EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS

1. Introduction

The Bank of Israel (hereinafter, "the Bank") performs its functions as a central bank and acts to achieve the objectives established for it pursuant to the Bank of Israel Law, 5770-2010 (hereinafter, "the Bank of Israel Law" or "the Law")—maintaining price stability, and supporting growth, employment, the reduction of social gaps, and the stability and orderly activity of the financial system. The Bank's activity is not intended to yield profits. Certain of the actions taken by the Bank have significant implications on its financial statements, yet at the same time, the achievement of the Bank's objectives and the fulfillment of its functions have market-wide economic benefits, which are not reflected in the financial statements.

According to the Bank of Israel Law, the Bank's functions consist of the following: managing monetary policy; holding and managing the foreign currency reserves of the State; supporting the orderly activity of the foreign currency market in Israel; acting as banker of the Government; regulating the economy's payment and settlement systems so as to ensure their efficiency and stability; issuing currency and regulating and guiding the cash system of the economy; supervising and regulating the banking system.

Owing to the currency imbalance which characterizes the Bank's Balance Sheet (see Section 3.1 below) and the fact that the financial statements are stated in local currency, the effect of the changes in the shekel exchange rates in relation to the currencies in which the foreign exchange reserves are stated in the Balance Sheet is expressed by large fluctuations in the shekel value of the reserves. The Bank does not take any steps to hedge the effect of these changes nor does it act to optimize the yield in shekel terms but rather in numeraire terms, in keeping with the guidelines of the Monetary Committee. Moreover, in recent years, the Bank has gradually increased the percentage of foreign exchange reserves invested in shares, which significantly influenced the yield on the reserve portfolio. However, the share appreciation gains are not included in the Bank's Statement of Operations as long as they are not realized but rather only charged to the revaluation accounts. The Bank of Israel reports the reserve portfolio performance in the context of the annual report on the Investment of the Foreign Exchange Reserves.

2. The Principal Changes in the Financial Statements

2.1 The Bank's Balance Sheet

The Bank of Israel's Balance Sheet at the end of 2017 totaled approximately NIS 401 billion, compared with approximately NIS 394 billion at the end of 2016—an increase of approximately NIS 7 billion (2 percent).

The main increase in the assets side is attributed to the increase in the balance of "Foreign currency assets abroad" by approximately NIS 10 billion, to approximately NIS 394 billion. In dollar terms, the scope of foreign exchange reserves[1] increased by approximately $15 billion, and their balance at year end amounted to approximately $113 billion. The increase is mainly a result of foreign currency purchases by the Bank in a total of approximately $7 billion, and exchange rate differentials, gains and revaluation totaling an additional approximately $7 billion.

Total liabilities on the Balance Sheet increased by approximately NIS 20 billion, as a result of several principal factors: (1) an increase in the net balance of monetary instruments[2]—*makam* and time deposits—by approximately NIS 9 billion, to approximately NIS 286 billion. Part of the increase derived from the need to sterilize the excess liquidity injected into the markets, *inter alia* as a result of said purchases of foreign exchange reserves; (2) an increase of approximately NIS 12 billion in the monetary base, which was mainly affected by the low interest environment and the Bank's intervention in the foreign exchange market; (3) an increase in the Government's deposits in the Bank by approximately NIS 3 billion; (4) a decrease of approximately NIS 4 billion in foreign currency liabilities abroad.

The Bank's Deficit Equity in 2017 increased by about NIS 0.8 billion, in the amount of the annual loss, with a Equity Deficit balance of about NIS 62.3 billion at the end of the year (see Section 4.5, "the Bank's Equity (Equity Deficit)").

2.2 Statement of Operations

The loss in the current year amounted to about NIS 788 million, compared with a loss of approximately NIS 5.3 billion in 2016. The decrease in loss was principally affected by an increase of approximately NIS 3 billion in the Bank's revenues from investments in foreign exchange reserves, including interest and other financial gains which in 2017 totaled approximately NIS 6 billion, and a decrease of approximately NIS 1.5 billion in

[1] In these explanatory remarks, the term "foreign exchange reserves" is used in its economic sense. The foreign exchange reserves are composed of the balance of "Foreign currency assets abroad", less the balance of "Foreign currency liabilities abroad". The change in the balance of "Foreign currency assets abroad" in 2017 amounted to approximately NIS 10 billion and the change in the balance of "Foreign currency liabilities abroad" in 2017 amounted to approximately NIS 4 billion.

[2] The balance of *makam* decreased by approximately NIS 13 billion and the balance of time deposits increased by approximately NIS 22 billion.

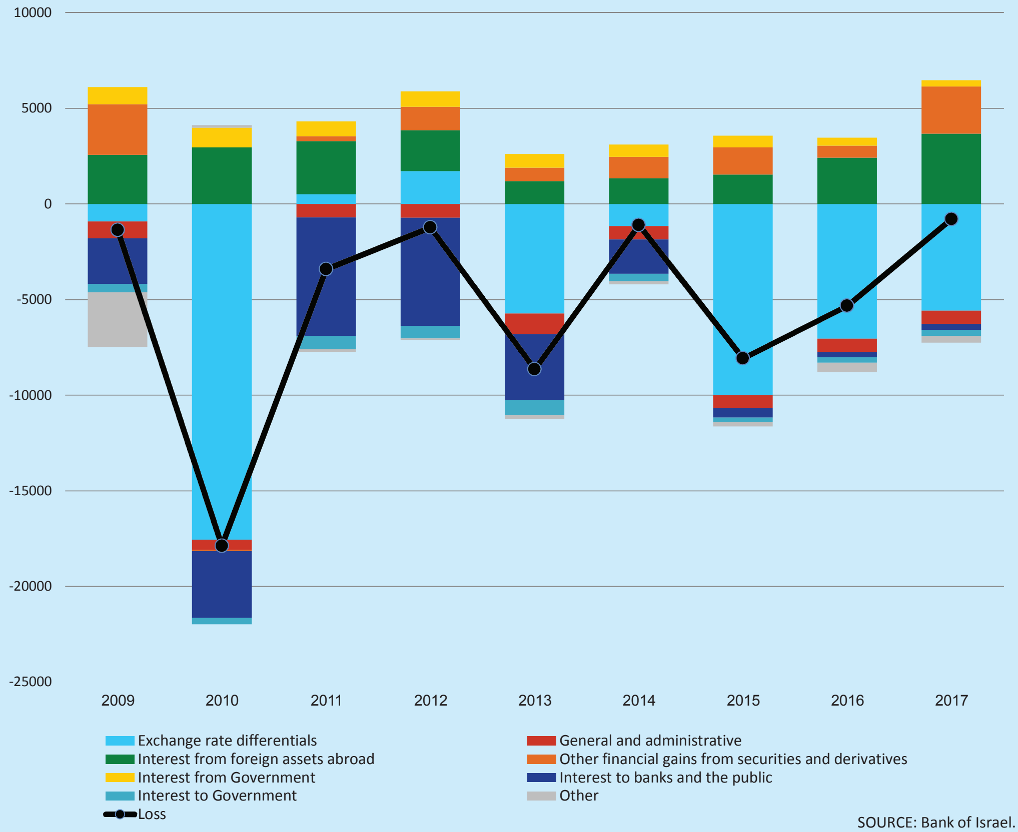
expenses in respect of exchange rate differentials which in 2017 amounted to NIS 5.6 billion (Figure 1). These expenses were mainly affected by the revaluation of the shekel in relation to the dollar at a rate of about 9.8 percent.

