Leumi Review

Issue No. 157 | August 2010

Leumi Review

Israel: Macroperspectives

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Contents

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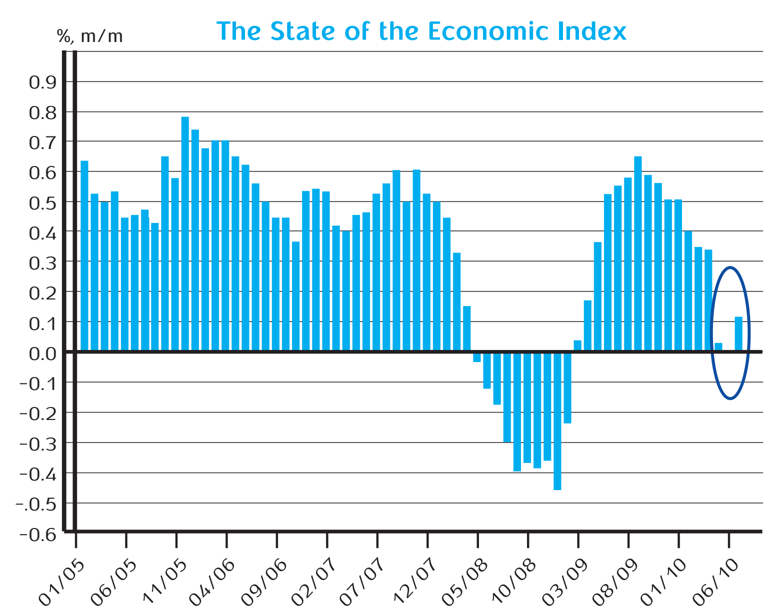
Economic activity
in the first half of 2010

The State of the Economy Index points to a deceleration in economic activity growth in the second quarter of 2010

The State of the Economy Index, that is published by the Bank of Israel (BoI), rose 0.1% m/m in June following stability of the index in April and May. This means that the overall increase of the index in the second quarter of 2010 was very small compared to previous quarters and apparently reflects slow economic growth during this quarter. The Central Bureau of Statistics (CBS) published a revised estimate of economic growth in the first quarter of 2010, according to which GDP grew by 3.4% q/q in annualized terms while the business sector's output rose by 4.4% during this period. Previous CBS estimates were higher, at 3.6% and 4.8% accordingly.

It is possible that these data point to a slowdown of growth in the second quarter of 2010 with exports of goods leading this development. Moreover, export data by geographic destination point to a stabilization of exports to all three main export destinations: the EU, the US and Japan. Therefore, the recent slowdown in exports seems to be widespread and not centered upon a particular region. Analysis of exports by economic branches also pointed towards widespread weakness in the second quarter of 2010. Looking ahead, an additional slowdown of exports growth is possible, especially looking towards 2011, during which economic growth is expected to decline in most of Israel's foreign trade destinations.



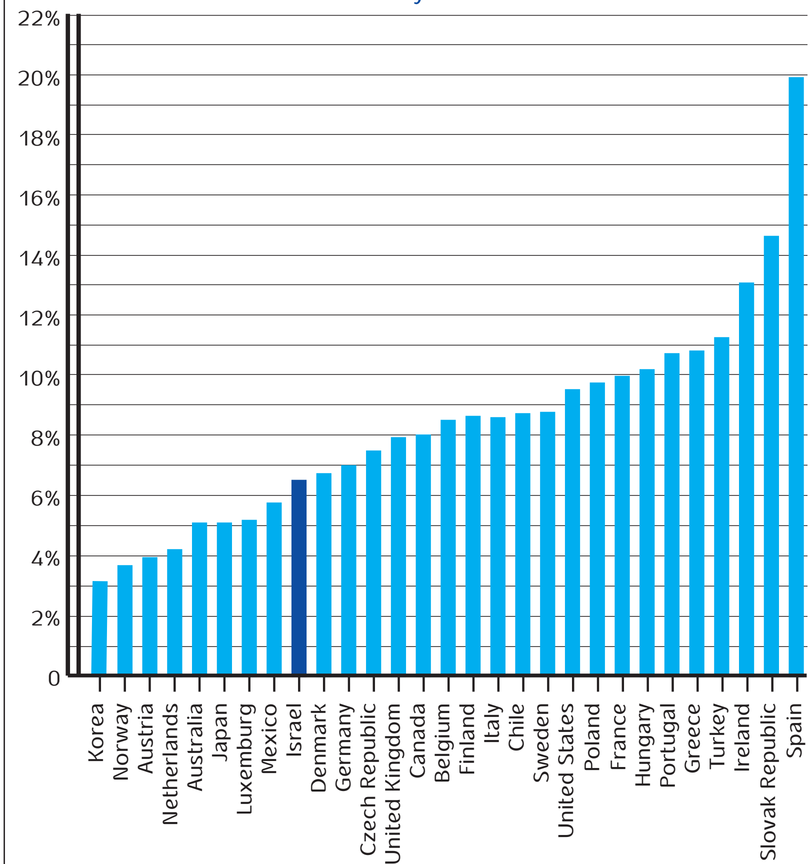
The slowdown of growth in the second quarter of 2010 is expected to continue in the upcoming quarters and through 2011, in which we estimate that GDP will grow by 3.2% compared to our estimate of 3.8% in 2010.

The rate of unemployment in Israel is relatively low in comparison to most OECD countries

The downward trend of the rate of unemployment in Israel continued in May. Monthly data published by the CBS show that the rate of unemployment has declined to 6.5%, the lowest rate since late 2008, during the peak of the global economic crisis. Such a low rate of unemployment may reflect the economy coming close to a state of "full employment". Note that the rate of unemployment tends to lag after the state of the economy and is not a leading indicator.

The quick recovery of the Israeli labor market and the decline of the rate of unemployment to a low level, reflect a greater degree of flexibility in this market than in the past along with stronger economic conditions in Israel at the start and during the global financial crisis.

The rate of unemployment in OECD countries
May 2010*



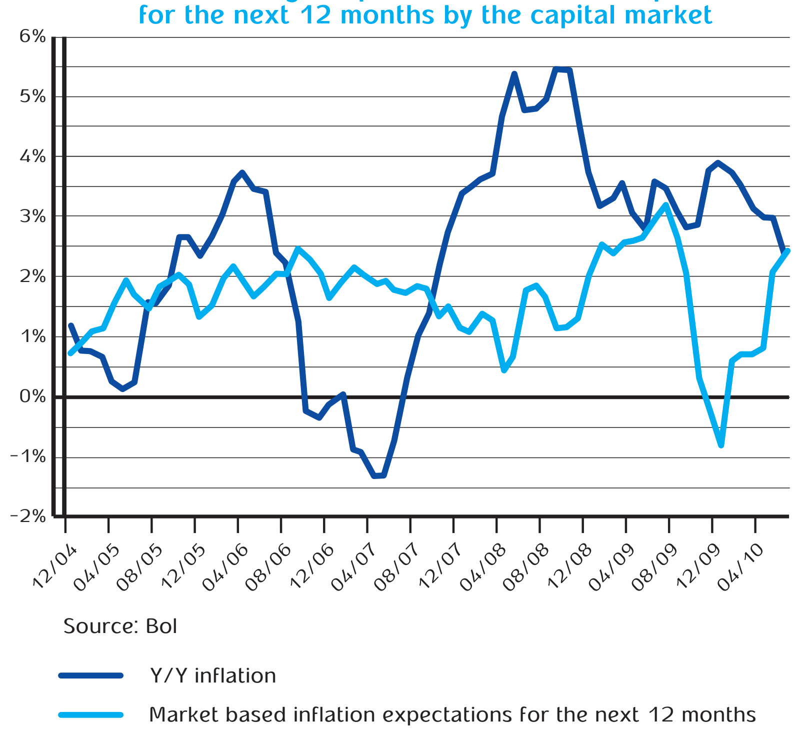
Israel is placed well compared to other countries: most OECD countries have a higher rate of unemployment than Israel, with an average of 8.6%, with a higher average among the European members of the OECD, of 9.6%.

* Norway and Chile - 04/10: UK, Greece and Turkey - 03/10

The CPI rose 0.3% m/m in June

The CPI rose 0.3% in June and year to date it has risen by 0.7%. During the past 12 months the CPI has risen by 2.4% and is within the price stability range of 1-3%. For all of 2010 inflation is expected to be at the center of this range. In comparison to actual inflation, which is within the target range, market based breakeven inflation for the next 12 months is above the upper limit of the target. Taken at face value, this is a troubling figure that may reflect future inflationary pressures with economic policy implications. Nonetheless, as can be seen in the accompanying chart, that shows actual inflation along with expected inflation for the same period, the correlation between these two measures of inflation – ex-ante expected and ex-post actual--is low and the levels rarely coincide. This means that the predictive power of market based inflation expectations is very low. Therefore, despite the widespread use of these expectations for policy and business purposes, a great deal of caution is needed when using these measures.

Inflation during the past 12 months and expected for the next 12 months by the capital market



Source: BoI

Although in most of the period presented in the graph the inflation was not within the price stability range of 1-3%, the expectations were. This also represents the low predictive power of market based inflation expectations.

The Bank of Israel hikes its interest rate to 1.75%

On July 26th the Bank of Israel (BoI) announced a 25bps hike to its interest rate for August, to 1.75%. Within the framework of the background conditions noted by the central bank, it is worth emphasizing the following:

• The inflation expectations of both private forecasters in the economy and of the BoI were revised upwards, while capital market derived inflation expectations are currently along the upper border of the price stability target range.

