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# SHEKEL

ECONOMIC AND FINANCIAL TRENDS IN ISRAEL

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## Overview

- Despite the global economic downturn, Israel's economy performed well in 2008, growing 2.3 percent in the third quarter. It is expected to end the year with a growth rate of 4.1 percent.

- Supporting this figure, industrial production grew 0.3 percent from July to September, which shows that the Israeli economy did not freeze.

- Bank of Israel Governor Stanley Fischer recently stated that Israel is better prepared for dealing with the economic crisis than most other countries.

- Balance of payments in the third quarter indicates a surplus of $0.5 billion in the current account following second quarter's $ 0.3 billion surplus, resulting in a $1.6 billion surplus for the first nine months of the year.

- From January- September 2008, total foreign investments reached $7.8 billion. During that period, foreign direct investments (FDI) remained strong, at a positive $8.3 billion.

- During the months January-November 2008, 2.8 million visitors entered Israel. This was a jump of 35 percent compared to the corresponding months in 2007, and an increase of more than 66 percent compared to 2006.

- At the end of the third quarter, Israel's unemployment rate reached 5.9 percent, which was lower than the unemployment rates of some of the leading economies of the world.

- In an effort to boost the economy the government is preparing a NIS21.7 billion stimulus program. The "acceleration program" contains incentives in the form of additional tax cuts, easy access to credit for small and medium businesses, infrastructure projects and funding for programs that will help the unemployed.

# Editor's Review

## Developed Market Economy Weathers New Challenges

"… In recent decades they returned in their masses. Pioneers, defiant returnees, and defenders, they made deserts bloom, revived the Hebrew language, built villages and towns, and created a thriving community controlling its own economy and culture…"
(The Declaration of Establishment of the State of Israel, 5.14.1948)

Six decades have passed since David Ben-Gurion read the Declaration of Establishment to the members of the young Israeli government. For sixty years the Israeli economy struggled to overcome diplomatic isolation, threats to national security and sparse natural resources. However, as of June 2008, Israel has officially come to be considered a "developed" nation, according to the British FTSE indices. Unfortunately, becoming part of the "big boys" club means not just enjoying status and prestige, but also bearing the weight of new economic difficulties, such as the current economic crisis. Therefore, it seems that Israel will feel the consequences of the global economic turmoil, but compared to other members of the club, the shock is expected to be much more moderate.

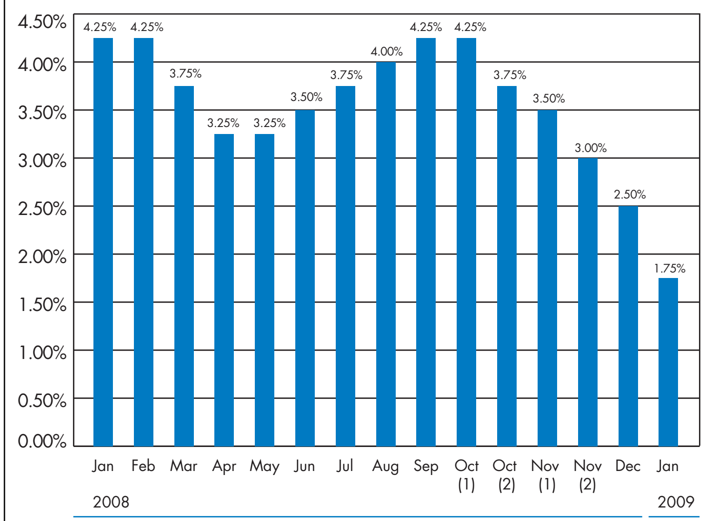
Considering the global economic downturn, the Israeli economy performed well in 2008. While growth is slowing, the forecast for 2008 GDP remains as high as 4.1 percent.

During the third quarter, growth slowed to 2.3 percent, which was considerably slower than the 5.1 percent growth during the first half. The business sector led the economy during the first half with an expansion of 5.9 percent and eased during the third quarter to just 1.9 percent.

