

## ***NOTES TO THE 2006 FINANCIAL STATEMENTS***

### **1. Accounting policies**

#### **a. General**

The financial statements are presented in accordance with generally accepted accounting principles adapted for the special activity of a central bank, and consistent with the practice of other central banks.

The main items presented in accordance with generally accepted accounting principles of central banks are:

1. Revaluation accounts, as detailed in Section 1.l below.
2. Local currency securities, as detailed in Section 1.f below.
3. Cash flow statements, as detailed in Section 1.q below.

#### **b. Definitions**

In these financial statements:

"The Bank" - The Bank of Israel

"CPI" - The Consumer Price Index as published by the Central Bureau of Statistics.

"Adjusted amount" - The nominal historical amount adjusted to the CPI in respect of December 2003, in accordance with the provisions of Opinions 23 and 36 of the Institute of Certified Public Accountants in Israel.

"Reported amount" - The adjusted amount as at the transition date (December 31, 2003), with the addition of amounts in nominal values that were added after the transition date and less amounts eliminated after the transition date.

"Nominal financial reporting" - Financial reporting based on reported amounts.

#### **c. Financial statements in reported amounts**

1. In October 2001 the Israel Accounting Standards Board published Accounting Standard No. 12, "Discontinuance of Adjustment of Financial Statements." Pursuant to this standard and in accordance with Accounting Standard No. 17 that was published in December 2002, the adjustment of financial statements for the effect of inflation was discontinued as of January 1, 2004.
2. In the past the Bank prepared its financial statements on the basis of historical cost, with no adjustment for changes in purchasing power of the Israeli currency. In the financial statements for 2005, comparable figures for the year ending December 31, 2003 were recalculated on a historical cost basis, adjusted for the changes in the CPI, as required by Accounting Standard No. 12, in order to prepare for the transition to nominal financial reporting.



## NOTES TO FINANCIAL STATEMENTS

The adjusted amounts included in the financial statements as at December 31, 2003 constituted the starting point for the nominal financial report as of January 1, 2004. Any additions and disposals made during the period were included in their nominal values.

3. Amounts of non-monetary assets do not necessarily reflect their realizable value or current economic value, but only the reported amounts of such assets.
4. The term “cost” in these financial statements means the reported amount of cost.

### **d. Reporting principles**

#### 1. Balance sheet:

- a. Non-monetary items (mainly fixed assets, investments presented at cost) are stated in reported amounts.
- b. Monetary items are stated in the balance sheet at their nominal historical values as of balance sheet date.

#### 2. Profit and loss account:

- a. Income and expenses deriving from non-monetary items (such as: depreciation and prepaid expenses and deferred income) or from provisions included in the balance sheet are derived from the difference between the reported amount of the opening balance and the reported amount of the closing balance.
- b. All other operating items (such as: interest income and expenses) are stated at their nominal values.

#### 3. Statement of changes in equity:

In accordance with the Bank of Israel Law, 5714-1954, the Bank must transfer its net profits to the government within 60 days from the end of its business year. As the Bank of Israel has an accrued loss through December 31, 2005 and 2006, the profits are set off against this and no transfers are made to the government.

### **e. Use of estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires the Bank's management to make estimates and assumptions regarding transactions or matters the final effect of which on the financial statements cannot be accurately determined at the time of their preparation. Even though the estimates and assumptions are based on management's best judgment, the final effect of such transactions or matters may be different from the estimates and assumptions made in their respect.



## **f. Securities**

### *Foreign currency securities*

Tradable foreign currency securities are stated at their market value as of the balance sheet date.

Interest and indexation income on foreign currency securities are recorded in the profit and loss account on an accrual basis and presented in the 'Interest income from foreign currency financial assets abroad' item.

Unrealized profits arising from the difference between the adjusted cost of securities and their market value are included in the 'Revaluation accounts' item in the balance sheet.

Unrealized losses at the end of the year due to a fall in the market price of securities to below their adjusted cost are transferred to the profit and loss account and are shown under 'Other financial income from (expenses on) securities and derivatives.' The adjusted cost of securities is their nominal value plus interest, indexation differentials and the balance of the premium or discount not yet amortized. The premium or discount is amortized over the period from the date of purchase until the date of redemption.

Income from the realization of securities is shown under 'Other financial income (expense) from securities and derivatives.'

### *Local currency securities*

Tradable local currency government securities are stated in the balance sheet at their market value as of balance sheet date.

The difference between the market value of securities and their original cost is recorded in the 'Revaluation accounts' item in the balance sheet.

