

# EXPLANATORY REMARKS TO THE 2010 FINANCIAL STATEMENTS



## 1. The Principal Changes in the Financial Statements

### 1.1 The Bank of Israel's balance sheet

The Bank of Israel's balance sheet totaled NIS 274 billion at the end of 2010 as against NIS 252 billion at the end of 2009—an increase of about NIS 22 billion (8.6 percent).

On the Assets side, this increase can be attributed to an increase of NIS 22 billion in the Bank's foreign currency financial assets abroad.

In 2010 the Bank purchased on the shekel-foreign currency market about \$11.9 billion, following the purchase of about \$32 billion in total during 2008 and 2009, which is due in part to the plan to purchase fixed amounts of foreign currency, a plan that commenced in March 2008 and ended in August 2009. As from August 2009 the Bank's policy is to intervene in the foreign currency market when there are irregular fluctuations in the exchange rate that do not correspond with the basic economic conditions of the economy.

The foreign exchange reserves<sup>1</sup> increased from \$61 billion at the end of 2009 to \$71 billion at the end of 2010 (an increase of about 17 percent).

On the Liabilities and Equity side, the increase can be attributed mainly to a mixed effect of changes: on the one hand there was an increase of NIS 36 billion in monetary absorption instruments—which was due to an increase of NIS 50 billion in the *makam* and a decrease of NIS 14 billion in time deposits—and an increase of NIS 3 billion in notes and coins in circulation; whereas on the other hand, there was a decrease of NIS 2 billion in revaluation accounts and a decrease of NIS 17.9 billion in the Bank's equity, which is a result of the loss for the year.

This purchase of foreign currency injected liquidity into the economy above the increase required in the monetary base<sup>2</sup>, and the Bank absorbed these surpluses with the use of monetary tools—expanding the issue of *makam* to the public and reducing the time deposits that it held for the commercial banks. Increasing the relative share of the *makam* in the monetary tools to 63 percent at the end of 2010, compared with 48 percent

<sup>1</sup> 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.

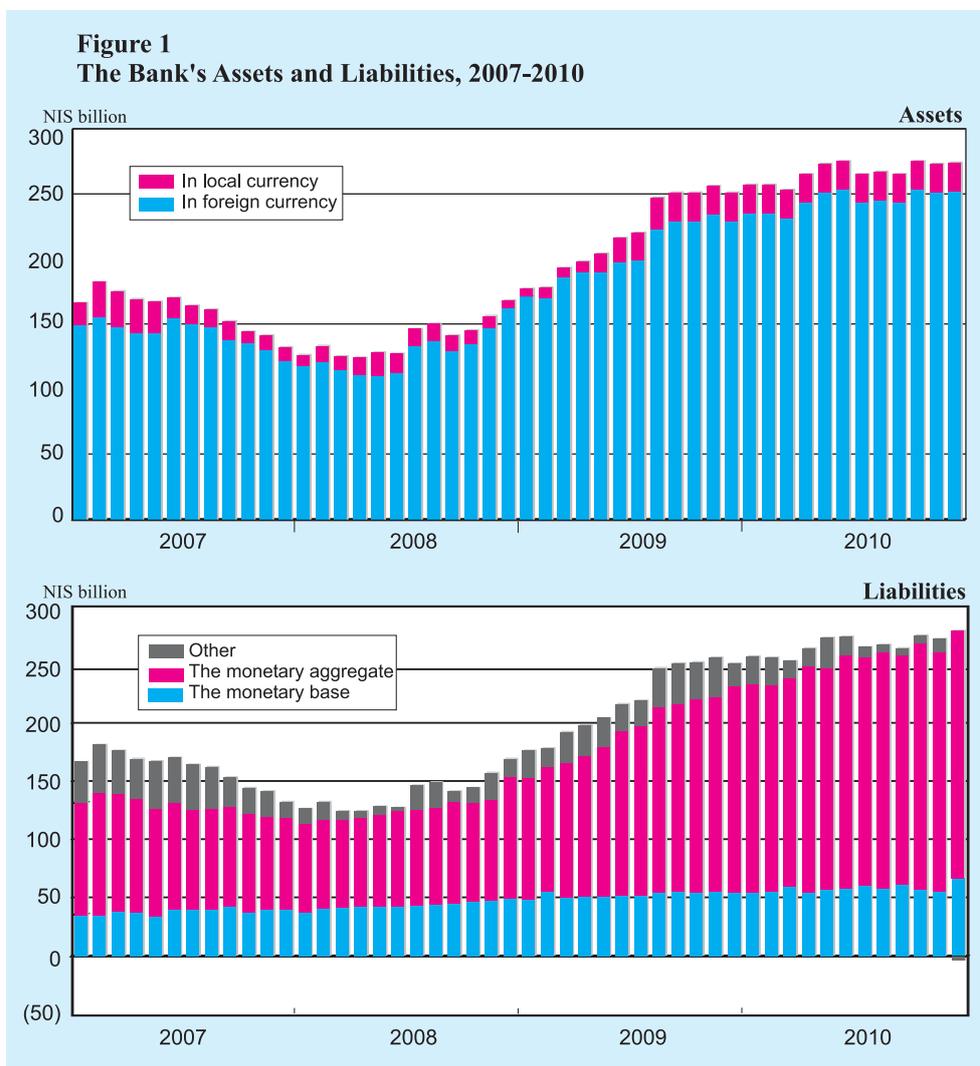
<sup>2</sup> The monetary base is composed of banknotes and coins in circulation and of the NIS-denominated current deposits of the banks with Bank of Israel.



at the end of 2009, derives from the goal to continue perfecting the money market in Israel, and from other advantages of makam over deposits as a monetary tool.

