

# ■ The Bank of Israel Explained

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## Goals, Functions and Authority



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**Dear reader,**

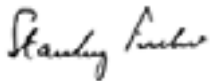
This booklet is intended to shed light on the Bank of Israel.

The Bank of Israel was established by law in 1954. In 2010 a new Bank of Israel Law was passed which redefines the objectives and roles of the Bank, the tools available to it to achieve those objectives, and how decisions are made in the Bank—in line with the norms accepted in most major economies.

Since its establishment the Bank of Israel has made an important contribution to building the economy and maintaining its strength and stability, and the history of the Bank is interwoven with the history of Israel.

The Bank remains an integral part of Israel's economic progress, and we invite you to learn more about its activities.

Sincerely,

A handwritten signature in black ink, reading "Stanley Fischer". The signature is written in a cursive, flowing style.

Stanley Fischer

Governor, Bank of Israel





## *What is the Bank of Israel?*

The Bank of Israel is the central bank of the State of Israel. Like other central banks around the world, it sets and conducts monetary policy, holds and manages the country's foreign exchange reserves, regulates and supervises the banking system, advises the government on economic matters, provides banking services to the government, operates a system of information and statistics on Israel's economy, regulates the country's payment and settlements systems, and issues the country's currency, i.e., banknotes and coins.

The Bank is a professional body, whose independence and freedom from the political arena enable it to use the tools available to it to achieve the goals that the law has set for the Bank.

The need for a central bank, the norm in every independent state, arose with the establishment of the State of Israel in 1948. The Bank was established in 1954, six years after the establishment of the State,

after recommendations regarding its functions and its organization were formulated, and the law establishing the Bank was passed. The Bank operated under that law from 1954, for a period of fifty-six years. In 2010 a new Bank of Israel Law was passed, and since then the Bank has operated under the new law, which emphasizes the independence of the Bank and redefines its goals, the tools available to it, and how its decisions are made.

The Bank is located in Jerusalem in Kiryat Ben Gurion, close to the Knesset (Israel's parliament), the Supreme Court, and government ministries. The Bank also has a branch in Tel Aviv.



## *The Functions of the Bank of Israel*

### **1. Conducting monetary policy**

The Bank of Israel's main function is to protect the value of the local currency, in other words, to maintain price stability. Additional functions are to support the attainment of the other goals of the government's economic policy, especially growth, employment, and the narrowing of social gaps, as well as the stability and proper activity of the financial system—all these provided that price stability is not undermined in the long run.

Maintaining the value of money is important for economic stability and strength, and for creating the conditions necessary for continued growth of output and employment. The value of money is reflected by the prices we need to pay for goods and services. Price increases—inflation—reduce the value of money, as the same amount of money can buy less.

### ***Why is it important to avoid high inflation?***

Inflation creates uncertainty about the future value of money, so that individuals and economic entities



invest time and effort in financial activities to protect against the erosion of the value of their money and uncertainty, activities reflected in reduced efficiency and productivity that hinder the economy from achieving its potential output. Uncertainty about the future value of money also has a negative impact on the profitability



of investments, deters long-term investment, and increases the risk premium required by investors and savers. High inflation also affects the economy's credit rating, thereby increasing the cost of credit and reducing the amount granted.

### ***What is price stability?***

Israel's government, in consultation with the Governor of the Bank, sets a price stability target—an annual rate of increase in the Consumer Price Index (CPI). The current target is between 1 percent and 3 percent a year, and the Bank is obliged to strive to achieve that goal. Some prices of goods and services will increase by more, and some by less, but the intention is that the prices of goods and services included in the CPI will increase on average at a rate within the target range. The aim is not to achieve as low a rate of inflation as possible, and downward deviations from the target are considered in the same way as upward deviations.

### ***How is price stability achieved?***

To achieve its objectives the Bank of Israel has a number of policy instruments in its arsenal, the main one being the short-term interest rate, which is set by a Monetary Committee headed by the Governor. That interest rate—the Bank of Israel interest rate—is

the basis of the interest the Bank charges the banks on the liquidity it makes available to them and of the interest it pays the banks on their deposits with the Bank. The Bank sets the rate of interest at a level that will keep inflation within the target range, or that will return inflation to within the range in a period not longer than two years. The Bank is independent in setting the short-term rate of interest and in using the monetary instruments to achieve its goals.

