



Bank of Israel

*Comptroller's Office and
Payment and Settlement Systems*

FINANCIAL STATEMENTS

*and Review of the Payment and
Settlement Systems*

FOR 2011

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Bank of Israel

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Independent Auditors' Report to the Governor and Supervisory Council of the Bank of Israel

We have audited the accompanying balance sheets of the Bank of Israel (hereinafter "the Bank") as of December 31, 2011 and 2010, and the related statements of operations and changes in equity of the Bank for each of the years ending on such dates (hereinafter "the financial statements") appearing on pages 6 to 36. These financial statements are the responsibility of the Supervisory Council, Governor, Director General and Acting Head of Comptroller's Office and Payment Systems of the Bank. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in Israel, including standards prescribed by the Auditors Regulations (Manner of Auditor's Performance)-1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Management of the Bank, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2011 and 2010, and the results of its operations and changes in equity for each of the years ending on such dates, in conformity with generally accepted accounting principles in Israel (Israeli GAAP), adapted for principles applicable to central banks, as detailed in Note 1a.

Somekh Chaikin
Certified Public Accountants (Isr.)

March 22, 2012

BALANCE SHEET AS OF DECEMBER 31, 2011

(TEVET 5, 5772)

	Note	2011	2010
Assets			
Foreign currency assets			
Foreign currency assets abroad	2		
Demand deposits		1,017	229
Short-term deposits		8,455	20,399
Tradable securities		254,235	224,308
Reverse repurchase agreements		15,393	1,767
Derivative financial instruments		917	-
The International Monetary Fund	3	6,964	5,850
Total foreign currency assets abroad		286,981	252,553
Other foreign currency assets			
Credit to the government	4	126	117
Total foreign currency assets		287,107	252,670
Local currency assets			
Tradable securities	5	19,595	19,672
Other	6	141	168
Total local currency assets		19,736	19,840
Other assets			
International financial institutions	7	923	926
Fixed assets	8	296	278
Total other assets		1,219	1,204
Total		308,062	273,714

The accompanying notes are an integral part of the financial statements.

(NIS million, reported amounts)

	Note	2011	2010
Liabilities and equity			
Banknotes and coins in circulation	9	48,975	44,828
Foreign currency liabilities			
Foreign currency liabilities abroad	2		
Derivative financial instruments		-	882
Other liabilities		884	-
Total foreign currency liabilities abroad		884	882
Other foreign currency liabilities			
Government deposits	10	2,008	1,228
Deposits of banking corporations	11	2,410	1,541
International financial institutions	12	5,190	4,890
Total other foreign currency liabilities		9,608	7,659
Total foreign currency liabilities		10,492	8,541
Local currency liabilities			
Government deposits	10	10,568	12,979
Deposits of banking corporations	11	129,438	99,857
Makam	13	121,532	134,909
Other liabilities	14	5,115	4,356
Total local currency liabilities		266,653	252,101
Total liabilities		326,120	305,470
Revaluation accounts	15	19,313	2,204
Equity (deficit)			
Share capital and general reserve	16	3,985	3,985
Accumulated losses		(41,356)	(37,945)
Total equity (deficit)		(37,371)	(33,960)
Total		308,062	273,714


Stanley Fischer

Governor


Dan Propper

Chairman of the Supervisory
Council


Hezi Kalo

Director General and Acting
Head of Comptroller's Office and
Payment Systems

March 22, 2012

STATEMENT OF OPERATIONS

FOR THE YEAR ENDED DECEMBER 31, 2011
(NIS million, reported amounts)

		FOR THE YEAR ENDED DECEMBER 31	
	Note	2011	2010
Interest income from			
Assets in foreign currency abroad	19	2,787	2,959
The government	20	776	1,022
Other	21	15	8
Total interest income		3,578	3,989
Interest expense			
On liabilities in foreign currency abroad	22	9	4
To banks and the public	23	6,197	3,500
To the government	24	625	328
Other	25	161	130
Total interest expense		6,992	3,962
Net interest income (expense)		(3,414)	27
Other financial income (expense)			
Securities and derivative financial instruments	26	255	(69)
Exchange rate differentials	27	498	(17,562)
Miscellaneous	28	(13)	211
Total other financial income (expense)		740	(17,420)
Loss on financial transactions		(2,674)	(17,393)
Expense of printing banknotes and minting coins		(34)	(53)
Administrative and general expenses	29	(706)	(528)
Other income	30	3	103
Net loss		(3,411)	(17,871)

The accompanying notes are an integral part of the statements.

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED DECEMBER 31, 2011

(NIS million, reported amounts)

	share capital and general reserve	Accumulated losses	Total deficit in equity
Balance as of January 1, 2010	3,985	(20,074)	(16,089)
Net loss for the year	-	(17,871)	(17,871)
Balance as of December 31, 2010	3,985	(37,945)	(33,960)
Net loss for the year	-	(3,411)	(3,411)
Balance as of December 31, 2011	3,985	(41,356)	(37,371)

The accompanying notes are an integral part of the statements.

NOTES TO THE FINANCIAL STATEMENTS FOR 2011



1. Accounting policies

a. General

The financial statements are presented in accordance with generally accepted accounting principles (Israeli GAAP), adapted for the special activity of a central bank and consistent with the practice of other central banks.

The main items presented in accordance with generally accepted accounting principles of central banks are:

1. Revaluation accounts—as detailed in Section 1.m below.
2. Cash-flow statements—as detailed in Section 1.t below.

b. Definitions

In these financial statements:

1. **"The Bank"**—the Bank of Israel.
2. **"CPI"**—the Consumer Price Index as published by the Central Bureau of Statistics.
3. **"Adjusted amount"**—the nominal historical amount adjusted to the CPI in respect of December 2003, in accordance with the provisions of Opinions 23 and 36 of the Institute of Certified Public Accountants in Israel.
4. **"Reported amount"**—the adjusted amount at the transition date (December 31, 2003), with additional amounts in nominal values that were added after the transition date, less amounts subtracted after the transition date.
5. **"Nominal financial reporting"**—financial reporting based on reported amounts.
6. **"Fair value"**—the amount for which it was possible to acquire or sell an asset (to undertake or repay a liability) in a current transaction between parties acting voluntarily.

c. Financial statements in reported amounts

1. In October 2001, the Israel Accounting Standards Board published Accounting Standard No. 12, "Discontinuance of Adjustment of Financial Statements". Pursuant to this standard, and in accordance with Accounting Standard No. 17, which was published in December 2002, the adjustment of financial statements for the effect of inflation was discontinued as of January 1, 2004.



2. In the past, the Bank prepared its financial statements on the basis of historical cost, with no adjustment for changes in purchasing power of the Israeli currency. In the financial statements for 2005, comparative figures for the year ended December 31, 2003, were recalculated on a historical-cost basis, adjusted for changes in the CPI as required by Accounting Standard No. 12, in order to prepare for the transition to nominal financial reporting.

The adjusted amounts at December 31, 2003 constituted the starting point for the nominal financial report as of January 1, 2004. Any additions and disposals made during the period were included in their nominal values.

3. Amounts of non-monetary assets do not necessarily reflect their realizable value or current economic value, but only the reported amounts of those assets.
4. The term "cost" in these financial statements, denotes the reported amount of cost.

d. Reporting principles

1. Balance Sheet:
 - a. Non-monetary items (mainly fixed assets and investments shown at cost) are stated in reported amounts.
 - b. Monetary items are stated in the balance sheet at their nominal values at the balance sheet date.
 - c. The balance sheet is presented in the format generally accepted by central banks worldwide.
2. Statement of Operations:
 - a. Income and expenses originating in non-monetary items (e.g., depreciation, prepaid expenses, and deferred income) or from provisions included in the balance sheet, are derived from the difference between the reported amount of the opening balance and the reported amount of the closing balance.
 - b. All other operating items (such as interest income and expense) are stated at their nominal values.
3. Statement of changes in equity:

The new Bank of Israel law came into effect on June 1, 2010 and on that date the Bank of Israel Law, 5714-1954 was repealed.

In accordance with Section 76 of Bank of Israel Law, 5770-2010, within three months from the end of each year the Bank will transfer its profits to the government according to the following provisions:

- a. If the equity amounts to 2.5 percent or more of total assets, the government will receive an amount equal to the net profit, less any deficit in retained earnings.

- b. If the equity amounts to more than 1 percent of total assets but less than 2.5 percent of total assets, the government will receive 50 percent of the net profit, less any deficit in retained earnings.
- c. If the equity amounts to 1 percent or less of total assets, the government will not receive any profits.

The Bank is permitted to record capital reserves arising from accounting principles, providing that the balance of net profit not transferred to the government as aforementioned is added to the retained earnings and not recognized as another capital item, unless agreed otherwise between the Governor and the Minister of Finance.

In accordance with these provisions, as of December 31, 2011 there is no obligation to transfer funds to the government.

e. Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires the Bank's management to make estimates and assumptions regarding transactions or matters the final effect of which, on the financial statements, cannot be determined with precision at the time the statements are prepared. Even though the estimates and assumptions are based on management's best judgment, the final effect of such transactions or matters may be different from the estimates and assumptions made in their respect.

f. Income recognition

Income and expenditure are charged to the Statement of Operations on an accrual basis.

Realized profits or losses from foreign currency and securities in local and foreign currency are transferred to the Statement of Operations. These profits or losses are calculated on the basis of average cost of the balances in that asset.

Unrealized profits are not transferred to the Statement of Operations, instead they are charged to the "Revaluation accounts" line in the balance sheet.

Unrealized losses are transferred to the Statement of Operations after offsetting unrealized profits in the same asset. These losses derive from the difference between the average cost of an asset and its fair value.

Unrealized losses from foreign currency securities, from local currency securities, or a specific foreign currency are not offset against unrealized profits from other securities or foreign currency.

Losses recognized in the Statement of Operations are not offset against unrealized profits that will accrued in the future.



g. Securities

Foreign currency securities

Tradable foreign currency securities are stated in the balance sheet at their fair value at the balance sheet date. The fair value of quoted securities is based on market prices. Unquoted securities are revalued on the basis of data obtained from outside sources.

The adjusted cost of securities is their face value plus the interest, indexation differentials and the balance of the premium or discount not yet amortized. The premium or discount is amortized over the period from the date of purchase until the date of redemption.

The difference between the original cost of the securities and their face value plus interest and the balance of the premium or discount not yet amortized is charged to the Statement of Operations.

Differentials from linkage to an index published overseas that accumulated on the principal and were not yet realized, as well as the difference between the fair value of the securities and their adjusted cost, are charged to the "Revaluation accounts" line in the balance sheet.

Interest income and amortization of the premium or discount are charged to the Statement of Operations on an accrual basis, and are stated in the item "Interest income from assets in foreign currency abroad".

Income from the disposal of securities is stated under "Other financial income (expenses on)—securities and derivative financial instruments".

The balance of the unrealized losses is charged to the Statement of Operations at the end of the year and stated under "Other financial income from (expenses on)—securities and derivative financial instruments".

Local currency securities

Tradable local currency government securities are stated in the balance sheet at their fair value at the balance sheet date.

The difference between the original cost of securities and their face value, plus interest and the balance of the premium or discount not yet amortized, is charged to the Statement of Operations.

CPI-indexation differentials accumulated on the principal and as yet unrealized, as well as the difference between the fair value of the securities and their adjusted cost, are charged to the "Revaluation accounts" line in the balance sheet.

Interest income from local-currency securities and amortization of the premium or discount are charged to the Statement of Operations on an accrual basis, and stated under "Interest income from the government".

The balance of unrealized losses is charged to the Statement of Operations at the end of the year and stated under "Other financial income from (expenses on)—securities and derivative financial instruments".

h. International financial institutions

International Monetary Fund (IMF)

The Bank of Israel's participation in the IMF less its liabilities on account of this participation is shown on the Assets side in the "International Monetary Fund" item.

The loans that were granted to the IMF according to the NAB arrangement and the Bank's Special Drawing Rights Holdings (SDR Holdings) are shown on the Assets side of the balance sheet under the item "International Monetary Fund". (See Note 3.)

Liabilities in respect of Drawing Rights granted by the IMF are shown on the liabilities side in the "International financial institutions" item.