The Statement of Operations does not include unrealized gains[3] from exchange rate differentials on foreign exchange reserves totaling approximately NIS 3 billion, which are reflected in the revaluation account on the Balance Sheet (see Notes 1m and 14 to the financial statements). Unrealized losses from exchange rate differentials totaling approximately NIS 19.6 billion, mainly in respect of the dollar, were offset against unrealized retained earnings in the revaluation accounts and were excluded from the Statement of Operations.

The Statement of Operations also does not include unrealized gains from the effect of the changes in the revaluation of tradable securities which are reflected in the revaluation accounts in the Balance Sheet. (See Note 1m to the financial statements). The revaluation of tradable securities in foreign currency (mainly the appreciation of the shares underlying the foreign exchange reserves portfolio) increased the revaluation account in 2017 by about NIS 4.7 billion (as opposed to an increase by about NIS 2.7 billion in 2016). The revaluation of tradable securities in local currency reduced the revaluation account in 2017 by about NIS 0.1 billion (as opposed to a reduction by about NIS 0.3 billion in 2016).

[3] In accordance with the Bank's accounting policy, gains deriving from holding the reserves as well as other gains are classified as either realized gains, and are included in the Bank's income, or as unrealized revaluation gains, which are carried to the revaluation accounts in the Balance Sheet and are not reflected in the Bank's income for the relevant year. The accumulated losses in the revaluation accounts are carried to the Statement of Operations at the end of the year.

Figure 1
The Developments in the Bank's Profit and Loss Items, 2009-2017
(NIS million)



SOURCE: Bank of Israel.

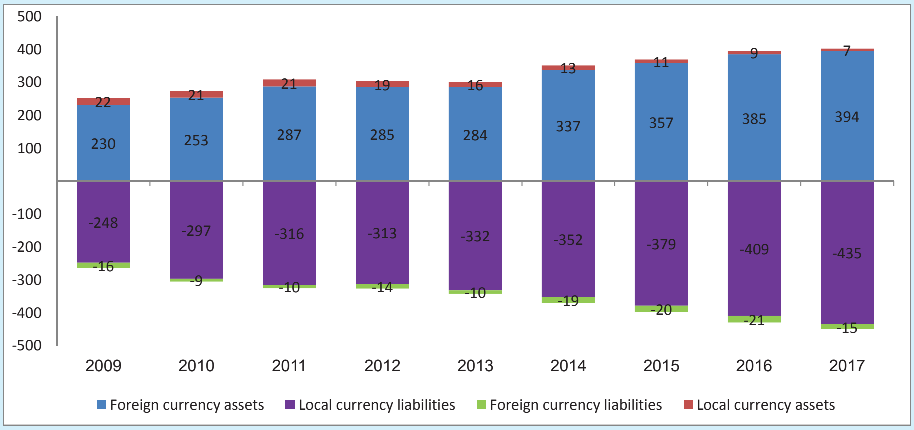
3. Analysis and Explanation of the Principal Changes in the Financial Statements

3.1 Characteristics and Composition of the Financial Statements

The financial statements have been prepared in conformity with generally accepted accounting principles in Israel (Israeli GAAP), adjusted to the special activity which is characteristic of a central bank, as generally practiced by other central banks (see Note 1 to the financial statements).

The Bank's financial statements are characterized by considerable currency imbalance in the composition of the Bank's assets and liabilities. This imbalance persisted in 2017. A large majority of the Bank's assets are denominated in foreign currency (about 98 percent at the end of 2017), whereas the Bank's liabilities are mostly in shekels; the liabilities in foreign currency only account for about 4 percent of the total Balance Sheet (Figure 2).

Figure 2
The Developments in the Bank's Assets and Liabilities, 2009-2017
(NIS billion)



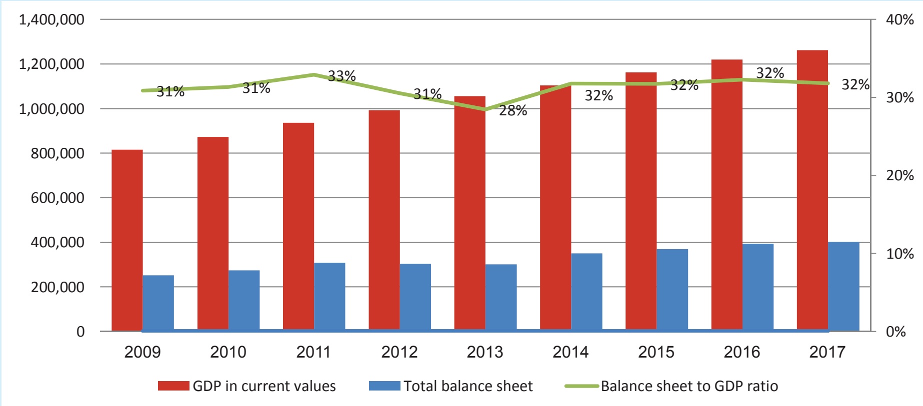
SORCE: Bank of Israel.

This situation is reflected in fluctuations in the Bank's reported financial results due to changes in the shekel's exchange rate in relation to foreign currencies (since the financial statements are stated in shekels) and to changes in local interest rates in relation to other economies.[4]

In 2008–17, foreign exchange reserves grew due to substantial purchases in the context of managing the monetary policy. These purchases increased the foreign exchange reserves managed by the Bank, while at the same time increasing the scope of monetary instruments used to absorb the excess funds injected in return for the purchase of foreign currency. The increase in the Balance Sheet is also affected by the increase in the quantities of banknotes and coins in circulation and the monetary instruments aggregate in view of product growth (Figure 3).

[4] The currency imbalance was first experienced in 1995–97 during which period the Bank adopted a tightening monetary policy to achieve the Government's inflation target. As a result of the ensuing capital inflows by the private sector, the Bank of Israel was forced to purchase foreign currency from the public to maintain the exchange rate at the lower end of the currency band and reabsorb the shekels injected to the market accordingly. The foreign exchange reserves grew from an average of a few billion dollars in previous decades to about $113 billion at the end of 2017. Simultaneously, the balance of monetary instruments, which until 1994 was substantially composed of monetary loans, as customary in central banks around the world, has been since composed of liabilities. In 2008–17, the balance of liabilities gradually increased to about NIS 286 billion at the end of 2017, as a result of the sterilization of injection using time deposits and *makam*.

Figure 3
Balance sheet to GDP Ratio, 2009-2017
(NIS million)



SOURCE: Bank of Israel.

