



Bank of Israel
Comptroller's Office

***FINANCIAL
STATEMENTS***

for 2008

*and
Israel's Payment and Settlement Systems*

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Bank of Israel

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Independent Auditors' Report to the Governor and Management of the Bank of Israel

We have audited the accompanying balance sheets of the Bank of Israel (hereinafter "the Bank") as of December 31, 2008 and 2007, 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 42. These financial statements are the responsibility of the Governor and Management 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, 2008 and 2007, 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.)

February 23, 2009

BANK OF ISRAEL**BALANCE SHEET AS OF DECEMBER 31, 2008**

(TEVET 4, 5769)

		December 31	
	Note	2008	2007*
Assets			
Foreign currency financial assets			
Foreign currency financial assets abroad	2		
Demand deposits		4,234	1,074
Short-term deposits		-	20,340
Tradable securities		154,894	97,811
Reverse repurchase agreements		2,457	1,210
Derivative financial instruments		-	5
Total foreign currency financial assets abroad		161,585	120,440
Other foreign currency financial assets			
The IMF	3	670	369
Credit to the government	4	1,111	1,724
Total other foreign currency financial assets		1,781	2,093
Total foreign currency financial assets		163,366	122,533
Local currency financial assets			
Credit to the government	4	332	5,547
Loans	5	-	481
Tradable securities	6	2,427	2,863
Reverse repurchase agreements		2,001	-
Total local currency financial assets		4,760	8,891
Other assets			
International financial institutions	7	836	836
Fixed assets	8	217	220
Other	9	210	222
Total other assets		1,263	1,278
Total		169,389	132,702

* See Note 1a

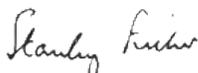
The accompanying notes are an integral part of the financial statements.

(NIS million, reported amounts)



December 31

	Note	2008	2007*
Liabilities and capital			
Banknotes and coins in circulation	10	34,360	28,966
Foreign currency financial liabilities			
Foreign currency financial liabilities abroad	2		
Repurchase agreements		-	10,983
Derivative financial instruments		620	-
Total foreign currency financial liabilities abroad		620	10,983
Other foreign currency financial liabilities			
Government deposits	11	6,860	6,552
Deposits of banking corporations	12	19,711	2,273
International financial institutions	13	671	699
Total other foreign currency financial liabilities		27,242	9,524
Total foreign currency financial liabilities		27,862	20,507
Local currency financial liabilities			
Government deposits	11	1,542	2,074
Deposits of banking corporations	12	43,614	12,698
Makam deposits	14	70,398	75,986
Total local currency financial liabilities		115,554	90,758
Other liabilities	15	3,763	3,640
Total liabilities		181,539	143,871
Revaluation accounts	16	5,299	5,667
Capital deficit			
Share capital and general reserve	17	3,985	3,985
Accumulated losses		(21,434)	(20,821)
Total capital deficit		(17,449)	(16,836)
Total		169,389	132,702


Stanley Fischer
Governor


Raphael Lankri
Head of Comptroller's Office and Payment Systems

February 23, 2009

STATEMENT OF OPERATIONS

FOR THE YEAR ENDED DECEMBER 31, 2008
(NIS million, reported amounts)

	Note	2008	2007*
Interest income from			
Financial assets in foreign currency abroad	19	3,433	5,920
Loans	20	189	379
The government	21	478	507
Other	22	51	24
Total interest income		4,151	6,830
Interest expense			
On financial liabilities in foreign currency abroad	23	221	1,090
To banks and the public	24	3,438	4,360
To the government	25	503	510
Other	26	85	98
Total interest expense		4,247	6,058
Net interest income (expense)		(96)	772
Other financial income (expense) from			
Securities and derivatives	27	2,438	1,197
Exchange-rate differentials	28	(2,318)	(6,607)
Miscellaneous	29	(1)	8
Total other financial income (expense)		119	(5,402)
Profit (loss) on financial transactions		23	(4,630)
Expenses on printing banknotes and minting coins		(73)	(55)
Administrative and general expenses	30	(614)	(612)
Other income	31	51	32
Net loss		(613)	(5,265)

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

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED DECEMBER 31, 2008
(NIS million, reported amounts)



	Share capital	General reserve	Total share capital and general reserve	Accumulated losses	Total deficit in equity
Balance as of January 1, 2007	848	3,137	3,985	(15,556)	(11,571)
Net loss for the year	-	-	-	(5,265)	(5,265)
Balance as of December 31, 2007	848	3,137	3,985	(20,821)	(16,836)
Net loss for the year	-	-	-	(613)	(613)
Balance as of December 31, 2008	848	3,137	3,985	(21,434)	(17,449)

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

NOTES TO THE 2008 FINANCIAL STATEMENTS

1. Accounting policies

a. General

The financial statements are presented in accordance with generally accepted accounting principles 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. Local currency securities, as detailed in Section 1.g below.
3. Cash-flow statements, as detailed in Section 1.t below.

From this year, the Balance Sheet is shown in the format normally used by central banks around the world. Comparative figures for 2007 have also been reclassified.

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 as at the transition date (December 31, 2003), with the addition of 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.





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, 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, comparable figures for the year ending 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 included in the financial statements as 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 such 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 as of the balance-sheet date.
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
In accordance with the Bank of Israel Law, 5714-1954, the Bank must transfer its net



profits to the government within 60 days of the end of its business year. The Bank of Israel incurred losses in 2008 and 2007. These losses were added to the accumulated loss, and therefore there was 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 (with the exception of income from local currency securities—see Note 1g).

Realized profits and/or losses—profits and/or losses from foreign currency and foreign currency securities 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 on the balance sheet.

Unrealized losses—losses originating in the difference between the average cost of an asset and its market value are charged to the "Revaluation accounts" line on the balance sheet. At year end, these losses are transferred to the Statement of Operations after offsetting unrealized profits in the same asset.

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

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

g. Securities

Foreign currency securities

Tradable foreign currency securities are stated at their fair value as of 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. Securities with maturity dates of up to three months are stated at an adjusted cost that constitutes a reasonable approximation of their fair value.

Interest and indexation income on foreign currency securities are charged to the Statement of Operations on an accrual basis and are shown in the “Interest income from financial assets in foreign currency abroad” item.

Unrealized losses are charged to the Statement of Operations at year end and are shown under “Other financial income from (expenses on) securities and derivatives.” The adjusted cost of the securities is their nominal value plus 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.

Income from the realization of securities is shown under “Other financial income from (expenses on) securities and derivatives.”

Local currency securities

Tradable local currency government securities are stated in the balance sheet at their market value as of the balance-sheet date.

The difference between the market value of securities and their original cost is charged to the “Revaluation accounts” line on the balance sheet.

Income from tradable government securities is included in the Statement of Operations on a cash basis in accordance with the matched timing principle, according to which accrued profits from government securities not yet received in cash from the government are not included in the Bank’s income.

Interest and indexation income on local currency securities are shown under “Interest income from the government.”

h. International financial institutions

International Monetary Fund (IMF)

The Bank of Israel’s participation in the IMF less its liabilities on account of its participation is shown on the Assets side of the “International financial institutions” item.

Special drawing rights (SDR) allocated by the IMF are shown on the liabilities side of 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 of 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 of the "International financial institutions" item.

i. Fixed assets

1. Fixed assets are stated at cost less accrued 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 at issue:
Buildings—fifty to sixty-seven years;
Motor vehicles—six and a half years;
Computers—four years;
Equipment—ten years.
4. Purchases of fixed assets in insignificant amounts are charged to the Statement of Operations.
5. Software that is not an integral part of the related hardware is shown under fixed assets at cost depreciated by the straight-line method over four years.

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. The liabilities are shown in the Bank's balance sheet at their face value.

k. *Makam* (short-term bills issued by the Bank of Israel)

The balance of *makam* in the balance sheet reflects the par value (redemption price) of *makam* held by the public less the balance of the 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.



The discount is the difference between the par value of the *makam* and the proceeds of their sale to the public. The discount is amortized by the straight-line method.

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 paid to the banks and the public” item.

I. 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 of the Supervisor of Banks, and the rate of future wage increase is estimated by the management. The vacation-pay provision is computed on the basis of accrued vacation days due as of the balance-sheet date. (See Note 15.)

m. Revaluation accounts

The revaluation accounts include unrealized profits from exchange rate differentials on balances denominated in foreign currency and unrealized profits from the revaluation of tradable securities in local currency and foreign currency to market 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 partly realized. No offsetting among different types of items is performed.

Any net loss in the revaluation accounts that originates in price differentials in foreign currency securities and exchange rate differentials on foreign currency balances is transferred to the Statement of Operations at the end of the year.

n. Foreign currency

Assets and liabilities denominated in or indexed to foreign currency are shown in New Israel Shekel (NIS) according to the representative rate of exchange as published by the Bank of Israel on 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. A 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 other currencies.

The exchange rates are itemized below:

	December 31			Change	
	2008	2007	2006	2008	2007
	(NIS)			(percent)	
US\$	3.8020	3.8460	4.2250	-1.1	-9.0
Euro	5.2973	5.6592	5.5643	-6.4	1.7
Special drawing rights (SDR) ^a	5.8561	6.0705	6.3510	-3.5	-4.4
First currency basket ^b	4.5214	4.9857	5.1489	-9.3	-3.2

^a SDR rate is based on a weighted 4-currency basket consisting of US\$, €, ¥, and £.

^b First currency basket was in effect until July 31, 1986, and consisted of: US\$ 0.3500; £ 0.1295; and € 0.4667.

o. Indexation

Assets and liabilities indexed to the Consumer Price Index (CPI) are shown according to the indexation terms determined for each balance.

Details of the Consumer Price Index follow^a:

	December 31			Change	
	2008	2007	2006	2008	2007
	(points)			(percent)	
CPI November	110.55	105.77	102.90	4.5	2.8
December	110.44	106.40	102.90	3.8	3.4

^a CPI is presented in points based on the 2002 average.



p. Interest rates

Rates of interest charged or paid by the Bank of Israel on the government's and the banks' local-currency balances are based on the Bank of Israel's interest rate or on prime.

	December 31			Change	
	2008	2007	2006	2008	2007
	(percent)				
Bank of Israel interest rate	2.50	4.25	4.50	-41.2	-5.6
Prime	4.00	5.75	6.00	-30.4	-4.2

q. Derivative financial instruments

The Bank of Israel uses financial instruments in its monetary and foreign exchange activities.

1. Activity in derivative financial instruments in Israel

a. Future remittances of *makam*

Outstanding liability for future remittance of *makam* as of the date of the financial statement corresponds to or approximates its fair value and is presented at par (redemption price) in Note 18, "Contingent liabilities and special commitments." Receipts on account of future issues of *makam* are shown in the balance sheet under "Other liabilities."

The Bank discontinued its activity in future remittances of *makam* on August 14, 2008.

b. Reverse repurchase agreements (R.Repo) for *makam* and government bonds

In October 2007, the Bank of Israel started performing R.Repo transactions in *makam* and government debentures. These transactions are treated as secured debt; accordingly, securities purchased within the framework of these transactions are not shown on the balance sheet.

Interest income accrued on account of these transactions is shown under "Other income."

c. Forward NIS/US\$ conversion transactions

These transactions are shown net under "Other assets" or "Other liabilities": future receipt of US\$ less future remittance of NIS.

In the Statement of Operations, the results of the transactions are shown under "Other financial income from (expenses on) securities and derivatives."

2. Financial instruments in activities abroad

a. Repurchase (repo) and reverse-repurchase (reverse 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 secure debt; accordingly, the securities sold under its terms are not subtracted from the Bank's assets. The repo liability is included in the "Foreign currency financial liabilities abroad" item. In the Statement of Operations, the results of these transactions are shown in the "Interest expense on financial liabilities in foreign currency abroad" item.

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

b. Foreign currency swaps

These transactions are included in the balance sheet in the sum of the difference 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 financial foreign currency assets abroad" item.

c. Futures

The balance of futures contracts at market prices on the date of the financial statement is given in Note 18, "Contingent liabilities and special 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 derivatives."

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—Impairment of Assets (hereinafter: the Standard), which establishes procedures that the Bank must apply in order 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 the usage value (the present value of an estimated future cash flow 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. Wherever the value of an asset exceeds its recoverable amount, the Bank recognizes an impairment loss in the amount of the difference between the book value of the asset 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 also corresponds to the general practice among central banks worldwide.

u. Taxes

According to the Bank of Israel Law, 5714-1954, concerning the payment of taxes, the Bank is tantamount to the State of Israel and, therefore, is exempt from paying certain taxes such as income tax and capital-gains tax.

2. Financial foreign currency assets abroad

(see section a below)

	December 31		December 31	
	2008	2007	2008	2007
	(NIS million)		(\$ million)	
Demand deposits	4,234	1,074	1,114	279
Short-term deposits	-	20,340	-	5,289
Tradable securities	154,894	97,811	40,740	25,432
Reverse repurchase agreements	2,457	1,210	646	315
Derivative financial instruments ^a	-	5	-	1
Total	161,585	120,440	42,500	31,316

^a Derivative financial instruments are shown net, i.e., future foreign currency liabilities minus future foreign currency assets (see Note 1.q.2).

Financial foreign currency liabilities abroad

(see section a below)

	December 31		December 31	
	2008	2007	2008	2007
	(NIS million)		(\$ million)	
Securities sold under repo agreements	-	10,983	-	2,856
Derivative financial instruments ^a	620	-	163	-
Total	620	10,983	163	2,856

^a Derivative financial instruments are shown net, i.e., future foreign currency liabilities minus future foreign currency assets (see Note 1.q.2).

a. Foreign-exchange reserves

In economic terms, as cited in the Explanatory Remarks, the reference to foreign exchange reserves includes the net balance of Repo transactions and derivatives. These balances consist of the balance of the “Financial assets in foreign currency abroad” item less the balance of the “Foreign currency financial liabilities abroad” item.

The currency composition of these balances corresponds to that of their possible uses. These uses, which also constitute a basis for the determination of the desired level of the reserves, are the sale of foreign currency to the government to service its debts and finance emergency imports; use of the reserves for the management of the Bank of Israel’s policies relating to the stability of the banking system and the foreign currency market; and use of



the reserves as an instrument for the implementation of monetary policy. (The yields on the foreign exchange reserves are shown in Table 2 in the Explanatory Remarks.)

The composition of the foreign exchange reserves is shown below:

	December 31		December 31	
	2008	2007	2008	2007
	(NIS million)		(\$ million)	
Foreign currency financial assets abroad	161,585	120,440	42,500	31,316
Foreign currency financial liabilities abroad	(620)	(10,983)	(163)	(2,856)
Total foreign exchange reserves, net	160,965	109,457	42,337	28,460

3. International Monetary Fund (IMF)

	December 31		December 31	
	2008	2007	2008	2007
	(NIS million)		(SDR million)	
International Monetary Fund (IMF) quota	5,436	5,636	928	928
Minus liability for the quota ^a	(4,766)	(5,267)	(814)	(867)
Total^b	670	369	114	61

^a The balance of the liability to the IMF is in notes and deposits.

^b The surplus of the reserve tranche over the "basic sum" of SDR 33 million bears interest at a rate set by IMF from time to time. The annual rate of interest on December 31, 2008, was 0.82 percent (on December 31, 2007 - 3.50 percent).

