EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS FOR 2009

A. The Bank of Israel's balance sheet

The Bank of Israel's balance sheet totaled NIS 252 billion at the end of 2009 as against NIS 169 billion at the end of 2008—an increase of about NIS 83 billion (49 percent).

On the Assets side, this increase can be attributed to an increase of NIS 67 billion in the Bank's foreign currency financial assets abroad, and about NIS 18 billion in tradable local currency government bonds.

In view of the global financial crisis and its repercussions, there was a need for extraordinary monetary policy measures to limit the impact of the crisis on the Israeli economy. In addition to lowering the interest rate, the Bank also began to acquire government bonds on the secondary market, and continued to purchase foreign currency as it had done in 2008.

In 2008, after more than ten years without intervening in the currency market, the Bank of Israel began to purchase US dollars in order to build up the country's foreign exchange reserves.[1] This step was taken in light of the needs of the economy, against the background of the rapid GDP growth in recent years, Israel's deeper integration into the global economy and the global financial system, and against the backdrop of the global economic situation. The Bank also operated in the foreign currency market when exchange rates were extremely volatile and were inconsistent with basic economic conditions or where the foreign currency market failed to function reasonably. Consequently, the foreign-exchange reserves grew to $61 billion at the end of 2009 (an increase of $18 billion).

Furthermore, this year the Bank purchased government bonds on the secondary market in an effort to ease the credit crunch and enhance the effects of its monetary policy and the ability of the Israeli economy to withstand the negative effects of the global economic crisis. As part of this plan, the Bank of Israel purchased government bonds for NIS 18 billion.

On the Liabilities side, the increase in the balance sheet can be traced mainly to an increase in monetary absorption instruments—*makam* and time deposits—by NIS 78 billion, as well as notes and coins in circulation by NIS 7 billion. This purchase of foreign currency and government bonds injected liquidity into the economy over and above the

[1] In these notes, the term "foreign exchange reserves" is used in its economic sense. The reserves are composed of the balance of "Foreign currency assets abroad" on the Assets side of the Bank's balance sheet, less the balance of "Foreign currency liabilities abroad" on the liabilities side of the balance sheet. These balances are used to determine the Bank of Israel's investment policy and its reporting to various entities and they therefore constitute the basis for the analysis of trends in these Explanatory Remarks.

increase required in the monetary base. The Bank absorbed these surpluses mainly by increasing the time deposits that it held for the commercial banks, and to a lesser degree by expanding the issue of *makam* to the public.

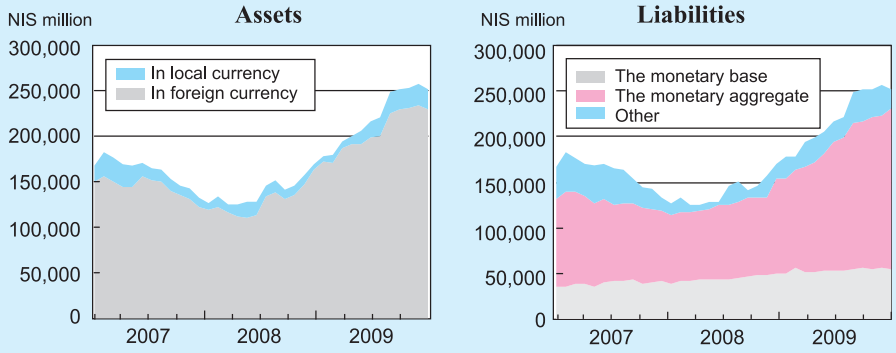
At the end of 2009, the balance of the monetary instruments[2] was NIS 176 billion, as against NIS 97 billion at the end of 2008.

The increase in the reserve of banknotes and coins in circulation, which together with the banks' local currency current deposits in the Bank of Israel form the narrow monetary basis, is largely the outcome of the decline in the rate of interest to its lowest rate, as this generates an increase in the demand for money and an increase in the monetary base.

These changes in the Bank's balance sheet led to a marked increase in surplus assets over liabilities in foreign currency, from NIS 131 billion at the end of 2008 to NIS 210 billion at the end of 2009 (see Note 18 to the Financial Statements). In contrast, the surplus of liabilities over assets in local currency grew, from NIS 149 billion at the end of 2008 to NIS 227 billion at the end of 2009.

This contributed to a marked increase in currency asymmetry in the Bank's financial statements that has been a feature of the Bank's balance sheet for more than ten years: while most of its assets are denominated in foreign currency, its liabilities are primarily in local currency[3] (Figure1).

Figure 1
The Bank's Assets and Liabilities, 2007-09



SOURCE: Bank of Israel.

[2] *Makam* and time deposits less monetary loans and repo auctions.

