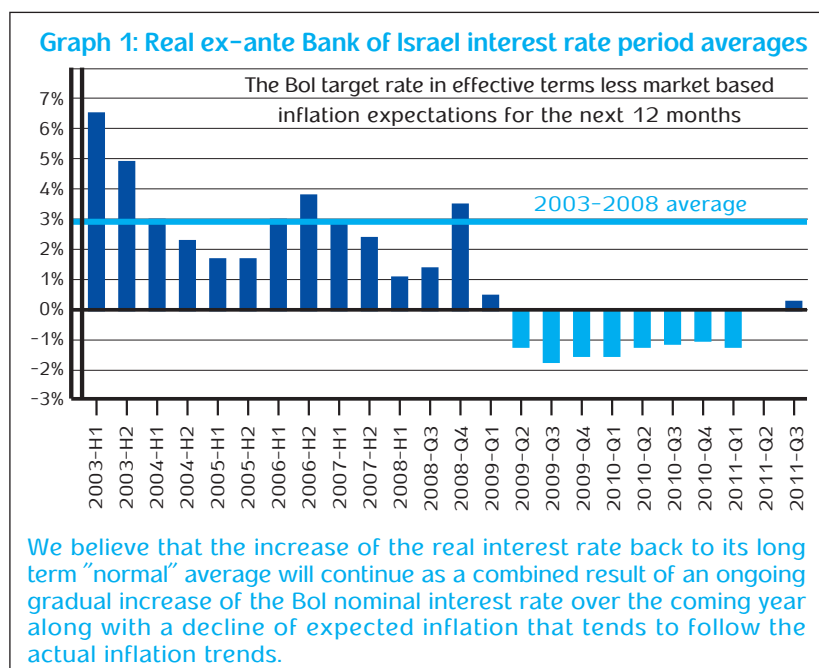
1. The year-on-year rate of inflation of 4.2% was high, although during the past four months was in accordance with the price stability target range on a seasonally adjusted basis.
2. The signs of a slowdown in economic growth in the second quarter of 2011 following export weakness.
3. Housing prices are expected to react to the BoI and Ministry of

Finance's (MoF) policy steps and to contribute to a de-acceleration of inflation over the coming year.

4. And as mentioned in the BoI's press release interest rates of large central banks are expected to remain low for a prolonged period following the weak economic growth outlook and the increase of global uncertainty.

These factors, along with the increase of the Israeli interest rate in the first half of 2011, led the BoI to decide not to change the interest rate for August 2011.

When assessing the level of the real interest rate (the gap between the BoI's effective interest rate and market based inflation expectations for the next 12 months - see Graph 1), the data shows that the real rate is now positive after a long period of negative rates. Nonetheless, the current real interest rate is still quite accommodative. We believe that the increase of the real interest rate back to its long term "normal" average will continue as a combined result of an ongoing gradual increase of the BoI nominal interest rate over the coming year along with a decline of expected inflation that tends to follow the actual inflation trends.



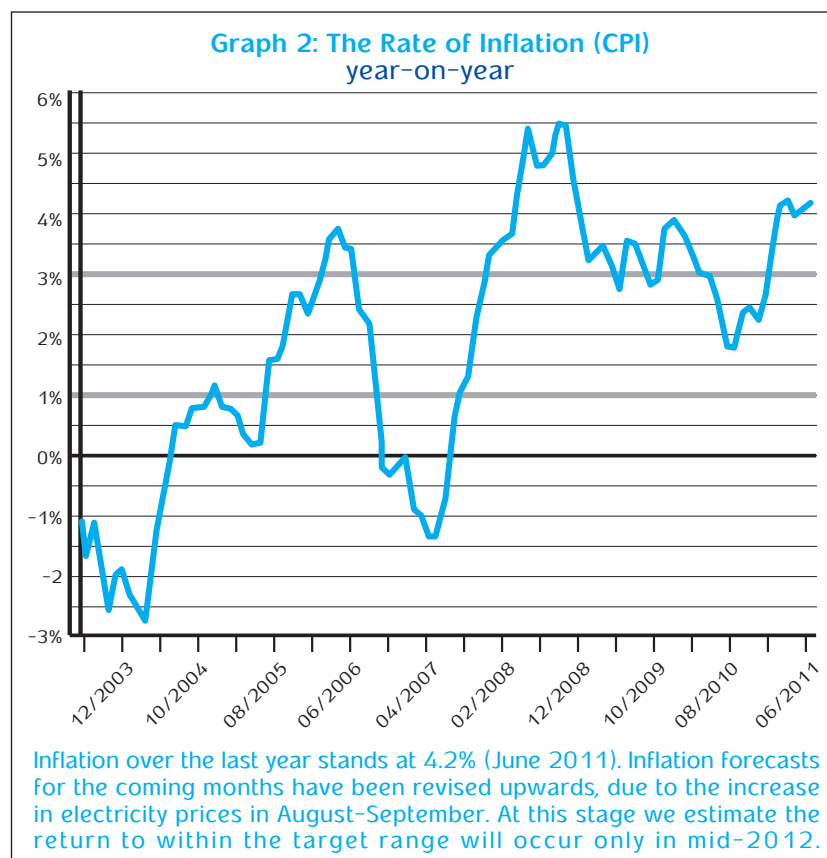
## June's consumer price index increased 0.4% M/M; inflation over the last year stands at 4.2%

The consumer price index (CPI) increased 0.4% m/m in June. The index has increased 2.2% since the start of the year. The main components contributing to the increase in June's CPI include clothing and shoes (8.6%), food excluding fruits and vegetables (0.8%), and housing (0.5%). The clothing and shoes component, which accounts for 3.5% of the general index, contributed 0.3 percentage points to the increase in the overall index. Its increase stems from "regular" seasonality, and also as a result of a technical upward correction in the component, carried out by the Central Bureau of Statistics (CBS) every June (and December). We note that in the upcoming three months a decline in the prices of clothing and shoes is expected, also in accordance with regular seasonality; therefore, this component is expected to moderate the increase in the overall index in the coming quarter.

The food component excluding fruits and vegetables, which has a 13.8% weighting in the overall index, contributed one-third of the increase in the general index since the beginning of the year. In June there was a notable rise in the milk products component, which recently stirred complaints among the public. In light of the continued rise in commodities prices around the world, we estimate this component

will continue to contribute to the rise in the general index also in the coming months. The housing component has increased at an annualized rate of 7% since the beginning of the year, while the rise in the demand for rental apartments has contributed to this trend. In this regard we note that according to 2008 census data the rate of home ownership in Israel fell to 66% from a level of 73% in 1995. According to this census, during this period approximately 270,000 households were added to the rental market.

As can be seen in Graph 2, inflation over the last year stands at 4.2%. Inflation forecasts for the coming months have been revised upwards, due to the electricity prices increase in August–September. According to an announcement from the Electricity

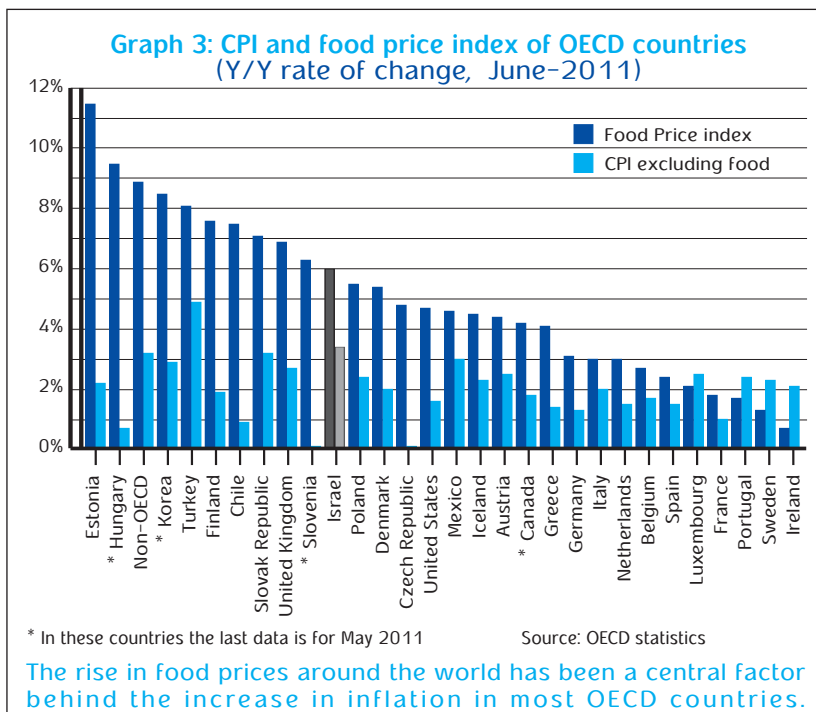


Authority, the electricity prices will increase by a rate of 9% which will contribute a 0.2 percentage point to the increase in the CPI. Furthermore, recently an increase in prices of additional types of energy products has occurred, and this is expected to lead to a rise in the CPI as well. Regarding August, the energy price in Israel won't rise, due to a tax reduction which the government decided on. In light of all this, the return of inflation to within the price stability target range (1-3%) is expected to take longer. At this stage we estimate the return to within the target range will occur only in mid-2012, while at the same time the Bank of Israel (BoI) will continue to gradually raise interest rates.

## The CPI - an international comparison

The rise in food prices around the world has been a central factor behind the increase in inflation in most OECD countries. This situation is portrayed in Graph 3, which presents the absolute contribution of the rise in food prices<sup>1</sup> over the trailing 12-month period to inflation, alongside the absolute contribution of all the other components of the index excluding food (it must be taken into consideration that the weighting of the food component in each country changes, and accordingly also its relative contribution to the rise in the index in each country).

Many OECD countries, in which there occurred a rise in inflation, caused by the rise in food prices, are still dealing with the effects of the global crisis and in particular with the effects of the deterioration in the debt crisis in Europe. The combination of the rise in inflation together with a weakening in the real economy presents the central banks of these countries with a significant challenge. On the one hand, a hike in the interest rate will make it difficult for the economy to return to normal activity while, on the other hand, keeping interest rates unchanged causes a rise in inflation expectations, and this situation represents fertile ground for a continuation of actual inflation. Also facing this dilemma is the European Central Bank (ECB), which



<sup>1</sup> Excluding fruits and vegetables.

decided at the beginning of July to hike its interest rate 25bps, to 1.5%. As already known, the ECB is currently facing a difficult problem due to the high economic disparity between the countries within the union.

