

August 28, 2006

EMEA Economics

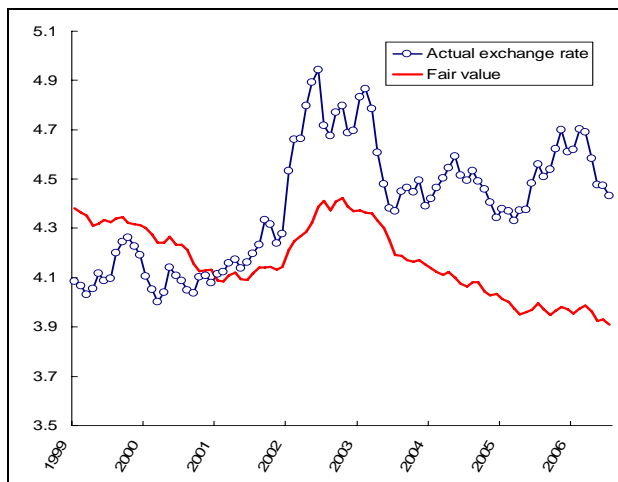
Israel: The Incredible Shekel

Israel's economy and financial markets have shown remarkable resistance. We have long argued that prudent fiscal management and structural reforms in the last couple of years have strengthened the Israeli economy and made its financial markets more resilient against exogenous shocks.

The shekel is still undervalued by about 30% against the currency basket. Our valuation models suggest that the shekel remains undervalued, which is not a surprising finding, since Israel has experienced a period of deflation, a post-recession productivity acceleration and fiscal consolidation.

Monetary tightening is almost over, but there are still risks, in our view. The Bank of Israel, albeit coming to the end of monetary normalisation, may still need to tighten the policy stance in the last months of the year. However, this would support our call on the shekel and a flatter yield curve, rather than threaten it.

ILS/USD Remains Undervalued, 1999-2006



Source: Morgan Stanley Research

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Economics

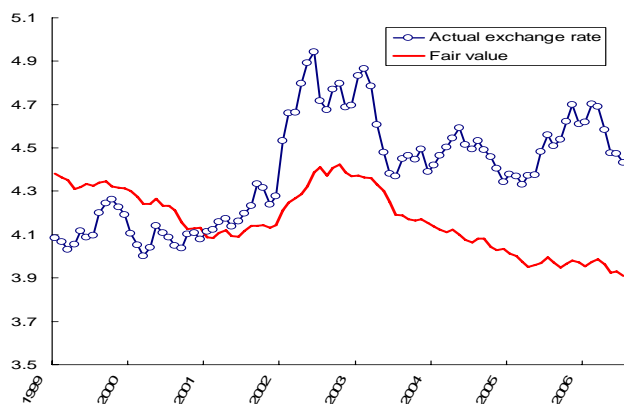
The Incredible Shekel

Israel's economy and financial markets have shown remarkable resistance. Who would have expected that the shekel would become stronger in the face of a global financial earthquake and serious military shocks at home? Just incredible, but not really surprising, in our view. We have long argued that prudent fiscal management and structural reforms in the last couple of years have strengthened the Israeli economy and made its financial markets more resilient against shocks. As a result, despite the narrowest interest rate differential vis-à-vis the developed world, the shekel has kept appreciating, especially against the dollar, and curtailed inflation pressures in the domestic economy. But is this Goldilocks performance sustainable going forward? We believe so, and here is why. Although simultaneous military campaigns have introduced downside risks to the growth outlook and strained public finances, we expect these shocks to be temporary and the economy to recover back to its robust growth trend later this year. Among all the factors contributing to our benign assessment, the shekel's fundamental valuation holds the key to macroeconomic performance in the near future.

The shekel is still undervalued by about 30% against the currency basket. Our exchange-rate valuation models suggest that the shekel is undervalued by 12.5% against the dollar, and even more so (about 30%) against the currency basket. This is not a surprising finding, since Israel has experienced a period of deflation, a post-recession acceleration in productivity growth, and a significant relative correction in the fiscal stance. Of course, we do not expect the shekel to appreciate all the way to its fair value any time

Exhibit 1

ILS/USD Remains Undervalued, 1999-2006



Source: Morgan Stanley Research

soon, because of residents' portfolio diversification into foreign assets, the global monetary tightening cycle and the higher risk premium associated with geopolitical uncertainties. Nevertheless, external accounts — showing a current account surplus of 3.5% of GDP and the continuing inflow of foreign direct investments — and productivity improvements — making Israel even more competitive in international markets — support a more favourable valuation for the shekel.

Fiscal discipline is the best way to minimise the fallout from military shocks. Israel has a long and unsuccessful history of experimenting with Keynesian policies whenever a shock depresses domestic demand. As the performance in the past three years has clearly shown, the best way to minimise the fallout from the hostilities in Lebanon and the Palestinian territories is maintaining fiscal discipline and letting the private sector take the lead in the output recovery process. In our view, the current administration, albeit having a tendency to increase 'social' spending, is likely to keep the overall fiscal framework intact and the budget deficit below 2% of GDP this year. However, although the debt-to-GDP ratio declined from over 100% in 2003 to 89% in the first half of 2006, it is still too high and puts pressure on the business sector. This is why Israel, experiencing a slowdown in the third quarter, needs uninterrupted fiscal prudence more than ever. Following an annualised growth rate of 5.9% in the first half of 2006, the drop in consumer and business spending will no doubt lower real GDP growth in the near future. But we believe that this is going to be temporary and expect a rebound in the fourth quarter, keeping the annual growth rate at around 4.8% this year.

Monetary tightening is almost over, but there are still risks, in our view. Even though inflation is now back within the central bank's target range of 1-3%, there are still underlying inflationary pressures in the economy that cannot be easily dismissed by the shekel's strength. The rate of business-sector GDP growth, even after the expected deceleration in the third quarter, is likely to remain robust enough to narrow the output gap going forward. Furthermore, our US economics team thinks that the pause is not necessarily the end of monetary tightening and therefore expects the Federal Reserve to raise the policy rate to 5.5% in the remainder of this year. Therefore, the Bank of Israel, albeit certainly coming to the end of its monetary normalisation campaign, may still need to tighten the policy stance in the last months of the year. However, this would support our call on the shekel and a flatter yield curve, rather than threaten it.

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