• The BoI raised doubts regarding the sustainability of the rate of recovery of real activity that has characterized the economy until recently.

• The BoI related in its announcement to both the considerable increase in the rate of mortgage grants and also to the question of prices in the housing market. On these matters it was stated: "An updated analysis on the question of housing prices shows their level does not deviate substantially from the appropriate price that matches the fundamental economic conditions. However, the rate of increase of prices, also in April, continues to be very rapid and their continued rise at this rate also in the future is expected to distance them from the level that matches the fundamental economic conditions."

• The main central banks around the world are expected to delay the movement towards interest rate hikes, in contrast to other central banks, such as Canada and New Zealand, that already began the process and are expected to continue to raise rates.

The background conditions mentioned above led the BoI to hike its interest rate by a moderate level, after no change was implemented since April 2010. It therefore appears the main factor behind the interest rate decision touches on the continued rise in housing prices and the concern that this will negatively impact both inflation in the economy and also financial and economic activity.

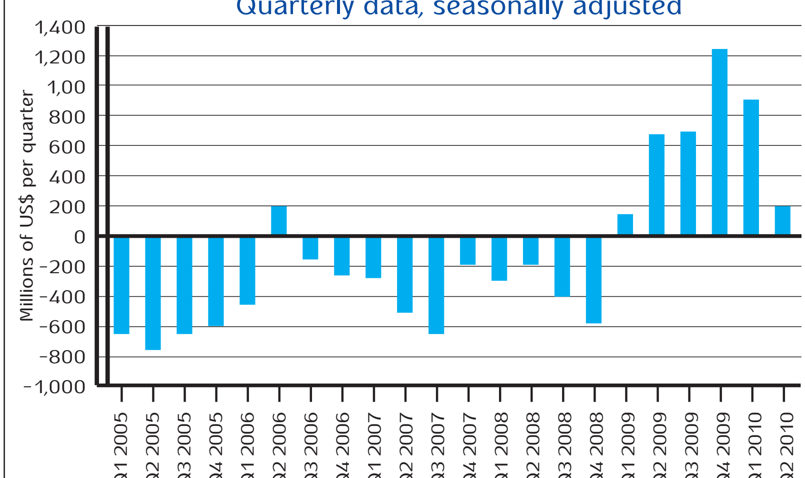
The surplus in Israel's basic goods foreign trade account narrows

Israel's overall trade deficit amounted to US$2.7bn in the first half of 2010, compared to US$2.0bn in the same period of 2009. This increase stems primarily from a rise in expenditures on oil imports. In addition to this broadly defined overall trade deficit, there is also a more narrowly-defined figure that neutralizes from the overall deficit volatile components such as ships, aircraft, fuel and diamonds. This "basic" trade deficit, which holds greater economic significance in terms of the central trends of the economy, is presented in the accompanying graph.

The weakness in exports is notable in most sub-sectors, except for the pharmaceuticals and the machinery and equipment sectors, which expanded by an accelerated rate in the second quarter. However, it is important to remember that the analysis of foreign trade data is based on data assessed in US dollar terms, and as such it is likely to be influenced by, among other things, changes in the exchange rate of the dollar in the world vis-à-vis different currencies. In the second quarter of the year the dollar strengthened (on a quarterly average) vis-à-vis the euro by of 9%, compared to the first quarter, a significant rate in relation to the past.

Therefore, taking into consideration the significant component of exports to Europe, it is possible the quantitative export data (that is total exports excluding the impact of the currency) will not indicate such a negative trend as that which is reflected in the data based in nominal US dollar terms.

The "basic" foreign trade deficit (-)/ surplus (+):
the trade balance less trade in diamonds, ships, aircraft and fuel
Quarterly data, seasonally adjusted



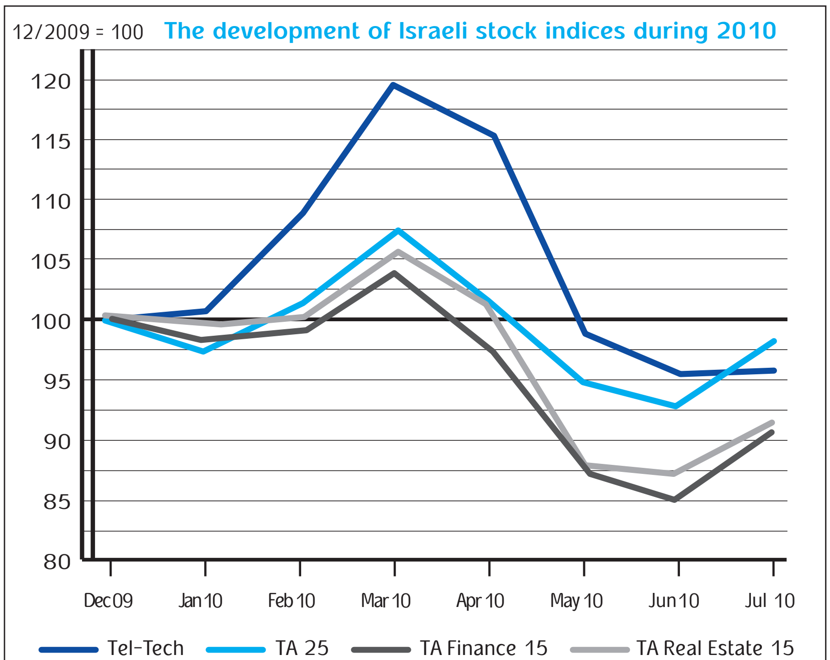
In the last six quarters there was no deficit according to this basic account, but instead there was a surplus. What this means is that there exists a surplus of exports over imports in the foreign trade goods account; however, the trend in recent quarters is one of a rapid decline in this surplus. The factor behind this narrowing surplus, in particular in the second quarter of this year, compared to the first quarter, is the decline in exports, and this development has negative economic implications of an economic slowdown. In contrast, imports expanded, albeit by only a low rate.

The Israeli Capital Market
in the first Half of 2010

At the beginning of April 2010 the TA-25 index of blue chip shares reached a new historic peak when it touched a high of 1,238 points, which is 110% above the low the index was at in November 2008. Throughout 2009 and in the first quarter of 2010 the Tel Aviv Stock Exchange (TASE) experienced sharp gains. However, in the period April - June 2010 there were price declines in Israel and in other countries around the world. That is against the backdrop of the deepening of the debt crisis in Greece and rising concerns that the crisis would spread to additional countries in the region that are characterized also by fiscal weakness, structural problems, and large government budget deficits. The threat to stability in the euro block even led to many concerns regarding the fate of the European Union in the event of Greece's rescue plan actually failing.

The situation around the world was also quite similar; however, it is important to remember that the gains registered around the world throughout 2009 and the first quarter of 2010 were more moderate. The S&P 500 Index in the US declined 12% during the period April - June 2010. The German DAX and the French CAC fell by 3% and 13%, respectively. The NIKKEI and the Hang-Seng registered declines of 15% and 5%, respectively. In China, the Shanghai Index fell by a high rate of 23%, due to, among other reasons, concerns of a slowdown in the high rate of growth of the Chinese economy.

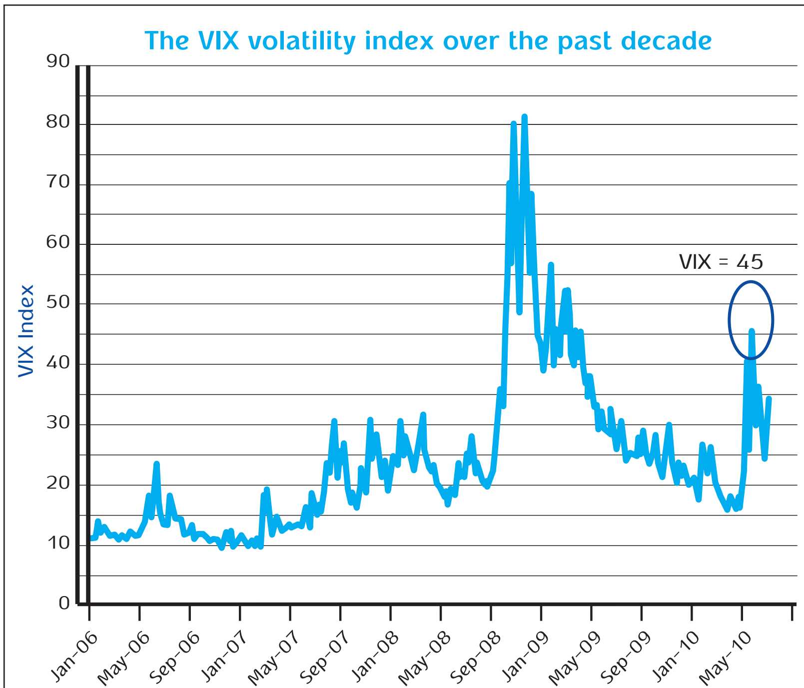
Additional indicators, such as the strengthening of the US dollar and increases in gold prices, testify as well to the prevailing panic in the markets in the recent period, alongside a move by investors to instruments considered more secure. Government budget cutting plans and tax hikes that are intended to



During April-June 2010, The TA-25 and the TA-100 indices fell 14% each. The Real Estate 15 Index dropped 17%; and the Tel-Tech Index fell by a sharp rate of 20%, due to, among other reasons, concerns regarding the damage to exports to European countries. The Bank Index, which suffered a certain weakness since the beginning of the year, fell an additional 18% in April -June.

reduce the giant debts that have accumulated in EU states are likely to support an economic slowdown in Europe. This is likely to impact also on Israel via the country's trade links with the EU, via its various sectors. Overall the EU accounts for 31% of total goods exports from Israel. However, we are of the opinion that the reaction of the markets to such a scenario at the present moment was overstated, regarding the expected economic situation in Europe and its implications.