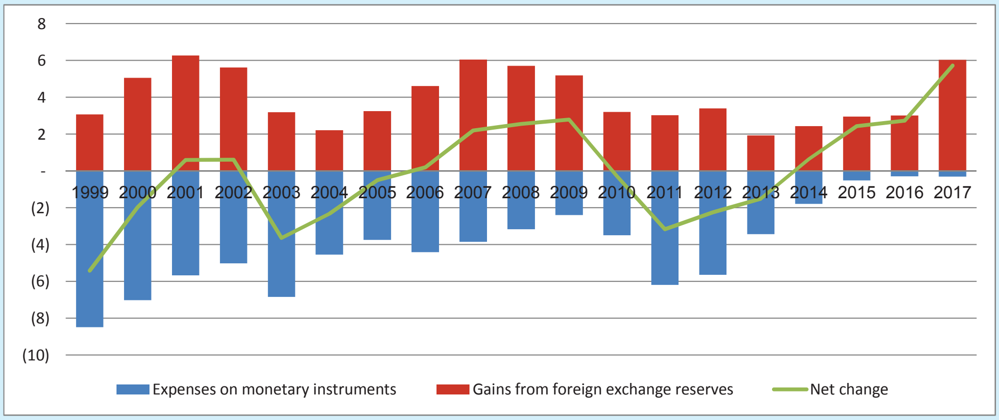
This increase in the Bank's Balance Sheet enhances the fluctuations in the Bank's profits given the gap between the yield on the reserves and the expenses in respect of the monetary instruments which now address a larger base. However, the negative gap between the yields narrowed markedly in recent years (Figure 4) and even reversed the trend: gains on the foreign exchange reserves have exceeded the financial expenses of foreign currency purchases using monetary instruments (*makam* and time deposits), a trend that continued in 2017. The main reason for the reversal in recent years is the reduction of the interest rate gaps between Israel and the markets in which the reserves are invested and the change in the risk profile of the investment portfolio due to the increase in the shares component. The interest rate spread between Israel and the United States, which in early 2008 was 1.25 percent, was reversed and in late 2017, the U.S. interest rate exceeded the Israeli interest rate by 1.4 percent (Figure 6).

The minimization of the gap between the yields on the reserves and expenses on the monetary instruments also contributed increased gains from foreign exchange reserves.

The purchases of foreign currency have had another impact on the volatility of profits which arises from their exchange rate differentials: as a result of the increased scope of foreign exchange reserves in the Bank's Balance Sheet, the rate of change in the exchange rate leads to higher reserves and therefore might enhance the volatility in the Bank's gains from this component.

A direct result of the enhanced scope of foreign exchange reserves in the Bank's Balance Sheet is the increased risk of exchange rate losses caused by the appreciation of the shekel which is a main factor in the Bank's losses and accumulated deficit—a Equity Deficit that at the end of 2017 amounted to approximately NIS 62.3 billion (see Section 4.5, "The Bank's Equity (Equity Deficit)"). The balance of the revaluation account which

Figure 4
Development of Gains from Foreign Exchange Reserves compared to Expenses on monetary Instruments, 1999-2017
(NIS billion)



SOURCE: Bank of Israel.

consists of unrealized gains at year end amounted to approximately NIS 13.5 billion, so that when examining the deficit from a broader perspective while including the balance of the revaluation accounts, the deficit balance totaled only about NIS 48.8 billion. However, as discussed above, while this situation affects financial reporting, it is not taken into consideration in managing the policy which is based on the Bank's functions and not for the purpose of minimizing the risk of losses in shekel terms.

Table 1 below presents the net balances in the Balance Sheet and the net operating results in the Statement of Operations in a different manner than the presentation in the financial statements for accounting purposes. The presentation is prepared in accordance with economic aggregates and the Bank's functions, for analyzing their effect on the Financial Statements for accounting purposes.

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

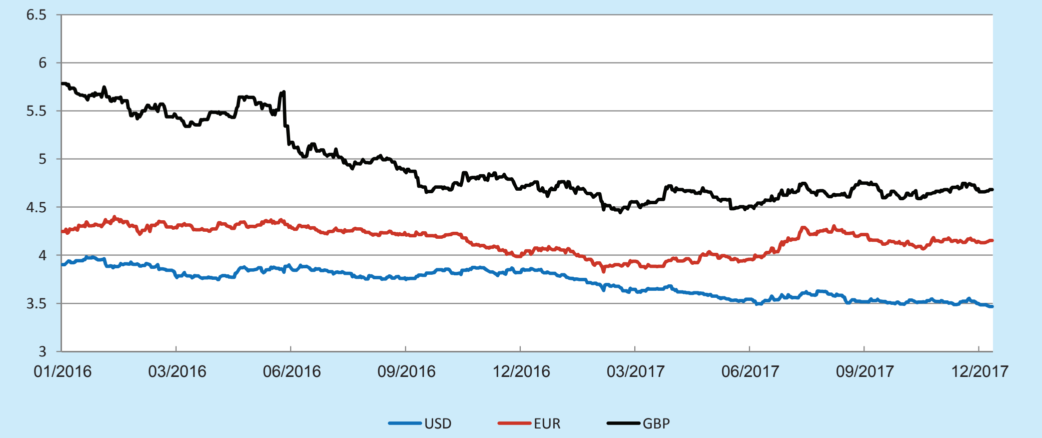
	December 31		Year ended December 31	
	2017	2016	2017	2016
	Balances		Income (expenses)	
	NIS million			
Net assets				
Foreign exchange reserves[a]	391,812	378,528	6,044	3,015
Securities portfolio in shekels	6,386	8,662	254	343
Total	**398,198**	**387,190**	**6,298**	**3,358**
Net liabilities and equity				
Monetary aggregate[b]	285,948	276,935	(315)	(288)
Monetary base[c]	122,677	110,498	(181)	(201)
Government balances[d]	26,819	24,289	(239)	(211)
Deposits of banking corporations in foreign currency	724	772	-	-
Other[e]	10,789	10,597	(773)	(931)
Revaluation accounts[f]	13,494	25,564	(5,578)	(7,053)
Bank's equity	(62,253)	(61,465)	-	-
Total	**398,198**	**387,190**	**(7,086)**	**(8,684)**
Net loss			**(788)**	**(5,326)**

[a] Foreign exchange reserves consist of total "Foreign currency assets abroad" less total "Foreign currency liabilities abroad".
[b] The balance of *makam* (central bank bills) and time deposits in local currency less monetary loans.
[c] The balance of banknotes and coins in circulation with the addition of the balance of the shekel demand deposits of banking corporations in the Bank. The expenses in respect of this item include money printing expenses and the income is from banks' local currency demand deposits.
[d] The balance of government deposits in foreign currency with the addition of the balance of government deposits in local currency less the outstanding credit to the government.
[e] The "Other" item consists of other balances in local currency with the addition of total other assets (fixed assets and international financial institutions) less the balance of other liabilities in local currency and other liabilities in foreign currency in respect of the IMF and international financial institutions.
[f] The item consists of exchange rate differentials on foreign exchange reserves (see Notes 1f and 1n to the financial statements. The capital gains are presented in the item from which they derive).

3.2 Effect of the Economic Environment on the Financial Statements

The year 2017 was characterized by an accelerated growth rate in the global economy compared to 2016. The continuing accommodative monetary policy adopted worldwide was expressed in 2017 by low and even negative interest rates in certain economies. The opposing trend in the United States also persisted: the federal funds rate was raised throughout the year three times to a level of 1.5 percent, improving the Bank's gains from the dollar interest component.

