DECEMBER
2009

SHEKEL

ECONOMIC AND FINANCIAL TRENDS IN ISRAEL

Published by the
Government of Israel
Economic Mission
Ministry of Finance

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Overview

- Third quarter growth rate was a positive 2.2 percent, following a 1.0 percent growth during the second quarter. The business sector grew from July to September, gaining 1.6 percent compared with 1.1 percent growth in the second quarter.

- On November 6, Fitch Ratings reaffirmed Israel's rating and outlook pointing to Israel's improved macroeconomic policy and structural reforms as the fundamentals for its strong growth and economic resilience.

- The balance of payments remained strong, ending third quarter with a $1.3 billion surplus, following a similar surplus in the second quarter. The Bank of Israel official forecast for the current account surplus was revised from $2 billion to $6.9 billion for 2009 and from $2 billion to $4.8 billion for 2010.

- The Israeli labor market began its recovery in July through September. The unemployment rate for the third quarter was 7.8 percent, 0.2 percent lower than the previous quarter.

- October 2009 was a record month for the Israeli tourism sector, with more than 328,000 visitors: a rise of 8.65 percent when compared to October 2008.

- Equity markets rose in both the second and third quarters. Compared with the second quarter, the TA-25 index gained around 15 percent by the end of the third quarter.

- A two-year budget was approved in July to demonstrate the stability of government spending and reassure investors of the government's commitment to spend responsibly despite the economic turbulence.

- The Ministry of Finance and the Ministry of Industry, Trade and Labor have issued a tender for the establishment and management of investment funds in the field of life sciences, with an emphasis on investment in bio-pharmacology. The investment funds are designed to address financial obstacles and to help enable the bio-pharmacology sector to expand and reach its full economic potential.

Editor's Review
Israel Exceeds Expectations

In November 2009, the Governor of the Bank of Israel, Professor Stanley Fischer, addressed the Conference of the Business Club, Haifa and the North. He pointed out that:

> *"In the past year, Israel's economy underwent a severe crisis that resulted from the worst global crisis since the Great Depression in the last century. The impact on Israel was relatively slight. Although unemployment increased, it did so by less than in large economies such as the U.S. The feeling currently is that we, both Israel and the global economy, are starting to emerge from the crisis…Israel's situation is better than the general situation abroad: no bank has failed, unemployment increased by less than had been expected, and there was renewed growth sooner than expected."*

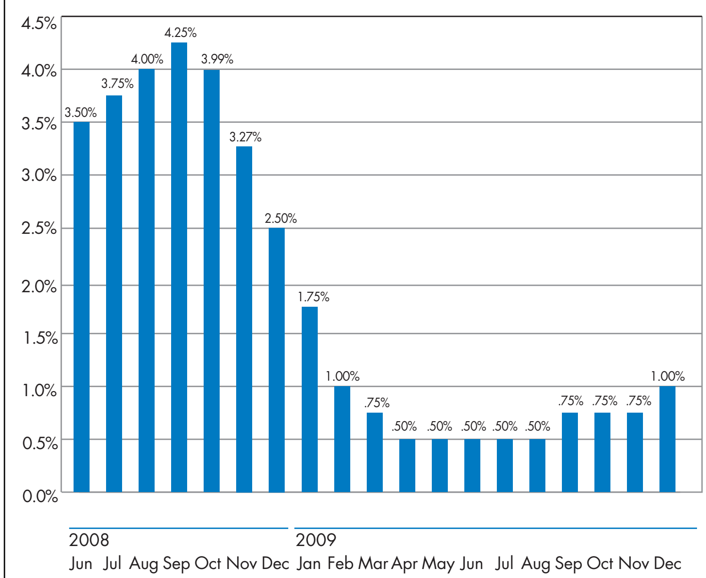
Professor Fischer reaffirmed this viewpoint at a recent event in New York, sponsored by the Israel Economic Mission.

Around the globe, economic indicators allude to the end of the recession, but Israel's economy is already on the rise. Most of the economic indicators point to a slow, but profound recovery.