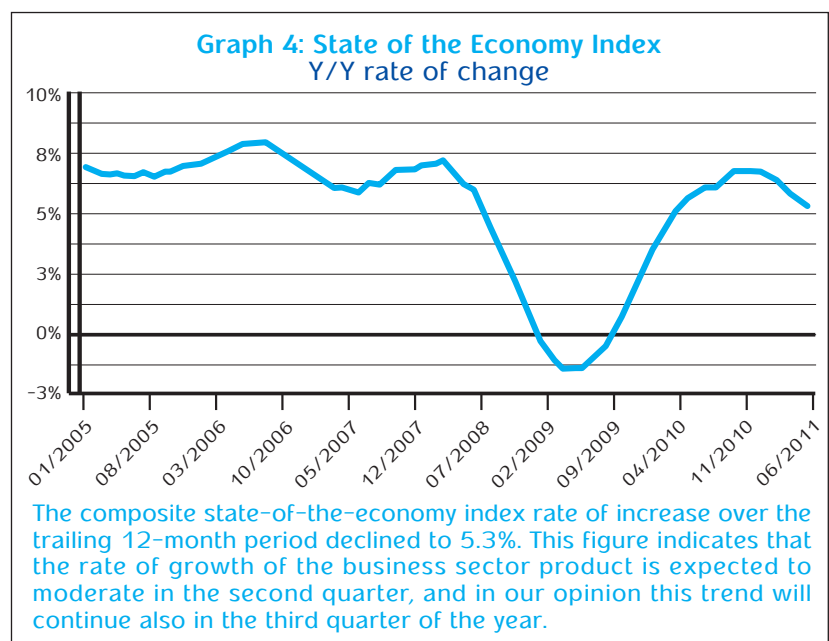
Relating to the reasons behind the rise in food prices around the world, at play are the effects of changes in supply (by many factors such as natural disasters, and changes in the amount of agricultural output and its composition), and also changes in demand (by many factors such as the use of fuels derived from agricultural products, improvements in standards of living, and more). There are those who claim food prices are also affected by speculative activities in these markets. The global rise in food prices has an impact on social welfare issues, in particular matters related to the increasing economic burden on the lower economic strata of society and the residents of poor countries.

**The composite state-of-the-economy index for June increased 0.2% M/M**

The composite state-of-the-economy index increased 0.2% in June, and as can be seen in Graph 4, its rate of increase over the trailing 12-month period declined to 5.3%. This figure indicates the expected moderation in the rate of growth in the second quarter business sector product, and in our opinion this trend will continue also in the third quarter of the year. According to the updated estimates

of the CBS, the business sector product increased 5.2% in the first quarter of the year (in annualized terms, excluding seasonality).

In an analysis of the components of this index in June, there is a notable mixed trend. The index of industrial manufacturing and the index of proceeds from trade and services both went up by a comfortable rate, whereas the indices of imports and exports showed weakness. It must be taken into consideration that at the monthly level, these components are volatile and therefore it is better to focus on a long-term look for these components. Regarding the import indices, it must be noted that from the June foreign trade data a slowing trend in the import of durable goods can be seen. Regarding the weakness in the export indices, as we noted in previous weekly surveys on this topic, this development is consistent with the trend in world trade. What must be especially noted is the moderation in the rate of increase



in the index of technology activity in the US, the Tech Pulse Index, the rate of increase of which has been moderating. To a high degree this index explains the changes in high-tech activity in Israel, which accounts for a central portion of export from Israel.

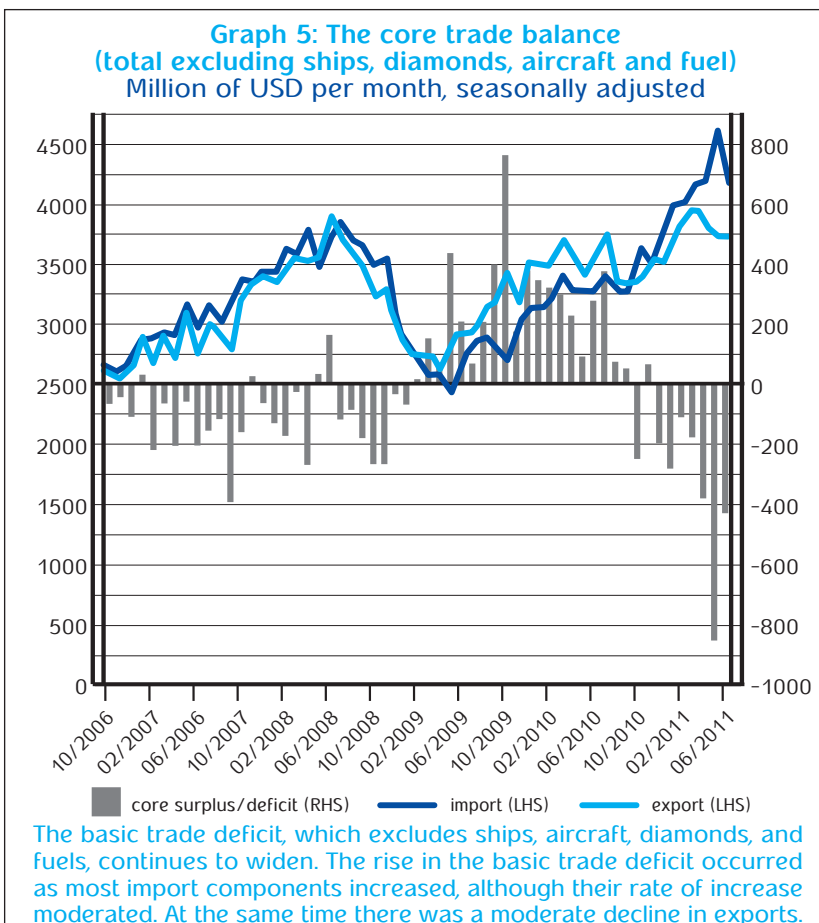
**The basic deficit in Israel's basic goods foreign trade account continued to expand**

Israel's trade deficit increased 61% in June of this year compared to the same period last year, bringing it to US\$7.2bn. The sharp rise reflects the increase in energy prices. The basic trade deficit, which excludes ships, aircraft, diamonds, and fuels, also continued to widen, albeit by a more moderate rate compared to May. The rise in the basic trade

deficit occurred as most import components increased, although their rate of increase moderated. At the same time there was a moderate decline in exports.

The import of durable goods remained stable, which is in line with the moderation in the rate of increase of private consumption. Export components are showing mixed trends: there is weakness in all components associated with the high-tech industry sectors, excluding the export of pharmaceuticals; the export of the mixed-high technology industries, which accounts for 30% of industrial exports, showed an increase in most components, while weakness was notable in the machinery and equipment sector; and all other export sectors increased, as their rates of increase moderated. As we noted in our previous survey on the topic of foreign trade, a trend of general moderation in export trade is expected to continue in the near term, this against the backdrop of a slowdown in world trade. It must be added that it is quite possible the forecast of global trade may even be revised downwards, in the event of a deterioration in the European debt crisis, and thus there will be a negative influence on Israeli exports as well.

In summary, we add that the trend of the expanding basic trade deficit will be expressed in a reduction in the surplus in the current account of the balance of payments, and it is possible this will reduce the intensity of the forces contributing to the strength of the shekel.



# Quarterly Summary of the Capital Market

## The Stock Market

The continuous upward trend in prices in the main stock indices that characterized the Israeli market since July of last year came to an end in January 2011. In the first five months of 2011 Israel's primary stock indices were relatively volatile, with a moderate downward trend. It appears the Israeli stock market found it difficult to establish a good "handle" from which to renew its upward trend. This was against the backdrop of a number of factors, including: geo-political instability in Israel's neighboring countries, changes in the degree of uncertainty in Israel's own local security situation, and the upward trend in local interest rates.

Only in June of this year was there a sign of stability in Israel's stock markets, and even a slight upward movement. Thus, from the start of the year through the end of June 2011 the TA-25 index of blue chip shares declined 8%, and the TA-100 index of the most actively traded shares fell 9%. Furthermore, the medium- and small-cap indices fell since the beginning of 2011 by an even sharper rate compared to the index of large cap shares, the TA-25. Thus, the TA-75 index fell 13% since the beginning of the year and the Yeter-50 index dropped 19%. Simultaneously, average daily turnover registered a decline.

The decline in Israel's stock indices since mid-January of this year is especially notable as it contrasts with the positive trends in international markets during that period. For the sake of illustration, both the S&P500 in the US and the German DAX rose 7% during the first five months of 2011, and the South Korean KOSPI increased 4%. Further to the above, these differences, between the gains in world markets and the declines in the local Israeli stock indices, reflect the relatively large influences of the macro-economic and geo-political factors that are specific to Israel in the recent period.

The sectors in which the rate of price declines was moderate relative to the average (the TA-100) during the first half of 2011 include the real estate and technology sectors. These trends match developments in the economic realm, and in particular the substantial expansion in construction starts, the amount of current construction, and the rise in housing prices. On the other hand, the oil and gas sector registered relatively large price declines. The fall in the prices of oil and gas stocks is not new. This began already back in November 2010, following very sharp price increases, of 950%, since the end of 2008. Weakness was also seen in the trade and services sectors.

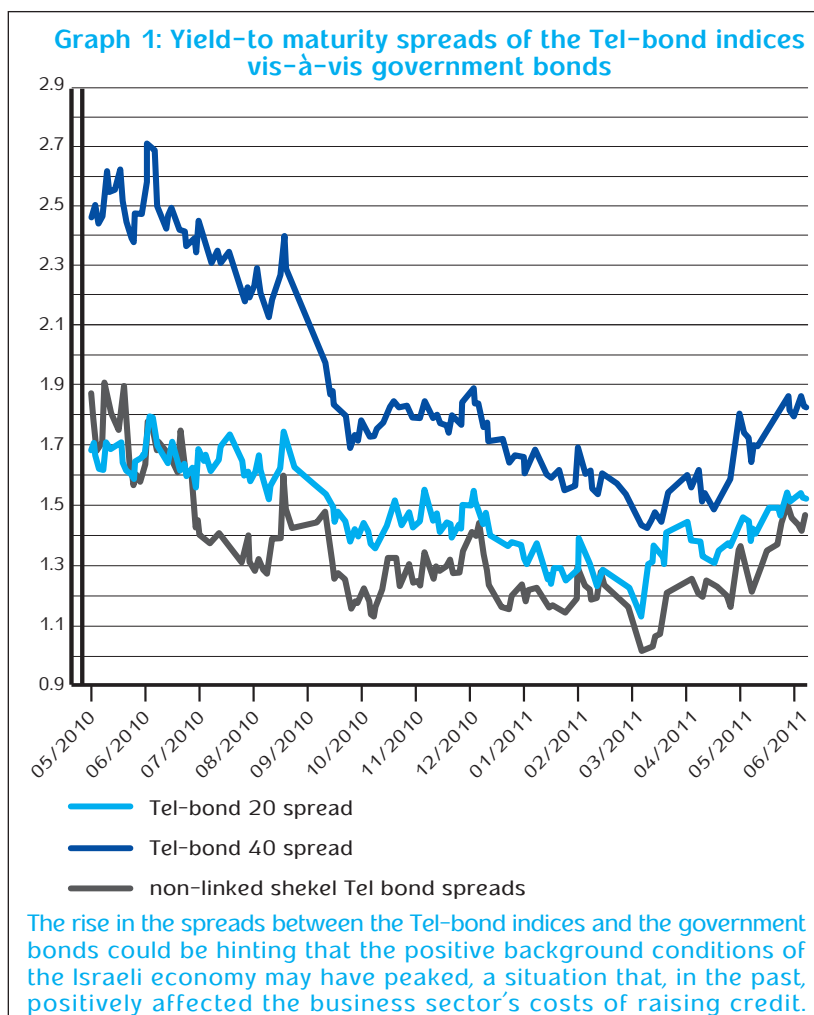
## The Bond Market

The negative trend in Israel's government bond market that had continued since November 2010 concluded towards the end of March 2011, and since then there has been a positive trend. Overall, the CPI-linked government bond index increased during April - June 2011 by 1.8%, while the non-linked shekel government bond index increased 1.6%. It appears this positive trend is connected to the developing assessment that the 2011 government budget deficit will be below target, with a consequent reduction in the financing needs of the government in the bond market.

An additional factor contributing to the positive trend is connected to the prevailing trends in international bond markets, and in particular the fall in the yields-to-maturity of US government bonds since the beginning of April.