Growth during the first half of the year was primarily the result of extensive exporting and high consumption. Exports of goods and services rose by 9.5 percent and private consumption increased by 5.6 percent. The third quarter increase was the result of rising private consumption, which grew by 2.8 percent. The remainder of the GDP components, hit by the shrinking of the global economy, decreased. Public consumption shrank by 2.9 percent, exports of goods and services went down by 13.4 percent and gross fixed capital formation declined by 15 percent. In addition, although Israelis kept on shopping, imports of goods and services lost 7 percent. The Central Bureau of Statistics forecasts that by the end of the year, public consumption will grow by 3.9 percent, exports of goods and services will increase by 3.6 percent and gross fixed capital formation, which includes infrastructure projects and housing, will see a 5.4 percent rise. Even the business sector is expected to produce positive growth of an impressive 4.5 percent.

The decline in third quarter national accounts can also be observed in the Economy Composite Index, which although indicating an accelerated growth of 3.5 percent during the first half of the year, lost more than 1 percent during the months of July to November. Most of the drop is attributed to declines in exports and imports. The only component that consistently rose was industrial production, which grew 0.3 percent from July to September. Although this figure is lower than the 3.8 percent increase recorded for the months of April to June, it still shows that the Israeli economy did not freeze.

**Central Bank Interest Rate**



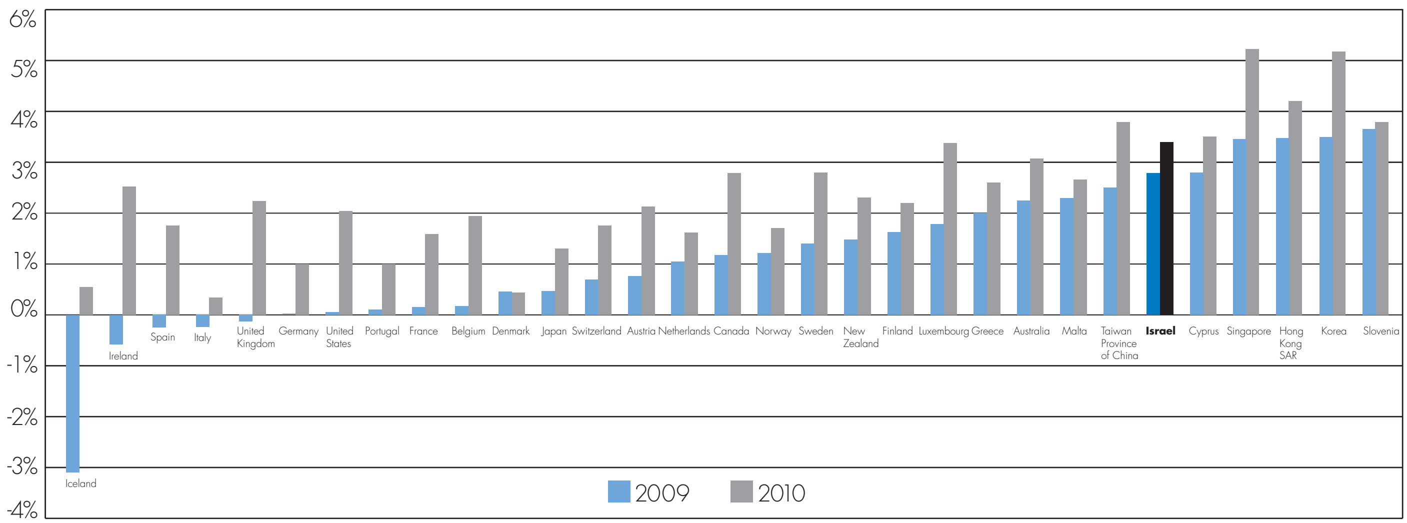

Source: The Bank of Israel

Despite the drop in exports of goods and services in the third quarter, Israel's balance of payments indicated a surplus of $0.5 billion in the current account following second quarter's $0.3 billion surplus and resulted in a $1.6 billion surplus for the first nine months of the year. Although the goods account was still in a $ 1.6 billion deficit, the services account and the transfers account kept the total balance of payments positive.

Part of the above outcome may be attributed to the ongoing flows of foreign investments into Israel. From January to September 2008, total foreign investments reached $7.8 billion. During that period, foreign direct investments (FDI) remained strong, at a positive $8.3 billion, while foreign portfolio investments (FPI) turned negative as Israel experienced a net outflow of passive investments, such as stocks bonds and bank accounts owned by foreigners.

The tourism industry was one of the most successful Israeli industries this year. During the first eleven months of 2008, 2.8 million visitors entered Israel. That was a jump of 35 percent compared to the corresponding months in 2007 and an increase of more than 66 percent compared to 2006.