Third quarter growth rate was a positive 2.2 percent, following a 1.0 percent growth during the second quarter. The business sector also grew from July to September, gaining 1.6 percent, which continued the positive trend of the second quarter. Most of third quarter positive results are attributed to the recovery in exports of goods and services, private consumption and gross fixed capital formation, which went up by an annual 21.8 percent, 8.9 percent and 23.2 percent respectively. These numbers continue the positive trend of the second quarter, when exports gained 14.6 percent, private consumption grew by 8.1 percent and capital formation earned 2.7 percent. The only GDP component growing less in the third than in the second quarter was public consumption, which went up by 1.2 percent compared to 12.6 percent in April to June. The local rise in consumption also helped to boost imports of goods and services. Compared to the second quarter rise of 4.8 percent, the third quarter increase of 61.9 percent is a significant improvement.

Following positive signals from the economy, the Bank of Israel has revised its forecast for 2009 from negative 1.5 percent to 0.0 percent, and from 1.0 percent to 2.5 percent in 2010. The business sector is expected to lose 0.8 this year and grow by 2.8 in 2010. GDP components' outlooks were also altered: exports of goods and services are expected to lose 11.6 percent compared with 2008, but will rise by 6.3 percent by the end of next year. Private consumption will probably decline by 0.5 percent by the end of December, but will add 3.5 percent in 2010. Gross fixed capital formation will end the year with a negative 6.9 percent change, and will regain 1.4 percent next year. Imports will also recover in 2010 and are expected to go up by 6.9 percent.

Central Bank Interest Rates, 2008-2009



Source: The Bank of Israel

Recovery is also seen in the State of the Economy Index, calculated by the Bank of Israel to reflect the level of economic activity in the market. The index rose 1.7 percent when compared to the previous quarter, during which it decreased by 1.4 percent. October's index was positive as well, growing 0.46 percent.

Evidence of the economic comeback can also be found in the Industrial Production Index. Although dropping 3.1 percent from April to June as compared with the previous quarter, it gained 2.4 percent in the third quarter. Most of the improvement in total production is a result of growth in production of quasi-traditional technology industries, which rose by 8.4 percent. An impressive rise was also recorded for the production in quasi-high technology industries, which climbed 3.4 percent during the same period.

Towards the end of the year, the tourism sector picked up the pace, making October the most successful month since 1948. Although the number of visitors for January through October fell by 12 percent in comparison to the same period last year, the descent from July to October compared to 2008 was only 1 percent. As was mentioned before, October 2009 was a record month, with more than 328,000 visitors: a rise of 8.65 percent when compared to October of 2008. On top of that, the government, determined to support new tourism, approved, as part of the Economic Efficiency Law, the establishment of a special government committee to enhance the development of new tourism projects.

National Account, 2006-2009 (Seasonally Adjusted)

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

				2008				2009		
	2006	2007	2008	I	II	III	IV	I	II	III
GDP	5.3	5.2	4.0	5.6	3.6	0.8	-1.6	-3.2	1.0	2.2
GDP per Capita	3.4	3.4	2.2	3.8	2.0	-1.0	-3.4	-4.9	-0.6	0.3
Business Sector Product	6.4	5.6	4.5	6.7	4.0	0.2	-2.7	-4.9	1.1	1.6
Private Consumption	4.3	6.3	3.6	9.3	-3.6	1.6	-2.4	-3.5	8.1	8.9
Public Consumption	3.0	3.4	2.1	14.6	-9.8	5.4	-0.7	-4.5	12.6	1.2
Fixed Capital Formation	11.3	15.3	4.4	16.9	-3.4	-14.9	-4.9	-15.8	2.7	23.2
Exports	6.0	9.3	5.2	19.6	-6.1	0.8	-35.6	-28.6	14.6	21.8
Imports	3.3	11.9	2.4	15.9	-9.5	-8.8	-25.0	-40.0	4.8	61.9

Source: Central Bureau of Statistics

What sets Israel apart from many developed, as well as emerging, economies is the ongoing surplus in the current account. Even though exports suffered a hit at the beginning of the year and money was pulled out of Israel, the balance of payments remained strong. The current account ended the third quarter with a $1.3 billion surplus, following a similar surplus in the second quarter. This is an impressive achievement compared with other countries. Moreover, the central bank's official forecast for the current account surplus was revised from $2 billion to $6.9 billion for 2009 and from $2 billion to $4.8 billion for 2010.