Balances related to other international financial institutions and investment in shares of the Bank for International Settlements (BIS)

The Bank of Israel's participation in other international financial institutions includes initial participation in their capital and additional participation payments toward increases in these institutions' capital. The Bank of Israel's participation in other international financial institutions is shown on the Assets side in the "International financial institutions" item according to the cost in the currency in which the participation was paid, expressed at the exchange rate on the transaction date. Liabilities to international financial institutions are shown on the Liabilities side in the "International financial institutions" item.

i. Fixed assets

1. Fixed assets are stated at cost less accumulated depreciation. Cost includes expenses directly attributable to the purchase of the asset.
2. Improvements and enhancements are charged to the cost of the assets, whereas maintenance and repairs expenses are charged to the Statement of Operations as incurred.
3. Depreciation is calculated by the straight-line method on the basis of the estimated useful life of the asset:
 - Buildings—fifty to sixty-seven years;
 - Motor vehicles—six and a half years;
 - Computers—four years;
 - Equipment—ten years.
4. Software that is not an integral part of the related hardware is shown under fixed assets at cost and depreciated by the straight-line method over four years.



5. Purchases of fixed assets in insignificant amounts are charged to the Statement of Operations.

j. Banknotes and coins in circulation

Banknotes and coins in circulation that were issued by the Bank reflect a liability on the Bank's part to their holders. This liability is shown in the Bank's balance at face value.

k. Short-term loan

The balance of short-term loan (called *makam*, their Hebrew acronym) in the balance sheet reflects the redemption price of *makam* held by the public, less the balance of unamortized discount. *Makam* sold by the government to the Bank of Israel but not yet sold to the public are not included in this balance.

Makam are issued for a period of up to a year. The discount is the difference between the redemption price of the *makam* and the proceeds of their sale to the public.

The discount is amortized over the period from its date of issuance to its date of redemption.

Expenses for amortization of the discount on the balance of *makam* held by the public are shown in the Statement of Operations in the "Interest expense to banks and the public" item.

l. Liabilities on account of employees' entitlements

All liabilities on account of employer-employee relations have corresponding reserves in accordance with law, agreement, practice and management's expectations.

Liabilities on account of employee pensions and severance pay are calculated by an expert actuary using the method of estimation of cumulative benefits with probabilities taken into account on the basis of past experience. The discount rate applying to the reserves is set in accordance with the rate established in directives issued by the Supervisor of Banks, and the rate of future salary increases is estimated by the management.

The provision for vacation pay is computed on the basis of the accrued vacation days at October 31, 2011 and the effective salary for vacation redemption at the balance sheet date. The difference in the liability that derives from the accrual of vacation days between October 31, 2011 and December 31, 2011 is immaterial. (see Note 14.)

m. Revaluation accounts

The revaluation accounts include unrealized profits from exchange rate differentials on balances denominated in foreign currency and unrealized profits from indexation and the revaluation of tradable securities in local currency and foreign currency to their fair value.

Separate revaluation accounts are maintained for each item (currency, security) and are transferred to the Statement of Operations when the item is fully or partially realized. No offsetting among different types of items is performed.

Any net loss in the revaluation accounts that originates in indexation differentials and price differentials in local currency and foreign currency securities and exchange rate differentials on foreign currency balances is transferred to the Statement of Operations at the end of the year. (See also Section f above).

n. Foreign currency

Assets and liabilities denominated in or indexed to foreign currency are shown in New Israel Shekel (NIS) according to the representative rates of exchange published by the Bank of Israel at the balance sheet date.

Income and expenses in foreign currency are included in the Statement of Operations at the representative rates of exchange in effect on the value day of the performance of each transaction.

Exchange rate differentials arising from the adjustment of assets and liabilities due to changes in the exchange rate include realized and unrealized exchange rate differentials.

Unrealized exchange rate differentials are charged separately for each currency to the "Revaluation accounts" item. Realized exchange rate differentials are transferred to the Statement of Operations and are calculated on the basis of the average cost of the balances of the currency at issue. Realization is calculated separately for foreign currency assets and foreign currency liabilities in each calendar month and for each currency.

The loss balance in the revaluation accounts at the end of the year is transferred to the Statement of Operations and is not offset against future unrealized profits.

Unrealized losses in one currency are not offset against unrealized profits in another currency.



The following table details NIS exchange rates against other key currencies:

	December 31			Change	
	2011	2010	2009	2011	2010
	(NIS)			(Percent)	
USD	3.8210	3.5490	3.7750	7.7	(6.0)
Euro	4.9381	4.7379	5.4417	4.2	(12.9)
Pound sterling	5.8918	5.4928	6.1112	7.3	(10.1)
Special drawing rights (SDR) ^a	5.8662	5.4825	5.9180	7.0	(7.4)

^a The SDR rate is published by the IMF, and is based on a weighted 4-currency basket consisting of USD, €, ¥ and £.

o. Indexation

Assets and liabilities linked to the CPI are shown in accordance with the indexation conditions determined for each balance.

Following are details of the CPI (based on the 2002 average):

		December 31			Change	
		2011	2010	2009	2011	2010
		(Points)			(Percent)	
CPI	November	120.4	117.4	114.8	2.6	2.3
	December	120.4	117.8	114.8	2.2	2.6

p. Interest rates

Some of the local currency interest on the government's and the banks' balances, which are collected or paid by the Bank of Israel, are based on the Bank of Israel interest rate or the prime interest rate.

The following are the interest rates as at December 31:

	December 31			Change	
	2011	2010	2009	2011	2010
	(Percent)				
Bank of Israel interest rate	2.75	2.00	1.25	37.5	60.0
Prime	4.25	3.50	2.50	21.4	40.0

q. Financial instruments

The Bank of Israel uses derivatives in its monetary policy and foreign exchange activities, both in Israel and abroad.

Activity in financial instruments in Israel

Forward NIS/USD conversion transactions

These transactions are shown net in the balance sheet under "Other assets" or "Other liabilities": future receipt of US dollars less future remittance of NIS.

In the Statement of Operations, the results of the transactions are shown under "Interest income from assets in foreign currency abroad".

Activity in financial instruments abroad

1. Repurchase (Repo) Agreements and Reverse-Repurchase (R.Repo) Agreements

The Bank carries out repurchase (Repo) agreements. Such a transaction is composed of the sale of securities under an agreement to purchase them in the future. The transaction is treated as a secured debt and accordingly the securities sold under its terms are not subtracted from the Bank's assets. The liability to purchase the securities is included in the "Repurchase agreements" item. In the Statement of Operations, the results of these transactions are shown in the "Interest expense on liabilities in foreign currency abroad" item.

The Bank also carries out reverse repo (R. Repo) agreements. These transactions are treated as a secured debt, and are included in the "Reverse repurchase agreements" item. Securities purchased within the framework of these agreements do not appear in the balance sheet. In the Statement of Operations, the results of these transactions are shown in the "Interest income from assets in foreign currency abroad" item.

2. Foreign currency swaps and forwards

These transactions are included in the balance sheet in the sum of the differences between the foreign currency received and the foreign currency to be remitted in the future, and are shown in net form in the "Derivative financial instruments" item.

In the Statement of Operations the results of these transactions are included in the "Interest income from assets in foreign currency abroad" item.



3. Futures

The balance of futures contracts at face value on the date of the financial statements is shown in Note 18—"Contingent liabilities and commitments".

In the Statement of Operations, the change in the value of the contracts is recorded under "Other financial income from (expenses on) securities and derivative financial instruments".

r. Offsetting financial balances

Financial assets and liabilities are presented in the balance sheet in net amount only when the Bank has a legal and enforceable offsetting right, and when it is intended to settle the asset or liability on a net basis or to realize the asset and settle the liability simultaneously.

s. Impairment of assets

The Bank applies Accounting Standard No. 15 (Amended)—Impairment of Assets (hereinafter: the Standard), which establishes procedures that the Bank must apply to ensure that its assets in the balance sheet (to which the Standard applies) are not stated in an amount greater than the recoverable amount, i.e., the net sale price or value in use (the present value of the estimated future cash flows expected to derive from the use and realization of the asset), whichever is higher.

The Standard applies to all balance sheet assets, except for financial assets. The Standard also lays down presentation and disclosure rules for assets that have been impaired. Where the value of an asset in the balance sheet exceeds its recoverable amount, the Bank recognizes an impairment loss in the amount of the difference between the asset's book value and its recoverable amount. A loss recognized in this manner is annulled only if changes occur in the estimates that were used to determine the recoverable amount of the asset from the date on which the last loss from impairment was recognized.

t. Cash-flow statements

These financial statements do not include cash-flow statements because such statements provide no significant information beyond that appearing in the financial statements; this practice corresponds with the general practice among central banks world wide.

u. Taxes

According to the Bank of Israel Law, 5770-2010, regarding the payment of taxes, municipal taxes, levies and other mandatory payments, the Bank is synonymous with the State of Israel, and therefore exempt from paying certain taxes such as income tax and capital gains tax.

2. Foreign currency assets and liabilities abroad

Foreign exchange reserves

As presented in the explanatory remarks, the economic analysis refers to foreign exchange reserves which consist of the balance of the "Foreign currency assets abroad" item less the balance in the "Foreign currency liabilities abroad" item. The Bank's investment policy relates to these balances.

Following is the composition of the foreign exchange reserves:

	December 31		December 31	
	2011	2010	2011	2010
	(NIS million)		(USD million)	
Foreign currency assets abroad	286,981	252,553	75,106	71,161
Less Foreign currency liabilities abroad	(884)	(882)	(231)	(248)
Total foreign exchange reserves	286,097	251,671	74,875	70,913

3. International Monetary Fund (IMF)

	December 31		December 31	
	2011	2010	2011	2010
	(NIS million)		(SDR million)	
IMF quota	6,225	5,089	1,061	928
Less liability for the quota	(4,315)	(3,953)	(735)	(721)
Reserve tranche^a	1,910	1,136	326	207
NAB loan	202	-	34	-
Special Drawing Rights (SDRs)	4,852	4,714	827	860
Total balance with IMF	6,964	5,850	1,187	1,067

^a The surplus of the reserve tranche over the basic sum of SDR 33 million bears interest at a rate set by the IMF from time to time. The annual rate of interest on December 31, 2011 was 0.11 percent (on December 31, 2010, 0.31 percent).

a. Bank of Israel participation in the IMF

Each member country of the International Monetary Fund has a quota for its participation in the Fund's capital which is denominated in the SDR currency. The quota is determined according to the country's economic indicators (national income, exports, balance of payments, and level of reserves) and it also determines the country's voting rights. The



part of the quota that is paid in cash (the Reserve tranche) is transferred to the Fund in foreign currency and may be withdrawn by the country, whereas the rest is deposited with the country's central bank in deposits and notes indexed to SDR.

In 2011 a reform was executed in the quotas and in the IMF's voting rights. In the first stage, which came into effect in March 2011, Israel's quota was increased by about SDR 133 million. At the end of the process the quota is expected to reach SDR 1,921 million

Since 1999, Israel has been part of IMF's Financial Transaction Plan. This plan is a mechanism through which an IMF member country may exchange SDR or foreign currency against its local currency, and another country is asked to perform a counter exchange. These exchanges can affect the composition of the quota (between the Reserve tranche and the notes and deposits), and liabilities on account of the quota, but they do not affect the level of the quota.

In 2010 Israel joined the IMF's arrangement known as NAB (New Arrangements to Borrow), the aim of which is to increase, when necessary, the IMF's resources for assistance. This is an arrangement by which countries provide a credit line to the IMF, thus expressing readiness to lend to the IMF at times of need, so that it can provide credit to countries experiencing a crisis.

In accordance with this arrangement, Bank of Israel provides a credit line in the amount of SDR 500 million that can be used by the IMF at times of need. In the event of any action being taken in the framework of this arrangement, the funds will be transferred from the foreign exchange reserves of Israel. The IMF will pay the SDR interest on this loan, which is for five years. On November 17, 2011 the IMF decided that the repayment period of new loans provided as from November 17, 2012 would be ten years. It was also decided that the repayment period of loans that had been provided between the beginning of 2011 and November 16, 2012 would be extended retroactively from five to ten years. The loan may be returned to Israel at an earlier date at its request, if it should need these funds. There was activity in this framework in 2011: the Bank of Israel transferred funds at the request of the IMF.

b. Special Drawing Rights (SDRs)

The balance includes SDRs allocated by the IMF to Israel. Against these allocations the Bank has a liability towards the IMF with no repayment date, which is shown in the liabilities side under the "International financial institutions" item.

Following the economic crisis, in 2009 the IMF decided to allocate to its members SDRs in the amount of USD 250 billion to support their foreign currency balances. In this context, in August and September 2009, the IMF made two SDR allocations, in which SDR 777 million was provided to Israel. In all, the IMF has granted Israel SDR 884 million to date. (See Note 12.)

At the end of 2009, Israel joined another IMF plan, "Voluntary arrangement for the purchase and sale of SDRs". Within the framework of this plan, Israel may be asked to sell or buy some SDRs from other IMF members, as instructed by the Fund. The total amount of these transactions may range from 50 percent to 145 percent of the accumulated allocation balance of the SDRs granted to Israel to date. The purchase or sale of SDRs according to this plan affect the balance of the SDRs held by the Bank of Israel, but not the balance of the Reserve tranche.

