EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS

The Bank of Israel's balance sheet totaled NIS 133 billion at the end of 2007 compared with NIS 158 billion at the end of 2006, a decrease of about 16 percent. The foreign exchange reserves,[1] which constitute the main component of the Bank's assets, fell this year by some NIS 13 billion (about 11 percent). This was mainly the result of the appreciation of the shekel against the dollar by about 9 percent and against the pound sterling by 7 percent.

The balance of the aggregate of the main monetary instruments[2] fell from NIS 88 billion at the end of 2006 to NIS 76 at the end of 2007. The decline was primarily the result of the drop of about NIS 20 billion in the balance of makam and the drop in the balance of monetary loans from NIS 7.5 billion at the end of 2006 to zero at the end of 2007. The reduction in the balance of makam followed the decision by the Bank of Israel to use them as an active monetary instrument, i.e., to inject or absorb liquidity according to the banks' liquidity situation, partly in preparation for the introduction of an RTGS system.

In contrast, the loan and deposit auctions are used to regulate liquidity on a daily basis and therefore the zero balance of monetary loans on December 31, 2007 is a coincidence and reflects the liquidity situation and injection/absorption of other entities on that day.

The Bank's Statement of Operations shows a sharp drop in profit from a relatively low level of NIS 83 million in 2006 to a loss of NIS 5.3 billion in 2007. This is explained by a decrease of about NIS 7.1 billion in the exchange rate differentials item. Thus, in 2007, an expense of NIS 6.6 billion was recorded in comparison to income of NIS 0.5 billion in 2006 as a result of the appreciation of the shekel against the dollar mentioned above.

The appreciation of the shekel against the dollar in 2006, 8.2 percent, was similar to that in 2007, but not all the negative exchange rate differentials created were recorded in the Statement of Operations. This is due to the accounting method used by the Bank of Israel, which recognizes only realized exchange rate ifferentials. As a result, the negative

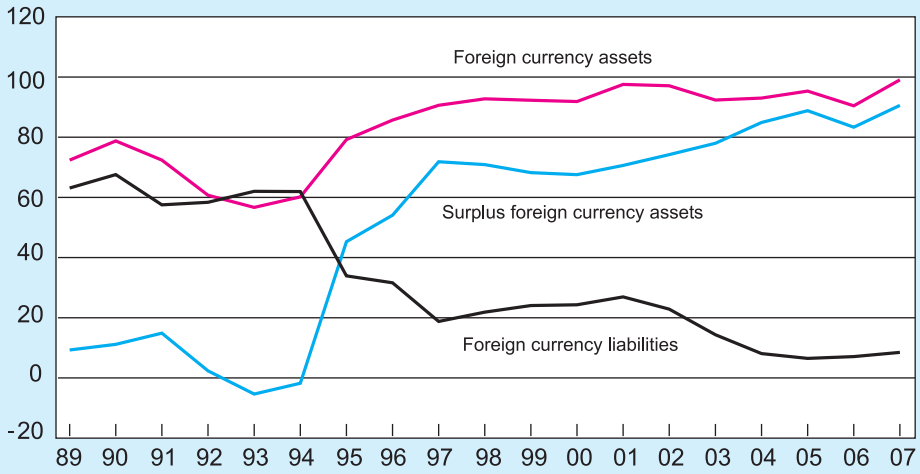
[1] In these notes, the term foreign exchange reserves is used in its economic sense and therefore they are presented net of the balances of repo transactions. The foreign exchange reserves are composed of the balance of "Financial Foreign Currency Assets Abroad" on the assets side of the Bank's balance sheet net of the balance of "Financial Foreign Currency Liabilities Abroad" on the liabilities side of the balance sheet. These balances are used to determine the Bank of Israel's investment policy and appear in its reports to various entities and therefore they constitute the basis for the analysis of trends in these notes. For the composition of the foreign exchange reserves, see Note 2 of the financial statements.

[2] Makam and time deposits net of monetary loans. The Bank of Israel has in the past also used other monetary instruments, such as options on the dollar exchange rate and shekel/dollar swap transactions. The issue of options ceased in 2006 and swap auctions ended in 2005.

exchange rate differentials created during the year are first offset against the balance of the revaluation account (if there is such a balance in that currency) and only after that is the remainder recorded in the Statement of Operations. In 2005, the balance of the revaluation account due to balances denominated in foreign currency stood at about NIS 11 billion and therefore most of the losses due to exchange rate differentials were offset in the revaluation account and therefore not reflected in the Statement of Operations.

During this same period, the Bank's income from its investment of the foreign exchange reserves not including exchange rate differentials (which includes only interest and other financial profit) grew by about NIS 1.4 billion, from NIS 4.6 billion at the end of 2006 to NIS 6 billion at the end of 2007 (see Figure 4). This increase was partly the result of price increases in international markets, the increase in the average interest rate on the Bank of Israel's foreign currency portfolio and the growth in the average balances of the portfolio in comparison to 2006.

Figure 1
Foreign Currency Assets, Liabilities, and Surplus Foreign Currency Assets of the Bank of Israel, 1989-2007
(percent of balance sheet, end-of-year, at current prices)



1. THE MAIN FACTORS INFLUENCING THE FINANCIAL STATEMENTS

The commercial activity of a central bank differs from that of a business since it is derived from the various functions assigned to the bank by law, and it is not necessarily directed towards earning a profit. The achievement of a central bank's objectives provides economy-wide benefits that are not reflected in its financial statements.

Several of the functions assigned to the Bank of Israel by the legislator have far-reaching effects on its financial statements. These include: the management of monetary policy, the management of the country's foreign exchange reserves, the government's banking activity in Israel and regulation of the amount of money in circulation.

In 2007, as in recent years, the explanation of the major changes in the Bank's financial statements is related to the fact that the vast majority of its assets are denominated in foreign currency or indexed to foreign currency while its liabilities are primarily in shekel (see Figure 1 and Table 2). This lack of symmetry in currencies was created during the period 1995–97 when the Bank adopted a contractionary monetary policy in order to achieve the inflation targets set by the government. The resulting import of capital by the private sector forced the Bank of Israel to purchase foreign currency from the public in order to maintain the foreign exchange rate at the lower boundary of the crawling band and to re-absorb the shekel that were injected into the economy for that purpose. The foreign exchange reserves grew from an average of a few billion dollars during the previous decade to about $23 billion in 1998, and since then they increased gradually to their present level of about $28 billion.

The monetary instruments aggregate, which until 1994 was composed primarily of monetary loans (as is the case for most central banks), is today composed primarily of liabilities, although this aggregate fell from a balance of about NIS 88 billion in 2006 to about NIS 76 billion in 2007. The decline in 2007 was primarily the result of a decrease of about NIS 20 billion in the balance of makam.

The lack of balance between currencies in the composition of the Bank of Israel's assets and liabilities exposes the Bank to volatility in its financial statements as a result of changes in the exchange rate of the shekel against foreign currencies and changes in the interest rate in Israel relative to other economies.

2. MAIN DEVELOPMENTS

This was the fourth successive year of rapid economic growth combined with economic stability which began in the second half of 2003. The direct influence of the global subprime crisis on the capital market in Israel has so far been relatively limited, thanks to positive macroeconomic results and the relatively small exposure of financial entities in Israel to this instrument.

The shekel strengthened significantly against the dollar again this year. Thus, the exchange rate of the dollar against the shekel fell by 9 percent which is similar to the 8.2 percent decline in 2006.