One main factor that likely explains the fall in prices in Israel is technical. As we noted, throughout the second half of 2009 and the first months of 2010 the leading indices in Israel rose by more than 100%. These gains were supported by positive macro-economic data coming out of Israel, and also increasing signs of stability of the local and global economies. In addition, the very low interest rate on risk-free assets, accompanied by an increase in investors' appetite for risk (as investors move to riskier instruments with higher yields), all contributed to the rise in prices. As a result of this, the public's portfolio of financial assets increased by a real rate of 5.7% in the first quarter of 2010. The main increase in the value of the portfolio stemmed from a rise in the value of the securities component, which increased 12% in the first quarter of 2010, in continuation of a similar rise in the final quarter of 2009. It is significant that the increase in the value of the portfolio reflects primarily the rise in stock and bond prices, the proportion of which in the portfolio increased during the first quarter of the year. Actually, it can be said that after a long period of gains in the stock markets, and taking into consideration the real rate of economic growth, the price declines that we are seeing now, can be understood as a natural process that is occurring at the right time as a pressure releasing valve. As mentioned above, the debt crisis in Europe was for all intents and purposes a catalyst for this process.



The nervousness in the markets is reflected in a sharp rise in the CBOE volatility index, which goes by the symbol VIX and measures volatility in the US stock market.

The bond market

Government bonds

Throughout April non-linked shekel and CPI-linked government bonds, with relatively short durations, were characterized by increases in their yields-to-maturity. At the same time, yields on longer-term bonds were relatively stable, and as a result the yield curve continued to flatten (the differential between yields on long-term and short-term bonds). In contrast, in the months May - June this trend changed and as prices fell in the stock market, bond prices began to rise and yields-to-maturity started retreating across the length of the yield curve, in the CPI-linked and the shekel bond markets (as investors moved to safer investments). The yields to maturity on CPI-linked bonds fell in the months May - June by 0.3 - 0.5%. A similar change was seen in the long-term shekel bonds. In contrast, the fall in the shorter segment of the shekel yield curve was more moderate in relation to the fall in the shorter segment of the CPI-linked yield curve.

The rise in the yields-to-maturity on the shorter-term non-linked shekel government bonds throughout April was supported by both the expectation for an interest rate hike by the Bank of Israel (BoI) and also by the expectation for an increase in the amount of T-bill (Makam) issues, targeted at absorbing the excess liquidity in the economy. During the second half of May, when expectations for an interest rate hike lessened, there began a decline in the yields-to-maturity among the shorter-term shekel bonds. In addition, a flow of demand from foreign investors that have been acting in the local T-bill market recently (the proportion of foreigners out of the total of T-bill holders in Israel rose from 4.5% in December 2009 to 22% in June of this year), represents a factor that also supports a decline in T-bill yields.

Looking forward, it is possible the substantial economic difficulties in Europe will strengthen the feeling among these investors and others that the BoI does not intend to hike the interest rate aggressively during the coming year (as can be understood from the recent interest rate decisions). Against this backdrop, T-bill purchases will continue for the purpose of realizing the various types of carry transactions being implemented. On the other hand, if the debt crisis in Europe will create a liquidity squeeze, it is possible we will see a temporary sell-off in the T-bill market.

The long end of the shekel and CPI-linked yield curves was affected also by short-term interest rates, but only by a relatively small degree. The long end of the yield curve was affected primarily by the changes in the government budget deficit and from the amount of government capital raising in the local bond market. During the months April - June 2010 there was capital redemption of tradable government bonds in the amount of NIS 20bn, in addition to capital redemption of non-traded government bonds in the amount of NIS 2bn. More than 60% of the redemptions were in CPI-linked bonds. According to the debt raising plans of the government, tradable bond issues in the months April and May equaled NIS 7.3bn, such that there was a very large net redemption that created heavy liquidity in the markets.

Looking forward the government budget deficit is expected to be significantly below the target, equaling 4% of GDP in place of 5.5% of GDP as originally targeted. Therefore, as mentioned, the amount of capital raising by the government will be relatively less than originally planned, especially in comparison to previous years and in comparison to the large amounts of redemption. In terms of the composition of the capital raising, the relatively small proportion of less than 20% of CPI-linked bonds in the government issues is notable, this in contrast to more than 60% in redemptions. These figures impact the "degree of scarcity" of CPI-linked bonds in the market, and consequently may support their pricing. Alongside this development, the government began to issue a series of short-term shekel bonds with a term of only six months to redemption. This "competitor" to the T-bill increases the supply of short-term non-linked shekel bonds and thus is likely to contribute to an upward trend of short-term shekel yields in the coming months.

An additional factor, which affects primarily the longer segment of the yield curve, relates to bond yields overseas (in particular the US). Despite the positive correlation between the yields in the US and the yields in Israel, recently the spreads between US and Israeli bonds widened, because of the sharp fall in yields on US government bonds. In other words, yield movements in Israel have still not caught up to the parallel yield declines in the US.

Corporate bonds

In contrast to the stock market, the corporate bond market remained relatively stable during the months April - June, with only moderate price increases. During this period the Tel-bond 40 Index increased by a trivial 0.3%. The Tel-bond 20 index registered a 3% increase, similar to the index of government bonds, which increased 3.5%.

Economic and Financial Indicators of Israel

	updated to:	Last three months: compared to the previous period*	Last three months: compared to the corresponding period*	2007	2008	2009
ECONOMIC ACTIVITY		real percent change				
Industrial output	May	3.4	10.1	5.2	7.0	-5.9
Revenue of trade and services sectors	May	1.4	10.3	9.1	-0.4	-3.0
State of the economy index	June	0.4	5.2	6.0	2.6	-1.1
ECONOMIC SECTORS		real percent change				
High-technology industrial output	May	6.6	9.5	5.3	16.5	-0.6
Sales of new dwellings in private construction	May	10.9	-2.0	4.3	-3.4	10.4
Hotel person nights	May	5.0	15.0	6.6	5.0	-8.0
of which: tourists	May	13.1	35.5	21.2	23.1	-20.8
FOREIGN TRADE		percent change (current US$ prices)				
Export of goods (ex. ships, aircrafts and diamonds)	June	-5.2	18.9	18.0	16.9	-13.8
of which:manufacturing (ex. diamonds)	June	-5.3	18.7	17.6	18.0	-14.0
agricultural	June	-1.9	23.9	29.4	-8.6	-6.1
Import of goods (ex. ships, aircrafts and diamonds)	June	0.2	29.8	20.6	21.0	-26.0
of which:raw materials (ex. diamonds and fuels)	June	1.4	33.5	17.4	13.4	-25.3
investment goods (ex. ships and aircrafts)	June	1.8	19.7	25.6	17.0	-27.8
consumption goods	June	1.8	19.4	25.8	20.1	-8.4
LABOR MARKET		real percent change				
Employee posts - Israeli workers	April	0.4	2.3	5.4	2.7	-0.1
Average wage per Israeli employee	April	2.0	0.0	2.0	-0.6	-2.6

		Last 3 months**	The corresponding period**	2007	2008	2009
GOVERNMENT BUDGET		percentage of GDP				
Total revenues and grants	June	29.5	28.0	34.3	32.3	30.3
Total expenditure and credit allocated	June	32.2	34.5	33.8	33.6	35.2
Deficit (-) / Surplus (+)	June	-2.7	-6.5	0.5	-1.3	-4.9
of which:deficit (-) / surplus (+) ex. credit (net)	June	-3.5	-7.4	0.0	-2.2	-5.6
Domestic borrowing (net)	June	-3.2	7.9	-0.7	2.8	5.4
Loans from abroad (net)	June	-1.0	0.4	-0.8	-0.9	0.7

		Last 3 months	Last 12 months	2007	2008	2009
PRICES, EXCHANGE RATES AND TOTAL YIELD INDICES		percent change (end of period)				
Consumer price index	June	1.5	2.4	3.4	3.8	4.2
Wholesale price index of manufacturing output	June	-0.3	3.6	11.4	-4.4	3.4
Price index of input in residential building	June	0.9	2.7	3.1	3.3	0.0
NIS/US$ exchange rate	June	3.9	-1.6	-7.7	-1.4	-0.5
NIS/EURO exchange rate	June	-4.8	-14.1	1.7	-1.8	2.6
NIS/trade-weighted exchange rate	June	4.4	-1.6	0.0	-42.3	0.1
Tel-Aviv 100 index	June	-14.3	23.6	26.3	-52.4	92.3
Tel-Aviv 25 index	June	-13.6	23.2	32.3	-47.7	78.6
Tel-Tech index	June	-19.7	15.5	-2.3	-63.2	109.9

