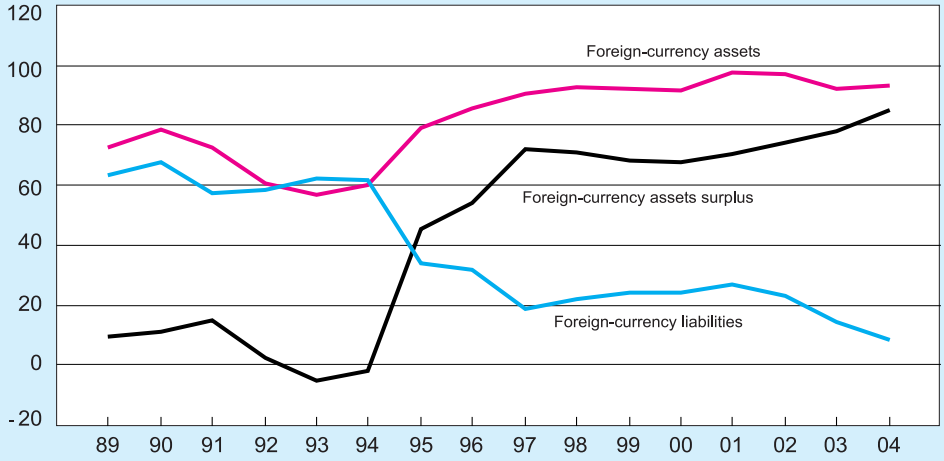
EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS FOR 2004

The major component of the Bank of Israel's assets, the foreign exchange reserves, increased by a moderate 1.6 percent in 2004, reaching NIS 115 billion at the end of the year. The aggregate of the main monetary instruments,[1] which constitutes the chief component of liabilities, rose by 4 percent: in December it averaged NIS 85 billion.

The changes in the Bank's Profit and Loss Account for 2004 were more significant. The Bank moved from a profit of about NIS 0.3 billion in 2003 to a loss of NIS 0.8 billion in 2004, because its income declined faster than did its expenses. Income from the reserves dropped mainly due to the decline in realized exchange-rate differentials and to negative capital gains, the result of the rise in the interest rate in the US. The Bank's expenses, which derive essentially from its use of the monetary instruments in pursuing its policy, declined because of the cuts in the interest rate in Israel, but as stated income fell faster.

Figure 1
Bank of Israel Foreign-Currency Assets, Liabilities, and Surplus Foreign-Currency Assets, 1989–2004
(percent of balance sheet, end-of-year, at current prices)



[1] Treasury bills and time deposits *minus* the monetary loans. The Bank of Israel also uses other monetary instruments—options and NIS/$ swaps—but these account for a very small quantity compared to the major instruments.

As in previous years, in 2004 the most notable aspect of the Bank of Israel's financial statements arose from the fact that the great majority (93 percent) of the Bank's assets are either denominated in or indexed to foreign currency, whereas most of its liabilities are in local currency. This currency imbalance was created in the years 1995–97, when the Bank adopted a tight monetary policy to achieve the inflation target set by the government. Private capital imports in that period exerted downward pressure on the exchange rate, and the Bank, to defend the exchange rate determined by the government (the lower limit of the exchange-rate band), bought about $ 16 billion from the public, and absorbed the NIS that flowed into the economy as a consequence. The Bank's foreign exchange reserves, that for about a decade had stood at between $ 4 billion and $ 7 billion, surged in the last few years to between $ 22 billion and $ 26 billion (Figure 1), and the aggregate of the monetary instruments, which until 1995 consisted mainly of monetary loans, as was customary in central banks around the world, today comprise mainly liabilities that incur expenses—Treasury bills and time deposits—totaling some NIS 88 billion.

Table 1
Exchange-Rate Differentials on Foreign-Currency Balances, 2003–2004

(NIS million, at current prices)

	2003	2004
Assets		
Foreign-exchange reserves	–3,471	124
Credit to the government—binational funds	–12	–2
International financial institutions	31	64
Liabilities		
Government deposits	1,553	69
Banks' foreign-currency deposits	121	37
International financial institutions	–3	–19
Deposits of the binational fund	13	3
Other liabilities—NIS/$ swaps	–501	–99
Total	–2,271	176
Realized exchange-rate differentials	2,506	947
Unrealized exchange-rate differentials	–4,777	–771

As a result of the imbalance between the currency compositions of the Bank's assets and its liabilities, a change in the exchange rate (NIS/$ and $ against other currencies) and differences between the interest-rate path in Israel and those in other countries may cause changes in the Bank's balance sheet and more significant changes in its Profit and Loss Account. This is the main reason that in several years since 1996 the Bank of Israel recorded losses (Tables 5.A.2 and 5.A.3); these led to deficits in the capital account, which in 2004 reached about NIS 14 billion.

1. MAIN DEVELOPMENTS

In 2004 the stability prevailing since the second quarter of 2003 was maintained. The sheqel stayed stable against the currency basket, the main component of which is the dollar. In the first half of 2004 the NIS depreciated by 1.5 percent against the currency basket, in the second half it appreciated by 0.7 percent, and over the year as a whole the NIS depreciated by a moderate 0.8 percent against the basket.

Economic stability was also reflected by the stabilization of inflation expectations at a low level that is consistent with the government's inflation target, which enabled the Bank of Israel to continue reducing the interest rate gradually, despite the reverse process with regard to interest on the dollar. Most of the reduction in the interest rate occurred in the first quarter of the year, with the rate being held steady at a low level for most of the rest of the year, and with further cuts at the end of the year and in January and February 2005. In 2004 as a whole the interest rate was reduced by 1.5 percentage points, following the reduction of 3.9 percentage points in 2003. The interest rate, which stood at 9.1 percent in December 2002, was down to 3.7 percent at the end of 2004 and 3.5 percent in February 2005, thus reaching its lowest level ever, without adversely affecting price stability.