Income from tradable government securities is included in the profit and loss account on a cash basis in accordance with the matched timing principle according to which accrued profits from government securities not yet received in cash from the government are not included in the Bank's income.

Interest and indexation income on local currency securities are shown under 'Interest income from the government.'

## **g. International financial institutions**

### *The International Monetary Fund (IMF)*

The Bank of Israel's participation in the IMF less its liability for participation is shown under assets in the item 'International financial institutions.'

Special drawing rights (SDR) allocated by the IMF are shown under liabilities in the item 'International financial institutions.'



*Balances related to other international financial institutions and investment in shares of the Bank for International Settlements (BIS)*

The Bank of Israel's participation in other international financial institutions includes initial participation in their capital and additional participation payments for increases in the capital of those institutions. The Bank of Israel's participation in other international financial institutions is shown under 'International financial institutions' as an asset according to the cost in the currency in which the participation was paid, translated at the exchange rate on the date the transaction took place. Liabilities to international financial institutions are shown under liabilities in the item 'International financial institutions.'

**h. Fixed assets**

1. Fixed assets are stated at cost.
2. Improvements and enhancements are added to the cost of the assets whereas maintenance and repairs are charged to expense as incurred.
3. Depreciation is calculated by the straight-line method on the basis of the estimated useful lives of the assets:
 

Buildings	—	fifty to sixty-seven years;
Vehicles	—	six and a half years;
Computers	—	four years;
Equipment	—	ten years.
4. Purchases of certain items of fixed assets for non-significant amounts are recorded in the profit and loss account.

**i. Banknotes and coins in circulation**

Banknotes and coins issued by the Bank reflect the Bank's liabilities towards holders of the banknotes and coins. The liabilities are shown in the Bank's balance sheet according to their denominated values.

**j. *Makam* (short-term bills issued by the Bank of Israel)**

The balance of *makam* in the balance sheet reflects the par value (the redemption price) of *makam* held by the public less the balance of the discount that has not yet been amortized. *Makam* sold by the government to the Bank of Israel but not yet sold to the public are not included in this balance.

The discount is the difference between the par value of the *makam* and the proceeds of their sale to the public. The discount is amortized by the straight-line method.

Expenses of amortizing the discount on the balance of *makam* held by the public are presented in the profit and loss account in the item 'Interest paid to the banks and the public.'



**k. Liabilities in respect of employees' rights**

The liability for employee pensions and severance pay is actuarially computed, and reflects the liability for pensions and severance payments to employees accrued as of the balance sheet date.

Provision for vacation pay is computed on the basis of vacation days due, accrued as of the balance sheet date. (See Note 13).

**l. Revaluation accounts**

The revaluation accounts include unrealized profits from exchange-rate differentials on balances denominated in foreign currency and unrealized profits from the revaluation of tradable securities in local currency and foreign currency to market value.

There are separate revaluation accounts for each item (currency, security), which are transferred to the profit and loss account when the item is realized in whole or in part.

The balance of the loss in the revaluation accounts arising from price differentials in foreign currency securities and from exchange-rate differentials on balances in foreign currency is transferred to the profit and loss account at the end of the year.

**m. Foreign currency**

The assets and liabilities denominated in foreign currency, or indexed to foreign currency, are presented in New Israeli Shekels according to the representative rate of exchange published by the Bank of Israel on the balance sheet date.

Differences in rate arising from the adjustment of assets and liabilities due to changes in the exchange rate include realized and unrealized exchange-rate differentials.

Unrealized exchange-rate differentials are charged separately for each currency in the 'Revaluation accounts' item. Realized exchange-rate differentials are transferred to the profit and loss account, and are calculated on the basis of the average cost of the balances of that currency. Realization is calculated separately for each calendar month for all foreign currency assets and liabilities and for each currency. A balance of loss in the revaluation accounts at the end of the year is transferred to the profit and loss account, and is not offset in the future against unrealized profits. Unrealized losses in one currency are not offset against unrealized profits in other currencies.

Income and expenses in foreign currency are included in the profit and loss account according to the representative exchange rates prevailing on the days that the transaction occurred.



## NOTES TO FINANCIAL STATEMENTS

Details of the exchange rates are as follows:

	December 31			Change	
	2006	2005	2004	2006	2005
	(NIS)			(percent)	
US\$	4.2250	4.6030	4.3080	-8.2	6.8
Euro	5.5643	5.4465	5.8768	2.2	-7.3
Special drawing rights (SDR) <sup>a</sup>	6.3510	6.5781	6.6679	-3.5	-1.3
First currency basket <sup>b</sup>	5.1489	5.1812	5.3263	-0.6	-2.7
Currency basket <sup>c</sup>	4.8253	5.0891	5.0061	-5.2	1.7

<sup>a</sup> SDR rate is based on a weighted 4-currency basket consisting of US\$, €, ¥, and £.