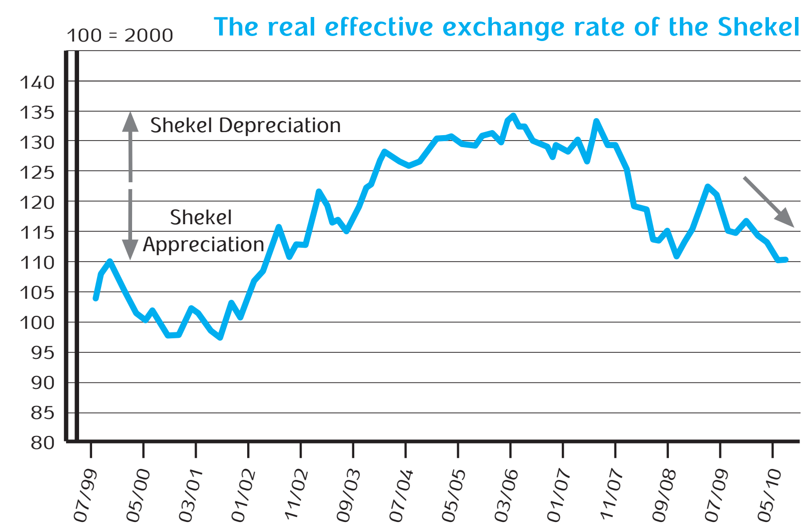
		The last month	The corresponding month			
INTEREST RATES		average of the last month (%)				
Bank of Israel interest rate	August	1.50	0.50	4.00	2.50	1.00
Non-linked treasury bill ("MAKAM")- 1yr yield to maturity	June	2.11	1.31	4.61	2.05	1.86
Non-linked government bond ("SHACHAR")-10yrs yield to maturity	June	4.71	5.53	6.01	5.27	5.13
CPI-linked government bond ("GALIL")-9yrs yield to maturity	June	1.97	2.86	3.48	3.45	2.45
Federal Reserve effective rate	July	0.18	0.16	4.50	0.25	0.12

* 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 Development of the Exchange Rate of the Shekel and its Implications

The real effective exchange rate appreciated substantially in recent months

The real effective exchange rate[1] is used as a measure of the degree of competitiveness of the shekel and is based on changes in the shekel exchange rate vis-à-vis the basket of currencies, excluding inflation differences between Israel and the states with which Israel trades[2]. In the first six months of 2010 the real exchange rate appreciated (a real strengthening of the shekel) by 5.1%, as the degree of competitiveness of the shekel deteriorated in the world (see attached graph). Because this relates to a development occurring in the basket of currencies (the effective exchange rate), it does not refer to a strengthening of the shekel vis-à-vis one specific currency (for example, the US dollar only), but instead is against a list of main currencies around the world. This strengthening trend of the shekel, together with a loss of competitiveness, has been continuing already for a long period.



Source: The Bank of Israel. The real effective exchange rate measurement is based on a geometric mean of the exchange rate of the shekel vis-à-vis 38 trading partner countries of Israel, excluding the inflation differentials between Israel and these countries.

When analyzing the level of the real exchange rate, we see that it has appreciated to the point of the peak of the real appreciation that occurred in October 2008.

What does this mean for the local economy?

The trend of appreciation in the local currency, if it indeed will continue in the coming months, will in and of itself continue to hurt the revenues of most Israeli exporters (this document does not deal with the question of the composition of expenditures and therefore also does not deal with the question of profitability). In particular this issue affects products that are sensitive

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[1] Calculated by the Bank of Israel.

[2] The nominal exchange rate is also used from time to time as a measure of the degree of competitiveness of the shekel. However, weighting the changes in price levels in Israel versus the price levels overseas in the real exchange rate makes this a better measurement from which to gauge.

to exchange rate developments, such as products from the traditional industries, and especially "off-the-shelf" products that are marketed in an especially competitive environment.

However, in an analysis of the impact of the exchange rate on exports it is worthwhile to take into consideration the composition of exports from the Israeli economy, which is High-Tech intensive. On this regard, we are reminded of an analysis carried out by the Bank of Israel[3] (BoI), which claims the real exchange rate indeed does not have a clear impact on exports from the more advanced sectors of the economy, but instead on the mixed sectors. In other words, there is a clear, positive impact felt in sectors characterized by medium and low levels of technology. Therefore, the fact that Israeli export is High-Tech intensive lessens the impact of the real appreciation of the currency at the aggregate level. However, certain sectors, especially those that are labor intensive, are likely to be hurt significantly from currency appreciation.

Take for example the clothing sector, which in addition to the negative impact felt by the exchange rate, its' profitability is also hurt as a result of the departure of many companies overseas. Furthermore these companies were exposed to the global economic recession during the period 2008-2009. In the event 2011 will suffer from an economic slowdown in the Western world, with an emphasis on Europe, there will be a renewed negative impact on the clothing products export sector. Also companies in the textile sector, which export a substantial portion of their output, are reporting a negative impact of the appreciation in the exchange rate on their financial results and deterioration in profitability. In addition to these industrial sectors, service sectors such as the tourism sector, have been negatively affected. The tourism sector revenues are dependent on tourist entries into the country, are being hurt by the appreciation in the shekel.

In February 2010 the Governor of the BoI, Prof. Stanley Fischer, addressed the conference marking 50 years of the central bank of Australia. In his speech he referred to the deterioration in the degree of competitiveness of the shekel and the intervention of the BoI in foreign currency trading over the last two years. The Governor referred to "foreign exchange problems in small, open economies," and made a differentiation between intervention in the foreign exchange market in the event of depreciation and appreciation. He mentioned that in the case of depreciation the central bank will not be able to intervene forever, because the amount of reserves that it can sell to the market is limited. In the second case intervention will be feasible as long as it is possible to neutralize the

[3] See the 2008 Annual Report of the Bank of Israel, page 82.

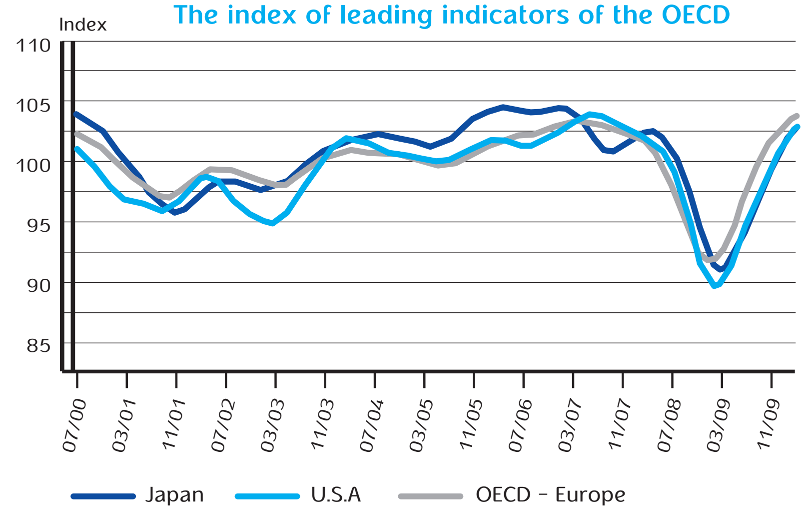
inflationary impact of the monetary expansion. In other words, it is up to the country to decide how much it is prepared to increase its foreign currency reserves, with all the consequences that are attached to such action. What will happen if the country will decide to cease intervention? Then it will be forced to consider regulations on internal capital flows, an issue the International Monetary Fund recently expressed a more positive opinion of compared to the past. The Governor concluded his speech by referring to capital flow regulations, saying "It is upon policy makers to make every effort to refrain from implementing such measures - but for central bankers it is never worthwhile to say never."

Until recently there were encouraging signs regarding economic activity overseas, but...

Despite the deterioration in the degree of competitiveness of exports that is reflected in the real exchange rate of the shekel, exports are affected also by quantitative changes, in other words, from the strength of global demand. In recent months signs of improvement have been seen in most of Israel's trading regions, which are the regions of demand for export. Against this backdrop the International Monetary Fund (IMF) in April 2010 revised upwards its forecasts for global economic growth in 2010.

This relatively optimistic approach, which prevailed until recently, is reflected in the "Index of Leading Indicators" of the OECD, seen in the attached graph. The purpose of this index, which weighs various indicators of economic activity, is to indicate the turnaround point in economic activity six months in advance[4].

The index of leading indicators of the OECD

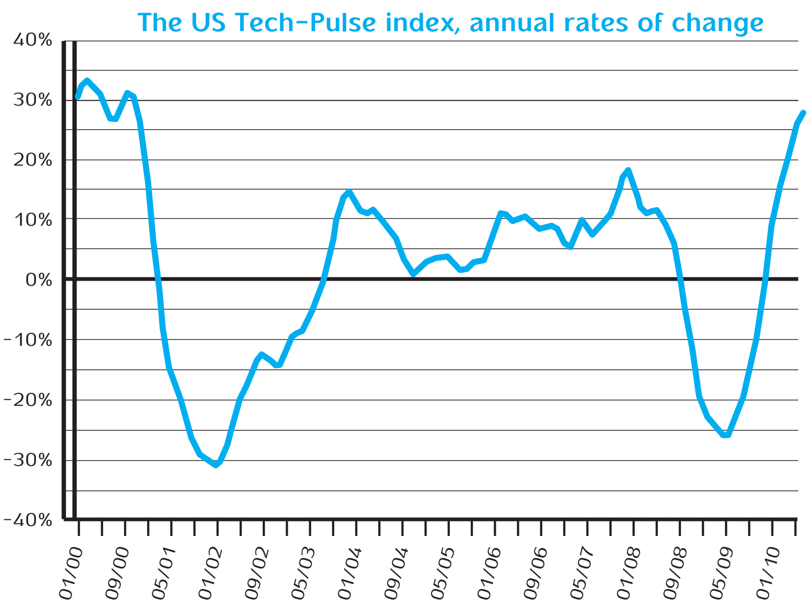


Source: OECD

The index, which relates to countries to which most Israel's exports are shipped, indicates an expected continued expansion in economic activity (the index relates to industrial production); however, there are strong and clear signs of a slowdown in the rate of economic growth.