4. Credit to the government

a. Binational funds

Credit on account of binational funds was given to the government of Israel for investment in conjunction with the United States government in binational funds involved for research, industrial development, and science. The funds deposited these amounts with the Bank of Israel and they are shown in the balance sheet as liabilities under the "Other liabilities" item. Part of the funds' credit and deposits earn fixed interest of 4 percent to 4.125 percent and the other part earns interest on the basis of LIBOR.

b. Long-term advances

The balance of long-term advances was zero as at December 31, 2011 and December 31, 2010.

In March 2010, an agreement was signed with the government regarding the restructuring of the debt with an option for early repayment, thus ending the disagreements between the Bank and the government regarding these amounts.

In accordance with the agreement, the debt was calculated for purposes of the restructuring, and Bank of Israel agreed to lower the interest rate and extend the repayment period. In addition, in accordance with the new conditions, the government was granted an early repayment option at amounts discounted to the date of payment. The government took advantage of the option and repaid the debt of NIS 394 million early, on March 9, 2010. The difference between the balance of the debt before signing the agreement and the amount of the early repayment was recognized in the Statement of Operations in previous years. (See Note 20.)

5. Tradable local currency securities

This item consists of tradable government securities indexed to the last CPI known on the balance sheet date, as well as unindexed securities. The securities are shown at fair value.

The yield to maturity on the securities portfolio at December 31, 2011 is 2.58 percent (December 31, 2010—2.85 percent).



6. Other assets

	December 31	
	2011	2010
	(NIS millions)	
Loans to employees	139	162
Sundry receivables	2	6
Total other assets	141	168

7. International financial institutions

	December 31	
	2011	2010
	(NIS million)	
Investment in BIS shares	282	282
Balance related to other international financial institutions ^{a,b}	641	644
Total	923	926

^a As follows:

- i) The World Bank Group
 - 1. IBRD—The International Bank for Reconstruction and Development
 - 2. IDA—The International Development Agency
 - 3. MIGA—The Multilateral Investment Guarantee Agency
 - 4. IFC—The International Finance Corporation
- ii) EBRD—The European Bank for reconstruction and Development
- iii) IDB—The Inter-American Development Bank
 - IIC—The Inter-American Investment Corporation

^b The methods for measuring and estimating the cost of investments and the investment estimates in reported values were changed in 2011 and 2010. The effect of the change amounted to an expense of NIS 3 million in 2011 and to income of NIS 90 million in 2010.

In 2011 Israel made a commitment to the ninth general capital increase of the Inter-American Development Bank (IDB). In this framework, the Bank of Israel undertook to purchase 223 paid-in shares and 8,966 callable shares for amounts of USD 2 million and USD 108 million, respectively.

The proceedings required in IDB were not completed in 2011 and therefore the liabilities are included in the contingent liabilities note. (See Note 18.)

8. Fixed assets^a

	Land and buildings ^b	Equipment, furniture, computers, software, and vehicles	Total
	(NIS million)		
Cost			
Balance as of December 31, 2010	229	196	425
Additions	7	39	46
Disposals	-	(1)	(1)
Balance as of December 31, 2011	236	234	470
Accumulated depreciation			
Balance as of December 31, 2010	45	102	147
Additions	5	23	28
Disposals	-	(1)	(1)
Balance as of December 31, 2011	50	124	174
Net book balance as of December 31, 2011	186	110	296
Net book balance as of December 31, 2010	184	94	278

^a A numismatic collection is kept at the Bank of Israel, which includes banknotes and coins issued in Israel from ancient times until today, along with various other items. According to an expert appraisal in November 2005, the value of the ancient coin collection is USD 1.7 million (the rest of the collection has yet to be appraised). The "Fixed assets" item does not include this collection.

^b The land of the Bank's premises in Jerusalem, with a depreciated cost of structures thereon amounting to NIS 173 million as of December 31, 2011 (NIS 174 million as of December 31, 2010), is leased from the Israel Land Administration through June 30, 2016. The Bank holds an option to extend the lease for another 49 years.

9. Banknotes and coins in circulation

	December 31, 2011		December 31, 2010	
	Quantity	NIS	Quantity	NIS
	(million)		(million)	
Banknotes in circulation				
NIS 20	34	683	35	709
NIS 50	46	2,288	48	2,397
NIS 100	141	14,090	145	14,486
NIS 200	152	30,356	129	25,773
Coins in circulation		1,556		1,461
Other ^a		2		2
Total		48,975		44,828

^a Consisting mainly of old banknotes that can be exchanged in the Bank of Israel.





On December 31, 2010 the legal date passed for exchanging Series A NIS banknotes and coins of a value of 5 agorot. On the same day the Bank recognized income in the amount of the face value of the Series A NIS banknotes and coins of a value of 5 agorot that are held by the public and were not exchanged in an amount of NIS 220 million. (See Note 28.)

10. Government deposits

Government balances comprise balances in local currency and balances in foreign currency.

All the government local currency balances in the Bank of Israel (excluding several extraordinary balances) can be offset against each other. The parties have no intention of offsetting the government's local currency balances with its foreign currency balances, and these balances are therefore stated separately.

	December 31		December 31	
	2011	2010	2011	2010
	(NIS million)		(USD million)	
Foreign currency^a				
Current deposits	959	307	251	87
Other foreign currency deposit	1,049	921	275	259
Total foreign currency deposits	2,008	1,228	526	346
Local currency^b				
Current deposits	10,568	12,979		
Total government deposits	12,576	14,207		

^a **Government foreign currency deposits**

The current deposits are used for financing budgetary activity. Some foreign currency government deposits bear interest at the rate paid on US Treasury bills with an average of six months to maturity. The rate of interest on December 31, 2011 was 0.061 percent (on December 31, 2010, 0.19 percent).

^b **Government local currency deposits**

The current deposits and the balances used for bond lending are designated for financing budgetary activity. Local currency current deposits, other than the government balances used for bond lending, bear (when in debit) or are paid (when in credit) interest at the prime rate. The average prime rate in 2011 was 4.38 percent (in 2010, 3.1 percent).

Government balances used for bond lending are paid interest at the Bank of Israel interest rate. The average interest rate on such balances in 2011 was 2.88 percent (in 2010, 1.6 percent).

11. Deposits of banking corporations

	December 31		December 31	
	2011	2010	2011	2010
	(NIS million)		(USD million)	
Foreign currency deposits^a				
Demand deposits	2,410	1,541	631	434
Local currency deposits^b				
Time deposits	106,024	78,374		
Demand deposits	23,414	21,483		
Total local currency deposits	129,438	99,857		
Total deposits of banking corporations	131,848	101,398		

^a Foreign currency deposits

Foreign currency demand deposits (called Pamach) serve as a liquid asset against nonresidents' foreign currency deposits. The reserve requirement ranges from 0 percent to 6 percent, depending on the term of the deposit.

^b Local currency deposits

1. The Bank of Israel receives local currency time deposits from the banks. The deposits are allocated by auction for terms of one day or one week. The deposits are not considered liquid assets with regard to the banking corporations' reserve requirements. In addition, deposits are received at the (overnight) deposit window available to the banking corporations at an interest rate of 0.5 percentage points under the Bank of Israel interest rate (until November 24, 2010 it was 0.25 percentage points under the Bank of Israel interest rate).

The interest rate for deposits at the window on December 31, 2011 was 2.25 percent (on December 31, 2010, 1.5 percent).

The average interest rate for deposits at the window in 2011 was 2.54 percent (in 2010, 1.4 percent).

The average interest rate for time deposits by auction on December 31, 2011 was 2.75 percent (on December 31, 2010, 1.99 percent).

The average interest rate for time deposits by auction in 2011 was 2.93 percent (in 2010, 1.59 percent).

2. The banking corporations' local currency demand deposits serve as a liquid asset against residents' local currency deposits. The reserve requirements ranges from 0 percent to 6 percent, depending on the term of the deposit.

12. International financial institutions

	December 31		December 31	
	2011	2010	2011	2010
	(NIS million)		(SDR million)	
Special Drawing Rights allocated ^a	5,184	4,846	884	884
Liabilities to international financial institutions ^b	6	44	1	8
Total	5,190	4,890	885	892

^a Special Drawing Rights (SDRs) are sums that member states in the International Monetary Fund (IMF) undertook to purchase from the Fund. No repayment date has been set for this liability. The IMF allocates SDR to its constituent states commensurate with the size of their quotas. In 2009 the IMF made two allocations to Israel, totaling SDR 777 million. (see Note 3.) Israel's allocation so far is SDR 884 million.

^b Liabilities in notes, deposits or letters of guarantee to the following institutions: IDA, IBRD, EBRD, MIGA and IDB. (see Note 1.h.)





13. *Makam*

	December 31	
	2011	2010
	(NIS million)	
Redemption value of <i>makam</i> sold to the public	123,418	136,418
Less discount at time of sale to public	(3,579)	(2,975)
Proceeds of sale of <i>makam</i> to the public	119,839	133,443
Plus reduction in discount for period to balance sheet date	1,693	1,466
Total balance of <i>makam</i>	121,532	134,909

The Short-Term Loan Law, 5744-1984, authorizes the government to issue short-term bills (called *makam*, their Hebrew acronym) to be sold only to the Bank of Israel, with the Bank selling them to, and buying them from, the public in order to regulate the money supply and carry out its functions. The government must deposit all proceeds from sales of these bills with the Bank of Israel and may not use them for any purpose other than repayment of the loan taken under said Law, or payment of the yield on it. The purchase of bills from the government by the Bank of Israel and the deposit of the proceeds of this sale with the Bank of Israel are not reflected in the Bank's balance sheet.

The balance of *makam* shown in the balance sheet reflects the redemption value of bills held by the public, less the balance of the unamortized discount.

14. Other liabilities

	December 31	
	2011	2010
	(NIS million)	
Pension and severance pay liabilities	3,897	3,771
Other liabilities on employees' rights	136	116
Binational funds	126	117
Accounts payable ^a	956	352
Total other liabilities	5,115	4,356

^a The balance mainly comprises accounts of statutory bodies that are managed in Bank of Israel.

a. Pension and severance pay liabilities

Pension liability is calculated according to the pension agreements with the Bank's employees and pensioners who commenced their employment before September 2002 and their survivors (on December 31, 2011—341 employees and 673 retirees; on December 31, 2010—368 employees, and 663 retirees). The pension liability includes future payment of benefits for Bank employees, former Bank employees whose pensions have been frozen, retirees, and survivors. It also includes obligations on account of the cash value of unused sick leave upon retirement and retirement grants.

The Bank's liability is calculated on the basis of salary and pension data for December 2011 and actuarial calculations. The calculation was performed using a method of estimating benefits which are accrued under various parameters: early retirement rates, pension rates for surviving spouses and orphans, employees' seniority and grade, relevant tax rates, etc.

The actuarial calculation is based on foreseen changes in white-collar mortality rates, in accordance with the Pension Fund Directives published by the Capital Market, Insurance, and Savings Division of the Ministry of Finance on May 17, 2007.

The Bank's actuarial liability was calculated on the basis of a 4 percent discount rate, in accordance with the public reporting directives of the Supervisor of Banks and based on past experience. The calculation assumes a real annual wage increase of up to 1.5 percent.

For Bank employees who commenced their employment after September 2002, the Bank's liability for pension and severance pay is covered by regular deposits with a recognized pension and severance-pay fund on behalf of the individual employee. Since sums deposited in said manner are neither controlled nor managed by the Bank, neither they nor the liabilities against which they were deposited are reflected in the balance sheet.

b. Liability for employees' and other rights

This item consists mainly of an NIS 96 million liability for employees' vacation (in 2010—NIS 92 million.)

The liability at December 31 is calculated on the basis of the accrued vacation days due at October 31 and the effective salary for vacation redemption at the balance sheet date. The difference in the liability that derives from the accrual of vacation days between October 31 and December 31 is immaterial.



15. Revaluation accounts

Revaluation accounts include unrealized profits from the revaluation of the following items (see Notes 1.g, 1.m, and 1.n):

	December 31	
	2011	2010
	(NIS million)	
Foreign currency balances	16,938	317
Tradable foreign currency securities	998	742
Tradable local currency securities	1,377	1,145
Total revaluation accounts	19,313	2,204

16. Share capital and general reserves in historical nominal values

Data on the Bank's share capital and general reserve appear in the financial statements in reported values. (See Note 1.c.). The amount in historical nominal values is NIS 320 million at December 31, 2011 and 2010.

The general reserve served in the past to increase the Bank's capital in accordance with Section 6 of the Bank of Israel Law, 5714-1954.

