

Financial Statements for 1999



Bank of Israel

JERUSALEM, February 2000

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BANK OF ISRAEL
BALANCE SHEET, AS OF DECEMBER 31st, 1999
(NIS million)

	Notes	31 December			Notes	31 December	
		1999	1998			1999	1998
Foreign reserves							
Foreign currency							
and foreign securities	2	93,504	94,325	Banknotes and coins in circulation	8	15,605	11,935
International financial institutions							
Balance with International Monetary Fund	3	375	— ^a	International financial institutions	9	680	714 ^a
Credit to the government							
Long-term debt	4	6,367	6,760	Deposits of the government	10	6,723	16,052
Loans							
	5	810	838	Treasury bills deposit		25,519	23,355
				Deposits of banking corporations	11		
				Local-currency time deposits		48,762	40,078
				Other		15,699	12,631
						64,461	52,709
Local-currency securities	6	6,049	5,528				
Other accounts	7	394	356	Other deposits and accounts	12	2,301	2,722
				Capital (negative capital)	13	(7,790)	320
		107,499	107,807			107,499	107,807

^a Reclassified.

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



Dr. David Klein
Governor



Zvi Auerbach
Comptroller

February 27, 2000

BANK OF ISRAEL
STATEMENT OF INCOME AND EXPENSES FOR THE YEAR ENDING
DECEMBER 31st, 1999

(NIS million)

	Notes	1999	1998
Income			
Foreign reserves ^a	15	(510)	19,581
Credit to the government	16	691	2,085
Loans		113	109
Local-currency securities		375	485
International Monetary Fund		13	— ^b
Other	17	92	39
Total income		774	22,299
Expense			
Deposits of the government ^c	18	(326)	2,396
Treasury bills deposit		2,911	2,714
Deposits of banking corporations			
Local-currency time deposits	5,383	4,372	
Other	19	794	978
International financial institutions		11	161 ^b
Other deposits and accounts	20	64	196 ^b
Printing banknotes and minting coins		45	54
Administrative and general expenses	21	623	494
Total expenses		9,505	11,365
Surplus of income over expenses (surplus of expenses over income)		(8,731)	10,934
<i>Less</i> government income subject to matched timing		—	415
Net annual profit (loss)		(8,731)	10,519
Loss brought forward		—	(1,551)
Profit (loss) at end of year		(8,731)	8,968
Transfer to government		—	8,968

^a In 1999 – expenses on the foreign reserves.

^b Reclassified.

^c In 1999 – income from the government's deposits.

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

BANK OF ISRAEL
STATEMENT OF NOMINAL AND ADJUSTED ASSETS AND LIABILITIES
FOR THE YEAR ENDING DECEMBER 31st, 1999

	31 December				Change over	
	Nominal		Adjusted		preceding year	
	1999	1998	1999	1998	Nominal	Adjusted
	(NIS million)				(percent)	
Assets						
Foreign reserves	93,504	94,325	93,504	95,573	-0.9	-2.2
International financial institutions ^a	375	–	375	–	–	–
Credit to the government	6,367	6,760	6,367	6,849	-5.8	-7.0
Loans	810	838	810	849	-3.3	-4.6
Local-currency securities	6,049	5,528	6,049	5,601	9.4	8.0
Other accounts ^b	394	356	836	807	10.7	3.6
Total assets	107,499	107,807	107,941	109,679	-0.3	-1.6
Liabilities and capital						
Banknotes and coins in circulation	15,605	11,935	15,605	12,093	30.7	29.0
International financial institutions ^a	680	714	680	723	-4.8	-5.9
Deposits of government	6,723	16,052	6,723	16,264		
Treasury bills deposit	25,519	23,355	25,519	23,664	9.3	7.8
Deposits of banking corporations						
Local-currency time deposits	48,762	40,078	48,762	40,608	21.7	20.1
Other	15,699	12,631	15,699	12,798	24.3	22.7
Other deposits and accounts	2,301	2,722	2,301	2,758	-15.5	-16.6
Capital (negative capital)	(7,790)	320	(7,348)	771	–	–
Total liabilities and capital	107,499	107,807	107,941	109,679	-0.3	-1.6

^a Reclassified.

^b Includes nonfinancial items, which are shown according to their historical cost (premises and equipment and participation in international financial institutions). These items have been adjusted in accordance with the changes in the CPI (see Note 1.b).

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

BANK OF ISRAEL
ASSETS AND LIABILITIES, BY INDEXATION BASES,
FOR THE YEAR ENDING DECEMBER 31st, 1999
(NIS million)

	31 December 1999					31 December 1998 ^a				
	In local currency		In or indexed to foreign currency	Non- financial items	Total	In local currency		In or indexed to foreign currency	Non- financial items	Total
	Indexed	Unindexed				Indexed	Unindexed			
Assets										
Foreign reserves			93,504		93,504			94,325		94,325
International financial institutions ^a		375		375						-
Credit to government		1,079	5,288		6,367		1,162	5,598		6,760
Loans		796	14		810		805	33		838
Local-currency securities	6,049				6,049	5,528				5,528
Other accounts		150	21	223	394		134	46	176	356
Total assets	6,049	2,025	99,202	223	107,499	5,528	2,101	100,002	176	107,807
Liabilities and capital										
Banknotes and coins in circulation		15,605			15,605		11,935			11,935
International financial institutions ^a		1	679		680			714		714
Deposits of the government		(13,387)	20,110		6,723		(4,531)	20,583		16,052
Treasury bills deposit		25,519			25,519		23,355			23,355
Deposits of banking corporations										
Local-currency time deposits		48,762			48,762		40,078			40,078
Other		4,958	10,741		15,699		4,700	7,931		12,631
Other deposits and accounts		7,960	(5,659)		2,301		8,379	(5,657)		2,722
<i>Of which Swaps with domestic</i>										
banking corporations ^b		5,872	(5,814)		58		5,858	(5,824)		34
Capital (negative capital)		(8,110)		320	(7,790)					320
Total liabilities and capital	-	81,308	25,871	320	107,499	-	83,916	23,571	320	107,807
Surplus assets (liabilities)	6,049	(79,283)	73,331	(97)		5,528	(81,815)	76,431	(144)	

^a Reclassified.

^b NIS/\$ swaps are shown in the balance sheet under 'Other deposits and accounts,' (net). In this table dollars to be received are shown in the column 'In or indexed to foreign currency,' and NIS to pay are shown in the column 'In local currency, unindexed,' so that the balance in the foreign-currency column is negative.

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

NOTES TO THE FINANCIAL STATEMENTS FOR 1999

1. Accounting policies

a. General

The financial statements are presented in nominal NIS (New Israel Sheqalim).

Income and expenses are recorded on accrual basis.

Assets and liabilities are shown inclusive of interest income and expenses accrued by the balance-sheet date.

Figures in the statement of changes in assets and liabilities (including 1998 figures) are adjusted by the Consumer Price Index (CPI) published in December 1999.

b. Foreign currency and indexation

Assets and liabilities indexed to the CPI are included in the financial statements adjusted by the last known CPI on the balance-sheet date.

Assets and liabilities denominated in or indexed to foreign currency are translated into NIS at the representative exchange rates in effect on the balance-sheet date.

Income and expenses in foreign currency are recorded in the statement of income and expenses at the representative exchange rates in effect on the date of transaction.

Income and expenses items include exchange-rate differentials arising from the revaluation of assets and liabilities denominated in or indexed to foreign currency according to the changes in the exchange rates of the foreign currencies vis-à-vis the NIS.

The data concerning the exchange rates and the CPI are as follows:

	31 December			Rate of change	
	1999	1998	1997	1999	1998
		(NIS)			(percent)
US\$	4.1530	4.1600	3.5360	-0.2	17.6
Euro ^a	4.1750	4.8960		-14.7	
Special drawing rights (SDR) ^b	5.7037	5.8523	4.7757	-2.5	22.5
First currency basket ^c	4.2711	4.6182	3.7958	-7.5	21.7
Currency basket ^d	4.4134	4.5588	3.7861	-3.2	20.4
CPI ^e		(index)			(percent)
November	168.5	166.2	153.6	1.4	8.2
December	168.5	166.3	153.1	1.3	8.6

^a The first euro exchange rate was published on January 4, 1999. The value shown herein for December 31, 1998 is that same rate.

^b Based on weighted 5-currency basket: US\$, DM, ¥, Ffr, and £.

^c In effect until July 31, 1986, and consisting of: US\$ 0.3500; £ 0.1295; DM 0.5150; Ffr 0.6832; and FI 0.2187.