International Monetary Fund (IMF)

The balance with the IMF (the reserve tranche) is part of the quota allocated to Israel, for which Israel paid the IMF in foreign currency.

The IMF quota

Each member country of the International Monetary Fund has a quota for its participation in the Fund's capital. The quota is determined according to the country's economic indicators (national income, exports, balance of payments, 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; the

rest is deposited with the country's central bank in deposits and notes indexed to Special Drawing Rights (SDR).

Until 1998, Israel drew down its reserve tranche and put up against this withdrawal a non-interest-bearing deposit in favor of the Fund. In the latest increase in members' participation (1999), Israel's quota was increased by SDR 262 million. The foreign currency payment for this increase, approximately SDR 66 million, was deposited with the Fund and has not been withdrawn by Israel.

The IMF Financial Transaction Plan

Israel has been taking part in the IMF's Financial Transaction plan since 1999. The plan is a mechanism through which a member country can exchange SDR or foreign currency against its local currency and another country is asked to execute a counter-exchange. The request to exchange foreign currency is passed on by the Fund on short notice. The IMF manages the sums transferred and received in these transactions in such a way that the share of the reserve tranche in the quota of each member country that participates in the plan remains similar. Until 2004, Israel's reserve tranche balance increased gradually due to transfers of foreign currency from Israel to other countries. In subsequent years, the Fund transferred foreign currency to Israel. In 2008, Israel's reserve tranche was increased by SDR 53 million. (In 2007, it was reduced by SDR 21 million.)

4. Credit to the government

Credit to the government is composed of foreign-currency and local-currency balances.

	December 31	
	2008	2007
	(NIS million)	
In foreign currency (see section a below)		
Long-term indexed advances (see section c below)	985	1,597
Binational funds	126	127
Total foreign-currency credit to the government	1,111	1,724
In local currency (see section b below)		
Current credit	-	5,132
Long-term unindexed advances (see section c below)	332	415
Total local-currency credit to the government	332	5,547
Total credit to the government	1,443	7,271



a. Credit to the government in foreign currency

This credit is composed of long-term advances indexed to the exchange rate of the first basket of currencies and of binational funds. Indexed long-term advances—these are indexed to the first basket of currencies and bear interest at a rate of 8 percent indexed to the same basket. See also Section c below.

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 for research, industrial development, and science. The funds deposited these amounts with the Bank of Israel; they are shown in the balance sheet on the liabilities side in the “Other liabilities” item. Both the credit and the funds’ deposits earn interest on the basis of LIBOR.

b. Credit to the government in local currency

1. Current credit

This item includes balances that are used to finance the government’s budgetary activity. These balances are defined as credit that the government may use to finance budgetary and extra-budgetary activity; accordingly, they are subject to Section 45(b) of the Bank of Israel Law, 5714–1954. Financial movements arising from government budgetary and extra-budgetary activity in Israel and financial movements with the Bank of Israel are recorded in these accounts.

All government balances in local currency in Israel (with the exception of several extraordinary balances) may be offset against each other. The government has no intention of offsetting its local currency balances with foreign currency balances; as such, these balances are presented separately. (See also Note 11.)

Interest at prime rate is charged on local currency government balances (when in debit) or is paid (when in credit). The average prime rate in 2008 was 5.11 percent (in 2007, 5.4 percent).

Interest expense on account of government local currency balances are shown in the Statement of Operations in net form. (See Note 25.)

2. Long-term credit in local currency

Unindexed long-term advances—this credit bears interest at prime +2 percent. The average interest rate in 2008 was 7.34 percent (in 2007, 7.6 percent). See also Section c below.

c. Long-term advances

Credit to the government is composed of an unindexed long-term advance and long-term advances indexed to the first basket of currencies. This credit was given until 1988.

- (a) Interest and indexation differentials on the principal balance on account of each year are due on December 31 of said year. The principal is payable in annual installments, the last of which will be due in 2012.
- (b)
 - i. Correspondence in September 2003 between the Minister of Finance and the Governor of the Bank of Israel included several agreements regarding “Proposals in the Economic Program for 2004 Relating to the Bank of Israel.” One of the items in that correspondence was “the repayment of the government’s debt to the Bank of Israel due to be repaid on December 31, 2003,” and it was determined that “the Bank of Israel will grant a loan to the government to finance the balance of the debt, principal and interest due for repayment on December 31, 2003.” The same section also specified the payback dates of the loan, the need for the conclusion of an agreement between the Bank and the Ministry of Finance on the interest payable, and that “If the Attorney General is of the opinion that the debt can be cancelled, then it shall be cancelled.” The amount of the debt—principal and interest—due for payback on December 31, 2003, was NIS 1,070 million (the total balance of the government debt, principal plus interest, prior to said payback was NIS 5,460 million).
 - ii. In February 2005, the Deputy Attorney General submitted his opinion on behalf of the Attorney General. According to the opinion, “There are no legal grounds preventing the Bank of Israel from canceling the government’s debt to the Bank as agreed between the outgoing Governor and the Minister of Finance.” The summary specifying the basis for this opinion stated, “It appears that from a legal standpoint the Bank of Israel has the authority to cancel a government debt to the Bank that predates the prohibition on granting loans to the government under Section 45 of the Bank of Israel Law.” As for the reasonableness of a decision by the Bank of Israel to cancel a government debt to the Bank, the summary noted, “If there are macroeconomic reasons supporting such a decision that are consistent with the Bank’s objectives and policies, such a decision would not be unreasonable.”
 - iii. On December 30, 2008, the Accountant General at the Ministry of Finance approached the Attorney General and asked him to intervene immediately to preclude the collection of the debt set for December 31, 2008. His request was not accepted. On January 4, 2009, the Attorney General stated in response that,





in his opinion, the dispute between the Ministry of Finance and the Bank of Israel was not a matter for legal decision but a topic to be elucidated and resolved at the echelon of the Prime Minister, the Minister of Finance, and the Governor of the Bank of Israel. On February 4, 2009, the Governor stated, in a letter to the Attorney General, that he agreed that the issue is not suited to a legal decision. The Governor stressed that even in the opinion of the Deputy Attorney General, as noted in Section ii above, the discretion to forgive or not forgive the debt resides with the Governor of the Bank of Israel only.

- iv. In view of the foregoing, based on the opinion of the Bank's legal department, and taking into account the fact that the government is making the scheduled repayments, the Bank is of the opinion that the debt will be repaid in full.

5. Loans

The Loans item is composed of monetary loans and other loans.

a. Monetary loans

In 2007 and 2008, the Bank of Israel provided banking corporations with monetary loans via auction and overnight monetary loans. Overnight monetary loans to banking corporations were provided at interest of 0.5 percent above the Bank of Israel rate (until December 23, 2008—1 percent over the Bank of Israel rate). The loans are not limited by quota and are given against appropriate guarantees.

The average interest rate for these loans in 2008 was 3.74 percent (in 2007—3.9 percent).

The average interest rate for overnight monetary loans in 2008 was 4.31 percent (2007—5.1 percent).

The outstanding balance of monetary loans as of December 31, 2008, and December 31, 2007 was zero.

b. Other loans

On December 31, 2007, the "Other loans" item included NIS 476 million in credit to Industrial Development Bank. At the end of 2008, outstanding credit on this account was zero.

In August 2002, Industrial Development Bank encountered liquidity problems and could not meet its liabilities. The Bank of Israel responded to a request from the bank and made available to it a special credit line to enable it to continue operating regularly. The credit line was originally NIS 2,200 million; it was reduced from time to time and was supposed to

expire at the end of July 2006. On October 30, 2005, the Bank of Israel agreed to a request from the bank to extend the term of the loan by two years, to July 31, 2008. Subsequently, the line of credit was extended until it was closed in December 2008. In accordance with the decision of the economic-social cabinet, since July 1, 2005, responsibility for repayment of the credit has resided with the government. Accordingly, the government paid off the balance of this credit line, in the sum of NIS 305 million, at the end of the period.

The Industrial Development Bank paid interest at the Bank of Israel rate on the unused portion of the credit.

At the time of the final payback and at the bank’s request, the Bank of Israel forgave NIS 48.6 million in debt that the bank had paid in the past on account of interest above the Bank of Israel rate. The forgiving of this debt is included in the Statement of Operations on the “Interest expense to banks and the public” line.

This credit is not expected to result in a future loss to the Bank of Israel.

6. Tradable local currency securities

This item consists of tradable government securities indexed to the last CPI known on the balance sheet date. The securities are shown at market value.

The yield to maturity on the local currency securities portfolio on December 31, 2008, was 2.83 percent, and average term to maturity of the portfolio was 2.32 years. (On December 31, 2007, the yield to maturity was 2.6 percent and the average term to maturity was 3.4 years.)

	December 31	
	2008	2007
	(NIS million)	
Time to redemption		
Less than one year	727	519
Between one and two years	954	715
Between two and three years	80	925
Between three and four years	323	76
Between four and five years	209	306
Five years or longer	134	322
Total	2,427	2,863



7. International financial institutions

	December 31	
	2008	2007
	(NIS million)	
Investment in BIS shares	282	282
Balance related to other international financial institutions (see section a below)	554	554
Total	836	836

a. Balances on account of other international financial institutions

The balances are on account of the following institutions:

IBRD—International Bank for Reconstruction and Development

IDA—International Development Association

IFC—International Finance Corporation

EBRD—European Bank for Reconstruction and Development

MIGA—Multilateral Investment Guarantee Agency

IDB—Inter-American Development Bank

IIC—Inter-American Investment Corporation

8. Fixed assets^a

	Land and buildings ^b	Equipment, furniture and vehicles	Total
Cost	(NIS million)		
Balance as of January 1, 2008	222	98	320
Additions	2	8	10
Subtractions	-	-	-
Balance as of December 31, 2008	224	106	330
Accumulative depreciation			
Balance as of January 1, 2008	30	70	100
Additions	5	8	13
Subtractions	-	-	-
Balance as of December 31, 2008	35	78	113
Net book balance as of December 31, 2008	189	28	217
Net book balance as of December 31, 2007	192	28	220

- ^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 US\$1.7 million. (The rest of the collection has yet to be appraised.) The Bank of Israel also has a library containing professional (economic, financial, etc.), legal, and general literature. According to an assessor's appraisal in 2006, the replacement value of the library was US\$3 million. The "Fixed assets" item does not include these items.
- ^b The land of the Bank's premises in Jerusalem, with a depreciated cost of the structures thereon amounting to NIS 177 million as of December 31, 2008 (NIS 180 million as of December 31, 2007), 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. Other assets

	December 31	
	2008	2007
	(NIS million)	
Loans to employees	208	220
Sundry receivables	2	2
Total	210	222





10. Banknotes and coins in circulation

	December 31, 2008		December 31, 2007	
	Quantity	NIS	Quantity	NIS
	(million)		(million)	
Banknotes in circulation				
NIS 20	31	612	25	505
NIS 50	46	2,298	47	2,370
NIS 100	140	13,998	131	13,098
NIS 200	81	16,132	59	11,748
Coins in circulation		1,287		1,212
Other ^a		33		33
Total		34,360		28,966

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

11. Government deposits

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

	December 31		December 31	
	2008	2007	2008	2007
	(NIS million)		(\$ million)	
Foreign currency (see section a below)				
Deposit for money borrowed under US government guarantee	6,635	6,011	1,745	1,563
Current deposits	204	303	54	79
Other foreign currency deposit	21	238	6	62
Total foreign currency deposits	6,860	6,552	1,805	1,704
Local currency (see section b below)				
Current deposits (see section b.1 below)	1,536	2,055		
Bond-price stabilization deposit (see section b.2 below)	6	19		
Total local currency deposits	1,542	2,074		
Total	8,402	8,626		

a. Government foreign currency deposits

Government foreign currency deposits derived from borrowing under a US government guarantee and some other foreign currency deposits bear interest at the rate paid on US Treasury bills with an average of 6 months to maturity. The rate of interest on December 31, 2008, was 0.43 percent (December 31, 2007—3.4 percent).

b. Government local currency deposits

1. Current deposits are composed of balances used for bond lending, balances for the financing of budgetary activity, and other balances. The portion of the government balances that is used for bond-lending activity bears the Bank of Israel rate of interest. The average rate of interest on these balances in 2008 was 3.69 percent (2007—3.9 percent). The other portion of the government balances bear (when in debit) or pay (when in credit) interest at prime. The average prime rate was 5.11 percent in 2008 (2007—5.4 percent).

The balance in this item also includes the balance of the National Insurance Institute and that of the Postal Bank, which, since March 1, 2006, has operated through the Israel Postal Company Ltd., a wholly government-owned corporation. Israel Postal Company Ltd., also operates by means of Postal Bank, Ltd., a government subsidiary.

2. The bond-price stabilization deposit represents the proceeds from the purchase, at source, of government securities by the Bank of Israel in order to stabilize prices on the Tel Aviv Stock Exchange (TASE). In accordance with an agreement with the Ministry of Finance, the proceeds are placed in a special deposit on behalf of the government but may not be used to finance government expenses. At the request of the Ministry of Finance, the bond-price stabilization arrangement was discontinued in January 1993 and the deposit is gradually being reduced against the redemption of such bonds purchased in the past. The redemption of these bonds will end in 2009.



12. Deposits of banking corporations

	December 31		December 31	
	2008	2007	2008	2007
	(NIS million)		(\$ million)	
Foreign currency deposits (see section a below)				
Demand deposits	14,806	771	3,894	200
Unrestricted deposits	4,905	1,502	1,290	391
Total foreign currency deposits	19,711	2,273	5,184	591
Local currency deposits (see section b below)				
Time deposits	28,313	300		
Demand deposits	15,301	12,398		
Total local currency deposits	43,614	12,698		
Total deposits of the banking corporations	63,325	14,971		

a. Foreign currency deposits

1. 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.
2. At the beginning of September 2007, the Bank of Israel started accepting foreign currency deposits from the banks as collateral for the banks' activities in the Zahav (RTGS) system. The deposits are for a term of 30 days. The balance of the deposits on December 31, 2008, was NIS 4,905 million (December 31, 2007—NIS 1,460 million).

b. Local currency deposits

1. The Bank of Israel receives local currency time deposits from the banking corporations. The deposits are allocated by auction for terms of one day or one week. The deposits are not considered liquid assets for the purpose of fulfilling the banking corporations' reserve requirements. In addition, overnight deposits are received at an interest rate of 0.5 percent under the Bank of Israel rate (until December 23, 2008—1 percent under the Bank of Israel rate).
The interest rate for overnight deposits on December 31, 2008, was 2 percent (on December 31, 2007—3.25 percent).
The average interest rate for overnight deposits in 2008 was 2.05 percent (in 2007—3 percent).

The average interest rate for time deposits by auction on December 31, 2008, was 2.45 percent.

The average interest rate for time deposits by auction in 2008 was 3.13 percent (in 2007—3.7 percent).

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

13. International financial institutions

	December 31	
	2008	2007
	(NIS million)	
Special Drawing Rights allocated ^a	624	649
Liabilities to international financial institutions ^b	47	50
Total	671	699

^a Special Drawing Rights (SDR) are sums that member states in the International Monetary Fund undertook to purchase from the Fund. The IMF allocates SDR to its constituent states commensurate with the size of their quotas. Israel's allocation thus far is SDR 106.4.