There were mixed trends in the exchange rate of the shekel against other major currencies. Thus, there was a 1.7 percent increase in the euro exchange rate and a decline of about 7 percent in the pound sterling exchange rate as opposed to increases of 2.2 percent and 4.4 percent respectively in 2006.

The trend in the exchange rate of the dollar was not uniform over the course of the year. Thus, there was a strong appreciation of the shekel against the dollar until May, which was primarily the result of positive fundamentals in the economy, especially the significant improvement in the current account surplus. This was followed by a reversal in trend characterized by a sharp depreciation of the shekel from May until August, which was in part the result of a low rate of interest and a negative interest rate differential between the shekel and the dollar, in addition to increased uncertainty with regard to Israel's security and political situation. In August, the trend of appreciation was renewed as a result of the worldwide weakening of the dollar and the improvement in the fundamentals of the economy.

The Bank of Israel rate of interest was reduced during the course of the year by one percentage point and stood at 4 percent at the end of the year. The trend in the rate of interest was not uniform during the course of the year. Thus, during the first half of the year, it was reduced by a cumulative rate of 1.5 percentage points in order to meet the inflation target following a sharp appreciation of the dollar. During the third quarter, the Bank of Israel raised the rate of interest by a cumulative 1.5 percentage points following an increase in inflation expectations, the result of a surge in commodity and energy prices, an increase in the risk premium and the effect of the global financial crisis. Beginning in September, the interest rate was left at a rate of 4 percent in view of the conflicting factors acting on inflation. Thus, on the one hand, further increases were expected in global energy and commodity prices while on the other hand domestic forces had emerged which were acting to strengthen the shekel, and there were fears that the global financial crisis would impact on the economy. The Bank of Israel rate of interest was lowered from 5 percentage points at the end of 2006 to 4 percent at the end of 2007, and on average, was reduced from 5.1 percent in 2006 to 3.9 percent in 2007.

The US rate of interest remained at 5.25 percent for most of the year and was lowered during the third quarter to 4.25 percent. The average rate of interest in the US was about 5 percent this year which was similar to the average for 2006.

The rate of inflation in 2007 was 3.4 percent, slightly above the upper limit of the target set by the government. The deviation was due in part to the rise in global food and energy prices during the year.

a. Foreign exchange reserves

The foreign exchange reserves fell during the year in dollar terms by $0.6 billion from $29 billion in 2006 to $28.4 billion in 2007, compared with an increase of $1.2 billion in 2006. (The average level of the reserves showed a different trend: it increased by about $0.9 billion, from $28 billion in 2006 to $28.9 billion in 2007.) The decline in the year-end level was primarily the result of withdrawals by the government (about $3.1 billion). The main reasons for the negative net amount of capital raised by the government abroad were the small size of the government deficit (which was about NIS 19 billion lower than planned) and significant revenues from privatization. The government did not issue bonds abroad apart from State of Israel Bonds. The increase in the profit of the Bank of Israel from the investment of the reserves and the revaluation of balances offset most of this decrease (about $2.5 billion).

The shekel value of the portfolio fell from NIS 123 billion in 2006 to about NIS 109 billion at the end of 2007. Beyond the decline in the dollar value of the portfolio, the decrease was primarily the result of the sharp 9 percent depreciation of the dollar against the shekel during the course of the year.

b. Exchange rate differentials

There were net negative exchange rate differentials of NIS 7.4 billion created in 2007 as a result of the adjustment of foreign currency balances in the balance sheet according to the representative exchange rate (about NIS 6.7 billion in 2006; see Table 1). Most of the amount (about NIS 8.4 billion) was accumulated on the foreign exchange reserves. According to the accounting method used in the Bank's financial statements, exchange rate differentials on the balance sheet balances are not fully recognized in the Statement of Operations unless they are realized. The realization for a particular foreign currency is recognized only when the balance held in that currency declines.

The unrealized exchange rate differentials are recorded in the revaluation accounts in the balance sheet. Future realizations in a particular currency are first offset against the revaluation account of that currency, if there is such an account, and only after that are they recorded in the Statement of Operations. A negative balance in the revaluation account of a particular currency at the end of the year is defined as realized and therefore appears in the Statement of Operations. As a result, the negative exchange rate differentials created as a result of the drop in the dollar exchange rate in 2006 were

Table 1
Exchange Rate Differentials[a] on Foreign Currency Balances, 2006–07

(NIS million, at current prices)

	2006	2007
Assets		
Foreign exchange reserves	-7,323	**-8,365**
Credit to the government—binational funds	-12	**-13**
International financial institutions	-19	**-19**
Liabilities		
Government deposits	582	**643**
Banks' foreign currency deposits	63	**285**
International financial institutions	29	**35**
Other liabilities—NIS/$ swaps	14	**14**
Total	-6,666	**-7,420**
Realized exchange-rate differentials	451	**-6,607**
Unrealized exchange-rate differentials	-7,117	**-813**

recognized as realized. However, this was not reflected in the Statement of Operations because they were completely offset by the balance of the revaluation account created up until the end of 2005. This was manifested in a decrease of NIS 7 billion in the balance of the revaluation accounts in the 2006 balance sheet, which was primarily due to the dollar revaluation account.

However, there remained no opening balance in the dollar revaluation account in 2007 since it had already been realized in 2006 and therefore the exchange rate differentials were recognized as realized in the Statement of Operations. As a result, a loss of about NIS 6.6 billion was recorded in the 2007 Statement of Operations due to exchange rate differentials. In contrast, a profit of NIS 0.5 billion was recorded in 2006 which was due to other currencies in the Bank's portfolio of assets, primarily the euro.

c. Monetary instruments

The Bank of Israel uses various monetary instruments to carry out its policy, and this is reflected in its balance sheet and Statement of Operations.

Until 1995, the Bank would inject liquidity into the economy, and as a result the monetary instruments aggregate was primarily composed of monetary loans. From that year onward, the proportion of monetary loans in the aggregate declined due to the need to absorb surplus liquidity created in the economy as a result of the Bank's activity in the foreign exchange market. As a result, the Bank became a net borrower from the banking system, primarily through time deposits and makam. Until 2001, time deposits constituted the main instrument for absorbing liquidity but with the removal of the ceiling on makam at the beginning of 2002, the Bank began to gradually increase their use at the expense of time deposits. In this way, the Bank also intended to expand the financial market and to achieve a more efficient utilization of monetary instruments.

The Bank's objective in expanding the use of makam was to create a fundamental liquidity deficit among the commercial banks. The Bank of Israel would then regulate the rate of interest through loan auctions for the banks in order to cover this deficit, which is the conventional method used in the advanced countries.

In 2007, following more than a decade of gradual expansion, the volume of makam was reduced by about 20 percent, from about NIS 96 billion at the end of 2006 to about NIS 76 billion at the end of 2007. This is explained by the decision of the Bank of Israel in 2007 to use makam as an active monetary instrument, which arose from, among other things, the desire to facilitate the introduction of the RTGS (Real Time Gross Settlement) system. In other words, the Bank would inject or absorb liquidity according to the liquidity situation among the banks.

The balance of monetary loans at the end of 2007 was zero, in contrast to a balance of about NIS 7.5 billion in 2006, although its average balance rose in 2007 to about NIS 9 billion, from about NIS 3 billion in 2006.