^d In effect since April 30, 1996, and consisting of: US\$ 0.6741; £ 0.0589; euro 0.2282 (in the currencies relevant at the time); and ¥ 6.5437.

^e Consumer Price Index based on the 1993 average.

c. Securities

Foreign securities are given on the balance sheet at their foreign-currency cost (average purchase price) or market value, whichever is the lower; each type of security is calculated separately.

Tradable local-currency securities are given at their adjusted value (par value *plus* accrued interest and indexation differentials) or at market value, whichever is the lower; each type of security is calculated separately. The difference between the market value on the purchase date and the par value is recorded in the statement of income and expenses in the year of purchase.

d. Participation in international financial institutions

The International Monetary Fund (IMF)

The IMF ('the Fund') determines the amount of participation in the Fund for each member country (its 'quota') according to the country's percentage voting right in it. The Fund adjusts countries' participation according to the increase in their capital and to their relative share in it. Participation is carried out via payment in foreign currency (25 percent of the participation, henceforth the 'reserve tranche'), and in local currency by means of the issue of non-negotiable notes in favor of the Fund (75 percent of the participation).

Up to 1998, Israel drew the entire balance of its reserve tranche, putting up against these withdrawals a non-interest-bearing deposit in favor of the Fund. Total assets thus equaled total liabilities and were shown 'net' on the liabilities side under 'International financial institutions.'

In 1999, the Fund increased its members' quotas, and Israel's was increased to SDR 262 million. The foreign-currency payment for this increase, about SDR 66 million, was deposited in the reserve tranche account in the IMF. The credit balance in the reserve tranche created a surplus of assets over liabilities in the Fund, shown on the assets side under the item 'International financial institutions—balance in the IMF,' (see Note 3).

The IMF's operational budget is a mechanism whereby the Fund makes foreign currency available to its members. (A country in need of foreign currency may ask for a loan from the sources in the operational budget.) Repayment of loans is divided between countries whose reserve tranche/quota ratio is higher than the average ratio of all member countries.

In October 1999, Israel joined the group of countries participating in the financing of the IMF's operational budget. Participation will raise the balance of the reserve tranche, on the one hand, and reduce Israel's liabilities to the fund (deposits and notes) on the other. Until the balance-sheet date, the balance of the reserve tranche had not been increased due to the operational budget.

Other International Financial Institutions

The Bank of Israel's participation in other international financial institutions consists of an initial payment for participation, and additional payments required to maintain the rate of the Bank of Israel's participation in those institutions. The Bank's participation in these institutions is shown at cost in the currency in which the payment for participation is made (see Note 9).

e. Premises and equipment

Bank premises and equipment are stated at cost net of cumulative depreciation. Depreciation is calculated by the straight line method, for the estimated useful life.

f. Treasury bills deposit

The Short-Term Loan Law, 5744 -1984, empowers the government to issue bonds to be sold only to the Bank of Israel. The Bank of Israel sells them to and buys them from the public to expand or reduce the money supply and to carry out its functions. In August 1996 the Knesset passed the Short-Term Loan Law (Amendment No.7 and Provisional Directive), 5756-1996, according to which “the government may not use the proceeds of sales of bonds to the Bank of Israel other than to redeem Treasury bills in accordance with this law or to pay the interest on them.” The proceeds of Treasury bills sold to the public and other related activities are therefore handled in a deposit intended specifically for these activities.

The Treasury bills deposit reflects the par value (redemption price) of Treasury bills held by the public less the balance of the discount from their date of issue. (Treasury bills sold by the government to the Bank of Israel but not yet sold to the public are shown in the ‘Treasury bills deposit’ as ‘net,’ i.e., the net effect of this transaction on the deposit is zero.)

The discount is the difference between the par value of the Treasury bills and the proceeds of their sale to the Bank. The discount is reduced by the compound interest method, on the basis of the interest rate of the Accountant-General in the Ministry of Finance at the time of the issue.

Capital gains and losses arising from sales of Treasury bills to the public are recorded in the statement of income and expenses when they are sold to or bought from the public.

g. Employee pensions, severance pay, and vacation pay

Provision for employee pensions and severance pay is actuarially computed on accrual basis, reflecting the obligation to pay pensions and severance pay to employees as accrued to the balance-sheet date. Provision for vacation pay is computed on the basis of vacation due until the balance-sheet date.

h. Derivative financial instruments

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

1. Derivative financial instruments in Israel:

a) NIS/US\$ swaps: The net balance of the NIS/US\$ swaps implemented by the Bank of Israel with Israeli banks is stated on the balance sheet under the item ‘Other deposits and accounts.’ These transactions are presented as the net balance of the transaction in NIS (including accrued interest) to be transferred to banks *less* dollars to be received from banks (translated according to the exchange rate at the balance-sheet date).

The results of swap transactions include interest and exchange-rate differentials, and are given in the statement of income and expenses under ‘Expenses on deposits of banking corporations.’

b) Purchase and sale options on the US\$/NIS exchange rate: The balance of options to the date of the financial statement is shown in Note 14, 'Contingent liabilities and special commitments.' Expenses arising from the exercise of options during the period of the statement, and expenses expected from their exercise in accordance with the representative exchange rate of the dollar on the balance-sheet date, *less* income from the premium on the options, are given in the statement of income and expenses under 'Other income' (in 1998 this was stated under 'Expenses on other deposits and accounts'). The income from the premiums on options is divided equally for the duration of the options according to the straight-line method. Advance income on the premium *plus* the expense accrued due to the difference between the exercise rate and the representative dollar exchange rate on the balance-sheet date is given under the 'Other deposits and accounts' item.

c) Future remittances of Treasury bills: The balance at par (redemption price) of Treasury bills for future remittance up to the date of the financial statement is given in Note 14, 'Contingent liabilities and special commitments.'

Payment on account of future issues of Treasury bills is stated in the balance sheet under 'Other deposits and accounts.'

2. Derivative financial instruments abroad:

a) Repurchase Agreements (Repo), Reverse Repo: The balances of repo and reverse repo agreements are stated in the balance sheet as 'Foreign reserves.'

In the statement of income and expenses the results of the transactions are recorded under 'Income from foreign reserves.'

b) Foreign-currency swaps: The transactions are given at net value: the balance of future foreign-currency receipts (in currency A) *less* future foreign-currency remittances (in currency B). In the balance sheet the transactions are included in 'Foreign reserves.'

In the statement of income and expenses the results of these transactions are included in the 'Income from foreign reserves' item.

c) Futures: The balances of futures contracts at market prices on the date of the financial statement are given in Note 14, 'Contingent liabilities and special commitments.'

In the statement of income and expenses the profit or loss from the change in the exchange rate of the contracts is given under 'Income from foreign reserves.'

i. Transfer of profits

In accordance with the Bank of Israel Law, 5714-1954, the Bank must transfer its net profits to the government within sixty days of the end of each business year. In 1999 the Bank's expenses exceeded its income, so that no profit was transferred to the government. The surplus of its expenses over its income will be nominally offset against future transfers of profit.

j. Matched timing

Income from the government on account of government securities is recorded in the statement of income and expenses on accrual basis. In order to prevent transfer to the government of accrued income from government securities not yet matched by

a cash flow from the government, those receipts from the government which have accrued in accounts in the year of the financial statement and are due to be paid by the government in the future are deducted from the 'Surplus of income over expenses' item. In a year that this income is paid by the government it is added to 'Surplus of income over expenses' and transferred to the government.

2. Foreign reserves: foreign currency and foreign securities

This item consists of:

	31 December		31 December	
	1999	1998	1999	1998
	(NIS million)		(\$ million)	
Tradable bonds and securities	83,862	92,311	20,193	22,190
Short-term deposits	7,702	3,140	1,855	755
Demand deposits	5,907	686	1,422	165
Derivatives ^a	(3,967)	(1,812)	(955)	(436)
Total	93,504	94,325	22,515	22,674

^a Derivatives are shown net, i.e., future foreign-currency liabilities *minus* future foreign-currency assets. Hence, a negative balance may arise in this item due to changes in exchange rates (see note 1.h.2).

The currency composition of the Bank of Israel's reserves matches the economy's import-financing and debt-servicing needs, thus reducing the purchasing-power exposure of the reserves to changes in cross rates, and thus to some extent hedging against the exchange-rate risk of Israel's external debt.

3. International financial institutions—balance with International Monetary Fund

	31 December		31 December	
	1999	1998	1999	1998
	(NIS million)		(SDR million)	
International Monetary Fund (IMF) quota ^a	5,295	3,899	928	666
<i>minus</i> liability for quota ^b	4,920	3,899	862	666
Balance with IMF^c	375	0	66	0

^a Participation in the IMF (the 'quota') is denominated in SDR (special drawing rights), and determined by the IMF for each member. The quota is purchased by the member with SDR, gold, and local currency.