[3] This currency asymmetry first began to manifest itself during the period 1995-1997, when the Bank adopted a contractionary monetary policy in order to attain the inflation targets set by the government. The resulting import of capital by the private sector forced the Bank of Israel to purchase foreign currency from the public in order to keep the exchange rate at the lower limit of the crawling band that was used at the time to re-absorb the local currency that was injected into the economy for this purpose. The foreign exchange reserves grew from an average of several billion US dollars in previous decades to $23 billion in 1998. At the same time, the balance of monetary instruments, which until 1994 was composed mainly of monetary loans, as accepted by central banks worldwide, has since then been composed of liabilities.

B. Statement of Operations

In the Statement of Operations, the Bank shifted from a loss of NIS 613 million in 2008, to a profit of NIS 1,360 million in 2009.

This improvement can be attributed principally to the decline in exchange rate differential expenses which this year were NIS 0.9 billion, as against NIS 2.4 billion in 2008, and to an increase in net interest income which this year was NIS 0.6 billion, as against expenses of NIS 0.1 billion in 2008.

Other financial income in respect of securities and derivatives was NIS 2.6 billion, as against NIS 2.5 billion in 2008.

The Bank's general and administrative expenses rose this year by NIS 265 million to NIS 879 million, as against NIS 614 million in 2008.

The fluctuations in the Bank of Israel's profits can be attributed to the currency asymmetry in the composition of its assets and liabilities. This asymmetry exposes the Bank to volatility in its reported financials due to changes in the exchange rates and to changes in Israel's interest trajectory relative to those of other economies.

In 2009, the NIS appreciated 0.7 percent against the US dollars (in 2008—1.1 percent), although the trend in the exchange rate was not uniform throughout the year. At the beginning of the year, the US dollar appreciated against other world currencies due to its role as a "safe haven" amid the collapse of the markets during the world financial crisis. This trend was supported by the Bank continuing to purchase foreign currency. Later in the year, against the background of the weakness of the dollar world wide, the trend of depreciation of the shekel halted, and it started to strengthen against the dollar.

This trend was reversed against other currencies—the pound sterling appreciated 10.1 percent (in 2008 it dropped 28 percent), and the euro rose 2.7 percent (in 2008 it fell 6.4 percent).

These fluctuations were reflected in the Bank's exchange rate expenses this year.

Net interest income rose this year to NIS 0.6 billion, mainly due to the effect of the Bank purchasing Israel Government bonds. The difference between the interest income on these bonds, and the expense of short-term interest on the monetary instruments which were used to absorb the injection of money created in the wake of this purchase, contributed to an increase in net interest income.

The growth in the monetary base, which reduced the extent of the required absorption, also helped reduce the interest expense.

During the year, the NIS interest rate drew considerably closer to interest rates abroad, and therefore had almost no impact on the Bank's profit, unlike most previous years.

The government's interest expense was affected by two contradictory factors; on the one hand, government reserves increased due to a smaller than expected deficit in

government activity and a particularly convenient environment for raising capital, which led to higher expenses, and on the other a sharp drop in the Bank of Israel interest rate which helped reduce expenses.

Provision for loss, which will likely be realized on account of an agreement to recycle long-term advances which were given to the government during the 1980s,[4] also contributed to the increase in these expenses.

Overall, the government recorded a net interest expense, excluding interest income from local currency securities, of NIS 0.3 billion (as against NIS 0.2 billion in 2008).

Net interest income from foreign currency reserves was NIS 2.6 billion this year, (in 2008—NIS 3.2 billion).

The interest expense on the monetary-instruments aggregate was NIS 2.4 billion this year (in 2008—NIS 3.1 billion).

Other financial income from securities and derivative financial instruments increased by NIS 0.1 billion due mainly to capital gains—the result of spread assets[5] (eurobonds), in which the spread between these assets and government bonds was reduced (their price rose as the financial crisis receded).

An economic review of the Bank's profits requires to sum the realized profits (losses) together with the change in the balance of the relevant item in the revaluation accounts (unrealized).

This year, the Bank of Israel posted total profit from capital gains of NIS 1.2 billion (as against NIS 3.3 billion in 2008). Capital gains were based principally on an increase in the prices of the spread assets (eurobonds) after events partly returned to normal this year. These profits were largely offset by the decline in value of government bonds, after the risk aversion declined, and investors shifted from secure government assets to more risky assets.

General and administrative expenses grew this year by NIS 0.3 billion. This was mainly the result of an increase in actuarial liabilities for retirement payments to employees and pensioners, due to a wage increase paid according to a master agreement from April 17, 2008, as well as a wage erosion supplement subsequent to a ruling handed down by the District Labor Court in August 2008.

[4] The Bank of Israel and the Ministry of Finance are currently in an advanced stage of negotiations towards signing the agreement. At the closing date of the balance sheet the agreement had not yet been signed.