The Bank's interest rate serves as the basis according to which a range of interest rates are set in the economy, including the rates of interest that the public (households and businesses) pays the banks on short-term loans and the rates of interest that it receives from the banks on its short-term deposits.

The levels of interest affect expenditure and savings, and hence, prices. A rate of interest that is too low discourages households and businesses from saving and makes it cheaper to borrow, encouraging them to increase expenditure, leading to pressure for price increases, while an interest rate that is too high discourages borrowing and excessively reduces demand and investment, leading to a slowdown in economic activity and to unemployment. Thus, in times of inflation the Bank increases the interest rate, and in times of recession and economic standstill, when there is no inflationary pressure, it lowers the interest rate.



### ***What tools are available to achieve the interest rate set by the Bank?***

The Bank of Israel has several tools which it uses so that the rate of interest in the economy will accord with that set by the Monetary Committee headed by the Governor. The rate of interest achieved via those tools directly affects banks' rates of interest vis-à-vis the public. The following are the main tools used by the Bank.

Deposit and/or loan auctions for the banks: These constitute the main tools used by the Bank to achieve the interest rate, because of the precision and speed of their effect. The Bank of Israel invites the banks to participate in auctions to borrow money from it for periods of one day or one week, or to deposit money

with it for short periods—according to the situation in the money market and the rates of interest set in the auctions. Against loans they take from the Bank, the banks put up collateral, including government bonds and short-term loan certificates (makam, their Hebrew acronym).

The monetary loans and deposits window: The Bank of Israel makes a window for monetary loans (against collateral) available to the banking corporations, the interest on which is a certain amount higher than the Bank's headline interest rate, and a window for monetary deposits, on which it pays a rate of interest a certain amount below the Bank's headline interest rate.

Short-term loans (makam): These are short-term securities (up to one year) issued by the Bank of Israel



to affect the level of the interest rate in the money market. They are issued to the general public, and their rate of return is determined in trading on the stock exchange and can be used to calculate the public's inflation expectations and expectations of changes in monetary policy.

**Repo:** A repurchase agreement (repo) is a transaction in which the Bank of Israel sells, possibly by auction, government bonds and makam to banks and financial institutions, and buys them back after one week at a pre-set price. In a reverse repo, the Bank of Israel purchases the government bonds and makam from the banks and financial institutions, and sells them back after one week at a pre-set price. In the case of the reverse repo, the amount paid by the Bank of Israel for those securities serves to increase liquidity in the economy. The difference between the price at which the Bank of Israel buys the securities and the price at which it sells them back represents the interest. Repos are one of the important tools used by central banks in many advanced economies to conduct monetary policy.

**Open market operations:** Another tool used by the Bank of Israel to provide liquidity is the purchase and sale in the secondary market of various types of government bonds for various terms.

## ***2. Holding and managing the country's foreign exchange reserves***

The Bank of Israel holds the foreign exchange reserves to provide liquidity in foreign currency when it is needed, such as to finance the repayments of the country's debt, to pay for exceptional government expenditure on imports at times of emergency, to provide liquidity in a financial crisis, or to be sold as necessary in the course of conducting monetary policy. The appropriate level of foreign exchange reserves is also important from the aspect of the international standing of the economy. The proper level of reserves reduces economic risk and improves the country's international credit rating, helping it to obtain credit at a reasonable cost.

In managing the reserves the Bank of Israel, like other central banks, follows a cautious approach, directed towards three objectives: maintaining a high level of liquidity; minimizing the various financial and credit risks; and maintaining the purchasing power of the reserves and obtaining an adequate return on the investments. The reserves are therefore invested mainly in low risk tradable assets with a relatively short time horizon, subject to the limitations specified in the law.

The currency mix of the foreign exchange reserves and their preferred level are determined in accordance with the policy rules, which are derived from the functions of the reserves.



### ***3. Supporting the orderly activity of the foreign currency market in Israel***

Foreign currency is traded between banks and their customers, and between the banks themselves. Every foreign currency trading day the Bank of Israel publishes representative exchange rates of the shekel against other currencies, based on the market rates some time prior to the announcement. It should be noted that the representative exchange rate is an indicator of the rate prevailing in the market, but it has no legally binding significance. The parties to a transaction indexed to foreign currency can therefore carry it out at any agreed exchange rate.