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



14. Makam deposits

	December 31	
	2008	2007
	(NIS million)	
Redemption value of <i>makam</i> sold to the public	71,722	77,561
Less discount at time of sale to public	(2,620)	(3,277)
Proceeds of sale of <i>makam</i> to the public	69,102	74,284
Plus reduction in discount for period to balance sheet date	1,296	1,702
Total balance of <i>makam</i>	70,398	75,986

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.

15. Other liabilities

	December 31	
	2008	2007
	(NIS million)	
Pension and severance pay liabilities ^{a,c}	3,447	3,320
Other liabilities on employees' rights ^{b,c}	143	157
Binational funds	131	141
Accounts payable	42	22
Total	3,763	3,640

^a Pension liability is calculated according to the pension agreements with Bank employees and pensioners who commenced their employment before September 2002 and their survivors (on December 31, 2008, this included 430 staff members and 628 retirees; as of December 31, 2007, this included 462 staff and 631 retirees). The pension liability includes future payment of benefits for bank employees, former 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 benefit data for December 2008 and on actuarial calculations. The calculation was performed using a method of estimating benefits being accrued under various parameters: rates of early retirement, 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 Funds 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 experience and with the public reporting directives of the Supervisor of Banks. The calculation assumes real annual wage increases of up to 2 percent per year.

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 This item is composed mainly of an NIS 85 million liability for employees' vacation (2007—NIS 102 million). Bank employees are entitled by law and labor agreements to annual vacation days and advanced-training days. The liability as of December 31, 2008, and December 31, 2007, were calculated on the basis of the determining wage for the redemption of vacation and vacation days as accrued up to the balance-sheet date.

^c On December 20, 2007, the Bank of Israel and its employees concluded a collective wage accord. In addition, on August 19, 2008, the Labor Court handed down its decision on a very small number of issues in the form of a compromise ruling. The new wage accord went into effect on August 20, 2008. The items include the effect of the new accord as of December 31, 2008. The main provisions of the new accord had already been applied in 2007.





16. Revaluation accounts

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

	December 31	
	2008	2007
	(NIS million)	
Foreign currency balances	2,169	3,321
Tradable foreign currency securities	2,432	1,591
Tradable local currency securities	698	755
Total	5,299	5,667

17. Share capital and general reserves in historical nominal values

Data on the Bank's share capital and general reserves appear in the financial statements in reported values. (See Note 1.c.) The following shows the data in historical nominal values:

	December 31	
	2008	2007
	(NIS million)	
Share capital	60	60
General reserve ^a	260	260
Total Bank capital in historical nominal values	320	320

^a The general reserve is in accordance with Section 6 of the Bank of Israel Law, 5714-1954, and has been applied in the past to increase the Bank's capital.

18. Contingent liabilities^a and commitments

	31 December	
	2008	2007
	(NIS million)	
1. Off-balance-sheet financial instruments		
1.1 Documentary credits and guarantees for government imports and exports		
1.1.1 Documentary credits	-	46
1.1.2 Guarantees	193	195
1.2 Liabilities to pay international financial institutions on demand	3,208	3,192
2. Commitments		
2.1 Derivative financial instruments in activity in Israel		
Future remittances of <i>makam</i> (at par)	160	640
Reverse Repurchase Agreements (RRepo)	1,740	-
2.2 Derivative financial instruments in activity in abroad		
2.2.1 Currency swaps and forward transactions		
Future receipts of foreign currency	5,009	2,964
Future payments of foreign currency	5,623	2,960
2.2.2 Repurchase Agreements (Repo) and Reverse Repurchase Agreements (RRepo)		
Repo	-	10,626
RRepo	2,382	1,055
2.2.3 Futures		
Sales commitments	797	17,185
Purchase commitments	519	3,192

^a Several claims are pending against the Bank of Israel. However it is the Bank's opinion, based on the opinion of Bank's Legal Department, that the probability of these claims being successful is low, and therefore no provisions have been recorded in respect thereof.





19. Interest income from financial assets in foreign currency abroad

(see section a below)

	For the year ended December 31	
	2008	2007
	(NIS million)	
Demand deposits	18	48
Short-term deposits	416	1,310
Tradable securities	2,904	4,446
Securities purchased as part of the RRepo Agreements	37	122
Derivative financial instruments ^a	58	(6)
Total	3,433	5,920

^a Interest expense on derivatives is shown net.

a. 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 23):

	For the year ended December 31	
	2008	2007
	(NIS million)	
Interest income from foreign currency financial assets abroad	3,433	5,920
Interest paid on foreign currency financial liabilities abroad ^a	(221)	(1,090)
Total income from foreign exchange reserves	3,212	4,830

^a See Note 23.

20. Interest income from loans

	For the year ended December 31	
	2008	2007
	(NIS million)	
From monetary loans	173	355
From other loans ^a	16	24
Total	189	379

^a Mostly deriving from interest on credit advanced to the Industrial Development Bank (see Note 5).

21. Interest income from the government

	For the year ended December 31	
	2008	2007
	(NIS million)	
Long-term advances		
Indexed	128	174
Unindexed	30	38
From binational funds	69	69
From local currency securities	251	226
Total	478	507

22. Other interest income

This item consists of interest income from the International Monetary Fund and interest on reverse repurchase agreements of makam and government bonds.

23. 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).



24. Interest expense to banks and the public

	For the year ended December 31	
	2008	2007
	(NIS million)	
In local currency		
On makam deposits	3,262	4,184
On local currency time deposits	29	25
Other ^a	49	1
Total in local currency	3,340	4,210
In foreign currency		
On banks' deposits	98	150
Total	3,438	4,360

^a Due to the forgiving of a debt of the Industrial Development Bank (see note 5).

25. Interest expense to the government

	For the year ended December 31	
	2008	2007
	(NIS million)	
On local currency deposits ^a	397	220
On foreign currency deposits	106	290
Total	503	510

^a Government local currency interest expense includes--in addition to interest expense on balances for financing the budget--interest expense on the bond price stabilization deposit, interest expense to the National Insurance Institute, and interest expense to the Israel Postal Company Ltd (see Notes 4 and 11).

26. Other interest expense

This item consists mainly of interest expense:

- a. To international financial institutions;
- b. On deposits of the US-Israel Binational Industrial Research and Development (BIRD) Foundation and a deposit of the US-Israel Binational Science Foundation.

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

	For the year ended December 31	
	2008	2007
	(NIS million)	
Foreign currency securities^a	2,506	1,057
Derivative financial instruments^b		
In foreign currency	(68)	137
In local currency	-	3
Total derivative financial instruments	(68)	140
Total	2,438	1,197

^a Including gain from the realization of securities and loss from reduction in their value at the end of the year.

^b Consisting mainly of financial income (expense) from the realization of derivative financial instruments.

28. 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.

29. Other financial income—miscellaneous^a

	For the year ended December 31	
	2008	2007
	(NIS million)	
In local currency	8	5
In foreign currency	(9)	3
Total	(1)	8

^a Consisting mainly of income from (expense on) fees and fines deriving from the Bank of Israel's financial activities.



30. Administrative and general expenses

	For the year ended December 31	
	2008	2007
	(NIS million)	
Staff wages and employees' rights ^a	551	548
General expenses	63	64
Total	614	612

^a This item consists mostly of employees' salaries (on December 31, 2008 there were 712 employee posts, and on December 31, 2007, 716), pension payments to retirees on unfunded (non-contributory) posts, and an update of the Bank's pension and vacation liabilities to employees.

31. Other income

This item consists mainly of dividend income and an update of the provision for Trade Bank.

EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS



Summary of the main changes in the financial statements

The Bank of Israel's balance sheet totaled NIS 169 billion at the end of 2008 as against NIS 133 billion at the end of 2007, an increase of about 27 percent. The foreign exchange reserves,¹ which constitute the main component of the Bank's assets, were NIS 161 billion in 2008 as against NIS 109 billion in 2007, 48 percent up. The increase traces mainly to purchases of foreign currency by the Bank of Israel, as a result of which the Bank injected NIS 44 billion into the economy.

The balance of the aggregate of main monetary instruments² increased from NIS 76 billion at the end of 2007 to NIS 97 billion at the end of 2008, due to an NIS 28 billion increase in the balance of deposits from banking corporations, an NIS 6 decrease in the balance of *makam*, and an NIS 2 billion increase in the balance of securities purchased under repo agreements. The Bank of Israel put the aggregate of main monetary instruments to active use in monetary injection/absorption in accordance with the banks' liquidity situation.

Local currency demand deposits from banking corporations were NIS 15.3 billion in 2008 as against NIS 12.4 billion in 2007. Foreign currency demand deposits from banking corporations were NIS 19.7 billion and NIS 2.3 billion, respectively.³

The Bank's Statement of Operations shows a loss of NIS 0.6 billion—much smaller than the NIS 5.3 billion loss in 2007. The main reason for the decline in loss was a NIS 4.3 billion decrease in the item reserved for expenses on account of exchange rate differentials—NIS 2.3 billion in 2008 as against NIS 6.6 billion in 2007.

¹ In these notes, the term "foreign exchange reserves" is used in its economic sense. The reserves are composed of the balance of "Financial foreign currency assets abroad" on the assets side of the Bank's balance sheet, less the balance of "Financial foreign currency liabilities abroad" on the liabilities side of the balance sheet. These balances are used to determine the Bank of Israel's investment policy and its reportage to various entities; therefore, they constitute the basis for the analysis of trends in these Explanatory Remarks. For the composition of the foreign exchange reserves, see Note 2 of the financial statements. In US\$ terms, the foreign exchange reserves were \$42 billion at the end of 2008 as against \$28 billion at the end of 2007.

² *Makam* and time deposits net of monetary loans and repo auctions. The Bank of Israel used additional monetary instruments in the past, such as options on the US\$ exchange rate and shekel/dollar swap transactions. The issue of options ceased in 2006 and swap auctions ended in 2005.

³ In US\$ terms, the banks' foreign currency deposits were \$5.2 billion in 2008 as against \$0.6 billion at the end of 2007.



The Bank's income from investing the foreign exchange reserves, including interest and other financial profits net of exchange rate differentials, was NIS 5.6 billion in 2008 as against NIS 6 billion in 2007. The decline traces to two contrasting effects: the increase in the reserves during the year led to larger income in local currency terms, whereas a decline in the yield net of exchange rate differentials—from 6.9 percent to 5.9 percent, reflecting price increases in foreign markets—combined with low interest rates on the Bank of Israel's foreign currency portfolio to reduce income.

1. Analysis of main changes in the financial statements and their causes

a. The effect of Bank of Israel activity on the financial statements

The Bank of Israel's activity is derived from the various functions that are tasked to the Bank by law and is not necessarily geared to earning a profit. The attainment of a central bank's objectives provides economy-wide benefits that are not reflected in the bank's financial statements.

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

In 2008, as in recent years, the Bank's financial statements are typified by currency asymmetry: that the vast majority of the Bank's assets are denominated in or indexed to foreign currency while its liabilities are primarily in local currency (Figure 1, Table 7). This asymmetry began to manifest itself in 1995–97, 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 bound of the crawling band that was used at the time 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\$ in previous decades to about \$23 billion in 1998 and thence, gradually, to \$28 billion in 2007.

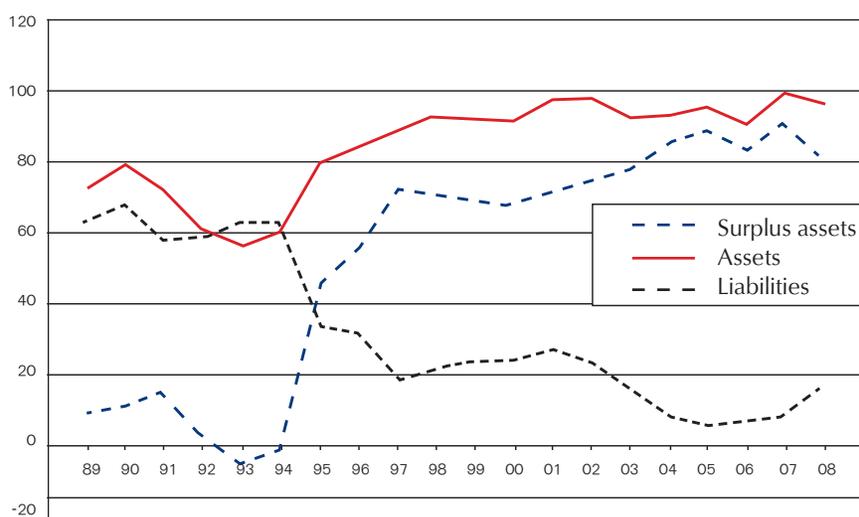
In 2008, after more than ten years without intervening in the currency market, the Bank of Israel began to purchase US\$ in order to build up the foreign exchange reserves. Consequently, the reserves increased by \$13.8 billion during the year and came to \$42 billion at year's end.

The currency asymmetry in the composition of the Bank of Israel's assets and liabilities

exposes the Bank to volatility in its reported financials due to changes in the exchange rate and in Israel's interest trajectory relative to those of other economies.

The monetary-instruments aggregate, composed primarily of monetary loans (as with most central banks) until 1994, is composed primarily of liabilities today. These liabilities increased from NIS 76 billion in 2007, largely in makam, to NIS 97 billion in 2008 (NIS 70 billion in makam and NIS 28 billion in time deposits, less NIS 2 billion in repo auctions). In the Bank of Israel balance sheet, money in circulation is a non-interest-bearing liability.

Figure 1
Foreign Currency Assets, Liabilities and Surplus Assets, 1989 to 2008
 (percent of balance sheet, end-of-year, at current prices)



b. Changes in US\$ exchange rates, interest rates, and inflation

Influenced by dramatic world economic events, 2008 was divided into two periods separated by September, when the U.S. Administration allowed the Lehman Brothers investment bank to collapse. In the first period, the turnaround in the world business cycle that began in 2007 continued, concluding a period of accelerated growth from which the Israel economy, too, had been benefiting since 2003. The second period was typified by the collapse of banking and financial institutions around the world and a liquidity and credit crunch in the United States and Europe, leading to steep declines in the prices of real and financial assets around the world.

Israel's inflation rate in 2008 was 3.8 percent, overshooting the government's inflation target.

The NIS continued to appreciate against the US\$, although more slowly than in the previous two years: the NIS/US\$ exchange rate declined by 1.1 percent, compared with a drop of 9 percent in 2007. The exchange rate against the dollar was severely volatile and



developed unevenly. Until July, the domestic currency gained strongly against the US\$, mainly due to strong economic fundamentals in view of downturns elsewhere in the world, and was also supported by mild US\$ depreciation abroad. This trend persisted even after the Bank of Israel began to purchase US\$ in March in order to build up the foreign exchange reserves. From July to November, the trend reversed direction; the NIS depreciated steeply, mainly due to strong appreciation of the US\$ against other world currencies due to its role as a “safe haven” amid the escalating world financial crisis, and also because the Bank of Israel expedited its US\$ purchases as part of its reserve-building program. In December, appreciation resumed as the US\$ lost ground against other currencies amid aggressive rate cutting by the “Fed” and expectations of continued fiscal expansion in the U.S. in order to extricate the American financial sector and economy at large from their difficulties.

