EXPLANATORY REMARKS TO THE 2011 FINANCIAL STATEMENTS

1. The Principal Changes in the Financial Statements

1.1 The Bank of Israel's balance sheet

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

1.1.1 Assets side

On the Assets side, this increase can be attributed mainly to an increase in the Bank's foreign currency financial assets abroad—from an amount of NIS 253 billion at the end of 2010 to NIS 287 billion at the end of 2011. The foreign exchange reserves[1] increased from $71 billion at the end of 2010 to $75 billion at the end of 2011 (an increase of about 6 percent).

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

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

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

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

1.1.2 Liabilities and Equity side

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

The purchase of foreign currency injected liquidity into the economy above the required increase in the monetary base[2], and the Bank absorbed these surpluses with the use of monetary instruments—by expanding the time deposits that it held for the commercial banks and reducing the issue of *makam* to the public, so that the balance of *makam* decreased at the end of 2011. The aggregate of monetary instruments[3] at the end of 2011 continued to comprise liabilities only and amounted to NIS 228 billion, compared with NIS 213 billion at the end of 2010, an increase of 7 percent.

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

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

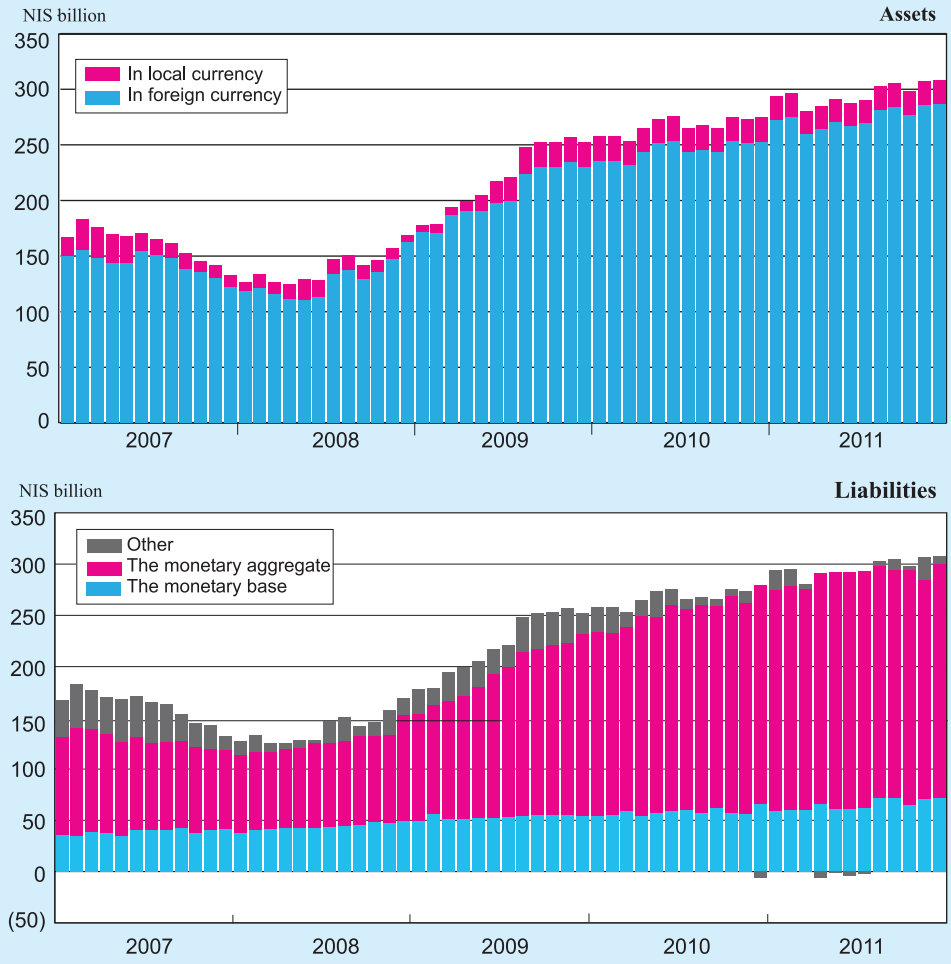
In 2011, similar to recent years, the changes caused an increase in the currency asymmetry in the composition of Bank of Israel's assets and liabilities. The currency asymmetry has been a feature of the Bank's balance sheet for more than ten years, since most of the Bank's assets are denominated in foreign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

