EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS

Summary of the main changes in the financial statements

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

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

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

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

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

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

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

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

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

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

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

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

In 2008, as in recent years, the Bank's financial statements are typified by currency asymmetry: that the vast majority of the Bank's assets are denominated in or indexed to foreign currency while its liabilities are primarily in local currency (Figure 1, Table 7). This asymmetry began to manifest itself in 1995–97, when the Bank adopted a contractionary monetary policy in order to attain the inflation targets set by the government. The resulting import of capital by the private sector forced the Bank of Israel to purchase foreign currency from the public in order to keep the exchange rate at the lower bound of the crawling band that was used at the time and to re-absorb the local currency that was injected into the economy for this purpose. The foreign exchange reserves grew from an average of several billion US$ in previous decades to about $23 billion in 1998 and thence, gradually, to $28 billion in 2007.

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

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

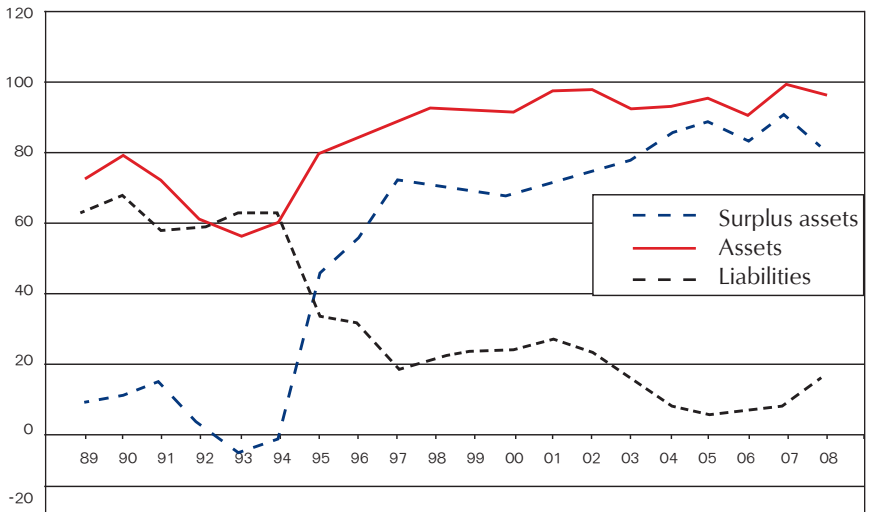
exposes the Bank to volatility in its reported financials due to changes in the exchange rate and in Israel's interest trajectory relative to those of other economies.

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

Figure 1

Foreign Currency Assets, Liabilities and Surplus Assets, 1989 to 2008

(percent of balance sheet, end-of-year, at current prices)



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

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

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

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

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

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

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

c. Accounting and economic changes in the financial statements

1. Foreign exchange reserves

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

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

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

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

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

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

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

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

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

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

Table 1

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

injection (+)/absorption(–)

(current prices)

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

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

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

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

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

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

1.1 Rate of return on the foreign exchange reserves

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

The returns obtained on the investment of the foreign exchange reserves are judged against a benchmark return. The benchmark is based on a hypothetical portfolio that is created according to pre-set rules and reflects the Bank's long-term investment strategy. The returns on the holdings of assets included in the benchmark, in all currencies, are weighted according to the weights of the currencies in the numeraire. The average duration of the benchmark is set according to the shortfall approach, in which benchmark duration is set so that the annual holding rate of return of the portfolio should not fall below a minimum desired threshold at the desired level of safety. A change in duration may occur due to a change in the parameters of the approach or in the yield and risk to maturity data in the foreign bond markets where the reserves are invested. At the end of 2008, the benchmark duration was fourteen months in the US$ portfolio and sixteen months in portfolios in other currencies.

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

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

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

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

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

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

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

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

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

b See note 2 to the financial statement.

2. Exchange rate differentials

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

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

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

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

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

(NIS million, at current prices)

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

3. Government accounts[5]

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

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

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

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

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

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

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

3.1 Credit to the government

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

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

3.2 Government deposits

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

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

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

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

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

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

Figure 2

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

(percent of GDP, at current prices)