[5] The Bank of Israel's benchmark is only composed of government bonds. A spread asset is an asset which is not included in the Bank of Israel's benchmark whose yield to maturity is usually valued by the spread from the yield to maturity of another security, generally a government security (e.g. a US Treasury bond) with similar characteristics. The yield spread reflects the risk inherent in the spread asset as against the government security.

C. Analysis of the main components in the Bank of Israel's balance sheet

The Bank's financial statements are prepared in accordance with generally accepted accounting principles (GAAP), adapted for the special activity of a central bank. Analysis of financial statements data, in line with broader more general economic aggregates, in addition to an analysis of the individual items which appear in the Bank's balance sheet, is essential for understanding the impact of economic trends on the accounting financial statements.

Table 1 shows the Bank's balance sheet in aggregate form which differs from the accepted accounting format to allow these changes to be analyzed. The items were analyzed according to the aggregate balance sheet reserves, as they appear in this table.

Table 1

Aggregate Balance-Sheet Balances, and the Resulting Profit and Loss

	For the year ended December 31		For the year ended December 31	
	2009	2008	2009	2008
	Balances		Income (expenses)	
	(NIS millions)			
Assets, net				
Foreign currency balances[a]	228,812	161,635	5,230	5,700
Securities portfolio in NIS	20,221	2,427	735	251
Total	**249,033**	**164,062**	**5,965**	**5,951**
Liabilities and capital, net				
Monetary aggregate[b]	176,489	96,710	(2,385)	(3,089)
Monetary base[c]	54,802	49,661	(69)	(56)
Government balances	19,581	6,923	(315)	(211)
Deposits of banking corporations in foreign currency	1,700	19,711	-	(98)
Other	8,397	3,207	(913)	(738)
Revaluation accounts[d]	4,153	5,299	(923)	(2,372)
Capital of the bank	(16,089)	(17,449)		
Total	**249,033**	**164,062**	**(4,605)**	**(6,564)**
Net profit (loss)	**-**	**-**	**1,360**	**(613)**

[a] Consisting of the balance in the item "Foreign currency assets abroad" on the asset side of the Bank's balance sheet, minus the balance in the item "Foreign currency liabilities abroad" on the liabilities side of the balance sheet.
[b] Consisting of the balance of *makam* and pazak (term deposits) minus the monetary loans and repurchase auctions.
[c] Consisting of banknotes and coins in circulation plus the banks' local currency demand deposits in the Bank of Israel.
[d] The profit (loss) on this item includes realized exchange rate differentials on foreign currency balances. (Realized capital gains are shown in the item to which they relate.)

1. Foreign exchange reserves

Foreign-exchange reserves[6] account for the largest part of the Bank's assets (about 92 percent of the Bank's total assets, as shown in Table 1).

The foreign-exchange reserves serve as a source of liquidity when needed and are also intended to provide additional benefits to the economy, such as reducing the probability of a crisis in Israel's foreign exchange market and enhancing Israel's status in global financial markets. The functions of the foreign-exchange reserves can be defined based on the benefit they bestow as well as possible uses that the government and the Bank of Israel can make from the reserves. These include: servicing government debt; financing imports in time of emergency: use of the reserves to manage the Bank's monetary policy with respect to stability of the banking system and foreign-exchange market; use of the reserves as an instrument for implementing monetary policy. Defining the functions of foreign exchange reserves also serves as the basis for deciding how to manage them, setting the currency numeraire, i.e., their currency composition, and determining the desired level of the reserves.

Further to the $14 billion increase which was recorded in the previous year, the foreign-exchange reserves rose by $18.1 billion in 2009 from $42.5 billion at the end of 2008 to NIS 60.6 billion.

In NIS terms, the foreign-exchange reserves increased by NIS 67 billion from NIS 161.6 billion in 2008, to NIS 228.8 billion at the end of 2009.

Several factors explain the change in the reserves (Table 3). As in previous years, much of the increase this year was due to the purchase of foreign currency by the Bank of Israel in the NIS-foreign currency market which amounted to $19.6 billion. The Bank's profit from interest and financial gains of $2.1 billion also boosted the reserves, as did the IMF's allocation of $1.2 billion of SDRs to the State of Israel in the wake of the financial crisis.

Some of these increases were offset by withdrawals of $4.6 billion by the private sector, and $0.2 billion by the government and National Institutions.

In 2009, the Bank of Israel continued its policy of purchasing foreign currency which began in 2008, for the purpose of increasing the country's foreign-exchange reserves and supporting the exchange rate. In continuation of the purchases made in 2008, fixed purchases initially of an average of $100 million daily were made.