It appears the difference between the rate of increase in CPI-linked bond prices and the rate of increase of non-linked shekel bonds reflects the relative acceleration of inflation in Israel during the first four months of 2011, during which time the consumer price index increased 1.3%, or 3.9% in annualized terms, a rate that deviates above the upper border of the target price stability range. The increase in government CPI-linked bond prices was greater in bonds of medium- and long-term durations. Similarly, also in the non-linked shekel market the rise in prices was more emphasized as the duration became longer.

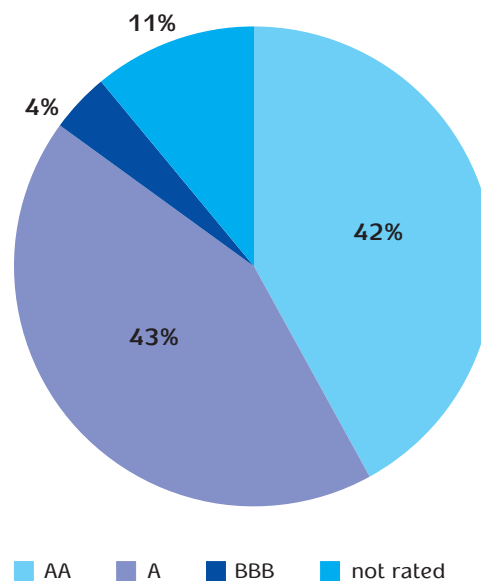
Prices in the Israeli corporate bond market were relatively stable in the first quarter of 2011. This stability occurred after a relatively rapid rise in corporate bond prices throughout 2010. In April 2011 there was substantial weakness in the corporate bond market, and in the May - June period there was a slow recovery in prices. As a result, the downward trend in spreads (corporate - government), notable during 2010 and in the first quarter of 2011 ended, and from April through June spreads widened. These trends can be seen in Graph 1, which presents the differential



between the yield-to-maturity rate of tradable corporate bond indices and the yield-to-maturity rate of government bonds. The rise in the spreads between the Tel-bond indices and the government bonds could be hinting that the positive background conditions of the Israeli economy may have peaked, a situation that positively affected the business sector's costs of raising credit.

The substantial increase in interest on the part of the public in corporate bonds in the first months of 2011, which was carried out primarily via mutual funds, created comfortable conditions for an increase in bond issues by companies in this market. The result was a relatively large amount of capital raising by companies with relatively high credit ratings. Thus, companies with credit ratings of A and AA accounted for 89% of the corporate bond issues in the first five months of 2011. In terms of the issuing sectors, there was a relatively wide dispersal across sectors, with notable presence from the following sectors: banks, real estate, and communications. Regarding the types of linkages of the bonds issued, most of the issues, more than two-thirds, were CPI-linked bonds, with the remaining issues being non-linked shekel bonds, both with fixed and variable rates.

Graph 2: Composition of corporate bond issues according to credit rate of the borrower, in the first half of 2011



On the background of the comfortable conditions for bond issues by companies there was a relatively large amount of capital raising by companies with relatively high credit ratings. Thus, companies with credit ratings of A and AA accounted for 89% of the corporate bond issues in the first five months of 2011.

# Economic and Financial Indicators of Israel

	updated to:	Last three months		2010	2009	2008
		compared to the previous period*	compared to the corresponding period*			
<b>ECONOMIC ACTIVITY</b>						
		real percent change				
Industrial output	May	1.5	0.7	8.0	-6.0	7.1
Revenue of trade and services sectors	May	0.8	3.8	8.7	-2.9	0.4
State of the economy index	June	0.7	5.6	6.0	0.8	2.1
<b>ECONOMIC SECTORS</b>						
		real percent change				
High-technology industrial output	May	-0.2	-4.1	8.9	-0.7	15.8
Sales of new dwellings in private construction	June	-6.8	-10.6	5.6	23.2	19.5
Hotel person nights	June	-6.4	-2.3	19.4	-15.5	4.7
of which: tourists	June	-10.4	-0.9	32.0	-27.4	22.6
<b>FOREIGN TRADE</b>						
		percent change (current US\$ prices)				
Export of goods (ex. ships, aircrafts and diamonds)	June	-2.4	8.1	26.1	-19.1	16.7
of which: manufacturing (ex. diamonds)	June	-2.4	8.2	26.5	-20.0	17.8
agricultural	June	-2.2	5.1	16.4	-12.8	-7.9
Import of goods (ex. ships, aircrafts and diamonds)	June	10.3	34.4	34.0	-32.0	20.9
of which: raw materials (ex. diamonds and fuels)	June	5.6	24.3	37.3	-31.4	13.4
investment goods (ex. ships and aircrafts)	June	8.9	54.1	26.4	-33.4	16.5
consumption goods	June	6.6	27.3	26.5	-15.8	19.8
<b>LABOR MARKET</b>						
		real percent change				
Employee posts - Israeli workers	April	0.3	2.9	3.9	0.2	2.7
Average wage per Israeli employee	April	-0.5	-0.3	1.0	-2.5	-0.6
		Last 3 months**	The corresponding period**	2010	2009	2008
<b>GOVERNMENT BUDGET</b>						
		percentage of GDP				
Total revenues and grants	June	28.5	28.9	29.2	28.2	31.5
Total expenditure and credit allocated	June	30.7	31.5	32.3	32.7	32.8
Deficit (-) / Surplus (+)	June	-2.2	-2.6	-3.1	-4.5	-1.3
of which: deficit (-) / surplus (+) ex. credit (net)		-2.8	-3.5	-3.8	-5.2	-2.1
Domestic borrowing (net)	June	-3.0	-3.1	1.5	5.0	2.7
Loans from abroad (net)	June	-0.2	-1.0	-0.1	0.7	-0.9
		Last 3 months	Last 12 months	2010	2009	2008
<b>PRICES, EXCHANGE RATES AND TOTAL YIELD INDICES</b>						
		percent change (end of period)				
Consumer price index	June	1.5	4.2	2.7	4.2	3.8
Wholesale price index of manufacturing output	June	0.6	8.7	3.7	3.4	-4.4
Price index of input in residential building	June	1.5	4.3	3.9	0.0	3.3
NIS/US\$ exchange rate	July	1.0	-11.0	-6.1	-0.5	-1.4
NIS/EURO exchange rate	July	-2.8	-0.5	-12.9	2.6	-1.8
NIS/Nominal trade-weighted exchange rate	July	-0.4	53.6	-4.4	0.1	-42.3
Tel-Aviv 100 index	July	-7.2	7.8	14.9	92.3	-52.4
Tel-Aviv 25 index	July	-6.9	9.4	15.8	78.6	-47.7
Tel-Aviv Technology index	July	-4.6	21.7	5.3	109.9	-63.2
		The last month	The corresponding month			
<b>INTEREST RATES</b>						
		average of the last month (%)				
Bank of Israel interest rate	August	3.25	1.75	2.00	1.00	2.50
Non-linked treasury bill ("MAKAM")- 1yr yield to maturity	July	3.53	2.10	2.4	1.9	2.0
Non-linked government bond ("SHACHAR")-10yrs yield to maturity	July	5.13	4.58	4.7	5.1	5.3
CPI-linked government bond ("GALIL")-9yrs yield to maturity	July	2.43	1.97	1.9	2.5	3.4
Federal Reserve effective rate	July	0.07	0.18	0.18	0.12	0.25

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

Previous period: last three months compared to the three month period before.

Corresponding period: last three months compared to the same period one year ago.

# The Residential Construction Sector in Israel

## Summary

- Construction starts are in an upward trend, and the continuation of this trend is important for lessening the pressures on housing prices. Note that the Prime Minister recently presented additional steps to increase the supply of housing, further to the previous steps already being implemented.
- At the same time, there is a downward trend in construction completions, possibly due to the shortage in skilled labor that companies in the sector have been reporting about. Furthermore, companies in the construction sector have been reporting on the negative impact that high land prices are having on sector activity.
- Demand levels for new and second-hand housing are decreasing. June's monthly sales of new private sector apartments was some 20% lower than in December 2010. We believe that this development may be attributed to the ongoing increase of the interest rate by the Bank of Israel (BoI) and the regulatory steps implemented by the BoI in the mortgage market. In addition, changes in the public's frame of mind and evolving expectations may have also played a role in the decision whether to purchase new housing currently.

- A downward trend in the proportion of investors in the residential market is evident. Continuation of this trend will support a moderation in the rise in housing prices and will also increase the supply of available housing units for potential home-buyers. Furthermore, the increasingly difficult financing conditions on mortgages are having an impact on first-time home buyers (young couples), the proportion of which out of total home purchasers is in a downward trend.

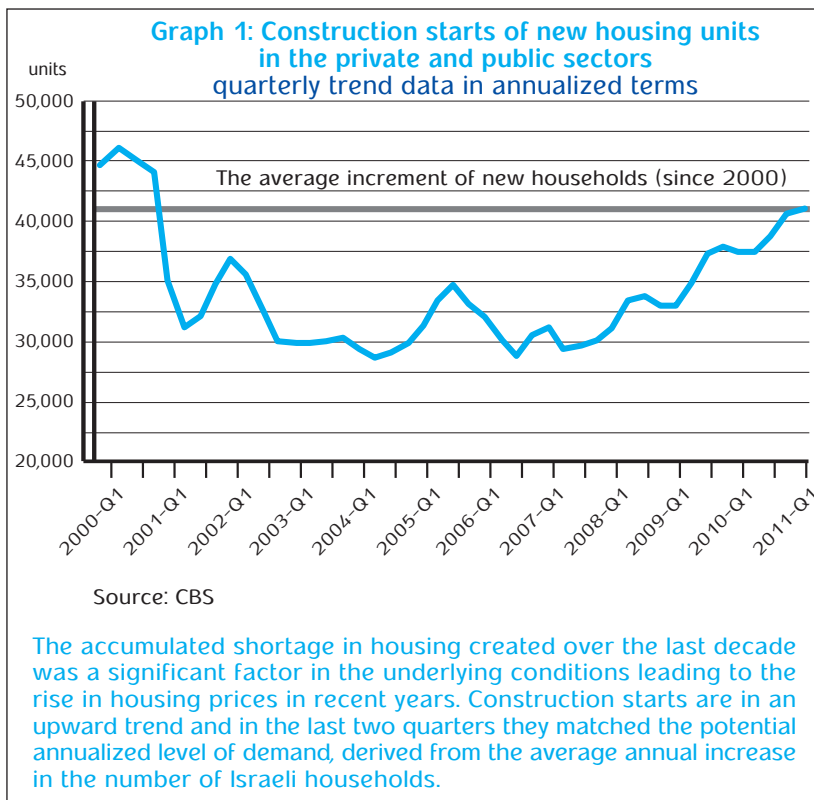
- The rate of increase of real housing prices has been moderating since the beginning of 2010. This development is evident in most regions of the country, except for the north and the south.

- According to a scenario we created, which incorporates a decline in demand for housing and an increase in supply, we found that in 2011, housing prices are expected to continue to increase, albeit by a decreasing rate.

## The Supply Side

**Construction starts** increased in the first quarter of 2011 to 43,500 units in annualized terms, compared to 41,000 units in the last quarter of 2010 (excluding seasonality). As can be seen in Graph 1<sup>1</sup>, construction

<sup>1</sup> In the diagram are presented trend data on construction starts, which are "smoothed" data.



starts in the last two quarters matched the potential annualized level of demand, derived from the average annual increase in the number of Israeli households.