As a result, the combination of monetary tools<sup>3</sup> at the end of 2010 continued to comprise liabilities only and amounted to NIS 213 billion, compared with NIS 176 billion at the end of 2009, an increase of 21 percent.

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 base, was largely the outcome of the relatively low rate of interest in the economy during 2010 (notwithstanding its increase to 2 percent), which generated an increase in the demand for money and the aforesaid increase in the monetary base.



<sup>3</sup> Makam and time deposits less monetary loans and repo auctions. The balance of monetary loans was zero at the end of 2010. The balances of repo auctions were zero at the end of 2010 and 2009.

These changes in the Bank's balance sheet led to an increase in surplus assets over liabilities in foreign currency in the amount of NIS 33 billion (about 16 percent), from NIS 210 billion at the end of 2009 to NIS 243 billion at the end of 2010. The surplus of liabilities over assets in local currency grew from NIS 227 billion at the end of 2009 to NIS 278 billion at the end of 2010, an increase of NIS 51 billion or 22 percent. (see Note 18 to the Financial Statements.)

In 2010, similar to recent years, there was an increase in the currency asymmetry in the composition of Bank of Israel's assets and liabilities. The currency asymmetry has been a feature of the Bank's balance sheet for more than ten years, since most of the Bank's assets are denominated in foreign currency, whereas its liabilities are primarily in shekel. The asymmetry exposes the Bank to fluctuations in its reported financial results as a result of changes in the exchange rates of the shekel in relation to foreign currencies, and to changes in Israel's interest trajectory relative to those of other economies (Figure 1)<sup>4</sup>.

## 1.2 Statement of Operations

In the Statement of Operations, the Bank recorded a loss of NIS 17.9 billion in 2010, compared with a profit of NIS 1.4 billion in 2009. The loss is attributed principally to the significant increase in exchange rate differential expenses.

Net interest income amounted to NIS 27 million this year, compared with NIS 552 million in 2009, a decrease of NIS 525 million.

Other financial expenses in respect of securities and derivatives amounted to NIS 69 million, compared with income of NIS 2.6 billion in 2009.

The other financial expenses, in respect of exchange rate differentials, amounted to NIS 17.6 billion, compared with NIS 0.9 billion in 2009.

The Bank's general and administrative expenses amounted to NIS 528 million in 2010, compared with NIS 879 million in 2009, a decrease of NIS 351 million (40 percent).

Net interest income amounted to NIS 27 million in 2010, compared with NIS 552 million in 2009.

Interest income from foreign currency abroad amounted to NIS 3 billion this year, compared with NIS 2.6 billion in 2009. The increase of NIS 0.4 billion is principally due to an increase in foreign currency assets.

<sup>4</sup> This currency asymmetry first began to manifest itself during the years 1995-1997, when the Bank adopted a contractionary monetary policy in order to attain the inflation targets set by the government. The resulting import of capital by the private sector forced the Bank of Israel to purchase foreign currency from the public in order to keep the exchange rate at the lower limit of the crawling band 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 world wide, has since then been composed of liabilities.



The interest expense to banks and the public, which are the interest expenses on the monetary aggregate, amounted to NIS 3.5 billion this year, compared with NIS 2.4 billion in 2009. The increase in interest expense, of approximately NIS 1.1 billion, is principally due to an increase in absorption using monetary instruments—*makam* and time deposits—in 2010, and to the expansion of the interest spread between the shekel interest rate and interest rates abroad, as a result of the interest rates in the developed countries remaining at their low levels and the interest of Bank of Israel being raised by about 1 percent to a level of 2 percent in October 2010. Conversely, the growth in the monetary base, which reduced the extent of required absorption, contributed to reducing the interest expenses.

Interest income from the government increased by about NIS 117 million, from NIS 905 million in 2009 to NIS 1,022 million in 2010. The increase in income was affected this year by two opposing factors: on the one hand, interest income from securities in local currency increased while on the other hand there was a decrease in credit to the government following the debt restructuring agreement<sup>5</sup> that was signed with the government that includes an early repayment option, following which there was a decrease in interest income.

Interest expense to the government decreased by about NIS 102 million, from NIS 430 million in 2009 to NIS 328 million in 2010. This is a result of two opposing factors: the decrease of the government's foreign currency deposits caused a decrease of interest expense while an increase in the government's local currency balances and the gradual increase of the interest rate led to an increase in the expense.

Net interest expense to the government, excluding interest income from securities in local currency, amounted to NIS 254 million, compared with NIS 314 million in 2009.

