Financial Division

Macroeconomic Department

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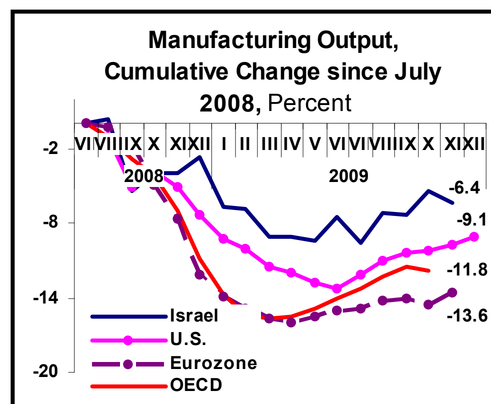
Macroeconomic Overview – February 16, 2010

Israel's Manufacturing Trend from a Global Perspective

The recovery of economic activity in recent months is reflected in industrial production data, among other parameters. Industrial production (excl. diamonds) **continued to contract in the first half of 2009**, much as in the second half of 2008 although more slowly. **In mid-year, however, the trend turned around and recovery was observed from then until year's end.** Just the same, **relative to the period preceding the financial crisis (July–August 2008),** there was a cumulative retreat of 6.4 percent (see Figure).



Industrial production decreased in 2009 by 6 percent on average, the steepest downturn that this parameter ever recorded, after three years of rapid growth (6.5 percent on annual average). **Output in most industries plummeted** (by 10–20 percent in most cases); **the only exception was electronic components,** which celebrated 30 percent growth due to Intel's new plant in Kiryat Gat. **Electronic components aside, industrial production fell by 8 percent.** Due to the nature of the crisis, most of the damage focused on the export sector, which contracted by 10 percent against the background of a 12 percent decline in global trade; the decrease in domestic sales was much gentler. **The abrupt slowdown in industrial production was accompanied by some 20,000 layoffs, 6 percent of sector employment.**

Despite the grim effects on the crisis on Israeli manufacturing, this sector took a relatively mild beating in comparison with its counterparts in developed countries (see figure). This was largely due to the different structure of Israel's manufacturing sector. Apart from the aforementioned centrality of Intel's new plant in manufacturing activity in 2009, the defense and pharmaceutical industries also helped to cushion the blow. **Industrial production in large economies, in contrast, was heavily affected by a severe decline in manufacturing of durable goods, especially motor vehicles.** As an example, the American carmaking industry, which generated 4.5 percent of U.S. industrial production in 2008, has shriveled by 26 percent since July 2008.

In 2010, we expect Israeli manufacturing output to increase by 5 percent. We base this outlook on the recovery trend in industrial production in recent months and additional indicators, mainly optimism among manufacturers, as reflected in the Manufacturers Association's survey of expectations and the Bank of Israel's Companies Survey; the high level of the manufacturing purchasing managers index; a rapid increase in imports of manufacturing raw materials; and stronger demand for high-tech labor.

The upturn, in our estimation, will be driven by a 9 percent increase in exports, abetted by 6 percent growth in global trade. In the domestic market, too, demand for manufactures is projected to increase, bolstered by an upturn in investments (after the steep retreat in 2009) and a faster pace of private consumption.

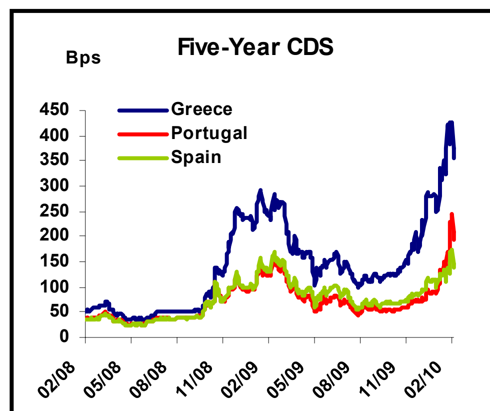
Putting the Eurozone to the Test

The countries along Europe's southern tier, foremost Greece, Spain, and Portugal, are suffering from large government deficits and rising debt/product ratios. These factors are fueling concern about national defaults, which, if they come to pass, will take a toll on Eurozone resilience, drive equity markets sharply down, and induce USD appreciation against the euro around the globe.