**Gross Domestic Product Growth Rate,** Constant Prices, Compared with Preceding Period




Source: International Monetary Fund, World Economic Outlook Database, October 2008

As sign of the strength in our economy, the unemployment rate dropped steadily in 2008 compared with 2007. At the end of the third quarter, unemployment reached 5.9 percent, which was lower than unemployment rates of some of the leading economies of the world. At the same time, participation in the civilian labor force remained at 56.4 percent. Reports of layoffs in the Israeli labor market are being published only now, long after many other countries have already tightened their belts.

The global slowdown lead to lower inflation in 2008. The CPI was 1.1 percent during July, yet dropped to -0.6 percent in November. Inflation for the past 12 months is 4.5 percent, and 3.9 percent year to date. Even though this is higher than the 1 to 3 percent target range set by the government, market expectations are that inflation will be lower next year, at around the level of 1 percent.

In an attempt to address the drop in prices, which indicates a slowing economy, the Bank of Israel reduced the Central Bank interest rate in the market from 4.25 percent in September to 2.5 percent in December and 1.75 in January 2009. This is the lowest level the Israeli rate has ever reached.

Exchange rates reflected the economic events in the local arena as well as in the global markets, and changed accordingly. In July, a low of 3.23 shekels per dollar was recorded but as the Israeli economy showed signs of slowing down, the exchange rate rose to about 3.8 shekels per dollar at the end of December. The Bank of Israel, enjoying the relatively cheap USD, continued its policy of increasing foreign currency reserves, and accumulated more than $10 billion since June, reaching the level of $ 41.4 billion by the end of December.

The government ended the year with a larger than expected deficit. Although November was the first month since the beginning of the year in which the cumulative balance of the budget was negative, December's governmental income was substantially lower than forecasted. Thus the deficit reached NIS 15.2 billion, which is approximately 2.1 percent of GDP. The deficit is a direct result of the global slowdown and its impact on income from taxes.

In an effort to boost the economy the government is preparing a special stimulus program. The "acceleration program" contains incentives in the form of continuing reductions in taxes, easier access to credit for small and medium businesses, infrastructure projects and funding for programs that help the unemployed. In addition, the government is now in the process of approving a safety net for pension funds, so that retired people will be spared the harshest effects of the crisis.

In a recent speech, Bank of Israel Governor Stanley Fischer stated that Israel is in a better position to handle these difficult economic times than most other countries. After the recent escalation of the conflict in Gaza, Moody's Investors Services said that "the present political and financial shockwaves do not pose an immediate threat to the country's profile risk." Judging from the latest data, we concur.

# Wall Street Perspective

## 2008: A Watershed Year for the Private Equity Market in Israel

Abe Finklestein, General Partner, Vintage Venture Partners

"Silicon Wadi." "The only real venture market outside the United States." Many superlatives have been used to describe the Israeli venture capital market. Given that the returns of top-quartile Israeli venture capital funds have almost tracked those of U.S. funds, there certainly is good reason for excitement. But, Israeli private equity is not only venture capital and, despite the global economic environment, we are optimistic about both the maturing Israeli venture capital market and the emerging non-venture private equity market.

### The Israel Venture Capital Sector is Reaching Maturity

Israel began its "Fifth Wave" of fundraising by Israeli venture capital funds in late 2007. During this wave, which is expected to run through 2011, we forecast that roughly 25-30 funds will raise a combined $2.5 billion to $3 billion. To put this in perspective, the market peaked during the "Third Wave" (1999-2001) when 85 funds raised $6.5 billion. This represents a natural progression into a maturity phase for the local venture capital market which will be roughly 20 years old by the end of the current wave.

At the company level, according to the Israel Venture Capital Research Center, Israeli private high-tech companies raised nearly $1.7 billion through the end of the third quarter of 2008, and should finish the year close to 2001 levels. Today, 65 percent of the investment in Israeli private high-tech companies comes directly from U.S. and European venture funds and strategic partners. Our research indicates that the vast majority of foreign investments are going toward mid- and later-stage companies. As a result, Israeli venture funds continue to focus on seed and early-stage opportunities. However, with less money being raised in this wave, far less money will be chasing quality early-stage deals, which is good news for both valuations and portfolio quality. We also expect that seed and early stage investments made during the global economic downturn will naturally begin to mature as we emerge from the current economic crisis. This will potentially set the stage for what will be very strong returns from investments during this period.