The Bank of Israel analyzes developments in the foreign exchange market (as well as developments in the domestic bond and securities markets). It collates information on trading in those markets and constructs indices that enable it to examine whether the financial markets are operating properly.

The Bank of Israel has announced that it will operate in the foreign exchange market in situations in which there are unusual exchange rate movements that do not reflect fundamental economic conditions, or when the foreign exchange market is not functioning appropriately.

### ***4. Regulating and supervising the banking system***

The banking system plays a central role in every country. The public deposits most of its monetary savings in the banks, and the banks, among other things, use that money to give credit to businesses and households. The public's bank accounts are used to implement a major part of payments made in the economy, and activity in foreign currency also takes place mainly via the banks. The need to regulate and supervise the banking system arises from the vital role that the system plays, from the recognition that the public's money must be protected, and the fact that a failure in the system is likely to have a severe impact on the functioning of the economy and those who deposited their money in the banks.

#### ***The functions of the Banking Supervision Department***

- Supervising the stability of the banking corporations—avoiding excess risks to their stability and protecting depositors' money;
- Ensuring that the banking corporations are managed properly;
- Maintaining fairness in bank/customer relations.

A corporation that wants to be a banking corporation and anyone who wants to hold five percent or more of the shares of a banking corporation must obtain a permit. Permits are granted after a comprehensive examination and discussion in the Licenses Committee. This is intended to ensure the bank's ability to operate, and to prevent unsuitable parties from engaging in banking, or from owning or wielding significant influence on a banking corporation.

A bank's activity is subject to rules and limitations in the area of proper management and risk control—rules regarding the structure of the board of directors and how it operates, adequate capital requirements taking into account the extent of the bank's risk-weighted assets, restrictions on the maximum size of loan that can be given to a single borrower and to parties with connections with the bank, etc.

The Banking Supervision Department performs bank inspections and assesses each bank's activity, based on the large amount of information that it receives from them. The purpose is to assess their stability and their business situation, to prevent them from taking excessive risks, and to ensure the observance of the directives relating to the proper management of banking business issued by the Supervisor of Banks. Based on the findings, the Banking Supervision Department

acts to correct the flaws, if any, and in cases of serious deficiencies even imposes sanctions.

The Bank of Israel acts to increase public supervision over banks' activity; it does so mainly by extending banks' obligations regarding proper disclosure of their business situation, their activities in the customer services field, and prices of their services.

Customers who feel that they have been treated wrongly by a bank can submit a complaint to the Public Enquiries Unit in the Banking Supervision Department in the Bank of Israel. The Unit investigates the complaint, and advises the customer and the bank of the results of its investigation. If the complaint is found to be justified, the bank must correct the fault. Further information on how to submit a complaint is available on the Bank's website.

The Bank of Israel carries out and publishes research on banking issues, and produces an annual review that describes and analyzes developments in Israel's banking system. In that way it broadens and deepens professional knowledge in that area, promotes the understanding of the processes in the system, and thus helps to strengthen the system, while also helping to discover any weaknesses and deal with them.



## **5. Advising the government on economic matters**

One of the functions of the Governor of the Bank of Israel is to provide the government with advice on economic matters. The various departments in the Bank, and in particular the Research Department, help the Governor in his formulation of policy recommendations and in assessing the government's policy by monitoring and analyzing economic developments, and by creating a research infrastructure for informed policy decisions. The results of ongoing analysis, research and assessments are presented to the decision makers in the Bank of Israel, government ministries and Knesset

committees and to the public, and contribute to the understanding of economic processes, the identification of trends and risks, the professional examination of policy proposals, and the formulation of policy in the Ministry of Finance and other ministries, including the formulation of the state budget.

Research and economic analysis follow three routes:

- **Monitoring and analyzing ongoing developments in the economy.** The results are published in the Bank's Annual Report, which by law is submitted to the government and the Knesset, and in periodic reports such as the Monetary Policy (Inflation) Report and Recent Economic Developments. The



Research Department also publishes a monthly composite state-of-the-economy index which gives a real-time indication of developments in the real side of the economy. It also publishes forecasts of GDP and uses (private consumption, public consumption, exports and investment) and the rate of unemployment.