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

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

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

Figure 1
The Bank's Assets and Liabilities, 2007-2011



1.2 Statement of Operations

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

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

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

1.2.1 Net interest expenses

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

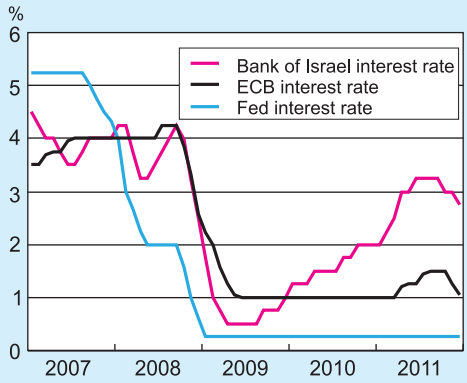
Interest income from foreign currency abroad amounted to NIS 2.8 billion this year, compared with NIS 3 billion in 2010. The decrease in interest income, notwithstanding the increase in the foreign exchange reserves, is principally due to holding assets having a relatively short duration, which bear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

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

The interest expenses to banks and the public, which are the interest expenses on the monetary aggregate[5], amounted to NIS 6.2 billion this year, compared with NIS 3.5 billion in 2010. The increase in interest expenses, of approximately NIS 2.7 billion, is principally due to an increase in net netabsorption using monetary instruments—*makam* and time deposits—and to the expansion of the interest gap between the shekel interest rate and interest rates abroad, as a result of the interest rates in the developed countries remaining at the low levels they reached in 2009 and the accelerated increase in the interest of Bank of Israel in the first half of 2011 (Figure 2). Nevertheless, the economic expansion increased the demand for the monetary base, and its growth reduced the extent of required absorption and contributed to reducing the interest expenses.

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

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



SOURCE: Bank of Israel, ECB and the Fed.

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

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

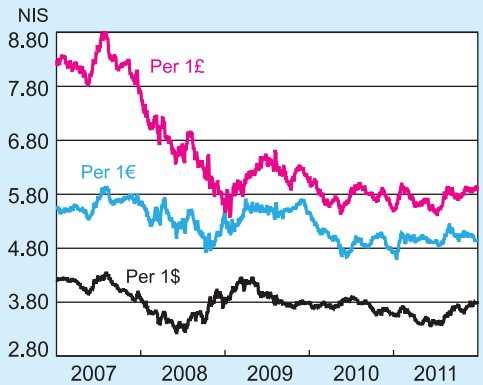
1.2.2 Other financial income

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

This year the Bank of Israel earned[6] from foreign currency securities an amount of NIS 319 million, compared with NIS 36 million in 2010. (see Note 26 to the Financial Statements.) The increase in income compared with last year is attributed to an increase in foreign currency assets, but even more—to a decrease in the yields to maturity of government bonds in the large and strong developed countries such as the US and Germany, which served as a "safe haven" for investors around the world as the debt crisis in Europe increased. An economic review of the Bank's capital gains requires adding the realized gains (losses) together with the change in the balance of the relevant item in the revaluation accounts (unrealized gains), a change that is not reflected in the statement of operations.