In terms of exits, the IPO markets are closed for Israeli technology companies, just as they have been closed for U.S. companies. However, on the mergers and acquisitions front, nearly $1 billion in M&A of Israeli venture capital fund-backed companies has taken place so far this year. At this pace, M&A in 2008 would equal 2007, despite more challenging market conditions, but it would still be half of the pace of 2006. This may turn out to be positive news, as the funds, given exit market conditions, will hopefully focus more on building their stronger companies into even larger businesses and many will emerge in even better shape for exits in 2010 and beyond.

### Non-Venture Private Equity is Rapidly Emerging

The non-venture Israeli private equity industry is still relatively young. Since 2003 roughly $3.7 billion has been raised by roughly 20 non-venture private equity funds.

However, to put this in perspective, $3.7 billion is only equal in size to one mid-size U.S. buyout fund. Further, the ratio of buyout and growth equity capital raised in Israel in 2007 to Israel's GDP was 50 percent less than the ratio in the U.S. and 33 percent less than the U.K. This would suggest, there is significant room for expansion of the Israeli buyout and growth equity industry.

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Venture capital and private equity in Israel are strong and bode well for the medium- to long-term.

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There have been several drivers for the emergence of the Israeli growth equity and buyout market. These include a relatively stable local economy, evolution of ownership of family businesses to professional management, a desire to build global businesses, and the opening of the domestic capital markets over the past few years. These drivers give us cause for optimism that this sector in Israel will continue to be attractive despite the capital market crisis and its impact on other geographies and sectors.

While Israeli companies and Israeli funds will also face their challenges given international economic conditions, the fundamentals for venture capital and private equity in Israel are strong and bode well for the medium- to long-term.

# State of Israel Bonds and Israel – A Partnership of Unparalleled Achievement

Joshua Matza, President and CEO, State of Israel Bonds

*Joshua Matza has served as President and CEO of State of Israel Bonds since March 2002. Prior to his appointment to Israel Bonds by then-Prime Minister Ariel Sharon and Finance Minister Silvan Shalom, he served 18 years in the Knesset and also as Minister of Health in the cabinet of Benjamin Netanyahu.*

In May 2008, a festive week of official events celebrating Israel's 60th anniversary included a salute to Israel Bonds at the Knesset. Hosted by Speaker Dalia Itzik with the participation of Prime Minister Ehud Olmert and Finance Minister Ronnie Bar-On, the tribute underscored a widespread consensus that today's dynamic Israel would not have been possible without Israel Bonds.

From its establishment in 1951 and continuing through the present day, the Israel Bonds organization has helped fund infrastructure projects that proved instrumental in fueling Israel's evolution from a socialist-style economy rooted in agriculture to a globally-focused economy grounded in cutting-edge high-technology.

The founding of Israel Bonds – officially the Development Corporation for Israel, wholly owned by the not-for-profit New York corporation American Society for Resettlement and Rehabilitation in Israel – had its origins in the aftermath of the War of Independence. The war had taken a terrible toll in casualties, and the nation's fledgling economy was devastated.

In September of 1950, Prime Minister Ben-Gurion convened a meeting of American Jewish leaders at the King David Hotel, where he proposed floating a bond issue. His concept was twofold: to obtain millions of dollars in funding for immigrant absorption and the construction of national infrastructure; and to engage Diaspora Jewry in building and developing the new Jewish state. The following spring, Ben-Gurion traveled to New York to personally launch the inaugural Independence Issue of Israel bonds.

With determination and efficiency, the newly-created Bonds organization began transforming the face of Israel. Towns were built for new immigrants. The National Water Carrier brought agricultural self-sufficiency. The Dead Sea Works became Israel's first major industrial undertaking. Power plants addressed Israel's lack of energy resources. Ports were built to receive vital imports and increase export potential. Existing transportation networks were expanded and new ones constructed.

Within six years of the creation of Israel Bonds, *Time* magazine hailed the organization's role in building Israel's economy as "astonishing."