<sup>b</sup> First currency basket was in effect until July 31, 1986, and consisted of: US\$ 0.3500; £ 0.1295; and € 0.4667.

<sup>c</sup> Currency basket in effect since May 2, 2000, and consists of: US\$ 0.6698; £ 0.0453; € 0.2493; and ¥ 7.2411.

### n. Indexation

Assets and liabilities indexed to the Consumer Price Index (CPI) are shown according to the latest known index at the balance sheet date, i.e., the November index.

Details of the CPI are as follows:

	December 31			Change	
	2006	2005	2004	2006	2005
	(points) <sup>a</sup>			(percent)	
CPI <sup>a</sup> November	102.9	103.2	100.5	-0.3	2.7
December	102.9	103.0	100.6	-0.1	2.4

<sup>a</sup> CPI is presented in points based on a 2002 average.

### o. Derivative financial instruments

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

#### 1. Activity in derivative financial instruments in Israel:

##### a) NIS/US\$ swaps

Swaps conducted by the Bank of Israel with domestic banks are shown net, i.e., the balance of dollars to be received from the banks (translated according to the exchange rate on the balance sheet date) less the balance of shekels to be transferred to the banks. The presentation in the balance sheet is according to whether there is a net debit or net credit balance. A net debit balance is shown under the item 'Other assets' and a net credit balance under 'Other liabilities.'



Interest expense on these transactions is presented in the profit and loss account under the item 'Interest paid to the banking corporations and the public.' (See Note 23).

In July 2005 the Bank of Israel ceased conducting these tenders, and therefore the balance of swaps for December 31, 2005 and 2006 in the balance sheet was zeroed.

*b) Purchase and sale options on the US\$/NIS exchange rate*

The Bank of Israel sells NIS/US\$ exchange-rate options to the banks. The balance of options on the date of the financial statement is shown in Note 17, '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 shown in the item 'Other financial income (expense) from securities and derivatives.' The income from the premium on options is spread evenly over the duration of the options using the straight-line method. Prepaid income on the premium plus expenses accrued in respect of the difference between the exercise rate and the representative dollar exchange rate on the balance sheet date is included in the 'Other liabilities' item. In August 2006 the Bank of Israel ceased these transactions, although there are still some options whose expiry dates had not yet been reached by December 31, 2006.

*c) Future remittances of makam*

The balance of the liability for future remittance of *makam* through the date of the financial statement is presented at par (redemption price) in Note 17, 'Contingent liabilities and special commitments.'

Receipts on account of future issues of *makam* are included in the balance sheet under 'Other liabilities.'

*2. Financial instruments in activities abroad:*

*a) Repurchase agreements (Repo), and Reverse Repurchase agreements (Reverse Repo)*

The Bank executes repurchase agreements (Repo). The securities sold in the repurchase agreements are presented in Note 2, 'Foreign currency financial assets abroad,' under 'Tradable securities.' The liability for buying the securities is included in the item 'Foreign currency financial liabilities abroad.' In the profit and loss account the results of the transactions are presented as 'Interest expense for foreign currency financial liabilities abroad.'

The Bank also executes reverse repurchase agreements (RRepo). These balances are shown in Note 2, 'Foreign currency financial assets abroad,' under 'Securities bought in reverse repurchase agreements.' In the profit and loss account, the results of these transactions are presented as 'Interest income from foreign currency financial assets abroad.'



*b) Foreign currency swaps*

The transactions are presented in the balance sheet at net value in the 'Foreign currency financial assets abroad' item: the balance of future foreign currency receipts less future foreign currency remittances.

In the profit and loss account the results of these transactions are included in the item, 'Interest income from foreign currency financial assets abroad.'

*c) Futures*

The balance of futures contracts at market prices on the date of the financial statement is given in Note 17, 'Contingent liabilities and special commitments.'

In the profit and loss account the change in the value of the contracts is recorded under 'Other financial income (expense) from securities and derivatives.'

**p. Impairment of assets**

The Bank applies Accounting Standard No. 15 - Impairment of assets (hereafter: the Standard), which defines procedures that the Bank must apply in order to ensure that its assets in the balance sheet are not stated in an amount greater than the recoverable amount, which is the higher of the net sale price and usage value (the present value of an estimated future cash flow expected to derive from the use and disposal of the asset). The Standard applies to all balance sheet assets, except for financial assets. The Standard also sets the rules of presentation and disclosure regarding assets which have been impaired. Where the value of an asset exceeds its recoverable amount, the Bank recognizes a loss from impairment in the amount of the difference between the book value of the asset and its recoverable amount. The loss so recognized will be cancelled only if changes occur in the estimates that were used to determine the recoverable amount of the asset from the date on which the last loss from impairment was recognized.