The NIS appreciated vigorously against other currencies as well—by 6.4 percent against the euro and a steep 28 percent against the pound sterling.

The Bank of Israel interest rate was lowered during the year by 1.75 percentage points and rested at 2.5 percent at year’s end. The rate cuts during the year should be described in a two-period structure separated by September. Until September, interest decisions were informed by clashing considerations—a considerably above-target inflation rate coupled with concerns about financial and real activity—that led to frequent changes in the interest trajectory. In September, the rate returned to where it had been at the beginning of the year, 4.25 percent. From September on, as the world crisis took a grave turn for the worse and signs of a turnaround in real activity solidified, all indicators pointed to the need to set interest on a downward path. Accordingly, the Bank of Israel lowered its rate steeply from then on, from 4.25 percent to 2.5 percent—an unprecedentedly low level—in four steps, two of which were decided upon at times other than the planned decision dates. Additional rate cuts followed in 2009.

c. Accounting and economic changes in the financial statements

1. Foreign exchange reserves

Foreign-exchange reserves account for the largest part of the Bank’s assets, and part of the Bank’s remaining assets are linked to foreign currencies.⁴ Due to this composition of assets, exchange-rate fluctuations and interest-rate changes around the world have a material effect on the Bank’s financial statements.

⁴ As noted, this composition of assets was created primarily during the 1995–97 period, during which the Bank of Israel purchased the economy’s surplus capital inflow in order to maintain the government’s exchange-rate policy, i.e., to defend the lower bound of the crawling exchange-rate band. The resulting import of capital by the private sector force the bank of Israel to purchase foreign currency from the public in order to keep the exchange rate within the lower bound of the crawling band and re-absorb the NIS that had been injected into the economy for this purpose. The foreign reserves increased from several billion US\$ in the previous decade to \$23 billion in 1998 and thence, gradually, to \$28 billion in 2007. In 2008, the Bank of Israel introduced a policy of purchasing of US\$, bringing the reserves to \$42 billion by year’s end.

The foreign exchange reserves serve as a source of liquidity when needed and are also intended to provide additional benefits to the economy, since the very fact that Israel maintains a certain level of foreign exchange reserves reduces the probability of a crisis in the foreign exchange market and enhances Israel's status in global financial markets. Defining the functions of the foreign exchange reserves is not simply a theoretical exercise; it also serves as the basis for determining the desired level of the reserves, deciding how to manage them, and setting the currency numeraire, i.e., the neutral currency composition according to which the foreign exchange reserves are managed. Since December 2003 this composition has been derived from the currency distribution of the possible uses of the reserves.

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

The foreign exchange reserves increased in 2008 by US\$13.8 billion, from \$28.5 billion in 2007 to \$42.3 billion at year's end, in contrast to a \$0.6 billion decrease in 2007.

The average level of the reserves increased by \$3.3 billion, from \$28.9 billion in 2007 to \$32.2 billion in 2008.

Several factors explain the change in the reserves. Purchases of foreign currency by the Bank of Israel in the NIS–foreign currency market boosted the reserves by \$12.1 billion, the private sector contributed \$4.3 billion, and the Bank of Israel's profits from interest and financial gains added \$0.7 billion.

On the other hand, withdrawals by the government and the National Institutions had a \$3.2 billion downward effect on the reserves.

The local currency value of the reserves increased from NIS 109 billion in 2007 to NIS 161 billion at the end of 2008. The aforementioned purchases of foreign currency accounted for most of the increase.

Under the influence of world economic events—an upturn in credit risks and a decline in interest rates—the composition of the foreign exchange reserves changed in 2008. The balance of short-term deposits of the Bank of Israel with foreign banks abroad fell from NIS 20.3 billion in 2007 to zero, net holdings of tradable securities climbed from NIS 97.8 billion to NIS 154.9 billion in the respective years, and the balance of securities sold under repo agreements decreased from NIS 10.9 billion to zero.

Table 1
Composition of Changes in the Monetary Base and Foreign Reserves, 1999–2008

injection (+)/absorption(-)

											(current prices)				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2008	I	II	III	IV
NIS million															
1. Change in monetary base (1) = (2 + 3 + 4 + 5)	3,927	311	4,364	1,437	3,567	966	7,357	-1,176	3,979	8,297	-1,439	275	1,210	3,029	3,784
2. Government and National Institutions	4,067	-2,729	-2,611	-6,065	3,479	1,601	-1,452	-3,789	-10,809	-17,371	-358	-9,490	-8,549	-10,755	11,423
3. Bank of Israel	-365	2,729	7,675	9,265	1,425	1,070	9,920	3,797	15,693	-17,305	-744	7,665	5,657	-4,162	-26,464
4. Foreign-currency conversions at Bank of Israel	0	0	0	0	0	0	0	0	0	43,995	0	2,416	4,283	18,338	18,958
5. Adjustments ^a	225	311	-700	-1,763	-1,337	-1,705	-1,111	-1,184	-905	-1,022	-337	-316	-181	-392	-133
\$ million															
Contribution to reserves															
6. Private sector ^b	647	-392	-105	-1,351	-1,204	-631	1,026	25	-196	4,291	-702	-168	1,830	761	1,868
7. Bank of Israel ^c	-198	971	1,067	2,040	1,445	993	125	1,845	2,512	12,789	845	1,810	1,100	4,983	4,896
8. Government and National Institutions ^c	-607	70	-944	-200	1,877	482	75	-673	-2,912	-3,204	-805	-615	-1,153	-856	-581
9. Change in reserves ^d (9) = (6 + 7 + 8)	-159	649	17	489	2,118	844	1,226	1,197	-595	13,877	-662	1,027	1,778	4,888	6,183

a Adjustments include: transfers from abroad by the National Institutions through the banks, defined as public-sector injection (in row 2). Government and Bank of Israel domestic foreign-currency receipts from and payments to the private sector (e.g., income tax receipts in foreign currency) do not change the monetary base, as they are transferred directly from the private sector to the government: on the one hand they are defined as government absorption and on the other they are defined as the private sector's contribution to the foreign reserves (without going via the Bank of Israel's trading-room floor).

b Including income tax payments in foreign currency by the private sector.

c Transfers by the government and the National Institutions, and Bank of Israel income from the foreign reserves (interest income, capital gains and cross-rate differentials).

d Including the change in interest accrued on the foreign reserves.

* By value date. Other data are by balance sheet date.



1.1 Rate of return on the foreign exchange reserves

The Bank of Israel invests the foreign exchange reserves primarily in tradable assets of relatively short average duration. This is done to ensure an appropriate level of liquidity and avoid the risk of large fluctuations in portfolio value as a result of possible swings 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 holdings of assets included in the benchmark, in all currencies, are weighted according to the weights of the currencies in the numeraire. The average duration of the benchmark is set according to the shortfall approach, in which benchmark duration is set so that the annual holding rate of return of the portfolio should not fall below a minimum desired threshold at the desired level of safety. A change in duration may occur due to a change in the parameters of the approach or in the yield and risk to maturity data in the foreign bond markets where the reserves are invested. At the end of 2008, the benchmark duration was fourteen months in the US\$ portfolio and sixteen months in portfolios in other currencies.

The actual annual rate of return on the reserve portfolio was 5.92 percent in 2008, slightly under the 6.12 percent benchmark. The difference reflects the contribution of investment decisions made according to the permitted degrees of freedom in the active management of the reserves, which are reflected in deviations of the composition of the portfolio from the benchmark composition. These degrees of freedom are relatively limited and are restricted by a set of rules that is part of the investment policy for the reserves. The added value of the active management of the reserves is expressed in the difference in yields between the foreign exchange reserves portfolio and its benchmark. The difference is usually positive and came to 0.09 percent on average over the past decade. In 2008, however, the difference was -0.2 percent, signifying a negative contribution of active management that traced mainly to the world financial crisis, which caused the markets to behave unusually and eroded the value of many diverse kinds of financial assets.

In 2007, foreign exchange reserves originating in Israeli commercial banks' deposits with the Bank of Israel were managed separately from the rest of the reserves in order to offset the Bank of Israel's exposures to the currency and interest risks that result from the acceptance of these deposits. In 2008, in contrast, these reserves were managed together with the rest. Accordingly, the yield on the reserves is calculated and reported on a gross basis, i.e., including reserves accrued by the acceptance of deposits, which came to \$5.2 billion at year's end (12.3 percent of the total reserves). Interest and indexation-differential



expenses in account of these deposits affect the Bank's Statement of Operations but have no effect on the yield calculations cited above.

The world financial crisis and, especially, the lowering of yield curves in the foreign bond markets where most of the reserves are invested, had a perceptible effect on the return on the reserves in 2008. Although the decrease in bond yields reduced the component of current interest income in the holding rate of return of the reserves, it concurrently raised the prices of the bonds—the increase was recorded as a capital gain—and thus contributed to the holding rate of return. The downturns in yields to maturity were partly an outcome of rate-cutting by several major countries' central banks, but they also reflected—especially in the U.S.—the result of “flight to quality” in view of the deteriorating state of large and well known financial institutions and the upturn in market uncertainty during the year. The capital gains occasioned by the last-mentioned factor are fully expressed in the benchmark yield of the reserves but are only partly reflected in the actual yield. This is because some of the actual reserves are invested in “spread assets” (assets not included in the benchmark); since the investor public does not perceive such assets as “safe haven” to the same extent, they derive less benefit from the flight-to-quality effect.

The return on the investment of the foreign exchange reserves is measured in terms of the currency composition of the numeraire rather than in terms of one currency or another. The arbitrary nature of measuring return in terms of a specific currency is particularly evident when assessing return in terms of the US\$ (2.8 percent in 2008) and the euro (8.6 percent in 2008) and the high volatility of these returns over time (Table 2).

In NIS terms, the rate of return in 2008 was 1.6 percent. This was lower than the rate in numeraire terms due to the negative effect of rate differentials on the total return, occasioned mainly by the appreciation of the US\$ against other currencies in which some of the reserves are invested and, to a lesser extent, by the 1.1 percent appreciation of the NIS against the US\$ in 2008. Importantly, the NIS rate of return, like all the rates in Table 2, is calculated by weighting the daily rates of return over time, irrespective of increases or decreases in the level of the reserves. Accordingly, it was affected by the level of the Bank of Israel's purchases of foreign currency during the year, which took place at an average rate that was more than 5 percent lower than the end-of-year rate. In the last decade, the holding period rate of return in NIS terms was 3.7 percent per year in nominal terms and 1.9 percent when discounted for increases in domestic prices.

Table 2
Foreign Reserves—Total, Income, Exchange Rate and Cross Rate Differentials, and Yields, 2006–08

	2008	2007	2006
Total foreign reserves			
	\$ million		
End of year	42,337	28,460	29,055
Annual average	32,159	28,886	27,955
Income and exchange rate and cross rate differentials			
	NIS million		
Total	3,790	-2,351	-2,707
Interest and capital gains	5,627	6,014	4,616
Cross rate differentials (\$/other currencies)	-1,837	-8,365	-7,323
	\$ million		
Total	539	2,087	1,771
Interest and capital gains	1,573	1,509	1,062
Cross rate differentials (\$/other currencies)	-1,034	578	709
Yields^a			
	Percent		
In terms of NIS			
Total	1.6	-0.5	-2.3
Interest and capital gains	5.9	6.9	3.9
Exchange rate differentials	-4.3	-7.5	-6.2
In terms of euro			
Total	8.6	-2.2	-4.3
In terms of \$			
Total	2.8	9.3	6.5
Interest and capital gains	5.9	6.9	3.9
In terms of use^b of foreign reserves	5.9	6.9	3.8
Benchmark yield	6.1	6.9	3.7

^a Yields (annual, compounded daily) refer to income from the foreign reserves, including profit or loss arising from changes in market prices.

^b See note 2 to the financial statement.



2. Exchange rate differentials

Net exchange rate differentials were negative at NIS 3.5 billion in 2008 as a result of the adjustment of foreign currency balances in the balance sheet according to the representative exchange rate (NIS 7.4 billion in 2007; see Table 3). Around NIS 1.8 billion in differentials accumulated on account of the foreign exchange reserves and NIS 1.7 billion accumulated on account of banking corporations' foreign currency deposits.

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 recognized as "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 realizations in a particular currency are first offset against the revaluation account of that currency, if such an account exists, and only afterwards are they charged to the Statement of Operations. A negative balance in the revaluation account of a particular currency at the end of the year is defined as realized and is therefore charged to the Statement of Operations.

In the Statement of Operations for 2008, an NIS 2.3 billion loss is recorded on account of exchange rate differentials, as against an NIS 6.6 billion loss in 2007.

Table 3
Exchange Rate Differentials on Foreign Currency Balances, 2007–08

(NIS million, at current prices)

	2008	2007
Assets		
Foreign exchange reserves	-1,837	-8,365
Credit to the government—binational funds	-1	-13
International financial institutions	-10	-19
Liabilities		
Government deposits	47	643
Banks' foreign currency deposits	-1,694	285
International financial institutions	23	35
Other liabilities—NIS/\$ swaps	2	14
Total	-3,470	-7,420
Realized exchange-rate differentials	-2,318	-6,607
Unrealized exchange-rate differentials	-1,152	-813

3. Government accounts⁵

Section 57(a) of the Bank of Israel Law states, “The Bank shall be the sole banker and fiscal agent of the government in Israel.” Accordingly, the government manages all of its local currency accounts and some of its foreign currency accounts with the Bank of Israel.

Government accounts with the Bank of Israel are classified in two groups—deposits for financing of the budget and other deposits (Table 4).

According to Section 45(b) of the Bank of Israel Law, the Bank may give the government “a provisional advance in order to bridge temporarily gaps in the government’s cash flow in the performance of the budget, provided that the sum of the temporary advance shall not exceed, at any time, 1.6 percent of the total ordinary budget at that time”.⁶ For this purpose, the government designates specific deposits for the financing of its budget. All local currency government deposits with the Bank of Israel (except for several exceptional balances) may be offset, but the government does not intend to offset its local currency deposits against its foreign currency deposits; therefore, these deposits are shown separately. Government debit balances that are not offset are recorded on the “Credit to the government” line.

From 1998 to 2005, the government’s NIS deposits were usually in debit whereas its foreign currency deposits had credit balances that were larger (Figure 3). Although overall the government had a credit balance in its deposits for financing the budget and met the requirement of the Law, this method of managing the accounts was costly and exposed the government to currency risk.

The NIS value of the government’s deposits is highly volatile due to their dependency on the US\$ exchange rate. In 2006–08, for example, exchange rate differentials reduced the government accounts by NIS 582 million, NIS 643 million, and NIS 47 million, respectively, whereas in 2005 they had a positive effect on the accounts. Most of the government’s foreign currency balances are placed in a deposit account for the raising of capital by means of the U.S. Government guarantee facility. This trend changed direction in 2006; since then, the government’s local currency deposits have usually had credit balances.

⁵ Government deposits in local currency can be offset one against the other, apart from a number of special deposits. However, the government does not intend to offset its local currency deposits against its foreign currency deposits and therefore the balances of these deposits appear separately in the financial statements. The economic analysis that appears in these notes refers to net government balances, i.e., the government balances that appear on the credit side of the balance sheet less the balances presented on the debit side (Table 4). The balances of the Postal Bank and the National Insurance Institute are included in the government balances on the credit side.