Israel Bonds' effectiveness has been particularly evident during times of crisis. During the Six-Day War, the organization secured over $250 million, a figure that more than doubled during the Yom Kippur War. When Iraqi scuds rained down on Tel Aviv in 1991, sales approached $1 billion. And as the Second Lebanon War raged, Israel Bonds mobilized an emergency campaign with the participation of Shimon Peres, then-UN Ambassador Dan Gillerman and then-U.S. Ambassador Danny Ayalon.

The unfailing ability to generate economic support under all circumstances highlights the organization's dependability and inclusiveness, which reaches beyond the Jewish community. Securities sold by Israel Bonds continue to be acquired by states, municipalities, financial institutions, corporations, universities, foundations and labor unions. Recently, the state and city of New York each purchased $15 million in Israel bonds.

Israel Bonds has consistently met annual sales goals set by The Israel Finance Ministry, securing nearly $26 billion since 1951. Sales have reached $1 billion every year since 2002. This has been achieved with an emphasis on efficiency and cost-effectiveness, placing Israel Bonds among Israel's least expensive means of raising overseas capital. This was noted by Moody's Investors Service, which in March 2008 cited Israel Bonds as a source of funding "at favorable costs." An article in the October 24, 2008 issue of *Ha'aretz* also applauded the Bonds organization as an "important and inexpensive way of generating capital."

Moreover, Israel's impeccable debt repayment record – it has never missed a single payment of principal or interest on any of the bonds it has issued – has made Israel bonds a particularly attractive investment during this period of market volatility.

As reported in the October 13 issue of *Globes*, "there has been no drop in the sale of Israel bonds." The article stated that executives from Morgan Stanley, UBS and Deutsche Bank praised Israel Bonds' "contribution toward maintaining Israel's financial soundness."

# ETFs: Investment Opportunities in the Israeli Capital Markets

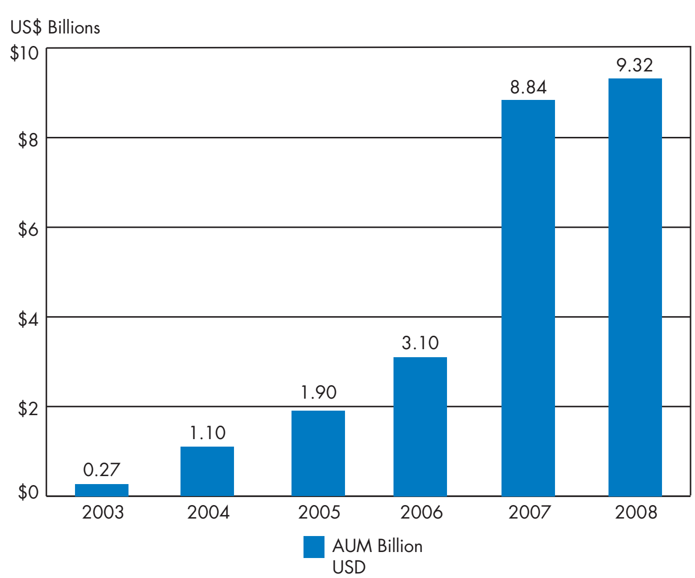
Roy Regev, Chairman and Co-Founder of KSM

Emerging markets have become popular in recent years as investors in developed countries seek outlets beyond their own economies. Israel has been one of these attractive markets due to strong economic indicators and steady growth. The Israeli GDP has grown about 5 percent over the past few years compared with 2 percent in developed economies. The Israeli shekel is strengthening and unemployment rate is declining on year-over-year basis. In June 2008, the FTSE upgraded Israel to developed market status, an impressive accomplishment for Israel's' young economy.

The expansion of the Israeli economy has coincided with the equally impressive growth of the Israeli capital markets. The Tel-Aviv Stock Exchange (the "TASE") has been a consistent performer and its main index, the TA-25, has outperformed most global indices with growth of over 140 percent in the last three years. The expansion of the capital markets and the out-performance of the Israeli indices has led to an inflow of approximately $50 billion of foreign investment over the last three years.  Exchange Traded Funds (ETFs) have been one of the preferred vehicles of investment by these foreign funds into the Israeli markets.

