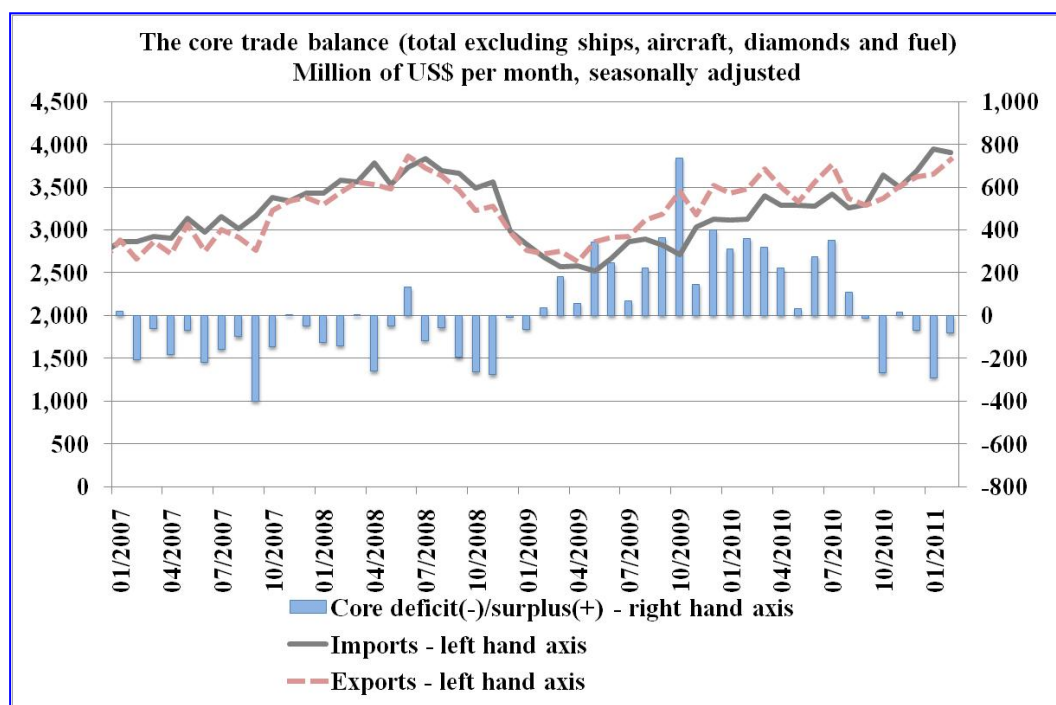


# Leumi Economic Weekly

March 16, 2011

## *The trade deficit increased in the first two months of 2011*

Israel's trade deficit amounted to US\$2.2bn in the first two months of the year (unadjusted data), representing a 143% increase compared to the same period of 2010. The increase in the overall deficit in the first two months of the year stems from, to a degree that cannot be ignored, the increase in fuel prices. Fuel happens to account for almost 20% of total imports. The core trade account (the total excluding ships, aircraft, diamonds, and energy materials) also amounted to a deficit in the first two months of this year, of US\$0.4bn (according to data excluding seasonality). This in contrast to the same period of last year when the core trade account amounted to a surplus of US\$0.7bn. This change in the trend, that is to say a turnaround from a surplus to a deficit, is the result of a more rapid increase in imports compared to exports.