^b Liabilities to the IMF in notes or deposits (see note 1.d).

^c The foreign-currency balance with the IMF (the 'reserve tranche') (see note 1.d).

The surplus of the reserve tranche over the 'basic sum' bears interest at a rate set by the IMF from time to time. The annual rate of interest as at December 31, 1999 was 3.9 percent. (The basic sum on the balance-sheet date was SDR 33 million.)

4. Credit to the government—long-term debt

This item consists of:

	31 December	
	1999	1998
	(NIS million)	
Long-term advances ^a		
Indexed ^b	5,151	5,461
Unindexed ^c	1,079	1,162
Credit for binational funds	137	137
Total	6,367	6,760

^a The interest and indexation differentials for each year are due for payment on 31 December of that year. The principal is due to be paid in annual payments, the last of which will be in the year 2012.

^b This credit is indexed to the rise in the first currency basket. NIS 5,149 million of it bears an interest rate of 8 percent, also indexed to that basket (the amount outstanding on 31.12.1998 was NIS 5,459 million).

^c This credit bears interest at prime rate plus 2 percent. The average rate of interest during 1999 was 16.5 percent (16.1 percent in 1998).

5. Loans

This item consists of:

	31 December	
	1999	1998
	(NIS million)	
Monetary loans	785	796
Other loans	25	42
Total	810	838

6. Local-currency securities

This item includes tradable government bonds indexed to the last CPI known on the balance-sheet date.

	31 December	
	1999	1998
	(NIS million)	
Market value	6,049	5,530
Adjusted value	6,387	5,812
Book value	6,049	5,528

The yield to redemption on the local-currency portfolio as at December 31, 1999 was 5.7 percent. Average time to redemption of the portfolio was 4.8 years.

7. Other accounts (assets)

This item includes mainly:

- a. Loans to employees;
- b. Participation in international financial institutions;
- c. Premises and equipment net of cumulative depreciation.

8. Banknotes and coins in circulation

This item consists of:

	31 December, 1999		31 December, 1998	
	Quantity	NIS	Quantity	NIS
	(million)		(million)	
Banknotes in circulation				
NIS 20	23	460	18	360
NIS 50	52	2,582	44	2,201
NIS 100	76	7,601	53	5,335
NIS 200	21	4,231	17	3,371
Coins in circulation	–	695	–	631
Other	–	32	–	33
Commemorative coins	–	4	–	4
Total		15,605		11,935

9. International financial institutions (liabilities)

This item consists of:

	31 December	
	1999	1998
	(NIS million)	
Special drawing rights (SDR) allocated ^a	610	626
Liabilities to international financial institutions	70	88
Total	680	714

^a Special drawing rights are money which members of the IMF received from the Fund. They are allocated by the IMF in accordance with each member country's quota, with no repayment date. Israel's balance was SDR 106 million (the same as on December 31, 1998). The Bank of Israel pays interest on SDRs, the rate being determined by the IMF. Accrued interest to the balance-sheet date is included in this item.

10. Deposits of the government

This item consists of:

	31 December	
	1999	1998
	(NIS million)	
Deposits for budget financing		
Local currency	(13,645)	(4,821)^a
Foreign currency		
Borrowing under US government guarantee	13,783	13,399
US government economic aid	4,007	4,024
Current deposit	1,405	1,637 ^a
Total foreign-currency deposits for budget financing	19,195	19,060
Total deposits for budget financing	5,550	14,239
Other deposits		
Bond-price stabilization local-currency deposit	267	292
Other foreign-currency deposits	846	1,455
Total other deposits	1,113	1,747
Accrued interest on government deposits	60	66^a
Total	6,723	16,052

^a Reclassified (accrued interest on government deposits is shown as a separate item this year).

Government deposits for financing the budget

Financial movements arising from government budgetary activity in Israel and abroad, and financial movements with the Bank of Israel, are recorded under 'Deposits for financing the government budget.' These are defined as deposits that the government may use to finance its budgetary activity and, accordingly, to which section 45b of the Bank of Israel Law, 5714-1954 applies.

Other deposits

Other deposits include a bond-price stabilization local-currency deposit and other foreign-currency deposits. The bond-price stabilization deposit represents the proceeds from the purchase at source of government securities by the Bank of Israel in order to stabilize prices on the Tel Aviv Stock Exchange (TASE). In accordance with an agreement with the Ministry of Finance, the proceeds are placed in a special deposit on behalf of the government, but may not be used to finance government outlays. At the request of the Ministry of Finance the arrangement for the purchase at source in order to stabilize bond prices was ended in January 1993. The bond-price stabilization deposit is gradually being drawn down against the redemption of bonds purchased in the past in order to stabilize prices. The redemption of bonds will end in the year 2009.

11. Deposits of banking corporations

a. Local-currency time deposit

This item consists of:

	31 December	
	1999	1998
	(NIS million)	
Daily deposits	20,700	10,000
Weekly deposits	18,000	14,000
Monthly deposits	10,000	16,000
Total	48,700	40,000
Accrued interest on deposits	62	78
Total	48,762	40,078

b. Other deposits

This item consists of:

	31 December	
	1999	1998
	(NIS million)	
Local-currency demand deposits	4,958	4,700
Foreign-currency deposits		
Against foreign-currency reserve requirement		
Foreign-currency demand deposits	610	589
Secondary foreign-currency reserve requirement	7,714	6,937
Total	8,324	7,526
Unrestricted deposits	2,417	405
Total foreign-currency deposits	10,741	7,931
Total	15,699	12,631

Banks' local-currency demand deposits in the Bank of Israel are used as liquid assets against residents' local- and foreign-currency deposits. The reserve requirement ranges from 0 percent to 6 percent, according to the term of the deposit.

Foreign-currency demand deposits are used as liquid assets against nonresidents' foreign-currency deposits.

The secondary foreign-currency reserve requirement deposits are used as liquid assets against the foreign-currency deposits of both residents and nonresidents.

The secondary reserve requirement against the public's foreign-currency deposits is 10 percent. At least 5 percent of this is deposited in the Bank of Israel, and the rest abroad. The Bank of Israel pays interest on the secondary foreign-currency reserve

requirement deposits at a rate similar to the interbank interest rate abroad.

The secondary foreign-currency reserve requirement includes accrued interest of NIS 122 million (NIS 84 million in 1998).

The average interest on foreign-currency deposits—secondary reserve requirement in the Bank of Israel—was 5.2 percent in 1999 (5.6 percent in 1998).

12. Other deposits and accounts

This item consists mainly of:

- a. Provision for employee pensions and severance and vacation pay;
- b. Deposits of the U.S.-Israel Binational Industrial Research and Development Fund and a deposit of the U.S.-Israel Binational Science Fund;
- c. Net balances on swaps transactions (see Notes 1.h.1a,14);
- d. Other outstanding credit;
- e. Expected expenses against the exercise of options on the dollar exchange rate *less* advance payments;
- f. In 1998—the balance of matched timing (see Note 1.j).

13. Capital (negative capital)

This item consists of:

	31 December	
	1999	1998
	(NIS million)	
Capital	60	60
General reserve	260	260
	320	320
Total annual loss	(8,731)	–
Matched timing balance ^a	621	–
	(8,110)	–
Total	(7,790)	320

^a The balance as at December 31, 1998. In a year when due to accrued losses no profit is transferred to the government, this balance is not updated (see note 1.j).

14. Contingent liabilities and special commitments

	31 December	
	1999	1998
	(NIS million)	
1. Contingent liabilities^a		
Documentary credits and guarantees for government imports and exports		
Documentary credits	118	139
Guarantees	91	266
Other contingent liabilities		
Uncalled amounts on participation in international financial institutions	3,393	3,367
2. Special commitments		
Financial instruments: deposits of the banking corporations		
Currency swaps with domestic banks		
Future receipts of dollars ^b	5,814	5,824
Future payments of NIS ^c	5,872	5,858
\$/NIS purchase options	1,080	1,572
\$/NIS sales options	519	50
Future remittances of Treasury bills (at par) (price at redemption)	680	720
Financial instruments: foreign reserves		
Currency swaps and forward transactions		
Future receipts of foreign currency	4,602	6,806
Future payments of foreign currency	4,877	7,332
Repurchase agreements (Repo)–Reverse Repo (RRepo)		
Repo	11,226	1,921
RRepo	7,635	670
Futures		
Sales commitments	1,327	79
Purchase commitments	–	1,203

^a Several claims were made on the Bank of Israel. The Bank of Israel does not consider it necessary to make a special provision for these claims, as the chances that they will be upheld are slight.