It is especially important to highlight the defensive features of the Israeli markets in the context of the volatility that is prevalent in the global capital markets. The TA-25 is a well diversified index with more than half its constituents comprised of Israel's stable and cash-generating telecom sector, Banks Hapoalim and Leumi and Israel Chemicals and Teva Pharmaceuticals. Only approximately 3.5 percent of the index is comprised of real estate assets, which considerately reduces the overall volatility and riskiness of the index. The TA-25 ended the month of October down 18 percent, which was a relative outperformance when compared with the 22 percent declines in the MSCI Emerging Market Index and similar declines in the U.S. indices. The Israeli market remains one of the top performing markets despite the global economic turmoil and presents investors with many attractive investment opportunities on both the macro and micro level.

**Israel's ETF Market Value**




Source: Bank of Israel, September 30, 2008

KSM is one of the leading financial companies in Israel and is the largest manager for Index Linked Certificates (ILCs), the ETF equivalent in the Israeli markets. KSM is part of the Excellence Nessuah Group, one of the largest investment houses in Israel. KSM manages more than 100 ILCs, tracking equity and bond indices, commodities and currencies and accounts for more than half of the total market in ILCs and 25 percent of the daily volume on the TASE. KSM ILCs can be utilized as an efficient entry tool into the Israeli markets as well as a cost effective tool to hedge existing positions (KSM offers a short product that is leveraged 200 percent-300 percent).

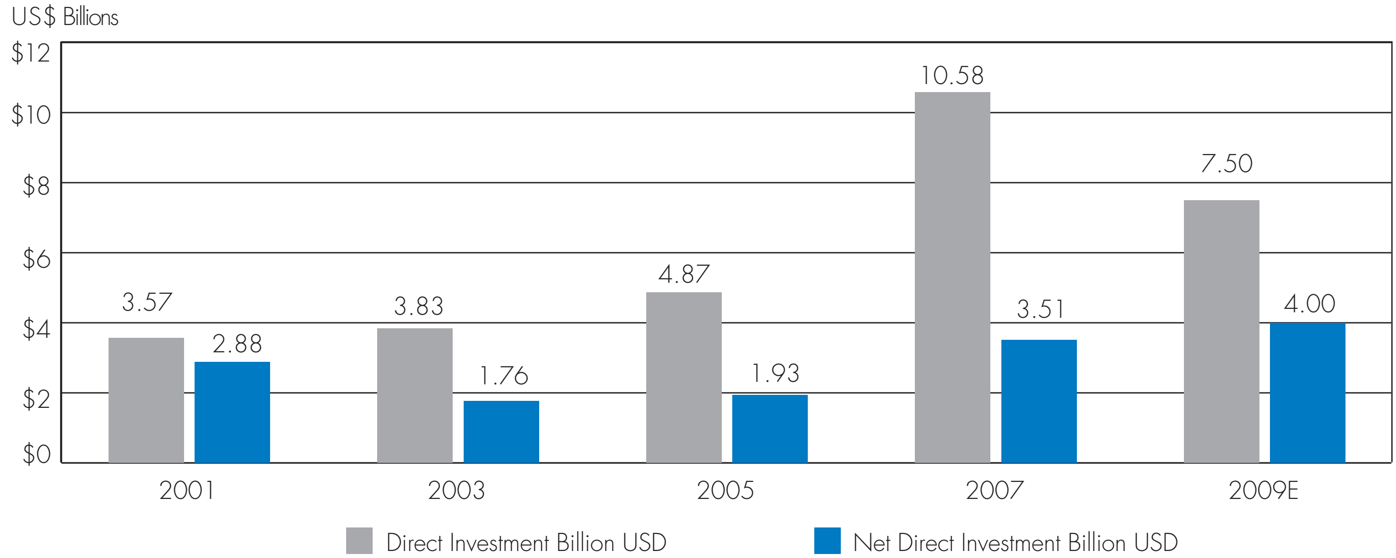
When describing KSM ILCs Co-Founder and Chairman Roy Regev said, "The company's ILCs – and especially its hedging tools – offer a sophisticated yet simple gateway to almost every angle of the Israeli capital market." He noted that the nature of the Israeli economy makes both straight index vehicles and shorts much more valuable and important these days.

KSM products can be divided into three main categories: Equity Indices Certificates, Bond Certificates and Leveraged Short Certificates.

KSM's Equity Indices Certificates cover the entire Israeli market, offering certificates that track the blue chip TA-25 index, the broad based TA-100 index, the small-cap Yeter 120 index and  sector specific indices.

KSM offers Bond Certificates that cover 15 different bond indices including all government and corporate bonds available.