The interest-rate differential between Israel and the US contracted, reaching 1.45 percentage points at the end of 2004 (3.7 percent in Israel vis-à-vis 2.25 percent in the US and 2 percent in the eurozone). This reflects the confidence in Israel's economy in the financial markets on the one hand, and concern regarding deficits in the US budget and current account on the other. The reduction in short-term interest combined with the lowering of the whole yield curve reflects the public's confidence in the Bank of Israel's monetary policy and in the government's fiscal policy, expressed in its fiscal discipline, the cuts in expenditure, and the adherence to the deficit path.

The reduction in the interest rate resulted in a sharp fall in the Bank of Israel's expenses on Treasury bills and time deposits, which constitute the major monetary instruments: the expenses went down by 32 percent, despite a 4 percent rise in the aggregate. Concurrently income on the government's local-currency deposits, which have negative balances, fell.

The foreign exchange reserves

The upward trend of the foreign exchange reserves moderated in 2004, and at the end of the year they stood at $ 26.6 billion (a rise of $ 0.8 billion in 2004 compared to a rise of $ 2.1 billon in 2003). In local-currency terms, the reserves rose by only NIS 1.8 billion, due to the appreciation of the NIS against the dollar.

The slowdown in the rate of increase of the reserves was due mainly to a smaller government contribution to them, the result of a decline in the government's foreign-currency borrowing: in 2004 the government took foreign-currency loans of $ 2.3 billion—$ 1.75 billion of which was in the framework of the US government guarantees—down from about $ 3 billion in 2003. Money raised via the State of Israel

Bonds came to $ 1.3 billion (–$ 0.2 billion net), compared to $ 1.6 billion ($ 0.3 billion net) in 2003.

Income from exchange-rate differentials

Changes in the NIS exchange rate against foreign currencies change the value of the reserves held in the different currencies in local-currency terms; these are exchange-rate differentials. When the reserve held in a particular currency falls, exchange-rate differentials arising as a result are defined as income from exchange-rate differentials; when the reserve rises or does not change, exchange-rate differentials constitute a revaluation in NIS of the same balance—they are not defined as income and are recorded in revaluation accounts in the Bank's balance sheet.

Profit or loss from exchange-rate differentials are defined as realized when the net balance of assets in foreign currency goes down. Realization is examined at the end of each calendar month for foreign-currency assets and liabilities for each currency separately. A loss balance in a revaluation account of a currency at the end of the year is recognized as realized and is transferred to the Profit and Loss Account.

In the last few years the foreign exchange reserves held by the Bank of Israel were on a rising trend, so that income from exchange-rate differentials (deriving from realization of balances, as stated) were relatively small. In 2004 they totaled NIS 0.9 billion, down from NIS 2.5 billion in 2003.

The currency composition of the reserves held by the Bank of Israel is determined from time to time in accordance with the Bank's decisions. In the system prevailing in the past, i.e., preserving a composition with fixed weights of several currencies, the weakening of the dollar, such as occurred in 2004,[2] would have required steps to be taken to revert to the currency balance: assets in currencies that had strengthened would be sold, and assets in currencies that had weakened would be bought. Taking such measures to maintain the currency composition of the reserves would affect income from realized exchange-rate differentials. At the beginning of 2004 the Bank of Israel changed the system of management of the currency composition of the reserves, and started describing the composition in terms of fixed quantities of currencies and not in terms of fixed shares of currencies. Under the new method, the currency balance of the portfolio is not rebalanced when there are exchange-rate changes, but only when there are additions or reductions of foreign currency from some external source. The change in the system, together with other changes introduced in the framework of the new management method, although they increased the Bank's income from the reserves in terms of the other currencies, expressed as a rise in total exchange-rate differentials, reduced the share that was realized, leading to a fall in the Bank's profit from exchange-rate differentials from 2003 to 2004.

[2] In 2004 the dollar weakened against the major currencies, as it had in 2002 and 2003, falling by 7.4 percent against the € and by 7 percent against the £ (in 2003, by 17 percent and 10 percent respectively).

The monetary instruments

The Bank of Israel employs various monetary instruments to implement its monetary policy, and this is reflected in the Bank's balance sheet and Profit and Loss Account. Since the second half of the 1990s the Bank has been a net borrower from the banking system. In this period the composition of the monetary instruments changed. In the past the Bank would use mainly time deposits to absorb money from the public. Following an agreement between the Bank and the Ministry of Finance in December 2001, the ceiling on Treasury bills was removed, and the Bank started gradually to make greater use of Treasury bills instead of time deposits. Thus the share of time deposits in the aggregate of the major monetary instruments declined from 58 percent at the beginning of 2002 to only 19 percent at the end of 2004. Treasury bills are the preferred instrument because they are a tradable, liquid instrument, that help the Bank of Israel to expand the short-term money market and to make more efficient use of the monetary instruments. In 2004 the average balance of Treasury bills rose by about NIS 14 billion[3] while the average balance of time deposits declined by about NIS 9 billion. In total the average balance of the aggregate rose by 6 percent, from NIS 79 billion in 2003 to NIS 84 billion in 2004.

The average balance of the monetary loans, about NIS 0.8 billion, has not changed significantly in the last few years.

The balance of NIS/$ swaps has remained steady in dollar terms since 1997, at $ 1.4 billion; the Bank's main use of this instrument continued to be to ensure the preservation of a range of monetary instruments available to the Bank.

