

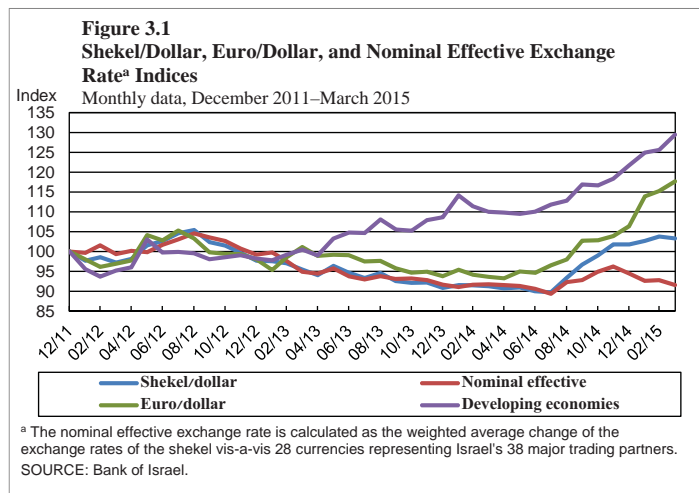
## C. THE FOREIGN EXCHANGE MARKET—THE EXCHANGE RATE AND SECTORAL CONVERSIONS

In August 2014, there was a change in the trend of the shekel's exchange rate, with the shekel depreciating by about 16 percent against the dollar between August 2014 and March 2015. This followed a prolonged appreciation of about 14 percent over about 2 years (from September 2012). In terms of the nominal effective exchange rate, which represents Israel's major trading partners, the shekel depreciated by only about 2.1 percent.

There was a parallel change in the activity of the main sectors in the foreign exchange market. Nonresidents shifted to net foreign exchange purchases and continued to increase the balance of their short-term shekel liabilities. Institutional investors increased their exposure to foreign exchange by reducing their hedging of foreign assets. In contrast, the nonfinancial sector shifted to net foreign exchange sales, mainly through increased foreign exchange sales by exporters and reduced foreign exchange purchases by importers.

In August 2014, there was a change in the trend of the shekel's exchange rate, with the shekel depreciating markedly against the dollar. This trend continued in the first quarter of 2015.

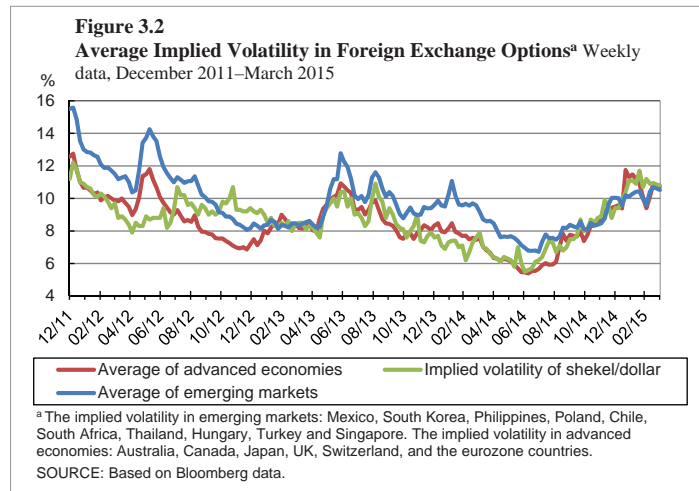
Summing up the period from August 2014 until March 2015, the shekel depreciated by about 16.1 percent against the dollar, and by about 2.1 percent in terms of the nominal effective exchange rate. Globally, the dollar strengthened by 10 percent against the euro, by 9 percent against the Swiss franc, and by 16 percent against the Japanese yen. During the period, the dollar strengthened by about 14 percent on average against the currencies of developing economies as well.



In parallel with the change in trend of the exchange rate in August 2014, there was also an increase in the expected volatility indices of the exchange rates in Israel and globally.

The average monthly level of the implied volatility of foreign exchange options in Israel, which represents the expected volatility of the exchange rate, increased by about 5 percentage points between the middle of 2014 and March 2015.

In parallel, the implied volatility of foreign exchange options in emerging markets increased by 3 percentage points, and in advanced economies it increased by 5 percentage points during the period.

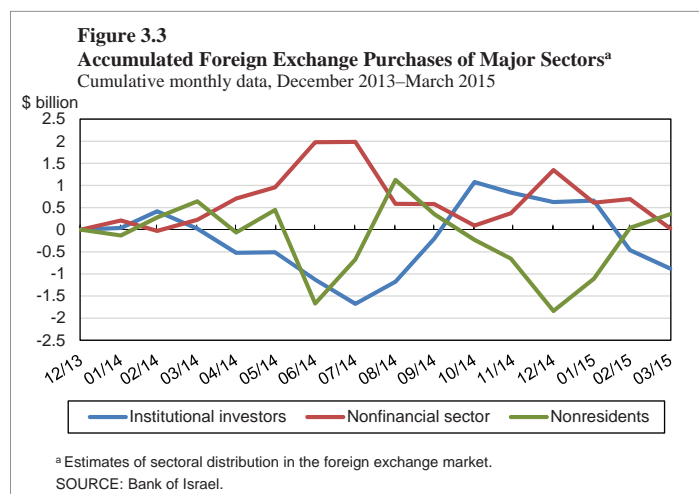


In August 2014, there was a change in the activity of the main sectors in the foreign exchange market.