Net interest income from foreign exchange reserves was NIS 3 billion this year, compared with NIS 2.6 billion in 2009.

Other financial expenses in respect of securities and derivative financial instruments amounted to NIS 69 million, compared with NIS 2.6 billion in 2009. The change is mainly due to a significant decline in capital gains from securities traded in foreign currency.

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

Overall, The Bank of Israel earned this year capital gains from foreign currency securities in the amount of NIS 0.3 billion, compared with NIS 2.8 billion in 2009. The decline in

<sup>5</sup> In March 2010 a debt restructuring agreement including an early repayment option was signed with the government. In the agreement, Bank of Israel agreed to reduce the interest and extend the repayment period; alternatively the government was granted an option to early repay the debt in amounts discounted to the date of repayment. On March 9, 2010 the government early, repaid the debt pursuant to the option.

capital gains compared with last year, even with an increase in foreign currency assets abroad, is attributed mainly to increases in the yields to maturity of government bonds in the USA and Europe in the last four months of 2010, following concerns regarding the economic recovery in the USA and the repayment abilities of countries having large amounts of national debt.

In 2010, the NIS appreciated 6 percent against the US dollar, compared with appreciation of 0.7 percent in 2009. The nominal effective exchange rate<sup>6</sup> of the NIS appreciated by 7 percent, compared with a devaluation of 2.5 percent in 2009. The change in the exchange rate was not uniform throughout the year; in the first half of the year the NIS weakened by 3 percent compared to the dollar, whereas in the second half it strengthened by 9 percent. These trends mainly reflect the weakening of the euro compared to the dollar in the first half and its strengthening in the second half. A similar trend is evident in the exchange rates of other principal foreign currencies against the shekel—a weakening of 10.1 percent in the pound sterling (an increase of 10.1 percent in 2009) and a weakening of 12.9 percent in the euro (an increase of 2.7 percent in 2009). These effects were reflected in the Bank's high expenses on exchange rate differentials this year.

General and administrative expenses decreased this year by NIS 351 million. This is the result of a decrease in wages and benefits to the Bank's employees and pensioners. The decrease in these expenses is due to a onetime adjustment of the actuarial liability for retirement payments to employees and pensioners, recorded in 2009.

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

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

The Bank's financial statements are prepared in accordance with generally accepted accounting principles (GAAP), adapted for the special activity of a central bank, as

<sup>6</sup> The nominal effective exchange rate is calculated as the weighted average of the shekel exchange rate against 28 currencies (representing 38 countries) according to the trade weight of Israel with these countries.



adopted by central banks. In order to understand the effect of the economic developments on the financial statements, presented hereunder is an analysis of the data in the financial statements, according to economic aggregates in line with the Bank's functions.

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

	December 31		For year ended December 31	
	2010	2009	2010	2009
	Balances		Income (expenses)	
	(NIS million)			
<b>Assets, net</b>				
Foreign currency balances <sup>a</sup>	251,671	228,811	2,874	5,230
Securities portfolio in NIS	19,672	20,221	948	735
<b>Total</b>	<b>271,343</b>	<b>249,032</b>	<b>3,822</b>	<b>5,965</b>
<b>Liabilities and equity, net</b>				
Monetary aggregate <sup>b</sup>	213,283	176,489	(3,500)	(2,385)
Monetary base <sup>c</sup>	66,311	54,802	(45)	(69)
Government balances <sup>d</sup>	14,090	19,581	(254)	(315)
Deposits of banking corporations in foreign currency	1,541	1,700	-	-
Others <sup>e</sup>	7,874	8,396	(332)	(913)
Revaluation accounts <sup>f</sup>	2,204	4,153	(17,562)	(923)
Equity of the Bank	(33,960)	(16,089)	-	-
<b>Total</b>	<b>271,343</b>	<b>249,032</b>	<b>(21,693)</b>	<b>(4,605)</b>
<b>Net profit (loss)</b>	<b>-</b>	<b>-</b>	<b>(17,871)</b>	<b>1,360</b>

<sup>a</sup> 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.

<sup>b</sup> Consisting of the balance of makam and time deposits in local currency minus the monetary loans and repurchase auctions.

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

<sup>d</sup> Consisting of the government's foreign currency deposits plus the government's local currency deposits minus the balance of credit to the government.

<sup>e</sup> The others balance consists of other balances in local currency plus the total of other assets (fixed assets and international financial institutions) minus other liabilities in foreign currency in respect of international financial institutions.

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

Table 1 and Figure 2 show the financial statements of the Bank in net amounts—that is net balance sheet amounts and net operating results in the Statement of Operations according to the functions performed by the Bank, and according to the principal activity it performs. The manner of their presentation is different from the accepted accounting presentation, for the purpose of analyzing the changes in the financial statements.