Government deposits

Over the last few years the situation of a debit balance in the government's local-currency deposits and a larger credit balance in its foreign-currency deposits persisted. The local-currency interest paid by the government on its deposits with negative balances was higher than the dollar interest it earned on its foreign-currency deposits, so that overall the government incurred net interest expenses. This occurred despite the fact that the overall balance of government deposits for financing the budget were in credit, as stated above. At the end of 2004 the government converted part of the balances in its foreign-currency accounts into local currency, so that the debit balance in the local-currency accounts was reduced. This reduction in the average debit balance in the NIS accounts together with the drop in the local-currency interest rate and the rise in the dollar interest rate contributed to a reduction to NIS 0.1 billion

[3] The difference in the balance of Treasury bills on 31 December between 2004 and 2003 is about NIS 18 billion, although the Bank of Israel increases the balance by NIS 1 billion every month. This is due to a series of Treasury bills totaling NIS 5.2 billion that were due to be redeemed in January 2004, but the redemption date for which was brought forward to 31 December 2003, in accordance with the rules regarding the timing of issues and redemption of Treasury bills.

in net interest expenses paid by the government on its accounts (from NIS 0.7 billion in 2003). The average balance of the government's deposits for financing the budget rose by NIS 1.5 billion in 2004 to an average of some NIS 11.5 billion.

The 1.6 percent fall in the dollar exchange rate against the NIS reduced the local-currency value of the government's dollar deposits by NIS 0.21 billion (in 2003 the value declined by NIS 1.5 billion).

The monetary base

The monetary base—banknotes and coins in circulation and the commercial banks' local-currency current-account deposits in the Bank of Israel—rose by about NIS 1 billion in 2004 (in 2003 it rose by NIS 3.6 billion, Tables 3 and 5). Banknotes and coins increased by NIS 1.6 billion in 2004 (NIS 1.1 billion in 2003), and the banks' current-account deposits in the Bank of Israel fell by NIS 0.7 billion. The rise was due to the Bank of Israel injection of NIS 1.1 billion in the course of 2004 (NIS 1.4 billion in 2003). The injection by the government and the national institutions derived mainly from conversions of foreign currency so that the effect on the monetary base was minimal (in 2003 this effect amounted to NIS 2.1 billion).

For most of the year the government absorbed money from the economy, injecting money just in June–July and December (NIS 6.4 billion and NIS 6.1 billion respectively). The injection in June–July was seasonal, and can be explained partly by the payment of

Table 2
Indicators of the Bank of Israel Profit, 1990–2004

	Profit (loss)	Realized exchange-rate differentials[a]	Net foreign-currency assets end-of-year	Change in currency-basket exchange rate during year	Treasury bills plus time deposits minus monetary loans 31 Dec.	Average interest, annual rates	
						Time deposits	Monetary loans
	NIS billion		$ billion		NIS billion		
	(at current prices)			percent	(at current prices)	percent	
1990	1.5	0.5	1.5	10.6	–	–	14.4
1991	1.9	0.8	2.0	11.2	–1.0	–	15.5
1992	1.7	0.6	0.3	16.3	–5.0	–	12.1
1993	1.3	–0.2	–0.8	6.3	–10.0	–	10.7
1994	1.8	0.4	–0.3	5.7	–8.0	–	12.7
1995	2.5	1.4	6.0	6.3	9.0	–	14.9
1996	–0.5	0.5	8.6	1.6	21.0	16.2	14.9
1997	–1.1	2.1	17.5	4.1	51.0	13.9	13.5
1998	10.9	13.1	18.4	20.4	63.0	11.9	11.5
1999	–8.7	–3.5	17.7	–3.2	73.0	12.2	11.8
2000	–6.7	–3.7	18.0	–5.5	80.0	9.4	8.9
2001	0.9	0.1	18.7	7.0	79.0	6.9	6.5
2002	1.7	0.9	20.2	13.0	77.0	7.0	6.6
2003	0.3	2.5	23.0	–1.6	84.0	7.5	7.1
2004	–0.8	0.9	25.4	0.8	87.0	4.3	3.8

[a] Until 1999 all exchange-rate differentials were defined as realized.

interest on bonds averaging NIS 2 billion. The injection in December was exceptional, as some of it was due to the early payment of the vacation supplement to government employees (payments postponed to 2005 as part of the economic recovery program and then brought forward to the end of 2004).

The Profit and Loss Account

The Bank of Israel's income from the foreign exchange reserves—interest and capital gains *plus* realized exchange-rate differentials (most of which derive from the foreign exchange reserves)—fell in 2004 by NIS 2.7 billion (from NIS 5.7 billion in 2003 to NIS 3 billion), and income from the government's accounts went down by NIS 0.6 billion. On the other side, expenses of the monetary aggregate declined by NIS 2.1 billion (from NIS 6.4 billion in 2003 to NIS 4.3 billion in 2004). The Bank ended 2004 with a net loss of NIS 0.8 billion, compared with a profit of NIS 0.3 in 2003.

The main item of the Bank's income is income from the foreign exchange reserves. Most of the reserves are invested in tradable bonds, whose price is subject to market fluctuations. In 2004 bond prices fell (yields rose), so that the Bank incurred capital losses of NIS 0.2 billion (in 2003, a profit of NIS 0.6 billion). Interest income also went down slightly, and expenses on foreign-currency derivatives rose a little.

Income from realized exchange–rate differentials declined by NIS 1.6 billion, apart from other things due to the changes mentioned above in the method of managing the reserves. These changes increased the total exchange–rate differentials, but lowered their realized share.

The Bank's financial statements are in NIS, whereas its income derives from assets most of which are in dollars; hence in 2004, when the dollar weakened by 1.6 percent against the NIS, income denominated in dollars went down in NIS terms. The strengthening of the euro against the NIS by 6.2 percent went a little way towards offsetting this effect.

Income form the government's accounts fell by NIS 0.6 billion because of the drop in the local-currency interest rate and the decline in the debit balance in the government's local-currency accounts.