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

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



SOURCE: Bank of Israel

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

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

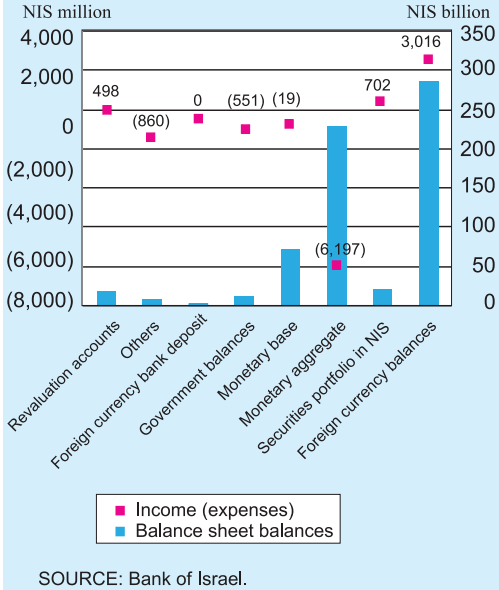
1.2.3 General and administrative expenses

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

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

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

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



SOURCE: Bank of Israel.

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

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

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

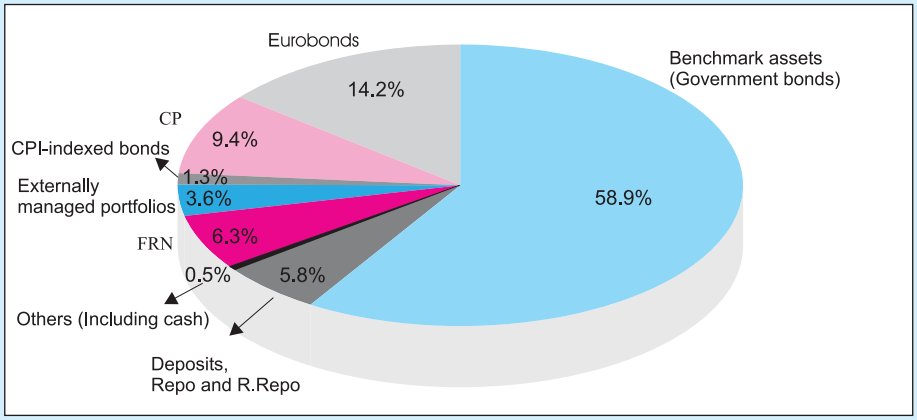
	December 31		For year ended December 31	
	2011	2010	2011	2010
	Balances		Income (expenses)	
	(NIS million)			
Assets, net				
Foreign currency balances[a]	286,097	251,671	3,016	2,874
Securities portfolio in NIS	19,595	19,672	702	948
Total	**305,692**	**271,343**	**3,718**	**3,822**
Liabilities and equity,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

[a] Consisting of the balance in the item "Foreign currency assets abroad" on the asset side of the Bank's balance sheet, minus the balance in the item "Foreign currency liabilities abroad" on the liabilities side of the balance sheet.
[b] Consisting of the balance of *makam* and time deposits in local currency minus the monetary loans and repurchase auctions.
[c] Consisting of banknotes and coins in circulation plus the banks' local currency demand deposits in the Bank of Israel. The expenses in respect of this item are mainly money printing expenses and income from the banks' local currency demand deposits.
[d] Consisting of the government's foreign currency deposits plus the government's local currency deposits minus the balance of credit to the government.
[e] The "other" balance consists of other balances in local currency plus the total of other assets (fixed assets and international financial institutions) minus other liabilities in local currency and other liabilities in foreign currency in respect of international financial institutions.
[f] The profit (loss) on this item includes realized exchange rate differentials on foreign currency balances. (Realized capital gains are shown in the item to which they are related.)

2.1 Foreign exchange reserves

In accordance with the Bank of Israel Law, 5770-2010, one of the Bank's functions is to hold the country's foreign exchange reserves[7] and manage them[8]. (see Figure 5—Asset Allocation of Foreign Exchange Reserves.) The Law specifies the financial actions the Bank is entitled to take in order to fulfill its responsibilities, including management of the reserves. According to the Law, the Monetary Committee, as advised by the Minister of Finance, will set the investment policy guidelines for the foreign exchange reserves. Managing the financial risk of the reserves according to its characteristics is at the heart of the investment policy. The principal financial risks are currency risk, price risk, credit risk, liquidity risk and quality of management risk.