^b The balance of swaps on the balance-sheet date was \$1,400 million (\$1,400 million in 1998).

^c Including interest accrued to the balance-sheet date of NIS 9 million (NIS 15 million in 1998).

15. Income from foreign reserves

This item consists of:

	Year ending 31 December	
	1999	1998
	(NIS million)	
Interest income	4,084	3,849
Capital gains (losses)	(930)	866
Exchange-rate differentials on the foreign reserves	(3,664)	14,866
Total	(510)	19,581

16. Income from credit to the government

This item consists of:

	Year ending 31 December	
	1999	1998
	(NIS million)	
Interest income		
Long-term advances	629	760
Credit to binational funds	62	59
Total	691	819
Exchange-rate differentials		
Long-term advances	–	1,245
Credit for binational funds	–	21
Total	–	1,266
Total	691	2,085

17. Other income

This item includes mainly:

- a. Net income on NIS/US\$ options (in 1998 this was shown under 'Expenses on other deposits and accounts');
- b. Commissions on foreign-currency activity;
- c. Exchange-rate differentials on participation in international financial institutions;
- d. Interest income from loans to employees.

18. Expenses on deposits of the government

This item consists of:

	Year ending 31 December	
	1999	1998
	(NIS million)	
Interest expenses (income) on government deposits		
In local currency ^a	(1,029)	(977)
In foreign currency ^b	756	708
	(273)	(269)
Exchange-rate differentials on government foreign-currency deposits	(53)	2,665
Total	(326)	2,396

^a On debit or credit balances on government local-currency deposits interest at prime is charged or paid respectively. The average rate of interest in 1999 was 13.5 percent (in 1998, 13 percent).

^b On the government's foreign-currency deposits of money borrowed under the US government guarantees and of US government economic aid, interest is paid at the rate payable on US T-bills with an average of six months to maturity. No interest is paid on other government foreign-currency deposits.

19. Expenses on deposits of banking corporations other

This item consists of:

	Year ending 31 December	
	1999	1998
	(NIS million)	
Interest payments		
On banks' local-currency demand deposits	4	9
On banks' foreign--currency deposits	393	353
On swaps	416	340
	813	702
Exchange-rate differentials		
On banks' foreign-currency deposits	(29)	1,150
On swaps	10	(874)
	(19)	276
Total	794	978

20. Expenses on other deposits and accounts

This item includes mainly:

- a. Expenses due to exchange-rate differentials on other deposits and other liabilities denominated in foreign currency;
- b. Interest payments on deposits of the U.S.-Israel Binational Industrial Research and Development Fund and a deposit of the U.S.-Israel Binational Science Fund;
- c. In 1998—net expenses on NIS/\$ swaps (see Note 17.a).

21. Administrative and general expenses

Administrative and general expenses—deflated by the CPI—rose by about one percent in 1999.

The rise in these expenses was mainly due to the increase in the Bank of Israel's pension liability arising from the wages agreement.

EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS

1. Main developments

In 1999 the Bank of Israel's expenses exceeded its income by NIS 8.7 billion, in contrast to 1998, when income exceeded expenses by NIS 10.9 billion. The sharp change stemmed mainly from income of the Bank's holding of foreign reserves: this went from an income of NIS 19.6 billion in 1998 to an expense of NIS 0.5 billion in 1999. (The change derived mainly from exchange-rate differentials on the reserves, which went from a positive NIS 14.9 billion in 1998 to a negative NIS 3.7 billion in 1999.) Another contributory factor was an increase of NIS 1.2 billion in interest payments on banking corporations' time deposits and Treasury bills. (This interest expense totaled NIS 8.3 billion.)

The foreign reserves themselves, which constitute the Bank's main asset, amounting to some 87 percent of its total assets, hardly changed during the year. Government deposits declined by NIS 9.3 billion, while time deposits and Treasury bills increased by NIS 10.8 billion.

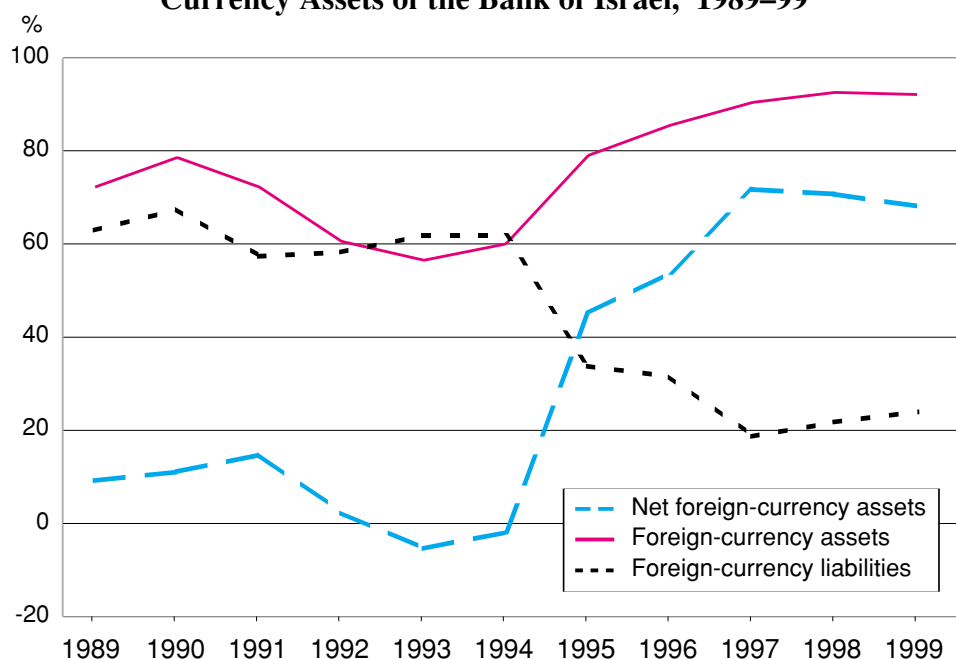
* * *

1999 was not the first year when there were sharp fluctuations in the balance of the Bank of Israel's income and expenses. In 1996 and 1997 the Bank's surpluses of expenses over income were NIS 0.5 billion and NIS 1.1 billion respectively (Table 1), and in 1998 this turned into a surplus of income over expenses of NIS 10.9 billion. Unlike an ordinary business concern, the Bank of Israel does not act out of profit and loss considerations, but aims to fulfill the functions the law imposes on it,

Table 1
Indicators of the Bank of Israel's Surplus Income, 1990 –99

	Surplus of income over expenses	Exchange-rate differentials	Surplus foreign- currency assets	Change in exchange rate during year	
				percent	
At current prices					
	NIS billion		\$ billion	Against \$	Against currency basket
1990	1.5	0.5	1.5	4.3	10.6
1991	1.9	0.8	2.0	11.5	11.2
1992	1.7	0.6	0.3	21.1	16.3
1993	1.3	-0.2	-0.8	8.0	6.3
1994	1.8	0.4	-0.3	1.1	5.7
1995	2.5	1.4	6.0	3.9	6.3
1996	-0.5	0.5	8.6	3.7	1.6
1997	-1.1	2.1	17.5	8.8	4.1
1998	10.9	13.1	18.4	17.6	20.4
1999	-8.7	-3.6	17.7	-0.2	-3.2

Figure 1
Foreign-Currency Assets and Liabilities and Net Foreign-Currency Assets of the Bank of Israel,^a 1989–99