## 2.1 Foreign exchange reserves

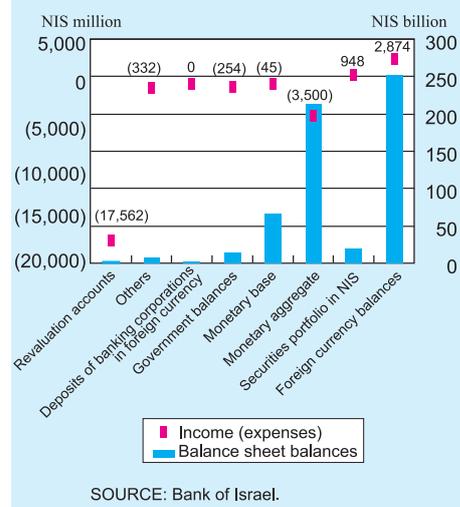
Foreign exchange reserves<sup>7</sup> account for the largest part of the Bank's assets—about 92 percent of the Bank's total assets at the end of 2010 (Table 1). In accordance with the Bank of Israel Law, 5770-2010, one of the Bank's responsibilities is to hold and manage the country's foreign exchange reserves<sup>8</sup>.

Holding and managing an appropriate level of foreign exchange reserves serve the goals of the Bank as provided in the Law and help it to fulfill its other responsibilities.

The foreign exchange reserves serve as a foreign currency source of liquidity that the Bank can use when needed, and their existence provides 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, benefits that also support the Bank in achieving its goals and performing its responsibilities. The desired level of the reserves, the principles that guide the Governor with respect to that level, and the investment policy of the reserves and its underlying guidelines, all derive from the possible uses of the reserves and the benefits arising from having them.

Possible uses Bank of Israel can make of the reserves are: (1) As the government's banker—selling foreign currency to the government when needed, for example for servicing the country's foreign currency debts or for financing imports in time of emergency; (2) Any use contributing to achieving the Bank's goal of supporting the stability and normal functioning of the financial system; (3) Using the reserves to perform

**Figure 2**  
Aggregate Balance Sheet Balances,  
and the Resulting Profit and Loss, 2010



<sup>7</sup> 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.

<sup>8</sup> Until the Bank of Israel Law, 5770-2110 came into effect on June 1, the reserves were managed in accordance with the Bank of Israel Law, 5714-1954 and the legal interpretation that was added to it over the years, and according to the investment policy established by the Bank's Governor.



the Bank's responsibilities: (a) implementing the monetary policy; (b) supporting the normal operation of the foreign currency market in Israel.

At the end of 2010 the foreign exchange reserves amounted to \$71 billion, compared with \$61 billion at the end of 2009, an increase of \$10 billion (about 16 percent).

In NIS terms, the foreign exchange reserves amounted to NIS 252 billion at the end of 2010, compared with NIS 229 billion at the end of 2009, an increase of NIS 23 billion or about 10 percent (Figure 3).

Several factors explain the increase in the reserves (Table 4). As in last year, most of the increase this year was due to the purchase of \$11.9 billion of foreign currency by the Bank of Israel in the NIS-foreign currency market, compared with \$19.6 billion in 2009.

This increase was offset by an overall loss of Bank of Israel from interest and financial gains in the amount of \$0.8 billion, compared with a profit of \$2.1 billion in 2009.

The financial gains are calculated in dollar terms, and therefore are greatly affected by changes in the exchange rate of the dollar in relation to the other currencies in which the reserves are invested.

Furthermore, the increase in the foreign exchange reserves was offset by withdrawals of the public sector in the amount of \$0.2 billion and of the government and national institutions in the amount of \$0.7 billion (last year—\$4.6 billion and \$0.2 billion, respectively).

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.

The government's net withdrawals from the foreign exchange reserves amounted to \$0.9 billion in 2010, similar to their amount in 2009 (about \$0.4 billion).

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. The balance in short-term deposits of NIS 20.4 billion at the end of 2010 consists of deposits in international financial institutions and of deposits in foreign banks which are fully guaranteed by governments abroad (an increase of \$7.6 billion).

### **2.1.1 Rate of return on the foreign exchange reserves**

The Bank of Israel invests the foreign exchange reserves primarily in tradable assets having a 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 Bank of Israel measures the return on the foreign exchange reserves in terms of

the currency numeraire, a basket comprised of a number of currencies in which most of the reserves are held. The composition of the numeraire's currency basket is determined according to fixed principles, which reflect the objectives of holding the reserves. Its composition is adjusted from time to time as needed, and is always known in advance. The numeraire also serves as an anchor for the currency risk of the reserves.

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 target 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 to maturity and risk data in the foreign bond markets where the reserves are invested. At the end of 2010, the benchmark duration was nine to ten months in the US dollar portfolio and in the euro portfolio. The benchmark duration for other currencies was longer.

The actual annual rate of return on the reserve portfolio in the numeraire was 1.24 percent in 2010, as against a return of 1.14 percent on the benchmark<sup>9</sup> (Table 2).

The difference between them of 0.10 percent is the surplus yield in the reserve portfolio, reflecting the contribution of investment decisions made according to the permitted degrees of freedom in the active management of the reserves, which are reflected in deviations of the composition of the portfolio from the benchmark composition. These degrees of freedom are relatively limited and are restricted by a set of compliance rules that is part of the investment policy for the reserves. The added value of the active management of the reserves is expressed in the difference in yields between the foreign exchange reserves portfolio and its benchmark, which is usually positive and amounted to 0.09 percent on average for the period 1999-2008 and also in 2010. In 2009, the difference was extremely high at 1.1 percent—following the recovery of the global financial markets from the crisis, which led to an increase in the value of many financial assets held in the reserves portfolio but not held in the benchmark (spread assets). The contribution of the active management in the years from 2001 until 2010 was on average 0.20 percent.