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



SOURCE: Bank of Israel

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

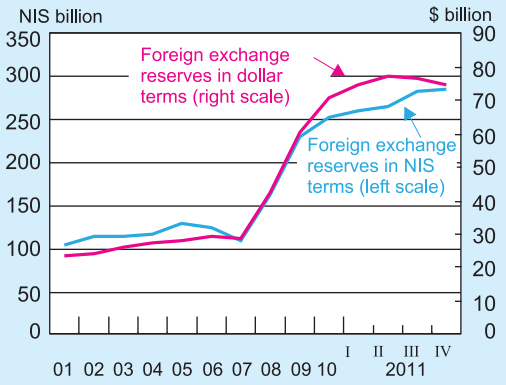
Foreign exchange reserves account for the largest part of the Bank's assets—about 93 percent of the Bank's total assets at the end of 2011, compared with 92 percent at the end of 2010 (Table 1). At the end of 2011 the foreign exchange reserves amounted

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

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

to $75 billion, compared with $71 billion at the end of 2010, an increase of $4 billion—about 6 percent. In NIS terms, at the end of 2011 the reserves amounted to approximately 286 billion shekels, compared to approximately 252 billion at the end of 2010, an increase of approximately 34 billion—14% (Figure 6).

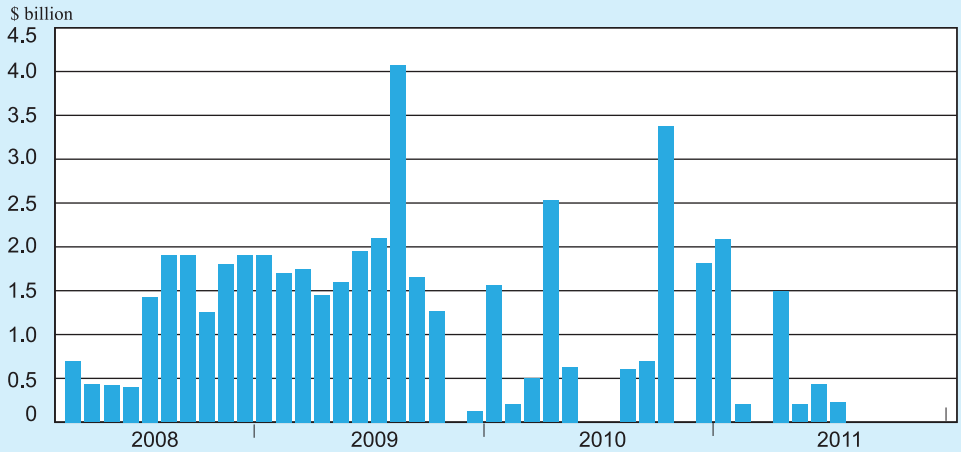
Figure 6
Foreign Exchange Reserves in NIS and Dollar Terms , 2001-2011



SOURCE: Bank of Israel.

The level of the reserves reflects purchases of dollars in accordance with the Bank's policy that began in March 2008 upon the implementation of a plan to increase the level of the reserves to the desired level in the long term (Figure 7). As from August 2009 the Bank's purchase policy is to intervene in the foreign currency market when there are irregular fluctuations in the NIS exchange rate that do not correspond with the basic economic conditions, or when the foreign exchange market fails to function properly.

Figure 7
Monthly Purchase of Foreign Currency by the Bank of Israel, March 2008 - December 2011



SOURCE: Bank of Israel.

Several factors explain the increase in the reserves (Table 2): As in last year, most of the increase this year was due to the purchase of $4.6 billion of foreign currency by the Bank of Israel in the NIS-dollar market, compared with the purchase of $11.9 billion in 2010. Added to this increase is an overall profit of Bank of Israel from interest and financial

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

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

Table 2
Contribution by Sector to the Foreign Exchange Reserves

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

[a] Includes the change in accrued interest on the foreign exchange reserves.
[b] Includes income tax payments from the private sector in foreign currency.
[c] Government and National Institutions transfers from abroad and Bank of Israel income from the foreign exchange reserves (income from interest, capital gains and cross-rate differentials between the USD and other currencies).
* Data according to value date. Other data in the table as at balance sheet date.