We note that the accumulated shortage in housing created over the last decade was a significant factor in the underlying conditions leading to the rise in housing prices in recent years. The Ministry of Construction and Housing estimates the accumulated shortage over the last decade to equal 80,000 – 100,000 housing units. Therefore, in our opinion, increasing the supply of housing is central to moderating the rise in housing prices. However, it is important to note that the impact of a change in the supply side in the housing market on housing prices is, by its nature, relatively slow. Thus, for example, the new housing units

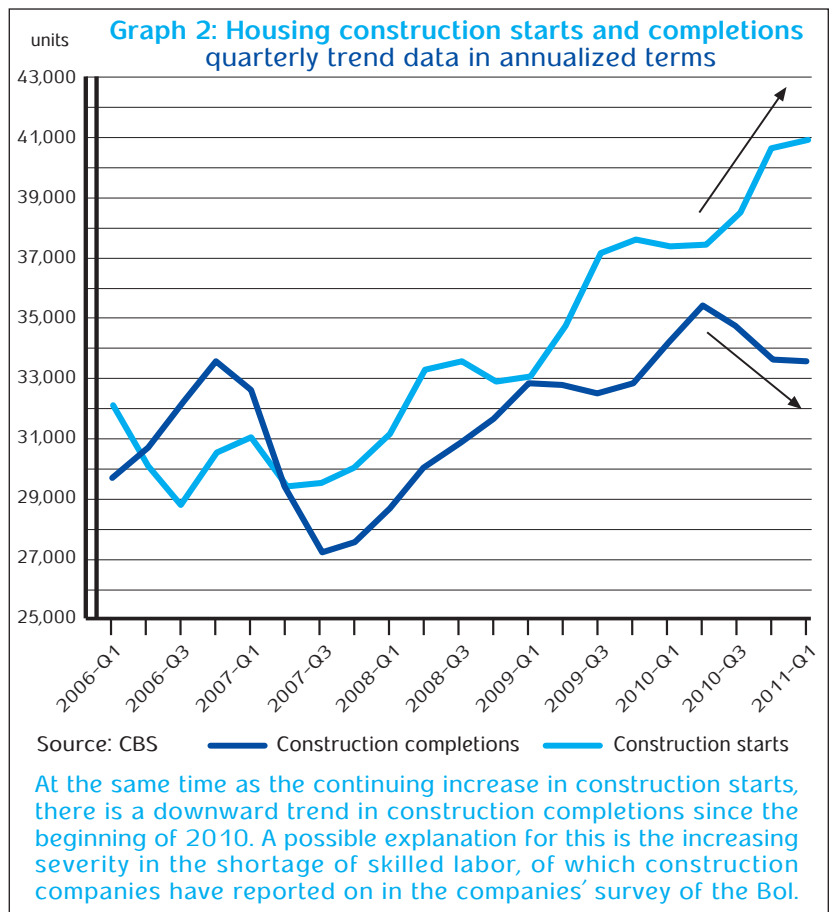
being built today incorporate the high land prices at which they were originally marketed, and therefore a certain constraint is created against reducing housing prices.

A quicker impact on housing prices is likely to occur against the backdrop of a slowdown in the demand. And indeed clear initial signs are beginning to be seen of the impact of the various regulatory steps taken by the Bank of Israel (BoI) in the mortgage market and the steps taken by the Ministry of Finance relating to real estate taxation. There are further details on the demand side later on this review.

Data from the Ministry of Construction and Housing show that the marketing of land by the ministry and by the Israel Land Administration in the first quarter of 2011 equaled 4,790 housing units<sup>2</sup>, and in April another 7,000 units were planned to be marketed. In the first four months of 2011 there were 35,370 housing units in annualized terms planned to be marketed. This represents a 16.3% increase in marketed housing units compared to 2010, and a 40.6% increase compared to 2009. These data support the upward trend in the number of construction starts. However, the companies and businesses survey of the Bank of Israel (BoI) shows that land prices still represent the most severe constraint on sector activity.

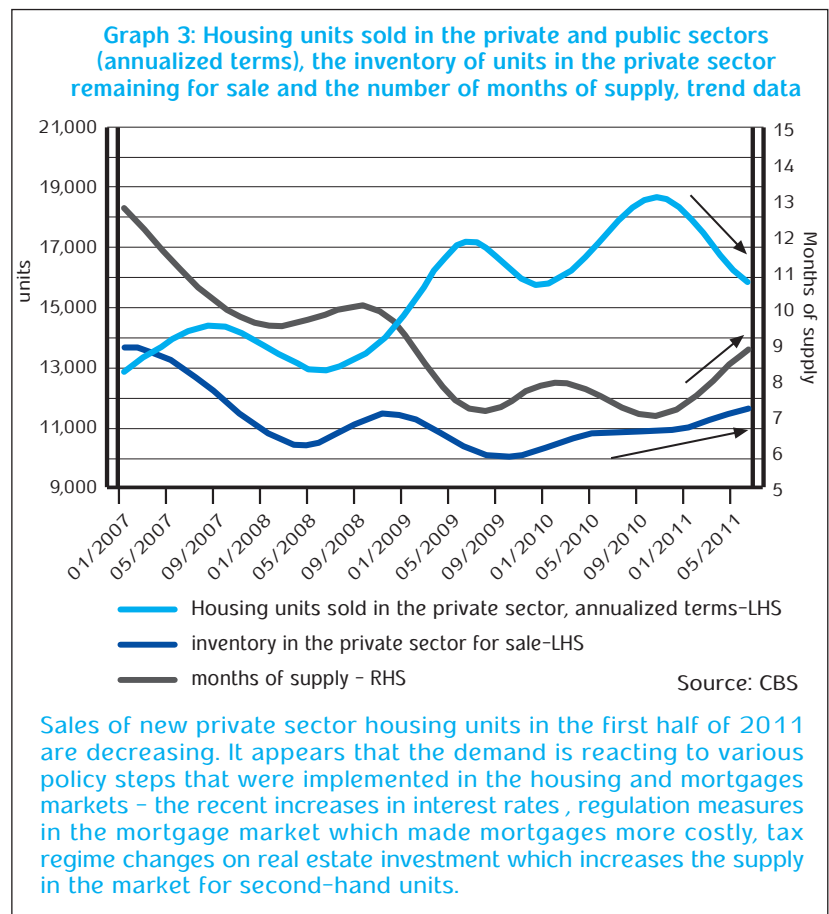
<sup>2</sup> Marketing data are gross, that is to say without discounting cancellations.

At the same time as the continuing increase in construction starts, there has been downward trend in **construction completions** since the beginning of 2010 (see Graph 2). A possible explanation for this is the increasing severity in the shortage of skilled labor, of which construction companies have reported on in the companies' survey of the Bol<sup>3</sup>. This shortage is likely to delay construction projects. According to data from the Ministry of Construction and Housing, the average construction time of housing units in the private sector increased by 2.5 months in the last three years. In 2010 the average construction time equaled 24.5 months, compared to an average of 22 months in the period 2000 - 2007.



### The Demand Side

Sales of new housing units in the first half of 2011 has been on a downward trend from the peak at 2010 (see Graph 3). According to new housing units sales data published by the Central Bureau of Statistics (CBS), there was a drop in June's monthly sales of new private sector apartments that amounted to 1,260 units, some 20% lower than in December 2010 (seasonally adjusted). As shown in the graph, the level of demand (in annualized



<sup>3</sup> We add that according to the survey of available employment positions by the CBS, there are 8,000 unfilled constructions positions, and 59% of these are for professional workers (builders, floorers, molders, and more).

terms) is similar to that of early 2009.

It appears that the demand is reacting to various policy steps that were implemented in the housing and mortgages market – the recent interest rates raises, regulation measures in the mortgage market which made mortgages more costly, and tax regime changes on real estate investment which increases the supply in the market for second-hand units.

Alongside the decreasing rate of sales, the inventory of housing units that remain for sale in the private sector has been increasing gradually. At the end of June the inventory stood at 12,000 new units (excluding seasonality). This is an increase of 12% compared to the average level in 2010. This increase is due to the substantial increase of the housing starts construction.

In light of this, the months of supply of housing units<sup>4</sup> increased in June to 8.8, which is the highest level since March-2009. Although this is

<sup>4</sup> The months of supply of housing units is the ratio between the inventory of units remaining for sale and the number of monthly sales, which reflects how many months the inventory of unsold apartments can last, assuming the current rate of sales will continue also in the following months (for example: when the inventory of unsold units stands at 10,000 units and sales equal 1,000 units per month, the number of months of supply will be 10).

a very early indicator, it may be an important sign pointing towards a transition in housing prices trends in 2012–2013. During this period, and within our central scenario, we expect a transition from price increases to stability and a decline in prices on a national level. Any decline in the pace of housing sales will support a more rapid increase of the months of supply indicator, thus accelerating the convergence towards housing price stability and possibly a decline in prices (see below for a breakdown on the relationship between months of supply and housing prices).

Regarding the second-hand housing market, the Ministry of Finance survey on the residential real estate sector for the first quarter of 2011, shows that the demand is still high but it's not increasing. Furthermore, the number of purchase transactions of second-hand units for residential purposes are a bit down in the first quarter of 2011 compared to the average number of transactions in 2010.

It must be noted that a sharp decline was registered in the activity of investors in the market, this after strong activity by this segment in the fourth quarter of 2010, before changes relating to taxation on real estate investment came into effect in January 2011. These tax changes included a hike in the purchase tax on housing units acquired for investment purposes, and the granting of an exemption on real estate capital gains tax for two years

on the sale of investment property. For the sake of illustration, the proportion of investors out of total transactions fell in March 2011 to 22%, the lowest proportion since 2004. In Tel Aviv the proportion of investors fell from 51% in the fourth quarter of 2010 to 40% in the first quarter of 2011. We note the decline in the activity of investors in the housing market is likely to help moderate the rise in prices since, as is known, the strong entrance of investors into the housing market, with the breakout of the global financial crisis, sustained to a great degree the rise in housing prices.

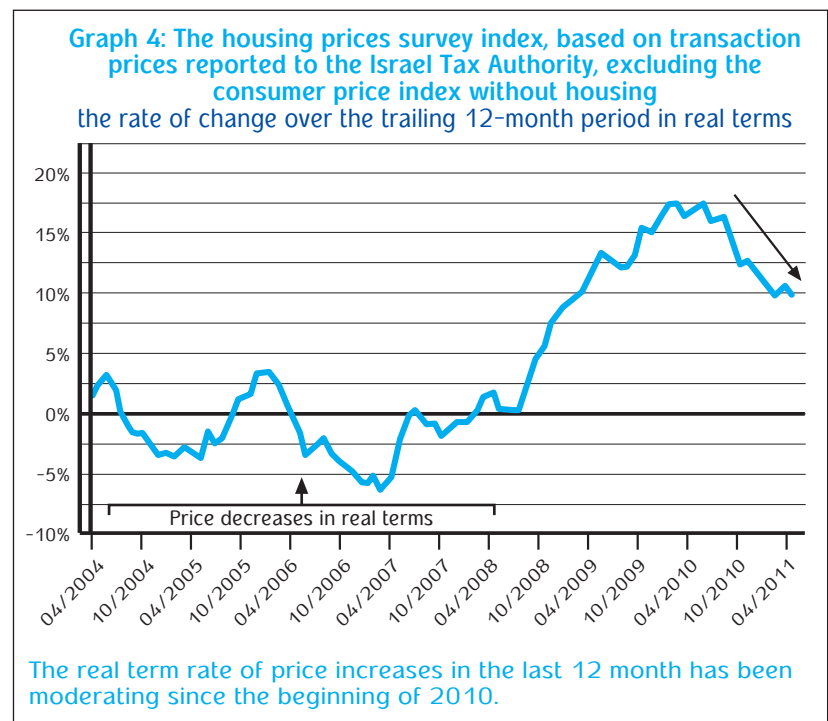
Another figure that arises from the Ministry of Finance survey relates to the downward trend that has occurred since the fourth quarter of 2010 in the proportion of first-time home buyers (young couples). The proportion of such buyers out of total purchasers fell in the first quarter of 2011 by seven percentage points to 38%. It is reasonable to assume that this segment of home purchasers is relatively sensitive to the terms of finance on mortgages, which became more severe in the past year.