- **Initiating economic policy proposals in accordance with the changing needs of the economy.** Notable instances of this are the participation in the preparation of the Economic Stabilization Program (1985), the formulation of the economic approach to the program to absorb the mass immigration of the 1990s, and the reforms in the money and capital markets. Other examples are participation in the formulation of the program to reduce poverty in Israel, the examination of the contribution of the negative income tax program (or Earned Income Tax Credit, EITC) to the reduction of poverty and encouragement of employment, and the formulation of proposals for government policy in reaction to the global economic crisis. The Bank's researchers participate in the formulation of economic policy via various committees, such as the Brodet Committee that recommended a

multi-year framework for the defense budget, and analyze the proposals put forward by other entities in the economy.

- **Studies into various aspects of Israel's economy.** These are published in the Bank's Discussion Paper series and in the Israel Economic Review, published jointly with the Israel Economic Association, and in other publications in Israel and abroad. The studies deal with identifying and analyzing basic economic processes and various policy issues.

## ***6. Providing banking services to the government***

The Bank of Israel is by law the government's only banker for its activity in Israel's domestic currency. The government, may, with the consent of the Bank of Israel, obtain services from other banks or financial entities only for purposes of its debt management and its fiscal activity. The Bank of Israel also provides the government with banking services in foreign currency.

As the government's banker the Bank also implements payment orders of government ministries and budgeted units or agencies in shekels or foreign currency, and manages their accounts.



## **7. Managing systems of information and statistics on Israel's economy**

The Bank of Israel manages a range of information and statistics systems on economic activity in Israel, systems that support the Bank's ability to fulfill its functions and achieve its goals. By law the Bank of Israel is entitled to obtain data and information from financial entities in Israel. In practice it collates and processes economic data and information from various sources: the Central Bureau of Statistics, the banks, the Tel Aviv Stock Exchange, the Israel Securities Authority, and others.

The Bank of Israel provides information and data on economic activity to the general public, international organizations, researchers, analysts and others in Israel and abroad, subject to secrecy and data security limitations. The Bank of Israel is a leading source of information on Israel's economy, especially on the financial sector and the capital market.

The Bank of Israel meets international standards with regard to statistical methods and definitions of the economic aggregates, as well as the management of data and the development of new sources of data.

Information, data and statistics are published on an ongoing basis on the Bank's website.

## **8. Regulating the payment and settlement systems**

The expansion of financial activity characteristic of many economies around the world and the increase in payments in international capital markets has boosted the importance of payment systems. As a result, central banks act to promote the security, reliability and efficiency of payment and settlement systems, and take steps to reduce settlement risks, headed by systemic risk, credit risks and liquidity risks. The central bank's activity in the payment systems—providing cash, settling payment orders, managing banks' current accounts, and overseeing the payment systems and means of payment—is a cornerstone of a modern payment system, and its involvement has deepened even further in the last few years.

The main payment systems in Israel are the Zahav system (the Hebrew acronym for Israel's Real Time Gross Settlement (RTGS) system), set up to enable immediate and final settlement of large sums to take place; the paper-based clearing house, for transferring paper payment instruments (checks, and various debits and credits); the banks' clearing house, that settles electronic debit and credit instructions; the Tel Aviv Stock Exchange Clearing Houses (the Securities

Clearing House and the Ma'of (Derivatives) Clearing House); and the credit card companies.

Since the shekel joined the international Continuous Linked Settlement (CLS) system in 2008, that system has settled the shekel against the other currencies it handles. The addition of the shekel to the list of seventeen currencies settled through the system significantly reduces the conversion risks involved in foreign currency transactions vis-à-vis the shekel.

The payment system incorporates transactions via various means of payment, including electronic debit or credit instructions, checks, debit cards, cash and payments via the Internet and cellular phones.

Most of the participants in the different payment systems are banks and large institutions. The

general public makes direct use of the various means of payment, and needs the interbank payment systems for transferring money from one bank to another.



## ***9. Issuing currency, and regulating and guiding the cash system in the economy***

The Bank of Israel has sole legal authority to issue banknotes, coins and commemorative coins.

The Governor, with the authorization of the Bank's Council and the government, determines the nominal value of banknotes to be issued, and they bear his facsimile signature. A public committee, the Committee for Planning Banknotes, Coins, and Commemorative Coins, made up of artists, public figures, academics, media experts and others, advises the Governor on all matters relating to the content, motifs, size, design, and security features, etc., of banknotes and coins.


### ***When is it decided to issue a new banknote?***

In a situation of high inflation, when the purchasing power of money is falling, the need arises for a larger denomination banknote, to make day-to-day transactions easier. Most series of banknotes around the world have four to six denominations.