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

⁶ The Law allows the temporary advance to be enlarged to 3.2 percent for two periods during the course of the year on the condition that neither period exceeds 30 days.



3.1 Credit to the government

In 2008, credit to the government was composed primarily of long-term advances that the government received in the 1980s in order to finance its budget deficits. Most of the loans were provided after the law forbidding the printing of money was enacted in 1985. The advances provided before 1985 are indexed to the first basket of currencies and bear an indexed rate of interest of 8 percent; the subsequent loan bears an interest rate of prime plus 2 percent. The loans will be paid back in annual installments by 2012.

In 2008, the government made NIS 0.7 billion in paybacks, much as it did in 2007, and outstanding credit to the government fell to NIS 1.3 billion. The government's interest payments in 2008 were NIS 0.2 billion, much as in 2007. Indexation to the first basket of currencies was zero, as in 2007.

3.2 Government deposits

The government's debit balance in its NIS deposits with the Bank of Israel continued to trend down. The net balance of government deposits for financing the budget in local currency was NIS 1.5 billion at the end of the year as against a negative NIS 3 billion in 2007. The average balance climbed from NIS 4.8 billion in 2007 to NIS 8.5 billion in 2008 as the government raised capital from internal sources in excess of its needs for exceptional payments in 2009.

Due to the contraction of the government's debit balance in its local currency deposits, interest expense to the government climbed from NIS 220 million in 2007 to NIS 397 million in 2008. In comparison, in 2003, 2004, and 2005, the government had interest income in the sums of NIS 943 million, NIS 342 million, and NIS 52 million, respectively. The trend changed in 2006 as the government was paid NIS 57 million in interest expense.

Interest expense on account of the government's foreign currency deposits decreased from NIS 290 million in 2007 to NIS 106 million in 2008; this was due to declining interest rates.

The average balance of government deposits for financing the budget in foreign currency was NIS 6.2 billion in 2008 as against NIS 6.3 billion in 2007. This change in the composition of the government's accounts reduces the exposure to changes in the exchange rate of the NIS against the various currencies and to changes in the interest spread between Israel and the US.

On some unindexed local currency deposits, interest at prime rate is charged (on debit balances) or paid (on credit balances). Interest at the Bank of Israel rate is paid

on some government reserves that are used for bond-lending activity. Government foreign currency deposits derived from borrowing under US government guarantee and a portion of the other foreign currency deposits earn interest at the rate paid on six-month US Treasury bills.

Figure 2
Total Financial Movements between the Bank of Israel and the Government, and the Bank of Israel Profit, 1980 to 2008

(percent of GDP, at current prices)

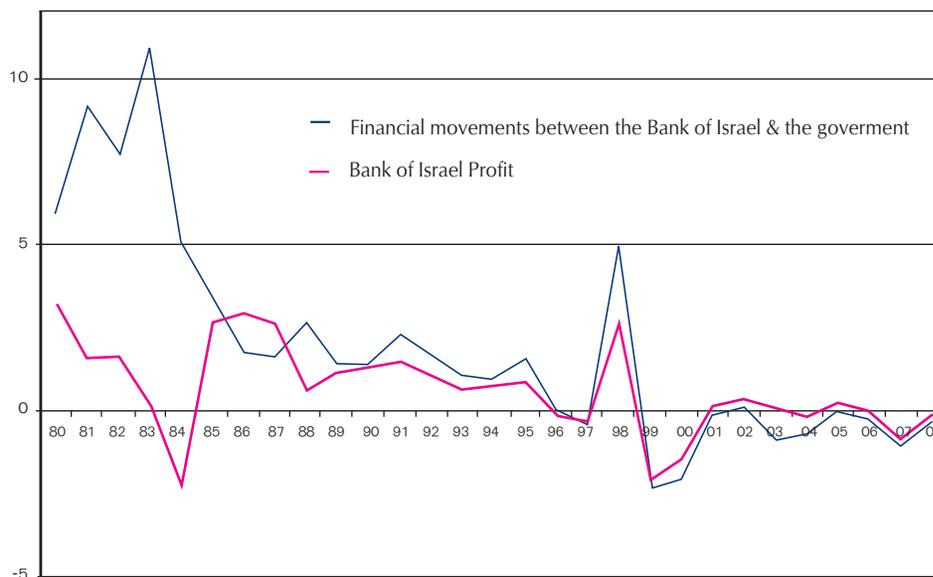


Figure 3
The Government's Local - and Foreign - Currency and Total Deposits for Budget Financing, 1995 to 2008

(annual average, NIS billion, at current prices)

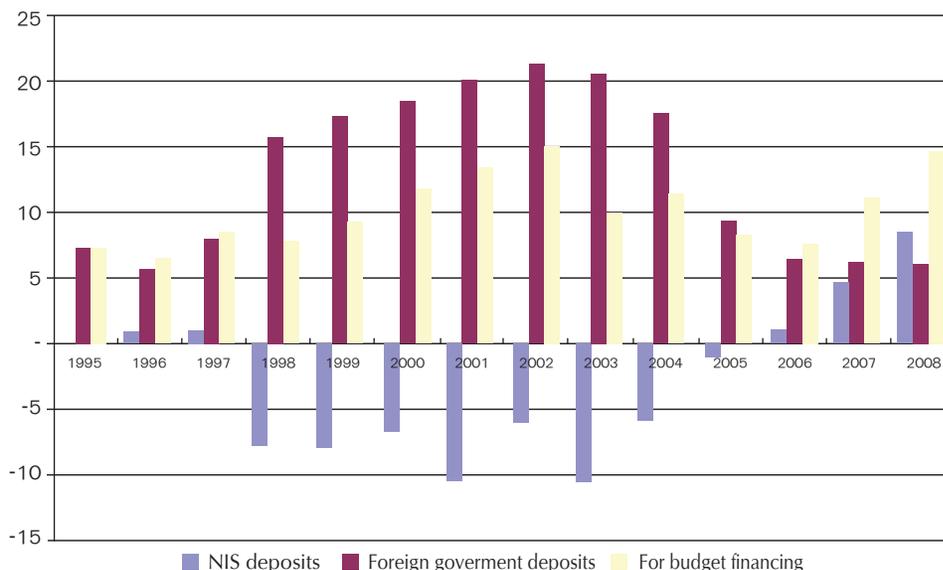


Table 4
Government Deposits with the Bank of Israel, 2006–08

(NIS million, current prices)

	2008	2007	2006
End-year balances			
Government deposits for budget financing			
Local-currency deposits	1,537	-3,077	-652
Foreign-currency deposits	6,838	6,314	6,066
Total government deposits for budget financing	8,375	3,237	5,414
Other deposits ^a	27	257	668
Total	8,402	3,494	6,082
Net change in government deposits	4,909	-2,588	-845
Sources of change			
Government contribution to foreign reserves ^b	-12,509	-13,023	-4,588
Government absorption	18,469	11,978	5,234
Government–Bank of Israel financial flow ^c	-1,094	-1,596	-1,582
Adjustments ^d	43	53	91

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

^b Government income and expenses abroad, loans received and loan repayments abroad.

^c Interest payments and redemption of government bonds held by the Bank of Israel; commission from the government; interest payments, repayment of principal and payment of indexation differentials on credit to the government, and interest payments by the Bank of Israel on government deposits (in local and foreign currency); exchange-rate differentials on government foreign-currency deposits; and transfer to the government of Bank of Israel's profit.

^d Including accrued interest on government deposits to the end of the year; interest payments by the government on credit from the Bank of Israel for binational funds (these payments are included under 'Government injection,' but in this table they are also included under 'Government–Bank of Israel financial flow'); State of Israel Bonds redemptions by tourists in Israel (these redemptions reduce the government's local-currency deposits, but are not included in 'Government injection')

3.3 Raising of capital

Net capital raised by the government abroad was negative in 2008, as in 2007. The government raised capital abroad in 2008 only by issuing State of Israel Bonds; it carried out no private issues. The reasons for this were the government's budget surpluses, instability in foreign markets, and the government's efforts to reduce its indebtedness.

3.4 State of Israel Bonds

The government raised \$1.2 billion in State of Israel Bonds in 2008, as in 2007. The government issues Israel Bonds on a regular basis during the year, using much of the proceeds to make payments abroad and depositing a small proportion of the proceeds with the Bank of Israel.

4. Monetary instruments

The Bank of Israel uses various monetary instruments to carry out its policies, and this is reflected in its Financial Statements.

Until 1995, the Bank was mainly an injector of liquidity into the economy; as a result, the monetary-instruments aggregate was composed largely of monetary loans. From that year onward, the proportion of monetary loans in the aggregate declined due to the need to absorb surplus liquidity created in the economy as a result of the Bank's activity in the foreign exchange market. As a result, the Bank became a net borrower from the banking system, primarily through time deposits and *makam*.

Until 2001, time deposits were the main instruments in the absorption of liquidity, but with the removal of the ceiling on *makam* at the beginning of 2002, the Bank began to gradually increase the use of *makam* at the expense of time deposits. In this manner, the Bank also intended to expand the financial market and achieve greater efficiency in the utilization of monetary instruments. At the end of 2007, the balance of time deposits was NIS 0.3 billion. The trend changed direction in 2008, as the balance of time deposits came to NIS 28 billion.

The Bank of Israel uses *makam* as an active monetary tool for the injection or absorption of liquidity depending on the commercial banks' state of liquidity. In 2007, after more than a decade of gradual growth, the volume of outstanding *makam* contracted to NIS 76 billion at year's end. Outstanding *makam* declined again in 2008, to NIS 70 billion.

Due to the two aforementioned changes, the total balance of the monetary aggregate increased from NIS 76 billion in 2007 to NIS 97 billion in 2008 (Table 7).

In 2008, the Bank of Israel became an active player in the foreign currency market for the first time in ten years by embarking on activity to build up its reserves. Although its purchases injected liquidity into the market, the entire liquidity surplus that resulted from this (i.e., the portion exceeding the quantity needed) was absorbed by means of monetary instruments. As a result of the injection created by the Bank's foreign currency purchases, the amount of monetary loans contracted and bank deposits increased. The pace of *makam* issues also contributed to the increase in absorption.

In August 2008, the Bank of Israel began issuing three-month *makam* once again. These issues accelerated after the events in September in response to strong demand for



investment via the money funds that entered the market at the beginning of the year. The money funds, which came onto the scene in response to demand originating in structural reforms and financial developments, generated brisk demand for short-term assets as part of the tendency to shorter terms and the preference of liquid and safe assets.

4.1 Short-term bills (makam)

The *makam* balance followed the downward trajectory that was first evinced in 2007, ending the year at NIS 70 billion as against NIS 76 billion a year earlier—a 7 percent decrease (after a 20 percent decline in 2007).

The decrease in interest expenditure on account of *makam*, from NIS 4.2 billion in 2007 to NIS 3.3 billion in 2008, also reflects the decreases in rates of return on these instruments and in the Bank of Israel rate.

4.2 Monetary loans and time deposits

To regulate liquidity on a daily basis, the Bank of Israel continues to use deposit and monetary-loan auctions. Therefore, the balances of these loans on any specific day have no particular significance.

The balance of monetary loans was zero at the end of 2008, as in 2007. The average balance of loans decreased from NIS 9 billion in 2007 to NIS 4.6 billion in 2008.

The balance of time deposits was NIS 28.3 billion at the end of 2008 as against NIS 300 million a year earlier. The average balance was around NIS 1 billion in both years.

4.3 Purchases of securities in repo transactions

In October 2007, the Bank of Israel began to carry out reverse repo transactions with institutional investors and banking institutions. These transactions are performed by auction in which the Bank of Israel purchases government bonds and *makam* from institutional investors and banking corporations and sells them back at the end of the auction term at a pre-determined price. The Bank's goal in these transactions is to promote the development of the repo market and, thereby, to deepen and enhance the capital market and improve liquidity and tradability in the securities markets. These transactions may help to reduce the cost of holding a stock of securities for market makers and other financial investors and to increase competition with the banking system.

The balances of repo transactions as of December 31, 2008, were NIS 2 billion (as against zero at the end of 2007). Income from these transactions was NIS 29 million in 2008 as against NIS 9 million in 2007. In contrast, the Bank incurred expenses due to the need to absorb the injection that was created by the use of this instrument.

5. The securities portfolio

The Bank of Israel's portfolio of securities includes CPI-indexed government bonds that the Bank purchased as part of its monetary policy and its intervention in the bond market. Many of these purchases were made in 1995 and 1996. The balance of the portfolio was NIS 2.4 billion at the end of 2008 as against NIS 2.9 billion a year earlier. The income from this portfolio is included in the Statement of Operations on a cash basis. Interest is paid annually and indexation is paid on maturity. The interest and indexation-differential income from this portfolio was NIS 251 million in 2008 as against NIS 226 million in 2007.

6. Demand deposits from banking corporations

Banking corporations use local currency demand deposits with the Bank of Israel to fulfill their liquidity requirements, in accordance with the directives of the Bank of Israel, and to settle various payments carried out through their intermediation. The balance of these deposits of banking corporations grew from NIS 12.4 billion in 2007 to NIS 15.3 billion in 2008. The average annual balance increased from NIS 11.4 billion to NIS 12 billion in the respective years (Table 6).

The government injected about NIS 9.6 billion through the commercial banks in 2008 (as against NIS 3.1 billion in 2007). The public withdrew NIS 13.4 billion in cash from the banking corporations (NIS 11.8 billion in 2007). Most of the withdrawal—NIS 8.6 billion (NIS 8.4 billion in 2007)—was intended for payments to the government via the Postal Bank, which in large part are made in cash (table 5).

In net terms, the Bank of Israel injected NIS 27 billion into the commercial banks by purchasing foreign currency and by using its various monetary instruments—makam, time deposits, monetary loans, and securities purchased in repo transactions—as against an injection of NIS 15.7 billion in 2007. Most of the difference was due to the Bank of Israel's purchases of foreign currency.

The balance of banks' foreign currency deposits grew perceptibly, from NIS 2.3 billion in 2007 to NIS 19.7 billion in 2008. Table 6 shows that the annual average of these deposits increased from NIS 0.9 billion in 2007 to NIS 1.6 billion in 2008. There are two main reasons for this increase: first, due to the world economic crisis, the banks increased their foreign currency deposits with the Bank of Israel by NIS 4 billion. Second, the Bank of Israel began to accept foreign currency deposits from the banks at the beginning of September 2007 as collateral for the banks' activity in the RTGS system. The balance of the deposits as of December 31, 2008, was NIS 4.9 billion (as of December 31, 2007—NIS 1.5 billion).



Table 5

Deposits of the Banking Corporations with the Bank of Israel, 2006–08

(NIS million, current prices)

	2008			2007			2006		
	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total
Change in banking corporations' deposits^a	2,903	17,438	20,341	552	23	575	-2,305	1,146	-1,159
Activity with the government ^b	-9,573	711	-8,863	-3,132	1,185	-1,947	4,511	1,167	5,678
Withdrawal (-) of banknotes from Bank of Israel	-13,393	0	-13,393	-11,792	0	-11,792	-10,435	0	-10,435
Activity with Bank of Israel ^c	-17,453	1,797	-15,656	15,533	-135	15,398	3,637	-54	3,583
Transfers from (+) and to (-) abroad	0	14,916	14,916	0	-1,044	-1,044	0	21	21
Foreign-currency conversions at Bank of Israel	43,995	0	43,995	0	0	0	0	0	0
Adjustments	-673	14	-658	-57	17	-40	-18	12	-6
Deposit of banknotes by the Postal Bank in Bank of Israel ^d	8,620	0	8,620	8,401	0	8,401	9,295	0	9,295

^a This does not include the change in time deposits.