### Housing Prices

In the first four months of the year the housing prices index, which is based on transactions data reported to the Israel Tax Authority, increased by a real rate<sup>5</sup> of 2.6%, and since the beginning of 2008 the real increase in housing prices equals 42% (a real increase of almost 15%

per year). However, as can be seen in Graph 4, the real rate of price increases in the last 12 month has been moderating since the beginning of 2010. This index increased in the beginning of 2010 at a real annualized rate of 17%, and in June its annualized increase amounted to 11% (the index is published with a two month lag, such that the published figure in June relates to the index for April).

<sup>5</sup> The calculation of the real increase in housing prices is by means of discounting the consumer price index excluding the housing component, from the housing prices index.



The accompanying table presents the rates of change in housing prices according to region (in nominal terms)<sup>6</sup>. The price increases rates moderated as can be seen also in a

<sup>6</sup> Housing prices according to region are based also on transactions prices reported to the tax authorities; however, in contrast to the national general index these prices do not include an additional qualitative discount according to such parameters as housing unit size in square meters, elevator, parking, socio-economic region, and more.

regional breakdown. Compared to the sharp increases in the past three years, in the first quarter of 2011 the rise in prices (nominal) moderated in most regions, except for the north and the south regions. For the sake of illustration, in the right column of the table the average prices of housing units are presented (with various characteristics), as reported to the tax authorities in the first quarter of 2011.

#### Average rate of increase in housing prices according to transactions data of the Israel Tax Authorities

	1999 - 2007	2008 - 2010	Q1-2011 vs. avg. 2010	Avg. housing unit price Q1-2011, NIS thousands
Jerusalem	6.4%	12.9%	9.6%	1,528
Tel Aviv	6.8%	17.1%	12.4%	1,994
Haifa	1.6%	9.2%	5.1%	703
Dan Region	5.5%	16.4%	6.4%	1,231
Central	5.4%	18.4%	9.2%	1,180
South	4.0%	12.2%	14.1%	796
Sharon	6.2%	13.4%	2.3%	1,383
North	1.7%	6.8%	36.9%	657
Haifa Kiriyyot	2.3%	11.2%	15.0%	673
Overall	4.9%	11.8%	7.0%	1,109

Source: CBS, calculations of the Economics Department

## Steps by the Ministry of Finance to cool the housing market

Within the framework of the efforts to end the hike in housing prices, the Ministry of Finance in June published temporary orders that include two steps:

1. Granting an exemption from real estate capital gains tax on housing units earmarked for residential use but used as offices during 2011–2012. Until now such housing units did not benefit from an exemption on real estate capital gains tax upon their sale. The Ministry of Finance expects this exemption will increase the supply of housing units in **high-demand areas**, by thousands of units. First, we note that the advantage of this step is in its potential to increase the supply relatively quickly. Furthermore, the increase in supply in areas of high demand, and especially in the Tel Aviv region, is likely to more substantially impact housing prices, compared to an increase in supply in the peripheral regions. The degree of impact on prices is of course dependent on the actual increase that will occur in supply, which is to say on the actual realization of the potential.

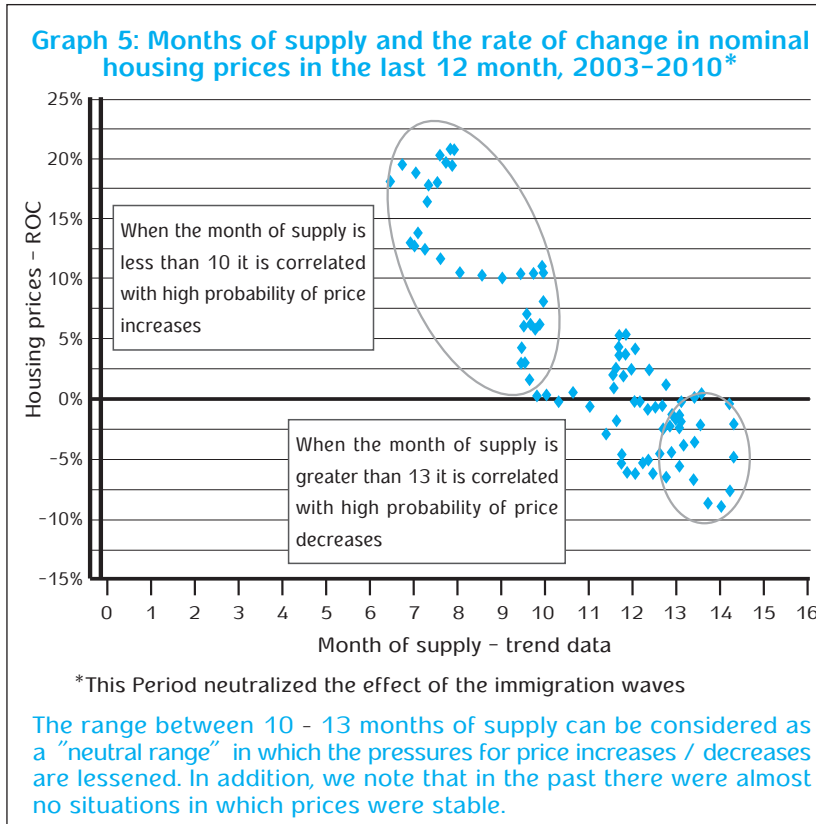
2. Cancellation of the exemption from real estate capital gains tax on housing units purchased for investment purposes, starting in 2013 (the cancellation of the exemption will apply to the real gain accumulate from the day the law is published, which is expected to be in July 2011). In contrast to the

above-mentioned step, the cancellation of the exemption from the real estate capital gains tax on housing purchased for investment purposes is intended to impact demand, by reducing the attractiveness of purchasing an additional unit by investors.

Note that the Prime Minister recently presented additional steps to increase the supply of housing. The details about this plans are yet to be published.

## Looking Forward

As we saw in the first section of this survey, housing construction starts are in an upward trend; however, there are a number of structural problems in the construction sector, including a shortage of skilled labor and insufficient land marketed that cause a hike in prices. On the demand side, clear initial signs are beginning to be seen of the impact of the various regulatory steps taken by the BoI in the mortgage market and the steps taken by the Ministry of Finance relating to real estate taxation. The impact of these steps is notable especially in relation to investment activity in the market. We estimate that the continued hike in the interest rate and additional regulatory steps, should they will be implemented, will lead to a reduction in the demand for housing. Regarding these trends of supply and demand, we set out to analyze potential scenarios to changes in housing prices. For this purpose we used data on the months of housing supply, which combines data on the supply of and demand for housing.



Graph 5 presents the relationship between the number of months of supply and the rate of change in nominal housing prices in the last 12 month. Analysis of this relationship raises the following findings:

a) Up to a level of ten months of supply there is a high probability for an **increase** in prices (nominal) on a national average.

b) Above 13 months of supply there is a high probability for a **decrease** in prices (nominal) on a national average.

c) In the range between 10 - 13 months of supply there is a mixed trend; but it can be said that in a market characterized by a downward trend in demand and an increase in the inventory of unsold housing units a higher probability for a decline in prices can be expected within this range, and in a market characterized by an upward trend in demand and a decline in the inventory of unsold housing units a higher probability for an increase in prices can be expected within this range.

**Accordingly, the range between 10 - 13 months of supply can be considered as a "neutral range" in which the pressures for price increases / decreases are lessened.**

d) In addition, we note that in the past there were almost no situations in which prices were stable. Graph 5 shows that there are only a small number of observation points in which the annual rate of change in housing prices is close to zero.

In accordance with the above-mentioned findings, we carried out a sensitivity analysis assuming different levels of demand for new housing units and supply of units for sale. The changes in the supply of units remaining for sale are based on the number of construction starts of sale units (in the private and public sectors)<sup>7</sup>. We note that a correlation exists between construction starts and the inventory of units in the private sector that remain for sale, however this inventory is affected by other factors and therefore it is important to emphasize that this is an exercise intended to enable the building of a scenario that will provide an estimate on the matter of the development of the inventory.

Below are the results of the sensitivity analysis:

- Under the assumption that the number of construction starts in 2011 will reach 21,000 units<sup>8</sup> similar to the number in 2010, and that the current number of monthly

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<sup>7</sup> That is to say, without the start of independent construction, such as do-it-yourself, purchase groups, and similar such projects.

<sup>8</sup> The number of construction starts in 2010 amounted to 39,000 units; however, 18,000 units were of independent construction. Thus only 21,000 units were built for the purpose of sale (both private and public sector). This analysis relates to housing construction starts for the purpose of sale only.

sales will amount to 1,550 units per month<sup>9</sup>, the same as in June, then the inventory of housing units for sale will increase slightly until the end of the year by 1,800 units. In such a situation, the number of months of supply will increase to 9–10 months. Consequently, it can be expected that the upward pressures on prices will weaken.

- In the event that the number of construction starts in the first quarter of 2011 will remain stable throughout the year, that is to say the number of construction starts of housing units for sale will increase to 25,000 units, also under the assumption of the current rate of sales, there will occur a relative increase in the inventory of housing units for sale. In such an event the number of months of supply by the end of the year will increase to a level of 11 months of supply, and in this situation the prices are expected to stabilize and then decrease.

For the sake of illustration, we created a scenario that describes the changes in the number of months of supply over the course of time. In the current situation – the average rate of sales is 1,550 units per month and an inventory of unsold housing units of 11,600 new units. The cells marked in blue are the “neutral range” of 10 – 13 months of supply.

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<sup>9</sup> The rate of sales relates to the sale of housing units in the private and public sectors.

Dynamic scenario in which a gradual decline in the rate of housing units sale occurs overtime						
Months of supply						
Monthly rate housing sales	Current situation	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012
1,550	8.8	9.6				
1,500			10.3	11.3	12.3	13.3

For the sake of the scenario we chose an intermediate level of housing construction starts for sale, of 23,000 units. At the same time there is a gradual decline of monthly sales of units in the private sectors. Such a decline in sales is likely to occur, for example, against the backdrop of the restraining steps taken by the Bol. It can be seen that in the scenario we created the number of months of supply will reach the threshold of 10 months within half an year and within one year the number of months of supply will reach the upper threshold of the neutral range where the pressure for price decrease are intensifying.

We incorporated the scenario above with the assumptions of our model of housing prices (nominal). Accordingly, the picture arrived at is presented in Graph 6. The national average of the rate of increase in housing prices (nominal) is expected to continue to moderate in 2011. A slight decline in prices is expected in 2012<sup>10</sup>. We note that a more rapid decline in the demand for housing than that described in the scenario and/or a more substantial increase in the rate of construction starts will accelerate the trend described in the forecast in the scenario.