The lack of control over monetary policy and the inability to induce depreciation are sapping these countries' competitiveness and making significant fiscal cutbacks more and more necessary.

The weakest link among Eurozone countries is **Greece,** which generates 3 percent of Eurozone product. Before the global crisis broke out, Greece enjoyed brisk economic growth—4.5 percent in 2006 and 2007—but suffered from chronic high unemployment rates and large budget and current-account deficits. The global crisis had a minor effect on the Greek economy by Eurozone standards, GDP contracting by only 1.1 percent in 2009. However, the government's inability to adjust its budget to the economic conditions, due to political instability, caused its deficit to soar from 4 percent of GDP in 2007 to 12.7 percent in 2009 and hiked the debt/product ratio to 112.6 percent. The Greek economy is expected to continue contracting in 2010 and to reattain a growth trajectory only in 2011. The greatest fear is that the loss of confidence in the Greek government's ability to maintain a tight fiscal policy, which would impair its ability to roll over EUR 20 billion in bonds that are due for redemption in April–May, will necessitate a rescue program or a declaration of bankruptcy.

The upturn in fears about the Greek government's ability to slash its deficit, coupled with rising yields on Greek government bonds, is making investors jittery about other European countries that have large deficits, foremost Portugal and Spain.



Portugal: the Portuguese economy (2 percent of Eurozone GDP) suffered from sluggish growth rates, high unemployment rates, and large current-account and government-balance deficit even before the global crisis. The crisis only made things worse: in 2009 the economy shrank by 2.8 percent, the government deficit climbed to 6.7 percent of GDP, and the unemployment rate ramped to a daunting 10.4 percent. The increase in the government deficit and upturn in the debt/GDP ratio, which was high to begin with, kindled fears about the country's financial stability. Portugal's growth rates are expected to remain lethargic due to major deleveraging in the private sector; therefore, the OECD economists project growth in 2010 and 2011 at and 0.8 percent and 1.5 percent, respectively.

Spain: unlike Greece and Portugal, Spain is a large country, generating 13 percent of total Eurozone product. Before the global crisis erupted, Spain was enjoying vigorous economic growth (averaging 3 percent in 2005–2008) and budget surpluses. However, its economy was saddled with high unemployment rates and large long-term current-account deficits. Spain was one of the countries hardest hit by the global crisis due to the emergence of a price bubble in its housing market. In 2009, the Spanish economy contracted by 3.6 percent and the budget deficit stood at 9.6 percent of GDP. The deep recession left its impact on the labor market, the unemployment rate rocketing to 19.5 percent at the end of 2009. Unlike many other Eurozone economies, Spain continued to contract in the third quarter of 2009 and, in the OECD's estimation, will continue to do the same in 2010. A slow recovery will commence only in 2011. Consequently, unemployment is expected to remain at around 20 percent in 2010.

In response to the fears of a Greek default, which triggered apprehensions about the stability of additional Eurozone countries, the markets raised the sovereign credit default swap spreads (CDS—the insurance premium in the event of bond default**)** (see figure).

Last week, on February 9, 2010, it was reported that the European Union, chaired by Germany, was taking action to prepare a relief program for Greece. The news pushed the market upward, lowered the three countries' CDS premiums (that of Greece by the largest extent), and bolstered the euro against the USD. Since such assistance is contrary to the European Union regulations, however, it is too early to declare the crisis over.

Financial Outlook

Monthly

	February	**March**	**April**
Inflation	-0.4%	0.1%	0.8%
BOI interest rate	1.25%	1.25%	1.25%

Annual

	2009	**2010**	**2010/12 months**
Inflation	3.9%	1.9%	2.6%
BOI interest rate, year's end	1.0%	3.0%	3.25%