Interest payments on Treasury bills and time deposits constitute the major component of the Bank's expenses. In 2004 average interest on Treasury bills dropped by about 1.5 percentage points, and on time deposits by about 3.2 percentage points (from 7.1 percent in 2003 to 5.6 percent in 2004 on Treasury bills, and from 7.5 percent to 4.3 percent on time deposits). Despite the marked (32 percent) increase in the balance of Treasury bills in 2004, interest expenses on the balance fell by NIS 0.7 billion (expenses on Treasury bills in 2003 include NIS 0.3 billion for the adjustment of the discount for previous years). The decline of 47 percent in the balance of time deposits together with the drop in interest on them reduced interest costs on the deposits by about NIS 1.4 billion. Total interest on the monetary aggregate, which in addition to Treasury bills and time deposits also includes the monetary loans, fell by 32 percent although the aggregate itself increased by about 4 percent.

All the above components of profit and loss amount to a loss of NIS 0.8 billion in 2004, after a profit of NIS 0.3 billion in 2003. This loss is added to the deficit balance of the Bank, which stood at NIS 13.9 billion at the end of 2004. It should be noted that the monetary activity of a central bank differs in essence from that of a commercial company, as the former derives from the bank's various roles as defined by law, and is not necessarily directed to earning a profit. The Bank's balance sheet and Profit and Loss Account reflect this, and they should be viewed in this light. This having been said, the Bank's capital, and in particular the capital deficit, is important from the aspect of the independence and functioning of the central bank.

2. MAIN ITEMS

a. The foreign exchange reserves[4]

The foreign exchange reserves make up the largest part (89 percent) of the Bank of Israel's assets, and some of the Bank's other assets are also indexed to foreign currency. This asset composition explains why the Bank's financial statements are greatly affected by exchange-rate fluctuations, changes in interest rates and other changes in the global economy.

Currently the reserves fulfill two types of function:

- the first relates to their possible uses;
- the second to the benefits to Israel's economy deriving from the fact that Israel holds a certain level of reserves.

The main use made of the reserves is their sale to the government for debt servicing, but there are other possible uses of the reserves, such as selling foreign currency to the government to finance essential imports at times of emergency, using them as an auxiliary instrument for conducting the Bank of Israel's policy in the foreign-currency market, and as an instrument to help implement monetary policy and to bolster stability in the financial markets.

One of the benefits of a high level of reserves is that it lowers the probability of a crisis in the foreign-currency market and improves Israel's standing in the international financial environment, as the size of a country's reserves is one of the parameters taken into account by international entities and the credit-rating companies when rating its financial stability.

Defining the roles of the reserves is not merely a theoretical exercise, but it provides a basis for determining the desired level of the reserves, a method for managing them, and a basis for setting the currency numeraire, i.e., the currency composition used as a guideline for managing the reserves. Since December 2003, this composition has been derived from the distribution by currency of the reserves' possible uses.

[4] For a detailed review of the functions of the foreign exchange reserves and the investment of the reserves in the current era see the 2003 and 2004 Annual Reports of the Foreign Currency Department.

Table 3
Composition of Changes in the Monetary Base and Foreign Reserves, 1998–2004
injection (+)/absorption(–)

(current prices)

	1998	1999	2000	2001	2002	2003	2004	2003 IV	2004 I	2004 II	2004 III	2004 IV
NIS million												
1.Change in monetary base (1) = (2 + 3 + 4 + 5)	242	3,927	311	4,364	1,437	3,567	966	3,002	2,538	549	–2,178	57
2. Government and National Institutions	1,901	4,067	–2,729	–2,611	–6,065	3,479	1,601	2,976	–4,277	1,629	20	4,229
3. Bank of Israel	–2,664	–365	2,729	7,675	9,265	1,425	1,070	528	7,180	–782	–2,042	–3,286
4. Foreign-currency conversions at Bank of Israel	1,746	–	–	–	–	–	–	–	–	–	–	–
5. Adjustments[a]	–741	225	311	–700	–1,763	–1,337	–1,705	–503	–365	–298	–156	–886
$ million												
Banks' foreign-currency activity with the Bank of Israel												
6. Foreign-currency sales (–) to Bank of Israel (6) = (8 – 9 – 7)	–492	–	–	–	–	–	–	–	–	–	–	–
7. Public-sector transfers to banks[b]	–163	–259	–345	–20	183	335	342	113	-11	202	27	124
8. Change in deposits with Bank of Israel	–369	585	–462	91	–982	–896	–232	255	–182	–85	227	–192
9. Transfers to (–)/from (+) rest of world	286	844	–117	111	–1,165	–1,231	–574	142	–171	–287	200	–316
10. Adjustments[c]	–343	–197	–275	–216	–186	27	–57	3	–97	130	–7	–83
Contribution to reserves												
11. Private sector[d] (11) = (9 + 10)	–57	647	–392	–105	–1,351	–1,204	–631	144	–268	–157	193	–399
12. Public sector[e]	2,399	–806	1,041	122	1,840	3,322	1,475	880	641	–292	–65	1,191
13. Change in reserves[f] (13) = (11 + 12)	2,342	–159	649	17	489	2,118	844	1,024	373	–449	128	792

[a] Adjustments include: transfers from abroad by the National Institutions through the banks, defined as public-sector injection (in row 2). Government and Bank of Israel domestic foreign-currency receipts from and payments to the private sector (e.g., income tax receipts in foreign currency) do not change the monetary base, as they are transferred directly from the private sector to the government: on the one hand they are defined as government absorption and on the other they are defined as the private sector's contribution to the foreign reserves (without going via the Bank of Israel's trading-room floor).
[b] NIS/$ swaps and other domestic foreign-currency payments.
[c] Transfers from abroad by the public sector through the banks, e.g., by the National Institutions.
[d] Including income tax payments in foreign currency by the private sector.
[e] Transfers by the government and the National Institutions from abroad, and Bank of Israel income from the foreign reserves (interest income, capital gains and cross-rate differentials).
[f] Including the change in accrued interest on the foreign reserves.