<sup>9</sup> The return on the foreign exchange reserves in 2010 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.



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

	2010	2009	2008
<b>Total foreign exchange reserves</b>		(\$ million)	
End of year	(70,913)	(60,612)	(42,513)
Annual average	(64,665)	(51,310)	(32,270)
<b>Income and cross rate differentials</b>		(NIS million)	
Interest and capital gains	2,874	5,230	5,700
Unrealized price differentials <sup>a</sup>	(157)	(1,533)	841
Cross rate differentials	(20,187)	454	(1,837)
<b>Total</b>	<b>(17,470)</b>	<b>4,151</b>	<b>4,704</b>
		(\$ million)	
Interest and capital gains	776	1,330	1,593
Unrealized price differentials <sup>a</sup>	(29)	(401)	226
Cross rate differentials	(1,495)	1,169	(1,034)
<b>Total</b>	<b>(748)</b>	<b>2,098</b>	<b>785</b>
<b>Yields<sup>b</sup></b>		(Percent)	
In terms of NIS			
Interest and capital gains	1.2	1.8	5.9
Exchange rate differentials	(8.3)	1.8	(4.3)
<b>Total</b>	<b>(7.1)</b>	<b>3.6</b>	<b>1.6</b>
In terms of euro			
<b>Total</b>	<b>6.7</b>	<b>0.8</b>	<b>8.6</b>
In terms of \$			
Interest and capital gains	1.2	1.8	5.9
Exchange rate differentials	(2.4)	2.5	(3.1)
<b>Total</b>	<b>(1.2)</b>	<b>4.3</b>	<b>2.8</b>
<b>In terms of use of foreign reserves</b>	<b>1.2</b>	<b>1.9</b>	<b>5.9</b>
<b>Benchmark yield</b>	<b>1.1</b>	<b>0.8</b>	<b>6.1</b>

<sup>a</sup> Unrealized price differentials express the annual change in the revaluation account of foreign currency tradable securities. (see Note 16 to the Financial Statements.)

<sup>b</sup> 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.

The return on the investment of the foreign exchange reserves is measured in terms of the numeraire. The arbitrary nature of measuring return in terms of a specific currency is particularly evident when assessing return in terms of dollars (a negative return of 1.2 percent this year) and in terms of euros (a positive return of 6.7 percent this year), and the

high volatility of these returns over time (Table 2). In NIS terms, the rate of return in 2010 was negative at 7.1 percent (compared with a positive return of 3.6 percent in 2009), due to the negative contribution made by exchange rate differentials to the total yield, which is the result of the NIS strengthening against the dollar and the euro, in which most of the reserves are invested. 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.

## 2.2 Revaluation accounts

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

The balance of the revaluation accounts declined by NIS 2 billion, from NIS 4.2 billion at the end of 2009 to NIS 2.2 billion at the end of 2010. This consists of a decline of NIS 2.2 billion in the revaluation account for balances denominated in foreign currency, a decline of NIS 0.1 billion in the revaluation account for tradable foreign currency securities and an increase of NIS 0.4 billion in the balance of the revaluation account for tradable local currency securities.

### 2.2.1 Revaluation account for balances denominated in foreign currency

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

Unrealized exchange rate differentials are charged to the Revaluation Accounts item in the balance sheet. Future losses from a particular currency are first offset against the revaluation account for that currency, if such an account exists, and only 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 charged to the Statement of



Operations.

In 2010 net losses from exchange rate differentials in the amount of NIS 17.6 billion on account of adjusting the balances denominated in foreign currency to the representative exchange rate were realized, compared with NIS 0.9 billion in 2009 (Table 3). These differentials were due to the weakening against the shekel of the US dollar, the euro and the other currencies in which the balances are held during the year.

Losses from exchange rate differentials were accrued mainly on the foreign exchange reserves—about NIS 20.2 billion (Table 3). The foreign exchange reserves accumulated losses from exchange rate differentials mainly towards the end of the year, as a result of the appreciation of the shekel against the other currencies in that period.

These losses from exchange rate differentials were offset somewhat by profits from exchange rate differentials in the amount of NIS 0.4 billion that accrued on balances of international financial institutions.

The realization of losses from exchange rate differentials at the end of the year reduced the balance in the revaluation account.