[6] Foreign-exchange reserves are composed of the balance of the "Financial foreign-currency assets abroad item" in the Bank's balance sheet, less the balance of "Financial foreign-currency liabilities abroad" item. These balances are used to determine the Bank's investment policy and its reportage to various entities, and therefore form the basis for the analysis of trends in these Explanatory Remarks.

From August 2009, the Bank of Israel began to operate in the foreign-exchange market only when there were serious fluctuations in the NIS exchange rate inconsistent with basic economic conditions, or when the foreign-exchange market failed to function normally.

Withdrawals by the private sector, mainly at the beginning of 2009, are withdrawals of foreign-currency balances which were transferred to Israel by commercial banks at the end of 2008 in view of the deteriorating financial crisis and increasing risk. This year, the government withdrew net negligible amounts from the reserves (about $0.4 billion), whereas in recent years it had withdrawn more substantial amounts - $13 billion in 2008 and 2007. This was a reflection of the balance of the government's activity abroad in 2009—a foreign deficit offset by raising capital abroad.

The global financial crisis led to a dramatic increase in credit risks in the international banking sector. Consequently, in September 2008 the Bank of Israel decided to discontinue making deposits in the international banking system and this directive remains in force to date. Reserves in short-term deposits of NIS 13 billion in 2009 consist of deposits in international financial institutions and foreign banks which are fully guaranteed by governments abroad.

Rate of return on the foreign-exchange reserves

The Bank of Israel invests the foreign-exchange reserves primarily in tradable assets of relative short 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 holding 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. The Bank's risk preference forms the basis for determining the parameters for this duration.

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 2009, the benchmark duration was nine months in the US dollars portfolio, and fourteen to sixteen months in other currencies.

The actual annual rate of return on the reserve portfolio in terms of the numeraire was 1.91 percent in 2009, as against a return of just 0.81percent on the benchmark[7] (Table 2). The difference between them, which this year was exceptionally high when compared with the previous decade, is the surplus yield in the reserve portfolio, reflecting the contribution of investment decisions made according to the permitted degrees of freedom in the active management of the reserves, which are reflected in deviations of the composition of the portfolio from the benchmark composition. These degrees of freedom are 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, which is usually positive and came to 0.09% on average for the period 1999-2008. In 2009, the difference was extremely high at 1.1% and can be attributed to the recovery of the global financial markets from the crisis which erupted in 2008. This recovery began this year and led to an increase in the value of many financial assets held in the reserves portfolio but are not held in the benchmark (spread assets).

The main contribution to the high surplus yield in 2009 can be traced to the high profits generated by the short- and long-term spread assets in the portfolio (assets not included in the benchmark). In 2008, in the wake of the deepening global financial crisis, yield spreads between various spread assets and government bonds reached record levels. These reflected the uncertainty prevailing in the markets at the time and investors' fears that major financial institutions would collapse. With the onset of the global recovery in 2009, and as uncertainty receded in the financial markets, the spreads contracted considerably throughout the year, so that at year end they were even lower than those immediately prior to the crisis. As a result, the value of these securities rose relative to government securities held in the benchmark, and they recorded high capital gains which were credited to the reserves portfolio.

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 US dollars (4.3 percent in 2009) and the euro (0.8 percent in 2009), and the high volatility of these returns over time (Table 2).

In NIS terms, the rate of return in 2009 was 3.6 percent, due to the positive contribution made by exchange rate differentials to the total yield: this is the result of the appreciation of non-dollar currencies in which some of the reserves are invested against the NIS,

[7] The return on the foreign exchange reserves in 2009 did not include the return originating in the foreign currency deposits of Israeli commercial banks. These deposits are managed separately from the rest of the reserves in order to offset the Bank of Israel's exposure to the currency and interest risks that result from the acceptance of these deposits.

partially offset by a 0.7 percent appreciation of the NIS against the US dollar in 2009. 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 not affected by the level of the Bank of Israel's purchases of foreign currency during the year.

Table 2
The Foreign Exchange Reserves—Total Income, Exchange Rate Differentials and Yield

		2009	2008	2007
Total foreign exchange reserves			($ millions)	
End of year		(60,612)	(42,513)	(28,556)
Annual average		(51,310)	(32,270)	(28,994)
Income and exchange rate and cross rate differentials			(NIS millions)	
Interest and capital gains		5,230	5,700	6,037
Unrealized price differentials[a]		(1,533)	841	1,570
Exchange rate differentials		455	(1,837)	(8,365)
Total		**4,152**	**4,704**	**(758)**
			($ millions)	
Interest and capital gains		1,330	1,593	1,514
Unrealized price differentials[a]		(401)	226	409
Exchange rate differentials		1,169	(1,034)	578
Total		**2,098**	**785**	**2,501**
Yields[b]			(Percent)	
In terms of NIS	Interest and capital gains	1.8	5.9	6.9
	Exchange rate differentials	1.8	(4.3)	(7.5)
	Total	**3.6**	**1.6**	**(0.5)**
In terms of euro	**Total**	**0.8**	**8.6**	**(2.2)**
In terms of $	Interest and capital gains	1.8	5.9	6.9
	Exchange rate differentials	2.5	(3.1)	2.4
	Total	**4.3**	**2.8**	**9.3**
In terms of use of foreign reserves		**1.9**	**5.9**	**6.9**
Benchmark yield		**0.8**	**6.1**	**6.9**