Estimates of the sectoral distribution of foreign exchange sales and purchases in the market show that during July 2014, nonresidents shifted to net foreign exchange purchases following a prolonged trend of sales. In August, institutional investors joined in the purchases.

The nonfinancial sector, which is generally a net purchaser of foreign exchange, became a net seller in August 2014. These trends reversed in the fourth quarter of 2014.

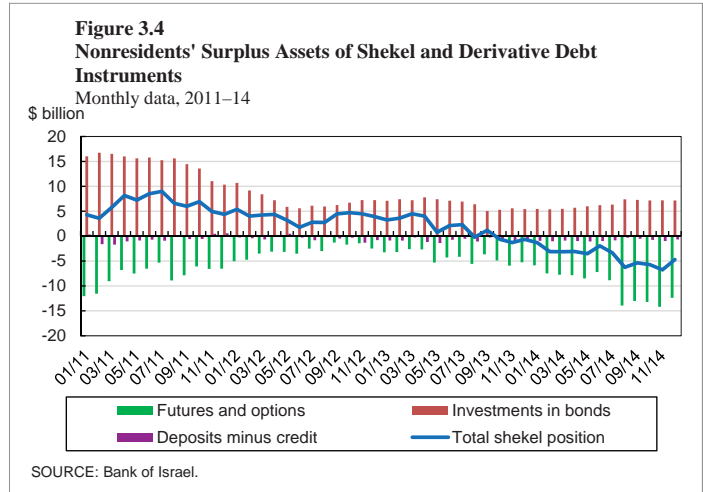
In the first quarter of 2015, nonresidents resumed purchasing foreign exchange in parallel with the renewed depreciation of the shekel. In contrast, institutional investors and the nonfinancial sector were net sellers of foreign exchange during that period.



The shift of nonresidents to purchasing foreign exchange in August 2014 was reflected in the continued increase in the balance of their shekel liabilities, through futures transactions.

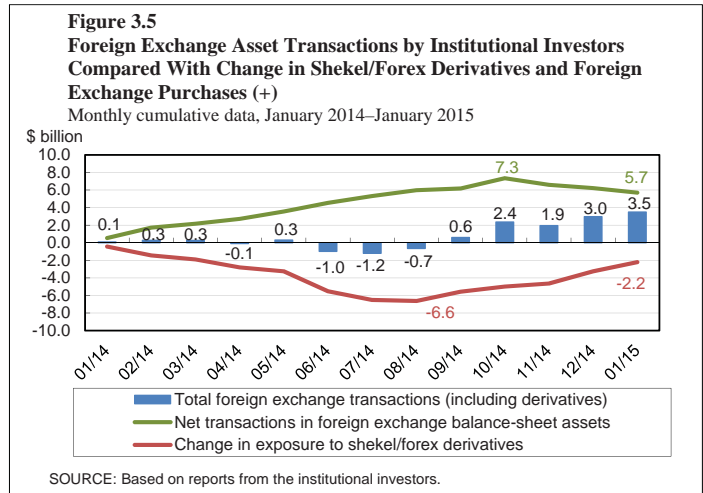
Nonresidents continued to increase their shekel liabilities in 2014, through derivative instruments, a trend that began in mid-2013.

In the past two years, nonresidents have steadily reduced their surplus shekel short-term assets (bonds, *makam* and derivatives). This balance reached a peak of about \$9 billion in mid-2011. In the third quarter of 2013, nonresidents shifted to surplus shekel liabilities.



Starting in August 2014, institutional investors reduced their hedging assets against foreign exchange risks.