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

^c Depositing time deposits, the purchase of makam, the sale of government bonds, and various interest payments.

^d Deposits of banknotes mainly by the Postal Bank; these deposits are a government absorption, and are included under 'Government injection'.

Table 6

Accounts of the Banking Corporations with the Bank of Israel, 1999–2008

(daily average, current prices)

	(daily average, current prices)														
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2008				
											I	II	III	IV	
Local-currency deposits and credit ^a															
NIS billion															
1. Demand deposits	5.5	6.6	7.8	8.3	8.3	9.0	9.8	10.2	11.4	12.0	11.9	11.7	11.9	11.8	12.6
2. Time deposits	44.1	46.0	46.5	33.5	30.5	21.0	9.3	2.6	0.7	0.9	0.6	0.9	0.1	0.0	2.7
3. Loans															
3.1 Monetary	0.8	0.8	0.8	0.8	0.8	0.8	0.6	3.3	9.0	4.6	2.1	4.5	7.8	5.3	0.9
3.2 Other	-	-	-	0.6	2.1	1.7	1.2	0.9	0.6	0.4	0.5	0.4	0.4	0.4	0.4
4. Net deposits (= 1+2-3)	48.8	51.8	53.4	40.4	36	27.5	17.4	8.7	2.5	7.9	9.9	7.7	3.8	6.1	14.0
5. Net deposits plus swaps	54.6	57.5	59.3	47.0	42.4	33.8	21.0	8.7	2.5	7.9	9.9	7.7	3.8	6.1	14.0
6. Net deposits plus swaps and makam ^b	78.6	83.3	89.8	85.3	91.4	97.8	97.5	97.0	87.8	83.4	87.2	82.2	78	81.4	91.9
Foreign-currency deposits and credit ^b															
\$ billion															
7. Deposits	2.0	2.2	2.4	2.1	0.5	0.3	0.3	0.2	0.9	1.6	0.8	0.5	1.1	2.4	2.6
8. Net deposits less swaps ^c	0.6	0.8	1	0.7	-0.9	-1.1	-0.5	0.2	0.9	1.6	0.8	0.5	1.1	2.4	2.6
NIS billion															
9. Net deposits less swaps ^c	2.4	3.3	4.0	3.5	-4.1	-4.7	-2.1	1.0	3.6	5.9	3.2	1.9	3.7	8.2	9.8
10. Total net deposits plus swaps and makam (= 6 + 9)	81.0	86.5	93.8	88.8	87.3	93.1	95.4	98.0	91.4	89.3	90.4	84.1	81.7	89.6	101.7
Rates of interest (percent) ^{d,e}															
11. Monetary loans	11.8	8.9	6.5	6.6	7.1	3.8	3.2	5.1	3.9	3.7	4.0	4.1	3.4	4.0	3.3
12. Time deposits	12.2	9.4	6.9	7.0	7.5	4.3	3.7	5.0	3.7	3.1	4.0	4.2	3.2	3.7	2.8

^a Items 1–10 include accrued interest.

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

^c Deposits less loans and less dollar swaps to be received. (Not including the part of the makam deposit resulting from the changing of government bonds into makam.)

^d In July 2005 the Bank of Israel stopped the NIS/\$ swap auctions.

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

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



7. 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 during the year by NIS 8.3 billion (Table 1) as against an NIS 4 billion increase in 2007. Banknotes and coins in circulation were worth NIS 34 billion in 2008 as against NIS 29 billion in 2007.

On daily average, NIS demand deposits increased by NIS 0.6 billion and the annual average grew gently.

The growth in the monetary base is primarily the result of injection by the Bank of Israel (NIS 27 billion) and absorption by the government and the National Institutions (NIS 17.4 billion). The government absorption was the result of the ongoing budget deficit, for which sources were raised on a daily basis.

8. Bank of Israel capital

The Bank of Israel's capital is composed of share capital and a general reserve, less the balance of accumulated losses.

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

The Bank of Israel had NIS 21.4 billion in cumulative losses in 2008 as against NIS 20.8 billion in 2007. According to the Bank of Israel Law, the Bank must transfer any profit it makes to the government at the conclusion of each business year but the Bank's losses are not covered by the government. The losses accumulate in the Bank's financial statements and are offset against future profits. The balance of accumulated losses came about mainly because interest expense incurred in the management of monetary policy exceeded interest income on the foreign exchange reserves and due to negative exchange rate differentials.⁷

⁷ Until 1999, there was a different policy for recognizing exchange rate differentials. All accumulated exchange rate differentials were recognized in the financial statements as realized and were transferred to the government at the end of the year. In 1998, an amount of about NIS 15 billion in exchange rate differentials was recorded in the financial statements due to steep depreciation of the NIS. A major part of these exchange rate differentials were already offset at the beginning of 1999 as a result of a decline in the exchange rate. However, since the profit balance had already been transferred to the government, the result was an increase in the accumulated loss. If the present method had been in use in 1998, the balance of the loss would be smaller than its level today.

9. The Statement of Operations

The Bank of Israel recorded a loss of NIS 0.6 billion in 2008, much smaller than the NIS 5.3 billion loss in 2007. The main reason for the contraction of the loss is that expenses on account of exchange rate differentials fell from NIS 6.6 billion in 2007 to NIS 2.3 billion in 2008. The Bank of Israel's income from the foreign exchange reserves, not including exchange rate differentials, decreased by NIS 0.4 billion—from NIS 6 billion in 2007 to NIS 5.6 billion in 2008. In US\$ terms, the increase was \$0.1 billion—from \$1.5 billion in 2007 to \$1.6 billion in 2008. Net expenses on account of the monetary aggregate fell from NIS 3.9 billion in 2007 to NIS 3.1 billion in 2008.

Table 7
Indicators of the Bank of Israel Profit, 1991–2008

	Profit (loss)	Realized exchange rate differentials ^a	Monetary aggregate December 31 ^b	Surplus foreign currency assets December 31	Average annual interest rates	
					Time deposits	Monetary loans
	NIS billion			\$ billion	percent	
(at current prices)						
1991	1.9	0.8	-1	2.0		15.5
1992	1.7	0.6	-5	0.3		12.1
1993	1.3	-0.2	-10	-0.8		10.7
1994	1.8	0.4	-8	-0.3		12.7
1995	2.5	1.4	9	6.0		14.9
1996	-0.5	0.5	21	8.6	16.2	14.9
1997	-1.1	2.1	51	17.5	13.9	13.5
1998	10.9	13.1	63	18.4	11.9	11.5
1999	-8.7	-3.5	73	17.7	12.2	11.8
2000	-6.7	-3.7	80	18.0	9.4	8.9
2001	0.9	0.1	79	18.7	6.9	6.5
2002	1.7	0.9	77	20.2	7.0	6.6
2003	0.3	2.5	84	23.0	7.5	7.1
2004	-0.8	0.9	87	25.4	4.3	3.8
2005	1.4	1.9	87	26.7	3.7	3.2
2006	0.1	0.5	88	27.4	5.0	5.1
2007	-5.3	-6.6	76	26.1	3.7	3.9
2008	-0.6	-2.3	97	35.0	3.1	3.7

^a Until 1999 all exchange rate differentials were defined as realized.

^b The publication of the currency basket exchange rate was discontinued on May 1, 2007, because the exchange rate band (which related to the currency basket exchange rate) was abolished on June 9, 2005, and that exchange rate is no longer used for monitoring or analysis.



9.1 Bank of Israel income

The main component of the Bank's income is derived from the foreign exchange reserves. Income from interest on the reserves decreased by 33 percent in 2008, at NIS 3.2 billion as against NIS 4.8 billion in 2007. The main reason for the decrease was a decline in the average interest rate on the bank's reserve portfolio.

Other financial income on the foreign exchange reserves increased from NIS 1.2 billion in 2007 to NIS 2.4 billion in 2008. The upturn is partly explained by an increase in capital gains due to falling yields in the US market, occasioned by the mortgage crisis.

9.2 Bank of Israel expenses

The main component of the Bank's expenses in 2008 was exchange rate differentials and interest expense to banks and the public. Expenses on account of exchange rate differentials were NIS 2.3 billion in 2008 as against NIS 6.6 billion in 2007.

The total negative exchange rate differential that came about due to the adjustment of balances denominated in foreign currency in the balance sheet to the representative exchange rate was NIS 3.5 billion (NIS 7.4 billion in 2007; see Table 3). Of this sum, NIS 1.8 billion was accrued on the foreign exchange reserves (Table 3) and NIS 1.7 billion accumulated on account of banking corporations' foreign currency deposits. As mentioned above, according to the method used for recognizing exchange rate differentials in the Bank's financial statements, the exchange rate differentials accumulated on balance-sheet balances are not fully charged to the Statement of Operations unless they are recognized as realized. Recognition of realization with regard to a particular currency occurs only when the balance held in said currency declines.

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

Net interest expense on account of the monetary aggregate decreased from NIS 3.9 billion in 2007 to NIS 3.1 billion in 2008. Most of the NIS 0.8 billion decrease in net expenses traces to an NIS 1 billion decline in expenditure on account of *makam* and an NIS 0.2 billion downturn in interest income on monetary loans. The decrease in expenses on account of *makam* originates in the decline in the average balance of these instruments, from NIS 87 billion in 2007 to NIS 77 billion in 2008, and a



decrease in their yields. The decrease in income from monetary loans comes from the decline in their average balance from NIS 9 billion in 2007 to NIS 4.6 billion in 2008.

Net interest expense to the government were NIS 25 million in 2008 as against NIS 3 million in 2007. This was due mainly to the increase in the government's average credit balance on its NIS deposits.⁸ The rate of interest on most of the government's current NIS deposits is the prime rate irrespective of the state of the balance (credit or debit). In contrast, the government does not receive interest from the Bank of Israel on credit balances in foreign currency deposits, except for special deposits. Therefore, a decrease in the average debit balance of the government's NIS deposits causes the Bank's interest expense to the government to increase.

General and administrative expenses totaled NIS 614 million in 2008, NIS 2 million more than in 2007.

⁸ See the "Government accounts" section.



THE PAYMENT AND SETTLEMENT SYSTEMS IN ISRAEL–2008

1. Main changes in the payment and settlement systems

The payment and settlement systems in Israel have undergone an upgrading process in recent years, which is now at an advanced stage. By the end of the process, the systems will meet the international standards set by the Bank of International Settlement (BIS).

The reform of the payment and settlement systems in recent years has encompassed a variety of issues, including the cancellation of retroactive entries, the extension of the bank business day and improvements in the clearing process for checks. The highlight of the reform is the creation of the Zahav system (Real Time Gross Settlement System) which began operating in the third quarter of 2007. The Zahav system enables the immediate and final settlement of large or urgent payments. It also serves as the final clearer for all the settlement systems, including the paper-based clearing house (checks), the banks' automated clearing house (known as Masav) and the Tel Aviv Securities Exchange (TASE) clearing houses. As part of the creation of the Zahav system, all the settlement systems in the economy were evaluated and some of them reorganized, thus contributing to their increased efficiency.

During the course of the year, some 216 thousand transactions were settled representing a total value of about NIS 21,850 billion. The inter-bank transactions in the Zahav system constituted about 72 percent of the total inter-bank amounts settled in the three main settlement systems (Zahav, Masav and checks).

The Bank of Israel is working to expand the use of the system and in this way encourages reinforcement of the economy's financial stability and reduction of risk in other payment systems (checks and Masav). The importance of stability in the payment systems and the reduction in risk is especially important in view of the global financial crisis, which became particularly acute in the second half of 2008. The existence of a system that enables immediate and final settlement in a period of financial uncertainty makes it possible for financial entities to implement transactions safely and without settlement risks.

In order to ensure the stability of the Zahav system and the minimization of legal risks related to it, the Bank of Israel had to create a legal framework for the system. Thus, on February 4, 2008, the Knesset approved the Payment Systems Law, 5768-2008 (hereafter: the "Law"). The Law relates to, among other things, the finality of settled payments in



the Zahav and CLS (Continuous Linked Settlement) systems, bankruptcy (dissolution) of a participant in the Zahav system and the granting of authority to the Bank of Israel to oversee the payment systems, defined as supervised.

The Zahav system has provided Israel with new options, both domestically and internationally, and made it possible for the shekel to be included in settlement by the CLS bank¹ in May 2008. The settlement in the CLS system is carried out simultaneously in the two relevant currencies and is final. The final and simultaneous settlement between two different currencies minimizes the risks involved in conversion transactions. The addition of the Israeli currency to the international settlement system significantly reduces the conversion risks involved in the international activity of business entities in Israel, reinforces the stability of the currency and also transforms the shekel into a convertible currency that is freely traded world wide.

The importance of joining the CLS was demonstrated in September 2008 (about four months after the shekel was added) when financial entities in Israel were able to safely continue carrying out transactions—through the CLS—with foreign banks threatened with bankruptcy.

In addition to the issues dealt with by the reform in the past, planning for check truncation was continued and a legislative memorandum for the proposed law Electronic Clearing of Checks, 5768-2008 was published. The legislation process will be voted on during 2009. At the same time, the appropriate operational infrastructure is being prepared to implement the law, which will include the ability to convey files with images of checks between the banks.

2. The payment systems in Israel

There are a number of interbank clearing houses operating in Israel: Zahav, the banks' clearing house (Masav), the paper-based clearing house (checks) and the TASE clearing houses (securities and derivatives). The Masav, the paper-based clearing house and the TASE clearing houses transfer net data to the Zahav clearing house. The settlement in the Zahav system is final and its results are transferred to the bookkeeping system of the Bank of Israel.

The interbank payment systems exist to facilitate payments between customers who maintain accounts at different banks. There is no need to use the interbank payment systems for transfer of payments between customers with accounts at the same bank.

¹ Up until the addition of the shekel, the CLS maintained settlement accounts in 15 currencies: the US dollar, euro, pound sterling, Swiss franc, Japanese yen, etc. Together with the shekel the Mexican peso joined the CLS as well.



The Zahav system

The Zahav system is similar to the RTGS (Real Time Gross Settlement) system existing in most other economies (both developed and emerging). The system was inaugurated at the end of July 2007 and it enables the final and immediate settlement of bilateral transactions between settlement participants, as well as net multilateral transactions initiated by the clearing houses (i.e., Masav, the TASE clearing houses and checks). Settlement in the Zahav system is safe since the participants are linked to the system through the SWIFT international communication system which is used for the safe transfer of funds in numerous countries in the world. The Zahav system meets the very high standards set by the State Authority for Information Security in Israel.

The main goal of the Zahav system is to reduced to a minimum the various risks associated with the other settlement systems, such as systemic risk, liquidity risk, credit risk, legal risk and operational risk. The system's settlement of interbank payments is immediate and final, such that the balances of each of the participants in the system are final.