The main use of the monetary loan auctions and time deposits is in the regulation of liquidity, and therefore no importance should be attributed to the balance of loans on any particular day.

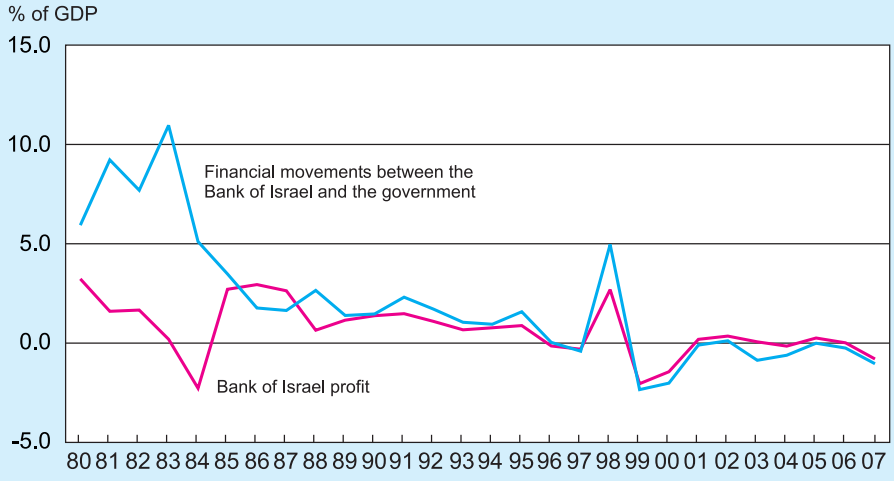
The balance of the monetary instruments aggregate fell from NIS 88 billion in 2006 to NIS 76 billion in 2007 as a result of the two abovementioned changes (see Table 2).

d. Government accounts[3]

The downward trend in the government's debit balance in its shekel accounts with the Bank of Israel and the decline in the credit balances of its foreign currency accounts, which began at the end of 2004, continued in 2007. Although the net balance of government deposits for financing the budget in local currency was in fact negative (in the amount of NIS 3 billion) at the end of the year, the average balance rose from NIS 1.1 billion in 2006 to NIS 4.8 billion in 2007. This increase is explained by, among other things, a budget surplus at the beginning of 2007 and the high rate of absorption by the government, primarily through taxes.

This change caused the Bank of Israel to increase the net interest expense on government local currency deposits from NIS 57 million in 2006 to about NIS 220 million in 2007. For purposes of comparison, in the years 2003, 2004 and 2005,

Figure 2
Total Financial Movements between the Bank of Israel and the Government, and the Bank of Israel Profit, 1980-2007
(percent of GDP, at current prices)



[3] Government deposits in local currency can be offset one against the other, apart from a number of special deposits. However, the government does not wish to offset between its local currency deposits and its foreign currency deposits and therefore the balances of these deposits appear separately in the financial statements. The economic analysis which appears in these notes refers to net government balances, i.e., the government balances that appear on the credit side of the balance sheet less the balances presented on the debit side (see Table 5). The balances of the Postal Bank and the National Insurance Institute are included in the government balances on the credit side.

The balance of the bond lending accounts is presented in the government balances on the credit side since the government does not wish to offset them against other government deposits.

interest income from the government was recorded in the amounts of NIS 943 million, NIS 342 million and NIS 52 million, respectively.

The average balance of government deposits for the financing of the budget in foreign currency fell from NIS 6.5 billion in 2006 to NIS 6.3 billion at the end of 2007. This change in the composition of the government's accounts reduces the exposure to changes in the exchange rate of the shekel against the various currencies and to changes in the interest rate differential between Israel and the US.

e. The monetary base

The monetary base, which is composed of banknotes and coins in circulation and shekel-denominated demand accounts of the banks with the Bank of Israel, rose during the year by some NIS 4 billion (see Table 3). Total currency in circulation grew in 2007 by about NIS 3.4 billion, primarily as a result of the demand by the banks for NIS 200 notes to be introduced in the ATM machines. The shekel demand deposits grew by about NIS 0.6 billion with a small increase in the annual average.

The growth in the monetary base is primarily the result of the injection by the Bank of Israel of about NIS 15.7 billion and the absorption by the government and the national institutions of NIS 10.8 billion. The absorption by the government was the result of the continuing decline in the budget deficit, primarily due to high tax revenues, the limited amount of capital raised by the government and the privatization of the Haifa refineries. The privatization of the refineries led to the absorption of about NIS 10 billion by the government in February (see Table 3). In June, the government injected about NIS 18 billion as a result of the redemption of state loans that were not refinanced. The injection of the Bank of Israel though various monetary instruments—makam, time deposits and monetary loans—offset a large part of the increase in government absorption.

f. The Statement of Operations

The Bank of Israel recorded a loss in 2007 of about NIS 5.3 billion compared to a small profit of NIS 83 million in 2006. The main reason for the decrease in profit was the expense of NIS 6.6 billion on exchange rate differential in 2007 compared with income of NIS 0.5 billion in 2006.

The main factor behind these expenses is the sharp depreciation of the dollar in 2007 of about 9 percent (see the section "Expenses" below).

The Bank of Israel's income from its foreign exchange reserves, not including exchange rate differentials, grew by NIS 1.4 billion, from NIS 4.6 billion in 2006 to NIS 6 billion in 2007. In dollar terms, this income grew by about $0.4 billion, from $1.1 billion in 2006 to $1.5 billion in 2007.

Net expenses on the monetary aggregate fell from NIS 4.4 billion in 2006 to NIS 3.9 billion in 2007.

Table 2
Indicators of the Bank of Israel Profit, 1990–2007

	Profit (loss)	Realized exchange rate differentials[a]	Net foreign currency assets end-of-year	Change in currency basket exchange rate during year	*Makam* plus time deposits minus monetary loans 31 Dec.	Average annual interest 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		15.5
1992	1.7	0.6	0.3	16.3	-5		12.1
1993	1.3	-0.2	-0.8	6.3	-10		10.7
1994	1.8	0.4	-0.3	5.7	-8		12.7
1995	2.5	1.4	6.0	6.3	9		14.9
1996	-0.5	0.5	8.6	1.6	21	16.2	14.9
1997	-1.1	2.1	17.5	4.1	51	13.9	13.5
1998	10.9	13.1	18.4	20.4	63	11.9	11.5
1999	-8.7	-3.5	17.7	-3.2	73	12.2	11.8
2000	-6.7	-3.7	18.0	-5.5	80	9.4	8.9
2001	0.9	0.1	18.7	7.0	79	6.9	6.5
2002	1.7	0.9	20.2	13.0	77	7.0	6.6
2003	0.3	2.5	23.0	-1.6	84	7.5	7.1
2004	-0.8	0.9	25.4	0.8	87	4.3	3.8
2005	1.4	1.9	26.7	1.7	87	3.7	3.2
2006	0.1	0.5	27.4	-5.2	88	5.0	5.1
2007	**-5.3**	**-6.6**	**26.1**	**-**	**76**	**3.7**	**3.9**

[a] Until 1999 all exchange rate differentials were defined as realized.
[b] The publication of the currency basket exchange rate was discontinued on May 1, 2007, because the exchange rate band (which related to the currency basket exchange rate) was abolished on June 9, 2005, and that exchange rate is no longer used for monitoring or analysis.