In countries such as France, Italy, China, and India a decline was seen from the peak levels of growth registered just a few months ago, while countries such as Canada, Britain, and Brazil are close to this situation. In contrast, in Germany, Japan, the US, and Russia the index is continuing to show an expansion

[4] The line at 100 signals the long-term trend of the industrial production index, and it represents the reference series of the index. When the index rises above 100 it means an expansion in activity and when it falls below 100 then a slowdown in activity is expected.



Source: Federal Reserve Bank of San Francisco

In contrast to the fragile situation evident in some countries of Europe, there are continuing signs of a recovery in the state of the High-Tech sector in the US, as can be seen from, among other things, the increase in the Tech-Pulse index. This index reflects developments in the US high-tech sector, and affects the Israeli high-tech sector as well.

in activity, albeit at a slower rate. Taking into consideration the fact that the index precedes the activity it measures by six months, it is likely to reflect an expected slowdown from the demand side for industrial activity in Israel for the remainder of 2010 and throughout 2011. This is the main reason behind our forecast that GDP growth in 2011 will be more moderate to that in 2010, with our current forecast calling for about 3% GDP growth in 2011.

Summary

Despite the errosion of Israel's competitiveness stemming from the strong exchange rate of the shekel, it appears that in 2010 it is likely the increase in global demand, which occurred primarily in the second half of 2009 and the first half of 2010, will compensate for this. This will also lead nonetheless to an expansion in Israeli exports, in an annualized rate. The economic slowdown in various parts of the Western world in the second half of 2010 is expected to negatively impact the trends in Israeli exports throughout 2011. However, and as noted previously, large differences are expected between the sectors. There will be an expansion in the High-Tech sectors, which are more sensitive to developments in demand, and to the strength of the recovery in this area in the US, and are less sensitive to the exchange rate. On the other hand, there will be relative weakness in the traditional sectors (with low levels of technology) that are more sensitive to the exchange rate. Among the sectors that are characterized as low and medium technology are the clothing, textile, and printing sectors.

Naturally there exists a relatively large degree of uncertainty regarding the development of the exchange rate in Israel and in the world; and therefore, companies, and in particular those that are more sensitive to the exchange rate, can prepare for this by using existing financial tools. Thus it is possible to partially reduce the risk to these sectors. This despite the fact that there is no complete solution to the problem of the real exchange rate, the importance of which is quite considerable from the point of view of the competitive strength of the export sectors of the Israeli economy.

Monetary Policy and Asset Prices in Israel – Is There Any Resemblance to the Events that Occurred in the US?

Introduction

The rapid rise in asset prices in Israel over the last two years, both financial (in particular in 2009) and housing prices, raised questions regarding the derived meaning of these developments. The Bank of Israel (BoI) even referred to these events within the framework of its interest rate discussions, and also in the central bank's discussions on housing matters carried out recently. This is all against the backdrop of the bubble in real estate prices in the US, which was a central factor behind the financial crisis there and in other places around the world. In this review we will relate to an analysis presented in the US by the chairman of the US Federal Reserve Bank, Mr. Ben Bernanke, and will shed light on the different situation in Israel, on the basis of data on both the public's portfolio of financial assets and also the local housing market.

What happened in the US?

At the beginning of January 2010 the chairman of the US Federal Reserve spoke at the annual conference of the American Economic Association. In his speech he presented a paper entitled "Monetary Policy and the Housing Bubble". In that paper the chairman analyzed the monetary policy implemented in the US, in particular during the middle of the last decade. Moreover they checked whether or not this policy led to the bubble in housing prices and if ultimately the policy was the reason behind the crisis of the last two years.

Several points were raised in the chairman's speech: the upward trend in housing prices in the US began at the end of the 1990s with annual rates of increase of 7-8%, which rose to annual rates of increase of 9-11% in the period 2000-2003. Therefore, in his words, the beginning of the acceleration in the rise in prices preceded the period of expansionary monetary policy (the interest rate reached 1% in 2003). On the other hand, the fastest rates of increase in prices occurred in 2004-2005. In those years the prices ranged between 15-17% per year, and therefore the contribution of monetary policy to this development cannot be completely ignored.

In the words of Mr. Bernanke, research conducted on this topic claim that only a small portion of the rise in housing prices stems from the monetary policy. However, in contrast to this research, the claim has been raised that the change that occurred in recent years in the method by which home purchases are financed, compared to the situation in the 1980s and 1990s, acted to strongly link monetary policy and housing prices. This is against the backdrop of the fact that approximately one-third of total mortgages granted are variable interest mortgages, which are very sensitive to changes in the interest rate. A significant interest rate cut acts to reduce the cost of mortgages and causes an incentive to increase housing demand and price increases. In recent years a variety of variable interest rate mortgages were offered to the US public. These mortgages were introduced as "new products" (called "exotic mortgages"), which permitted low monthly payments in the initial years of the loan. The inherent risks found in these products were not always clear to the borrowers. The chairman claimed that apparently this is the main reason for the bubble in housing prices.

An international comparison shows that the degree of monetary policy expansion among 20 advanced countries in the years 2002-2006 was only weakly, and not so clearly, linked to the rise in housing prices. Apparently in 11 of the 20 countries there was more restraining monetary policy than what was in the US, but housing prices rose more so.

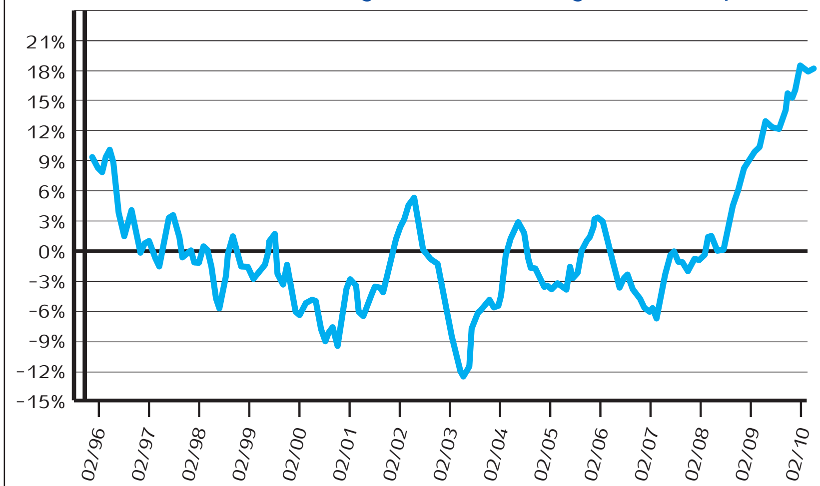
The main conclusion of the chairman, against the backdrop of the above findings, was that the source of the problems and the bubble in housing prices was the poor regulatory environment, and less so the expansionary monetary policy.

What happened in Israel?

At the end of 2009 the BoI initiated an upward trend in the local interest rate, after rates had been cut during the year to as low as 0.5%. One of the factors behind the change in the interest rate in recent months, and upon which the BoI referred to, touched on the rise in asset prices, among them being housing prices. Up until then the BoI had not used the term "asset price inflation" as an excuse to raising interest rates. Since expansionary monetary policy began to be implemented and as the interest rate approached zero, the public channeled some of its assets to investment instruments with higher rates of risk, but with the possibility of higher returns.

Thus, part of the increase in housing prices in 2008-2009 stems from housing purchases for investment purposes, and from the ability to get mortgages at exceptionally low rates. Regarding housing units for investment purposes, data from the Finance Ministry show that the total number of units purchased for investment purposes ("additional apartment") amounted to 31,000 units in 2009 (an increase of 13% compared to 2008). That is out of the overall total of 102,000 housing purchases (new and second hand). This increase was centered primarily in the May-August 2009 period (a 23% increase between 2009 and 2008), against the backdrop of, among other things, the cut in the BoI interest rate to a low of 0.5% (nominal). The substantial cut in the interest rate led to a significant increase in the number of loans granted in the banking system at non CPI-linked shekel rates. In 2009 the total amount of these loans amounted to NIS 20.8bn, accounting for 60% of total loans, compared to 2007 when these types of loans accounted for 35% of the total, and in 2008 when the figure was 48%. This change in the public's loan preference should be seen in terms of a "new product" which until that point the public did not use so much. In the first quarter of 2010 there was a sharp decline registered in the number of housing purchases for investment purposes compared to the fourth quarter of 2009.