The Israeli labor market, as was similarly observed in other countries, weakened during the second quarter, but began recovering in July through September. The unemployment rate for the third quarter was 7.8 percent, 0.2 percent lower than the previous quarter and only 1.7 percent higher when compared to the corresponding quarter in 2008. Expectations for 2009 are that the unemployment rate will end the year around 8.0 percent.

As recovery kicked off, inflation rose. By the end of November, the CPI reached 3.9 percent year to date and 3.8 percent since November 2008. After a drop at the beginning of the year, prices went up from March through November with a slight drop of 0.3 percent in September. The Bank of Israel, aiming to keep inflation within the target range set by the government (1 to 3 percent), announced a rate hike of 0.25 percent in September, becoming the first central bank in the world to raise the interest rate since the beginning of the global recession. Since then, two other rate hikes were announced bringing the central bank's interest rate to 1.0 percent in December and 1.25 percent in January 2010.

Equity markets, similar to the rest of the world, rose through both the second quarter and third quarter. Compared with the second quarter, the TA-25 index gained around 15 percent and by the end of November, gains were 25.5 percent as compared to the end of June.

The resilience of the economy is also reflected in government fiscal policy. A two-year budget was approved in July, assuring the stability of government spending, and reassuring investors regarding the commitment of the government to spend responsibly despite the economic turbulence. This year's approved deficit of 6 percent of GDP was calculated according to previous, conservative forecasts (-1.5 percent growth rate) and since economic have conditions improved, it is expected that the deficit will not reach this level. As of the end of November, the deficit reached the level of NIS 26.6 billion, approximately 60 percent of the approved NIS 44.355 billion, which also confirms the above forecast.

On November 6, when reaffirming Israel's rating and outlook, Fitch Ratings' senior director stated that, "Israel has fared better than many other, small, open economies in the recent global economic and financial downturn, suffering only a mild recession compared to rated peers in Europe and Asia." We concur.

Israel's Economy: Resilient Amidst Global Financial Crisis

Dr. Yuval Steinitz, Minister of Finance, State of Israel

Dr. Steinitz was appointed by Prime Minister Benjamin Netanyahu to serve as the Minister of Finance in April 2009. Since 1999, he served as a member of the Knesset. Dr. Steinitz is a philosophy professor at Haifa University and an author of four books.

In April 2009, I was appointed Finance Minister of the State of Israel. I assumed this post during one of the most challenging and complex times to have ever faced the Israeli economy and the Treasury. We were dealing with the worldwide economic crisis and its repercussions for Israel, at a time when there was still no approved budget for the current year. This reduced the government's ability to produce a remedy for the crisis itself, and was exacerbated by rising tensions between workers' organizations, employers' organizations, and the government. Prior to the global financial meltdown, Israel had been making great strides, including posting consistently high growth rates, reducing public debt, attaining a smaller than forecasted budget deficit, and fostering a robust high-tech industry fueled by start-up companies and venture capital funds. Nevertheless, despite these strengths, the crisis had a negative impact on Israel's economy. We attribute this chiefly to the global nature of our real economy and the financial institutions affected by the crisis. Export figures for the end of 2008 and the first quarter of 2009 declined, risk premiums rose, and the economy was faced with a contraction of credit. All of this significantly affected the real economy and investments. Immediate results included a drop in the stock market followed by negative growth factors for the end of 2008 and the beginning of 2009. To address the situation we utilized three different strategies.