### ***When is it decided to issue a new series of banknotes?***

The following are instances when it would be decided to issue a new series of banknotes:





A governmental decision to change the public message or the images depicted on the banknotes;

A change in the name of the currency;

The design and security features have become outdated;

Counterfeits in excess of a certain level.

### ***How is a banknote issued?***

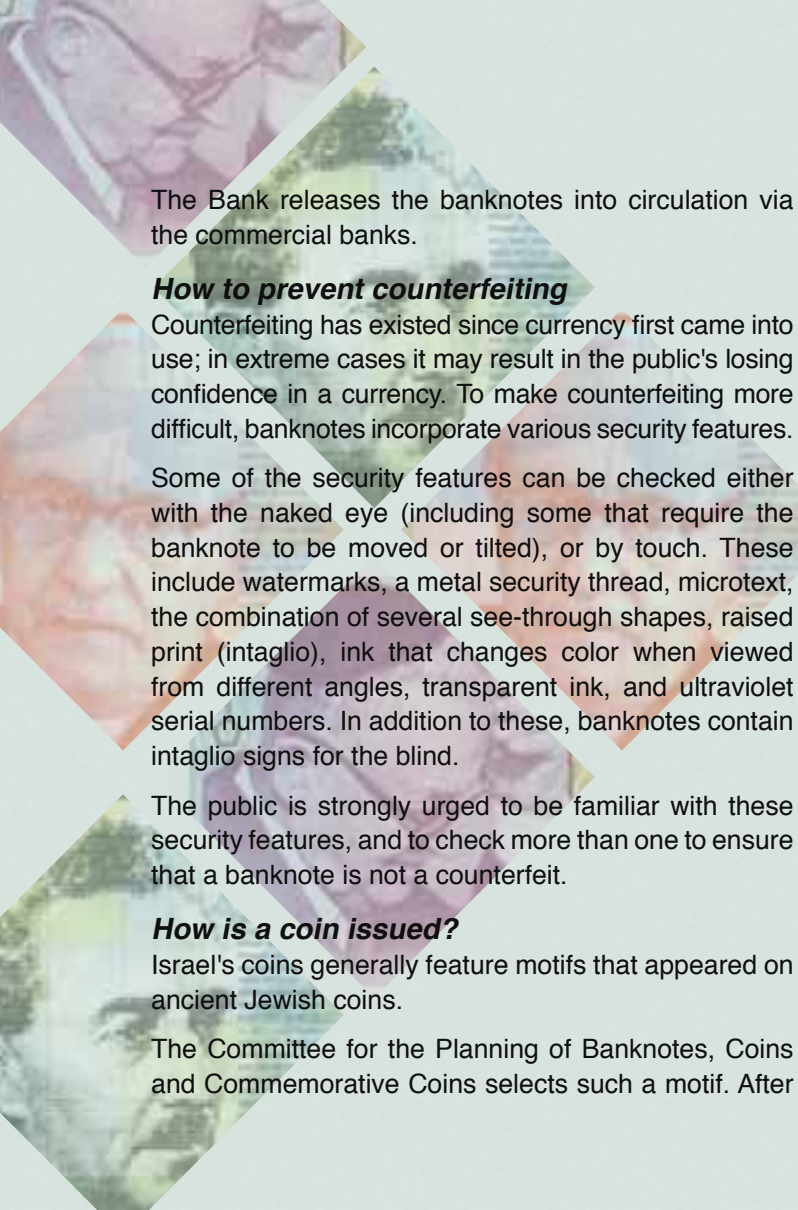
The process starts with the selection of a subject to be featured on the note. Following approval by the Government, there is a competition between designers. The Committee for Planning Banknotes, Coins, and Commemorative Coins selects what it considers the most suitable proposed design, and presents it to the Governor for approval. When the Governor has approved the design for the banknotes, and the other approvals required by law have been obtained, the preparations for printing commence.

At the design stage the anti-counterfeit security features are also chosen—a watermark, a metal security thread, ink that changes color when viewed from different angles, etc.

Since 1969 the banknotes have usually carried portraits of Israel's deceased presidents, prime ministers and other personalities who left their imprint on Israel and the Jewish people, and also give expression to subjects related to their activities.