2.1.1 Rate of return on the foreign exchange reserves

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

The returns obtained on the investment of the foreign exchange reserves are judged against a benchmark return. The benchmark is based on a hypothetical portfolio that is created according to pre-set rules and reflects the Bank's long-term investment strategy. The returns on the holding of assets included in the benchmark, in all currencies, are weighted according to the weights of the currencies in a currency basket (the numeraire).

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

The actual annual rate of return on the reserve portfolio in terms of the numeraire was 1.27 percent in 2011, as against a return of 1.07 percent on the benchmark[9] (Table 3). The difference between them of 0.20 percent is the surplus yield in the reserve portfolio, reflecting the contribution of investment decisions made according to the permitted degrees of freedom in the active management of the reserves, which are reflected in deviations of the composition of the portfolio from the benchmark composition. These degrees of freedom are restricted by a set of compliance rules that is part of the investment policy for the reserves. The added value of the active management of the reserves is expressed in the difference in yields between the foreign exchange reserves portfolio and its benchmark, which is usually positive and amounted to 0.24 percent on average for the period 2002-2011. The low level of the benchmark yield in the last three years, which was 1.01 percent on average, compared with the previous years, is a result of

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

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

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

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

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

[a] Unrealized price differentials express the annual change in the revaluation account of foreign currency tradable securities. (see Note 15 to the Financial Statements.)
[b] Yields, which are shown at annual rates, are based on daily calculations, and relate to income from the foreign exchange reserves, including profit or loss resulting from market price changes.
* Recalculated due to the change in the currency basket.

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

2.2 Revaluation accounts

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

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

2.2.1 Revaluation account for balances denominated in foreign currency

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

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

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

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

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

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

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

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

2.2.2 Revaluation account for tradable foreign currency securities

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

2.2.3 Revaluation account for tradable local currency securities

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

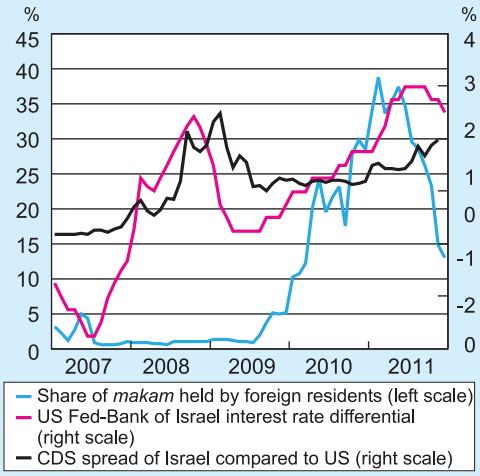
2.3 Monetary instruments

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

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

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

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



SOURCE: Bank of Israel.

The growth in imported capital was reflected in an increase in the rate of *makam* held by foreign residents: before the financial crisis exacerbated, in September 2008, the foreign residents held only 1 percent of the total balance of *makam*; upon the widening of the interest gap with the developed countries the local interest rate attracted investments of foreign residents, and in January 2011 they amounted to 34 percent of the total balance of *makam*, compared with 13 percent in December 2011 (Figure 8). The decrease in 2011 in the balance of *makam* held by foreign residents was due to an increase in Israel's CDS margin[10], measures implemented by Bank of Israel to reduce the capital movements into the economy, and the Bank lowering the interest rate as from the last quarter of 2011.