Figure 5
Developments in Shekel Exchange Rates vs. Foreign Currencies, 2017 and 2016

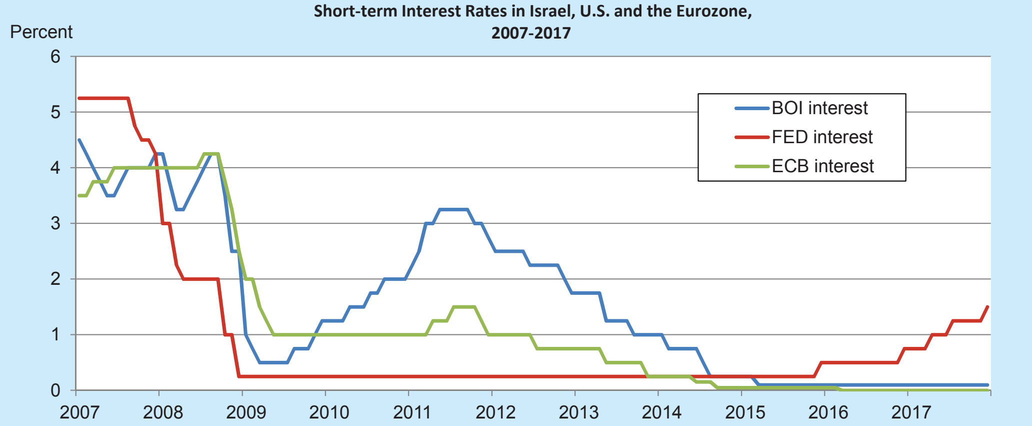


SOURCE: Bank of Israel.

Global stock markets experienced sharp increases in the year mainly in emerging markets with government yields remaining low, reduced corporate bond margins and risk parameters kept steady at a low level. The rise in yields improved the Bank's profits from the interest component but at the same time reduced its capital gains. In 2017, the investment in equities made a positive contribution to the Bank's profits with the main contribution arising from appreciation of shares in U.S. stock markets by about 21.3 percent in the year.

The dollar, which is the principal currency in which the reserves are held, weakened this year in relation to most currencies, and the shekel appreciated against the dollar by about 9.8 percent. Following the appreciation, exchange rate expenses were recorded, which, as discussed above, were a major contribution to the loss in the year (Figure 5).

Figure 6
Short-term Interest Rates in Israel, U.S. and the Eurozone, 2007-2017



SOURCE: Bank of Israel.

The Bank of Israel's interest rate has remained unchanged since March 2015 at 0.1 percent. The Bank's expenses on the monetary aggregate, which are affected by the Bank's interest, remained similar in level to previous years (Figure 12).

In 2017, the annual inflation rate was positive for the first time since 2014. The Israeli CPI increased in the year by 0.4 percent, as opposed to a negative rate of 0.2 percent in 2016. The increase in inflation in Israel corresponded to the inflation rate in the majority of OECD countries as an indication of global factors.

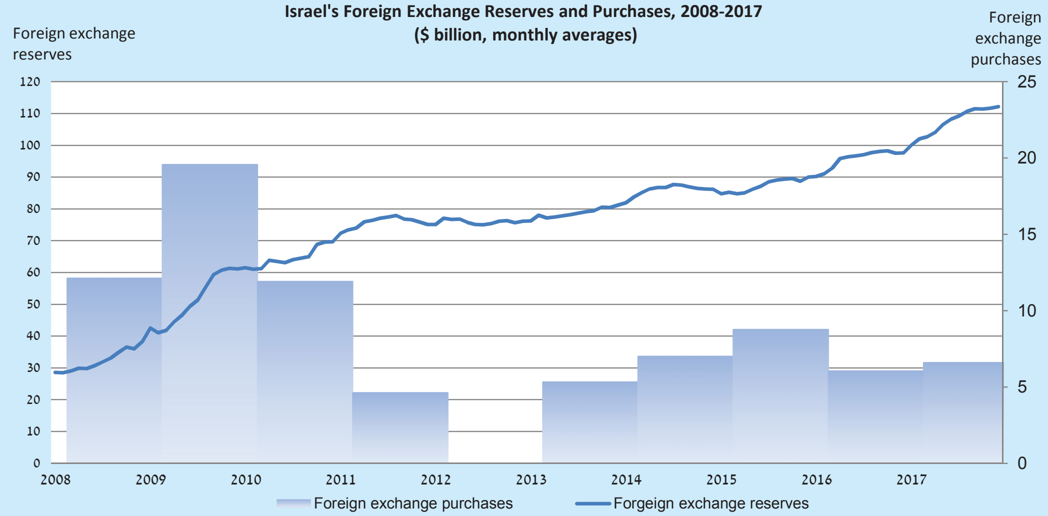
The increase in the CPI had a positive influence on the indexation component of local currency tradable securities. This influence, however, is low due to their relatively low share of the Bank's total investments.

4. Selected Items

4.1 Foreign Exchange Reserves[5]

One of the Bank's functions according to the Bank of Israel Law is to hold and manage the State's foreign exchange reserves.[6] In accordance with the Law, the Monetary Committee, headed by the Governor, was granted various authorities pertaining to managing the reserves, outlining the reserves' investment policy guidelines and monitoring the implementation of the policy.

Figure 7
Israel's Foreign Exchange Reserves and Purchases, 2008-2017
($ billion, monthly averages)



Source: Bank of Israel calculations.

5 See details in the 2017 Investment of Foreign Exchange Reserves Report, which is published separately. In this report, the yield on holding the reserve portfolio is measured in currency basket terms—the numeraire. The numeraire represents the multicurrency composition of the basket which reflects the potential uses of the reserves.

6 The investment management policy of foreign exchange reserves is determined by the Bank and reported to various entities, and therefore these reserves form the basis for the analysis of trends in these explanatory remarks (see Note 2 to the financial statements).

In 2017, foreign exchange reserves increased by about NIS 13.3 billion (an increase of about 3.5 percent), reaching a total of about NIS 391.8 billion (about $113 billion). The increase in reserves derived from foreign exchange purchases by the Bank of Israel totaling approximately NIS 24 billion, interest income and realized capital gains, excluding exchange rate differentials, of approximately NIS 10.8 billion against negative exchange rate differentials which were a main factor in the decrease of approximately NIS 23.6 billion in reserves. The negative exchange rate differentials were mainly accrued as a result of the appreciation of the shekel by about 9.8 percent against the dollar (Figure 5).

In dollar terms, the reserves grew by about NIS 14.6 billion, mainly as a result of purchases totaling some $6.6 billion and an amount of approximately $4.3 billion mostly deriving from positive exchange rate differentials due to the weakening of the dollar in relation to the euro and pound sterling, currencies which account for about 30 percent of the reserves. The increase in reserves was also supported by interest income, capital gains and revaluation of prices in a total of some $3.2 billion (Table 2).