Based on the design chosen for the banknote, the printing house prepares the printing plates. At the same time the paper on which the notes will be printed is prepared. The paper most commonly used around the world is that manufactured from cotton. The current series of Israel's banknotes includes one made from polymer (a high durability plastic-type material)—the NIS 20 note.

The printing process consists of several stages, and at the end of each stage checks are performed on the sharpness of the color, the amount of ink, the accuracy of the positioning of the different elements, the inclusion of the security features, etc. The notes are printed on large sheets, each of which contains a number of banknotes. The banknotes are then cut from the sheets and packed into bundles.



The Bank releases the banknotes into circulation via the commercial banks.

### ***How to prevent counterfeiting***

Counterfeiting has existed since currency first came into use; in extreme cases it may result in the public's losing confidence in a currency. To make counterfeiting more difficult, banknotes incorporate various security features.

Some of the security features can be checked either with the naked eye (including some that require the banknote to be moved or tilted), or by touch. These include watermarks, a metal security thread, microtext, the combination of several see-through shapes, raised print (intaglio), ink that changes color when viewed from different angles, transparent ink, and ultraviolet serial numbers. In addition to these, banknotes contain intaglio signs for the blind.

The public is strongly urged to be familiar with these security features, and to check more than one to ensure that a banknote is not a counterfeit.

### ***How is a coin issued?***

Israel's coins generally feature motifs that appeared on ancient Jewish coins.

The Committee for the Planning of Banknotes, Coins and Commemorative Coins selects such a motif. After

a decision has been made regarding the design, the size of the coin and the metal from which it will be produced, a tender is held to select a designer. Certain elements appear on all coins: the year of minting, the emblem of the State of Israel, and captions in Hebrew, English and Arabic.

When the Governor has approved the design and other legally required approvals have been obtained, the production process starts.

The graphic design of the coin is transferred to the mint, selected by tender, which then produces the dies. These will be used for stamping the previously produced blanks, ordered according to a specification regarding the type of alloy, the diameter and thickness of the blank, and its metallurgical properties.

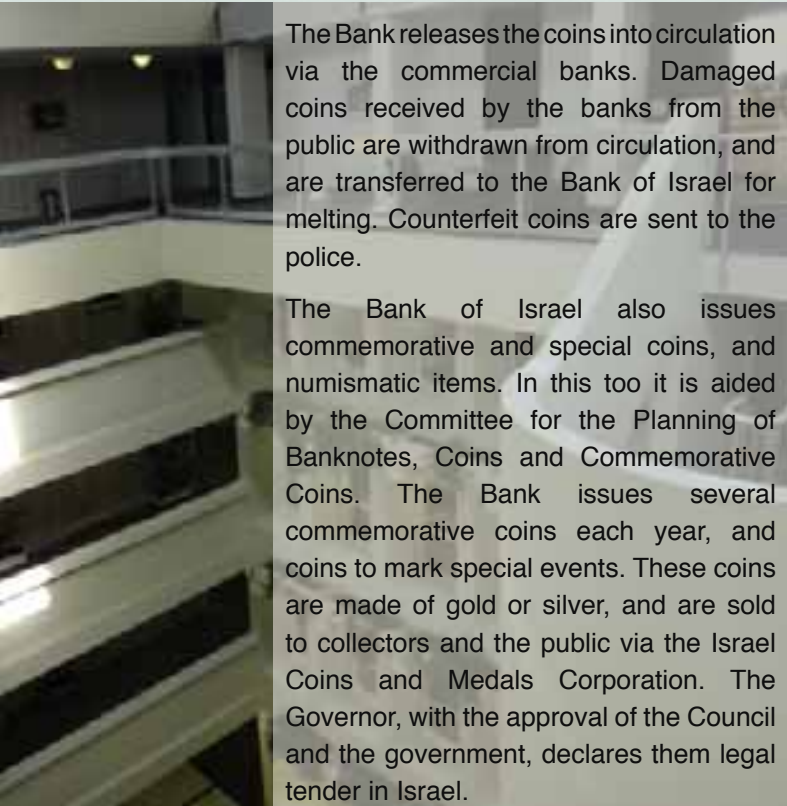
The mint first carries out a trial run of production. When this has been approved, the quantity of coins ordered is minted. Coins are minted to be counterfeit-proof and recognizable by all automatic vending and other machines. As with the printing of banknotes, the minting process takes place under strict scrutiny.