Table 4
Foreign Reserves—Total, Income, Exchange-Rate and Cross-Rate Differentials and Yields, 2002–2004

		2002	2003	2004
Total foreign reserves				
$ million				
End of year		23,669	25,788	26,632
Annual average		23,943	23,826	25,987
Income and exchange-rate and cross-rate differentials				
NIS million				
Total		17,880	–276	2,224
Interest and capital gains		5,622	3,195	2,100
NIS/$ exchange-rate differentials		7,192	–8,177	–1,906
Cross-rate differentials ($/other currencies)		5,066	4,706	2,030
$ million				
Total		2,212	1,740	938
Interest and capital gains		1,172	707	470
Cross-rate differentials ($/other currencies)		1,040	1,033	468
Yields[a]				
Percent				
In terms of NIS	Total	17.8	–1.3	1.8
	Interest and capital gains	5.2	2.2	1.7
	Exchange-rate differentials	12.1	–3.4	0.1
In terms of euro	Total	–7.3	–11.4	–4.1
In terms of $	Total	9.9	6.7	3.5
	Interest and capital gains	5.2	2.2	1.7
In terms of use[b] of foreign reserves		5.2	2.2	1.7
Benchmark yield		5.0	1.9	1.7

[a] Yields (annual, compounded daily) refer to income from the foreign reserves, including profit or loss arising from changes in market prices.
[b] See note 2 to the financial statement.

The yields on the reserves

The Bank of Israel invests the foreign exchange reserves mainly in tradable securities with a relatively short average duration, to ensure an appropriate level of liquidity and to avoid the danger of wide swings in the value of the portfolio which could occur in the wake of fluctuations in the financial markets. The average duration of the foreign reserves portfolio since 1999 has been set at sixteen months; towards the end of 2002 the duration of the dollar part of the portfolio was reduced to 11 months because of the rise in the risk of obtaining a negative holding-period rate of return on the reserves portfolio against the background of the very low yields to maturity in the US market and the rise in the probability that they would increase. The duration of the non-dollar part of the reserves remains 16 months.

In 2004 the yield on the reserves was 1.7 percent. The yield is measured in terms of the currency numeraire of the reserves' uses, and not in terms of any specific currency. The arbitrariness of measuring yield in terms of any specific currency is highlighted

by looking at the yield in dollar terms (3.5 percent in 2004), and in euro terms (–4.1 percent in 2004), and the high volatility of the yields in terms of these currencies over the last few years (Table 4). The yield in terms of NIS was 1.8 percent, reflecting the stability of the NIS against the currency composition of the uses, and the low level of income from interest and capital obtained from the investment of the reserves.

The yield on the reserves in 2004 was greatly affected by the low level of the yield to maturity, mainly in the US market. This low level was the result of the expansionary monetary policy pursued by the US since 2001 which by the end of 2002 had brought yields to maturity in the US market to very low levels. Their low level reduces the current-income component of the holding-period rate of return and thus lowers the yield. Changes in yield to maturity in the capital markets also had an effect on the holding-period rate of return. Yields to maturity in the US and Europe rose in the first half of 2004, and followed no clear trend in the second half. The decline in yields reflects a rise in bond prices, and vice versa. Thus the contribution of changes in yields to maturity to the holding-period rate of return during the year was not uniform.

The yield achieved on the investment of the foreign exchange reserves is compared with the benchmark yield. The benchmark is a hypothetical portfolio made up of various assets that reflects the Bank's long-term investment strategy. The market yields of the assets included in the benchmark, in all currencies, are weighted by the weights of the assets in the basket of uses. The actual yield on the investment of the reserves in 2004, 1.7 percent, exceeded the yield on the benchmark of 1.67 percent. The difference reflects the contribution of investment decisions. It is achieved by utilizing the degrees of freedom for deviations from the currency composition of the uses, from the duration of the benchmark, and from its asset composition. These degrees of freedom are relatively limited.

The bank's financial statements, shown in NIS, give expression to changes in the exchange rate of the NIS against other currencies, changes which are not taken into consideration in managing the portfolio.

Changes in foreign-currency cross rates

The main feature in international currency markets in 2004 was the continued weakening of the dollar against all the major currencies. This process has persisted since the end of 2000, when it reached a peak of $ 0.825 per euro (on 26 October 2000). Concern in the international markets over the escalating US budget and trade deficits exacerbated the weakening of the dollar; at the end of 2004 it fell below $ 1.36 to the €, bringing the decline against that currency since 2000 to about 40 percent (7 percent in 2004). The 1.6 percent fall of the dollar against the NIS resulted in a rise of only NIS 1.8 billion in the NIS value of the portfolio, despite its more significant increase in dollar terms.

Until the beginning of December 2003 the currency composition of the reserves was managed according to a numeraire comprising fixed weights of several currencies. This method of management was aimed at preserving the purchasing power of the

reserves in terms of the economy's foreign-currency uses, an approach that was appropriate to the exchange–rate regime in effect until a few years ago. A weakening of one of the currencies in the portfolio against the others led to the sale of some of the assets in the currencies that strengthened and the purchase of assets in the weakened currency, in order to maintain the purchasing power of the reserves. The sale of assets in a currency that had strengthened generally resulted in income due to realized exchange–rate differentials. Since the beginning of 2004 the numeraire has been defined chiefly in terms of the government's debt-servicing requirements, which are not affected by changes in the exchange rate, so that it is defined in terms of fixed quantities of currencies, and not fixed shares of the total. Changes in exchange rates of the currencies in the portfolio against each other no longer necessitate a revised currency composition. This change was one of the reasons for the reduction of NIS 1.6 billion in profit from realized exchange–rate differentials (from NIS 2.5 billion in 2003 to NIS 0.9 billion in 2004).