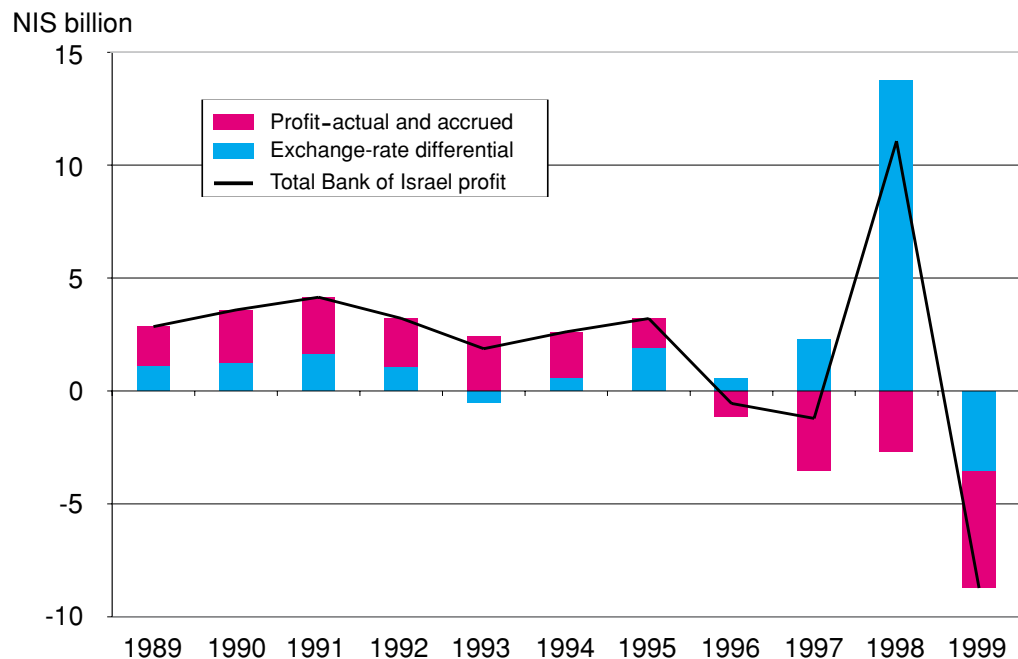


^a Percent of balance sheet, end-of-year, at current prices.

and to take steps in accordance with the government's targets. In the last decade the bank has focused more and more on achieving the inflation target set by the government, subject to the constraints imposed on it (the exchange-rate regime, and the ceiling on the issue of Treasury bills), in the context of the prevailing general economic conditions, including the budget deficit and the government's injection. The Bank's financial results arise from its performing its functions, and reflect *inter alia* the effects of the constraints mentioned above. The attainment of price stability benefits the whole economy, as it is a condition for sustainable growth, but this is not reflected in the Bank of Israel's financial statements.

In 1994-98 the Bank of Israel purchased about \$17 billion from the public. In order to prevent monetary expansion, which may well have endangered the achievement of the inflation targets determined by the government for those years, the Bank of Israel absorbed the excess liquidity this created. It did this via time deposits of the banking corporations, the sale of Treasury bills (approaching the maximum amount permitted by law), NIS/\$ swap transactions, and by reducing the discount-window loans. In that period, too, as part of the long-term reform of monetary instruments, the Bank reduced the reserve ratios, and converted some of the foreign-currency reserve requirements into local-currency ones. As a result, in the last few years most of the Bank's assets (92 percent at end-1999) have been denominated in or indexed to foreign currency, whereas most of its liabilities are in local currency, with only a small part (24 percent at end-1999) in or indexed to foreign currency. Surplus foreign-currency assets can affect the Bank's income and expenses, as yields on foreign-currency assets and liabilities (rates of interest abroad *plus* exchange-rate

Figure 2
The Bank of Israel Profit—Total, Profit Actually Received
and from Accrual, and Profit from Exchange-Rate
Differentials, 1989–99^a



^a At average 1999 prices.

differentials) are likely to be different from those on local-currency assets and liabilities (unindexed domestic rates of interest).

The exchange-rate regime, which allows the rate to move within a wide band—about 43 percent¹ at the end of 1999—and the openness of the foreign-currency market in Israel to capital flows create a situation in which wide exchange-rate fluctuations may occur. As the Bank of Israel has a surplus of assets in foreign currency, a change in the exchange rate in either direction, i.e., either appreciation or depreciation of the NIS, can result in a relatively large surplus of expenses or income deriving from exchange-rate differentials.

Exchange-rate differentials arise partially from internal developments, such as the weakening of the NIS in 1998, and partially from external factors over which the Bank of Israel has no control and which are unpredictable, e.g., changes in cross-rates between the dollar and other currencies as occurred in 1999. In 1998, income from exchange-rate differentials of NIS 13.1 billion was recorded, caused mainly by the depreciation of the NIS against the dollar, and only to a small extent by cross-rate differentials between the dollar and other currencies. The exchange-rate differentials exceeded the surplus of actual and accrued expenses (NIS 2.1 billion), so that the Bank of Israel ended 1998 with a significant surplus of income over expenditure. Most of the exchange-rate differentials in 1999, unlike in the previous year, arose from the strengthening of the dollar against the euro, and only a small part was due

¹ On December 31, 1999, the upper limit of the sloping band was 43.3 percent above the lower limit.

Figure 3
Income from Exchange-Rate Differentials,^a 1997–99



^a At current prices. Accrual of income starts anew of January 1 of each year. The graph shows the development of income each year.

to the strengthening of the NIS against the dollar during the year.² Exchange-rate differentials in 1999 were negative, in the amount of NIS 3.6 billion, and these were added to the actual and accrued surplus of expenses of NIS 5.1 billion.

Exchange-rate differentials, which arise from revaluing foreign-currency assets and liabilities, are to all intents and purposes income and expenses. If the net assets held by the Bank in foreign currency do not change, however, or if they increase, as was the case in the Bank of Israel's balance sheet in the last few years, exchange-rate differentials are income and expenses recorded in the accounts, but are not realized in the period in which they occurred and were recorded. An ordinary business concern can distribute profit earned but not yet received only by realizing assets or taking loans. A central bank, as the issuer of money, is the only entity in the economy which can transfer profits earned but not yet actually received, without realizing assets or taking loans. The Bank of Israel's exceptionally large surplus income in 1998 derived entirely from exchange-rate differentials not actually received, and as required by the law these profits (*minus* the expenses surpluses of 1996 and 1997) were transferred to the government. The law does not prevent the government from using the Bank of Israel's profits transferred to it, but it uses these receipts—profits as yet unrealized—to

² The calculation of exchange-rate differentials is mainly affected by exchange-rate developments during the year. Thus, during 1999 the NIS appreciated by 0.2 percent against the \$; taking the 1999 annual average, the exchange rate declined (i.e. appreciated) by 0.4 percent compared with the rate at the end of 1998 while using the annual average of both years gives a depreciation of the NIS against the \$ of 8.9 percent.

Table 2
Composition of Change in the Monetary Base and Foreign Reserves, 1997–99

(current prices)

	1997	1998	1999	1998		1999				
				IV	I	II	III	IV		
<i>NIS million</i>										
1. Change in monetary base (1)=(2+3+4+5)	3,670	242	3,927	-1,361	3,093	-1,766	-871	3,471		
Injection (+)/absorption (-)										
2. Government and National Institutions	1,234	1,901	4,067	2,298	1,116	424	-1,995	4,522		
3. Bank of Israel	-20,205	-2,664	-365	-3,524	2,133	-2,236	942	-1,204		
4. Foreign-currency conversions at Bank of Israel	23,324	1,746	0	0	0	0	0	0		
5. Adjustments ^a	-683	-741	225	-135	-156	46	182	153		
<i>\$ million</i>										
Banks' foreign-currency activity with the Bank of Israel										
6. Foreign-currency sales to Bank of Israel (6)=(8-9-7)	-6,948	-492	0	0	0	0	0	0		
7. Public-sector transfers to banks ^b	-614	-163	-259	-59	14	-86	-30	-157		
8. Change in deposits with Bank of Israel	-320	-369	585	66	-27	79	-65	598		
9. Transfers to (-)/from (+) rest of world	7,242	286	844	125	-41	165	-35	755		
10. Adjustments ^c	-261	-343	-197	-87	-24	-69	18	-122		
Contribution to reserves										
11. Private sector ^d (11)=(9+10)	6,981	-57	647	38	-65	96	-17	633		
12. Public sector ^e	1,776	2,399	-806	921	-626	-148	-60	28		
13. Change in reserves ^f (13)=(11+12)	8,757	2,342	-159	959	-691	-52	-77	661		

^a Adjustments include: transfers from abroad by the National Institutions through the banks, defined as public-sector injection. Government and Bank of Israel 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 injection 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 NIS/\$ swaps and other domestic foreign-currency payments.

^c Transfers from abroad by the public sector through the banks, e.g., by the National Institutions.

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

^e 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).

^f Including the change in accrued interest on the foreign reserves.

finance its domestic deficit (injection), as in fact it did in 1999. From an economic point of view, this constitutes 'printing money,' with all that it entails.