17. Assets and liabilities according to indexation bases

	December 31, 2011				December 31, 2010			
	In local currency	In foreign currency ^a	Nonfinancial items	Total	In local currency	In foreign currency ^a	Nonfinancial items	Total
	(NIS million)				(NIS million)			
Assets								
Foreign-currency assets abroad	-	286,981	-	286,981	-	252,553	-	252,553
Credit to the government	-	126	-	126	-	117	-	117
Tradable securities in local currency	19,595	-	-	19,595	19,672	-	-	19,672
Other assets	141	-	-	141	168	-	-	168
International financial institutions	-	-	923	923	-	-	926	926
Fixed assets	-	-	296	296	-	-	278	278
Total assets	19,736	287,107	1,219	308,062	19,840	252,670	1,204	273,714
Liabilities								
Banknotes and coins in circulation	48,975	-	-	48,975	44,828	-	-	44,828
Foreign currency liabilities abroad	-	884	-	884	-	882	-	882
Government deposits	10,568	2,008	-	12,576	12,979	1,228	-	14,207
Deposits of banking corporations	129,438	2,410	-	131,848	99,857	1,541	-	101,398
International financial institutions	-	5,190	-	5,190	-	4,890	-	4,890
<i>Makam</i>	121,532	-	-	121,532	134,909	-	-	134,909
Other liabilities	4,989	126	-	5,115	4,239	117	-	4,356
Revaluation accounts	1,377	17,936	-	19,313	1,145	1,059	-	2,204
Total liabilities	316,879	28,554	-	345,433	297,957	9,717	-	307,674
Difference	(297,143)	258,553	1,219	(37,371)	(278,117)	242,953	1,204	(33,960)

^a Including foreign currency indexed.





18. Contingent liabilities^a and commitments

	31 December	
	2011	2010
	(NIS million)	
Off-balance-sheet financial instruments		
Guarantees for government exports	51	233
Documentary credit	125	-
Liabilities to pay international financial institutions on demand	3,214	3,024
Liabilities to pay International Monetary Fund on demand ^b	2,734	2,741
Liabilities to purchase shares from international financial institutions ^c	420	-
Commitments in respect of financial instruments		
Currency swaps and forward transactions		
Future receipts of foreign currency	28,851	21,620
Future payments of foreign currency	27,894	22,478
Repurchase Agreements (Repo) and Reverse Repurchase Agreements (R.Repo)		
R.Repo	15,792	1,784
Futures transactions on bonds—in face value terms		
Sales commitments	-	320

^a Several claims are pending against the Bank of Israel. However, it is the Bank's opinion, based on the opinion of the Bank's Legal Department, that the probability of these claims being upheld is low, or that the sums involved are not significant.

^b See Note 3.a.

^c See Note 7.

19. Interest income from financial assets in foreign currency abroad

	For the year ended December 31	
	2011	2010
	(NIS million)	
Demand deposits	3	4
Short-term deposits	46	33
Tradable securities	2,662	2,900
Securities purchased under R.Repo agreements	20	21
Derivative financial instruments, net	31	(15)
IMF	25	16
Total interest income from assets in foreign currency abroad	2,787	2,959

Interest income from (expense on) foreign exchange reserves

The following shows the composition of interest income from (expense on) foreign exchange reserves. (see Notes 2 and 22.)

	For the year ended December 31	
	2011	2010
	(NIS million)	
Interest income from foreign currency assets abroad	2,787	2,959
Less interest expense on foreign currency liabilities abroad	(9)	(4)
Total income from foreign exchange reserves	2,778	2,955

20. Interest income from the government

	For the year ended December 31	
	2011	2010
	(NIS million)	
Long-term unindexed advances ^a	-	2
From binational funds	74	72
From local currency securities	702	948
Total	776	1,022

^a See Note 4.

21. Other interest income

This item consists of interest income from banks in respect of balances carrying the Bank of Israel interest rate.

22. Interest expense on financial liabilities in foreign currency abroad

This item consists of interest expense in respect of securities sold within the framework of repurchase agreements. (see Note 19.)



23. Interest expense to banks and the public

	For the year ended December 31	
	2011	2010
	(NIS million)	
<i>Makam</i>	3,275	2,234
Time deposits	2,922	1,266
Total	6,197	3,500

24. Interest expense to the government

	For the year ended December 31	
	2011	2010
	(NIS million)	
On account of local currency balances ^a	624	318
On account of foreign currency balances	1	10
Total	625	328

^a The expense of local currency interest paid to the government includes interest expense on government balances for financing the budget.

25. Other interest expense

This item consists mainly of interest expense to international financial institutions, on deposits of the US-Israel Binational Industrial Research and Development Foundation, on deposit of the US-Israel Binational Science Foundation, and expenses with respect to the National Insurance Institute and the Postal Bank.

26. Other financial income from (expense on) securities and derivatives

	For the year ended December 31	
	2011	2010
	(NIS million)	
Securities In foreign currency ^a	319	36
Derivative financial instruments in foreign currency ^b	(64)	(105)
Total	255	(69)

^a Gain from the sale of securities and loss from reduction in their value at the end of the year, net.
^b Including financial income from (expense on) the realization of derivative financial instruments.

27. Other financial income from (expense on) exchange rate differentials

This item consists of realized exchange rate differentials on account of balances denominated in foreign currency. (see Notes 1.m and 1.n.)

28. Other financial income (expense)—miscellaneous

	For the year ended December 31	
	2011	2010
	(NIS million)	
In local currency ^a	4	223
In foreign currency	(17)	(12)
Total^b	(13)	211

^a In 2010 the amount included income in an amount of NIS 220 million in respect of Series A NIS banknotes and coins of a value of 5 agorot that are held by the public and were not exchanged. (See Note 9.)
^b The other income (expenses) is from fees from the Bank of Israel's financial activities.



29. Administrative and general expenses

	For the year ended December 31	
	2011	2010
	(NIS million)	
Staff wages and employees' rights ^a	275	268
Pension and retirement ^b	341	182
General expenses ^c	90	78
Total	706	528

^a Salaries and provision for employees' vacation (683 employee posts on December 31, 2011 and 708 employee posts on December 31, 2010).

^b Unfunded (non-contributory) pension payments to pensioners and an update of the Bank's liability for pension and retirement payments (total balance, after the update, was NIS 3,897 million at balance sheet date. See Note 14.)

^c The item comprises, inter alia, expenses relating to the professional services of the Bank's external auditors. The auditor's fees from auditing the financial statements for 2010 constitute 62% of the auditor's total fees from the Bank in 2011.

30. Other income

This item consists of dividend income and the effect of changing the method for measuring the cost of investments in reported values in international financial institutions and the resulting change in estimates. (See footnote 2 in Note 7.)

EXPLANATORY REMARKS TO THE 2011 FINANCIAL STATEMENTS

1. The Principal Changes in the Financial Statements

1.1 The Bank of Israel's balance sheet

The Bank of Israel's balance sheet totaled NIS 308 billion at the end of 2011 as against NIS 274 billion at the end of 2010—an increase of about NIS 34 billion (12.5 percent).

1.1.1 Assets side

On the Assets side, this increase can be attributed mainly to an increase in the Bank's foreign currency financial assets abroad—from an amount of NIS 253 billion at the end of 2010 to NIS 287 billion at the end of 2011. The foreign exchange reserves¹ increased from \$71 billion at the end of 2010 to \$75 billion at the end of 2011 (an increase of about 6 percent).

In the first half of 2011, the Bank of Israel continued to operate in the foreign currency market to restrain the appreciation pressures on the shekel, which were created upon the widening of the difference in interest rates compared to developed countries and the drawing of short-term capital into the economy. In 2011 the Bank purchased about \$4.6 billion, less than in 2010, in which it purchased about \$11.9 billion. The purchases of foreign currency stopped in the second half of 2011 upon the transition to devaluation of the exchange rate.

The lower activity in the developed countries, which are the principal target markets of Israeli exports, together with the appreciation pressures on the shekel, have had a negative effect on exports, and therefore were the main reasons that caused the Bank to purchase foreign currency in the first half of 2011; the reason being that the purchases have an expanding effect on economic activity through their effect on the exchange rate. At the same time, in January of 2011 the Bank imposed on the banking institutions a 10 percent reserve requirement with respect to transactions in foreign currency derivatives of foreign residents, and a reporting requirement with respect to certain transactions. The decrease in capital movements that is caused by imposing a reserve requirement reduces the demand for local currency, and therefore makes it possible to purchase

¹ In these explanatory remarks, the term "foreign exchange reserves" is used in its economic sense. The reserves are composed of the balance of "Foreign currency assets abroad" on the assets side of the Bank's balance sheet, less the balance of "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 its reporting to various entities and they therefore constitute the basis for the analysis of trends in these explanatory remarks.





less foreign currency and provides more freedom in managing the interest policy. The Bank's policy since August 2009 is to intervene in the foreign currency market when there are irregular fluctuations in the exchange rate that do not correspond with the basic economic conditions of the economy.

1.1.2 Liabilities and Equity side

On the Liabilities and Equity side, the increase can be attributed mainly to a mixed effect of changes, the principal ones being as follows: on the one hand there was an increase of NIS 15 billion in monetary absorption instruments—*makam* and time deposits; an increase of NIS 4 billion in banknotes and coins in circulation; and an increase of NIS 17 billion in revaluation accounts; whereas on the other hand, there was a decrease of NIS 3 billion in the Bank's equity, which is a result of the loss for the year.

The purchase of foreign currency injected liquidity into the economy above the required increase in the monetary base², and the Bank absorbed these surpluses with the use of monetary instruments—by expanding the time deposits that it held for the commercial banks and reducing the issue of *makam* to the public, so that the balance of *makam* decreased at the end of 2011. The aggregate of monetary instruments³ at the end of 2011 continued to comprise liabilities only and amounted to NIS 228 billion, compared with NIS 213 billion at the end of 2010, an increase of 7 percent.

The increase in the monetary base, which is comprised of banknotes and coins in circulation, together with the banks' local currency current deposits with the Bank, is largely the outcome of the expansion in economic activity, and it continues the trend of recent years.

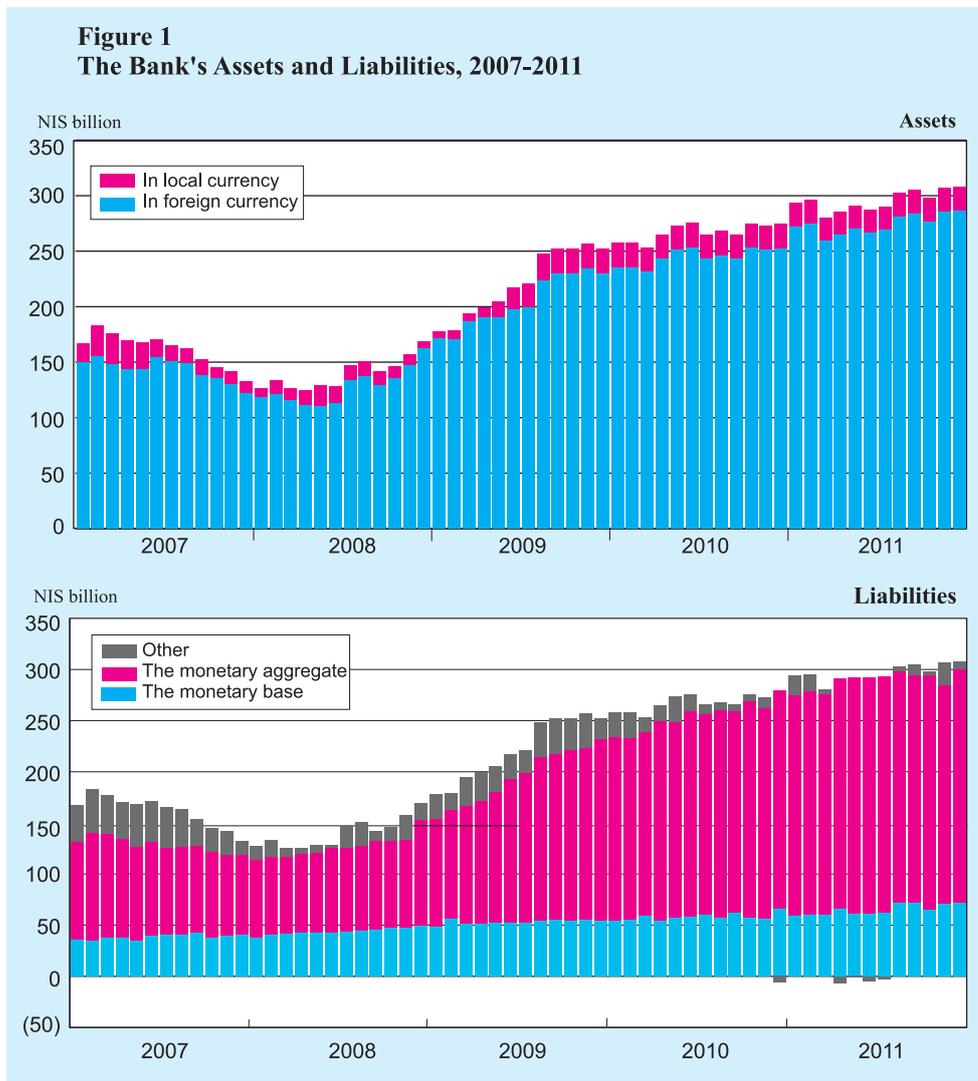
These changes in the Bank's balance sheet led to an increase in surplus assets over liabilities in foreign currency—from NIS 243 billion at the end of 2010 to NIS 259 billion at the end of 2011. Conversely, the surplus of liabilities over assets in local currency grew from NIS 278 billion at the end of 2010 to NIS 297 billion at the end of 2011. (See Note 17 to the Financial Statements.)