Income

The main component of the Bank's income is derived from various types of income on its foreign exchange reserves. Income from the interest on the foreign exchange reserves grew by 20 percent this year from NIS 4 billion in 2006 to NIS 4.8 billion this year. In dollar terms, the rate of growth was even higher (30 percent). The increase in these revenues, despite the reduction in the US rate of interest, was a result of the increase in the average rate of interest on the Bank's foreign exchange reserves portfolio and the growth in the average size of the portfolio relative to 2006.

The 9 percent depreciation of the dollar against the shekel reduced the shekel value of the Bank's interest income, which explains why the return in dollar terms is higher.

Other financial income on the foreign exchange reserves doubled from NIS 0.6 billion in 2006 to NIS 1.2 billion in 2007. This increase is explained in part by an increase in capital gains, following the decline in yields in the US market brought on by the mortgage crisis.

Expenses

The main components of the Bank's expenses are exchange rate differentials and interest expenses on monetary instruments. In 2007 expenses due to exchange rate differentials amounted to about NIS 6.6 billion. The total negative exchange rate differentials created as a result of the adjustment of balances denominated in foreign currency in the balance sheet to the representative rate stood at about NIS 7.4 billion (compared with NIS 6.7 billion in 2006; see Table 1). The main part of the amount—about NIS 8.4 billion—was accumulated on the foreign exchange reserves (see Table 1). As mentioned above, according to the method used for recognizing exchange rate differentials in the Bank's financial statements, the exchange rate differentials accumulated on the balance sheet balances are not recorded in their entirety in the Statement of Operations unless they are recognized as realized. The recognition of realization with regard to a particular currency only occurs when the balance in that currency declines.

Unrealized exchange rate differentials are recorded in revaluation accounts in the balance sheet. Future realizations in a particular currency are first offset against the revaluation account of that currency, if there is such an account, and only then are they recorded in the Statement of Operations. A negative balance on a revaluation account in a particular currency at the end of the year is defined as realized and is therefore recorded to the Statement of Operations.

At the end of 2006, there was a negative balance on the dollar revaluation account and therefore negative exchange rate differentials resulting from the drop in the dollar exchange rate in 2006 were recognized as realized. However, they were not reflected in the Statement of Operations since they were offset almost completely against the balance of the revaluation account created up to 2005. This was reflected in the NIS 7 billion decline in the balance of the revaluation accounts in the balance sheet, which was primarily the result of the decrease in the dollar revaluation account. However, there remained no opening balance on the dollar revaluation account since it had been realized in 2006 and therefore all the exchange rate differentials that had been created were recognized as realized in the Statement of Operations. For this reason, there are recognized expenses in the amount of about NIS 6.6 billion arising from exchange rate differentials in the 2007 Statement of Operations, while in 2006 there were revenues of about NIS 0.5 billion that derived mainly from other currencies in the Bank's asset portfolio, particularly the euro.

The net interest expenses on the monetary aggregate decreased from NIS 4.4 billion in 2006 to NIS 3.9 billion in 2007. The decrease in net expenses in the amount of about NIS 0.5 billion was primarily the result of a decline of NIS 0.3 billion in the expenses on makam and an increase of NIS 0.2 billion in interest revenues on monetary loans. The decrease in expenses on makam was a result of the decline in their average balance from NIS 88 billion in 2006 to NIS 85 billion in 2007 and the fall in their yields.

The increase in income from monetary loans is a result of the growth in their average balance relative to 2006, from about NIS 3 billion to about NIS 9 billion, and was affected by the decrease in the average rate of interest in 2007.

For the first time in many years, net interest payments to the government were recorded in 2007 in the amount of about NIS 3 million as compared to net income of NIS 163 million in 2006. This was due to the reduction in the government's average debit balance on its shekel deposits (see the section "Government accounts"). The rate of interest on most of the government's current shekel deposits is the prime rate, whether there is a credit or debit balance. In contrast, the government does not receive interest from the Bank of Israel on credit balances in foreign currency deposits, except for special deposits. Therefore, the reduction in the average debit balance of the government in its shekel deposits results in higher interest payments to the government.

General and administrative expenses totaled NIS 612 million in 2007 which were similar to those in 2006 (NIS 613 million). These expenses include an amount of NIS 131 million due to the introduction of the new mortality tables published by the Chief Actuary of the Ministry of Finance. This was offset by the effect of the collective bargaining agreement signed on December 20, 2007 which resulted in a decrease of some NIS 67 million in salary expenses. A few clauses were submitted to the Labor Court for arbitration, but their effect was not included in the financial statements since the Court had not reached a decision.

g. Bank of Israel share capital

In 2005, the Bank of Israel for the first time applied Accounting Standard 12 of the Accounting Standards Institute in its financial statements. It calls for the one-time adjustment of non-monetary components of the balance sheet to the CPI for December 2003. This adjustment increased the Bank's share capital and general reserve to NIS 4 billion as compared to NIS 320 million previously.

The Bank of Israel has a balance of about NIS 20.8 billion in accumulated losses as compared to about NIS 15.6 billion in 2006. According to the Bank of Israel Law, the Bank must transfer any profit it makes to the government at the conclusion of each business year though the Bank's losses are not covered by the government. The losses are accumulated in the Bank's financial statements and are offset against future profits. The balance of accumulated losses came into being primarily during 1999 and 2000 as a result of the interest expenses incurred in carrying out monetary policy, which exceeded interest income on the foreign exchange reserves due to negative exchange rate differentials.[4]

[4] Until 1999, there was a different policy for recognizing exchange rate differentials. All accumulated exchange rate differentials were recognized in the financial statements as realized and were transferred to the government at the end of the year. In 1998, an amount of about NIS 15 billion in exchange rate differentials was recorded in the financial statements following a large deprecation of the shekel. A major part of these exchange rate differentials were already offset at the beginning of 1999 as a result of a decline in the exchange rate. Since the profit balance had already been transferred to the government, the

3. MAIN ITEMS IN THE FINANCIAL STATEMENTS

a. Foreign exchange reserves

Foreign exchange reserves account for the largest part of the Bank's assets, and part of the Bank's remaining assets are linked to foreign currencies.[5] This asset composition leads to a situation in which fluctuations in exchange rates and changes in global interest rates have a major impact on the Bank's financial statements.

Foreign exchange reserves serve as a source of liquidity when needed and are also intended to provide additional benefits to the economy, since the fact that Israel has a certain level of foreign exchange reserves reduces the probability of a crisis in the foreign exchange market and enhances Israel's status in the global financial markets.

The definition of the functions of the foreign exchange reserves is not simply a theoretical exercise but serves as the basis for determining their desired level and the way in which they are managed and in setting the currency numeraire, which is the neutral currency composition according to which the foreign exchange reserves are managed.

Israel's foreign exchange reserves are managed in accordance with the Bank of Israel Law, 5714–1954 and its later legal interpretations. Together they define the Bank's methods of operation in foreign exchange and place restrictions on the types of assets it is allowed to invest in. In those areas in which the Bank is not restricted by the Law, it acts within a framework that reflects its priorities and limits the various risks that the portfolio is exposed to.

The yield on the foreign exchange reserves

The Bank of Israel invests the foreign exchange reserves primarily in tradable assets with a relatively short duration. This is done in order to ensure an appropriate level of liquidity and to avoid the risk of large fluctuations in the value of the portfolio as a result of possible swings in the financial markets.