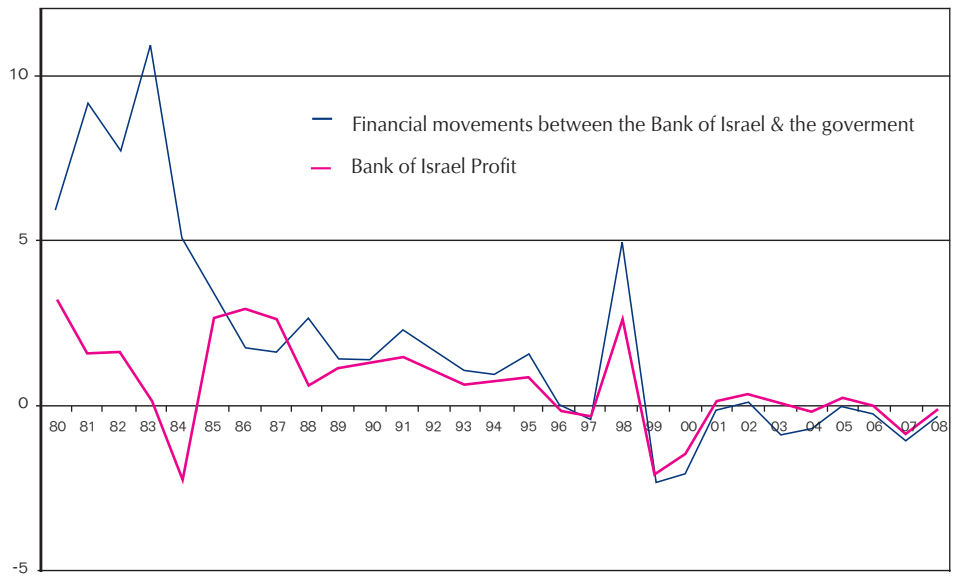

Figure 3

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

(annual average, NIS billion, at current prices)

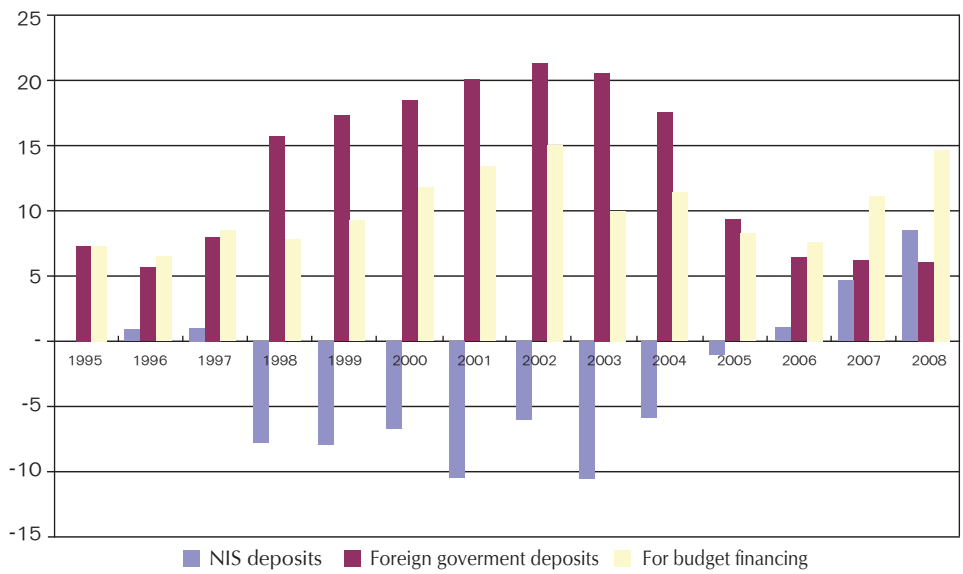

Table 4
Government Deposits with the Bank of Israel, 2006–08

(NIS million, current prices)

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

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

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

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

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

3.3 Raising of capital

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

3.4 State of Israel Bonds

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

4. Monetary instruments

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

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

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

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

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

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

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

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

4.1 Short-term bills (makam)

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

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

4.2 Monetary loans and time deposits

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

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

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

4.3 Purchases of securities in repo transactions

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

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

5. The securities portfolio

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

6. Demand deposits from banking corporations

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

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

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

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

Table 5
Deposits of the Banking Corporations with the Bank of Israel, 2006–08

(NIS million, current prices)

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

a This does not include the change in time deposits.

b Government injection via the banking corporations' demand deposits.

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

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

Table 6
Accounts of the Banking Corporations with the Bank of Israel, 1999–2008

(daily average, current prices)

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

a Items 1–10 include accrued interest.

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

c Deposits less loans and less dollar swaps to be received. (Not including the part of the makam deposit resulting from the changing of government bonds into makam.) In July 2005 the Bank of Israel stopped the NIS/$ swap auctions.

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

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

7. The monetary base

The monetary base, composed of banknotes and coins in circulation and the banks' NIS-denominated demand accounts with the Bank of Israel, rose during the year by NIS 8.3 billion (Table 1) as against an NIS 4 billion increase in 2007. Banknotes and coins in circulation were worth NIS 34 billion in 2008 as against NIS 29 billion in 2007.

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

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

8. Bank of Israel capital

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

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

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

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

9. The Statement of Operations

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

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

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

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

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

9.1 Bank of Israel income

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

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

9.2 Bank of Israel expenses

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

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

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

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

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

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

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

8 See the "Government accounts" section.