Changes in the foreign exchange reserves and their causes

Changes in the foreign exchange reserves are caused by the activities of the government and the national institutions, foreign-currency activities of the private sector, and activity of the Bank of Israel.

In 2004 the government contributed $ 0.2 billion to the reserves, the national institutions $ 0.3 billion, and the Bank of Israel, via its management of the reserves, about $ 1 billion, a total contribution from the public sector of about $ 1.5 billion (in 2003 the contribution was $ 3.3 billion). The contribution of the government and the national institutions took place mainly in April and November, when the government raised money in foreign currency. During the rest of the year the government essentially reduced its deposits. The private sector withdrew $ 0.6 billion of foreign currency from the reserves in 2004, $ 0.25 billion of which was reducing its deposits in the Bank of Israel. Overall, the foreign exchange reserves grew by $ 0.8 billion in 2004.

The guarantees

In 2004 the government raised about $ 2.3 billion on capital markets abroad—$ 1.75 billion under the US government guarantees and another $ 0.5 billion on the global market. In 2003 the government borrowed about $ 3 billion. These loans were taken at low rates of interest, due to market conditions and the US government guarantees.

Economic aid

As in most of the previous years, the aid received in 2004, $ 0.48 billion, related to the previous year's US budget, with the delay due to the late approval of that budget. (The aid for the 2004 budget year, $ 0.36 billion, was received in January 2005.) Aid shown in the Bank's books consists of civilian aid, which is reducing by $ 120 million a year and is due to end completely in 2006, and part of the defense aid. Most of the defense aid, which totaled $ 1.9 billion, is used for direct payment to suppliers for defense imports, and the government therefore deposits with the Bank of Israel only

the part intended for domestic uses, which in 2004 again totaled about $ 0.5 billion, as it has in the last few years.

State of Israel Bonds

In 2004 the government raised about $ 1.3 billion from issues of State of Israel Bonds. In 2003 the amount raised reached a peak of $ 1.6 billion, due to the supportive atmosphere towards Israel among Jews worldwide generated by Palestinian terrorist activity. It is expected that the Bonds will raise about $ 1 billion a year in the next few years. Part of the money raised via the Bonds is used for payments abroad, and the rest is deposited in the Bank of Israel. Israel pays a higher rate of interest on the State of Israel Bonds than it pays on other bonds it issues, but continues to issue them mainly to maintain an additional avenue of raising money in times of need.

The government had foreign-currency expenses of $ 3 billion in 2004, mainly on repayment of past debts and interest payments, and these were offset against the money raised as described above, so that the government's contribution to the foreign exchange reserves in 2004 was small, only $ 0.2 billion net (in 2003 it contributed $ 1.5 billion).

The private sector withdrew $ 0.6 billion from the foreign exchange reserves in 2004 (see the section on the banking corporations' accounts below).

The Bank of Israel's contribution to the reserves totaled about $ 1 billion in 2004 ($ 1.4 billion in 2003). Interest receipts totaled $ 0.4 billion ($ 0.8 billion in 2003), and exchange–rate differentials, $ 0.5 billion ($ 1 billion in 2003).

b. Government accounts

According to Section 57(a) of the Bank of Israel Law, 5714–1954, "The Bank shall be the sole banker and fiscal agent in Israel of the Government." Hence, the government holds all its local-currency accounts and some of its foreign-currency accounts in the Bank of Israel.

In 2004 the average balance of the government accounts was NIS 11.7 billion (NIS 10.2 billion in 2003), consisting of a NIS 17.7 billion credit balance in the foreign-currency account and a NIS 6 billion deficit in the local-currency account (compared to a NIS 20.8 billion in the dollar accounts and a negative NIS 10.6 billion in the local-currency accounts in 2002 and 2003). The reduction of the negative balance in the local-currency account together with the lower local-currency interest rate and the rise in the dollar interest rate resulted in a decline in the Bank of Israel's income from government accounts. In 2004 net interest income from the government accounts came to NIS 0.1 billion, down from NIS 0.7 billion in 2003.

The government's local-currency accounts have a seasonality with a monthly cycle: at the beginning of each month the balance declines, due mainly to wage payments, and in the middle of each month it rises as a result of tax collection. The amplitude of this fluctuation (the difference between the highest and lowest value of the variable) is about NIS 10 billion. Payments made inside Israel, such as wages, constitute an

Table 5
Government Deposits with the Bank of Israel, 2002–2004

(NIS million, current prices)

	2002	2003	2004
End-year balances			
Government deposits for budget financing			
Local-currency deposits	–12,400	–12,626	–7,406
Foreign-currency deposits	20,316	20,619	13,185
Total government deposits for budget financing	7,916	7,993	5,779
Other deposits[a]	236	325	735
Total	**8,152**	**8,318**	**6,514**
Net change in government deposits	**3,893**	**166**	**–1,804**
Sources of change			
Government contribution (+) to foreign reserves[b]	–2,634	6,686	776
Government absorption (+)	7,635	–1,966	–247
Government–Bank of Israel financial flow[c]	–1,161	–4,615	–2,384
Adjustments[d]	53	61	51

[a] Including the local-currency deposit to stabilize bond prices, another deposit in foreign currency, and interest accrued on government deposits (see note 10 on Deposits of the Government).
[b] Government income and expenses abroad, loans received and loan repayments abroad.
[c] Interest payments and redemption of government bonds held by the Bank of Israel; commission from the government; interest payments, repayment of principal and payment of indexation differentials on credit to the government, and interest payments by the Bank of Israel on government deposits (in local and foreign currency); exchange-rate differentials on government foreign-currency deposits; and transfer to the government of Bank of Israels profit.
[d] Including accrued interest on government deposits to the end of the year; interest payments by the government on credit from the Bank of Israel for binational funds (these payments are included under 'Government injection,' but in this table they are also included under 'Government–Bank of Israel financial flow'); State of Israel Bonds redemptions by tourists in Israel (these redemptions reduce the government's local-currency deposits, but are not included in 'Government injection').

injection, and domestic receipts such as tax collection, means absorption. Hence, to maintain a constant level of liquidity in the economy, the Bank of Israel acts to smooth the above effect by means of various monetary instruments, mainly auctions for daily and weekly time deposits.