The yields obtained on the investment of the foreign exchange reserves are compared to a benchmark yield. The benchmark is based on a hypothetical portfolio that is created according to pre-set rules and reflects the Bank's long-term investment strategy. The yields on the holdings of assets included in the benchmark, in all currencies, are weighted according to the weights of the currencies in the numeraire.

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result was an increase in the accumulated loss. If the present method had been in use in 1998, the current accumulated loss would be significantly lower.

[5] As mentioned, this composition of assets was created primarily during the period 1995–97 during which the Bank of Israel purchased the economy's surplus imported capital in order to maintain the government's exchange rate policy, i.e., in order to maintain the lower bound of the crawling exchange rate band.

Table 3
Composition of Changes in the Monetary Base and Foreign Reserves, 1998–2007
injection (+)/absorption(–)

(current prices)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2006 IV	2007 I	2007 II	2007 III	2007 IV
NIS million															
1.Change in monetary base (1) = (2 + 3 + 4 + 5)	242	3,927	311	4,364	1,437	3,567	966	7,357	-1,176	**3,979**	**630**	**1,174**	**2,067**	**2,177**	**-1,439**
2. Government and National Institutions	1,901	4,067	-2,729	-2,611	-6,065	3,479	1,601	-1,452	-3789	**-10,809**	**-960**	**-16,208**	**13,048**	**-7,291**	**-358**
3. Bank of Israel	-2,664	-365	2,729	7,675	9,265	1,425	1,070	9,920	3,797	**15,693**	**2,256**	**17,688**	**-10,917**	**9,666**	**-744**
4. Foreign-currency conversions at Bank of Israel	1,746	0	0	0	0	0	0	0	0	**0**	**0**	**0**	**0**	**0**	**0**
5. Adjustments[a]	-741	225	311	-700	-1,763	-1,337	-1,705	-1,111	-1,184	**-905**	**-665**	**-306**	**-64**	**-198**	**-337**
$ million															
Banks' foreign-currency activity with the Bank of Israel															
6. Foreign-currency sales (–) to Bank of Israel (6) = (8 – 9 – 7)	-492	0	0	0	0	0	0	0	0	**0**	**0**	**0**	**0**	**0**	**0**
7. Public-sector transfers to banks[b]	-163	-259	-345	-20	183	335	342	-1,003	270	**287**	**197**	**279**	**-20**	**14**	**14**
8. Change in deposits with Bank of Israel	-369	585	-462	91	-982	-896	-232	-133	290	**21**	**312**	**1,592**	**-847**	**-115**	**-609**
9. Transfers to (–)/from (+) rest of world	286	844	-117	111	-1,165	-1,231	-574	870	20	**-266**	**116**	**1,314**	**-827**	**-129**	**-623**
10. Adjustments[c]	-343	-197	-275	-216	-186	27	-57	156	5	**70**	**44**	**209**	**-35**	**-25**	**-79**
Contribution to reserves															
11. Private sector[d] (11) = (9 + 10)	-57	647	-392	-105	-1,351	-1,204	-631	1,026	25	**-196**	**160**	**1,522**	**-862**	**-154**	**-702**
12. Public sector[e]	2,399	-806	1,041	122	1,840	3,322	1,475	200	1,172	**-400**	**1,280**	**-74**	**-678**	**312**	**40**
13. Change in reserves[f] (13) = (11 + 12)	2,342	-159	649	17	489	2,118	844	1,226	1,197	**-596**	**1,440**	**1,448**	**-1,540**	**158**	**-662**

[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, 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.

The average duration of the benchmark was set at 16 months[6] at the beginning of 1999 in accordance with the shortfall approach.[7] In the third quarter of 2006, the parameters of this method were modified in order to reflect the risk-return tradeoff implied by the preferences of the Bank's management more accurately. The new parameters were applied only to the dollar portfolio, which has led to an increase in the duration of the benchmark dollar portfolio to 24 months. The duration of the benchmarks for the portfolios in other currencies remained unchanged at 16 months.

The actual annual return on the foreign exchange reserves was 6.91 percent, identical to the benchmark level of 6.91 percent.[8] Any difference between them would reflect the contribution of investment decisions made according to the permitted degrees of freedom in the active management of the reserves, which are reflected in deviations of the composition of the portfolio from the benchmark composition. These degrees of freedom are relatively limited and are restricted by a set of rules that is part of the investment policy for the reserves. The added value of the active management of the reserves is expressed in the difference in yields between the foreign exchange reserves portfolio and its benchmark; this difference was close to zero in 2007, and over the past decade averaged 0.11 percent.

The return on the foreign exchange reserves was affected to a large extent this year by the reduction in yields on short- and medium-term bonds in the US market, which followed the mortgage crisis during the second half of the year. The Federal Reserve gradually lowered the rate of interest in the months September-December 2007 from 5.25 percent to 4.25 percent. The yields to maturity increased in the euro zone but were still lower than those in the US market. The decline in bond yields reduced the current interest income component in the yield on the foreign exchange reserves holdings but raised the prices of those bonds, which is recorded as a capital gain that raises the holding period rate of return.

The yield on the investment of the foreign exchange reserves is measured in terms of the currency composition of the numeraire rather than in terms of one currency or another. The arbitrary nature of measuring yield in terms of a specific currency is particularly evident when assessing yield in terms of the dollar (9.3 percent in 2007) as opposed to the euro (2.2 percent in 2007) and the high volatility of these yields

[6] From the beginning of 2003 until mid-2005, the duration of the dollar portion of the benchmark portfolio was temporarily shortened to 11 months. This was done as a result of the very low yields to maturity in the US market and the increased probability that they would be increasing. The duration of the non-dollar portion of the benchmark portfolio remained at 16 months.

[7] According to this approach, the duration target is determined such that the portfolio's annual holding yield does not fall below the desired minimum level at the relevant level of risk. The parameters from which the duration is derived are determined according to the risk preferences of the portfolio owner.

[8] The yield on the reserves is calculated and reported net of those reserves that are managed against the foreign currency deposits of Israeli commercial banks at the Bank of Israel. The average level of these deposits was $800 million in 2007 (2.65 percent of the total reserves). These deposits serve as the banks' collateral for transferring funds via the RTGS system. The funds in the deposits are invested in a way that offsets, to whatever extent possible, the Bank of Israel's exposure to currency and interest rate risk that is the result of receiving these deposits. These investments bear interest approximately equal to that paid to the banks on their deposits.

over time (see Table 4). In shekel terms, the yield this year was -0.5 percent, which was primarily the result of the weakening of the dollar against the shekel by 9 percent during the course of the year. Other currencies in which the reserves are invested also weakened against the shekel, except for the euro which strengthened by 1.7 percent against the shekel. The strengthening of the euro and the interest income and capital gains offset most of the effect of the strengthening of the shekel against the dollar and other currencies. During the last decade, the holding period rate of return in shekel terms was 6.1 percent per year in nominal terms and 3.7 percent when discounted for local price increases.