[a] Unrealized price differentials are expressed by the annual change in the revaluation account of foreign currency tradable securities (see Note 16 to the Financial Statements).
[b] Yields, which are shown at annual rates, are based on daily calculations, and relate to income from the foreign exchange reserves, including profit or loss resulting from market price changes.

2. Monetary instruments

Monetary policy is used to attain the inflation target, by supporting growth and financial stability.

The Bank of Israel sets the interest rate for lending to or borrowing from banking corporations, as necessary. The Bank uses the various monetary instruments to inject or absorb the required level of liquidity at the set rate of interest. The monetary instruments include loans/deposits of banking corporations, as well as market instruments—*makam* and repo.

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 the country's reserves, a process which continued through 2009 in view of the repercussions of the global financial crisis. The Bank was also active in the government bonds market.

The purchase of foreign currency and government bonds injected more liquidity into the market than the required increase in the monetary base. The Bank therefore re-absorbed these surpluses to ensure that the short-term interest rate would be consistent with its set interest rate. Until August, surplus liquidity was absorbed from the banks mainly through banking corporation time deposits at the expense of *makam* . Consequently, these deposits mushroomed from NIS 6 billion in December 2008, to more than NIS 80 billion at the end of 2009. The decline in the use of *makam* issues to absorb surplus liquidity was just one of a series of monetary instrument measures introduced by the Bank in January. The use of time deposits to absorb surplus liquidity at the expense of *makam* strengthened the pass-through mechanism from monetary policy by diverting investors' resources. Since August, the Bank has absorbed surplus liquidity by accelerating the pace of *makam* issues as well.

At the end of 2009, the balance of monetary instruments was NIS 176 billion, as against NIS 97 billion at the end of 2008. Of this NIS 92 billion was in time deposits (as against NIS 28 billion in 2008) and NIS 85 billion in *makam* (as against NIS 70 billion in 2008).

Expense on account of the monetary instruments

Net interest expense on account of the monetary instruments aggregate was NIS 2.4 billion in 2009, as against NIS 3.1 billion in 2008.

The reduction in NIS interest rate led to a decline in expenditure, which was partially offset by an increase in the aggregate reserve due to the need to increase the pace of liquidity absorption.

The expenses on account of *makam* still accounts for the major part of the interest expense for monetary instruments—about NIS 2 billion. This is because of the size of the

makam balance (NIS 78 billion on average) relative to the balance of time deposits (NIS 59 billion on average) and because *makam* are issued for a period of up to a year, so that the interest paid on account of *makam* is higher than the interest paid for time deposits, which are deposited for a day or a week.

3. Israeli currency securities portfolio

After almost ten years during which the Bank of Israel gradually reduced its shekel government bonds portfolio, in 2009 the balance in this portfolio rose sharply from NIS 2 billion at the end of 2008, to NIS 20 billion at the end of 2009, due to Bank of Israel purchases on the secondary market.

The Bank of Israel adopted an expansionist monetary policy in an effort to reduce the impact of the global financial crisis on the Israeli economy, action similar to that taken by many other countries.

In February 2009, the Bank of Israel began to purchase government bonds on the secondary market, and in March it announced that it would expand the use of this tool and purchase an average of NIS 200 million worth of government bonds daily, with the intention of purchasing NIS 15-20 billion through this plan. These purchases were designed to support the cuts in the longer-term interest rate, thus easing the credit crunch and supporting economic activity. In August, the Bank announced that it would discontinue these purchases, which amounted to NIS 18 billion. Due to the marked increase in the balance of the portfolio, interest income from this portfolio grew considerably to NIS 0.8 billion in 2009 (as against NIS 0.3 billion in 2008).

Interest income and the amortization of discount or premium for this portfolio is included in the Statement of Operations on an accrual basis. The income from indexation differentials as well as the revaluation to market value, is credited to the Revaluation accounts item in the balance sheet.

A negative balance in a revaluation account is charged at the end of the year to the Statement of Operations. In 2009, this had an effect of NIS 54 million.

4. The monetary base

The monetary base, composed of banknotes and coins in circulation and the banks' NIS-denominated demand accounts with the Bank of Israel, rose 10 percent during the year, from NIS 49.7 billion at the end of 2008, to NIS 54.8 billion at the end of 2009.