Not only were the exchange-rate differentials of 1998 not realized in 1999, but in 1999 there were additional expenses (arising from differentials which were also unrealized) recorded in the accounts in the cross-rate and exchange-rate differential categories. When the 1998 profits were transferred to the government in February 1999,³ the Bank reported (Bank of Israel Financial Statements for 1998, p.21), "In January 1999 and in the first half of February the NIS appreciated, leading to (unrealized) losses of NIS 3.5 billion due to exchange-rate differentials. This means that in February, when the Bank of Israel transferred its 1998 profits to the government, they had already been wiped out in part." The Bank's financial results for 1999 show that the trend evident in January and February did not change during the rest of the year. The government's deposits declined during the year by NIS 9.3 billion (Table 4), so that the government used the unrealized profits transferred to it. As there is no symmetry between transfers of profits and losses to the government—profits are transferred in their entirety in the year they occur, while losses are not covered in the year they occur—a situation arose in which the Bank in 1998 transferred unrealized profits to the government, the government used the profits, and in the next year, 1999, there were losses, albeit unrealized, which the government did not cover in that year. The proper thing to do would be to prevent these fluctuations by changing the legal requirement for the Bank to transfer unrealized profits to the government, and establishing a fund in the Bank's balance sheet in which these profits would accrue. The directives of the central banks of the members of the euro zone require them to act thus, and several other central banks do so too.

In order to prevent greater monetary expansion—arising from interest payments on banks' time deposits, Treasury bills, and NIS/\$ swaps, and from the government injection—than that needed to reduce the rate of interest in 1999, the Bank acted to increase time deposits and Treasury bills (their combined balance at end-1999 was NIS 74.3 billion, up from NIS 63.4 billion at end-1998). The increase in the balances and the rise in the average rate of interest were expressed, as stated, in an increase of NIS 1.2 billion in the Bank's expenses on these items.

³ The Bank's profits must be transferred within sixty days from the end of the year, at their value on December 31.

2. Main items

a. The foreign reserves

The foreign-exchange reserves held by the Bank of Israel totaled \$22.5 billion at the end of 1999. The annual average rise was about one percent. The government received the 1999 US economic aid of about \$ 1 billion in December 1999, and made payments abroad during the year for current expenses, interest, and repayments of past loans. (Borrowing under US government guarantees ended in 1998.) The government received tax and other payments in foreign currency, a factor which has been growing in the last few years. The fact that the government is prepared to accept payments from certain entities in foreign currency saves the payers fees, and avoids the possibility of a fall in the exchange rate resulting from foreign-currency conversions on the market. Although these payments are transferred from abroad to the government's accounts, they are recorded as private-sector contribution to the foreign reserves (Table 2, Row 11), and are also defined as government domestic absorption. In accordance with these definitions, the government and the national institutions made a negative contribution of \$0.6 billion to the foreign reserves. The Bank of Israel made a negative contribution, because of reductions in nearly all categories of income from the reserves: during the year the dollar strengthened against several of the other important currencies, mainly the euro, and this led to negative exchange-rate differentials, in dollar terms, on that part of the reserves not held in dollars (about \$0.8 billion). Interest rates world-wide rose in 1999, mainly in the US, resulting in falling bond prices and accounting and capital losses (of about \$0.2 billion) on the Bank of Israel's reserves. Interest income in dollar terms in 1999 was similar to that in 1998.

The strengthening of the NIS against the dollar during the year was yet another factor which reduced the local-currency income from the reserves.

The Bank of Israel invests the foreign reserves mainly in tradable assets with a relatively short average term, to ensure an appropriate liquidity level, and avoid the risk of wide fluctuations in the value of the portfolio in response to fluctuations in financial markets. The average investment horizon of the reserves, which was about twelve months for several years, was increased to sixteen months in 1999. This was a step in the long-term strategy adopted by the Bank of Israel in the light of the findings of research carried out by the Bank, which showed that the yield on such investments is expected to be higher, long term.

The currency composition of the Bank of Israel's reserves matches the economy's import-financing and debt-servicing needs, thus reducing the purchasing-power exposure of the reserves to changes in cross rates, and thus to some extent hedging against the exchange-rate risk of Israel's external debt. Hence, changes in the value of and yield on the foreign reserves should be measured in terms of the same currency composition as their uses and not in terms of any specific currency.

The rise in returns to maturity in the capital markets of most industrialized countries and particularly that in the US was reflected in falling bond prices. As a result, the annual yield on investments of the reserves, in terms of uses, was 3.3 percent, lower than that in previous years. Despite the relatively low level of the nominal yield, it was positive in real terms, due to the very low rates of inflation in the industrialized countries. The arbitrariness of measuring yield in terms of any specific currency is

Table 3
Foreign Reserves —Total, Income, and Yields, 1997–99

	1997	1998	1999	Rates of change (percent)	
				1998	1999
Total foreign reserves					
<i>\$ million</i>					
End of year	20,332	22,674	22,515	12	-1
Annual average	17,004	21,689	21,955	28	1
Income					
<i>NIS million</i>					
Total	5,545	19,581	-510		
Interest and capital gains	2,929	4,715	3,154		
NIS/\$ exchange rate differentials	4,464	13,421	-203		
Cross-rate differentials (\$/other currencies)	-1,848	1,445	-3,461		
<i>\$ million</i>					
Total	305	1,627	-83		
Interest and capital gains	845	1,237	761		
Cross-rate differentials (\$/other currencies)	-540	390	-844		
Yields^a					
<i>Percent</i>					
In terms of NIS—total	9.5	24.1	-0.6		
Interest and capital gains	5.0	5.8	3.5		
NIS/\$ exchange-rate differentials	4.5	18.3	-4.1		
In terms of euro ^{a,b} —total	17.1	0.9	15.3		
In terms of \$ ^a —total	1.2	7.9	-0.6		
Interest and capital gains	5.3	6.0	3.2		
In terms of use ^c of foreign reserves ^a	5.0	6.0	3.3		
Market return ^d	5.2	6.0	3.2		

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

^b In 1999, in terms of euro and DM; in 1997–98, in terms of DM.

^c Geographical composition of imports, and the currency composition of debt servicing.

^d In terms of use of foreign reserves (for international comparison).

highlighted by comparing the yield in terms of the dollar, -0.6 percent, to that of the euro, 15.3 percent, and by the high long-term volatility of the yields in terms of both these currencies (Table 3).

The yield on investing the reserves can be compared with the 'market yield' by means of an appropriate benchmark, calculated from the yield on various financial assets, and based on internationally published indices. The calculation of the benchmark yield takes into account representative assets with an average horizon of sixteen months which satisfy other criteria governing the investment of reserves, such as liquidity and credit risk. Market yields of assets in each currency are weighted according to that currency's share in the basket of uses. The actual yield in 1999, 3.3 percent, was slightly above the benchmark (3.2 percent). In managing the portfolio, the Bank of Israel deviates only marginally, if at all, from the currency composition of uses, so that this factor has a relatively small effect on the yield in terms of uses. Investment decisions focus mainly on keeping the horizon of the portfolio to about sixteen months, and managing the composition of the assets in it.

b. Government accounts

In accordance with the law, the Bank of Israel is the government's sole banker in Israel. Hence, the government holds all its local-currency accounts and some of its foreign-currency ones in the Bank of Israel. It is permitted to hold accounts abroad not via the Bank of Israel.

The government's deposits in the Bank of Israel are divided into three categories:

1. Deposits for budget financing, which the government uses to finance budgetary activities, and which are therefore covered by section 45b of the Bank of Israel Law, 5714 -1954, which prevents the Bank from 'printing money.' These deposits consist of a current deposit in local currency, via which the government manages nearly all its budgetary activities (including payments to and receipts from abroad), a current deposit in foreign currency, a deposit of money borrowed under the US government guarantee arrangement, and a deposit for US economic aid. These deposits for budget financing are considered as one unit: in the last few years the current deposit in local currency has had a considerable negative balance, while the foreign-currency deposits have had significant positive balances.
2. Other deposits, including a bond-price stabilization deposit in local currency, and various foreign-currency deposits.
3. A Treasury bills deposit, consisting of the proceeds of sales to the public and interest accrued on Treasury bills. This deposit is intended for use by the Bank of Israel to implement its monetary policy by means of sales, purchases, and redemption of Treasury bills. Although formally this deposit belongs to the government, the law does not permit the government to use it for its regular activities.