In 2011, similar to recent years, the changes caused an increase in the currency asymmetry in the composition of Bank of Israel's assets and liabilities. The currency asymmetry has been a feature of the Bank's balance sheet for more than ten years, since most of the Bank's assets are denominated in foreign currency, whereas its liabilities are primarily in shekels. The asymmetry exposes the Bank to fluctuations in its reported financial results as a result of changes in the exchange rates of the shekel in relation to

² The monetary base is composed of banknotes and coins in circulation and of the NIS-denominated current deposits of the banks with Bank of Israel.

³ The monetary aggregate includes the balance of *makam* and time deposits in local currency less monetary loans and repo auctions. The balances of monetary loans and of repo auctions were zero at the end of 2011 and 2010.

foreign currencies, and to changes in Israel's interest trajectory relative to those of other economies (Figure 1)⁴.



1.2 Statement of Operations

In the Statement of Operations, the Bank recorded a loss of NIS 3 billion in 2011, compared with a loss of NIS 18 billion in 2010. The loss in 2011 is attributed principally to an increase in the Bank's interest expenses, and particularly interest expenses to the

⁴ This currency asymmetry first began to manifest itself during the years 1995-1997, when the Bank adopted a contractionary monetary policy in order to attain 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 keep the exchange rate at the lower limit of the crawling band and to re-absorb the local currency that was injected into the economy for this purpose. The foreign exchange reserves grew from an average of several billion US dollars in previous decades to \$75 billion at the end of 2011. At the same time, the balance of monetary instruments, which until 1994 was composed mainly of monetary loans, as accepted by central banks world wide, has since then been composed of liabilities.





banks and the public; these increased from NIS 3.5 billion in 2010 to NIS 6.2 billion in 2011. The loss in 2010 is attributed principally to exchange rate differential expenses in the amount of NIS 17.6 billion. (In 2011 the Bank recorded income from exchange rate differentials in the amount of NIS 0.5 billion.)

1.2.1 Net interest expenses

Net interest expenses amounted to NIS 3.4 billion this year, compared with net interest income of NIS 27 million in 2010.

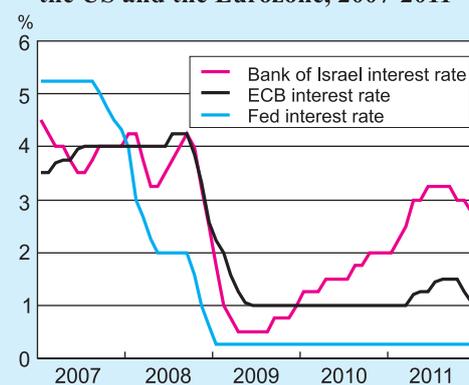
Interest income from foreign currency abroad amounted to NIS 2.8 billion this year, compared with NIS 3 billion in 2010. The decrease in interest income, notwithstanding the increase in the foreign exchange reserves, is principally due to holding assets having a relatively short duration, which bear low interest, in an interest environment that in the last year reached a historical low.

Interest income from the government was NIS 776 million this year, compared with NIS 1,022 million in 2010. The main reason for the decrease in 2011 is that income from linkage differentials on securities in local currency that were redeemed was lower in 2011 than in the previous year.

The interest expenses to banks and the public, which are the interest expenses on the monetary aggregate⁵, amounted to NIS 6.2 billion this year, compared with NIS 3.5 billion in 2010. The increase in interest expenses, of approximately NIS 2.7 billion, is principally due to an increase in net netabsorption using monetary instruments—*makam* and time deposits—and to the expansion of the interest gap between the shekel interest rate and interest rates abroad, as a result of the interest rates in the developed countries remaining at the low levels they reached in 2009 and the accelerated increase in the interest of Bank of Israel in the first half of 2011 (Figure 2). Nevertheless, the economic expansion increased the demand for the monetary base, and its growth reduced the extent of required absorption and contributed to reducing the interest expenses.

Interest expenses to the government increased by about NIS 297 million, from NIS 328 million in 2010 to NIS 625 million

Figure 2
Short-Term Interest Rates in Israel, the US and the Eurozone, 2007-2011



SOURCE: Bank of Israel, ECB and the Fed.

⁵ The monetary aggregate includes the balance of *makam* and time deposits in local currency less monetary loans and repo auctions.

in 2011. The increase in the interest expenses is mainly the result of an increase in the average balance of interest-bearing government accounts and an increase in the average interest rate in 2011.

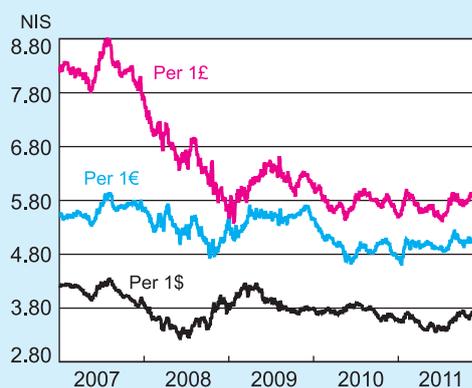
1.2.2 Other financial income

Other financial income in respect of securities and derivative financial instruments amounted to NIS 255 million in 2011, compared with expenses of NIS 69 million in 2010. The change is mainly due to an increase in capital gains from securities traded in foreign currency.

This year the Bank of Israel earned⁶ from foreign currency securities an amount of NIS 319 million, compared with NIS 36 million in 2010. (see Note 26 to the Financial Statements.) The increase in income compared with last year is attributed to an increase in foreign currency assets, but even more—to a decrease in the yields to maturity of government bonds in the large and strong developed countries such as the US and Germany, which served as a “safe haven” for investors around the world as the debt crisis in Europe increased. An economic review of the Bank’s capital gains requires adding the realized gains (losses) together with the change in the balance of the relevant item in the revaluation accounts (unrealized gains), a change that is not reflected in the statement of operations.

Other financial income in respect of exchange rate differential, amounted to NIS 17.1 billion in 2011, of which NIS 0.5 billion is income from realized exchange rate differentials that were recognized in the statement of operations, and the major part of NIS 16.6 billion is income from unrealized exchange rate differentials that were recognized in the balance sheet within the revaluation account. Conversely, in 2010, expenses from exchange rate differentials amounted to NIS 19.8 billion, the major part of which was realized exchange rate differentials of NIS 17.6 billion that were recognized in the statement of operations, and the rest was unrealized exchange rate differentials in the amount of NIS 2.2 billion that offset the revaluation account in the balance sheet.

Figure 3
The Exchange Rate of the NIS vis-a-vis the Dollar, Euro and Pound Sterling, 2007-2011



SOURCE: Bank of Israel

⁶ Gain from sale of securities and impairment loss on securities at year-end, net.



The income was affected by the change in exchange rates during the year (Figure 3): In 2011 the NIS was devalued by 7.7 percent against the dollar, compared with appreciation of 6 percent in 2010. The change in the exchange rate was not uniform throughout the year; in the first half of the year the dollar weakened by 3.8 percent against the NIS, whereas in the second half it strengthened by 11.9 percent. These trends mainly reflect the weakening of the dollar against the euro in the first half and a strengthening in the second half. A similar trend is evident in the exchange rates of other principal foreign currencies against the shekel—a strengthening of 7.3 percent in the pound sterling (compared with a weakening of 10.1 percent in 2010) and a strengthening of 4.2 percent in the euro (compared with a weakening of 12.9 percent in 2010).

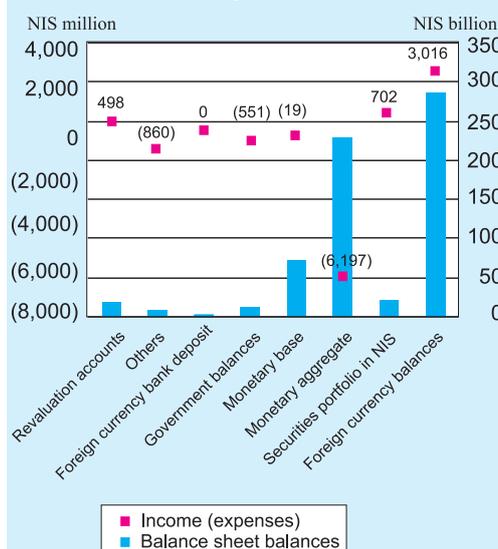
1.2.3 General and administrative expenses

The Bank's general and administrative expenses amounted to NIS 706 million in 2011, compared with NIS 528 million in 2010, an increase of NIS 178 million (about 34 percent). The increase is mainly due to adjustment of the actuarial liability for pension and retirement payments to employees and pensioners.

2. Analysis and Explanation of the Principal Changes in the Financial Statements

The Bank of Israel performs the responsibilities imposed on it, and acts to achieve the goals that were set for it by law in its capacity as a central bank. Therefore, its activity is not necessarily aimed at achieving profits. Some of the Bank's functions—including managing foreign exchange reserves, managing the monetary policy, acting as banker to the government, issuing currency and organizing the economy's cash system—have significant effects on the financial statements. Along with this, the Bank's achievement of its goals and fulfillment of its responsibilities have economic benefits for the economy in general, which are not necessarily reflected in the financial statements.

Figure 4
Aggregate Balance Sheet Balances,
and the Resulting Profit and Loss, 2011



SOURCE: Bank of Israel.

The Bank's financial statements are prepared in accordance with generally accepted accounting principles (GAAP), adapted for the special activity of a central bank, as adopted by other central banks. In order to understand the effect of the economic developments on the financial statements, presented hereunder is an analysis of the data in the financial statements, according to economic aggregates in line with the Bank's functions.

Table 1 and Figure 4 show the financial statements of the Bank in net amounts—that is, net balance sheet amounts and net operating results in the Statement of Operations according to the functions performed by the Bank, and according to its principal activities. They are presented differently than accepted in accounting, for the purpose of the economic analysis of the differences.

Table 1
Aggregate Balance Sheet Balances, and the Resulting Profit and Loss

	December 31		For year ended December 31	
	2011	2010	2011	2010
	Balances		Income (expenses)	
	(NIS million)			
Assets, net				
Foreign currency balances ^a	286,097	251,671	3,016	2,874
Securities portfolio in NIS	19,595	19,672	702	948
Total	305,692	271,343	3,718	3,822
Liabilities and equity, net				
Monetary aggregate ^b	227,556	213,283	(6,197)	(3,500)
Monetary base ^c	72,389	66,311	(19)	(45)
Government balances ^d	12,450	14,090	(551)	(254)
Deposits of banking corporations in foreign currency	2,410	1,541	-	-
Other ^e	8,945	7,874	(860)	(332)
Revaluation accounts ^f	19,313	2,204	498	(17,562)
Equity of the Bank	(37,371)	(33,960)	-	-
Total	305,692	271,343	(7,129)	(21,693)
Net loss			(3,411)	(17,871)

^a Consisting of the balance in the item "Foreign currency assets abroad" on the asset side of the Bank's balance sheet, minus the balance in the item "Foreign currency liabilities abroad" on the liabilities side of the balance sheet.

^b Consisting of the balance of *makam* and time deposits in local currency minus the monetary loans and repurchase auctions.

^c Consisting of banknotes and coins in circulation plus the banks' local currency demand deposits in the Bank of Israel. The expenses in respect of this item are mainly money printing expenses and income from the banks' local currency demand deposits.

^d Consisting of the government's foreign currency deposits plus the government's local currency deposits minus the balance of credit to the government.

^e The "other" balance consists of other balances in local currency plus the total of other assets (fixed assets and international financial institutions) minus other liabilities in local currency and other liabilities in foreign currency in respect of international financial institutions.