Table 2
Contribution to Foreign Exchange Reserves, by Sector

	2017	2016	2017	2016
	NIS million		USD million	
Change in foreign exchange reserves	**13,284**	**25,105**	**14,564**	**7,872**
Bank of Israel				
Purchases	24,030	23,086	6,600	6,040
Profits	6,044	3,015	1,643	785
Price revaluation	4,726	2,734	1,565	728
Exchange rate differentials and other[a]	(23,618)	(11,289)	4,268	(1,604)
Total Bank of Israel	**11,182**	**17,546**	**14,076**	**5,949**
The government[b]	**2,000**	**7,532**	**464**	**1,920**
The private sector[c]	**102**	**27**	**24**	**3**

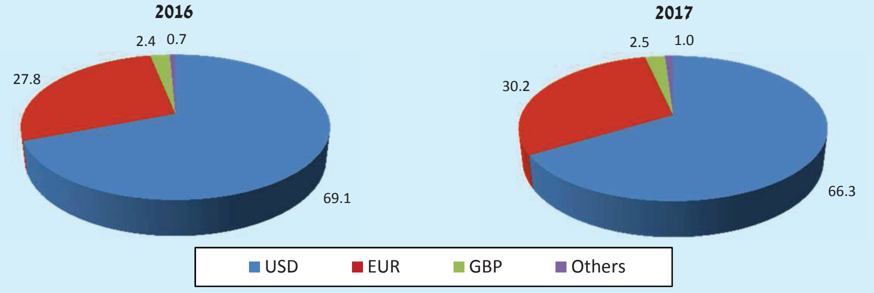
[a] Includes the Bank's payments and receipts in foreign currency.
[b] Transfers from abroad by the Government and national institutions.
[c] Includes income tax payments of the sector in foreign currency.

The scope of foreign exchange purchases in the year was dictated by the trend of large scope purchases dating back to 2008.[7] The developments in foreign exchange reserves from 2008 to date are shown in Figure 7.

[7] Partly as a direct result of a plan to mitigate irregular fluctuations in exchange rates which are not commensurate with the market's basic economic principles which was followed by a plan to mitigate the effect of gas production on the exchange rates, put into practice in May 2013.

The investment policy underlying the reserves is reflected in the asset and currency distribution of the reserve portfolio. The reserve currency distribution at the end of 2017 was essentially similar to the distribution at the end of 2016 (Figure 8): the weight of the main portfolio currencies–dollar, euro and pound sterling–was not significantly changed.

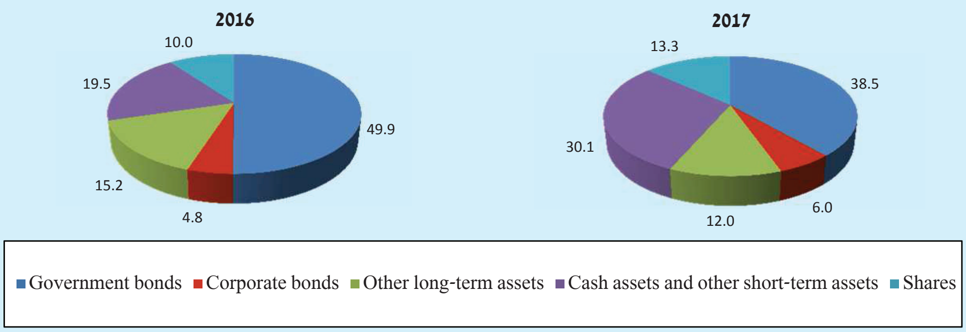
Figure 8
Currency Distribution of the Foreign Exchange Reserves Portfolio, 2017 and 2016 (Percent, by end of year)



SOURCE: Bank of Israel calculations.

In 2017, the trend of increased investments in the short-run spread assets in the portfolio at the expense of investments in short-term government bonds continued against the backdrop of their yield gap as a result of which at year end the investment in cash and in other short-run margin assets was 30.1 percent (an increase of about 10.6 percent points). In addition, the rates of investment in shares were raised by 3.3 percent points against reduced investment in government bonds by about 10.4 percent points and in long-run spread assets by about 3.2 percent points (Figure 9).

Figure 9
Assets Distribution of the Foreign Exchange Reserves Portfolio, 2017 and 2016 (Percent, by end of year)



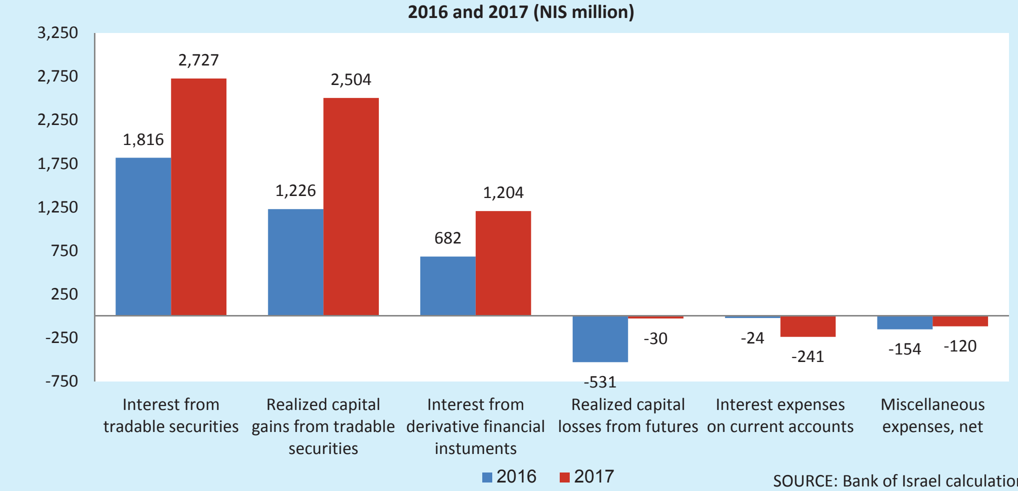
SOURCE: Bank of Israel calculations.

4.1.1 Income from the Foreign Exchange Reserves

The income from interest and capital gains[8,9] in respect of foreign exchange reserves, excluding exchange rate differentials, amounted in 2017 to approximately NIS 6 billion, compared with approximately NIS 3 billion in 2016 (Table 3). The income is comprised of: interest income of approximately NIS 3.7 billion and capital gains and other income of approximately NIS 2.3 billion (in 2016—NIS 2.5 billion in interest and NIS 0.5 billion in capital gains).

The income from interest and capital gains is mainly in respect of securities and is comprised of interest income totaling approximately NIS 2.7 billion and realized capital gains totaling approximately NIS 2.5 billion. (In 2016—approximately NIS 1.8 billion in interest and approximately NIS 1.2 billion in capital gains). Figure 10 below presents the composition of gains based on the type and source of income.

Figure 10
Composition of Realized Gains from Foreign Exchange Reserves, 2016 and 2017 (NIS million)



SOURCE: Bank of Israel calculations.

The analysis of realized gains from foreign exchange reserves demonstrates that compared with last year, income from interest on securities increased by approximately NIS 0.9 billion. The main increase in interest income derives from dollar-denominated bonds which were affected by the increase in the U.S. interest rate.

Income from realized capital gains from securities, deriving mainly from the shares portfolio, increased by about NIS 1.3 billion this year, affected by the increased investment in shares and the appreciation of the share indices underlying the reserves portfolio.

[8] Based on the Bank's accounting policy, gains deriving from holding the reserves are classified into "realized" gains that are included in the Bank's earnings, and unrealized revaluation gains that are carried to the revaluation accounts in the Balance Sheet and are not expressed in the Bank's income for the year.

[9] Capital gains are included in the Financial Statements in "Other financial income".

Derivative financial instruments made a positive contribution to gains from foreign exchange reserves. Interest income was recognized from derivative financial instruments and gains on investments in foreign currency derivatives totaling approximately NIS 1.2 billion (as opposed to NIS 0.7 billion in 2016), which reflected attractive interest rate spreads in these transactions this year, and their volume increased.