The Zahav system operates from 7:45 to 18:30 each business day. The system is managed by a control room in the Bank of Israel, which is responsible for ensuring the ongoing operation of the system, treating various types of business problems, giving warnings on technical problems. The control room also provides help desk services to system participants.

The system is used to settle bilateral transactions between customers and between banks, as well as transactions between the banks and the Bank of Israel, including credit to the banks, banks' deposits with the Bank of Israel, withdrawal of cash from the Bank of Israel, etc. In addition, the system settles the net results of the other payment systems (Masav, the paper-based clearing house and the TASE clearing houses).

In 2008, a total of 193,500 transactions were settled in the Zahav system, which represents an average of 645 transactions per business day and a total of about NIS 6,480 billion for the year. The remainder of the transactions in the Zahav system were carried out by the clearing houses and by the Bank of Israel and totaled about NIS 15,370 billion.

Table 1
Activity in the Zahav System, January–December 2008

	Total		Interbank transactions*	
	Number of transactions	Value	Number of transactions	Value
		(NIS million)		(NIS million)
January	22,039	2,017,494	19,938	638,853
February	20,030	1,766,263	18,148	573,925
March	21,947	1,821,358	20,252	686,934
April	19,911	1,773,874	18,315	597,756
May	18,194	1,953,038	16,294	529,900
June	17,163	2,293,280	14,973	546,177
July	18,286	1,929,742	15,616	566,758
August	15,186	1,842,560	13,297	464,954
September	16,341	1,692,060	14,664	526,628
October	14,682	1,382,779	13,264	458,207
November	15,712	1,523,965	13,883	431,202
December	17,047	1,854,398	14,847	459,048
Total	216,538	21,850,811	193,491	6,480,342

*Including transactions of the banks and their customers.

The banks' clearing house

The banks' clearing house is composed of the paper-based clearing house (checks) and the Masav automated clearing house (Masav). The clearing house operates according to an agreement between its members, i.e., the commercial banks in Israel, the Postal Bank and the Bank of Israel. Some of the clearing house members operate directly within the clearing house while others are represented by other banks.

The banks' clearing house is managed by its Board which consists of 14 members, half of whom are from the Bank of Israel and half of whom are from the banking system. The banks' clearing house operates according to the "clearing house regulations," which are periodically updated by the Board. The Board meets every month to discuss the ongoing needs of the clearing house and to update the clearing house regulations according to those needs. Once a year the Board publishes the report regarding its activity.



Paper-based clearing house (checks)

The instruments presented by the banks to the paper-based clearing house are primarily checks, which are currently presented electronically only. In addition, non-magnetic debits and credits (which are manual transmissions) are also presented, as well as returned checks and manual transmissions.

The number of checks drawn in 2008 (including checks deposited at the bank from which they were drawn) totaled 159 million units, with a value of NIS 924 billion (Table 7). About NIS 800 billion, which represents about 86 percent of total checks presented and drawn, were presented at the inter-bank clearing house; the rest were deposited at the banks from which they were drawn.

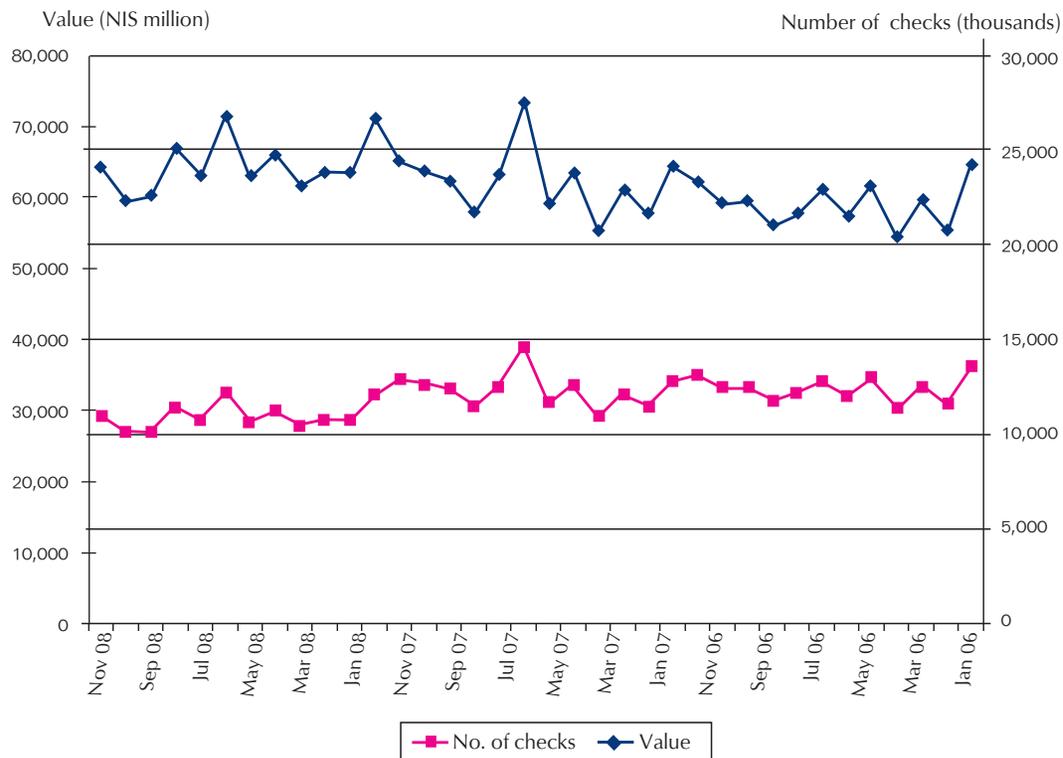
In the past, the banks' reports to the Bank of Israel included the amount of a debit or a credit for checks presented and returned to other banks. Starting in October 2008, the banks also report the number of checks transferred or received from other banks, as well as the number of returned checks that were transferred or received. The numbers of checks cleared from periods prior to October 2008 shown in Figure 1 and Table 2 are estimates based on the figures reported for October–December 2008.

The transmissions settled manually in 2008 constituted about one percent of the total transmissions (checks and manual transmissions) settled by the paper-based clearing house, although they represented about three percent of the total value. The value of manual transmissions in 2008 totaled about NIS 26 billion, as compared to NIS 106 billion in 2007. The significant decline was primarily the result of the reduction in issues of shares that were carried out in the past using manual debits, as well as the transfer of large sums between the banks, some of which had previously been transferred through manual credits and this year were implemented through the Zahav system, or through Masav.

During 2008, various measures were taken to halt the use of manual transmissions and this process will continue in 2009, such that the return of credits in Masav, which is currently done by manual credits, will be carried out by Masav, and the electronic collection docketts will be cleared in the electronic clearing house, like checks.

The figure below shows amounts and totals of the cleared checks.

Figure 1
Checks cleared, 2006 to 2008



Comment: The number of checks up until September 2008 is only an estimate.

In 2008, about 138 million transmissions were received by the paper-based clearing house (of which 136 million were checks) with a value of about NIS 826 billion. The number of checks returned constituted 2.4 percent of the number of checks presented to the paper-based clearing house.



Table 2
The Paper-Based Clearing House, by Type of Instrument, 2006–08

(Instruments presented and returns, monthly average)

	2006		2007		2008		Change in 2008	
	Value	Number	Value	Number	Value	Number	Value	Number
	(NIS million)	(thousands)	(NIS million)	(thousands)	(NIS million)	(thousands)	percent((percent)
Manual instruments	101,104	1,056	106,328	3,172	26,359	1,994	-75.2	-37.1
Debits	36,477	369	54,836	2,737	21,360	1,742	-61.0	-36.3
Credits	64,627	687	51,492	435	4,999	251	-90.3	-42.2
Checks	730,220	152,579	772,128	151,762	800,123	135,348	3.6	-10.8
Presented	710,269	149,145	748,528	148,254	776,264	131,739	3.7	-11.1
Returns	19,951	3,434	23,601	3,508	23,859	3,609	1.1	2.9
Total	831,323	153,636	878,457	154,934	826,482	137,342	-5.9	-11.4

SOURCE: State Loans Administration, Clearing Section.

The above figures indicate that the number of checks presented fell by about 11 percent relative to the previous year, while their value grew by about 4 percent. Thus, the average value of checks presented to the paper-based clearing house grew from NIS 5,090 in 2007 to NIS 5,900 in 2008. This is explained by the fact that starting in October 2008 real figures were received for the number of checks while previously only an estimate was made.

Automated clearing house (Masav)

The automated banks' clearing house (Masav) settles inter-bank transactions that are not based on paper or cash. Thus, Masav handles direct credits and debits for non-bank institutions.

The total value of transactions cleared by Masav in 2008 was NIS 1,738 billion, of which credits accounted for about NIS 1,473 billion, authorized debits for NIS 261 billion and the return of debits for NIS 5 billion. The return of credits is handled by the paper-based clearing house, and not by Masav, using manual transmissions. During 2008, preparations were made for the creation of a system for the return of credits in Masav, which should begin operating fully during the second half of 2009.

Table 3
Transactions in the Banks' Automated Clearing House (Masav), 2006-08

	2006		2007		2008		change in 2008	
	Value	Transactions	Value	Transactions	Value	Transactions	Value	Transactions
	(NIS billion)	(Million)	(NIS billion)	(Million)	(NIS billion)	(Million)	(Percent)	(Million)
Credits	5,436.7	89.0	5,940.0	93.0	1,472.8	96.3	-75.2	3.6
Debits	215.0	141.0	235.0	146.0	260.8	152.9	11.0	4.7
Debits returned	3.6	4.4	3.9	4.5	4.9	5.0	26.7	10.3
Total	5,655.2	234.4	6,178.9	243.5	1,738.5	254.2	-71.9	4.4

SOURCE: Masav.

Of the credits, 8 percent were transferred by banks, about 72 percent were transferred directly by the institutions for the payment of salaries and other credits and about 20 percent were transferred to banks, which sent them previously. The share of inter-bank transfers within total credits in Masav was about 37 percent, while the value of credits sent directly by the institutions constituted about 42 percent.

Table 4
Credits via Masav, by Type of Recipient, 2008

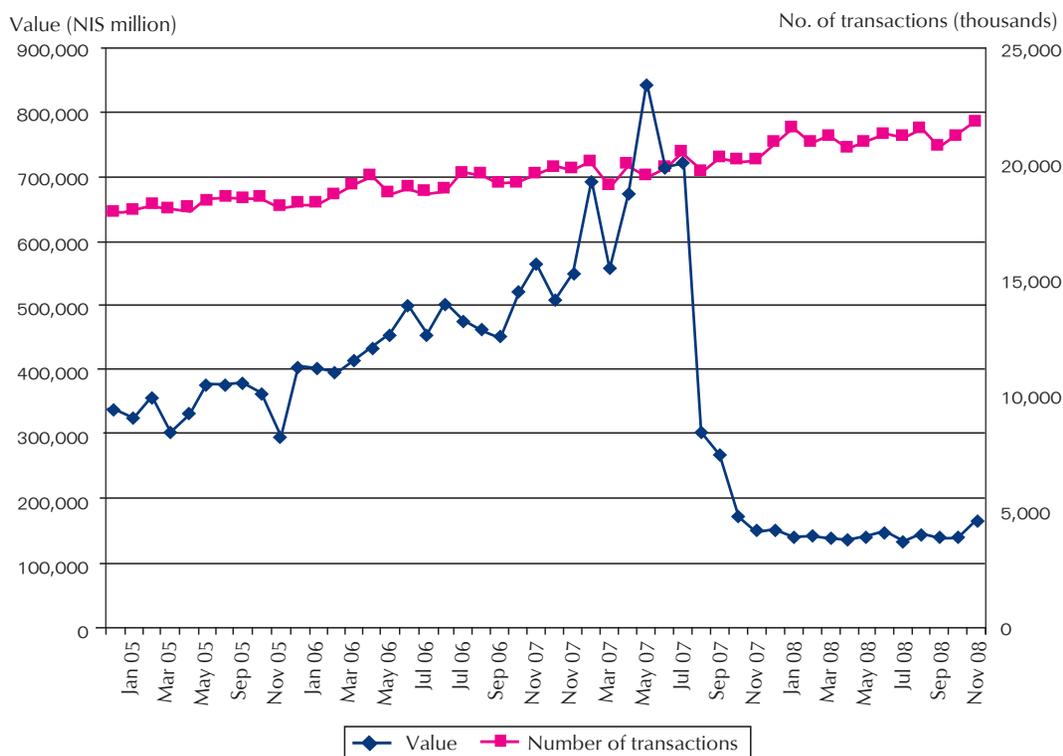
	Transactions	Value	Transactions	Value
	(million)	(NIS billion)	(percent)	(percent)
Interbank	7.4	541.9	7.7	36.8
Salaries	49.9	238.1	51.8	16.2
Institutions	19.1	381.9	19.8	25.9
Without clearance	19.9	310.9	20.7	21.1
Total credits	96.3	1,472.8	100.0	100.0

SOURCE: Based on Masav.

With the introduction of the Zahav system, part of credits, particularly those initiated by the banks, was transferred to it from Masav. As a result, total credits this year declined by about 75 percent relative to the previous year (NIS 1,473 billion in 2008 as compared to NIS 5,940 billion in 2007). The main impact of the Zahav system on credits in Masav was in total inter-bank credits, which totaled about NIS 542 billion this year as compared to an estimated NIS 4,384 billion in the previous year. Credits carried out directly by the institutions through Masav (salaries and other credits) fell relative to the previous year, but

at a more moderate rate. According to the regulations of the Bank of Israel,² it is prohibited to implement payments in Masav or the paper-based clearing house (manual credits) in an amount exceeding NIS 3 billion, except in extraordinary circumstances as defined by the Bank of Israel, such as the transfer of payments by banks or institutions in batches. These regulations went into effect in November 2007 and resulted in a sharp drop in the number of transactions in excess of NIS 3 billion in Masav (to a monthly average of about 1,900 transactions as compared to 9,000 transactions per month in the previous year).

Figure 2
Transactions in the Masav Clearing House, 2005 to 2008



The sharp reduction in the value of transactions in Masav in the last months of 2007, which can be clearly seen in Figure 2 above, was a result of the beginning of the Zahav system's operation.

In addition to the decline in the total value of transactions in Masav, there was also a drop in the average value of credits (inter-bank and others) from about NIS 64,000 in 2007 to about NIS 15,000. This was due to the transfer of the settlement of large credits to the Zahav system.

² Letter from the head of the comptroller's office dated October 31, 2007.

The TASE clearing houses

The TASE calculates the net value for each bank and transfers the results to the Zahav system for the purpose of settlement and debiting/crediting of the banks' relevant accounts at the Bank of Israel. The clearing houses settle the transactions related to all securities and provide additional services, such as the payment of interest, dividends and redemptions of bonds. In addition, the TASE clearing houses settle payments resulting from the purchase of derivatives and their expiry in the Maof clearing house.

Since the introduction of the Zahav system, the settlement of paper-based transactions has been completely parallel (including time of settlement) to the financial settlement (i.e., delivery versus payment).