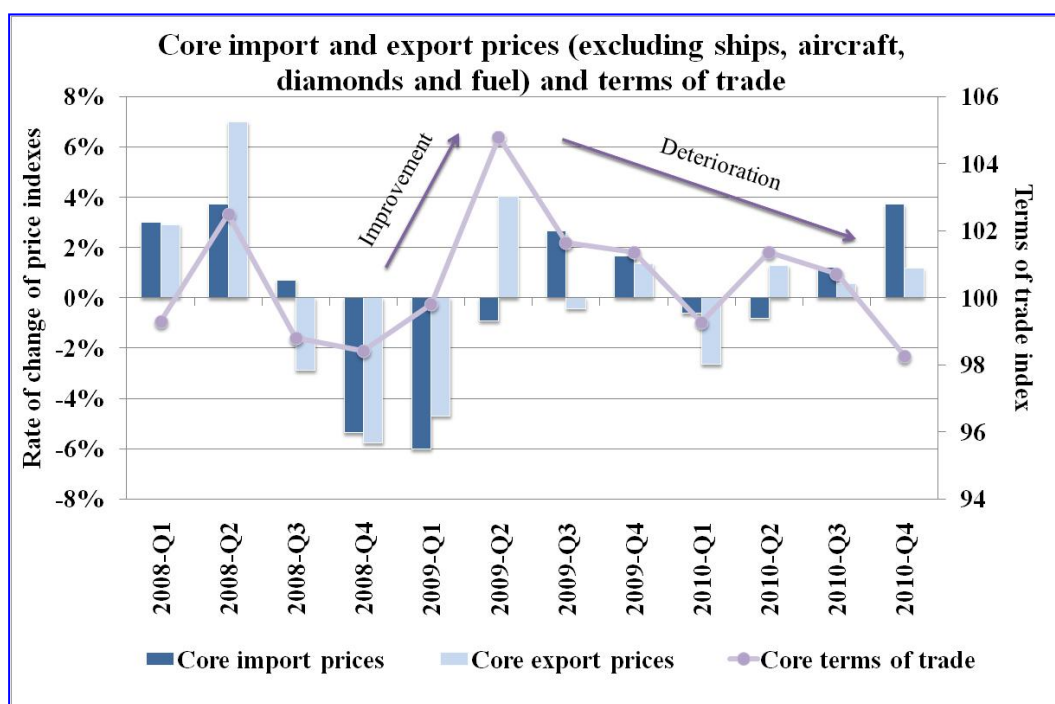
The increase in imports is reflected in all components, with this trend being in-line with the substantial increase in local real investments and in private consumption, and in particular the consumption of durable goods. In contrast, there has been a notable weakness in exports, stemming from among other things a deterioration in competitiveness in international markets due to the continuing appreciation in the exchange rate of the shekel vis-à-vis the different currencies. We note that the chemicals excluding pharmaceuticals sector, which accounts for 20% of industrial exports, contributed to the increase in exports. This sector benefited from

the rise in fertilizer prices around the world, which for the most part occurs when there is a global increase in food prices. Furthermore, there was a notable increase in the export of a number of central high-tech sectors, among them being the control and supervision equipment sector, and the electronic components sector (which is influenced primarily by the activity of Intel).

Looking forward, the increase in imports is expected to continue in light of the strength of local demand, both for investments and private consumption. On the export side, no change can be seen at this point in the forces that have led until now to the appreciation in the real effective exchange rate, which has hurt Israeli export competitiveness. Thus, it appears that in the coming year the core trade deficit will continue to expand, and this is likely to lead to a reduction in the current account surplus of the balance of payments.

***A continuing deterioration in Israel's terms of trade in 2010 due to a more rapid increase in import prices relative to export prices***

An analysis of import and export prices (excluding ships, aircraft, diamonds, and fuel) shows, as can be seen in the accompanying graph, a sharp improvement in Israel's terms of trade in the first half of 2009. This improvement stems from a sharp decline in import prices (and in particular of raw material prices that influence the costs of production in the industrial export sectors), alongside a more moderate decline in export prices, in the first quarter of 2009, while in the following quarter export prices actually increased. Since the third quarter of 2009 there has been a deterioration in the improvement of the terms of trade, a development that has led to a decline in the core trade surplus, to the point whereby it fell into deficit, beginning from the fourth quarter of 2009.