Table 4
Foreign Reserves—Total, Income, Exchange Rate and Cross Rate Differentials and Yields, 2005–07

		2005	2006	2007
Total foreign reserves			$ million	
End of year		27,858	29,055	**28,460**
Annual average		27,035	27,955	**28,886**
Income and exchange rate and cross rate differentials			NIS million	
Total		7,584	-2,707	**-2,351**
Interest and capital gains		3,150	4,616	**6,014**
NIS/$ exchange-rate differentials		4,434	-7,323	**-8,365**
			$ million	
Total		-76	1,771	**2,087**
Interest and capital gains		688	1,062	**1,509**
Cross rate differentials ($/other currencies)		-764	709	**578**
Yields[a]			Percent	
In terms of NIS	Total	6.5	-2.3	**-0.5**
	Interest and capital gains	2.6	3.9	**6.9**
	NIS/$ exchange rate differentials	3.9	-6.2	**-7.5**
In terms of euro	Total	14.9	-4.3	**-2.2**
In terms of $	Total	-0.3	6.5	**9.3**
	Interest and capital gains	2.6	3.9	**6.9**
In terms of use[b] **of foreign reserves**		2.6	3.8	**6.9**
Benchmark yield		2.4	3.7	**6.9**

[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 Bank's financial statements, which are presented in shekels, reflect changes in the shekel exchange rate against foreign currencies; these changes are not taken into account in the management of the foreign exchange reserves.

Changes in the foreign currency reserves

The foreign exchange reserves declined in dollar terms by $0.6 billion, from $29 billion in 2006 to $28.4 billion in 2007, as compared to an increase of $1.2 billion in 2006.

The $0.6 billion decline in the foreign exchange reserves was the result of the $3.1 billion negative contribution of the government, the positive contribution of the national institutions in the amount of about $0.3 billion, the positive contribution of the Bank of Israel in the amount about $2.5 billion and the negative contribution of the private sector in the amount of about $0.2 billion.

The contribution of the government to foreign exchange reserves

The government's cash flow in foreign currency does not all pass through its accounts at the Bank of Israel. Part of its activity is carried out directly through its accounts abroad. Therefore, part of the government's activity in foreign currency does not directly affect the foreign exchange reserves at the Bank of Israel.

The government receipts in foreign currency are primarily composed of grants from the US government and capital raised abroad. The payments made by the government in foreign currency include those for defense imports, the redemption of the State's debt and the interest on that debt and expenditures of the various ministries.

Raising of capital

As in 2006, the net capital raised by the government abroad was negative in 2007. The government raised capital abroad in 2007 only through the State of Israel Bonds and did not carry out any private issues. The reasons for this were the government's budget surplus, the instability in foreign markets and the government's efforts to reduce the economy's internal and external indebtedness.

State of Israel Bonds

The government raised a total of $1.2 billion through State of Israel Bonds as compared to $1.3 billion in 2006. Much of the money raised was used for payments abroad and only a small proportion was deposited at the Bank of Israel. The government continues to issue State of Israel Bonds on an ongoing basis in order to preserve this channel for raising capital for when it is needed in the future.

Economic aid from the US

The assistance received from the US that appears in the Bank's books is composed of civilian assistance and convertible defense aid. The civilian aid was reduced over time by $120 million each year and came to an end in 2006. The funds for 2006 ($120 million) were only received in March 2007. The convertible defense aid totaled $0.4 billion this year, compared with $0.8 billion in 2006.

Government payments in foreign currency

The repayment of State debt and the interest payments on that debt, which constitute the majority of the government's expenses in foreign currency, totaled $4.3 billion in

2007, a decline of $0.5 billion relative to 2006 ($4.8 billion). These expenses resulted in the government's significant contribution to reducing the foreign exchange reserves in May in the amount of about $0.7 billion and in August in the amount of about $0.6 billion.

Government payments in foreign currency exceeded receipts and as a result the government was responsible for a $3.1 billion reduction in foreign exchange reserves in contrast to a reduction of about one billion dollars in 2006.

The contribution of the Bank of Israel to the foreign exchange reserves

The main contribution of the Bank of Israel to the foreign exchange reserves in 2007 was composed of the Bank's profit of $1.5 billion from the investment of the reserves and from the revaluation of the portfolio according to end-of-year market prices and cross rates. Thus, the exchange rate differentials in dollar terms on the non-dollar portion of the portfolio contributed about $0.6 billion to the reserves and the revaluation of the portfolio according to market prices contributed another $0.4 billion.

The contribution of the private sector to the foreign exchange reserves

The contribution of the private sector to the foreign exchange reserves in 2007 totaled only $159 million, but this did not occur uniformly over the course of the year. In February, the private sector imported $2.3 billion, which apparently reflected the need by the banks to provide collateral against monetary loans, which had grown significantly. In August, the private sector imported $0.8 billion, which was partly the result of the banks' need to provide collateral for activity in the RTGS system. In 2006, the contribution of the private sector totaled $25 million.

The shekel value of the portfolio fell from NIS 123 billion in 2006 to about NIS 109 billion at the end of the year. Most of the decrease, beyond the decline in its dollar value, was the result of a sharp 9 percent depreciation in the exchange rate of the dollar against the shekel during the course of the year.

b. Government accounts

According to Section 57(a) of the Bank of Israel Law: "The Bank shall be the sole banker and fiscal agent in Israel of the government." Thus, the government manages all of its shekel accounts and part of its foreign currency accounts at the Bank of Israel.

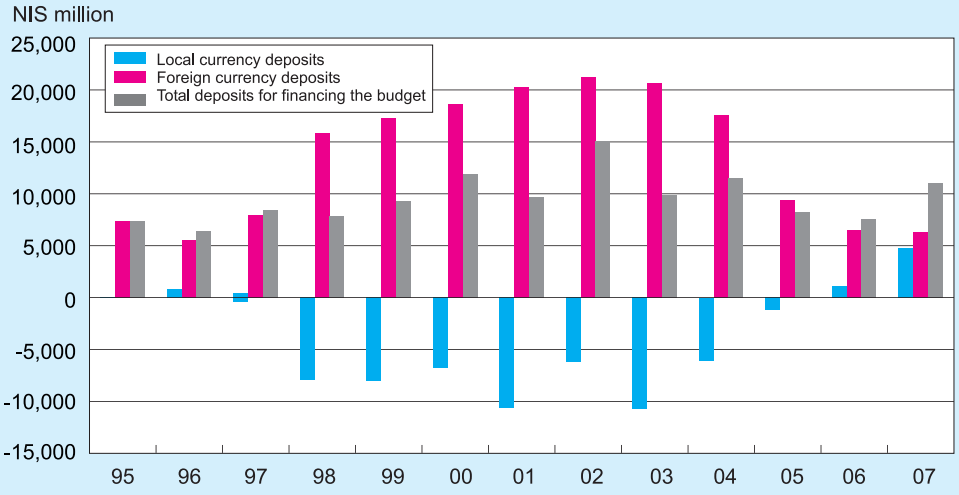
The government's deposits at the Bank of Israel are classified into two groups: deposits for the financing the budget and other deposits (see Table 5).[9]

[9] Government deposits in local currency can be offset one against the other, apart from a number of special exceptions. However, the government does not wish to offset between its local currency deposits and its foreign currency deposits and therefore the balances of these deposits appear separately in the financial statements. The economic analysis which appears in these notes refers to net government

According to Section 45(b) of the Bank of Israel Law, the Bank may make to the government "a provisional advance in order to bridge temporarily gaps in the government's cash flow in the implementation of the budget, …. provided that the total of the temporary advance shall not exceed, at any time, 1.6% of the total ordinary budget at that time."[10] To this end, the government has designated accounts for financing the budget.

Since 1998, shekel deposits have usually had high debit balances, which were exceeded by the credit balances on foreign currency deposits (see Figure 3). Although overall the government had a credit balance in its deposits for financing the budget—and met the requirement of the Law—this method of managing the accounts is costly and exposes the government to currency risk.