The government raised about $ 1.75 under the guarantees arrangement (in addition to money raised via State of Israel Bonds and on the global market), and received about $ 0.5 billion in civilian aid, and $ 1.9 billion in military aid (for details see the section above on the foreign exchange reserves).

Government deposits with the Bank of Israel divide into two categories: (a) deposits for budget financing, (b) other deposits. In both categories some deposits are in NIS, and some in dollars.

Since 1994 total NIS deposits have had a negative balance,[5] while foreign-currency deposits have had a credit balance which exceeded the debit balance of the local-

[5] Except for a few days during the period when they were in credit.

currency deposits. Although total government deposits for budget financing have a credit balance so that the government is fulfilling the anti-money-printing law,[6] holding accounts in this form results in the government obtaining income from its accounts, as will be explained below.

The difference between prime interest that the government pays on its local-currency accounts with debit balances (an average of 5.7 percent in 2004) and the interest it receives on its credit balances in its foreign-currency accounts, which is similar to the rate on US bonds maturing in six months (2.5 percent in 2004) was 3.2 percentage points (in 2003 the difference was 7.7 percentage points).

At the end of 2004 the government converted some of the balance in its foreign-currency accounts into NIS, thereby reducing its debit balance in its local-currency accounts. Although this step, combined with the contraction of the interest-rate differential between the NIS and the dollar, contributed to a significant lowering of the government's overall interest expenses on its accounts, their main effect on government expenses will be felt in 2005, since most of the conversions took place at the end of the year.

Government interest payments on its budget-financing deposits in 2004 totaled NIS 96 million, despite the fact that as stated these deposits overall had a credit balance.

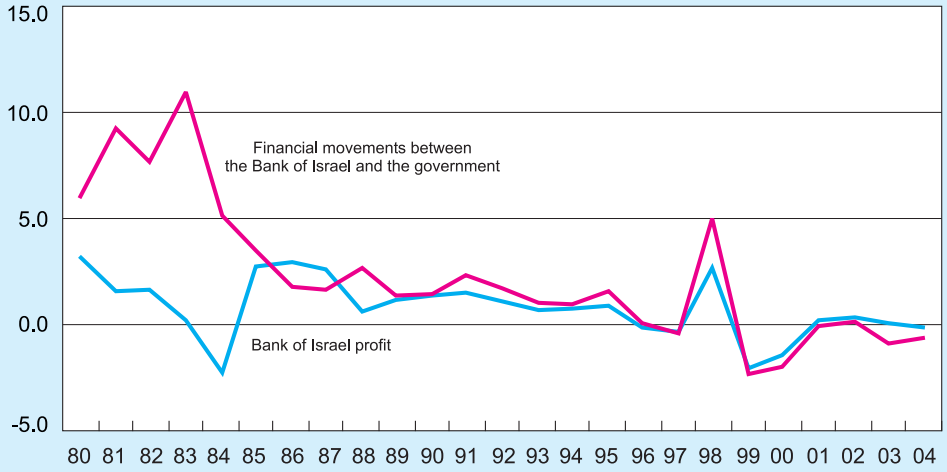
In addition to the interest loss, this type of accounts management causes wide fluctuations in the NIS value of the foreign exchange reserves due to its dependence on the dollar exchange rate: a drop in the $/NIS exchange rate reduces the balance in the accounts in NIS terms. As the balance in the government foreign-currency account went down, and the NIS appreciated by only 1.6 percent against the dollar in 2004 (compared with 7.6 percent appreciation in 2003), the decline in the total balance in budget-financing accounts in local-currency terms was not very different from the reduction in dollar terms.

Long-term advances

Long-term advances are loans given to the government in the distant past to finance its budget deficits. The loans bear interest, some of them are indexed to the first-currency-basket exchange rate, and the principal is due to be repaid by annual payments through to 2012. In 2004 the NIS depreciated by 3.8 percent against the first currency basket, so that the government paid indexation differentials totaling NIS 0.1 billion. It also paid interest of NIS 0.4 billion, and repaid NIS 0.5 billion of principal, as it has done in each of the last few years.

[6] Section 45(a) of the Bank of Israel Law allows the Bank of Israel to provide the government with a provisional advance, at its request, for purposes of bridging a temporary gap in its cash flow in performing the budget, on condition that the total of such provisional advances does not at any time exceed 1.6 percent of the normal annual total budget. The Law permits the temporary advances to increase to 3.2 percent in two periods during the year, provided that neither of the periods exceeds 30 days.

Figure 2
Total Financial Movements between the Bank of Israel and the Government, and the Bank of Israel Profit, 1980–2004 (percent of GDP, at current prices)



The government has asked the Bank of Israel to wipe out these long-term advances, and the matter is under discussion by the Bank of Israel and the Ministry of Finance.

c. Monetary instruments

Treasury bills and time deposits

The Bank of Israel employs various instruments to implement its monetary policy. In the last few years Treasury bills have become the major monetary instrument,[7] and every year their share in the aggregate of monetary instruments increases at the expense of time deposits. In 2004 the Bank of Israel sold an average of NIS 1 billion of Treasury bills a month to the public above the redeemed part of the debt that was recycled, at the same time gradually replacing the banks' time deposits, which are nontradable, with Treasury bills, which are traded on the stock exchange. In total the average balance of Treasury bills rose by NIS 14 billion, while time deposits dropped by about NIS 9 billion. The reduction of interest rates greatly cut the cost of using these instruments, from NIS 6.5 billion in 2003 to NIS 4.4 billion in 2004.