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

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

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

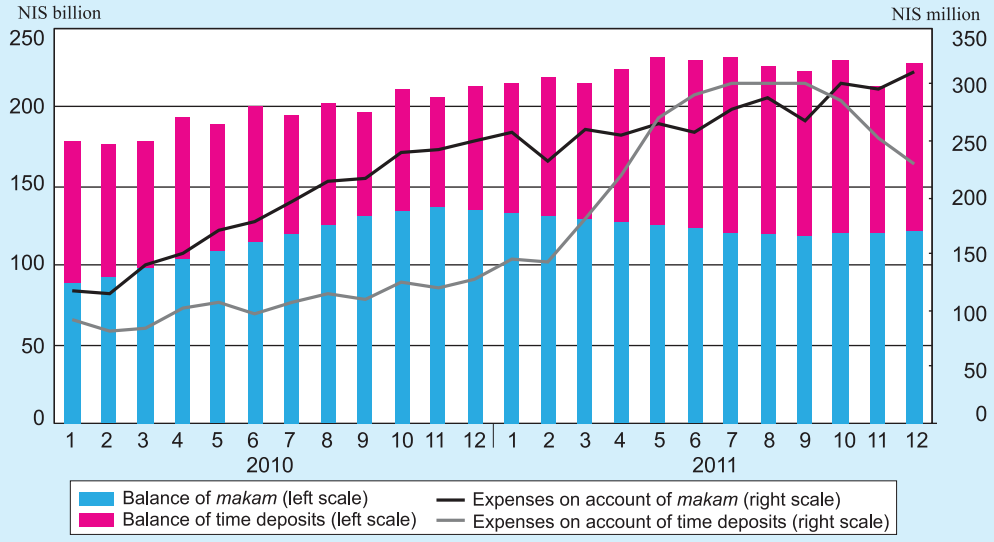
In 2011, Bank of Israel purchased $4.6 billion as aforementioned. Purchases of foreign currency have an expanding effect on the economy's liquidity, and given the level of interest set by Bank of Israel, the liquidity surpluses are reabsorbed through the monetary instruments. At the end of 2011, the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

2.3.1 Expenses on account of the monetary instruments

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

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

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



SOURCE: Bank of Israel.

2.4 Israeli currency securities portfolio

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

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

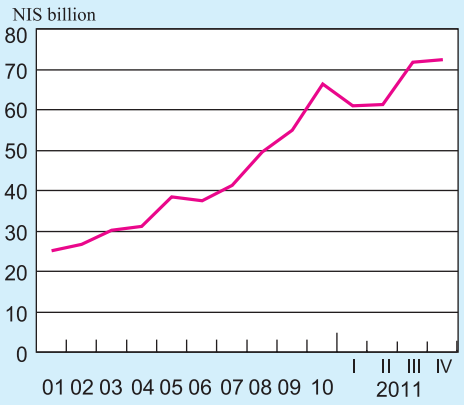
Interest income and the amortization of discount or premium for this portfolio are included in the Statement of Operations on an accrual basis in the item "interest income from the government". This item also includes income from linkage differentials on securities that were realized or redeemed. The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

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

2.5 The monetary base

The monetary base, composed of banknotes and coins in circulation and the banks' NIS-denominated demand accounts with the Bank of Israel, rose 10 percent during the year, from NIS 66 billion at the end of 2010 to NIS 72 billion at the end of 2011. The rate of increase, which is the same as that of last year, is for the most part a result of the expansion in economic activity, and continues the trend of recent years (Figure 10). The increase in the monetary base this year is due to an increase of 11 percent in the cash held by the public (calculated as the difference between the total of banknotes and coins in circulation and the cash held by the banks), to an increase of 9 percent in the cash held by the banks and to a decrease of 3 percent in the demand accounts of the banks in Bank of Israel (Figure 11).