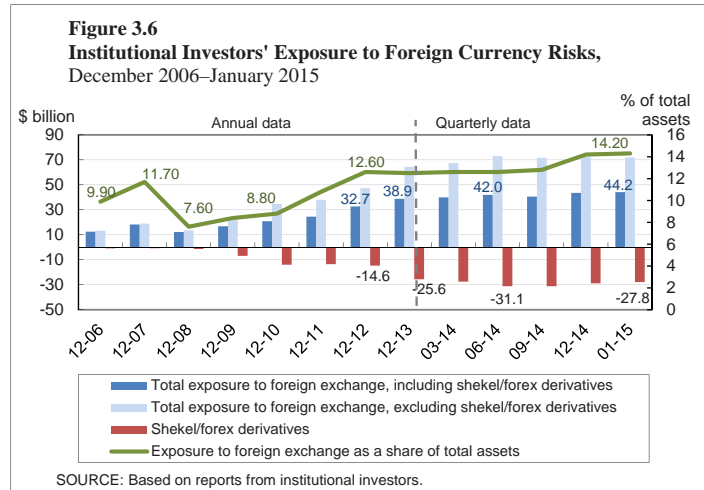
Starting in August 2014, institutional investors reduced the balance of foreign exchange sales futures transactions. This balance increased significantly in recent years, to about \$30 billion, as a result of a strategy of hedging investments abroad, due to the prolonged appreciation of the shekel.



Starting in August, the reduced scope of hedging by institutional investors, in parallel with continued investment in foreign securities, contributed to a gradual increase in institutional investors' share of exposure to foreign exchange out of total assets.

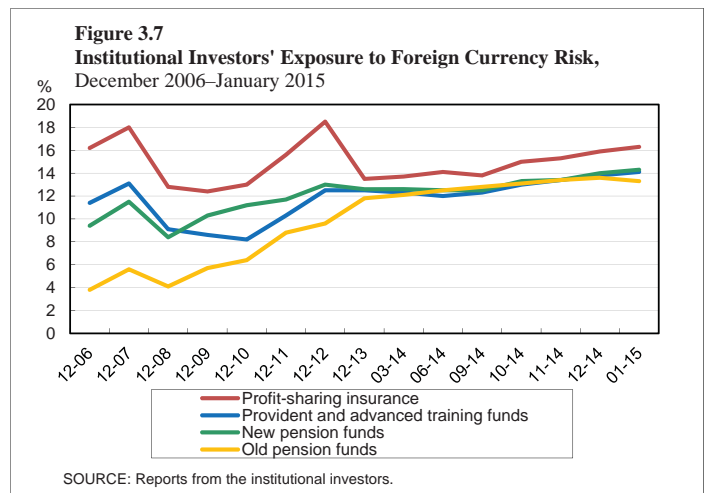
Institutional investors' share of exposure to foreign exchange increased from 12.6 percent in July 2014 to 14.2 percent in December 2014. The balance of foreign exchange assets was \$43.5 billion at the end of 2014.

The increase in exposure to foreign exchange was characteristic of all institutional investors during this period.



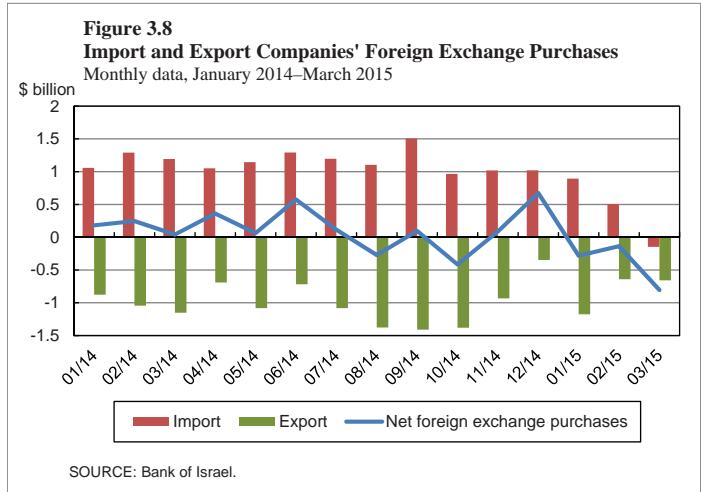
Starting in 2013, there has been a marked convergence of institutional investors' rates of exposure to foreign exchange, to a level between 14 percent and 16 percent of total assets.

Between mid-2011 and the end of 2012, insurance companies increased their exposure to foreign exchange to about 18 percent of total assets, compared to only about 12 percent in provident funds and new pension funds, and about 10 percent in the old pension funds. Starting in 2012, there has been a marked convergence in rates of exposure to foreign exchange risk.



The nonfinancial sector shifted to net sales against the background of the change in trend of the exchange rate in August 2014.

The change in the balance of net conversions of exporters and importers is prominent, alongside the acceleration of the shekel's depreciation. Between August and October 2014, and in the first quarter of 2015, exporters increased net sales of foreign exchange, while importers reduced their net purchases of foreign exchange.

