



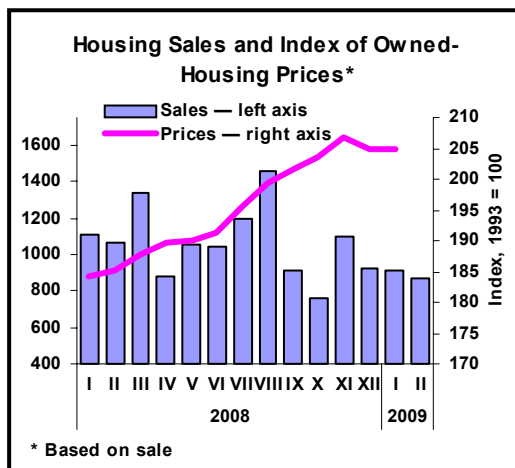
## Macroeconomic Overview – April 27, 2009

### The March Consumer Price Index— Housing and Inflation

The March CPI climbed by 0.5 percent, bringing the inflation rate to 3.6 percent in the past twelve months and -0.1 percent since the beginning of the year. Two components of the index, owned-housing services and fresh fruit and vegetables, posted conspicuous increases; in contrast, clothing and footwear prices fell steeply.

The main factor behind the 1.8 percent upturn in owned-housing prices was 4.4 percent depreciation of the NIS against the USD during the relevant measuring period. Concurrently, however, prices of leases in contract not indexed to the USD grew as well. **The increase in owned-housing prices in recent months clashes with prior outlooks of stable if not declining prices**, prompted by the steep increase in this component last year; the recession, which one would expect to dampen housing demand, and the weakening of the pass-through of the exchange rate to housing prices, which should have made housing prices less sensitive to exchange-rate shocks.

Let us remember, however, that **the owned-housing services component of the CPI is measured on the basis of a sample of leases and not on housing sale contracts**. When we examine sales transactions, we find a **clear downward trend in sales and stabilization of prices coupled with the beginning of a slight decrease** (see graph). It is very likely that the recession is prompting individuals to delay housing purchases in response to the decrease in their purchasing



power and their expectation of a significant price decline in the future. If this is indeed the case, **the continued increase in the housing-prices component of the CPI may trace to the substitution effect of renting a dwelling instead of buying one**. However, since trends in the housing rental market and the housing sales market cannot move in contradictory directions for long, we expect the rate of increase in housing prices to slow in the months to come.

**Core inflation — the CPI net of its food and energy components — increased in March by a steep 0.5 percent after having fallen by 0.5 percent in February**. This, of course, was the outcome of the upturn in the owned-housing price component, which is included in this index. However, **even net of housing prices, core inflation edged up by 0.1 percent on the heels of a precipitous 0.6 percent decrease in February**. Even after an adjustment for seasonal effects, the inflation has picked up perceptibly. Thus, the index climbed by 0.4 percent in March on the heels of a 0.2 percent upturn in February. In annual terms, inflation was 2 percent in the past three months as against -1.6 percent in November 2008–January 2009.

**Does this mean that inflation is making a comeback?** The answer to this question is critical, especially in view of the ongoing recession. If the answer is yes, the economy may be facing stagflation, which will make it very hard for our responsables to conduct a policy that will end the recession. **In our estimation, the answer to this question is no**. The price increases are reflected in specific goods and services and, in our opinion, do not necessarily attest to an inflationary process. **Even the steep increase in the money supply does not threaten Israel an inflationary eruption in the short term, given the current state of the economy**.

The April CPI is expected to surge by 1 percent due to seasonal factors. Furthermore, we estimate the inflation rate at 1.6 percent in 2009 and 1.2 percent in the next twelve months.

## Are the Equities Markets Saying that Growth is Back?

Since March, the equities markets — abroad and in Tel Aviv — have posted increases (20–30 percent) and corporate bond issues have been surging as well. Do these upturns signal the end of the downturn and the onset of recovery from the recession?

The data relating to the real economy, in Israel and abroad, remain gloomy and indicate that the recession is continuing:

### **United States**

- **Industrial production** contracted by 1.5 percent in March, much as in February, and by 12.8 percent in the past year.
- **Retail sales** retreated by 1.1 percent in March after edging upward by 0.3 percent in February, bringing their performance in the past twelve months to –9.4 percent.
- **Housing starts** plummeted by 10.8 percent in March and by 48.4 percent over the past year in cumulative terms.
- **The labor market** continued to lose ground, shedding 663,000 jobs in March after losing 651,000 in February. The unemployment rate climbed from 8.1 percent to 8.5 percent.

### **Israel**

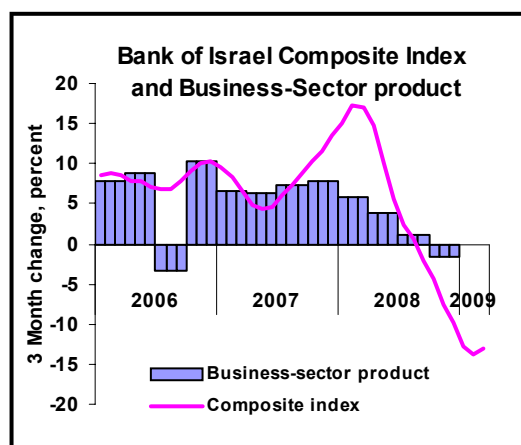
- The Bank of Israel's **composite state-of-the-economy index** fell by 0.9 percent in March after declining by 1.2 in February. The index began to slip in August 2008, coinciding with the worsening of the recession. Contributing factors in the decline were contractions in imports and commerce and services revenues. As the graph shows, the composite index marches in tandem with business-sector product. Accordingly, the steep index decline in early 2009 indicates that the falloff in business product worsened as well.
- **Foreign trade has contracted badly.** In the first quarter of 2009, exports of goods (excluding diamonds) tumbled by 33 percent, imports of goods (excluding diamonds, ships and aircraft, and fuel) by 35 percent, and imports of raw materials by 46 percent (all in annual terms).

These indicators show that the macro data remain dismal, meaning that all talk of recovery from the recession is premature.

In this spirit, the IMF lowered its 2009 outlooks significantly in March relative to the January outlooks. According to the new prognosis, U.S. and eurozone GDP will contract by 2.8 percent and 4.2 percent, respectively, and world trade will fall by a dramatic 11 percent.

The last-mentioned development will impact the Israeli economy appreciably due to its harmful effects on exports, which account for 40 percent of the country's GDP.

Concurrently, the Bank of Israel cut its 2010 growth outlook from 2.3 percent to 1 percent and left its 2009 outlook unchanged at –1.5 percent.



## Financial Outlook

### Monthly

	April	May	June
Inflation	1.0%	0.0%	0.3%
BOI interest rate	0.5%	0.5%	0.5%

### Annual

	2007	2008	2009
Inflation	3.4%	3.8%	1.6%
BOI interest rate, year's end	4.0%	2.5%	0.5%