In an inflationary target regime, in which the interest rate is the policy instrument used to achieve goal, the amount of money is determined by the public's demand. The Bank of Israel sterilizes the liquid surpluses created in the banking system to ensure that the shortest-term interest rates are consistent with the declared interest rate. Monetary

aggregate trends, including the monetary base, therefore reflect the public's demand for money, given market interest rates and market condition.

The sharpest interest rate drop in 2009 led to an increase in the demand for money and subsequent increase in the monetary base.

The Bank of Israel injected NIS 19 billion net to the monetary base, while the government and National Institutions absorbed NIS 14 billion (Table 3). Most of this injection can be attributed to the expansionist monetary policy adopted by the Bank in 2009: foreign exchange purchases injected NIS 77 billion, and the purchase of government bonds injected NIS 18 billion. The Bank of Israel fully sterilized the surplus liquidity through the monetary instruments, mostly (NIS 63 billion) through time deposits, and to a lesser extent (NIS 13 billion) through *makam* . The government absorption was mainly the result of the large amount of borrowing by the government on the local market, due to large-scale anticipated redemptions and concern over the repercussions of the crisis on the budget deficit.

The monetary base does not bear interest. In 2009, the cost of printing money was about NIS 72 million, similar to 2008.

Demand deposits from banking corporations

Banking corporations use demand deposits with the Bank of Israel to fulfill their liquidity requirements in accordance with Bank of Israel directives, and to settle various payments carried out via the banks. The balance of these deposits declined from NIS 15.3 billion in 2008 to NIS 13.3 billion at the end of 2009.

The government injected about NIS 6.6 billion through the commercial banks in 2009 (as against NIS 9.6 billion in 2008). The public withdrew NIS 13.4 billion in cash from the banking corporations, similar to 2008 (Table 4).

In net terms, the Bank of Israel injected NIS 18 billion into the commercial banks (NIS 27 million in 2008) by purchasing foreign currency (NIS 77 billion) and government bonds (NIS 18 billion), and by using various monetary instruments (NIS 77 billion).

Table 3
The Monetary Base and the Foreign Exchange Reserves—Changes and their Sources

					2009				
	2005	2006	2007	2008*	2009	I	II	III	IV
Change in monetary base (NIS million)									
1) Injection (absorption) of government and National Institutions[a]	(1,452)	(3,789)	(10,809)	(17,371)	(14,195)	(5,398)	(7,001)	(10,145)	8,348
2) Injection from (absorption by) Bank of Israel	9,920	3,797	15,693	(17,305)	(58,855)	(14,170)	(13,247)	(17,017)	(14,419)
3) Injection from foreign-currency conversions by Bank of Israel	-	-	-	43,995	77,413	21,628	20,372	30,171	5,241
4) Adjustments[b]	(1,111)	(1,184)	(905)	(1,022)	778	(240)	1,327	(226)	(83)
5) Total change in monetary base (1+2+3+4)	**7,357**	**(1,176)**	**3,979**	**8,297**	**5,141**	**1,820**	**1,451**	**2,783**	**(913)**
Change in foreign exchange reserves ($ millions)									
Contribution to reserves									
6) Private sector[c]	1,026	25	(196)	4,291	(4,559)	(4,127)	(351)	(91)	10
7) Bank of Israel[d]	125	1,845	2,512	12,789	22,866	5,234	6,543	9,936	1,154
8) Government and National Institutions[d]	75	(673)	(2,912)	(3,204)	(208)	706	(247)	(153)	(515)
9) Total change in foreign reserves[e] (6+7+8)	**1,226**	**1,197**	**(595)**	**13,877**	**18,099**	**1,813**	**5,945**	**9,692**	**649**

[a] The government injection includes also the injection of the National Insurance Institute and of the Postal Bank.
[b] Adjustments include: transfers by the National Institutions from abroad via the banks but which are defined as public sector injection (in Row 2). Foreign currency domestic receipts and payments of the Bank of Israel and the government to the private sector, such as income tax receipts in foreign currency, do not change the monetary base as they are transferred directly from the private sector to the government; on the one hand they are defined as government absorption, while on the other they are defined as the private sector contribution to the foreign exchange reserves.
[c] Including income tax payments by the business sector in foreign currency.
[d] Government and National Institutions transfers from abroad and Bank of Israel income from the foreign exchange reserves (income from interest, capital gains and cross-rate differentials between the US$ and other currencies.
[e] Including the change in accrued interest on the foreign exchange reserves.
* Data according to value date. Other data in the table as at balance sheet date.