1. We devised a "braking and impetus" economic program, the purpose of which was to enable us to deal broadly with the repercussions of the crisis and return the economy to one of growth. Our economic program contains five main components:

- Credit and Export Incentives

The worldwide financial crisis, the contraction of credit availability and the downturn in world demand have hampered Israel's export industries. To cope with the credit restrictions, we enacted a program that provided guarantees to banks, created non-bank credit funds, and extended credit to small- and medium-sized businesses. As an additional remedy, state guarantees were also offered to support the export industries.

- Employment Advancement and Curbing Unemployment

One of the negative effects of the crisis has been a reduction in employment and an increase in unemployment. To mitigate the effects of this damage and contribute to increased employment in the future, we will be introducing initiatives aimed at promoting employment in the outlying regions of the country and among women, by offering financial incentives, expanding vocational training programs and increasing support for childcare facilities. In addition, a fund has been set up to offer help to enterprises that find themselves in difficulty. A campaign has been expanded to reduce the number of foreign workers in the economy.

- Structural Reforms

The introduction of reforms to the economy constitutes a central component of the foundation for growth and the creation of impetus for future growth. The reforms on which we shall concentrate include comprehensive land reform, electrical grid reform, reform of Israeli ports, urban revitalization, with a specific focus on increasing personal and business safety.

- Tax Reform and Reduction

We presented a plan that includes a gradual reduction in the rate of taxation on individuals and companies over the next several years. We are also working to minimize tax exemptions and tax evasion, as well as to make the tax collection system more efficient. These operations will make it possible to expand the tax basis and consequently reduce the rate of taxation. The reduction in taxation in the coming years will increase competition in the business sector and attract foreign investment.

- Investment in Physical Infrastructure and Human Capital

These investments will play a central role in the advancement of the Israeli economy in the long term, harnessing its relative advantages and strengthening its competitiveness.

In this context, we will work to ensure the implementation of various infrastructure projects, expand support for high-tech industries, and provide benefits and incentives to Israeli scientists living abroad to encourage them to return to Israel.

2. Another issue on which we have focused is the conversion of the annual state budget into a two-year budget for 2009-2010. The two-year budget, the first in Israel's history, will enable the government to enact the reforms required for dealing with the global economic crisis while maintaining the reliability in the state's fiscal policy. It will also provide additional stability to the economy, helping to decrease uncertainty while restoring confidence.

Simultaneous to conversion of the budget, we have created a multi-year plan to reduce the budget deficit, and enable a return to a deficit of up to 1.0 percent of GDP by 2014. Meeting this target will strengthen the stability of the state's fiscal policy and will stimulate a downward trend in the public debt. This action will protect the stability of the economy from future shocks and will create wiggle-room for monetary policy to support economic activity.

3. The third area in which we have taken action was the signing of an agreement between the government, the representatives of economic organizations and the representatives of organized labor. This mutual commitment of economic interests will contribute to the advancement of the program, by ensuring good labor relations during this complex period.

These comprehensive rehabilitative programs have already borne fruit. During the third quarter of 2009, economic growth was restored, and the latest data indicates that this trend will continue. This positive trend is receiving additional support from the world-wide economic recovery, although in Israel it has been led mainly by internal factors, such as the increase in the export of goods and services and the increase in private consumption, as shown by the last quarter's results (exports grew in the third quarter at an annual rate of 21.8 percent and private consumption grew by 8.9 percent). These increases can be attributed to an economic policy that emphasized confidence in the economy and the reduction of the public's fears and uncertainty. Also worth mentioning is that the government's economic policy has been approved by various international institutions and bodies. Proof of this can be found in the surveys of Israel's economy conducted by the international credit rating companies, and their decisions to keep their ratings of our government's debt unchanged for the duration of the crisis. Furthermore, during my visit to the United States in September, I received considerable praise, both in Washington and on Wall Street, for Israel's economic policy, and the effective steps we took in reaction to the crisis.