Figure 3
The Government's Local- and Foreign-Currency Deposits for Financing the Budget, 1995-2007
(annual average)



balances, i.e., the government balances that appear on the credit side of the balance sheet less the balances presented on the debit side (see Table 5). The balances of the Postal Bank and the National Insurance Institute are included in the government balances on the credit side. The balance of the bond lending accounts are presented in the government balances on the credit side since the government does not wish to offset them against other government deposits.

[10] The Law allows the temporary advance to be enlarged to 3.2 percent for two periods during the course of the year on the condition that neither period exceeds 30 days.

On the debit balances in its shekel accounts the government pays interest at prime, whereas on the interest paying foreign currency accounts it receives the rate of interest payable on six-month US T-bills. The interest rate differential between the dollar and the shekel caused the government net interest expenses in those years. In 2003, for example, the government paid a net NIS 0.7 billion in interest payments, although the overall balance of its deposits was in credit.

Beyond the expenses incurred on interest, the method of managing the government accounts causes high volatility in the shekel value of the foreign exchange reserves, due to the high dependence on the dollar exchange rate. Thus, for example, in 2007 negative cumulative exchange rate differentials on the government accounts totaled about NIS 0.6 billion (Table 1), in contrast to years when the differentials were positive—for instance, in 2005 there were positive differentials on the reserves of about NIS 0.8 billion.

Starting from the end of 2004, there was a noticeable reduction in the debit balances in the shekel accounts simultaneous with the reduction in credit balances on foreign currency deposits. Although the government deposits for financing the budget were negative in the amount of about NIS 3.1 billion (see Table 5), the annual average of these deposits grew from NIS 1.1 billion in 2006 to NIS 4.8 billion in 2007. This increase is explained by, among other things, the budget surplus at the beginning of the year and the high level of absorption by the government, particularly through taxes. This change led the Bank of Israel to record net interest expenses on government shekel deposits of about NIS 220 million as compared to expenses of NIS 57 million in 2006. For purposes of comparison, in the years 2003, 2004 and 2005, interest income from the government was NIS 943 million, NIS 342 million and NIS 52 million respectively. As a result, there were net interest payments to the government of about NIS 3 million, as opposed to net receipts from the government of NIS 163 million in 2006. In 2005, net interest income from the government totaled about NIS 686 million.

There were no major changes recorded this year in the average balance of government foreign currency deposits for financing the budget. The average balance fell from NIS 6.5 billion in 2006 to NIS 6.3 billion in 2007. The main components of this balance do not include the current foreign currency account but rather the deposit of capital raised under the US guarantee and the deposit of economic aid received from the US government.

Credit to the government

Credit to the government is primarily composed of long-term advances made to the government in the 1980s in order to finance its budget deficits. Most of the loans were provided prior to the Non-Printing of Money Law in 1985, apart from an additional loan provided in 1988 to redeem the bank shares. The advances provided prior to 1985 are indexed to the first basket of currencies and carry an indexed rate of interest of 8 percent while the latter loan bears an interest rate of prime plus 2 percent. The loans will be redeemed through annual payments by 2012.

Table 5
Government Deposits with the Bank of Israel, 2005–07

(NIS million, current prices)

	2005	2006	2007
End-year balances			
Government deposits for budget financing			
Local-currency deposits	-48	-652	**-3,077**
Foreign-currency deposits	6,680	6,066	**6,314**
Total government deposits for budget financing	6,632	5,414	**3,237**
Other deposits[a]	295	668	**257**
Total	6,927	6,082	**3,494**
Net change in government deposits	413	-845	**-2,588**
Sources of change			
Government contribution (+) to foreign reserves[b]	-840	-4,588	**-13,023**
Government absorption (+)	2,677	5,234	**11,978**
Government–Bank of Israel financial flow[c]	-1,457	-1,582	**-1,596**
Adjustments[d]	33	91	**53**

[a] Including the local-currency deposit to stabilize bond prices, another deposit in foreign currency, and interest accrued on government deposits (see note 11 on Government Balances).
[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').

In 2007, the government redeemed NIS 0.7 billion in credit as compared to NIS 0.6 billion in 2006 and the balance of credit to the government declined to NIS 2.1 billion. Interest payments by the government totaled about NIS 0.2 billion in 2007 as compared to NIS 0.3 billion in 2006 and indexation was close to zero, as it was in 2006, due to the decline in the first currency basket exchange rate.

c. The securities portfolio

The Bank of Israel's portfolio of securities includes CPI-indexed government bonds that the Bank purchased as part of its monetary policy and its intervention in the bond market. A large proportion of the purchases were made in 1995 and 1996 although the Bank of Israel continued its purchase of securities until 2002. The income from this portfolio is included in the Statement of Operations on a cash basis. Interest is paid annually, and indexation is paid on maturity. The interest income from this portfolio remained unchanged in 2007 at NIS 0.2 billion.

d. Monetary instruments

The Bank of Israel utilizes various monetary instruments to implement policy. Until 1995, monetary loans constituted the main component of the monetary aggregate, as is the case in most advanced economies. During 1995-97, the Bank of Israel intervened in the foreign exchange market to offset the effect of the inflow of foreign currency on the exchange rate. This activity caused an injection of liquidity into the economy which the Bank had to absorb. As a result, the structure of the monetary aggregate was altered and the Bank of Israel became a net borrower from the banking system, primarily through makam and time deposits.

Until 2001, the Bank absorbed liquidity primarily through time deposits but since the removal of the ceiling on makam at the beginning of 2002, it has gradually moved from time deposits to makam with the goal of enhancing the money market in Israel and improving the effectiveness of monetary policy. The Bank of Israel's objective in expanding the volume of makam is to achieve a level of absorption that will create a fundamental liquidity deficit among the commercial banks. The Bank of Israel will then regulate the rate of interest in the economy through monetary loan auctions offered to the banks to cover this deficit, the usual practice in the advanced economies.

After a decade of gradual expansion, the quantity of makam was reduced from NIS 96 billion at the end of 2006 to NIS 76 billion at the end of 2007, a drop of about 20 percent. In view of the assessment that the makam market has reached sufficient maturity, the Bank of Israel decided to use makam in a more active manner in order to manage the liquidity situation among the banks and also to facilitate the introduction of the RTGS (Real Time Gross Settlement) system. The use of makam is dictated by the current liquidity needs of the banks according to the expected developments within a horizon of several months rather than on a daily basis. In order to regulate liquidity on a daily basis, the Bank of Israel continues to use deposit and loan auctions.

The marked drop in the total volume of makam is not completely reflected in the interest expenses on them. This is because the reduction was gradual and the decrease in the average balance of makam was even more moderate (from NIS 88 billion in 2006 to NIS 85 billion in 2007). The decline in expenses incurred due to makam, which also reflects the influence of the drop in yield, totaled about NIS 0.3 billon.

The balance of monetary loans was zero at the end of 2007 while in 2006 it was about NIS 7.5 billion. As mentioned above, the deposit and loan auctions cater for the banks' liquidity requirements on a daily basis, which leads to volatility in their balances. Therefore, the balances on any specific day do not have any particular significance. The average balance of loans in 2007 stood at about NIS 9 billion, as opposed to an average of NIS 3 billion in 2006. The growth in interest income on these loans, from NIS 0.2 billion in 2006 to NIS 0.4 billion in 2007, was also affected by the decline in the average rate of interest in 2007.