<sup>10</sup> We emphasize that the scenario and the forecast model of housing prices relate to the national average and that at the regional level differences are more likely. Furthermore, it is worthwhile to remember that this is referring to the index of housing prices, which is not included in the consumer price index.

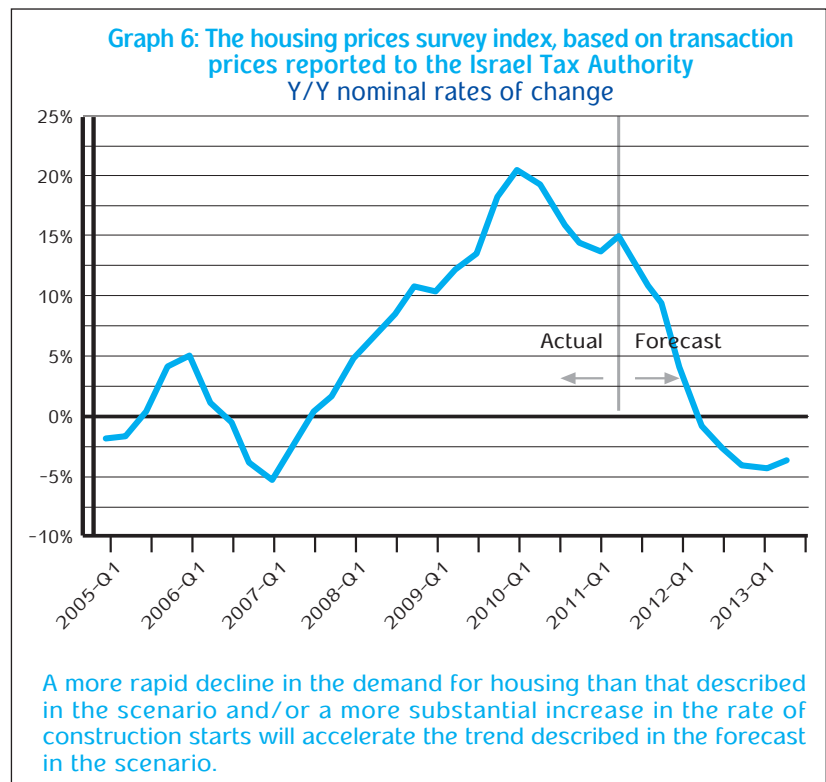
## Summary

- The accumulated shortage in housing created over the last decade was a significant factor in the underlying conditions leading to the rise in housing prices in recent years. Therefore, increasing the supply of housing is, in our opinion, a central step towards moderating the rise in housing prices.

- Since the beginning of the year the housing prices index increased by a real rate of 2.6%, and it is notable that the rate of increase of real prices in the last 12 month has been moderating since the start of 2010.

- The findings of an analysis we carried out show that the "neutral range" of housing supply at which the pressures to increase / decrease prices are lessened is located within 10 - 13 months. In accordance with a possible scenario we built that combines a decline in demand for housing and an increase in supply, until the end of the year, housing prices are expected to continue to rise, albeit at a reduced rate.

- Overall, supply in the housing market adjusts relatively slowly and therefore the policy steps that have been implemented over the past year are likely to become more and more evident within the next year or two. It is possible that while supply expands, demand will contract following changes in the background conditions which previously included the low interest rate and the instability of financial markets. Thus, in order to avoid a situation of overshooting of supply, with all of



its consequences, proper planning of the supply side trajectory is imperative today, as this is what will dictate the market equilibrium prices.

- A faster transition to an environment of declining prices, on a national average, is likely to occur in the event of considerable "overshooting" in construction starts of housing units for sale and/or in the event of a harsh cessation in demand, for example against the backdrop of a continuing deterioration in the security situation, an economic slowdown that is surprising in its severity and timing, and a considerable increase in mortgage costs, for example, against the backdrop of very severe regulatory steps by the Bol in this area.

# Real Investments in the Israeli Economy

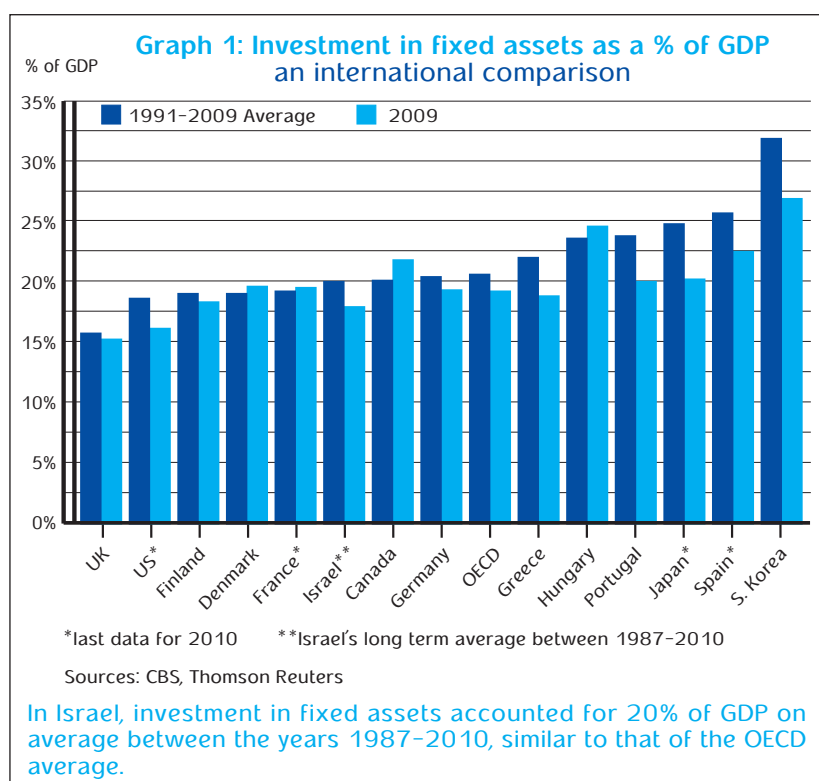
Investment is a central component in the long-term growth process of any economy. This refers to investment in physical capital, which influences an economy's production capability, and also other physical capital such as buildings for industrial factories and offices, and also residential construction. Gross domestic investment is comprised of investment in fixed assets and of changes in the capital inventory. In this article we will focus on investment in fixed assets. Fixed assets are broken down into three main categories - buildings and

construction works, machinery and equipment, and finally intangible assets. When analyzing the data across more than two decades, buildings and construction works account for 51% of total investment in fixed assets, machinery and equipment account for 42%, and intangible assets account for an additional 7%.

## Investment in Israel: an international comparison

In Israel, investment in fixed assets accounted for 20% of GDP on average between the years 1987 - 2010 (see Graph 1). In the last three years there have been signs of a downward trend in this rate, as investments in fixed assets stood at 19.6% of GDP in 2008 and 17.9% of GDP in 2010. Thus, on an international comparison, Israel is placed "comfortably in the middle" with an investment rate similar to that of the OECD average. However, in the last two years the rate of investments in fixed assets was below the historical average as a result of the global financial crisis, which raised the level of risk in Israel and across the world.

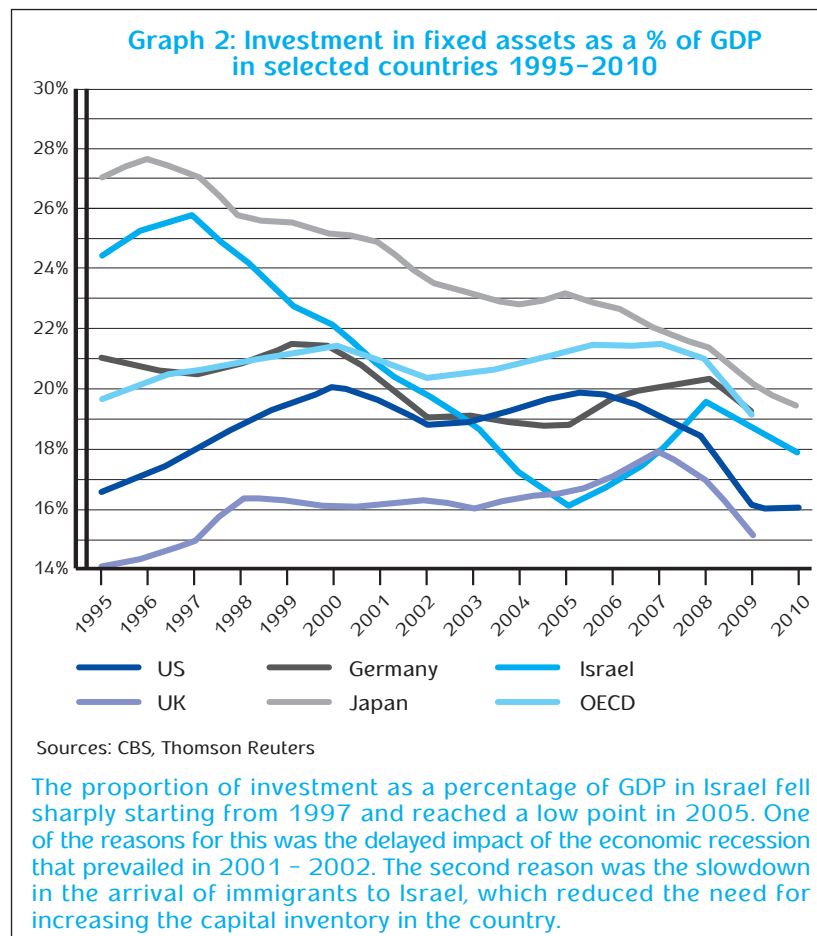
Graph 2 shows the development of the proportion of investment as a percentage of GDP across time of a few select countries and the OECD average. In 2010 the rate of



investment in fixed assets in the US stood at 16.1%, the lowest level registered in the last 16 years. Another outstanding country is Japan, where the rate of investment in fixed assets stood at 30% in 1991, but fell continuously and reached 19% in 2010. For the sake of comparison, the rate of investment in Israel fell sharply starting from 1997 and reached a low point in 2005. One of the reasons for this was the delayed impact of the economic recession that prevailed in 2001 - 2002. The second reason was the slowdown in the arrival of immigrants to Israel, which reduced the need for increasing the capital inventory in the country. This contrasts with the first half of the 1990s when there was large public investment in residential construction, which was intended to answer the needs of the immigrants.