In its recently published report on Israel, the IMF indicated that there were many underlying factors that shielded Israeli output from exposure to the global economic slump. Some of the most significant indicators include a strong balance of payments, stable housing and credit markets and high levels of household savings in the quarters leading up to the global meltdown. However, government also played a role in shepherding the Israeli economy during this uncertain period, by enacting a series of bold and timely policies. The IMF report pointed out several of these policies including the relaxation of monetary policy, programs aimed at stabilizing credit flows, and finally, the accommodation of automatic stabilizers in 2009 and the adoption of the two-year budget for 2009-10. According to the IMF, this decisive plan, on top of the public debt reduction and structural reforms that were taking shape over the last decade, helped to keep the worst effects of the global crisis at bay.

I would like to point out, however, that despite the encouraging statistics in recent months, the uncertainty that has resulted from the crisis has not yet passed completely. Some of the negative consequences of the crisis, such as the weakness of the labor market, still exist. Furthermore, it is certain that in future years, additional challenges will await us. As they arise, I am confident that we will be prepared to meet them, while we continue to advance toward our long-term goals. These include strengthening Israel's productivity and fostering prosperity by remaining at the forefront of the global economy.

Israel Sea Water Desalination Facilities: A Response to Water Deficiency

Uzi Levin, Head of PPP Projects Division
Efrat Shriki, Coordinator, PPP Projects Division
Ayelet Yosfan-Shaul, Shimon Avraham, Project Managers, PPP Projects Division
Israel Ministry of Finance

Over the last decade, the world's natural water resources have been drying up and dwindling. There are many reasons for this phenomenon. Global warming has increased the frequency and length of droughts. Pollution has affected the quality of many of the water resources. While water resources have been waning, demand has increased as a result of population growth and improved quality of life. According to U.N. statistics, in the last 100 years, the world population has grown by 400 percent while water usage has increased by 900 percent. In 2000, 1.5 billion people lacked access to a fresh water source. These changes have all contributed to a significant deterioration in the quality and adequacy of the global water system.

In Israel, there is a grave lack of fresh water sources that will only worsen in the coming years. That lack of water stems from reasons both geographic and demographic. With regards to the former, Israel is located in the Middle East, a region famous for its vast deserts. However, the booming population and quality of life have resulted in increased water usage, while the growing number of drought years (a year of only 65 percent of average rainfall) has imposed a serious water crisis.

Regional fresh water resources are in danger, posing new challenges to the state of Israel. According to a recent U.N. report, the critical red line for water deficiency per capita is considered to be 500 m^3 per annum. Israeli fresh water resources are capable of providing only 200 m^3 per year, 60 percent below the U.N. benchmark. It is projected that by the year 2020, the Israeli population will grow by approximately three million people. Therefore, it will prove essential to increase the output of water sources output by at least 40 percent (300 m^3).

The geo-political history of Israel has been significantly affected by water deficiency, and this issue continues to be a focus of the Middle East conflict.

Israel sits along the Jordan River Water System, a border it shares with Jordan, Lebanon, and Syria. Usage of the Jordan River Water System, which includes the Sea of Galilee, one of Israel's chief water sources, dramatically affects the reserves and politics of these countries.

In the past, serious conflicts have escalated between these nations regarding the privilege of managing the common water sources. In their peace treaty, Israel and Jordan came to an understanding about water sources distribution. It has been noted that this topic will be an important consideration in any peace negotiations between Israel and her neighbors (Syria, Lebanon and the Palestinian territories).

As it faces the challenges of the water system crisis, the Israeli government plans to enlarge the water sources of Israel on the one hand, while working to restrict water usage on the other. The following initiatives are designed to adjust and create sustainability in the water sources.

1. Reduce Water Usage

The Israeli government is using explanatory and informative measures to educate the public to reduce water demand. It has passed new legislation that restricts agricultural and industrial usage and has added a 'drought-tax' for private citizens that ties water usage to the size of each household.

2. Enlarge Water Supply

a. Sewage Treatment - Most of the sewage in Israel is being purified in facilities located near urban centers, providing water suitable for agricultural and industrial production. Israel is the world leader in recycling waste water, purifying more than 75 percent of its sewage.

b. Water Desalination - The Israeli government has set a goal for enlarging its supply through desalination. By the year 2013, water desalination facilities will turn out 600 m^3 per year, and by 2020, that amount will increase to 750 m^3 per year. By 2013, 75 percent of home usage supply will be desalinated sea water.