**q. Cash flow statements**

These financial statements do not include a cash flow statement, as it does not contain significant information beyond that which appears in the financial statements. This is also in accordance with the general practice among central banks worldwide.

**r. Taxes**

According to the Bank of Israel Law, 5714-1954, concerning the payment of taxes, the Bank's laws follow that of the State of Israel and therefore the Bank is exempt from paying certain taxes such as income tax and capital gains tax.



## 2. Foreign currency financial assets abroad

	December 31		December 31	
	2006	2005	2006	2005
	(NIS million)		(\$ million)	
Tradable securities	111,773	119,760	26,455	26,018
Short-term deposits	24,160	16,364	5,718	3,555
Demand deposits	1,000	1,250	237	272
Reverse repurchase agreements	2,891	4,885	684	1,061
Derivative financial instruments <sup>a</sup>	36	284	9	62
<b>Total</b>	<b>139,860</b>	<b>142,543*</b>	<b>33,103</b>	<b>30,968*</b>

\* Reclassified.

<sup>a</sup> Derivative financial instruments are shown net, i.e., future foreign currency liabilities minus future foreign currency assets (see note 1.o.2).

### a. Foreign exchange reserves

In economic terms, as mentioned in the Explanatory Remarks, the reference to foreign exchange reserves includes the net balance of Repo transactions. These balances are comprised of the balance of the 'Foreign currency financial assets abroad' item less the balance of the 'Foreign currency financial liabilities abroad' item.

The balance of the 'Foreign currency financial liabilities abroad' item shows the balance of securities sold in the framework of the repurchase agreements.

The currency composition of these balances matches their possible uses. These uses, which also constitute a basis for the determination of the desired level of the reserves, consist of selling them (foreign currency) to the government to service its debts and to finance imports in an emergency; using them to implement the Bank of Israel's policy on the stability of the banking system and the foreign currency market; and using them as an instrument for implementing monetary policy. (The yields on the foreign exchange reserves are shown in Table 4 in the Explanatory Remarks to the Financial Statements.)

Details of the foreign exchange reserves are as follows:

	December 31		December 31	
	2006	2005	2006	2005
	(NIS million)		(\$ million)	
Foreign currency financial assets abroad	139,860	142,543	33,103	30,968
Foreign currency financial liabilities abroad	(17,103)	(14,314)	(4,048)	(3,110)
<b>Total foreign exchange reserves</b>	<b>122,757</b>	<b>128,229</b>	<b>29,055</b>	<b>27,858</b>



### 3. International financial institutions

	December 31	
	2006	2005
	(NIS million)	
The IMF (see section a below)	521	933
Investment in BIS shares	282	282
Balances related to other international financial institutions (see section b below)	554	554
<b>Total</b>	<b>1,357</b>	<b>1,769</b>

#### a. The International Monetary Fund (IMF)

The balance with the IMF (the reserve tranche) constitutes part of the quota allocated to Israel for which Israel paid the Fund in foreign currency.

##### *The quota in the IMF*

Each member country has a quota allowing it to participate in the capital of the Fund. The quota is determined according to the country's economic situation (national income, exports, balance of payments, level of the reserves) and it also determines the country's voting rights. Part of the quota (called the reserve tranche) is transferred to the Fund in foreign currency, and can be withdrawn by the country, and the rest is deposited in the country's central bank in deposits and notes indexed to Special Drawing Rights.

Up to 1998 Israel drew down its reserve tranche, putting up against this withdrawal a non-interest-bearing deposit in favor of the Fund. In the latest increase in members' participation, in 1999, Israel's quota rose by SDR 262 million. The foreign currency payment for this increase, approximately SDR 66 million, was deposited in the Fund, and has not been withdrawn by Israel.

##### *The IMF Financial Transactions Plan*

Since 1999 Israel has been part of the IMF's financial transaction plan. The plan is a mechanism through which a member country can exchange SDR or foreign currency against its local currency, and another country is asked to execute a counter-exchange. The request to exchange foreign currency is passed on by the Fund at short notice. The IMF manages the sums transferred and received in these transactions in such a way that the share of the reserve tranche in the quota of each member country participating in the plan remains similar. Through 2004, Israel's reserve tranche balance grew gradually due to Israel's transfer of foreign currency to other countries. Since 2004, the Fund has transferred foreign currency to Israel. In 2006 Israel's reserve tranche was reduced by about SDR 59 million.