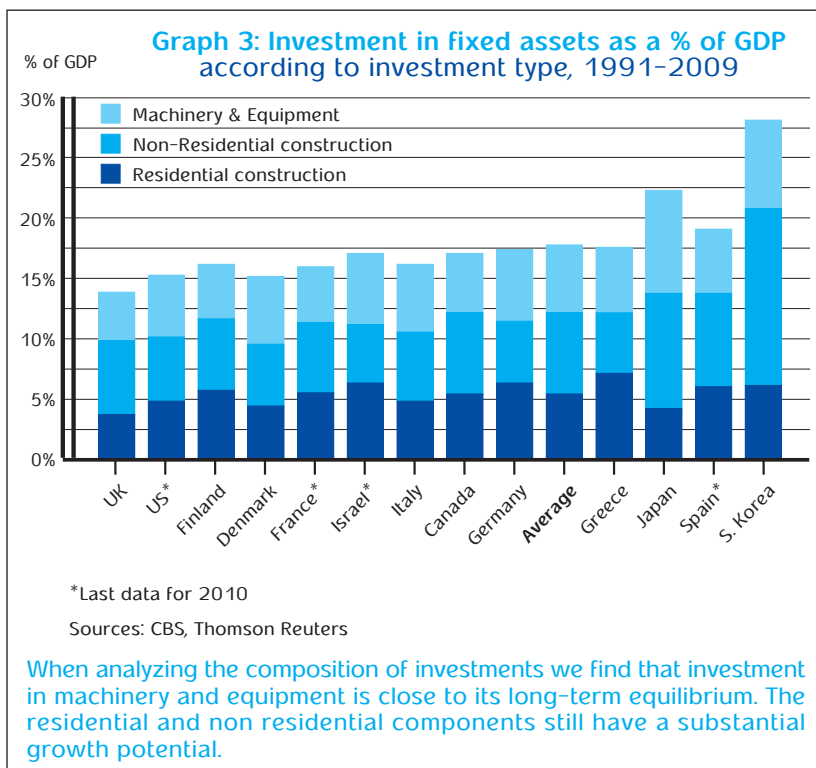
When analyzing the composition of investments we find that investment in machinery and equipment in Israel, which refers to investment in production equipment which in turn influences the manufacturing capacity of the economy, stands at 5.9% of GDP, while the average in the comparison countries stands at 5.6% of GDP (see Graph 3). In 2010 investment in machinery and equipment in Israel stood at 6.1% of GDP. According to these data it is possible that Israel is close to its long-term equilibrium point for this component and the growth potential (in terms of percentage of GDP) is close to its maximum. It is important

to note that during the past decades a substantial transformation in the make-up of the economy occurred, from one based heavily on traditional industry and agriculture, to a high-technology intensive economy. The economy has become much more dependent on human capital and less so on physical capital. This claim helps to explain the decline in investment in machinery and equipment up to 2007. Since then, there occurred a substantial rise in investment in physical capital. It is possible that the renewed upward trend in investment in physical capital that occurred since 2007 is the result of the development in the energy sectors of the economy, as well as compensation for the past years of under-investment.



Regarding residential construction in Israel, this component reached an historical low of 4.1% of GDP in 2007, while since then there has been an increase to a level of 4.9% of GDP in 2010. This figure is below the 5.5% of GDP average of the comparison countries mentioned above, and thus shows the potential for further expansion in residential construction in the coming years. In this regard, it must be taken into consideration that Israel's population growth is substantially greater than that in most developed countries in the world. Demographic growth implies the creation of more households, and thus more housing units are needed and more investment than what may be required in the comparison countries. Therefore, the low investment in residential construction in Israel is even more notable.

Finally, non-residential construction in Israel stood at 3.2% of GDP in 2010, a figure that is substantially below the average, which stands at 6.7% of GDP. This result points to the fact that Israel has a large growth potential from this component, which has almost reached an historical low (in 2005 it stood at 3.1% of GDP). We examined, for example, investment in guest houses in Israel. According to the 2010 annual report of the Bank of Israel (BoI), since 2001 almost no new hotels were opened in Israel, and the number of rooms remained stable throughout the last decade, at a time when in most developed countries (especially in Mediterranean countries), the number of rooms increased. It is almost certain that during the past decade, and especially at its beginning, there was no need to increase the number of rooms due to a decline in the number of tourists. But in recent years demand by Israelis for guest services grew strongly, and demand by foreign tourists increased as well. This increase has brought the hotel sector close to full capacity during certain periods and signals the need for additional investment in order to increase supply.



### Investment in machinery and equipment

Investment in machinery and equipment derives from two sources, local production and import. Historically, the import component has accounted for 69% of the

sources of investment in machinery and equipment, while local production stands at 31%. As such, investment is very sensitive to Israel's international terms of trade, and is very volatile. The Bol (in its 2009 annual report) defines these investments in the list of relatively low value added uses. When analyzing the quarterly rates of change we find that the average annualized rate of change stands at 4.1%, with a standard deviation of 10%. This large variance in the level of investment hints that in addition to the macro-economic factors that influence the level of investment in machinery and equipment, a significant aspect of uncertainty exists that makes it difficult to forecast investments. In our analysis, which is based on research published by the Bol, an attempt was made to integrate the aspect of uncertainty into an econometric model, the purpose of which is to analyze what are the macro-economic factors that impact investment in machinery and equipment in Israel. Incorporated into this model were variables that affect demand for investment, such as the utilization of capital in industry and the cost of capital inventory.

### **What is capital utilization?**

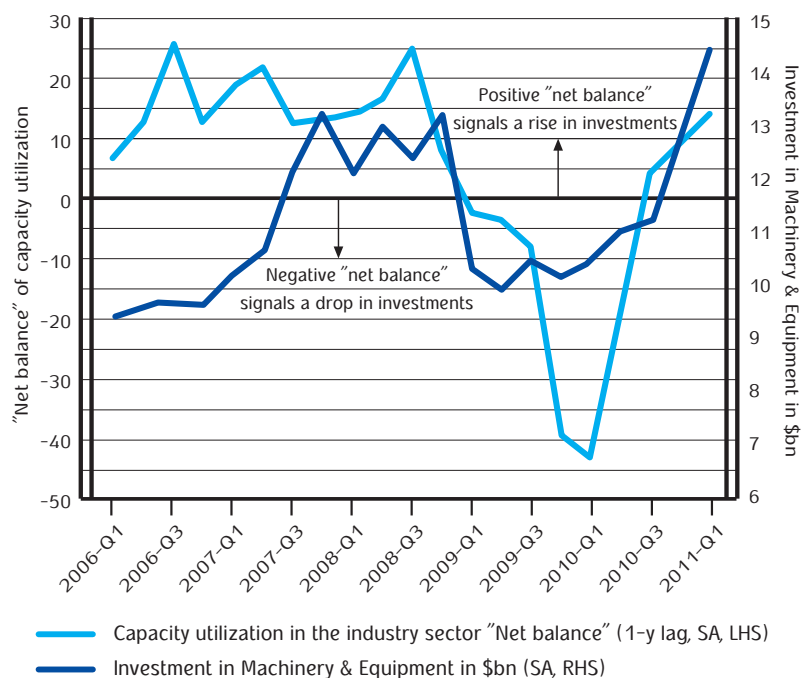
Capital utilization gives an indication of the need for expansion/contraction in capital investment (equipment and machinery). When the level of capital utilization is low we would expect investment to decline. On the other hand, high

capital utilization signals the need for expansion. Therefore, in this case we would expect to see an increase in investment. The Bol business survey (of manufacturing firm) asks, among other things, if the capital utilization of companies in the industrial sectors is likely to change. In the questionnaire there are five possibilities: a substantial increase, a moderate increase, no change, a substantial decrease, and a moderate decrease.

In order to estimate what will be the capital utilization in industry, a "net balance" was created. This net balance calculates the difference between the portion of companies expecting an increase in capital utilization and the portion of companies expecting a decline in capital utilization. As can be seen in Graph 4, a positive correlation exists between the net balance and the rate of investment in machinery and equipment. When the companies survey signals an increase in capital utilization (a positive net balance), we see that after a year there exists a rise in investment, and vice versa. Therefore, the question in the survey regarding capital utilization precedes and accurately anticipates the trend seen in the area of investments, and this with the understanding that investment plans are generally a long and medium term process.

Looking forward, this figure of capital utilization according to the business survey throughout 2010 and the start of 2011 has a very positive value (the average net

Graph 4: "Net Balance" of capital utilization, according to the business survey of the Bol (with a one-year lag) and investment in machinery and equipment in NIS billions, quarterly data, seasonally adjusted



Source: CBS, Bol

A positive correlation exists between the net balance sheet and the rate of investment in machinery and equipment. The "net balance" is based on the Bol business survey and it calculates the difference between the portion of companies expecting an increase in capital utilization and the portion of companies expecting a decline in capital utilization.

balance between the first quarter of 2010 and the first quarter of 2011 stands at 18, that is to say a high capital utilization). Today the economy is approaching full employment; therefore continued economic growth will also require an additional increase in investment. According to first quarter 2011 data, investment in machinery and equipment indeed increased 14.9% compared to the last quarter of 2010 (74% in annualized terms). At least according to capital utilization data, we expect a continued expansion in investment in machinery and equipment throughout 2011.

In the model mentioned above, different factors affect real investments in the economy, such as the real interest rate, the real exchange rate, the unemployment rate, immigration, and the TA-100 index of the 100 most actively traded shares on the Tel Aviv Stock Exchange (TASE). The novelty of the Bol model upon which we based our work is reflected in combining into the model the uncertainty factors, which are derived from the real interest rate, the GDP, the TA-100 index, Israel's terms of trade, and a geo-political index.

As we saw from the business survey in the discussion on capital utilization, the process of investment is the result of long and medium term planning, but it is also influenced by the present economic situation, and therefore shocks in the economy at all periods of time help to predict the level of

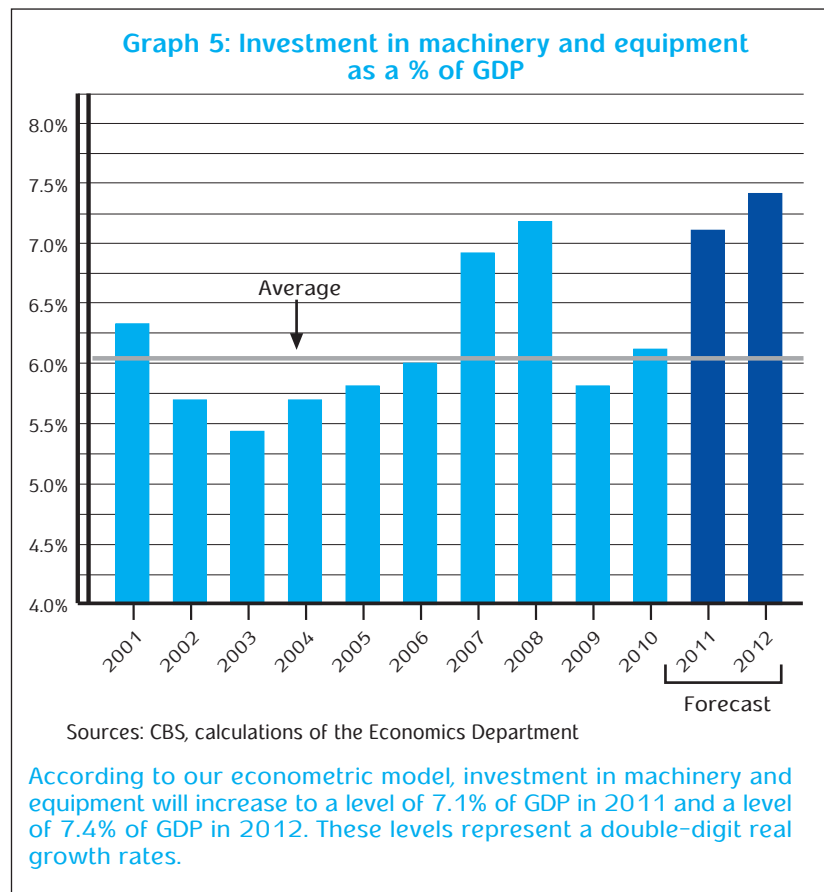
investment in the future. We found that incorporating the components of uncertainty enables us to make effective forecasts of one to one-and-a-half years forward. According to the model, investment in machinery and equipment will increase to a level of 7.1% of GDP in 2011 and a level of 7.4% of GDP in 2012 (see Graph 5). These represent double-digit real growth rates. This forecast returns the level of investment to the upward trend that was apparent since 2003 and which was cut during the period of the global financial crisis.