In contrast, capital losses from foreign currency derivatives totaling NIS 30 million (in 2016—approximately NIS 531 million) were recorded, which mainly resulted from stock market index futures. Dollar transactions in the year incurred capital losses, offset by capital gains from transactions in euro and Japanese yen. These investments, however, represent a small part of the overall equity investment, in which gains were recorded.

In 2017, unrealized gains from foreign exchange reserves increased, as reflected by the fair value of the assets in the revaluation account at year end. The balance of this account, which is unrealized and not included in the Bank's profits, increased by approximately NIS 4.7 billion in 2017 (an increase of approximately NIS 2.7 billion from last year) (Table 3). The increase in the revaluation account this year was mostly derived from the rise in share prices.

From an overall perspective of realized and unrealized gains from foreign exchange reserves, excluding exchange rate differentials, overall income grew by approximately NIS 5 billion (in keeping with an increase of approximately NIS 3.8 billion in 2016). The annual yield on the portfolio in numeraire terms in 2017 amounted to 3.03 percent, exceeding the yield of 1.56 percent in 2016.

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

	2017	2016	2015
Total foreign exchange reserves:		USD million	
End of year	113,011	98,447	90,575
Annual average	107,567	95,777	87,389
Income (expenses) and exchange rate differentials - economic calculation:		NIS million	
Interest and capital gains	6,044	3,015	2,924
Unrealized price differentials[a]	4,726	2,734	(968)
Exchange rate differentials	(23,403)	(11,069)	(10,093)
Total	**(12,633)**	**(5,320)**	**(8,137)**
Income (expenses) and exchange rate differentials- economic calculation:		USD million	
Interest and capital gains	1,643	785	748
Unrealized price differentials[a]	1,565	728	(253)
Exchange rate differentials	4,316	(1,552)	(2,943)
Total	**7,524**	**(39)**	**(2,448)**
Rates of return[b]:		Percent	
In numeraire terms of foreign exchange reserves	**3.03**	**1.56**	**0.64**

[a] Unrealized price differentials express the annual change in the revaluation account of foreign currency tradable securities (see Note 14 to the financial statements).
[b] Rates of return, which are shown in annual terms, are based on daily calculations, and relate to income from the foreign exchange reserves, including gains or losses resulting from market price changes.

4.2 Revaluation Accounts

The revaluation accounts are composed of unrealized gains from exchange rate differentials on balances denominated in foreign currency and of unrealized gains from indexation and revaluation of tradable securities in local and foreign currency to their fair value. This item also includes a revaluation account in respect of unrealized gains or losses arising from changes in actuarial assumptions underlying the calculation of the pension allowance in respect of benefits to employees and pensioners (see Notes 1m and 14 to the financial statements).

4.2.1 Revaluation Account of Balances denominated in Foreign Currency

The balance of the revaluation account of balances denominated in foreign currency at year end was approximately NIS 3.2 billion, compared with approximately NIS 19.6 billion in 2016, a decrease of approximately NIS 16.4 billion.

In 2017, negative exchange rate differentials were accrued in respect of the adjustment of the balances denominated in foreign currency to the representative exchange rates in a total of approximately NIS 22 billion (Table 4), mainly as a result of the appreciation of the shekel against the dollar at a rate of about 9.8 percent this year (Figure 5). In keeping with the Bank's accounting policy, an amount of approximately NIS 16.4 billion out of negative exchange rate differentials was carried to the revaluation account and offset against a retained credit right (this amount is comprised of offsetting the majority of the dollar revaluation reserve accrued at the end of 2016 in a total of approximately NIS 19.5 billion and the accrual of positive exchange rate differentials this year, mainly owing to the revaluation of the euro by about NIS 3.2 billion). The balance of negative exchange rate differentials, totaling approximately NIS 5.6 billion, was charged to the Statement of Operations as expenses from exchange rate differentials.

In 2016, negative exchange rate differentials totaling approximately NIS 10.5 billion arising mainly from the weakening of the euro and pound sterling were accrued, of which approximately NIS 7.1 billion was charged to profit and loss and the balance of approximately NIS 3.5 billion was offset from the revaluation account.

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

	2017	2016
	NIS million	
Assets		
Foreign currency balances	(23,403)	(11,069)
The IMF	-	-
Credit to the government—binational foundations	(12)	(2)
Liabilities		
Government deposits	1,117	306
Foreign currency deposits of banking corporations	93	33
International financial institutions	205	211
Binational foundation deposits	13	2
Total	**(21,987)**	**(10,519)**
Realized exchange rate differentials in profit and loss	(5,578)	(7,053)
Unrealized exchange rate differentials	(16,409)	(3,466)

4.2.2 Revaluation Account from Tradable Securities in Foreign Currency

The balance of the revaluation account from tradable securities in foreign currency at the end of 2017 was approximately NIS 11.9 billion, compared with approximately NIS 7.1 billion in 2016. The increase of approximately NIS 4.8 billion derived mainly from the increase in the revaluation account in respect of the investments in equities due to the rise in global stock markets in the course of 2017.

4.2.3 Revaluation Account from Tradable Securities in Local Currency

The balance of the revaluation account from tradable securities in local currency at the end of 2017 was approximately NIS 0.8 billion, a decrease of approximately NIS 0.1 billion compared with 2016. The decrease was mostly affected by the drop in market prices of tradable securities in local currency.

4.2.4 Revaluation Account from Actuarial Gains or Losses in respect of Benefits to Employees and Pensioners

At the end of 2017, the revaluation account consisted of a debit balance of approximately NIS 2.3 billion (approximately NIS 2.1 billion in 2016).

According to the Bank's accounting treatment method, any change in the Bank's liability in respect of benefits to employees and pensioners[10] arising from changes in actuarial assumptions[11] or from the gap between estimates and actual results is carried to the revaluation account in the Balance Sheet. The account may also represent a debit balance at year end, contrary to the other revaluation accounts described above. Any other changes in the Bank's liability in respect of benefits to employees and pensioners are carried to the Statement of Operations.

4.3 Monetary Base

The monetary base is comprised of the total banknotes and coins in circulation and the demand deposits of the commercial banks in the Bank of Israel[12] and is determined according to the liquidity demand at the Bank's given interest rate. The monetary base is affected both by factors which are not under the control of the Bank, such as government

[10] The Bank uses a discount rate based on the yield curve of government interest (the series of yields to maturity of government bonds in Israel with different maturities).

[11] The actuarial assumptions consist of: demographic assumptions on the future characteristics of employees and on former employees such as mortality tables, early retirement rates etc. and financial assumptions such as the discount interest rate and deviation for experience in the reporting period compared with the assumptions used last year for the reviewed period.

[12] The public's demand deposits also form part of liquidity in the economy, yet the Bank can only influence their scope indirectly by imposing a reserve requirement on the commercial banks.

accounts[13], and by factors which are controlled by the Bank, such as purchases of foreign exchange and *makam* issuances, as a means of achieving the various objectives of the monetary policy (Table 5). The Bank either absorbs liquidity from the markets or injects liquidity to the commercial banks to satisfy demand for the monetary base based on the BOI's interest rate.