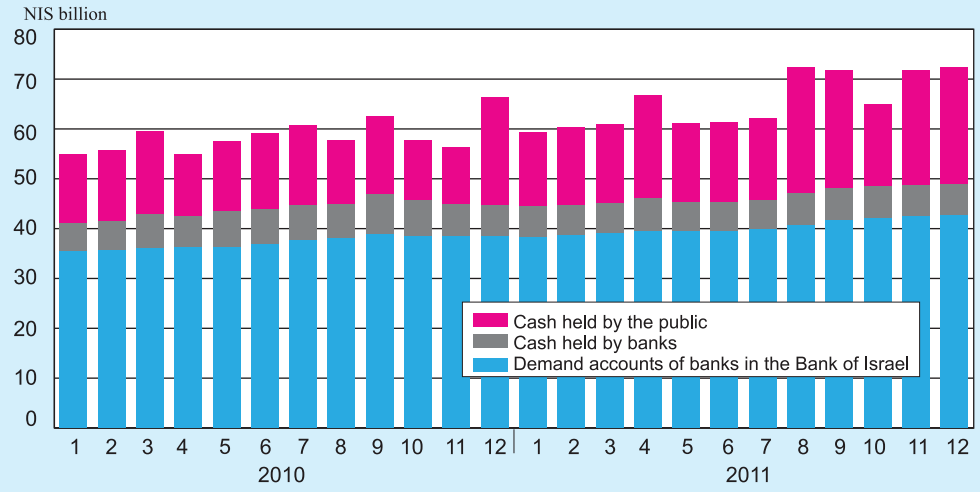
Figure 10
Balance of Monetary Base, 2001-2011



SOURCE: Bank of Israel.

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

Figure 11
Components of Monetary Base, 2010-2011



SOURCE: Bank of Israel.

Table 5
The Monetary Base—Changes and their Sources

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

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

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

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

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

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

2.5.1 Cost of printing money

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

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

2.6 Demand deposits of banking corporations

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

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

2.7 Banking corporations' foreign currency deposits

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

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

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

[a] Not including the change in term deposits.
[b] Government injection via the banking corporations' demand deposits.
[c] Depositing of term deposits, purchasing *makam*, selling government bonds and various interest payments.

2.8 Government accounts

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

Government accounts with the Bank of Israel are composed of deposits in NIS and foreign currency[11], as well as credit given to the government.

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

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

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

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

[11] Government deposits in local currency may be offset against one another, other than some special deposits, but the government does not intend to offset its local currency deposits against its foreign currency deposits and these balances are therefore stated separately in the financial statements. The economic analysis that appears in these explanatory remarks refers to net government balances, i.e. the government balances that appear on the credit side of the balance sheet less the balances presented on the debit side.

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

2.9 Bank of Israel equity

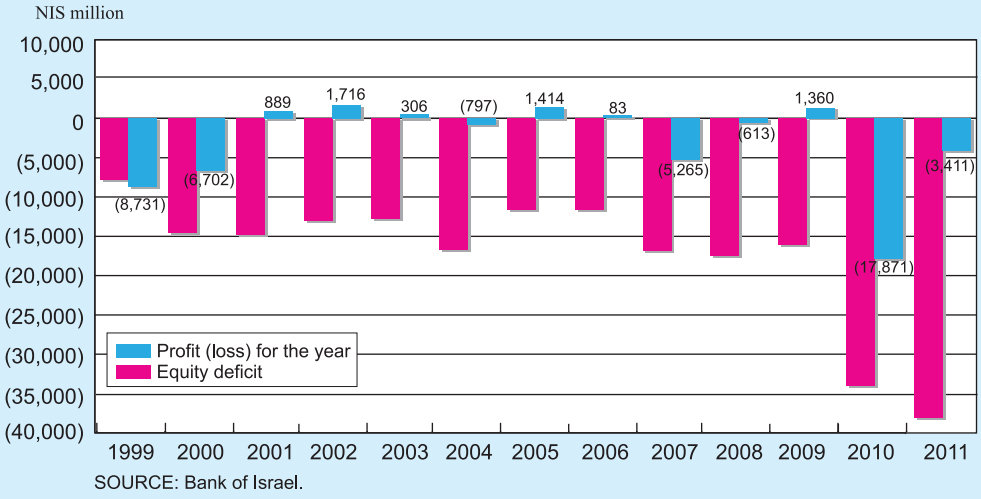
The Bank of Israel's equity is composed of share capital and a general reserve, less the balance of accumulated loss. In line with Accounting Standard 12 of the Israel Accounting Standards Board, the Bank's equity includes a one-time adjustment of non-monetary components in the balance sheet to the CPI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

2.9.1 The Bank's equity deficit

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

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

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



SOURCE: Bank of Israel.

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

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

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