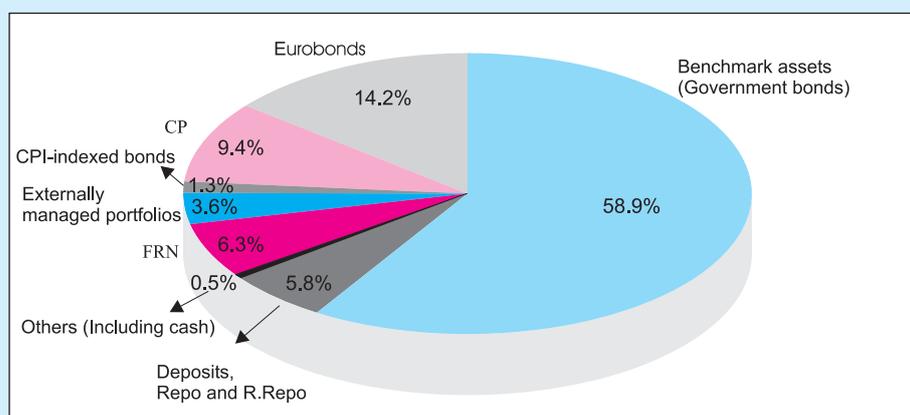
^f The profit (loss) on this item includes realized exchange rate differentials on foreign currency balances. (Realized capital gains are shown in the item to which they are related.)



2.1 Foreign exchange reserves

In accordance with the Bank of Israel Law, 5770-2010, one of the Bank's functions is to hold the country's foreign exchange reserves⁷ and manage them⁸. (see Figure 5—Asset Allocation of Foreign Exchange Reserves.) The Law specifies the financial actions the Bank is entitled to take in order to fulfill its responsibilities, including management of the reserves. According to the Law, the Monetary Committee, as advised by the Minister of Finance, will set the investment policy guidelines for the foreign exchange reserves. Managing the financial risk of the reserves according to its characteristics is at the heart of the investment policy. The principal financial risks are currency risk, price risk, credit risk, liquidity risk and quality of management risk.

Figure 5
Asset Allocation of Foreign Exchange Reserves, 2011
(Annual average)



SOURCE: Bank of Israel

Holding and managing foreign exchange reserves, according to that stated in the Bank of Israel Law, serve the goals of the Bank as provided in the Law and help it to fulfill its other responsibilities.

Foreign exchange reserves account for the largest part of the Bank's assets—about 93 percent of the Bank's total assets at the end of 2011, compared with 92 percent at the end of 2010 (Table 1). At the end of 2011 the foreign exchange reserves amounted

⁷ Foreign exchange reserves are composed of the balance of the "Foreign currency assets abroad" item in the Bank's balance sheet, less the balance of "Foreign currency liabilities abroad" item. These balances are used to determine the Bank's investment policy and its reporting to various entities, and therefore form the basis for the analysis of trends in these explanatory remarks.

⁸ Until the Bank of Israel Law, 5770-2010 came into effect on June 1, 2010 the reserves were managed in accordance with the Bank of Israel Law, 5714-1954 and the legal interpretation that was added to it over the years, and according to the investment policy established by the Bank's Governor.



gains in the amount of \$74 million, compared with a loss of \$758 million in 2010, and transfers of the private sector to the foreign exchange reserves in the amount of \$119 million, compared with withdrawals of \$199 million in 2010. This increase was offset by withdrawals of the government and national institutions in the amount of \$861 million, compared with \$650 million in 2010.

The global financial crisis led to a dramatic increase in credit risk in the international banking sector. Consequently, in September 2008 the Bank of Israel decided to discontinue making deposits in the international banking system and this directive remains in force to date. The balance of short-term deposits, which includes deposits in international financial institutions and deposits in central banks, was NIS 8.5 billion at the end of 2011, compared with NIS 20.4 billion at the end of 2010, a decrease of NIS 11.9 billion. (See "short-term deposits" item in the Bank's balance sheet.)

Table 2
Contribution by Sector to the Foreign Exchange Reserves

Year	Change in exchange reserves ^a	Private sector ^b	Bank of Israel	Government and National Institutions ^c
	(1)=(2)+(3)+(4)	(2)	(3)	(4)
	(NIS million)			
2002	489	(1,351)	2,040	(200)
2003	2,118	(1,204)	1,445	1,877
2004	844	(631)	993	482
2005	1,226	1,026	125	75
2006	1,197	25	1,845	(673)
2007	(596)	(196)	2,512	(2,912)
2008*	13,876	4,291	12,789	(3,204)
2009	18,099	(4,559)	22,866	(208)
2010	10,301	(199)	11,150	(650)
2011	3,962	119	4,704	(861)
I	3,612	4	4,009	(401)
II	2,888	21	2,939	(72)
III	(1,082)	69	(1,210)	59
IV	(1,456)	25	(1,034)	(447)

^a Includes the change in accrued interest on the foreign exchange reserves.

^b Includes income tax payments from the private sector in foreign currency.

^c Government and National Institutions transfers from abroad and Bank of Israel income from the foreign exchange reserves (income from interest, capital gains and cross-rate differentials between the USD and other currencies).

* Data according to value date. Other data in the table as at balance sheet date.

2.1.1 Rate of return on the foreign exchange reserves

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

The returns obtained on the investment of the foreign exchange reserves are judged against a benchmark return. 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 returns on the holding of assets included in the benchmark, in all currencies, are weighted according to the weights of the currencies in a currency basket (the numeraire).

The return on the foreign exchange reserves is measured in terms of a currency basket—the numeraire. The numeraire is a basket comprised of a number of currencies, which reflects the objectives of holding the reserves, and it serves as the basis for the currency distribution of the benchmark, against which the reserve portfolio is managed. The return on the reserve portfolio, in terms of any currency or basket, is not affected by changes in the amount of the reserves during the period, even if they originate externally to the reserves portfolio itself, for example withdrawals of the government or purchases of foreign currency by Bank of Israel. Calculating the return in this manner is in accordance with accepted practice in the investment management industry in Israel and the world, and its objective is to enable a meaningful comparison of returns on the reserves from year to year, against the returns on other managed portfolios, which is possible only when the return does not depend on changes in the size of the portfolio.

The actual annual rate of return on the reserve portfolio in terms of the numeraire was 1.27 percent in 2011, as against a return of 1.07 percent on the benchmark⁹ (Table 3). The difference between them of 0.20 percent is the surplus yield in the reserve portfolio, reflecting 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 restricted by a set of compliance 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, which is usually positive and amounted to 0.24 percent on average for the period 2002-2011. The low level of the benchmark yield in the last three years, which was 1.01 percent on average, compared with the previous years, is a result of

⁹ The return on the foreign exchange reserves in 2011 did not include the return originating in the foreign currency deposits of Israeli commercial banks. These deposits are managed separately from the rest of the reserves in order to offset the Bank of Israel's exposure to the currency and interest risks that result from the acceptance of these deposits.



the low levels the interest rates and yields to maturity reached on the markets in which the reserves were invested, as a result of the global financial crisis which became more severe in September 2008.

Since the reserve portfolio is a multi-currency portfolio, measuring returns in terms of a specific currency is somewhat arbitrary—for example when assessing returns in terms of dollars (0.19 percent this year) and in terms of euros (3.5 percent this year), and the high volatility of these returns over time (Table 3).

Table 3
The Foreign Exchange Reserves—Total Income, Exchange Rate Differentials and Yield

	2011	2010	2009
Total foreign exchange reserves		(\$ million)	
End of year	74,875	70,913	60,612
Annual average	75,744	64,665	51,310
Income and cross rate differentials		(NIS million)	
Interest and capital gains	3,016	2,874	5,230
Unrealized price differentials ^a	256	(157)	(1,533)
Cross rate differentials	17,644	(20,187)	454
Total	20,916	(17,470)	4,151
Income (expenses) and cross rate differentials—economic calculation:		(\$ million)	
Interest and capital gains	833	776	1,330
Unrealized price differentials ^a	52	(29)	(401)
Cross rate differentials	(776)	(1,495)	1,169
Total	109	(748)	2,098
Yields^b		(Percent)	
In NIS terms			
Interest and capital gains	1.20	1.16	1.8
Exchange rate differentials	6.65	(8.29)	1.8
Total	7.85	(7.13)	3.6
In Euro terms	3.5	6.66	0.8
In USD terms			
Interest and capital gains	1.20	1.16	1.80
Exchange rate differentials	(1.01)	(2.38)	2.50
Total	0.19	(1.22)	4.30
In terms of numeraire of foreign reserves	1.27	*1.73	1.91
Benchmark yield	1.07	*1.19	0.81

^a Unrealized price differentials express the annual change in the revaluation account of foreign currency tradable securities. (see Note 15 to the Financial Statements.)

^b Yields, which are shown at annual rates, are based on daily calculations, and relate to income from the foreign exchange reserves, including profit or loss resulting from market price changes.

* Recalculated due to the change in the currency basket.

In NIS terms, the rate of return in 2011 was positive at 7.85 percent (compared with a negative return of 7.13 percent in 2010), due to the positive contribution made by exchange rate differentials—a result of the NIS weakening against the numeraire currencies and particularly against the dollar, in which most of the reserves are invested.

2.2 Revaluation accounts

The revaluation accounts are composed of unrealized profits from exchange rate differentials on balances denominated in foreign currency and of unrealized profits from indexation differentials and revaluation of tradable securities in local and foreign currency to their fair value. The revaluation accounts are managed separately for each item (currency, security) and are recognized in the Statement of Operations when all or part of the item is realized. There is no offset between different types of items. The balance of the loss in the revaluation accounts, which derives from linkage differentials and price differences of securities in local and foreign currency and from exchange rate differentials on balances denominated in foreign currency, is recognized at the end of the year in the Statement of Operations.

The balance of the revaluation accounts increased by NIS 17.1 billion, from NIS 2.2 billion at the end of 2010 to NIS 19.3 billion at the end of 2011. This consists of an increase of NIS 16.6 billion in the revaluation account for balances denominated in foreign currency, an increase of NIS 0.3 billion in the revaluation account for tradable foreign currency securities and an increase of NIS 0.2 billion in the balance of the revaluation account for tradable local currency securities. (See Note 15 to the Financial Statements.)

2.2.1 Revaluation account for balances denominated in foreign currency

According to the accounting method used in the Bank's financial statements, exchange rate differentials on balance sheet balances are not fully charged to the Statement of Operations unless they are realized. Realization for a particular foreign currency is recognized only when the balance held in that currency declines.

Unrealized exchange rate differentials are charged to the Revaluation Accounts item in the balance sheet. Future losses from a particular currency are first offset against the revaluation account for that currency, if such an account exists, and only if there is a negative balance in the revaluation account of a particular currency at the end of the year, will it be charged to the Statement of Operations. Losses that were recognized in the Statement of Operations are not offset from future unrealized profits.



In 2011 exchange rate differentials amounted to NIS 17.1 billion on account of adjusting the balances denominated in foreign currency to the representative exchange rate—most of the exchange rate differentials in the amount of NIS 17.6 billion were accrued on the foreign exchange reserves, and they were offset somewhat by losses from exchange rate differentials in the amount of NIS 0.6 billion that accrued on balances of international financial institutions, deposits of the government and foreign currency deposits of the banking corporations. Of the amount of NIS 17.1 billion that was recorded in 2011 from exchange rate differentials, about NIS 0.5 billion was recorded as income from realized exchange rate differentials in the Statement of Operations, and about NIS 16.6 billion was recognized in the revaluation accounts in the balance sheet as unrealized exchange rate differentials (Table 4).

Table 4
Exchange Rate Differentials Due To Adjustment of Foreign Currency Balances to the Representative Exchange Rate

	2011	2010
	(NIS million)	
Assets		
Foreign exchange reserves	17,644	(20,187)
Credit to the government—binational funds	9	(7)
The International financial institutions	114	(81)
Liabilities		
Government deposits	(204)	35
Banks' foreign currency deposits	(96)	71
The International financial institutions	(339)	387
Binational fund deposits	(9)	7
Total	17,119	(19,775)
Realized exchange rate differentials	498	(17,562)
Unrealized exchange rate differentials	16,621	(2,213)

Conversely, in 2010 there were negative foreign exchange differentials in the amount of NIS 19.8 billion on account of adjusting the balances denominated in foreign currency to the representative exchange rate—of which most, in the amount of NIS 20.2 million, accrued on the foreign exchange reserves, and were offset by profits from exchange rate differentials in the amount of NIS 0.5 billion that accrued on balances of international financial institutions, deposits of the government and foreign currency deposits of the banking corporations. Of the amount of NIS 19.8 billion that was recorded in 2010 from negative exchange rate differentials, about NIS 17.6 billion was recorded as expenses

from realized exchange rate differentials in the Statement of Operations, and about NIS 2.2 billion reduced the revaluation accounts in the balance sheet (Table 4).