Sea water desalination facilities are established in cooperation between the public and the private sectors, in a system known as PPP (Public Private Partnerships). One main advantage of the PPP system is the effective risk allocation between the government and the private sector that lets each side demonstrate its expertise in risk management.

In this way, the government isolates its own risks, such as deviation from set schedules or construction costs, which are often addressed by the private side.

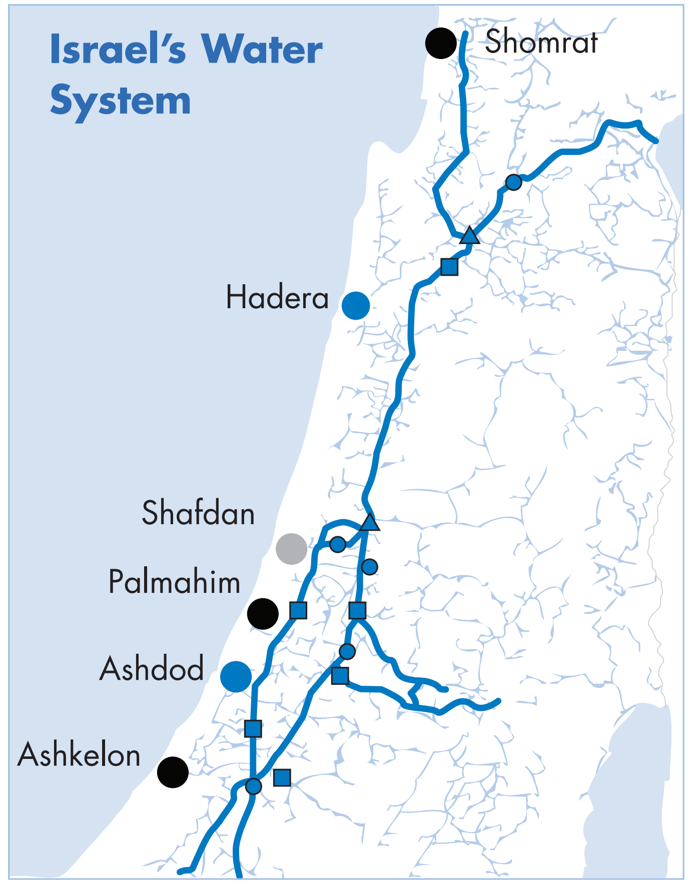
The concession agreement on these deals is for 25 years, in which the concessionaire is responsible for the execution, construction, financing and operation of the facility. Upon the expiration of the operation period, the facility is then transferred to the government. The open market competition in the international tender process has determined that water will be bought by the government at the rate of 65-75 cents per m^3.

To date, there are three large sea water desalination facilities in Israel, all located along the Mediterranean coast(Ashkelon, Palmahim and Hadera) which are scheduled to turn out 230 million m^3 per annum by the end of 2009, constituting 30 percent of home usage in Israel. Those facilities are currently undergoing an expansion process that will enable production of an additional 60 million m^3 per annum, resulting in a sum capability of 290 million m^3 per year (about 35 percent of home usage).

Three additional water desalination facilities are currently in an initiation and tender process, and are expected to produce 300 million m^3 per year, constituting an additional 40 percent of home usage.

By 2013, all six sea water desalination facilities will produce 600 million m^3 per year, an achievement representing 75 percent of home usage. The estimated investment amount is approximately $1.8 billion, and the estimated total operation cost is close to $300 million.

The supervision and management of the projects on behalf of the government is being performed by an inter-cabinet tender committee headed by the Ministry of Finance, and includes representatives from the National Water Authority, the Ministry of Environmental Protection and the Ministry of National Infrastructures. All of the projects are coordinated by the PPP Division of Public-Private Partnerships, a division of the Ministry of Finance that focuses on initiating and executing infrastructure PPP projects.