Table 4
Banking Corporations' Deposits in the Bank of Israel

	In local currency	In foreign currency	Total	In local currency	In foreign currency	Total	In local currency	In foreign currency	Total
	2009			2008			2007		
	(NIS million)								
Change in banking corporations' deposits[a]									
Activity with the government[b]	(6,629)	(74)	(6,703)	(9,574)	711	(8,863)	(3,132)	1,185	(1,947)
Withdrawal (–) of banknotes from Bank of Israel	(13,423)	-	(13,423)	(13,393)	-	(13,393)	(11,792)	-	(11,792)
Activity with Bank of Israel[c]	(59,016)	1,185	(57,831)	(17,453)	1,797	(15,656)	15,533	(135)	15,398
Transfers from (+) and to (–) abroad	-	(19,134)	(19,134)	-	14,916	14,916	-	(1,044)	(1,044)
Foreign-currency conversions at Bank of Israel	77,413	-	77,413	43,995	-	43,995	-	-	-
Adjustments	(334)	12	(322)	(672)	14	(658)	(57)	17	(40)
Total change	(1,989)	(18,011)	(20,000)	2,903	17,438	20,341	552	23	575
Deposit of banknotes by the Postal Bank in Bank of Israel	6,607	-	6,607	8,620	-	8,620	8,401	-	8,401

[a] Not including the change in term deposits.
[b] Government injection via the banking corporations' demand deposits
[c] Depositing term deposits, purchasing *makam*, selling government bonds and various interest payments.
[d] Deposits of banknotes deposited mainly by the Postal Bank; these deposits are absorbed by the government, and are included in the definition of "government injection."

5. Government accounts

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 composed of deposits in NIS and foreign currency,[8] as well as credit given to the government.

In 2009, the government held NIS 20.3 billion in deposits, as against NIS 8.4 billion at the end of 2008. This marked increase is mainly on account of the government's local currency deposits—the result of absorbing NIS 15 billion from the public (Table 5) through the issue of bonds, in view of the expectation of large-scale redemptions and an expected decline in tax revenues.

Net capital raised by the government abroad was positive in 2009 at NIS 4.9 billion (about $1.5 billion), the largest US dollar issue ever made by an Israeli government.

The government raised $1.2 billion through State of Israel Bonds, similar to the amount raised in 2008.

Table 5

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

	2009	2008	2007
		NIS millions	
End-year balances			
Government deposits			
Local-currency deposits	11,852	1,506	(3,252)
Foreign-currency deposits	8,480	6,860	6,551
Total government deposits	**20,332**	**8,366**	**3,299**
Net change in government deposits			
Government contribution (+) to foreign reserves[a]	(1,278)	(12,509)	(13,024)
Government absorption (+)	14,949	18,469	11,977
Government–Bank of Israel financial flow[b]	(1,709)	(1,094)	(1,596)
Adjustments[c]	3	203	53
Total change	**11,965**	**5,069**	**(2,588)**

[a] Government income and expenses abroad, receipt and repayment of government loans abroad.
[b] Payment of interest and redemption of government bonds held by the Bank of Israel; various fees from the government; credit to the government—interest payment, repayment of principal and payment of indexation differentials and interest on government deposits (in local and foreign currency); exchange rate differentials on government foreign currency deposits; and transfer of Bank of Israel profit.
[c] Including: interest accrued on government deposits to the end of the year; government interest payments on credit to the government for binational funds (these payments are included in "government injection," but in this table are also included in "Government–Bank of Israel financial flow"); and repayment of Israel Bonds to tourists in Israel (the repayment reduces the government's local currency deposits, but is not included in "government injection").

[8] Government deposits in local currency may be offset against one another, but the government does not intend to offset its local currency deposits against its foreign currency deposits and these balances are therefore stated separately in the financial statements. The economic analysis that appears in these 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.

Credit to the government

Credit to the government is composed primarily of long-term advances that the government received during the 1980s in order to finance its budget deficits. In 1985 a law forbidding the printing of money was enacted, and no advances have been given since then—with the exception of an extraordinary loan given in 1988 for redeeming some of the banking shares. The advances given before 1988 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 +2 percent. The loans will be repaid in annual installments by 2012.

At the end of 2009, the balance of the credit received by the government was NIS 0.8 billion, as against NIS 1.4 billion at the end of 2008. The Bank of Israel and Ministry of Finance are at an advanced stage of negotiating the settlement of a dispute between them regarding amounts that were expressed in correspondence from September 2003. The emerging solution is to recycle the long-term advances under conditions to be agreed. At the date of closing the financial statements, such settlement agreement had not been signed.

Income from interest paid by the government in 2009 includes the effect of the reduction in the interest rate for the anticipated recycling of advances consistent with the principles set forth together with the Ministry of Finance. The effect for previous years is included in the "Interest expense to the government" item.