The profits from the exchange rate differentials in 2011 are due to the strengthening against the shekel of the USD, the euro and other currencies in which the balances are held during the year. The reasons for this year's devaluation were, inter alia, a decrease in exports and a deterioration in the current account, political instability in the Middle East, strengthening of the dollar in the world, imposing a liquidity requirement on transactions of foreign residents in foreign currency derivatives, cancelling the exemption from capital gains tax of foreign residents, and towards the end of the year—also the lowering of the interest rate.

2.2.2 Revaluation account for tradable foreign currency securities

The balance of the revaluation account for tradable foreign currency securities amounted to NIS 1 billion in 2011, compared with NIS 0.7 billion in 2010. The increase is mainly attributed to a decrease in the yields-to-maturity of government bonds in the large and strong developed countries, such as the US and Germany, which is reflected in an increase in the prices of these bonds.

2.2.3 Revaluation account for tradable local currency securities

The balance of the revaluation account for tradable local currency securities amounted to NIS 1.4 billion at the end of 2011, compared with NIS 1.1 billion at the end of 2010. Most of the increase in the balance of the revaluation account is due to the accrual component for indexation, and the rest—the price differentials component.

2.3 Monetary instruments

The principal objective of Bank of Israel is to maintain price stability, and the Bank of Israel Law also provides that the Bank should also support achieving other objectives of the government's economic policy—in particular growth, employment and reducing social gaps—provided that in the opinion of the Monetary Committee this does not negatively affect obtaining price stability over time.

The Bank of Israel uses various monetary instruments: adjusting the interest rate, which is the primary instrument of the monetary policy, managing the State's foreign currency reserves, providing loans to banking corporations or receiving deposits from them, and using market instruments—*makam* and repo auctions. By means of the various monetary instruments Bank of Israel injects or absorbs the amount of liquidity needed in order to support the interest rate set by the Monetary Committee.

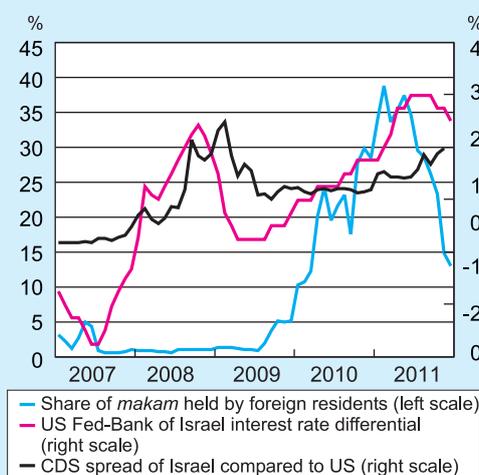


In the first half of 2011, the Bank of Israel continued to purchase dollars in order to offset the short-term effect of the significant injections of capital into the Israeli market— injections that caused the strengthening of the shekel following the widening of the gap between the interest rates of Israel and western economies. These forces also characterized other rapidly growing economies around the world, which were less affected by the financial crisis, and therefore the interest rates in them were higher than in the developed economies.

The growth in imported capital was reflected in an increase in the rate of *makam* held by foreign residents: before the financial crisis exacerbated, in September 2008, the foreign residents held only 1 percent of the total balance of *makam*; upon the widening of the interest gap with the developed countries the local interest rate attracted investments of foreign residents, and in January 2011 they amounted to 34 percent of the total balance of *makam*, compared with 13 percent in December 2011 (Figure 8). The decrease in 2011 in the balance of *makam* held by foreign residents was due to an increase in Israel's CDS margin¹⁰, measures implemented by Bank of Israel to reduce the capital movements into the economy, and the Bank lowering the interest rate as from the last quarter of 2011.

The measures the Bank implemented to reduce the capital movements into the economy included imposing a reserve requirement of 10 percent on transactions of foreign residents in foreign currency derivatives—which reduces the advantages for foreign residents of having shekel deposits compared to foreign currency deposits, as they do not receive the local interest rate on the entire principal of the deposit rather only on the principal less the reserve requirement. This measure reduced the effective interest gap for the foreign resident investors. Along with the actions of Bank of Israel on the foreign currency market, in July of this year the Knesset Finance Committee cancelled the tax exemption on capital gains arising indirectly from government bonds having a maturity of up to one year from their date of issuance, such as through mutual funds, and in last November an amendment to the Income Tax Ordinance was approved that

Figure 8
Share of *Makam* Held by Foreign Residents, 2007-2011
 (in terms of end of period market value)



SOURCE: Bank of Israel.

¹⁰ CDS (Credit Default Swap) is a financial instrument for hedging credit risks—of, inter alia, the country. The CDS margin is the monetary premium that the seller of a CDS requires on its commitment to repay the debt if the issuer of the debt becomes insolvent.

cancelled the tax exemption from capital gains tax on a direct sale and interest income from short-term government bonds.

In 2011, Bank of Israel purchased \$4.6 billion as aforementioned. Purchases of foreign currency have an expanding effect on the economy's liquidity, and given the level of interest set by Bank of Israel, the liquidity surpluses are reabsorbed through the monetary instruments. At the end of 2011, the balance of monetary instruments was NIS 228 billion, compared with NIS 213 billion at the end of 2010. In 2011 the absorption through issuances of *makam* of liquidity surpluses that are created by purchases of foreign currency was reduced, and the surplus liquidity was absorbed by time deposits. In any case, the reduction in the issuances of *makam* led to an increase in the relative share of the time deposits, as an alternate instrument for supporting the short-term interest rate, so that there was a change in the composition of the monetary instruments aggregate: the time deposits increased and the *makam* decreased. At the end of 2011 the monetary aggregate comprised NIS 106 billion in time deposits, about 47 percent of all the monetary instruments (compared with NIS 78 billion at the end of 2010—about 37 percent), and NIS 122 billion in *makam*, about 53 percent of all these instruments (compared with NIS 135 billion at the end of 2010—about 63 percent).

2.3.1 Expenses on account of the monetary instruments

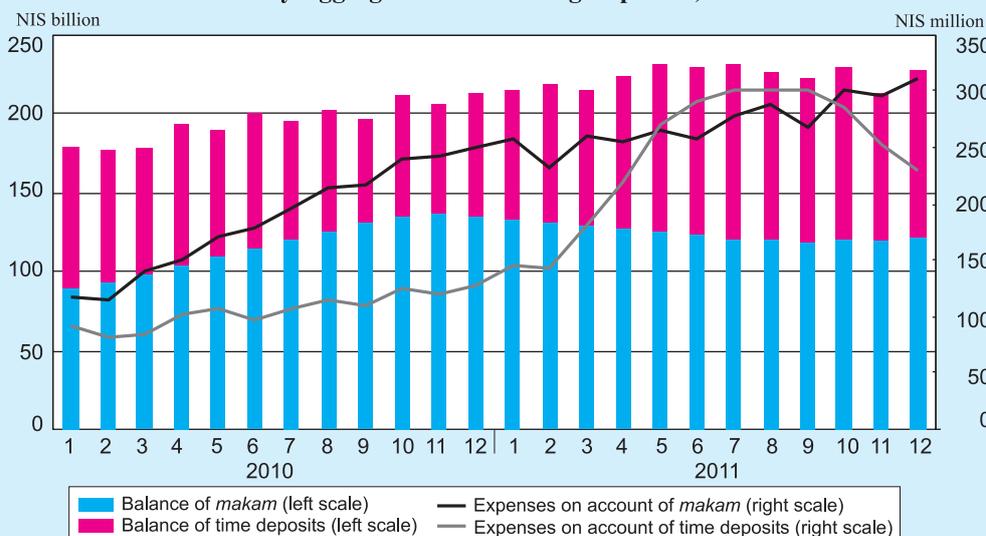
Interest expenses on account of the monetary instruments aggregate was NIS 6.2 billion in 2011, compared with NIS 3.5 billion in 2010.

The increase in interest expenses is due to an increase in the Bank of Israel interest rate in 2011—from an average of 1.6 percent in 2010 to an average of 2.88 percent in 2011 (a change that contributed about three quarters of the increase in the interest expenses), and to an increase in the required absorption, by means of increasing the monetary instruments aggregate (the increase in the monetary instruments aggregate contributed about a quarter of the increase in the interest expense). The expenses on account of *makam* still account for the major part of the interest expense for monetary instruments, about NIS 3.3 billion, because of the size of the *makam* balance (NIS 124 billion on average) relative to that of the time deposits (NIS 100 billion on average) and because *makam* are issued for a period of up to one year, so that the interest paid on account of *makam* is higher than the interest paid for time deposits, which are deposited for a day or a week (Figure 9).





Figure 9
Balance of Monetary Aggregate and Resulting Expenses, 2010-2011



SOURCE: Bank of Israel.

2.4 Israeli currency securities portfolio

At the end of 2011, the balance of the Israeli currency securities portfolio amounted to NIS 19.6 billion, similar to that in 2010 (NIS 19.7 billion). Most of the portfolio was purchased by the Bank in 2009, the year in which the Bank adopted an expansionary monetary policy in an effort to reduce the impact of the global financial crisis on the Israeli economy, as was done in many other countries around the world: the Bank purchased tradable government securities in the amount of NIS 18 billion on the secondary market, in order to support the cuts in the longer-term interest rates, thus easing the shortage of credit and supporting economic activity. These purchases were discontinued in August 2009.

Income from interest and linkage differentials on this portfolio amounted to NIS 702 million in 2011 (compared with NIS 948 million in 2010). The main reason for the decrease in 2011 is that the income in 2011 from linkage differentials on securities that were redeemed is lower than the income in the previous year.

Interest income and the amortization of discount or premium for this portfolio are included in the Statement of Operations on an accrual basis in the item "interest income from the government". This item also includes income from linkage differentials on securities that were realized or redeemed. The income or losses from indexation differentials as well as the revaluation to market value, is recognized in the revaluation accounts item in the balance sheet. A debit balance in a revaluation account is charged

at the end of the year to the Statement of Operations. At the end of 2011 the revaluation account had a credit balance (see Section 2.2.3).

2.5 The monetary base

The monetary base, composed of banknotes and coins in circulation and the banks' NIS-denominated demand accounts with the Bank of Israel, rose 10 percent during the year, from NIS 66 billion at the end of 2010 to NIS 72 billion at the end of 2011. The rate of increase, which is the same as that of last year, is for the most part a result of the expansion in economic activity, and continues the trend of recent years (Figure 10). The increase in the monetary base this year is due to an increase of 11 percent in the cash held by the public (calculated as

the difference between the total of banknotes and coins in circulation and the cash held by the banks), to an increase of 9 percent in the cash held by the banks and to a decrease of 3 percent in the demand accounts of the banks in Bank of Israel (Figure 11).

In an inflation targeting regime, in which the interest rate is the policy instrument used to achieve the nominal goal, the amount of money is determined by the public's

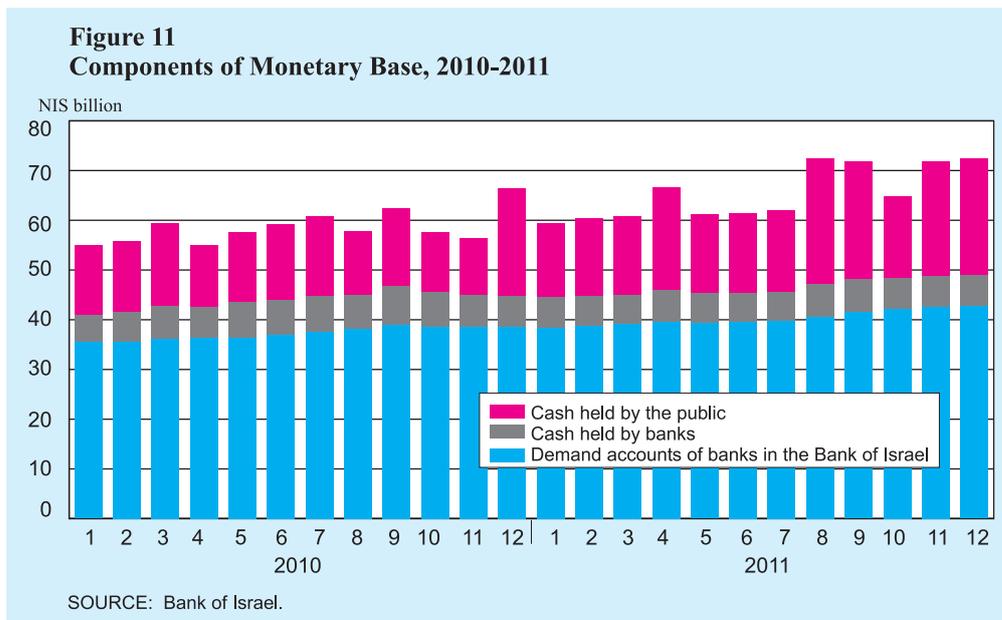
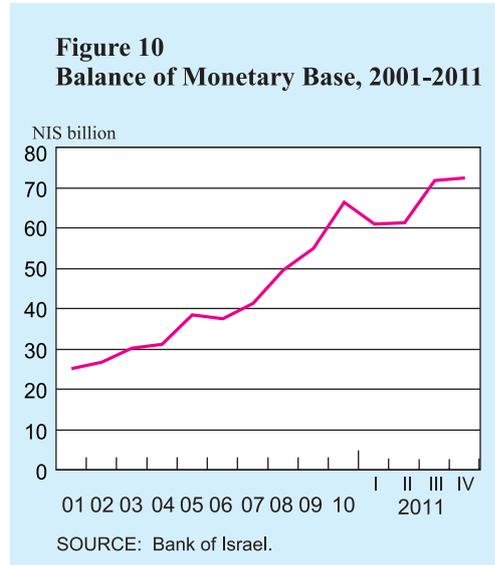