Table 5
Turnover of Trade in Securities, 2005–08

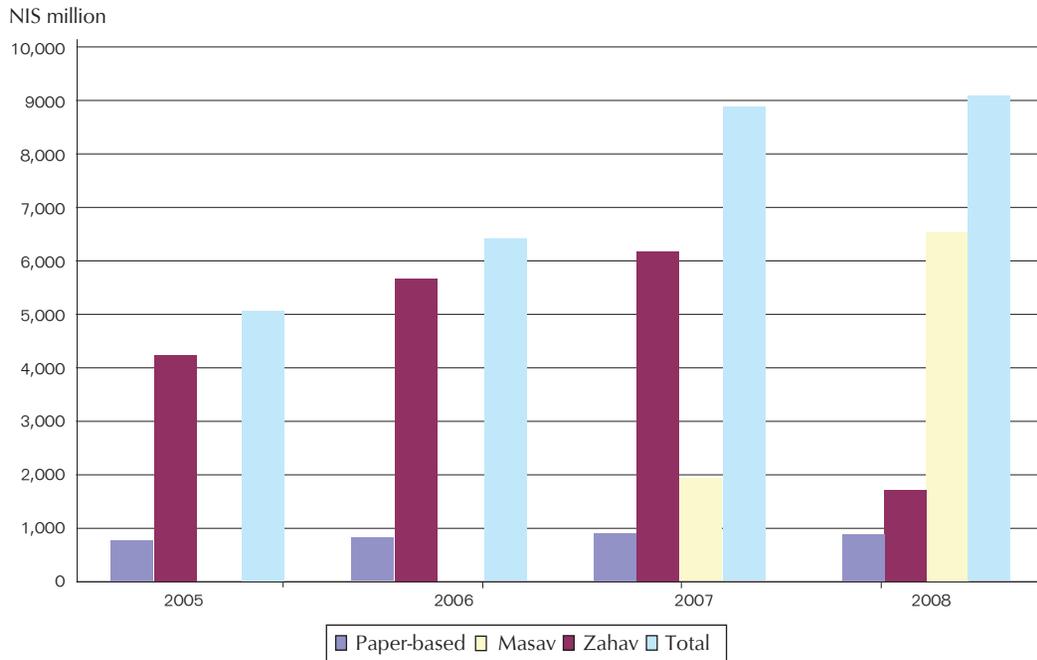
Period	Shares and convertibles	(NIS billion)		Bonds		
		Government	Other	Total	Makam	Total
2005	245.4	275.1	53.1	328.2	165.6	739.2
2006	360.3	356.0	68.1	424.1	197.5	981.9
2007	506.2	635.7	164.7	800.4	207.0	1,513.6
2008	481.3	760.6	224.2	984.8	192.1	1,658.2
Increase in 2008 (%)	-4.9	19.6	36.1	23.0	-7.2	9.6

SOURCE: TASE.

Summary of payment systems activity

The Zahav system operated for a full calendar year in 2008 as opposed to its activity during only part of 2007. Prior to the introduction of the Zahav system, when the settlement of funds was carried out only in the check clearing house and Masav, Masav's average share was about 85 percent while the check clearing house's share was about 15 percent. In 2008, most of the large inter-bank amounts were transferred to the Zahav system for direct settlement and therefore the relative shares of the clearing houses (Masav, checks and Zahav) changed significantly. In 2008, about 72 percent of the total value of inter-bank transactions handled by the payment systems was settled in the Zahav system. Masav settled about 19 percent of the total value (credits, about 16 percent; debits, about 3 percent) and the checks clearing house settled about 9 percent of the total value.

Figure 3
Total Clearing House Activity, 2005 to 2008



3. The impact of the financial crisis on the activity of the payment systems

The global financial crisis worsened in the third quarter of 2008 and its impact on the Israeli economy appeared towards the end of the year (November and December). Figures for the payment systems in 2008 do not indicate that the crisis had any significant effect; however, indications of its impact can be seen in certain components of the data. Following are the components of payment system activity which were most significantly affected by the crisis in the last quarter of 2008.

The Zahav system

The value of transactions in the Zahav system declined starting from the beginning of the year. The value of interbank transactions in the Zahav system declined continuously during the course of the year as a result of the shekel being added to the CLS. Thus, orders previously carried out directly in the Zahav system are now settled on a net basis in the CLS account within the Zahav system. There was a noticeable drop of about 13 percent in the value of inter-bank transactions during the last quarter of the year relative to the previous quarter.

The paper-based clearing house

Total activity in the paper-based clearing house did not decline significantly during the last quarter of the year, although there were changes in its components. The total value of checks presented during the fourth quarter was lower than in the previous one by about 9 percent. At the same time, the value of returns grew by about 5 percent compared to the previous quarter. This implies that the proportion of returned checks in the total value of checks presented increased to about 3.3 percent during the last quarter of the year as compared to less than 2.9 percent in the previous quarter.

Masav

The financial crisis had only a small impact on Masav transactions. The main change occurred in the value of credits, which fell during the last quarter of the year by only half a percent relative to the previous quarter. The significant drop in the value of credits in Masav during this quarter was a result of the drop in value of salary credits, which fell by about 18 percent relative to the previous quarter. However, since the share of salary credits within total credits in Masav is relatively small, the impact on the total value of transactions in Masav was negligible.

The TASE clearing houses

There was no decline in the total value of settlements in the TASE clearing houses during the last quarter of the year, though there was a decline during the first and second quarters relative to the previous one.

During the fourth quarter, only the value of settlements in shares and convertibles declined compared to the previous quarter and this by 24 percent. This was a result of the downtrend in the annual yields on shares. The decline during this quarter was more severe than in previous ones.

Table 6

Activity of the Components of the Payment System, by Quarter, 2008

(Value NIS billion)

	Zahav	Paper-based	Masav	TASE	
	Interbank	Checks presented	Check returns	Salaries	Shares and convertibles
Q1	1,899.7	198.3	6.0	32.1	144.2
Q2	1,673.8	191.3	5.9	42.5	124.2
Q3	1,558.3	202.3	5.8	44.5	121.0
Q4	1,348.5	184.3	6.1	36.5	91.9
Total 2008	6,480.3	776.3	23.9	155.5	481.3
Quarterly increase, %					
Q1	0.5	3.5	-9.5	-19.1	-2.2
Q2	-11.9	-3.6	-2.9	32.2	-13.9
Q3	-6.9	5.8	-0.2	4.7	-2.6
Q4	-13.5	-8.9	5.2	-17.9	-24.0

4. Means of payment

The payment and settlement systems include payments in cash and payments by way of the clearing houses. Previous sections surveyed the activity of the clearing houses in 2008; while this section will focus on the debiting of current accounts held by the public through all the means of payment, including cash withdrawals.

The public's transactions using the means of payments include the total debits of the public, i.e., checks, cash withdrawn at ATMs and banks, authorized debits (through Masav) and other types of debits, which include automated transfers (through Zahav and Masav), as well as transfers between customers and banks.

According to figures of the Banking Supervision Department the debits of current accounts held by the public totaled NIS 21,474 billion in 2008, which represents a small decrease compared to 2007 (NIS 22,750 billion). In recent years, the total value of debits of current accounts held by the public has increased by an annual rate up 15 to 30 percent. This year, however, there was a decrease of about 6 percent.

Most of the debits of current accounts held by the public are not classified into categories, but rather are defined as “other debits,” which also include credit card debits. In addition, “other debits” include business transactions between customers and banks, such as the purchase of securities, the purchase of foreign currency, the payment of commissions, etc. The remaining debits involve the withdrawal of cash by the public from the banks or from ATMs, debits by check and authorized debits.

It should be mentioned that data on the debits of the public’s accounts differ from the data on settlement, since they include all debits, even if they were carried out at the withdrawing bank and did not pass through the clearing house to reach the beneficiary bank.

Table 7
Debits on the Public’s Current Accounts, 2004–08

NIS billion	Checks	Cash withdrawals	Direct debits	Other	Total
2004	787.0	115.0	421.0	11,160.0	12,483.0
2005	821.0	137.0	471.0	13,731.0	15,160.0
2006	888.0	143.0	527.0	15,910.0	17,468.0
2007	970.4	158.0	572.1	21,050.5	22,750.9
2008	924.1	162.6	633.8	19,753.6	21,474.0
Increase in 2008 (percent)	-4.8	2.9	10.8	-6.2	-5.6

Transactions (million)	Checks	Cash withdrawals	Direct debits	Other	Total
2004	166.0	134.0	155.0	265.0	720.0
2005	164.0	134.0	163.0	274.0	735.0
2006	163.0	138.0	171.0	304.0	776.0
2007	164.6	139.8	177.9	343.0	825.3
2008	159.3	135.4	187.8	337.7	820.2
Increase in 2008 (percent)	-3.2	-3.2	5.6	-1.5	-0.6

SOURCE: Banking Supervision Department, Bank of Israel.



Use of checks

According to the reports from the banks, about 159 million checks were drawn in 2009, of which about 136 million were presented to the inter-bank clearing house and the rest (about 14 percent) deposited at the bank from which they were drawn.

The number of checks drawn and their value were lower this year than in previous year, a trend which characterizes other developed countries as well and which is explained primarily by the growing use of credit cards and execution of automated transfers. According to the reports from the banks, the average value of a check was about NIS 5,800 in 2008, which is somewhat higher than in the previous year (NIS 5,700).

Of the checks drawn in 2008, about 4.4 million (about 2.8 percent) were returned. Of the total value of checks drawn (NIS 826 billion), about 2.9 percent were returned. About half of the checks were returned because of insufficient coverage, while the rest were returned for other reasons, such as checks with a no-longer-valid date, an unrecognized signature, etc.

During the last months of the year, the percentage of returned checks was higher than the average for 2008 and in December totaled about 3.25 percent of the value of checks presented.

Table 8
Checks Drawn and Checks Returned, 2008

	Checks drawn		Checks returned		Percent of returns	
	Number	Value	Number	Value	Number	Value
	(thousands)	(NIS million)	(thousands)	(NIS million)	(percent)	(percent)
January	13,652	82,148	373	2,823	2.73	3.44
February	12,567	72,658	343	2,187	2.73	3.01
March	14,002	78,205	354	2,156	2.53	2.76
April	13,375	75,991	340	2,136	2.54	2.81
May	12,984	74,379	353	2,592	2.72	3.48
June	13,552	79,091	355	2,225	2.62	2.81
July	14,091	83,425	384	2,411	2.72	2.89
August	12,452	75,487	337	2,091	2.71	2.77
September	13,105	74,392	352	2,223	2.69	2.99
October	12,764	74,231	413	2,452	3.23	3.30
November	13,294	74,517	369	2,288	2.78	3.07
December	13,509	79,608	420	2,586	3.11	3.25
Total	159,347	924,131	4,394	28,169	2.76	3.05

SOURCE: Banking Supervision Department, Bank of Israel.

Withdrawal of cash

The withdrawal of cash by the public totaled about NIS 163 billion this year, which is about 3 percent higher than during the previous year (NIS 158 billion). The rate of increase in the withdrawal of cash was more moderate this year, which was a result of the increased use of credit cards.

The total value of cash withdrawals from ATMs increased this year, as it has in recent years. The proportion of these withdrawals within the total value of cash withdrawals (i.e. from ATMs and via bank tellers) was about 87 percent, while its proportion of total withdrawals was 44 percent. This difference is due to the fact that the average withdrawal via bank tellers exceeds the average ATM withdrawal.

Table 9
Cash Withdrawals, 2004-08

	Cash Withdrawals		Currency in the hands of the public	
	(NIS billion)	(increase percent)	(average NIS billion)	(increase percent)
2004	115.1	3.5	20.0	7.5
2005	137.0	19.0	22.6	13.2
2006	143.1	4.5	25.0	10.5
2007	158.0	10.4	27.3	9.1
2008	162.6	2.9	31.7	16.2

SOURCE: Banking Supervision Department, and the comptroller's office, Bank of Israel.



Authorized debits

There were about 187 million authorized debits in 2008, as compared to 178 million in 2007, while the value of authorized debits was NIS 630 billion as compared to NIS 572 billion in 2007. This upward trend is characteristic of other developed countries as well.

Authorized debits constitute a significant proportion of total direct debits. According to data published by the BIS, the total value of these debits in the wealthiest countries grew continuously during the period 2002-06³ at an average annual rate of 16 percent.

Table 10
Authorized Debits, 2004–08

	Transactions (million)	Value (NIS billion)	Annual increase (percent)
2004	155.4	420.9	-0.3
2005	162.6	471.3	12.0
2006	170.6	527.0	11.8
2007	177.9	572.2	8.6
2008	187.5	632.9	10.6

SOURCE: Banking Supervision Department, Bank of Israel.

Other debits

Other debits of the public's current accounts are not classified and mainly include one-time or standing orders for the transfer of funds to an account of the same customer or that of a different customer, as well as debits resulting from business transactions between the customer and the bank. Other debits also include orders to debit an account using a credit card,⁴ as well as payments made by the public by way of the banks in the Zahav system, though they do not include payments made by the banks for themselves.

Other debits totaled NIS 20,068 billion during the period under review, as compared to NIS 21,050 billion in the previous year. This year, for the first time, the value of other debits declined, which occurred despite the small increase in the number of transactions in this category.

³ Statistics on Payments and Settlement in Selected Countries, March 2008.

⁴ Some of the banks include this in authorized debits.

The proportion of other debits in total debits of the public was about 92 percent this year, although the number of other debits was only about 42 percent of the total number of debits of the public's accounts. This means that the average transaction in other debits (including credit-cards), NIS 58,800, was higher than for the other types of debits.

Debits via credit cards

The data on credit card transactions are reported directly to the Banking Supervision Department by the credit card companies.

In 2008, about 641 million transactions were carried out by credit card with a total value of NIS 154 billion, which represents a 10.1 percent increase over the previous year. This rate of increase in the value of purchases is similar to the average rate in recent years.

The number of credit card transactions in 2008 was almost four times larger than the number of transactions by checks, while the total value of check transactions was six times larger than the total value of credit card transactions. The explanation for this difference lies in the fact that the average credit card transaction was NIS 241, while the average check had a value of NIS 5,800.

Table 11
The Use of Credit Cards, 2004–08

	Transactions (thousands)	Value (NIS million)	Annual change (percent)
2004	442,538	102,446	10.5
2005	482,451	113,062	10.4
2006	531,964	125,768	11.2
2007	585,498	139,442	10.9
2008	641,274	153,528	10.1

SOURCE: Banking Supervision Department, Bank of Israel.

The figures in Table 11 relate only to transactions in shekels, including cash withdrawals by means of credit cards; however, the use of credit cards issued by Israeli companies also includes purchases and withdrawal of cash in foreign currency. The withdrawals in foreign currency, which are mainly implemented abroad, totaled NIS 7.1 billion in 2008, and the proportion of purchases abroad in total credit card purchases was 4.4 percent, which is similar to what it has been in recent years.



Total means of payment

The public's retail means of payment consists primarily of checks, cash and credit cards. In 2008, as in previous years, the majority of payments made by the public were carried out by check, about 13 percent were in cash and the rest were made by credit card. The proportion of use of check has declined somewhat in comparison to 2004 while the use of credit cards and cash has increased somewhat.

It should be mentioned that despite the continuous increase in the value of credit card transactions in recent years (2004–08), the total value of transactions executed by check has also increased. It appears that 2008 was a turning point, with total payments by check declining by NIS 46 billion and total payments by credit card increasing by NIS 13 billion (see Table 7 and 11 above).

Figure 4
The Public's Retail Means of Payment, 2004 to 2008