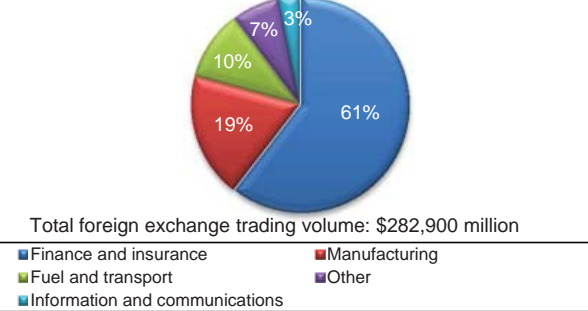


ZOOM IN



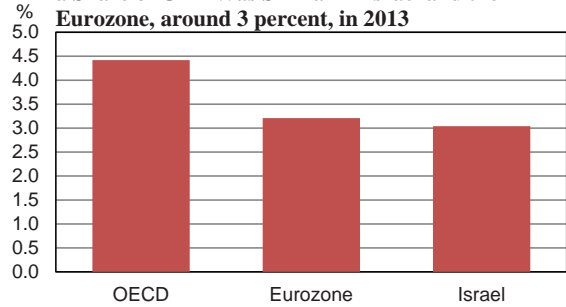
CONCENTRATION AND INDUSTRY DISTRIBUTION IN THE FOREIGN EXCHANGE MARKET

**Figure 3.9**  
The finance and insurance industry made up most of forex trading volume<sup>a</sup> by Israeli residents in 2014



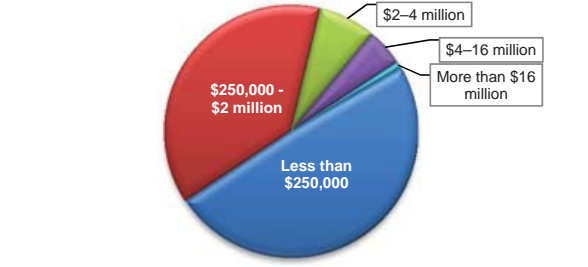
<sup>a</sup> Excluding swap transactions.  
SOURCE: Bank of Israel.

**Figure 3.10**  
Average Daily Forex Derivative Trading Volume as a Share of GDP Was Similar in Israel and the Eurozone, around 3 percent, in 2013



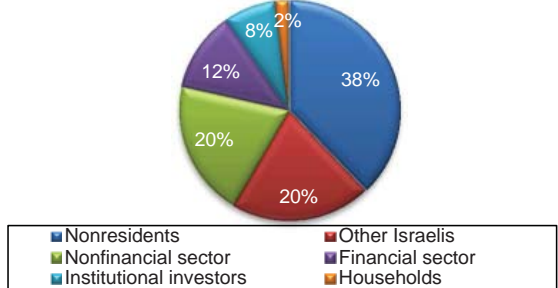
SOURCE: Based on BIS.

**Figure 3.11**  
Half of forex transactions<sup>a</sup> in 2014 were small—less than \$250,000



<sup>a</sup> Excluding swap transactions.

**Figure 3.12**  
Nonresidents' share of trading volume<sup>a</sup> in Israel's foreign exchange market was 40 percent in 2014



<sup>a</sup> Excluding swap transactions.  
SOURCE: Bank of Israel.

Main indicators in the foreign exchange market								
	Level <sup>a</sup>			Change				
	2012	2013	2014	2012	2013	2014		2015
						First half	Second half	First quarter
Shekel/dollar representative exchange rate	3.73	3.47	3.89	-2.3%	-7.0%	-1.0%	13.1%	2.3%
Shekel/euro exchange rate	4.92	4.78	4.73	-0.3%	-2.8%	-1.8%	0.7%	-9.5%
Dollar/euro exchange rate	1.32	1.38	1.22	2.0%	4.6%	-0.9%	-11.0%	-11.6%
Yen/dollar exchange rate	86.16	104.98	119.49	11.2%	21.8%	-3.5%	17.9%	0.4%
Nominal effective exchange rate (January 2, 2008 = 100)	91.57	84.59	87.19	-0.8%	-7.6%	-1.1%	4.3%	-3.4%
Average daily trading volume - conversions, swaps and OTC options (\$ million)	4,978	4,157	8,428	-23.8%	-16.5%	54.1%	31.6%	-12.8%
Nonresidents' share of trading volume <sup>b</sup>	41.0%	34.6%	31.6%	1.8	-6.4	-5.0	2.0	10.9
Nonresidents' foreign exchange purchases (\$ million)				-5,868	-914	-1,662	-175.7	2657.2
Foreign exchange purchases by the nonfinancial sector (\$ million)				6,181	4,431	2,102	-254.9	-2051.2
Foreign exchange purchases by institutional investors (\$ million)				1,921	-3,659	-1,003	1632.8	-1534.4
Actual volatility of the shekel/dollar exchange rate (moving 20-day average) <sup>b</sup>	5.5%	3.5%	9.3%	-0.1	-2.0	-0.1	5.9	-4.9
Implied volatility of shekel/forex OTC options <sup>b</sup>	9.4%	7.9%	9.4%	-1.8	-1.5	-1.9	3.4	1.4

<sup>a</sup> Level at the end of the period.

<sup>b</sup> Change in percentage points.