### Summary

In this article we presented the development of investment in fixed assets in Israel, both across time and also in an international comparison. The findings show the rate of investment in fixed assets in Israel is similar to the OECD average. It is notable that between the years 1997 - 2006 the decline in the rate of investment in Israel was the sharpest among the comparison countries mentioned in this report.

Looking forward, we see the potential for an expansion in investment in fixed assets, primarily in the area of construction, due to the full use of the existing capital inventory, and the need to increase the supply of guest services and residential buildings. This will have a contribution to future growth in the economy.

According to our forecasts, investment in machinery and equipment is expected to recover



in the years 2011 - 2012 and return to the upward trend that was cut earlier due to the global financial crisis. Furthermore, the development of new sectors in the economy (primarily in the field of energy) will lead to additional investment in machinery and equipment, which will substantially increase the required capital inventory. According to data from the Ministry of National Infrastructures, an amount of US\$3.7bn is expected to be invested in Israel's Natural gas economy during the years 2010 - 2015. We note this figure is not expressed in the results of the model and therefore it is possible we will see in the coming years even stronger growth in investment in fixed assets, together with a contribution to further economic growth.

# Bank Leumi le-Israel B.M. and subsidiaries

Condensed Consolidated Balance Sheet as at 31 March 2011 (NIS millions)

Reported amounts

	31.3.2011	31.3.2010	31.12.2010
ASSETS	(Unaudited)	(Unaudited)	(Audited)
Cash and deposits with banks	36,802	41,664	30,052
Securities	47,090	52,526	55,791
Securities borrowed or purchased under agreement to resell	2,068	638	1,190
Credit to the public (a) (b)	230,017	217,994	234,255
Allowance for credit losses (a) (b)	(4,946)	(10,381)	(10,274)
Net credit to the public	225,071	207,613	223,981
Credit to governments	357	407	379
Investments in companies included on equity basis	2,032	2,196	1,924
Buildings and equipment	3,665	3,543	3,638
Goodwill (a)	45	121	45
Assets in respect of derivative instruments (a)	8,419	6,019	8,716
Other assets (a)	2,957	2,904	2,454
Total assets	328,506	317,631	328,170
LIABILITIES AND EQUITY CAPITAL	31.3.2011	31.3.2010	31.12.2010
	(Unaudited)	(Unaudited)	(Audited)
Deposits of the public	248,258	244,579	249,584
Deposits from banks	3,814	3,160	2,691
Deposits from governments	721	678	660
Securities loaned or sold under agreement to repurchase	1,533	175	1,006
Debentures, bonds and subordinated notes	26,985	26,812	26,939
Liabilities in respect of derivative instruments (a)	10,170	7,277	9,985
Other liabilities (a)	13,827	11,969	13,320
Total liabilities	305,308	294,650	304,185
Non-controlling interest	314	285	318
Shareholders' equity attributed to the shareholders of the banking corporation	22,884	22,696	23,667
Total shareholders' equity	23,198	22,981	23,985
Total shareholders' equity and liabilities	328,506	317,631	328,170

**Condensed Consolidated Statement of Profit and Loss  
for the Period Ended 31 March 2011 (NIS millions)  
Reported amounts**

	For the Three Months Ended 31 March		For the Year Ended 31 December
	2011 (Unaudited)	2010 (Unaudited)	2010 (Audited)
Net interest income before provision in respect of credit losses	1,939	1,807	7,433
Provision in respect of credit losses	(102)	130	584
Net interest income after provision in respect of credit losses	<u>2,041</u>	<u>1,677</u>	<u>6,849</u>
<b>Operating and other income</b>			
Operating commissions	975	904	3,710
Profits from investments in shares, net	30	74	216
Other income	18	21	185
Total operating and other income	<u>1,023</u>	<u>999</u>	<u>4,111</u>
<b>Operating and other expenses</b>			
Salaries and related expenses	1,319	1,136	4,615
Building and equipment maintenance and depreciation	408	380	1,591
Depreciation of goodwill (a)	—	4	80
Other expenses (a)	327	313	1,604
Total operating and other expenses	<u>2,054</u>	<u>1,833</u>	<u>7,890</u>
Operating profit before taxes	<u>1,010</u>	<u>843</u>	<u>3,070</u>
Provision for taxes on operating profit	382	333	1,256
Operating profit after taxes	<u>628</u>	<u>510</u>	<u>1,814</u>
Equity in after-tax operating profit (loss) of companies included on equity basis	<u>(42)</u>	<u>85</u>	<u>420</u>
<b>Net operating profit</b>			
Before attribution to holders of non-controlling interest	586	595	2,234
Attributed to holders of non-controlling interest	(10)	(3)	(39)
Attributed to shareholders' of the banking corporation	<u>576</u>	<u>592</u>	<u>2,195</u>
Profit net, from extraordinary items after-tax before attribution to holders of non-controlling interest	<u>1</u>	<u>4</u>	<u>183</u>
<b>Net profit for the period</b>			
Before attribution to holders of non-controlling interest	587	599	2,417
Attributed to holders of non-controlling interest	(10)	(3)	(39)
Attributed to shareholders' of the banking corporation	<u>577</u>	<u>596</u>	<u>2,378</u>
<b>Basic and diluted earnings per share</b>	<b>(NIS)</b>		
Net operating profit attributed to shareholders' of the banking corporation	0.39	0.40	1.49
After-tax profit from extraordinary items attributed to shareholders' of the banking corporation	<u>—</u>	<u>—</u>	<u>0.12</u>
Total	<u>0.39</u>	<u>0.40</u>	<u>1.61</u>

(a) Comparative figures have been reclassified for adaptation to the method of presentation in the current period.

(b) Comparative figures in respect of credit to the public and allowance for credit losses have not been restated pursuant to implementation of the new directives, and are not comparable with current data.

The complete quarterly report for the period ended 31 March 2011 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 31 March 2011, according to which the financial statements have been prepared, was NIS 3.481.

**Condensed Consolidated Statement of Changes in Shareholders' Equity**  
**For the Period Ended 31 March 2011 (NIS millions)**  
**Reported amount**

For the Three Months Ended 31 March 2011 (Unaudited)

	Capital reserves			Accumulated other comprehensive income (expenses)							Total	Non-controlling Interest	Total shareholders' equity
	Share capital	Premium	Share-based payment transaction and others (a)	Total share capital and capital reserves	Adjustments in respect of presentation of securities available for sale at fair value	Translation adjustments	Capital reserve in respect of companies included on equity basis	Retained earnings	Loans to employees for purchase of the Bank's shares				
Balance at the beginning of the period	7,059	1,129	10	8,198	468	(460)	25	15,437	(1)	23,667	318	23,985	
Adjustment of opening balance in respect of change to impaired debts and IFRS (b) (c)	—	—	—	—	—	381	—	(1,090)	—	(709)	(14)	(723)	
Net profit for the period	—	—	—	—	—	—	—	577	—	577	10	587	
Proposed dividend	—	—	—	—	—	—	—	(400)	—	(400)	—	(400)	
Adjustments in respect of companies included on equity basis, net	—	—	—	—	—	(53)	16	2	—	(35)	—	(35)	
Adjustments in respect of presentation of securities available for sale at fair value	—	—	—	—	(240)	—	—	—	—	(240)	—	(240)	
Profits in respect of securities available for sale that were realized and charged to profit and loss	—	—	—	—	(84)	—	—	—	—	(84)	—	(84)	
Related tax effect	—	—	—	—	108	—	—	—	—	108	—	108	
Balance at the end of the period	<u>7,059</u>	<u>1,129</u>	<u>10</u>	<u>8,198</u>	<u>252</u>	<u>(132)</u>	<u>41</u>	<u>14,526</u>	<u>(1)</u>	<u>22,884</u>	<u>314</u>	<u>23,198</u>	

For the Three Months Ended 31 March 2010 (Unaudited)

	Capital reserves			Accumulated other comprehensive income (expenses)							Total	Non-controlling Interest	Total shareholders' equity
	Share capital	Premium	Share-based payment transaction and others (a)	Total share capital and capital reserves	Adjustments in respect of presentation of securities available for sale at fair value	Translation adjustments (b)	Retained earnings	Loans to employees for purchase of the bank's shares					
Balance at the beginning of the period	7,059	972	197	8,228	309	(474)	—	14,176	(377)	21,862	596	21,862	
Net profit for the period	—	—	—	—	—	—	—	596	—	596	—	596	
Other comprehensive expenses in companies included on equity basis which was directly recorded to retained earnings	—	—	—	—	—	—	—	(66)	—	(66)	—	(66)	
Adjustments in respect of presentation of securities available for sale at fair value	—	—	—	—	536	—	—	—	—	536	—	536	
Profits in respect of securities available for sale that were realized and charged to profit and loss	—	—	—	—	(63)	—	—	—	—	(63)	—	(63)	
Related tax effect	—	—	—	—	(145)	—	—	—	—	(145)	—	(145)	
Adjustments from translation in respect of companies included on equity basis	—	—	—	—	—	(30)	—	—	—	(30)	—	(30)	
Loans to employees for purchase of the Bank's shares	—	—	—	—	—	—	—	—	6	6	—	6	
Balance at the end of the period	<u>7,059</u>	<u>972</u>	<u>197</u>	<u>8,228</u>	<u>637</u>	<u>(504)</u>	<u>—</u>	<u>14,706</u>	<u>(371)</u>	<u>22,696</u>	<u>—</u>	<u>22,696</u>	

For the Year Ended 31 December 2010 (Audited)

	Capital reserves			Accumulated other comprehensive income (expenses)						
	Share capital	Premium	Share-based payment transaction and others (a)	Total share capital and capital reserves	Adjustments in respect of securities available for sale at fair value	Translation adjustments (b)	Capital reserve in respect of companies included on equity basis	Retained earnings	Loans to employees for purchase of the bank's shares	Total shareholders' equity
Balance as at 1 January 2010	7,059	972	197	8,228	309	(474)	—	14,176	(377)	21,862
Net profit for the period	—	—	—	—	—	—	—	2,378	—	2,378
Expiration of options	—	157	(157)	—	—	—	—	—	—	—
Employee benefit – tax effect	—	—	(30)	(30)	—	—	—	—	—	(30)
Dividend paid	—	—	—	—	—	—	—	(500)	—	(500)
Proposed dividend	—	—	—	—	—	—	—	(500)	—	(500)
Adjustments in respect of companies included on equity basis, net	—	—	—	—	—	14	25	(117)	—	(78)
Adjustments in respect of presentation of securities available for sale at fair value	—	—	—	—	538	—	—	—	—	538
Profits in respect of securities available for sale that were realized and charged to profit and loss	—	—	—	—	(303)	—	—	—	—	(303)
Related tax effect	—	—	—	—	(76)	—	—	—	—	(76)
Loans to employees for purchase of the Bank's shares	—	—	—	—	—	—	—	—	376	376
Balance as at 31 December 2010	<u>7,059</u>	<u>1,129</u>	<u>10</u>	<u>8,198</u>	<u>468</u>	<u>(460)</u>	<u>25</u>	<u>15,437</u>	<u>(1)</u>	<u>23,667</u>

(a) Including NIS 10 million of other capital reserves.

(b) Adjustments arising from translation of the financial statements of foreign subsidiaries, whose functional currency is different from the functional currency of the Bank, were moved to retained earnings that were accumulated due to the change to reporting according to IAS 21, in the sum of NIS 381 million.

(c) Including NIS 7.21 million in respect of change implementation of impaired debts directives (NIS 1,319 million gross).

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31 May 2011



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