At the end of 1999, the balance of the government's deposits for budget financing was NIS 5.6 billion, down from NIS 14.2 billion at the end of 1998 (Table 4 and Note 10). The decline in the government's deposits for budget financing occurred in the local-currency deposits, which showed a debit balance of NIS 13.6 billion at the end of 1999, compared with a debit balance of NIS 4.8 billion at the end of 1998, meaning that local-currency credit was taken from the Bank of Israel. The foreign-currency deposits for budget financing had a credit balance in 1999, and rose slightly

in the course of the year, and reached the equivalent of NIS 19.2 billion at the end of the year.⁴

The sharp decline of NIS 9.3 billion in the government's total deposits in 1999 was the outcome of the following (Tables 2 and 4):

- * In 1999, the government had a budget surplus abroad, but due to the reduction in its overseas borrowing (having received the last tranche of the US-government-guaranteed loans in 1998) it transferred abroad \$0.8 billion (NIS 3.4 billion) of its deposits with the Bank of Israel.
- * The domestic budget deficit was partly 'financed' by injection,⁵ which reduced the government's deposits by NIS 3.1 billion. Part (about NIS 2 billion) of the government's injection arose as a result of payments being brought forward from the year 2000 to the end of 1999, due to concern about the effects of the Y2K bug. Using the government's deposits with the Bank of Israel for budgetary purposes in Israel and abroad is, from an economic point of view, printing money, especially in the light of the rise of these deposits in 1998 resulting from the transfer of the Bank of Israel's unrealized profits.
- * During 1999, the government paid the Bank of Israel NIS 2.8 billion (in 1998, with the transfer to it of the Bank's profits, the government received NIS 7.4 billion from the Bank). The main financial movements between the Bank of Israel and the government were:
 - a. government payment of about NIS 1 billion for interest and repayment of principal on long-term advances (in 1998 payment of these two items was similar to this amount, but due to depreciation the government also paid indexation of exchange-rate differentials, so that the total payment in 1998 was NIS 2.4 billion);
 - b. government payment of interest and repayment of principal on bonds held by the Bank of Israel, totaling NIS 1.4 billion (similar to the amount paid in 1998);
 - c. the government's local-currency deposit showed an average debit balance of NIS 7.9 billion in 1999, on which it paid interest of about NIS 1 billion (similar to that in 1998);
 - d. the Bank paid NIS 0.8 billion of interest on the government's foreign-currency deposits (in 1998 it paid interest of NIS 0.7 billion, and exchange-rate differentials of NIS 2.7 billion);
 - e. in 1999 there was no transfer in the profit account (in 1998 net profit of NIS 9.0 billion was transferred).

The reduction of NIS 9.3 billion in the government's deposits roughly matches the transfer of Bank of Israel profits in 1998. It has been noted above that those profits were unrealized, so that from an economic point of view the government deposit, which increased as a result of the transfer, should not have been used. The government

⁴ On balances (credit or debit) in its local-currency accounts, the government receives or pays interest at prime. On balances in the guarantees and economic aid deposits it receives interest at the rate paid on US government six-month bonds. The government does not receive interest on balances in its other foreign-currency deposits. These deposits are not meant to have debit balances. If they do, the government is charged interest at the overnight rate plus 5 percentage points.

⁵ The government's injection is the surplus of its payments to the private sector on the domestic market. This surplus includes budgetary expenses, interest payments, and repayment of principal *minus* receipts, including tax receipts, unilateral receipts (from the domestic private sector), and loan receipts (domestic borrowing). Receipts and payments may be in either local or foreign currency.

Table 4
Government Deposits with the Bank of Israel, 1997–99
(NIS million, current prices)

	1997	1998	1999
End-year balances			
Government deposits for budget financing			
Local-currency deposits	–5,761	–4,821	–13,645
Foreign-currency deposits	11,395	19,060	19,195
Total government deposits for budget financing	5,634	14,239	5,550
Other deposits ^a	1,594	1,813	1,173
Total	7,228	16,052	6,723
Net change in government deposits	1,349	8,824	–9,329
Sources of change			
Government contribution to foreign reserves ^b	4,403	2,092	–3,443
Government injection	–283	–781	–3,139
Government–Bank of Israel financial flow ^c	–2,804	7,444	–2,783
Adjustments ^d	33	69	36

^a Including the local-currency deposit to stabilize bond prices, another deposit in foreign currency, and interest accrued on government deposits (see note 10 on Deposits of the Government).

^b Income and loans received from abroad, government expenditure abroad and repayment of loans abroad.

^c Transfer to the government of Bank of Israel's profit (in 1998, when there was a profit); 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 (in 1997-98, when the first currency-basket rose); interest payments by the Bank of Israel on government deposits (in local and foreign currency); and cross-rate differentials on government foreign-currency deposits.

^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 bi-national funds' (these payments are included under 'Government injection,' but in this table they are also included under 'Government-Bank of Israel financial flow'); bond redemptions by tourists in Israel (these redemptions reduce the government's local-currency deposits, but are not included in 'Government injection').

should have borrowed money from the public to finance its domestic expenses (government injection) and its expenses abroad.⁶

Long-term advances

According to section 45 of the Bank of Israel Law, which was effective until August 1985, in the course of the fiscal year the Bank could lend the government up to 20 percent of its normal budget—‘temporary advances.’ At the end of the fiscal year the government, with the agreement of the Bank of Israel, would convert some of these advances into ‘long-term advances.’⁷

Until March 1977, twelve long-term advances were made under various conditions of indexation of the principal and the interest; in March 1978 these advances were consolidated. From 1978 to 1985, ten such advances were made. The principal of all of them was indexed to the (first) currency basket (the interest on six of them was also indexed to the basket, while the interest on the other four was unindexed). In March 1988, the government received a loan intended to pay for some of the bank shares as part of the Bank Shares Arrangement. (As it transpired the government did not require the loan, as the redemption of the bank shares was almost completely recycled.) This was the only loan advanced after section 45b of the Bank of Israel Law was amended in 1985 (this amendment popularly known as the ‘No Printing’ Law), and it accorded with the section which enabled loans for repayment of government debts. The terms of 1998 loan—it was unindexed and at prime interest plus 2 percent—differed from those of its predecessors. Since then, the government has received no loans from the Bank of Israel.

In the agreements covering the loans extended between 1978 and 1985 (loans indexed to the exchange rate against the first currency basket) it was stated that if on December 31 of any year that the value of the currency basket was above its value on December 31 of the previous year, the government would pay the Bank a sum equal to the multiple of the balance of the principal of the loan before the payment of the principal on the same day and the rate of the said rise. Every year since the Bank

⁶ The attitude of the Ministry of Finance to the financing of budgetary expenses in the context of its deposits with the Bank of Israel is as follows:

- a. The Ministry of Finance does not borrow money from the public to cover expenses up to:
 - i. the real realized profits, which according to the 1990 joint Ministry/Bank of Israel team are government income;
 - ii. financial activity between the Ministry and the Bank of Israel *minus* repayments of principal and payments of interest on government bonds held by the Bank.These expenses are financed by the transfer of the Bank of Israel’s profits to the government, or by using the government’s deposits with the Bank.
- b. According to the Ministry of Finance’s declared approach, other expenses are financed by income and borrowing from the public.

In 1999, no accounting profits were transferred to the government; the ‘real realized profits’ and the financial movements between the government and the Bank of Israel were financed by reducing the balance of the government’s deposit in the Bank. Financial flows which fall in two fiscal years may, according to the Ministry’s approach, be financed by changes in its deposits. For example, civil servants’ salaries for December 1999 amounting to some NIS 2 billion, which would normally have been paid in January 2000, were brought forward to the end of 1999 due to concerns regarding the millennium bug.

⁷ The long-term advances are loans granted for 25 years. Payments of principal, interest, and exchange-rate differentials are made on December 31 each year. Repayment of the principal starts five years from the time the loan is advanced; payments of interest and exchange-rate differentials start in the first year. Indexation is to the first currency basket.

of Israel first made long-term advances until 1988, the NIS has depreciated against the first currency basket. In 1999 the NIS appreciated against the basket for the first time (i.e., exchange-rate differentials on long-term advances were negative), so that no indexation differentials were collected.

Transfer of profits to the government

In accordance with the Bank of Israel Law, the Bank's profits are transferred in their entirety to the government each year. The Law does not relate specifically to the case when the Bank makes a loss. Interpretation of the Law, based *inter alia* on normal accounting practice, is that in instances when the Bank's expenses exceed its income, i.e., there is a loss, the government does not 'cover' the loss in the year it occurs: in a year when the Bank makes a profit after one or more years of losses, it transfers them to the government after deducting these losses.