**Table 3**  
**Exchange Rate Differentials Due To Adjustment of Foreign Currency Balances to the Representative Exchange Rate**

	2010	2009
	(NIS million)	
<b>Assets</b>		
Foreign exchange reserves	(20,187)	454
Credit to the government—binational funds	(7)	(1)
The International financial institutions	(81)	(6)
<b>Liabilities</b>		
Government deposits	35	138
Banks' foreign currency deposits	71	(1,185)
The International financial institutions	387	38
Binational fund deposits	7	-
<b>Total</b>	<b>(19,775)</b>	<b>(562)</b>
Realized exchange rate differentials	(17,562)	(923)
Unrealized exchange rate differentials	(2,213)	361

### 2.2.2 Revaluation account for tradable foreign currency securities

The balance of the revaluation account for tradable foreign currency securities amounted to NIS 0.8 billion in 2010, compared with NIS 0.9 billion in 2009. (see Note 16 to the financial statements.)

### 2.2.3 Revaluation account for tradable local currency securities

The balance of the revaluation account for tradable local currency securities amounted to NIS 1.1 billion at the end of 2010, compared with NIS 0.7 billion at the end of 2009.

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.

## 2.3 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 at which it lends to or borrows 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 or deposits of banking corporations, as well as market instruments—*makam* and repo.

In 2010, Bank of Israel continued to purchase dollars in order to somewhat offset the effect of the significant injections of capital into the Israeli market, and into other rapidly growing economies around the world, injections which caused the strengthening of the shekel. The purchase of foreign currency injected more liquidity into the market than the required increase in the monetary base and Bank of Israel re absorbed these surpluses to ensure that the short-term interest rate would be consistent with its set interest rate. During most of the year, Bank of Israel continued to increase the relative share of *makam* from the monetary instruments, and at the end of 2010 it reached 63 percent, compared with 48 percent at the end of 2009.

At the end of 2010, the balance of monetary instruments was NIS 213 billion, compared with NIS 176 billion at the end of 2009. In 2010 the composition of the monetary instruments aggregate changed, and there was a decrease in time deposits compared to an increase in *makam*. In 2010 the monetary instruments aggregate comprised NIS 78 billion in time deposits (compared with NIS 92 billion at the end of 2009) and NIS 135 billion in *makam* (compared with NIS 85 billion at the end of 2009).



### 2.3.1 Expense on account of the monetary instruments

Net interest expense on account of the monetary instruments aggregate was NIS 3.5 billion in 2010, compared with net expenses of NIS 2.4 billion in 2009.

The increase in interest expenses is due to an increase of 1 percentage point in the Bank of Israel interest rate in 2010 and to an increase in the required absorption mainly by means of an increase in *makam*. The expenses on account of *makam* still account for the major part of the interest expense for monetary instruments—about NIS 2.2 billion.

This is because of the size of the *makam* balance (NIS 115 billion on average) relative to that of the time deposits (NIS 80 billion on average) and because *makam* are issued for a period of up to one year, so that the interest paid on account of *makam* is higher than the interest paid for time deposits, which are deposited for a day or a week.

### 2.4 Israeli currency securities portfolio

At the end of 2010, the balance of the Israeli currency securities portfolio amounted to NIS 19.7 billion, similar to that in 2009 (NIS 20.2 billion). In 2009 Bank of Israel adopted an expansionary monetary policy in an effort to reduce the impact of the global financial crisis on the Israeli economy, as was done in many other countries, and it purchased securities in the amount of NIS 18 billion on the secondary market. The purchase of bonds was designed to support the cuts in the longer-term interest rates, thus easing the shortage of credit and supporting economic activity. These purchases were discontinued in August 2009.

Interest income from this portfolio amounted to NIS 0.9 billion in 2010 (compared with NIS 0.8 billion in 2009).

Interest income and the amortization of discount or premium for this portfolio are 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. The balance of the revaluation account was positive at the end of 2010.

## 2.5 The monetary base

The monetary base, composed of banknotes and coins in circulation and the banks' NIS-denominated demand accounts with the Bank of Israel, rose 10 percent during the year, from NIS 54.8 billion at the end of 2009 to NIS 66.3 billion at the end of 2010 (Figure 3).

In an inflationary target regime, in which the interest rate is the policy instrument used to achieve the nominal goal, the amount of money is determined by the public's demand. The Bank

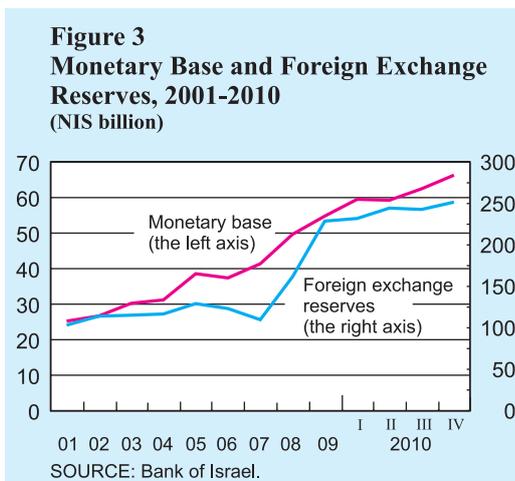
of Israel absorbs the liquidity surpluses created in the banking system to ensure that the shortest-term interest rates are consistent with the declared interest rate. Monetary aggregate trends, including the monetary base, therefore reflect the public's demand for money, given market interest rates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

Due to the low rate of interest on short-term deposits, the public chose to leave its money in current accounts, instead of short-term deposits, and in doing so caused the aforesaid rise in the monetary base.