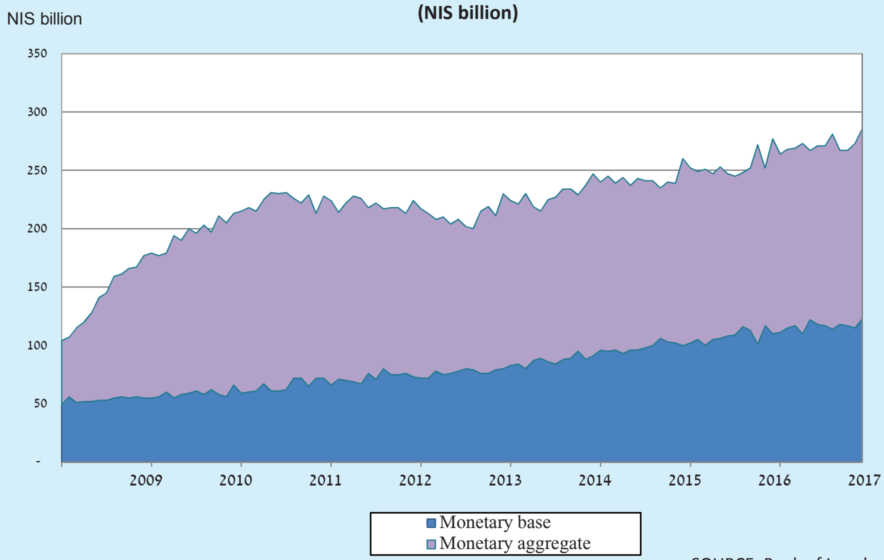
The Bank adapts the monetary base to the interest rate using monetary instruments—by issuing *makam* and by using auctioned interest-bearing deposits or loans of the banks, which are not included in the monetary base[14], in accordance with their liquidity needs. This year, the Bank pursued its intervention in the foreign exchange market in accordance with its policy to operate in this market when the shekel exchange rate is not in line with the fundamental economic conditions underlying its development.

In keeping with the trend of the last few years, the monetary base grew in 2017 by about NIS 12.2 billion (in 2016 by approximately NIS 10.8 billion), reaching approximately NIS 122.7 billion at the end of the year (Figure 11). Similarly to last year, the largest injection to the monetary base made by the Bank in a total of approximately NIS 24 billion (approximately NIS 23 billion in 2016) was a result of the Bank's intervention in the foreign exchange market (Table 5). The Bank absorbed the excess liquidity beyond the demand for the monetary base to avoid the pressure of short-term interest being lowered to a lower level than that determined by the Bank. The absorption was carried out through the monetary instruments aggregate (*makam* and time deposits) in the amount of approximately NIS 9 billion, which was offset by the injection of approximately NIS 1.2 billion, partly from payments in respect of the monetary instruments.

In 2017, the Government absorbed approximately NIS 4 billion from the market (as opposed to injecting approximately NIS 4 billion in 2016).

[13] The Government's actions also affect the monetary base since the Government's accounts are managed at the Bank (in conformity with the Bank of Israel Law, 5770–2010).
[14] Since they are not recognized for the purpose of compliance with the reserve requirement.

Figure 11
Developments in the Monetray Aggregate and Monetary base, 2009-2017
(NIS billion)



SOURCE: Bank of Israel calculations.

Table 5
The Monetary Base—Changes and their Sources

Year	Change in monetary base	Injection (+) / absorption (-) by the government and national institutions[a]	Injection (+) / absorption (-) by the Bank of Israel	Injection from foreign currency conversions at the Bank of Israel	Adjustments[b]
	(1)=(2)+(3)+(4)+(5)	(2)	(3)	(4)	(5)
	NIS million				
2012	748	(9,130)	10,047	-	(169)
2013	6,443	(10,452)	(2,414)	19,037	272
2014	11,699	1,171	(14,190)	24,632	86
2015	8,427	(14,036)	(11,543)	33,842	164
2016	10,787	3,538	(15,814)	23,086	(23)
2017	**12,179**	**(3,864)**	**(7,819)**	**24,030**	**(168)**

[a] The Government's injection also includes injections by the National Insurance Institute and by the Postal Bank.
[b] Adjustments include: transfers by the national institutions from abroad via the banks but which were defined as public sector injections until the end of 2012 (in column 2). Foreign currency domestic receipts and payments by the Bank 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.

4.4 Aggregate of Monetary Instruments[15]

Israel experienced a positive inflation rate in 2017 for the first time since 2014. The Israeli CPI increased this year by 0.4 percent compared to a negative rate of about 0.2 percent last year. The increase in inflation corresponded to the increase in most OECD countries. The Israeli monetary policy in recent years was accommodative and acted to support activity and exports and restore the low inflation to its target range taking into account financial stability considerations in the context of the sharp rise in housing prices and the low margin level in the corporate market. The interest rate in 2017 remained low at 0.1 percent since its lowering in March 2015.

The determination of the monetary interest rate is the main tool used by the monetary policy to achieve its targets, primarily maintaining price stability. The monetary interest rate serves as a benchmark for market interest rates, through which it dictates individuals' consumption and savings, the scope of investment in the economy and the exchange rate, and through the latter—the profits and activity of the exports and import substitutions sector and the balance of payments. All these are factors through which the interest rate impacts on prices.

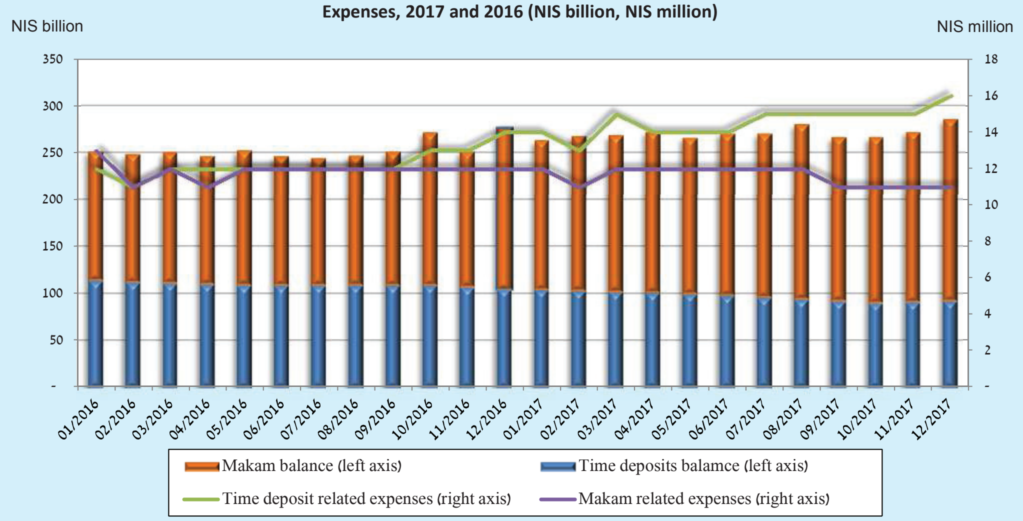
To effectively implement the interest rate declared by the Bank of Israel, the Bank injects or absorbs the needed funds into/from the market, in line with its own determined interest rate. This is done through extending loans to banking corporations or receiving deposits from banking corporations and through the issue of *makam*, as applicable. This is particularly relevant in the event of sterilization of the positive contribution of foreign exchange purchases to the monetary base.