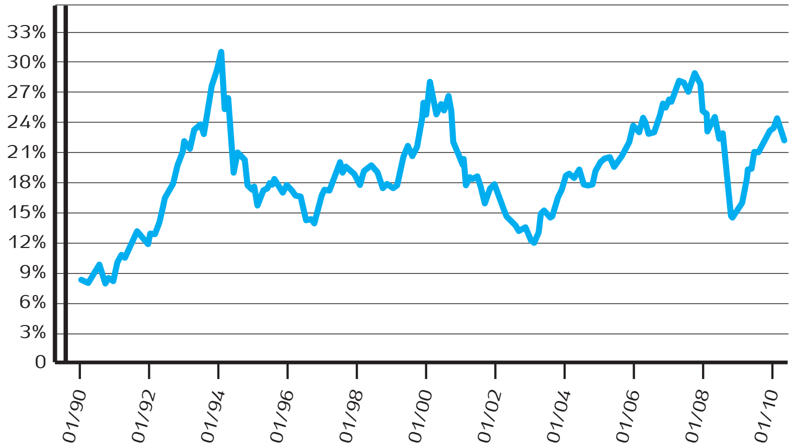
Housing prices according to "the housing prices survey" of the Central Bureau of Statistics
(Real term rates of change over the trailing 12-month period)



After years of a fall in housing prices (negative rates of change), last year the rate of increase accelerated strongly, although this is not a long-term development similar to the situation in the US.

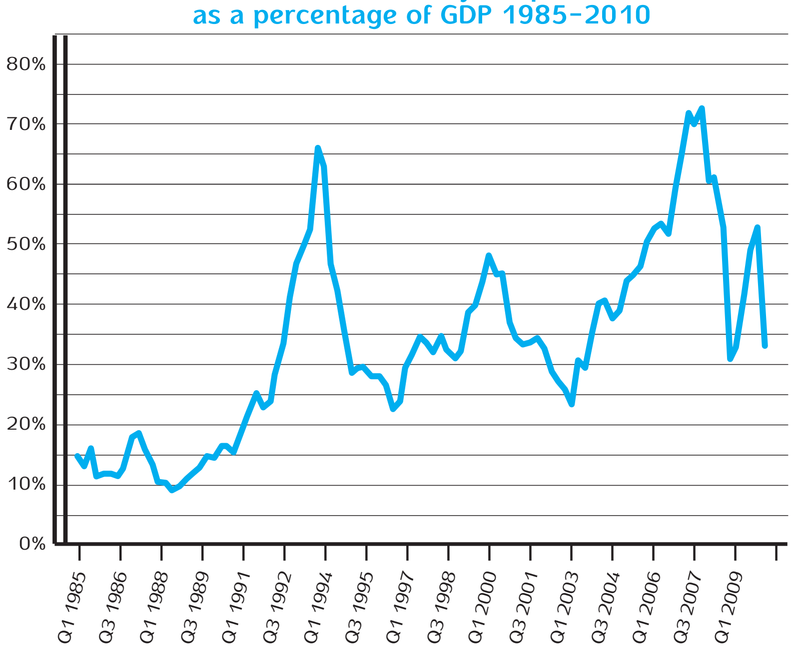
Since the increase in demand for housing in the short-term is not accompanied by an increase in supply, which is a longer-term process, the impact of the low interest rate was primarily on prices and less on activity in the sector. This development is reflected in the attached graph, which presents the real change in housing prices over the last 14 years (the change in nominal housing prices, excluding the CPI without housing). Although the prices increase accelerated strongly, the real level of housing prices is still below the level of prices from a decade ago. Due to these developments, the BoI decided to act to moderate the rise in housing prices. At the end of May, a new directive was published by the Supervisor of Banks. The directive referred to the issue of the risks associated with housing loans. Its purpose was moderating the increase in housing prices and the amount of credit for housing, which stemmed from, among other things, the low interest rates in the economy. In our opinion, the BoI is using this regulatory tool in order to prevent, as much as possible, a hike in the interest rate. This is against the backdrop of concerns over the potential negative effects on exports (exchange rate effect) and on economic growth (due to uncertainty regarding global economic activity).

The proportion of domestic and overseas stocks in the Israeli public's portfolio of financial assets
(January 1990 - May 2010)



Over the past two decades there were periods in which the Israeli public's "appetite for risk" (the public's decision to hold at any point in time a certain proportion of stocks in the portfolio) was reflected in a higher holding rate than what is seen today, reaching 27-30%.

The value of stocks held by the public in Israel as a percentage of GDP 1985-2010



This ratio in the first quarter was higher than what it was back in the beginning of 2000, but below the peak level it had reached at the end of 1993, and in comparison to the all-time peak recorded at the end of 2007. In the second quarter of this year the ratio moderated in light of the price declines registered in the stock market.

And what happened to financial asset prices?

The public's portfolio of financial assets increased 22% in 2009, reaching a value of NIS 2,300bn at the end of December 2009. This follows an 8.2% fall in the value of the portfolio in 2008. All the components of the portfolio increased over the past year, with the domestic and overseas stocks component contributing to the increase 65%. This is primarily against the backdrop of the rise in stock prices in stock markets in Israel and overseas. An additional expression of the substantial impact of the rise in prices can be seen in the attached graph, which presents the proportion of stocks in the public's portfolio of financial assets. Since the beginning of 2010 through the end of May the value of the portfolio of assets has increased 1%, and in May 2010 the proportion of shares in the portfolio was 22%.

When analyzing the development of the value of stocks held by the public (based both on the impact of prices on securities and also on company issues/erasures), which account for part of the public's portfolio of financial assets, a number of trends are indicated, in historical terms. In the first quarter of 2010 the ratio of the market capitalization of the Tel Aviv Stock Exchange (TASE) to the country's GDP reached 61%, representing a substantial increase from the level at the end of 2008.

Summary

The main conclusion of the chairman of the US Federal Reserve on matters relating to the bubble in residential real estate prices was that it was not the prevailing low level of the short-term interest rate, but instead the rise in the wide use of different types of risky loans, which permitted low payments in the short-term, that led to the rise in demand in the housing market and as a result a price bubble. As a result, the best response in his opinion must be regulatory and not monetary. In Israel, in contrast, over the last two years there has been a substantial increase both in housing prices and also in financial asset prices, but these developments are not substantial when looking over the long-term. Furthermore, the current situation does not reflect peak price levels; and also the nature of the mortgage granting process in Israel is such that it greatly reduces the possibility of reaching a crisis situation similar to what occurred in the US economy. However, the BoI chose to act recently by means of a regulatory tool in order to moderate the rise in prices and to prevent in the future the creation of a situation of a price bubble.

The Residential Construction Sector

Summary

• In recent quarters there has been an increase in the number of residential construction starts. The number today (in annualized terms) is higher than at any time over the last decade.

• The national rise in housing prices averaged an annualized 15.9% in the first quarter of 2010, and is now higher than the average rate of price increases registered in 2009 (an average of 14%). It is important to note that last year's "tail effects" contribute about 5% to these year-over-year price changes. The acceleration in the rise in housing prices characterized all regions, excluding the Dan region, which is the central region of Israel.

• We estimate that the national average of housing prices will continue to rise in the short term. The main reasons behind the upward price pressure are the loose monetary policy and the low supply of new dwellings.

• We estimate that baseline of low monetary policy rate and a supply shortage will persist. Therefore we do not exclude the possibility of a double-digit price increases this year as well.

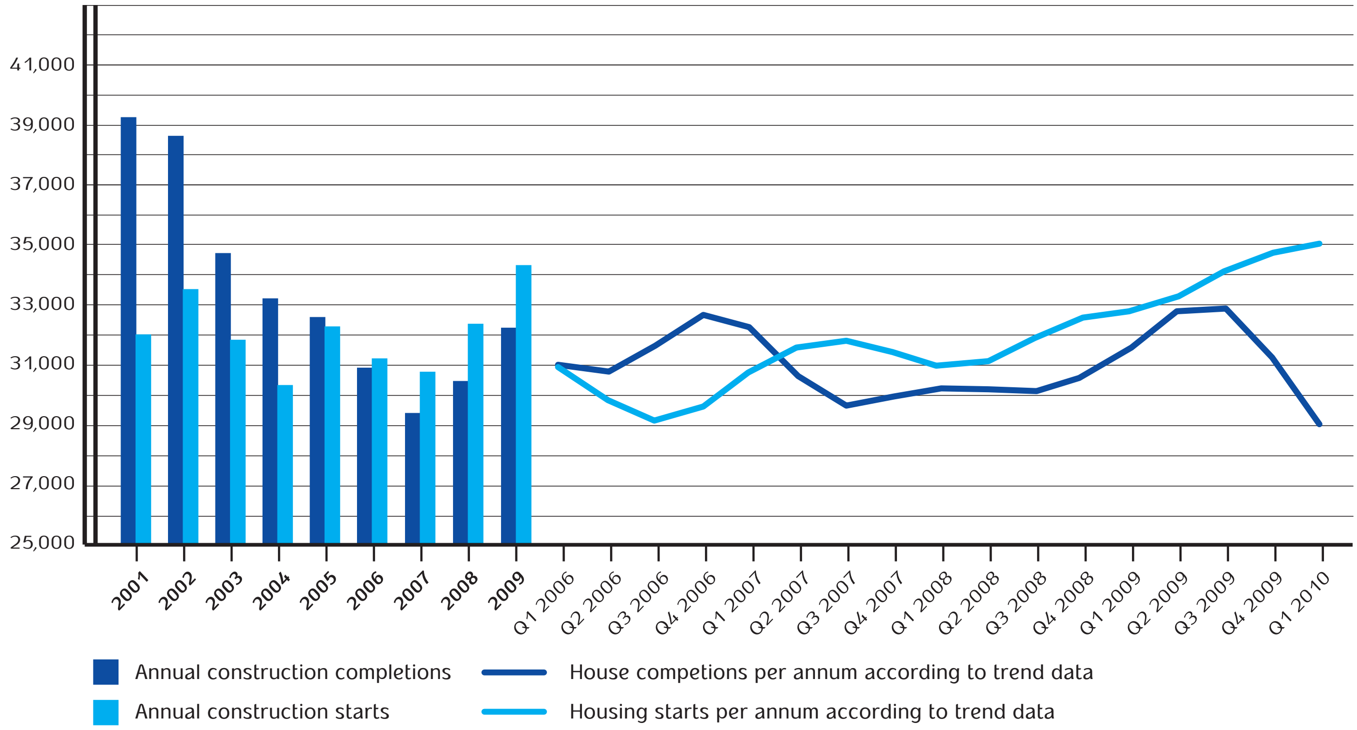
• Recently, the Bank of Israel (BoI) implemented regulatory actions with the purpose of restraining in the demand for housing. Though, it seems that the policy implemented until now is not sufficient to quickly restrain the rise in demand.