## Foreign Direct Investment – Israel




Source: IMF, International Financial Statistics

The most popular certificate is the Tel-Bond, which consists of corporate bonds, fixed-interest and CPI-linked bonds with the highest market capitalization among all the bonds traded on the TASE. In the past year, investment in these Bond Certificates totaled more than $2 billion, making them the largest and most popular financial instruments in the Israeli ETF market.

The KSM Leveraged Short Certificates have become the preferred tool for hedge funds and other institutional investors investing in Israel. They are effective, low cost proven vehicles for current holders of Israeli equities to hedge existing positions. The Leveraged Short Certificates are easy to access, highly liquid and offer a wide range of solutions for implementing almost any strategy within the Israeli capital market.

Regev believes the wider use and utility of the Leveraged Short products has allowed some investors to reduce their use of derivatives for hedging. "This has occurred for three reasons. First, you do not need to roll the Leveraged Short Certificates as you do with derivatives. Rolling a derivative is not only inconvenient but it also exposes the investor to interest rate and dividend risk. Second, the liquidity within the Leveraged Short is far greater than other hedging tools in the market. And lastly, our Leveraged Short products cover the majority of the Israeli market."

The promotion of Israel from emerging to developed market does have some consequences, but the overall outlook is positive. "It is great to have an objective institution (FTSE) concluding that our economy is getting better," Regev said. "It is excellent for our foreign direct investment."

## National Account, 2005-2008 (Seasonally Adjusted)

Rate of Change (Annual Terms, Percent, Constant Prices), Compared with Preceding Period

| | | | | 2007 | | | | 2008 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 | I | II | III | IV | I | II | III |
| GDP | 5.3 | 5.2 | 5.3 | 5.7 | 6.3 | 5.5 | 5.8 | 5.2 | 4.1 | 2.3 |
| GDP per Capita | 3.5 | 3.4 | 3.4 | 3.9 | 4.7 | 3.6 | 3.8 | 3.4 | 2.5 | 0.7 |
| Business Sector Product | 6.5 | 6.5 | 6.1 | 6.7 | 7.2 | 6.8 | 7.1 | 5.8 | 5.0 | 1.9 |
| Private Consumption | 4.0 | 4.5 | 6.6 | 8.5 | 4.0 | 8.0 | 3.9 | 10.3 | -1.6 | 2.8 |
| Public Consumption | 2.9 | 2.3 | 2.6 | -1.5 | 9.5 | -1.1 | -2.6 | 9.1 | -8.5 | -2.9 |
| Fixed Capital Formation | 2.3 | 10.1 | 14.2 | 14.4 | 18.5 | 47.2 | -10.4 | 8.0 | 5.0 | -15.0 |
| Exports | 4.3 | 5.9 | 8.4 | 8.1 | 12.3 | 9.1 | 14.9 | 13.2 | -2.1 | -13.4 |
| Imports | 3.5 | 3.3 | 12.3 | -3.0 | 23.4 | 8.7 | 9.4 | 10.3 | -10.8 | -7.0 |

Source: Central Bureau of Statistics

## Web Sites of Interest

Bank of Israel:
http://www.bankisrael.gov.il/firsteng.htm

Central Bureau of Statistics:
http://www.cbs.gov.il/engindex.htm

Dun & Bradstreet's Israel:
http://www.dundb.co.il/english/index.asp

Investment Promotion Center:
http://www.investinisrael.gov.il

Israel Economic Mission:
http://www.israeleconomicmission.com

Israel Government Portal:
http://www.israel.gov.il/firstgov/english

Israel Ministry of Finance:
http://www.mof.gov.il/mainpage_eng.asp

Israel Ministry of Foreign Affairs:
www.mfa.gov.il/mfa

Israel Ministry of Industry, Trade & Labor:
http://www.moit.gov.il

Israel Ministry of Tourism:
http://www.goisrael.com

Israel Science and Technology Home Page:
http://www.science.co.il

Israel Venture Association:
http://www.iva.co.il

Israel Venture Capital Research Center:
http://www.ivc-online.com

MATIMOP: Israeli Industry Center for R&D:
http://www.matimop.org.il

Standard & Poor's Israel:
http://www.standardpoors.co.il

State of Israel Bonds Organization:
http://www.israelbonds.com

Tel Aviv Stock Exchange:
http://www.tase.co.il/taseeng/homepage.htm

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