Table 5
The Monetary Base—Changes and their Sources

Year	Change in monetary base (1)=(2)+(3)+(4)+(5)	Injection (absorption) of government and National Institutions ^a (2)	Injection from (absorption by) Bank of Israel (3)	Injection from foreign currency conversions by Bank of Israel (4)	Adjustments ^b (5)
(NIS million)					
2002	1,437	(6,065)	9,265	-	(1,763)
2003	3,567	3,479	1,425	-	(1,337)
2004	966	1,601	1,070	-	(1,705)
2005	7,357	(1,452)	9,920	-	(1,111)
2006	(1,176)	(3,789)	3,797	-	(1,184)
2007	3,979	(10,809)	15,693	-	(905)
2008*	8,297	(17,371)	(17,305)	43,995	(1,022)
2009	5,141	(14,195)	(58,855)	77,413	778
2010	11,509	1,418	(32,962)	43,752	(699)
2011	6,078	(2,142)	(7,494)	16,170	(456)
I	(5,433)	(13,638)	56	8,131	18
II	525	7,138	(13,826)	7,273	(60)
III	10,481	120	9,864	766	(269)
IV	505	4,238	(3,588)	-	(145)

^a The government injection includes also the injection of the National Insurance Institute and of the Postal Bank.

^b Adjustments include: transfers by the National Institutions from abroad via the banks but which are defined as public sector injection (in column 2). Foreign currency domestic receipts and payments of the Bank of Israel and the government to the private sector, such as 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, while on the other they are defined as the private sector contribution to the foreign exchange reserves.

* Data according to value date. Other data in the table as at balance sheet date.

demand. The Bank of Israel absorbs the liquidity surpluses created in the banking system to ensure that the shortest-term interest rates are consistent with the declared interest rate. Monetary aggregate trends, including the monetary base, therefore reflect the public's demand for money, given market interest rates and market conditions.

At the end of 2011 the banknotes and coins in circulation increased by 9 percent, compared with 8 percent at the end of 2010, a rate that is significantly lower than that of 2009 and 2008. In those years, as a result of the exacerbation of the financial crisis as

from September 2008, and the resulting sharp cut in the interest rate, the amounts of the banknotes and coins increased by 21 percent and 19 percent, respectively. This increase is mainly due to the nonexistence of attractive channels of investment, and not to an unusual need for liquidity in order to finance demand.

The Bank of Israel injected NIS 8.7 billion net into the monetary base, while the government and national institutions absorbed NIS 2.1 billion (Table 5). Most of the injection by Bank of Israel is due to the foreign currency purchases, which injected liquidity of NIS 16.2 billion. Bank of Israel absorbed net liquidity surpluses of NIS 7.5 billion. This amount comprised, on the one hand, absorption of NIS 15 billion by Bank of Israel through the monetary instruments—expansion of absorption through time deposits by the amount of NIS 28 billion and reduction of absorption through *makam* by the amount of NIS 13 billion—and on the other hand an injection of NIS 7.5 billion, mainly payments on account of the monetary instruments in the amount of NIS 6.2 billion.

2.5.1 Cost of printing money

The cost of printing money and minting coins amounted to NIS 34 million in 2011, compared with NIS 53 million in 2010.

On December 31, 2010 the legal date passed for exchanging Series A NIS banknotes and coins with a value of 5 agorot. As a result, the Bank recognized income in the amount of the face value of the Series A NIS banknotes and coins of a value of 5 agorot that are held by the public and were not exchanged to the new series—in an amount of NIS 220 million. This income was presented in 2010 under the item “Other financial income—miscellaneous”.

2.6 Demand deposits of banking corporations

Banking corporations use demand deposits with the Bank of Israel to fulfill their liquidity requirements in accordance with Bank of Israel directives, and to settle various payments carried out via the banks. The balance of these deposits amounted to NIS 23.4 billion at the end of 2011, compared with NIS 21.5 billion at the end of 2010.

The government injected NIS 1.1 billion through the commercial banks in 2011, compared with absorption of NIS 2.7 billion in 2010. The public withdrew NIS 6.9 billion in cash from the banking corporations, compared with NIS 5.3 billion in 2010 (Table 6). In net terms, the Bank of Israel injected NIS 8.6 billion into the commercial banks, compared with NIS 11 billion in 2010. The net injection of Bank of Israel into the commercial banks was executed in 2011 by purchasing foreign currency (NIS 16.2 billion) and the absorption was through the various monetary instruments (NIS 7.6 billion).



2.7 Banking corporations' foreign currency deposits

The balance of banks' foreign currency deposits amounted to NIS 2.4 billion at the end of 2011, compared with NIS 1.5 billion at the end of 2010 (Table 1).

Table 6
The Change in Banking Corporations' Deposits in the Bank of Israel^a

	2011			2010			2009		
	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total
(NIS million)									
Activity with the government ^b	(1,147)	492	(655)	2,660	1,418	4,078	(6,629)	(74)	(6,703)
Withdrawal of banknotes from Bank of Israel	(6,882)	-	(6,882)	(5,254)	-	(5,254)	(13,423)	-	(13,423)
Activity with the Bank of Israel ^c	(7,578)	95	(7,483)	(32,894)	(71)	(32,965)	(59,016)	1,185	(57,831)
Transfers from (+) and to (-) abroad	-	275	275	-	(1,511)	(1,511)	-	(19,134)	(19,134)
Foreign currency conversions at Bank of Israel	16,170	-	16,170	43,752	-	43,752	77,413	-	77,413
Adjustments	1,368	7	1,375	(93)	5	(88)	(334)	12	(322)
Total change	1,931	869	2,800	8,171	(159)	8,012	(1,989)	(18,011)	(20,000)

^a Not including the change in term deposits.

^b Government injection via the banking corporations' demand deposits.

^c Depositing of term deposits, purchasing *makam*, selling government bonds and various interest payments.

2.8 Government accounts

Section 48(a) of the Bank of Israel Law, 5770-2010, which came into effect on June 1, 2010, states (like the previous law), "The Bank shall be the sole banker of the government in its banking activity in Israeli currency". Accordingly, the government manages all of its local currency activity, and a considerable part of its foreign currency activity with the Bank of Israel.

Government accounts with the Bank of Israel are composed of deposits in NIS and foreign currency¹¹, as well as credit given to the government.

Credit to the government is composed of the credit balance in respect of binational funds, which was given to the government of Israel for investing in conjunction with the United States government in binational funds involved in research, industrial development, and science. The balance of credit to the government was NIS 126 million at the end of 2011, compared with NIS 117 million at the end of 2010. At the end of 2011, the government held NIS 12.6 billion in deposits, compared with NIS 14.2 billion at the end of 2010. The net decrease is due to an increase of about NIS 0.8 billion in the government's foreign currency deposits and a decrease of about NIS 2.4 billion in local currency deposits (Table 7).

Table 7
Government Deposits in the Bank of Israel—Changes and their Sources

	2011	2010	2009
	NIS million		
Government deposits balances as of December 31			
Local currency deposits	10,568	12,979	11,852
Foreign currency deposits	2,008	1,228	8,480
Total government deposits	12,576	14,207	20,332
Net change in government deposits			
Government contribution to foreign reserves ^a	(3,639)	(3,312)	(1,278)
Government absorption (Injection)	2,603	(598)	14,949
Government–Bank of Israel financial flow ^b	(199)	(2,065)	(1,709)
Adjustments ^c	(396)	(150)	4
Total change	(1,631)	(6,125)	11,966

^a Government income and expenses abroad, receipt and repayment of government loans abroad.

^b Payment of interest and redemption of government bonds held by the Bank of Israel; various fees from the government; credit to the government—interest payment, repayment of principal and payment of indexation differentials and interest on government deposits (in local and foreign currency); exchange rate differentials on government foreign currency deposits; and transfer of Bank of Israel profit.

^c Including: interest accrued on government deposits to the end of the year; government interest payments on credit to the government for binational funds (these payments are included in "Government injection", but in this table are also included in "Government-Bank of Israel financial flow"); and repayment of Israel Bonds to tourists in Israel. (the repayment reduces the government's local currency deposits, but is not included in "Government injection".)

¹¹ Government deposits in local currency may be offset against one another, other than some special deposits, but the government does not intend to offset its local currency deposits against its foreign currency deposits and these balances are therefore stated separately in the financial statements. The economic analysis that appears in these explanatory remarks 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.



Net capital raised by the government abroad was positive this year, amounting to only \$90 million, as a result of the repayment of bonds. In 2011 the government issued bonds abroad in the amount of \$0.5 billion, and also raised \$1.1 billion through State of Israel Bonds.

2.9 Bank of Israel equity

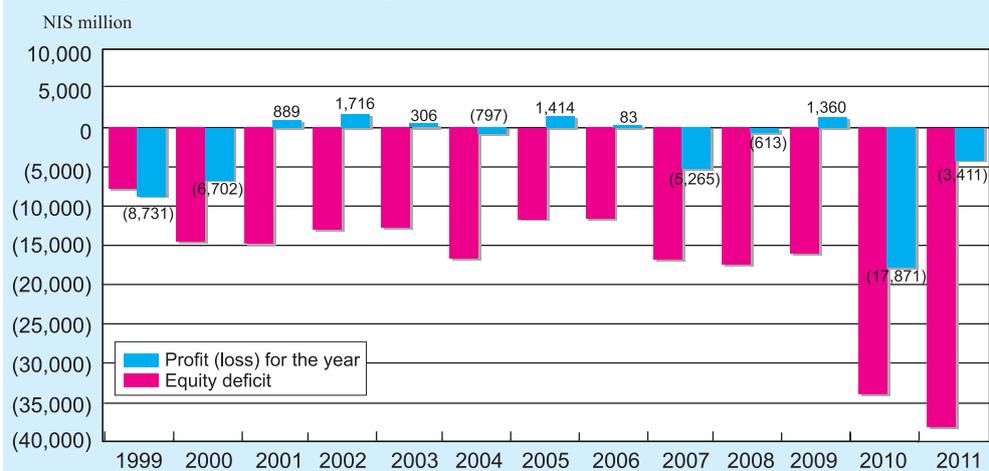
The Bank of Israel's equity is composed of share capital and a general reserve, less the balance of accumulated loss. In line with Accounting Standard 12 of the Israel Accounting Standards Board, the Bank's equity includes a one-time adjustment of non-monetary components in the balance sheet to the CPI for December 2003. This adjustment increased the Bank's share capital and general reserve to NIS 4 billion, as against NIS 320 million previously.

2.9.1 The Bank's equity deficit

At the end of 2011 the Bank's equity deficit amounted to NIS 37.4 billion, compared with NIS 34 billion at the end of 2010, an increase that derives from the loss of NIS 3.4 billion in 2011—most of which is due to the increase in interest expenses to the banks and the public.

The Bank's accumulated loss was NIS 41.4 billion at the end of 2011, compared with NIS 37.9 billion at the end of 2010 (Figure 12). The accumulated loss is a result of the currency asymmetry in the composition of Bank of Israel's assets and liabilities. The asymmetry exposes the Bank to fluctuations in its reported financial results.

Figure 12
Development of the Bank's Equity Deficit and the Current Profit (Loss), 1999-2011



In accordance with the Bank of Israel Law, 5770-2010, within three months from the end of each year the Bank is required to transfer its profits to the government according to the following provisions:

1. If the equity amounts to 2.5 percent or more of total assets, the government will receive an amount equal to the net profit, less any negative balance of retained earnings.
2. If the equity amounts to more than one percent of total assets but less than 2.5 percent of total assets, the government will receive 50 percent of the net profit, less any negative balance of retained earnings.
3. If the equity amounts to one percent or less of total assets, the government will not receive any profits.

Since the Bank has an equity deficit, it did not transfer to the government any profits in 2011 in accordance with these provisions.