## *Decision Making in the Bank of Israel*



The Bank releases the coins into circulation via the commercial banks. Damaged coins received by the banks from the public are withdrawn from circulation, and are transferred to the Bank of Israel for melting. Counterfeit coins are sent to the police.

The Bank of Israel also issues commemorative and special coins, and numismatic items. In this too it is aided by the Committee for the Planning of Banknotes, Coins and Commemorative Coins. The Bank issues several commemorative coins each year, and coins to mark special events. These coins are made of gold or silver, and are sold to collectors and the public via the Israel Coins and Medals Corporation. The Governor, with the approval of the Council and the government, declares them legal tender in Israel.

### ***The Governor of the Bank***

The Governor of the Bank of Israel is appointed by the President of the State, on the recommendation of the government, for a five-year term of office, and can be reappointed for one additional term of office only. The Governor manages the Bank, acts as chairperson of the Monetary Committee, is a member of the Bank's Council, and serves as advisor to the government on economic matters. Decisions on the Bank's economic policy are taken by the Monetary Committee, and the Council supervises the management of the Bank.

### ***The Monetary Committee***

The Monetary Committee sets the policy for achieving the Bank's objectives, including monetary policy. The Committee decides on the level of the Bank of Israel interest rate and the tools of monetary policy to be used by the Bank. The Committee may decide that the Bank should intervene in the foreign currency market if necessary to achieve its objectives.

The Governor decides on the desired long-term level of the foreign exchange reserves, and the Monetary Committee, with the approval of the Minister of Finance, may change the principles by which that level is

determined. The Monetary Committee, in consultation with the Minister of Finance, determines the guidelines for the policy regarding the investment of the foreign exchange reserves.

The Monetary Committee has six members. Three are from the Bank—the Governor, who serves as chairperson of the committee, the Deputy Governor, and an additional Bank employee who is appointed by the Governor. The other three members of the committee are representatives of the public with the appropriate skills, experience and academic achievements.

Since research on the subject shows that decisions by a group of professionals are on average better than those of one person, the process of decision making by the Monetary Committee should contribute to the right decisions being made.

The Committee's decisions are made by a majority vote, with the Governor having a casting vote in the event of a tied vote.

### ***The Council***

The functions of the Council are to supervise the orderly and efficient management of the Bank, discuss the annual work plan formulated by the Bank's management, approve the annual budget for the Bank's administrative activity and the Bank's

financial statements, approve the salary terms for Bank employees, appoint an internal auditor for the Bank, discuss recommendations of the Audit Committee, made up of representatives of the public on the Council, and appoint a committee headed by the Governor to correct any deficiencies.

The Council has seven members: two from the Bank—the Governor and Deputy Governor—and five representatives of the public. One of the representatives from among the public is appointed by the government, in consultation with the Governor, to serve as chairperson.

### ***The Visitors Center***

The purpose of the Bank of Israel's Visitors Center is to familiarize the public with:

The Bank's main functions and its contribution to Israel's economy;

The history of money in Israel and how Israel's banknotes and coins reflect the heritage of the Jewish people and the State of Israel.

A visit to the Center incorporates a variety of interesting attractions and exhibits, including:

An exhibition of ancient coins; banknotes and coins issued in Israel from pre-State days to the present, substitutes for money, and more.



A tour through the exhibits shows the development of different means of payment, such as, what served as money before coins existed? When were coins first used? What was the first series of banknotes issued in Israel? What is the origin of the motifs used in the designs on Israel's currency? What events and personalities that left their mark on the nation and Israel are depicted on the currency?

Within the museum are:

- Interactive computer stations that by means of games illustrate the functions of the Bank of Israel, the history of money, and the Bank's contribution to Israel's economy.
- Films that show the development of the means of payment and the essential role fulfilled by the Bank of Israel in maintaining price stability.

- Talks on special economic issues (by prior arrangement).

The Visitors Center is intended for the general public, including children aged eight years or older. Visits are in the form of guided tours, and are free of charge, but must be arranged in advance, by telephone: 02-655-2828, fax: 02-666-9552, or Internet:

**[www.bankisrael.org.il/vcenter.htm](http://www.bankisrael.org.il/vcenter.htm)** .

### ***Interested in more information?***

Much information on all areas of the Bank of Israel's activities is available on the Bank's website:

**[www.bankisrael.org.il](http://www.bankisrael.org.il)**