The Bank's profits are calculated by the usual accounting methods, and some arise from revaluation of its foreign-currency assets and liabilities—exchange-rate differentials. As there was no decline in net foreign-currency assets, these exchange-rate differentials may be seen as unrealized profits. Unlike a commercial concern, a central bank can transfer unrealized profits to the government without selling assets or taking loans. In 1990 the director-general of the Ministry of Finance appointed a joint team from the Ministry of Finance and the Bank of Israel to determine what part of the Bank of Israel's profits should be defined as normal government income. The team recommended that part of the Bank's income actually received and expenses actually paid should be added to the government's income, and classified as 'real realized profits.' The team's recommendations relate to the classification of part of the Bank's income and expenses, so that estimates of real realized profits are likely to be very different from—larger or smaller than—the accounting profit. Moreover, the real realized profits may be positive even when the Bank incurs accounting losses (Table 5). Essentially, real realized profits are not profits in the accounting sense, and in the current economic situation, they are not real in the economic sense. The team did not recommend a change in the obligation to transfer all the Bank's profits to the government. Nor was any constraint placed on uses the government may make of the profits transferred to it, so that all the accounting profits are deposited in a local-currency deposit intended to finance the budget.

The team's recommendations were based on several principles and were appropriate to the situation prevailing at that time, 1990.⁸

After they had been submitted, monetary policy changed, and there were also great changes in the exchange-rate regime and in the economy's openness to capital flows from abroad. These changes had significant effects on the Bank of Israel's accounting profits in general, and on the estimates of real realized profits in particular. The change in the Bank's foreign reserves was very marked: in the distant past the main function of the foreign reserves was to finance the economy's foreign-currency expenses, but from 1995 to 1997 the reserves expanded due almost entirely to constraints imposed on the foreign-currency regime in the implementation of monetary policy. A situation was thus created in which income from the reserves covered some of the expenses arising from their conversion. The Bank's actual income from

⁸ For details, see Financial Statements for 1998, Bank of Israel, pp 26-27.

the reserves (i.e., the income without exchange-rate differentials and accruals) are a major component in the estimate of real realized profits, whereas the expenses incurred by absorbing conversions of capital inflow, which increase the reserves, have no effect on that estimate. In 1999, for example, the Bank had an excess of expenses over actual income and accruals of NIS 5.1 billion, and of NIS 3.6 billion from exchange-rate differentials, yet the government recorded income of NIS 3.9 billion from the Bank's real realized profits. In the conditions which have arisen in the last few years, the government must redefine the share of the Bank of Israel's profits which should be included in its income.

c. Banking corporations' deposits

The deposits of the banking corporations rose by about NIS 11.8 billion in 1999. Time deposits increased by some NIS 8.7 billion, and local-currency and foreign-currency demand deposits by NIS 3.1 billion.

Time deposits were introduced towards the end of 1996, and have now become the main instrument, quantitatively, through which the Bank operates its monetary policy. The NIS 8.7 billion rise in time deposits derived from the need to sterilize to the required extent the injections which had occurred during the year. The main components of the increase were interest payments on the time deposits themselves (about NIS 5 billion), and the government's injection (about NIS 3 billion).⁹

In NIS/\$ swap transactions, the Bank of Israel borrows local currency from the banks for a fixed term (28 days), and lends them dollars for the same term. The

Table 5
Balance-Sheet and Real Realized Profits of Bank of Israel, 1990-99
(NIS million, current prices)

	Balance-sheet profits	Real realized profits
1990	1,462	112
1991	2,012	420
1992	1,789	301
1993	1,262	184
1994	1,767	-109
1995	2,384	869
1996	-456	1,346
1997	-1,095	2,389
1998	10,519	3,890
1999	-8,731	3,868

⁹ At the end of December 1999, the government brought forward payments of about NIS 2 billion. Concomitantly, in December 1999 the Bank of Israel increased time deposits, which declined in January 2000.

dollar balance of swaps, amounting to \$1.4 billion, did not change in 1998–99. The Bank of Israel paid the banks interest of NIS 0.4 billion on these transactions (NIS 0.3 billion in 1998). Due to the relative stability of the NIS/\$ exchange rate, the Bank did not incur real expenses because of exchange-rate differentials (in 1998 these yielded an income of NIS 0.9 billion).

The banking corporations' demand deposits increased by NIS 3.1 billion, mainly due to the following factors (Table 6):

The banks' demand deposits are used to carry out most of the government's payments and to collect some taxes and other government receipts. A small part of the government's payments are made via the Post Office Bank, which is not defined as a banking corporation; by comparison, the Post Office Bank's share in collecting payments to the government (mainly taxes and other compulsory payments) is relatively high. The estimates in Table 6 show that the government's local-currency activity with the banks in 1999, i.e., its injection via the banking corporations, amounted to NIS 10.8 billion, and the public withdrew NIS 10.1 billion in cash from the banks. Some of these withdrawals were used for normal consumption of money in circulation, but most were intended for payments to the government via the Post Office Bank, many of which, it turns out, are made in cash. The government's net injection in 1999 was NIS 3.1 billion— injection of NIS 10.8 billion via the accounts of the banking corporations and absorption of NIS 6.4 billion via the Post Office Bank, mostly in cash.¹⁰

The balance of the banking corporations' unrestricted deposits in foreign currency increased from \$97 million at the end of 1998 and \$114 million at the end of November 1999 to \$582 million at the end of 1999. The greatest part by far of the rise in December 1999 was apparently connected to concerns over the millennium bug.

The net activity of the banking corporations with the Bank of Israel was negligible in 1999, but incorporated significant monetary flows, mainly depositing in time deposits with the Bank, the purchase of Treasury bills, and the sale of government bonds to the Bank (including bond/Treasury bills swaps). These transactions amounted to NIS 9 billion. The Bank of Israel paid interest of NIS 8.4 billion on total time deposits and Treasury bills.

¹⁰ Government injection also includes other items, e.g., domestic receipts from and payments to the private sector in foreign currency. See note a) to Table 2.

Table 6
Change in Deposits of the Banking Corporations, and Sources of the Change, 1997–99

(NIS million, current prices)

	1997		1998		1999	
	In NIS	In foreign currency	In NIS	In foreign currency	In NIS	In foreign currency
Change in deposits^a	2,519	-347	-1,320	215	257	2,811
Activity with the government ^b	5,667	-394	6,728	-601	10,775	-1,082
Withdrawal (-) of banknotes from Bank of Israel	-6,159	-6,159	-7,155	-7,155	-10,051	-10,051
Activity with Bank of Israel	-20,205	-928	-2,664	1,501	-509	324
Transfers from (+) and to (-) abroad	24,484	24,484	1,078	1,078	3,532	3,532
Foreign-currency conversions						
at Bank of Israel	23,325	-23,355	1,745	-1,749	0	0
Adjustments	-109	-154	26	-14	42	37
Deposit of banknotes by Post Office Bank						
in Bank of Israel ^d	5,014	5,014	5,598	5,598	6,383	6,383

^a Not including the change in time deposits.

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

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

^d The depositing of banknotes, performed mainly by the Post Office Bank. These represent government absorption, and are included in the definition of 'Government injection.'

Table 7
Accounts of the Banking Corporations with the Bank of Israel, 1997–99

	1997	1998	1999	1998	1999			
				IV	I	II	III	IV
Local-currency deposits and credit^a								
<i>NIS billion</i>								
1. Demand deposits	2.7	4.5	5.5	5.1	5.1	5.3	5.7	5.7
2. Time deposits	22.9	36.9	44.1	37.0	41.6	43.5	45.2	46.2
3. Monetary loans	1.7	0.8	0.8	0.8	0.8	0.8	0.8	0.8
4. Net deposits (= items 1+2+3)	23.8	40.6	48.8	41.3	45.9	48.0	50.1	51.2
5. Net deposits <i>plus</i> swaps	29.7	45.9	54.6	47.1	51.6	53.7	55.9	57.2
6. Net deposits <i>plus</i> swaps and Treasury bills ^b	47.4	67.1	78.6	69.1	74.5	77.9	80.6	81.4
Foreign-currency deposits and credit^a								
<i>\$ billion</i>								
7. Deposits	2.1	1.9	2.0	1.9	2.0	1.9	2.0	2.1
8. Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
9. Net deposits <i>less</i> swaps ^c	0.4	0.5	0.6	0.5	0.5	0.5	0.6	0.7
<i>NIS billion</i>								
10. Net deposits <i>less</i> swaps ^c	1.3	1.8	2.4	2.1	2.2	2.2	2.3	2.8
11. Total net deposits <i>plus</i> swaps and Treasury bills (= items 6+10)	48.7	68.8	81.0	71.1	76.8	80.1	82.9	84.2
<i>Rates of interest (percent)^d</i>								
12. Monetary loans	13.5	11.5	11.8	11.5	13.0	11.8	11.3	11.0
13. Time deposits	13.9	11.9	12.2	12.0	13.4	12.3	11.8	11.5

^a Items 1–11 include accrued interest.

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

^c Deposits *less* loans and *less* dollar swaps to be received.

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