6. Banking corporations foreign currency deposits

The balance of banks' foreign currency deposits declined considerably, from NIS 19.7 billion at the end of 2008, to just NIS 1.7 billion at the end of the year.

At the end of 2008, against the deteriorating financial crisis and increase in risk, there was noticeable evidence of capital being returned to its country of origin, particularly due to the lack of confidence in the banking system. As a result, at the end of 2008 the banks increased their foreign currency deposits with the Bank of Israel sharply after transferring foreign currency worth $15 billion from abroad (Table 4).

At the beginning of 2009, the financial markets in Israel stabilized, and the public's fears of holding foreign currency in commercial banks abroad receded somewhat. Consequently, the private sector withdrew NIS 19 billion in foreign currency that it had brought to Israel.

7. Revaluation accounts

The revaluation accounts are composed of unrealized profits from exchange-rate differentials on the foreign exchange reserves and unrealized profits on account of the revaluation of tradable securities in local and foreign currency to their fair value.

The balance of the revaluation accounts declined by NIS 1.1 billion, from NIS 5.3 billion in 2008 to NIS 4.2 billion in 2009. This consists of a NIS 1.5 billion decline in the revaluation account in respect of tradable foreign currency securities and a NIS 0.4 billion increase in the balance of the revaluation account for balances denominated in foreign currency.

Balances denominated in foreign currency

According to the accounting method used in the Bank's financial statements, exchange rate differentials on balance sheet balances are not fully charged to the Statement of Operations unless they are 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 losses from a particular currency are first offset against the revaluation account for 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 2009, net negative exchange rate differentials of NIS 0.6 billion were created on account of adjusting the balances denominated in foreign currency to the representative exchange rate (in 2008—NIS 3.5 billion, Table 6). These differentials are traced to the depreciation of the US dollar against the NIS during the year, which was partially offset by the effect of the appreciation of other currencies against the NIS.

Negative exchange rate differentials were accrued mainly on banks' foreign currency deposits—about NIS 1.2 billion. Banks' deposits denominated in US dollars accumulated negative exchange rate differentials, mostly at the beginning of the year, when the portfolio balances were high due to the import of capital at the end of 2008, in addition to the sharp depreciation of the NIS exchange rate during this period.

These negative exchange rate differentials were offset by positive exchange rate differentials of NIS 0.6 billion accrued on the foreign exchange reserves.

The expense on exchange rate differential in 2009 was NIS 0.9 billion. Here too, the effect of the weaker US dollar against the NIS is evident, less the effect of the appreciation of other leading currencies in the reserves portfolio against the NIS.

The difference between the total exchange rate differentials accrued and realized increased the balance in the revaluation account.

Tradable foreign currency securities

The revaluation account balance on account of tradable foreign currency securities declined from NIS 2.4 billion in 2008 to just NIS 0.9 billion in 2009.

In the wake of the financial crisis, there was a perceptible "flight to quality," i.e., an upsurge in the purchase of US government bonds. This led to a marked decline in yields and rising prices, which was reflected not only in capital gains which were realized in the Statement of Operations, but also in an increase in the balance of this revaluation account. During the course of 2009, the returns increased leading to lower prices for the portfolio held in US government bonds, and this was primarily reflected in a decline of the revaluation account balance.

Table 6
Exchange rate Differentials Due To Adjustment of Foreign Currency Balances to the Representative Exchange Rate

	2009	2008
	(NIS millions)	
Assets		
Foreign exchange reserves	454	(1,891)
Credit to the government—binational funds	(1)	(1)
International financial institutions	(6)	(10)
Liabilities		
Government deposits	138	47
Banks' foreign currency deposits	(1,185)	(1,694)
International financial institutions	38	23
Binational fund deposits	-	2
Total	**(562)**	**(3,524)**
Realized exchange-rate differentials	(923)	(2,372)
Unrealized exchange-rate differentials	361	(1,152)

Tradable local currency securities

The revaluation account balance on account of tradable local currency securities was only NIS 0.7 billion in 2009 (similar to last year). This, despite the sharp increase in the size of the portfolio following the bond purchases. The reason for this is that the accrual component for indexation on the new purchases is still small, and the price differentials component was almost zero as the price of the bonds at the end of year is extremely close to their average purchase price.

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

In 2009, the Bank of Israel had cumulative losses of NIS 20.1 billion, compared with NIS 21.4 billion in 2008. This decline can be attributed to net profit of NIS 1.4 billion in 2009.

According to the Bank of Israel Law, the Bank must transfer any profit it makes to the government within 60 days of the conclusion of each business year, but the Bank's losses are not covered by the government. The profits are transferred to the government after being offset against the balance of the accumulated losses, if there are any. The Bank of Israel did therefore not transfer profit to the government in 2009, and will not do so until the entire balance of the accumulated losses in the Bank's books is offset.