The supply side: housing units in stages of construction

The inventory of housing units under construction in the first quarter of 2010 increased sharply and stood at 63,965 units, representing a 6.3% increase compared to the same period last year. This level is 4,000 units more than the level of inventory that characterized the years 2004 - 2008 (60,000 units). The proportion of housing units under construction now initiated by the private construction sector equals 87%, while the remaining 13% were initiated by the public sector. The changes in the inventory of units under construction over the past year stem from the increase in construction starts that began at the same time as there was a decline in construction completions.

According to data from the Central Bureau of Statistics (CBS), in 2008 there were 2.1 million households in Israel. In the years 2001-2008 the number of households increased 38,900 on average each year. During these years the average number of construction starts equaled 31,800 units per year. In other words, there existed a gap between the number of housing

Construction starts and completions,
actual figures and according to trend data



Source: Central Bureau of Statistics, adapted by the Department of Economics

The number of construction starts increased over the past year 6.6% and stood in the first quarter of 2010 at 35,016 units (according to trend data). The current level of construction starts is higher than that which characterized the past decade. The number of construction completions fell over the past year 8.1%, reaching 29,065 units (according to trend data).

The annual rate of price changes according to the survey of housing prices

Annual average of the rate of change of prices, quarter vs. the same quarter of the preceding year

	10 years average 1999 - 2008	Cumulative increase 2008 - 2009	Annual average 2009	Annual rate of change 1st quarter 2010*
Jerusalem	4.9%	23.4%	12.3%	17.4%
Tel Aviv	4.0%	31.0%	21.4%	32.3%
Dan Region	3.6%	35.6%	14.8%	13.3%
Center	2.4%	32.0%	17.3%	27.7%
Sharon	4.2%	22.4%	14.8%	21.4%
North	-0.1%	7.7%	9.8%	17.1%
South	1.9%	21.4%	14.7%	23.3%
Haifa, city	-0.9%	13.0%	15.7%	15.3%
Haifa Bay	-0.3%	18.8%	17.5%	12.9%
Natl. Average	2.8%	18.5%	14.0%	15.9%

Source: Central Bureau of Statistics, adapted by the Department of Economics

* The tail effect of the price increases during 2009 contribute around 5% to the year-over-year increase in the national average.

units demanded (established according to the number of new households only, ignoring the trend of the improvement in the standard of living) and the number of housing units supplied (which is a result of the number of construction starts). This gap, of 7,000 units per year, which is equivalent to approximately 20% of the number of construction starts, was filled via a reduction in inventory (approximately 2,500 units each year). The rest is explained by measurement problems that may stem from few reasons; an underestimation of illegal construction, the occupation of empty housing units, the conversion of warehouses into residential units, the addition of residential units to existing buildings (without these units being defined as separate units) and statistical errors that may also stem from the manner in which the number of households was assessed.

The increase in activity on the supply side in the construction sector is the result of a significant increase in housing prices over the last two years, which stemmed from an increase in the demand for housing units. As can be seen in the accompanying table, the annual change in the average price of housing units in the ten years ending in 2008 was stable at 2.8%. In the years 2008 - 2009 there began a substantial increase in housing prices which encompassed all regions, in particular the regions of demand in the center of the country. This trend continued as well in the first quarter of 2010.

The price changes presented in the accompanying table were calculated by comparing the average price of housing units in each quarter to the same quarter in the preceding year. In some regions the sharp increase in prices began already in 2008, yet in most cases the increases began in 2009; therefore, we chose to present the cumulative increase in these two years. Overall, the average level of prices in 2009 was 18.5% higher compared to 2007, while in the regions of demand in the center of the country the cumulative increase in prices was 30-35%.

In the first quarter of 2010 (compared to the same quarter of 2009) the sharp rise in housing prices was maintained in each region. In most regions (except in Dan Region) housing prices increased by a rate higher than the average in 2009. The severe increase in prices aroused broad debate of whether the increases were justified on economic terms and whether or not a bubble exists in real estate prices. As already said, in recent years the number of households increased greater than the number of housing units; therefore, there existed a surplus in basic demand for housing that led to a reduction in housing inventory and the creation of housing alternatives. The expansionary monetary policy implemented by the Bank of Israel (BoI) since the end of 2008, together with the absence of attractive alternative investments that matched the public's risk-versus-return preferences, moved many households to take advantage of the low interest rates in the economy in order to purchase housing units. All these developments, in combination with a relatively low and inflexible inventory of housing units, combined to create surplus demand for housing. That led to a sharp decline in the inventory of new housing units for sale. The plans of the Ministry of Construction and Housing for lowering housing prices involved an increase in the marketing of land by the Israel Lands Authority. The amount of land marketed in the first quarter was doubled relative to the average in 2009, and stood at 9,500 housing units in the quarter, of which 3,550 were marketed in the Jerusalem region, 2,650 units in the Tel Aviv and central regions, 1,550 units in the southern region, and 1,750 units in the Haifa and northern regions.

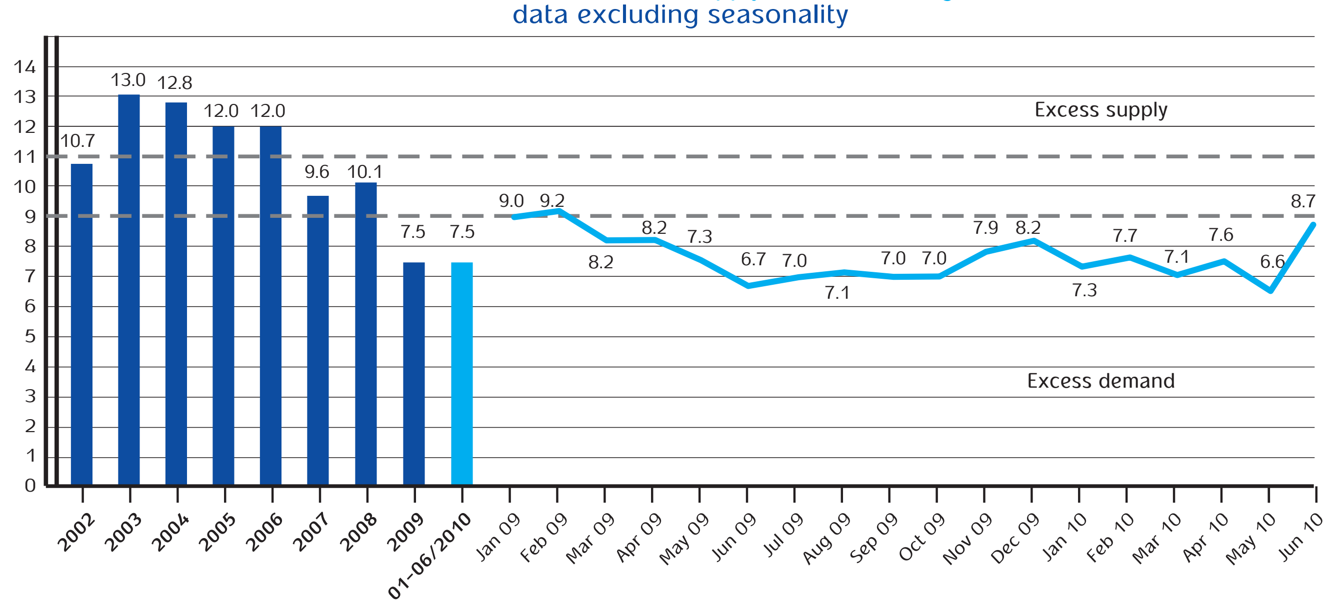
Looking forward: the supply side

We estimate that in the coming year the housing market will continue to be characterized by surplus demand. In May 2010 the level of inventory of new housing units built in the private sector stood at 8,991 units, compared to an average of 11,250 units in the years 2007-2008. Past data show that the closing of this gap (an addition of 2,250 units to the inventory of housing units for sale) will take 2-3 years.

The number of months of housing supply[5] represents a good indicator of surplus demand/supply in the

[5] The number of months of housing supply equals the inventory of new housing units offered for sale at the end of the month divided by the number of new units sold in the same month.

The number of months of supply, national average,
data excluding seasonality



Source: Central Bureau of Statistics, adapted by the Department of Economics

When the number of months of housing supply ranges between 9 - 11, then there is no notable excess supply or demand in the housing market. However, since within housing prices there exists relative inflexibility downward, this situation is generally reflected in a decline in transactions and not in a decline in prices.

housing market. In our opinion, when the number of months of housing supply ranges between 9-11, then there is no notable excess supply or demand in the housing market. A drop in the number of months of housing supply to below nine indicates surplus demand in the market and is accompanied in most cases by price increases. An increase in the number of months of housing supply to above 11 indicates surplus supply.