In keeping with the trend of recent years, the balance of monetary instruments remains composed solely of liabilities, amounting to approximately NIS 286 billion in late 2017, compared with approximately NIS 277 billion at the end of 2016 (an increase of about 3 percent). This increase was derived from the need to sterilize the surplus funds injected into the markets as a result of forex purchases (Figure 12). In 2017, the monetary aggregate consisted of approximately NIS 194 billion in time deposits, accounting for about 68% of total monetary instruments (compared with approximately NIS 172 billion in 2016 - about 62 percent), and approximately NIS 92 billion in *makam*, accounting for about 32 percent of total monetary instruments (compared with approximately NIS 105 billion at the end of 2016, about 38 percent).

[15] The aggregate of monetary instruments consists of the balance of *makam* and term deposits in local currency less monetary loans. The balance of monetary loans at the end of 2017 and 2016 was zero.

Interest expenses in respect of the aggregate of monetary instruments in 2017 amounted to approximately NIS 315 million, compared with approximately NIS 288 million in 2016. The increase in interest expenses mostly stemmed from the increase in the monetary aggregate (Figure 12).

Figure 12
Balance of Monetary Aggregate and related Monthly Expenses, 2017 and 2016 (NIS billion, NIS million)



SOURCE: Bank of Israel calculations.

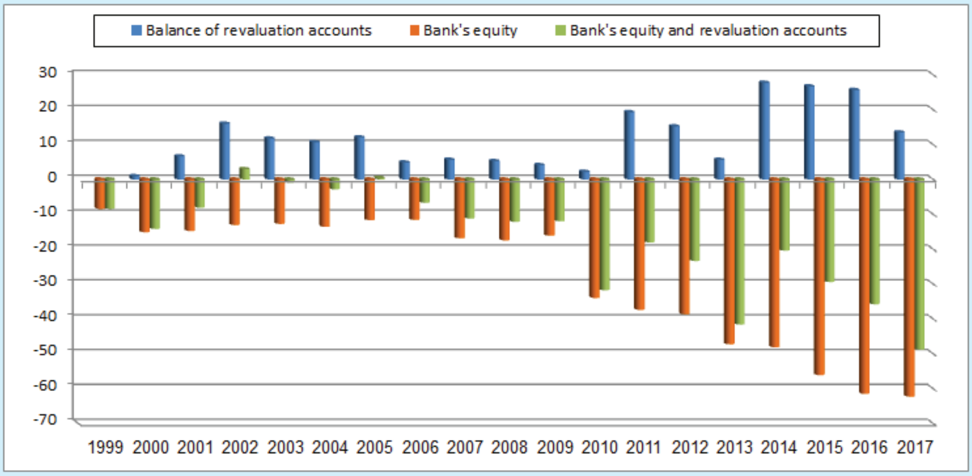
4.5 The Bank's Equity (Deficit Equity)

The Bank has an Deficit Equity of approximately NIS 62.3 billion. The accumulated losses, which played a major part in the creation of an Deficit Equity, began forming in 1999 after the Bank had transferred to the Government in 1998 some NIS 9 billion in gains, the vast majority of which derived from exchange rate differentials due to the shekel's depreciation. In 1999, however, it became clear that the bulk of the gains were unrealized gains which, had they not been transferred to the Government, would have been offset against the losses of that year. This is because in 1999, negative exchange rate differentials were recorded following the shekel's appreciation, which resulted in a loss in said year. The loss created an unprecedented Deficit Equity in the Bank's Balance Sheet, which has been sustained to date.

In 2000, the Bank of Israel revised the accounting policy of revenue recognition and began to treat realized and unrealized gains differently, as customary in central banks around the world. Unrealized gains are carried to revaluation accounts in order to prevent the recurrence of transferring unrealized gains, mainly arising from exchange rate differentials, in years in which the shekel significantly depreciates (see Note 1f to the financial statements).

The balance of revaluation accounts at the end of 2017 amounted to approximately NIS 13.5 billion. Overall, the net balance of the Bank's equity with the addition of revaluation accounts amounted to approximately NIS 48.8 billion. Figure 13 presents the Bank's Deficit Equity and revaluation accounts and their general trend.

Figure 13
The Bank's Equity and Revaluation Accounts, 1999-2017
(NIS billion)



SOURCE: Bank of Israel calculations.

4.5.1 Composition of the Deficit Equity

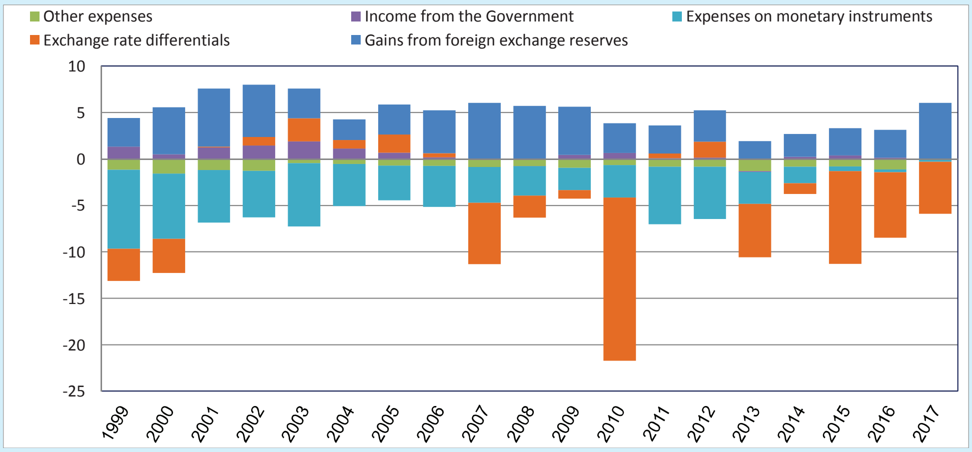
The analysis of the Bank's Deficit Equity indicates that the main components that contributed to the deficit are expenses in respect of exchange rate differentials which over said years aggregated approximately NIS 55 billion and expenses in respect of using monetary absorption instruments which aggregated to approximately NIS 76.8 billion. In contrast, gains from foreign exchange reserves in said years totaled approximately NIS 76.2 billion, minimizing the gap between gains from foreign exchange reserves and expenses in respect of monetary absorption instruments, excluding losses on exchange rate differentials, to about NIS 600 million only.[16] This trend of minimizing the gap between the gains from foreign exchange reserves and the cost of monetary instruments has continued in recent years. There has been growth in the foreign exchange reserve portfolio's volume (and related income) and an increase in the portfolio's equity component whose yield is higher, while at the same time there has been a decrease in interest expenses on the monetary instruments. The decrease in interest expenses is a result of the reducing of the BOI's interest rate in recent years to 0.1 percent in the context

[16] This calculation only consists of realized gains and excludes unrealized price revaluation differentials.

of the accommodative monetary policy. The effect of the exchange rate differentials is large and volatile, and due to the appreciation of the shekel in 2017 has continued to contribute to increasing the Bank's Deficit Equity.

Other results, which mainly consist of various interest expenses, general and administrative expenses and banknote printing expenses, contributed approximately NIS 17.5 billion to the deficit. In contrast, net income from the Government (bonds and deposits) mitigated the accumulated deficit by approximately NIS 10.4 billion. Figure 14 presents the development of the main loss components of the deficit on an annual basis, from 1999 when the deficit was first created.

Figure 14
Principal Loss Components, 1999-2017
(NIS billion)



SOURCE: Bank of Israel calculations.