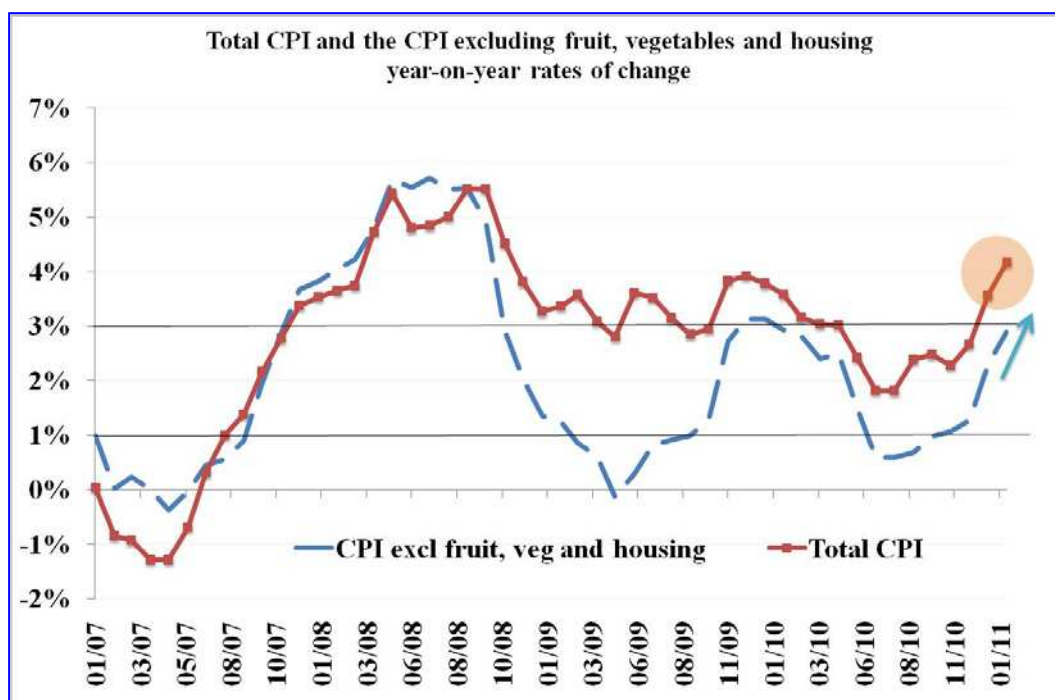


The change in the price indices of imports and exports in 2010 shows a deterioration in Israel's terms of trade, because as the import prices of raw materials for industry increased 8%, there was only a relatively moderate increase of 0.6% in export prices. In other words, exporters absorbed almost all the rise in raw material prices. To this must be added the fall in

revenues to exporters as a result of the appreciation in the real effective exchange rate of the shekel. On the other hand, it must be remembered that an analysis of export profitability requires analysis of additional data (that is beyond the scope of this document), including the costs of labor (including labor productivity), the impact of the appreciation on imports, the low level of the interest rate that influences financial costs, etc.

***February's CPI increased 0.3% m/m, while over the trailing 12-month period prices increased 4.2%***

The consumer price index (CPI) increased 0.3% m/m in February, with a notable 1.2% rise in prices of food excluding fruits and vegetables. As can be seen in the accompanying graph, the rate of increase of prices over the trailing 12-month period continues to be above the price stability target range (1-3%), reaching 4.2%. In addition, the CPI excluding the housing component and the fruits and vegetables component has increased rapidly since the third quarter of 2010, at a rate of 2.9%. The CPI excluding the housing and the fruits and vegetables components was influenced, by a significant degree, by the increase in food prices, which have experienced a notable acceleration in their rate of increase, because of the rise in food prices in the world. Furthermore, this index was influenced by the rise in fuel prices. It is worthwhile to note that the heavy influence of external factors (such as commodities prices), heightens the uncertainty surrounding the local inflation environment and the interest rate.



Relating to the housing component, the annual rate of increase of the owned dwellings services sub-component, which is based on rental prices of renewed contracts, continues at an average rate of 5-7%, and thus contributes to the high inflationary environment. Housing prices as gauged in the housing prices survey index, which is based on transaction prices (the sale and purchase of housing units) that are reported to the tax authorities, increased 16% in December 2010 (the figure is always published with a two month delay). We note that this represents a decline from the annual rate of increase of 20% and higher in the first half of

2010. However, this is still a very high rate of increase, and in our opinion a process of a more significant moderation in housing prices will be on-going.

Looking forward, we expect a continued increase in the annual rate of change of the CPI, in light of the continuing upward pressure on housing prices, and the high level of commodities prices. We estimate the high inflation environment, together with strong real economic activity, as reflected in the national accounts data and in various other indicators, will require the continuation of the process of hiking interest rates, with a transformation from a negative real interest rate to positive real rates. We note that these estimates are in-line with the last interest rate announcement of the Bank of Israel (BoI), in which it was noted that the prospects are increasing for a more rapid process of interest rate hikes relative to the previous forecasts. A more rapid hike in interest rates, in the event it will be required, is expected to ultimately rein in the inflationary pressures, but this will only occur later in the year.

*Author: Sagit Cohen*

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