The balance of time deposits at the end of 2007 stood at NIS 300 million as opposed to a balance of zero in 2006. The average balance fell from NIS 3 billion in 2006 to NIS 1 billion in 2007. The balance at the end of 2007 reflects the banks' overnight deposits.

Reverse repo transactions

In October 2007, the Bank of Israel began carrying out reverse repo transactions with institutional investors and banking institutions. These transactions are carried out by auction in which the Bank of Israel purchases government bonds and makam from institutional investors and banking corporations and sells them back a week later at a pre-determined price. The Bank's goal in these transactions is to promote the development of a repo market, and thus to deepen and enhance the capital market, and to improve liquidity and tradability in the securities markets. These transactions are likely to help reduce the cost of holding a stock of securities for market makers and other financial investors and increase competition with the banking system. The balances of these transactions as of December 31, 2007 were zero. The income accumulated due to these transactions totaled NIS 9 million in 2007.

e. Demand deposits of the banking corporations

The local currency demand deposits of the banking corporations at the Bank of Israel are used to fulfill the banks' liquidity requirements, in accordance with the directives of the Bank of Israel, and for the settlement of various payments carried out through the banks. In 2007, the balance of these deposits of banking corporations grew from NIS 11.8 billion in 2006 to NIS 12.4 billion in 2007. The average annual balance grew from NIS 10.2 billion in 2006 to NIS 11.4 billion in 2007 (see Table 7).

Table 6 shows that the government injected about NIS 3.1 billion shekels through the commercial banks in 2007.[11] The public withdrew about NIS 11.8 billion in cash from the banking corporations. Much of this, about NIS 8.4 billion, was intended for payments to the government via the Postal Bank, many of which are made in cash. The Bank of Israel absorbed NIS 15.5 billion net from the commercial banks through the various monetary instruments: makam, time deposits and monetary loans. In 2006, absorption totaled only NIS 3.6 billion. The main reason for the increase was the absorption of about NIS 24 billion by the Bank of Israel in 2007 via makam.

The balance of banks' foreign currency deposits remained unchanged at NIS 2.3 billion. Table 7 shows that the annual average of these deposits grew from NIS 0.2 billion in 2006 to NIS 0.9 billion in 2007. There are two main reasons for this increase: first, the Bank of Israel began to accept foreign currency deposits from the banks at the beginning of September 2007 to serve as collateral for the activity of the banks in the RTGS system. The deposits are for a period of 30 days. The balance of the deposits as of December 31, 2007 was NIS 1.5 billion, which includes most of the unrestricted deposits of the banks with the Bank of Israel on that day. The second reason is related to the increase in the average balance of monetary loans, which required the banks to provide the Bank of Israel with appropriate collateral. The collateral is likely to

[11] Net absorption by the government in 2006 totaled about NIS 12 billion. This includes, in addition to government injection through the banking corporations, absorption carried out through the Postal Bank in the amount of about NIS 8.4 billion.

Table 6
Deposits of the Banking Corporations with the Bank of Israel, 2005–07

(NIS million, current prices)

	2005			2006			2007		
	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total
Change in banking corporations' deposits[a]	3,725	-488	3,237	-2,305	1,146	-1,159	**552**	**23**	**575**
Activity with the government[b]	6,382	1,796	8,178	4,511	1,167	5,678	**-3,132**	**1,185**	**-1,947**
Withdrawal (–) of banknotes from Bank of Israel	-12,457	-	-12,457	-10,435	-	-10,435	**-11,792**	**-**	**-11,792**
Activity with Bank of Israel[c]	9,747	-6,200	3,547	3,637	-54	3,583	**15,533**	**-135**	**15,398**
Transfers from (+) and to (–) abroad	-	3,907	3,907	-	21	21	**-**	**-1,044**	**-1,044**
Foreign-currency conversions at Bank of Israel	-	-	-	-	-	-	**-**	**-**	**-**
Adjustments	53	9	62	-18	12	-6	**-57**	**17**	**-40**
Deposit of banknotes by the Postal Bank Office Bank in Bank of Israel[d]	8,767		8,767	9,295		9,295	**8,401**		**8,401**

[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 *makam*, the sale of goverment 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, 1998–2007

(daily average, current prices)

											2006	2007			
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	IV	I	II	III	IV
Local-currency deposits and credit[b]															
NIS billion															
1. Demand deposits	4.5	5.5	6.6	7.8	8.3	8.3	9.0	9.8	10.2	11.4	10.3	10.6	11.3	11.9	11.9
2. Time deposits	36.9	44.1	46.0	46.5	33.5	30.5	21.0	9.3	2.6	0.7	0.7	0	0	1.9	0.6
3. Loans															
3.1 Monetary	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.6	3.3	9	7.4	13.9	16.6	3.4	2.1
3.2 Other	–	–	–	–	0.6	2.1	1.7	1.2	0.9	0.6	0.8	0.7	0.6	0.6	0.5
4. Net deposits (= 1 + 2 – 3)	40.6	48.8	51.8	53.4	40.4	36.0	27.5	17.4	8.7	2.5	2.9	-4.0	-5.9	9.8	9.9
5. Net deposits plus swaps	45.9	54.6	57.5	59.3	47.0	42.4	33.8	21.0	8.7	2.5	2.9	-4.0	-5.9	9.8	9.9
6. Net deposits plus swaps and *Makam*[c]	67.1	78.6	83.3	89.8	85.3	91.4	97.8	97.5	97.0	87.8	95.9	90.2	82	91.8	87.2
Foreign-currency deposits and credit[b]															
$ billion															
7. Deposits	1.9	2.0	2.2	2.4	2.1	0.5	0.3	0.3	0.2	0.9	0.3	1.0	1.2	0.5	0.8
8. Net deposits less swaps[d]	0.5	0.6	0.8	1.0	0.7	-0.9	–1.1	-0.5	0.2	0.9	0.3	1.0	1.2	0.5	0.8
NIS billion															
9. Net deposits less swaps[d]	1.8	2.4	3.3	4.0	3.5	–4.1	–4.7	-2.1	1.0	3.6	1.2	4.2	4.9	2.3	3.2
10. Total net deposits plus swaps and *makam* (= 6 + 9)	68.8	81.0	86.5	93.8	88.8	87.3	93.1	95.4	98.0	91.4	97.1	94.4	86.9	94.1	90.4
Rates of interest (percent)[e]															
11. Monetary loans	11.5	11.8	8.9	6.5	6.6	7.1	3.8	3.2	5.1	3.9	5.1	4.2	3.7	3.9	4.0
12. Time deposits	11.9	12.2	9.4	6.9	7.0	7.5	4.3	3.7	5.0	3.7	5.4	3.3	2.7	3.6	4.0

[a] Items 1–10 include accrued interest.

[b] Net deposits plus NIS swaps for remittance and *makam* deposit (excluding the part of the deposit arising from the replacement of government bonds by *makam*).

[c] Deposits less loans and less dollar swaps to be received. (Not including the part of the makam deposit resulting from the changing of government bonds into makam.) In July 2005 the Bank of Israel stopped the NIS/$ swap auctions.

[d] In 2005 different types of monetary loans and time deposits were introduced. Interest rates shown in this table are weighted rates of all of these loans and deposits.

[e] Annual rate, based on quarterly and yearly calculations respectively.