The number of months of housing supply, as a function of the number of monthly sales and of the inventory of housing units offered for sale

Number Of Monthly Sales	Inventory of units offered for sale		
	9,000	**10,000**	**11,000**
800	11.3	12.5	13.8
900	10.0	11.1	12.2
1,000	9.0	10.0	11.0
1,100	8.2	9.1	10.0
1,200	7.5	8.3	9.2
1,300	6.9	7.7	8.5
1,400	6.4	7.1	7.9
1,500	6.0	6.7	7.3

As of the 2nd quarter, excuding seasonality, average monthly sales were 1,295 housing units and the number of units for sale stood at 9,762 units. In other words, the market is at the lower mid portion of the sensitivity table. The changes required to create excess supply are very substantial and it does not appear as though these will occur within the coming two years.

In order for the number of months of new housing supply to reach levels that characterize surplus supply, the number of monthly sales will need to drop by 500 units (38%), or the inventory of housing units for sale will need to increase by 1,250 units (13%), or a combination of these two events. The chances of a combination of these events occurring are low as long as the main working assumptions of the scenario exist. Furthermore, past experience proves that even this is not enough to lead to a substantial decline in housing prices. A combination such as this did not occur even during the low of 2003, at which point the number of monthly sales fell to only 1,000 units.

From where then can a substantial fall in prices come from?

The CBS estimates there exist in Israel 140,000 empty housing units. A scenario in which the economic, political and/or other conditions will lead to this large number of empty units being put up for sale in a short period will be able to lead to a decline in prices. Among the owners, two groups that own empty units and have the ability to place them up for sale in a short period are (1) foreign residents and (2) investors. Developments that may trigger the sale of these units possibly include the desire to realize capital gains, the exchange for a more attractive investment, and deterioration in the geo-political situation in Israel.

The demand side

According to data from capital gains taxes on real estate, during the first quarter of 2010 there were 25,737 housing transactions, of which 6,097 involved new units and 19,640 involved second-hand units. In other words, for each transaction involving a new unit, there were on average three additional transactions involving second-hand units. The average price for a housing unit was NIS 958 thousand in this quarter.

In order to restrain the rise in housing prices, the Supervisor of Banks issued a directive to mortgage banks to increase the provisions for doubtful debts for mortgages with a rate of financing higher than 60% (the BoI estimates this directive is equivalent to an increase of 10 basis points to the interest rate on a mortgage). In our opinion, the policy that was implemented until now is not sufficient in order to restrain the rise in housing demand. Furthermore, it appears the BoI intends to continue to manage very expansionary monetary policy, such that the policy steps that will be required in order to restrain the sharp increase in housing demand will be more severe than those policies implemented until now. These steps are likely to include limiting the amount of loans for housing and changing the process of calculating the risky assets at mortgage banks, such that the high capital adequacy of these banks cannot be used for significantly expanding the amount of credit for housing[7].

Summary

The residential construction sector benefits from a substantial rise in the level of activity that stems primarily from the low interest rate in the economy, which has led to a sharp rise in housing prices. We estimate that the national average of housing prices will continue to rise. We expect the baseline of low monetary policy rate and a supply shortage will persist in the near term. Therefore we do not exclude the possibility of a double-digit price increases this year as well.

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[7] Under the rules of Basel 2 the capital adequacy of mortgage banks almost doubled. The reason for this stems from the reduction in the proportion attributed to housing loans to risky assets. Capital adequacy ratio = the capital base/risky assets (the reduction in risky assets raises the capital adequacy ratio).

Bank Leumi le-Israel B.M. and subsidiaries

Condensed Consolidated Balance Sheet as at 31 March 2010 (NIS millions)

Reported amounts

ASSETS	31.3.2010 (Unaudited)	31.3.2009 (Unaudited)	31.12.2009 (Audited)
Cash and deposits with banks	41,664	38,712	42,933
Securities	52,526	47,677	57,505
Securities borrowed or purchased under agreement to resell	638	229	744
Credit to the public	207,613	212,878	204,669
Credit to governments	407	500	407
Investments in companies included on the equity basis	2,196	2,048	2,178
Buildings and equipment	3,543	3,513	3,553
Other assets	9,044	12,495	9,786
Total assets	317,631	318,052	321,775

LIABILITIES AND EQUITY CAPITAL	31.3.2010 (Unaudited)	31.3.2009 (Unaudited)	31.12.2009 (Audited)
Deposits of the public	244,579	254,565	250,418
Deposits from banks	3,160	3,181	3,785
Deposits from governments	678	852	712
Securities loaned or sold under agreement to repurchase	175	193	273
Debentures, bonds and subordinated notes	26,812	20,567	25,261
Other liabilities	19,246	19,603	19,182
Total liabilities	294,650	298,961	299,631
Minority interest	285	255	282
Shareholders' equity	22,696	18,836	21,862
Total liabilities and equity capital	317,631	318,052	321,775

Condensed Consolidated Statement of Profit and Loss for the Period Ended 31 March 2010 (NIS millions)

Reported amounts

	For the Three Months Ended 31 March		For the Year Ended 31 December
	2010 (Unaudited)	2009 (Unaudited)	2009 (Audited)
Net interest income before provision for doubtful debts	1,807	1,362	7,023
Provision for doubtful debts	130	354	1,517
Net interest income after provision for doubtful debts	1,677	1,008	5,506
Operating and other income			
Operating commissions	904	831	3,511
Profits from investments in shares, net	74	95	707
Other income	21	77	345
Total operating and other income	999	1,003	4,563
Operating and other expenses			
Salaries and related expenses	1,136	883	4,052
Building and equipment maintenance and depreciation	380	364	1,514
Other expenses	317	317	1,371
Total operating and other expenses	1,833	1,564	6,937
Operating profit before taxes	843	447	3,132
Provision for taxes on operating profit	333	42	1,191
Operating profit after taxes	510	405	1,941
Equity in after-tax operating profit of companies included on equity basis	85	34	81
Minority interest in after-tax operating profits of subsidiaries	(3)	(11)	(36)
Net operating profit	592	428	1,986
After-tax profit from extraordinary items	4	1	28
Net profit for the period	596	429	2,014

Basic and diluted earnings per share	(NIS)		
Net operating profit	0.40	0.29	1.35
After-tax profit from extraordinary items	—	—	0.02
Total	0.40	0.29	1.37

The complete quarterly report for the period ended 31 March 2010 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 2010, according to which the financial statements have been prepared, was NIS 3.713.

Condensed Consolidated Statement of Changes in Shareholders' Equity
For the Period Ended 31 March 2010 (NIS millions)

Reported amount

For the Three Months Ended 31 March 2010 (Unaudited)

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

For the Three Months Ended 31 March 2009 (Unaudited)

	Share capital	Premium	Capital reseves in respect of share-based payment transaction and others (a)	Total share capital and capital reserves	Other comprehensive income: Adjustments in respect of presentation of securities available for sale at fair value	Other comprehensive income: Translation adjustments (b)	Retained earnings	Loans to employees for purchase of the bank's shares	Total shareholders' equity
Balance at the beginning of the period	7,059	855	284	8,198	(648)	(502)	11,998	(374)	18,672
Net profit for the period	—	—	—	—	—	—	429	—	429
Expiration of options	—	117	(117)	—	—	—	—	—	—
Other comprehenseve income in companies included on the equity basis which was directly recorded to retained earnings	—	—	—	—	—	—	(5)	—	(5)
Adjustments in respect of presentation of securities available for sale at fair value	—	—	—	—	(481)	—	—	—	(481)
Profits in respect of securities available for sale that were realized and charged to profit and loss	—	—	—	—	(205)	—	—	—	(205)
Related tax effect	—	—	—	—	256	—	—	—	256
Adjustments from translation in respect of companies included on the equity basis	—	—	—	—	—	165	—	—	165
Loans to employees for purchase of the bank's shares	—	—	—	—	—	—	—	5	5
Balance at the end of the period	7,059	972	167	8,198	(1,078)	(337)	12,422	(369)	18,836

For the Year Ended 31 December 2009 (Audited)

					Other comprehensive income				
	Share capital	Premium	Capital reseves in respect of 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	Total shareholders' equity
Balance as at 1 January 2009	7,059	855	284	8,198	(648)	(502)	11,998	(374)	18,672
Net profit for the period	—	—	—	—	—	—	2,014	—	2,014
Expiration of options	—	117	(117)	—	—	—	—	—	—
Benefit in respect of shares based payment transaction	—	—	30	30	—	—	—	—	30
Other comprehensive income in companies included on the equity basis which was directly recorded to retained earnings	—	—	—	—	—	—	164	—	164
Adjustments in respect of presentation of securities available for sale at fair value	—	—	—	—	2,357	—	—	—	2,357
Profits in respect of securities available for sale that were realized and charged to profit and loss	—	—	—	—	(876)	—	—	—	(876)
Related tax effect	—	—	—	—	(524)	—	—	—	(524)
Adjustments from translation in respect of companies included on the equity basis	—	—	—	—	—	28	—	—	28
Loans to employees for purchase of the bank's shares	—	—	—	—	—	—	—	(3)	(3)
Balance as at 31 December 2009	7,059	972	197	8,228	309	(474)	14,176	(377)	21,862

(a) Including NIS10 million of other capital reserves.
(b) Adjustments arising from translation of the financial statements of foreign subsidiaries, which operating currency is different from reporting currency.

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Galia Maor
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26 May 2010

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