The banking corporations' local-currency demand deposits

The banking corporations' local-currency demand deposits serve to meet the banks' reserve requirements in accordance with the Bank of Israel directives, and to make various payments. The banks draw cash from the Bank of Israel: in 2004 they drew

[7] Formally, Treasury bills are issued by the Government of Israel, but to all intents and purposes they are Bank of Israel monetary instrument.

some NIS 10.2 billion. The Post Office Bank, on the other hand, deposits cash: in 2004 it deposited NIS 8.5 billion (Table 6).

The banking corporations' foreign-currency deposits

The banks' foreign-currency deposits are divided into those required to meet the Bank of Israel reserve requirement, and unrestricted deposits. Total foreign-currency deposits stood at $ 0.37 in 2004, of which $ 0.26 were deposits to meet the reserve requirement. In the past there was a secondary reserve requirement of 10 percent. The rise in the level of the foreign exchange reserves enabled the Bank gradually to abolish that requirement in a process that ended in May 2003; this was done to increase the amount of foreign currency available to the private sector, in the context of the policy of other central banks throughout the world to reduce reliance on liquidity rates as an instrument of monetary policy. In 2004 the private sector withdrew most of its unrestricted deposits from the Bank of Israel, leaving a balance of only $ 0.1 billion at the end of the year.

Table 6
Deposits of the Banking Corporations with the Bank of Israel, 2002–2004

(NIS million, current prices)

	2002			2003			2004		
	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total
Change in banking corporations' deposits[a]	**286**	**(3,708)**	**(3,422)**	**2,439**	**(4,442)**	**(2,003)**	**(680)**	**(1,033)**	**(1,713)**
Activity with the government[b]	62	885	947	10,177	1,482	11,659	8,553	1,504	10,057
Withdrawal (–) of banknotes from Bank of Israel	(8,875)	–	(8,875)	(9,057)	–	(9,057)	(10,230)	–	(10,230)
Activity with Bank of Israel[c]	9,062	876	9,938	1,243	(95)	1,148	890	(29)	861
Transfers from (+) and to (–) abroad	–	(5,449)	(5,449)	–	(5,852)	(5,852)	–	(2,534)	(2,534)
Foreign-currency conversions at Bank of Israel	–	–	–	–	–	–	–	–	–
Adjustments	37	(20)	17	76	23	99	107	26	133
Deposit of banknotes by Post Office Bank in Bank of Israel[d]	7,695	–	7,695	7,888	–	7,888	8,539	–	8,539

[a] This does not include the change in time deposits.
[b] Government injection via the banking corporations' demand deposits.
[c] Depositing time deposits, the purchase of Treasury bills, the sale of government bonds, and various interest payments.
[d] Deposits of banknotes mainly by the Post Office Bank; these deposits are a government absorption, and are included under 'Government injection.'

Table 7
Accounts of the Banking Corporations with the Bank of Israel, 1998–2004

(daily average, current prices)

	1998	1999	2000	2001	2002	2003	2004	2003 IV	2004 I	2004 II	2004 III	2004 IV
Local-currency deposits and credit[a]												
NIS billion												
1. Demand deposits	4.5	5.5	6.6	7.8	8.3	8.3	9.0	8.4	9.0	9.0	9.0	9.1
2. Time deposits	36.9	44.1	46.0	46.5	33.5	30.5	21.0	28.6	26.3	19.5	21.2	17.0
3. Loans												
3.1 Monetary	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
3.2 Other	–	–	–	–	0.6	2.1	1.7	2.1	2.0	1.8	1.6	1.5
4. Net deposits (= 1 + 2 – 3)	40.6	48.8	51.8	53.4	40.4	36.0	27.5	34.1	32.5	25.9	27.8	23.8
5. Net deposits plus swaps	45.9	54.6	57.5	59.3	47.0	42.4	33.8	40.4	38.7	32.3	34.2	30.1
6. Net deposits plus swaps and Treasury bills[b]	67.1	78.6	83.3	89.8	85.3	91.4	97.8	95.3	98.3	95.2	99.4	98.1
Foreign-currency deposits and credit												
$ billion												
7. Deposits	1.9	2.0	2.2	2.4	2.1	0.5	0.3	0.3	0.3	0.3	0.3	0.4
8. Net deposits less swaps[c]	0.5	0.6	0.8	1.0	0.7	-0.9	–1.1	–1.1	–1.1	–1.1	–1.1	–1.0
NIS billion												
9. Net deposits less swaps[c]	1.8	2.4	3.3	4.0	3.5	–4.1	–4.7	–4.8	–4.7	–4.9	–4.9	–4.4
10. Total net deposits plus swaps and Treasury bills (= 6 + 9)	68.8	81.0	86.5	93.8	88.8	87.3	93.1	90.4	93.6	90.3	94.5	93.8
Rates of interest (percent)[d]												
11. Monetary loans	11.5	11.8	8.9	6.5	6.6	7.1	3.8	5.3	4.0	3.4	4.0	3.7
12. Time deposits	11.9	12.2	9.4	6.9	7.0	7.5	4.3	5.7	4.6	4.2	4.2	4.1

[a] Items 1–10 include accrued interest.
[b] Net deposits plus NIS swaps for remittance and Treasury bills deposit (excluding the part of the deposit arising from the replacement of government bonds by Treasury bills).
[c] Deposits less loans and less dollar swaps to be received.
[d] Annual rate, based on quarterly and yearly calculations respectively.