The Bank of Israel injected NIS 11 billion net to the monetary base, while the government and national institutions absorbed NIS 1.4 billion (Table 4). Most of this injection can be attributed to the expansionary monetary policy adopted by the Bank this year: foreign currency purchases injected liquidity of NIS 43 billion, and the Bank of Israel fully absorbed the surplus liquidity through the monetary instruments—an amount of NIS 50 billion was absorbed through *makam*, compared with an injection of NIS 14 billion through time deposits

The cost of printing money amounted to NIS 53 million in 2010, compared with NIS 72 million in 2009.

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





**Table 4**  
**The Monetary Base and the Foreign Exchange Reserves—Changes and their Sources**

Year	Change in monetary base				The sectors' contribution to the foreign exchange reserves				
	Change in monetary base (1)=(2)+(3)+(4)+(5)	Injection (absorption) of government and National Institutions <sup>a</sup>	Injection from (absorption by) Bank of Israel	Injection from foreign currency conversions by Bank of Israel	Adjustments <sup>b</sup>	Private sector <sup>c</sup>	Bank of Israel	Government and National Institutions <sup>d</sup>	Change in foreign exchange reserves <sup>e</sup>
		(2)	(3)	(4)					
(NIS million)									
2001	4,364	(2,611)	7,675	-	(700)	(105)	1,067	(944)	18
2002	1,437	(6,065)	9,265	-	(1,763)	(1,351)	2,040	(200)	489
2003	3,567	3,479	1,425	-	(1,337)	(1,204)	1,445	1,877	2,118
2004	966	1,601	1,070	-	(1,705)	(631)	993	482	844
2005	7,357	(1,452)	9,920	-	(1,111)	1,026	125	75	1,226
2006	(1,176)	(3,789)	3,797	-	(1,184)	25	1,845	(673)	1,197
2007	3,979	(10,809)	15,693	-	(905)	(196)	2,512	(2,912)	(596)
	8,297	(17,371)	(17,305)	43,995	(1,022)	4,291	12,789	(3,204)	13,876
2009	5,141	(14,195)	(58,855)	77,413	778	(4,559)	22,866	(208)	18,099
<b>2010</b>	<b>11,509</b>	<b>1,418</b>	<b>(32,962)</b>	<b>43,752</b>	<b>(699)</b>	<b>(199)</b>	<b>11,150</b>	<b>(650)</b>	<b>10,301</b>
I	4,709	(1,855)	(1,676)	8,444	(204)	(22)	905	980	1,863
II	(249)	8,573	(20,240)	11,686	(268)	(185)	1,417	(611)	621
III	3,220	(5,799)	4,321	4,874	(176)	19	3,937	(792)	3,164
IV	3,829	499	(15,367)	18,748	(51)	(11)	4,891	(227)	4,653

<sup>a</sup> The government injection includes also the injection of the National Insurance Institute and of the Postal Bank.

<sup>b</sup> Adjustments include: transfers by the National Institutions from abroad via the banks but which are defined as public sector injection (in column 2). Foreign currency domestic receipts and payments of the Bank of Israel and the government to the private sector, such as income tax receipts in foreign currency, do not change the monetary base as they are transferred directly from the private sector to the government; on the one hand they are defined as government absorption, while on the other they are defined as the private sector contribution to the foreign exchange reserves.

<sup>c</sup> Including income tax payments by the business sector in foreign currency.

<sup>d</sup> 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).

<sup>e</sup> 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.

## 2.6 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 amounted to NIS 21.5 billion at the end of 2010, compared with NIS 13.3 billion at the end of 2009.

The government absorbed NIS 2.7 billion through the commercial banks in 2010, compared with an injection of about NIS 6.6 billion in 2009. The public withdrew NIS

5.3 billion in cash from the banking corporations, compared with NIS 13.4 billion in 2009 (Table 5).

In net terms, the Bank of Israel injected NIS 11 billion into the commercial banks (compared with NIS 18 billion in 2009) by purchasing foreign currency (NIS 44 billion) and absorbing about NIS 33 billion through various monetary instruments.

**Table 5**  
**Banking Corporations' Deposits in the Bank of Israel**

	In 2010			In 2009			In 2008		
	In Local currency	In foreign currency	Total	In Local currency	In foreign currency	Total	In Local currency	In foreign currency	Total
	(NIS million)								
<b>Change in banking corporations' deposits<sup>a</sup></b>									
Activity with the government <sup>b</sup>	2,660	1,418	4,078	(6,629)	(74)	(6,703)	(9,574)	711	(8,863)
Withdrawal (-) of banknotes from Bank of Israel	(5,254)	-	(5,254)	(13,423)	-	(13,423)	(13,393)	-	(13,393)
Activity with Bank of Israel <sup>c</sup>	(32,894)	(71)	(32,965)	(59,016)	1,185	(57,831)	(17,453)	1,797	(15,656)
Transfers from (+) and to (-) abroad	-	(1,511)	(1,511)	-	(19,134)	(19,134)	-	14,916	14,916
Foreign currency conversions at Bank of Israel	43,752	-	43,752	77,413	-	77,413	43,995	-	43,995
Adjustments	(93)	5	(88)	(334)	12	(322)	(672)	14	(658)
<b>Total change</b>	<b>8,171</b>	<b>(159)</b>	<b>8,012</b>	<b>(1,989)</b>	<b>(18,011)</b>	<b>(20,000)</b>	<b>2,903</b>	<b>17,438</b>	<b>20,341</b>
Deposit of banknotes by the Postal Bank in Bank of Israel <sup>d</sup>	1,783	-	1,783	6,607	-	6,607	8,620	-	8,620

<sup>a</sup> Not including the change in term deposits.