Legend

- Signed Contract
- Contract in Formation/Tender
- Feasibility Study

2007
- Agriculture Sector - 1 Billion Cube
- Industry Sector - 150 Million Cube
- Home Usage Sector - 750 Million Cube

1.9 Billion Cube

2020
- Agriculture Sector - 1.2 Billion Cube
- Industry Sector - 190 Million Cube
- Home Usage Sector - 1.1 Billion Cube

2.5 Billion Cube

2005
- Desalinated Water - 30 Million Cube

2009
- Desalinated Water - 230 Million Cube

2012
- Desalinated Water - 550 Million Cube

2012 - 70% of the Home Usage-Desalinated Water!

INBAL, PPP DIVISION

Israel Ministries of Finance and Industry, Trade and Labor Issue Tender for Establishment and Management of Investment Funds in the Area of Life Sciences

The Ministry of Finance and the Ministry of Industry, Trade and Labor have issued a tender for the establishment and management of investment funds in the field of life sciences, with an emphasis on investment in bio-pharmacology. The decision to establish the funds is based on more than a year of on-the-ground ministry work along with research which indicated that the Israeli bio-pharmacology market holds vast potential that has not yet been realized.

The investment funds will be established in a standard venture capital fund format, and each fund will be managed by a professional managing body with extensive experience in bio-pharmacology investment both in Israel and abroad. The manager will be selected by the state in a two-stage process. The first stage – the preliminary selection stage – will ensure that only first- rate teams will be chosen as the funds' managers.

The managing body will be granted independence in its management of the fund and decision-making. The government, which will invest $80 million in the venture, will act as a limited partner in the funds alongside private investors from Israel and abroad. Apart from the economic potential inherent in investment in the life sciences industry in Israel, embodied in the funds' structure are government incentives that enhance the attractiveness of the alternative of investment in Israel for both local and foreign capital.

The main reason for the joint venture is Israel's excellent bio-pharmacology industrial infrastructure. This infrastructure is not currently operating at full capacity because of, among other reasons, the large-scale investment and long-time horizons that ordinarily accompany innovations in this field.

The investment funds are designed to address these financial obstacles and to help enable this sector to expand and reach its full economic potential.

The investment funds are being established as part of the Finance Ministry's effort to promote a growth-oriented policy. The funds are expected to help maintain Israel's status as a technological power and increase its GDP.

Those interested are invited to review the Prequalification for Participation in Tender document (PDF format) located at: http://www.financeisrael.mof.gov.il/BioFund.htm

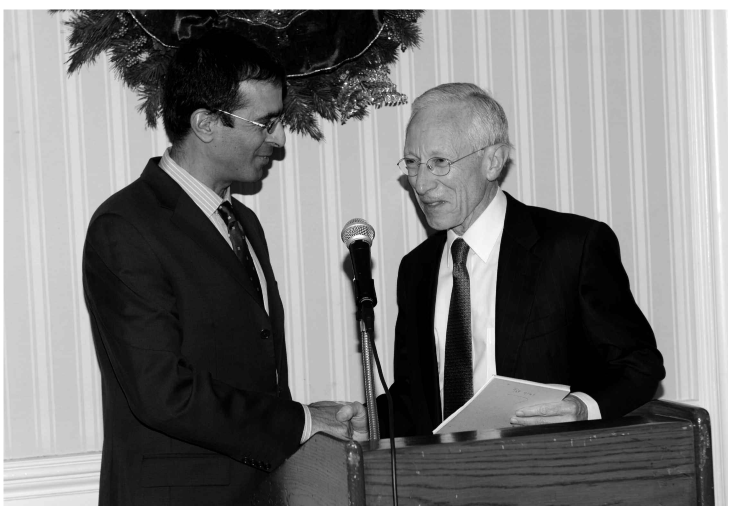


Photo:Shahar Azran

Zvi Chalamish (left), head of the Israel Ministry of Finance in the Americas, greets Professor Stanley Fischer, Governor of the Bank of Israel, who spoke at an event in New York for investors, sponsored by the Israel Economic Mission Ministry of Finance.

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