<sup>b</sup> Government injection via the banking corporations' demand deposits.

<sup>c</sup> Depositing of term deposits, purchasing *makam*, selling government bonds and various interest payments.

<sup>d</sup> Deposits of banknotes deposited mainly by the Postal Bank; these are absorbed by the government, and are included in the definition of "government injection".





## 2.7 Banking corporations' foreign currency deposits

The balance of banks' foreign currency deposits amounted to NIS 1.5 billion at the end of 2010, similar to the balance at the end of 2009 (NIS 1.7 billion). (Table 1).

## 2.8 Government accounts

Section 48(a) of the Bank of Israel Law, 5770-2010, which came into effect on June 1, 2010, states (like the previous law), "The Bank shall be the sole banker and fiscal agent of the government in Israel". Accordingly, the government manages all of its local currency accounts, and a considerable part 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<sup>10</sup>, as well as credit given 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 March 2010 an agreement was signed with the government with respect to a restructuring of the debt with an option for early repayment, thus ending the previous years' disagreements between the Bank and the government regarding these amounts. The debt was calculated for purposes of the restructuring, and Bank of Israel agreed to lower the interest and extend the repayment period. In addition, in accordance with the new conditions the government was granted an option for early repayment at amounts, discounted to the date of payment. The government took advantage of the option and repaid the debt of NIS 394 million early, on March 9, 2010.

The difference between the balance of the debt before signing the agreement and the amount of the early repayment was recognized in the Statement of Operations. Most of the effect was recognized as a provision in the previous year, since the outline of the agreement was known already at the end of 2009. The effect for previous years is included in the "Interest expense to the government" item.

Therefore, the balance of credit to the government was zero at the end of 2010, compared with NIS 0.8 billion at the end of 2009.

At the end of 2010, the government held NIS 14.2 billion in deposits, compared with NIS 20.3 billion at the end of 2009. The net decrease in government deposits is mainly due to a decrease of about NIS 7.3 billion in the government's foreign currency deposits, net of an increase of about NIS 1.1 billion in local currency deposits (Table 6).

<sup>10</sup> Government deposits in local currency may be offset against one another, other than some special deposits, but the government does not intend to offset its local currency deposits against its foreign currency deposits and these balances are therefore stated separately in the financial statements. The economic analysis that appears in these 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.

Net capital raised by the government abroad was positive this year, amounting to only \$44 million, as a result of the repayment of bonds. In 2010 the government issued bonds abroad in the amount of €1.5 billion, and also raised \$1.1 billion through State of Israel Bonds.

**Table 6**  
**Government Deposits in the Bank of Israel—Changes and their Sources**

	2010	2009	2008
NIS million			
<b>December 31 balances</b>			
<b>Government deposits</b>			
Local currency deposits	12,979	11,852	1,506
Foreign currency deposits	1,228	8,480	6,860
<b>Total government deposits</b>	<b>14,207</b>	<b>20,332</b>	<b>8,366</b>
<b>Net change in government deposits</b>			
Government contribution to foreign reserves <sup>a</sup>	(3,312)	(1,278)	(12,509)
Government absorption (Injection)	(598)	14,949	18,469
Government–Bank of Israel financial flow <sup>b</sup>	(2,065)	(1,709)	(1,094)
Adjustments <sup>c</sup>	(150)	4	201
<b>Total change</b>	<b>(6,125)</b>	<b>11,966</b>	<b>5,067</b>

<sup>a</sup> Government income and expenses abroad, receipt and repayment of government loans abroad.

<sup>b</sup> 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.

<sup>c</sup> 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").

## 2.9 Bank of Israel equity

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





## 2.9.1 The Bank's equity deficit

At the end of 2010 the Bank's equity deficit amounted to NIS 37.9 billion, compared with NIS 20.1 billion at the end of 2009, increased by the loss of NIS 17.9 billion in 2010. The loss is mainly due to foreign exchange differentials that amounted to NIS 17.6 billion in 2010, compared with NIS 0.9 billion in 2009.

The loss for 2010 was added to the accumulated loss of the Bank (Figure 4). This is a result of the currency asymmetry in the composition of Bank of Israel's assets and liabilities. The asymmetry exposes the Bank to fluctuations in its reported financial results, so that the appreciation of the shekel in relation to the principal currencies held by Bank of Israel led to high foreign exchange differentials at the end of 2010.

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

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

Since the Bank has a equity deficit, it did not transfer to the government any profits in 2010 in accordance with these provisions.