	December 31		December 31	
	2006	2005	2006	2005
	(NIS million)		(SDR million)	
International Monetary Fund (IMF) quota	5,897	6,110	928	928
Minus liability for the quota <sup>a</sup>	5,376	5,177	846	787
<b>Total<sup>b</sup></b>	<b>521</b>	<b>933</b>	<b>82</b>	<b>141</b>

<sup>a</sup> The balance of the liability to the IMF is in notes and deposits

<sup>b</sup> The surplus of the reserve tranche over the 'basic sum' of SDR 33 million bears interest at a rate set by IMF from time to time. The annual rate of interest on December 31, 2006, was 4.1 percent (on December 31, 2005 – 3 percent).

#### **b. Balances related to other international financial institutions**

The balances relate to the following institutions:

IBRD	–	The International Bank for Reconstruction and Development
IDA	–	The International Development Association
IFC	–	The International Finance Corporation
EBRD	–	The European Bank for Reconstruction and Development
MIGA	–	The Multilateral Investment Guarantee Agency
IDB	–	The Inter-American Development Bank
IIC	–	The Inter-American Investment Corporation



#### 4. Credit to the government

Credit to the government consists mainly of long-term advances, that were provided through 1988.

	December 31	
	2006	2005
	(NIS million)	
Long-term advances <sup>a,c</sup>		
Indexed <sup>b</sup>	2,168	2,698
Unindexed <sup>c</sup>	498	581
Credit for binational funds <sup>d</sup>	139	152
<b>Total</b>	<b>2,805</b>	<b>3,431</b>

<sup>a</sup> 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.

<sup>b</sup> This credit is indexed to the first currency basket, and bears interest at a rate of 8 percent, also indexed to the same basket.

<sup>c</sup> This credit bears interest at prime rate plus 2 percent.

The average rate of interest during 2006 was 8.9 percent (2005 – 7.3 percent).

<sup>d</sup> This credit was given to the government for investment in the Binational (US–Israel) Industrial Research and Development Fund and the Binational (US–Israel) Science Fund, established in cooperation with the US government. The Funds deposited their money in deposits in the Bank of Israel, and it is presented in the balance sheet under “Other Liabilities” (see Note 13). The credit and the deposits bear interest.

<sup>e</sup> i. Correspondence in September 2003 between the Minister of Finance and the Governor of the Bank of Israel included several agreements regarding “Proposals in the Economic Program for 2004 Relating to the Bank of Israel.” One of the items in that correspondence was “the repayment of the government’s debt to the Bank of Israel due to be repaid on December 31, 2003,” and it was determined that “the Bank of Israel will grant a loan to the government to finance the balance of the debt, principal and interest due for repayment on December 31, 2003.” The same section also specified the repayment dates of the loan, the fact that the Bank and the Ministry of Finance should reach an agreement on the interest payable, and that “if the Attorney General is of the opinion that the debt can be cancelled, then it shall be cancelled.”

The amount of the debt, principal and interest, due for repayment on December 31, 2003 was NIS 1,070 million (the total balance of the government debt, principal plus interest, prior to the above repayment was NIS 5,460 million). The debt due to be repaid on December 31, 2003 was duly repaid, as at that time the views of the Attorney General regarding the debt had not been received. Furthermore, as the Bank and the Ministry of Finance had not reached an agreement with regard to the rate of interest on the loan to finance the repayment of that debt, no such loan was granted to the government. In 2004, as in later years, the advances and the interest on them, were repaid by the government as required.

ii. In February 2005 the opinion of the Deputy Attorney General, on behalf of the Attorney General, was received, according to which “there are no legal grounds preventing the Bank of Israel from cancelling the government’s debt to the Bank as agreed between the outgoing Governor and the Minister of Finance.” In the summary giving the basis for this opinion it was written that “it appears that from a legal standpoint the Bank of Israel has the authority to cancel a government debt to the Bank that dates back to a time prior to the prohibition on granting loans to the government under section 45 of the Bank of Israel Law.” With regard to the reasonableness of a Bank of Israel decision to cancel a government debt to the Bank, it noted that “if there are macroeconomic reasons supporting such a decision that are consistent with the Bank’s objectives and policies, such a decision would not be unreasonable.” Summarizing the position, it stated that “we stress that our conclusion that there are no legal grounds preventing the Bank of Israel from cancelling a government debt to the Bank applies in the light of the special circumstances in this case, which is about a debt created in essence prior to the amendment of section 45 of the Bank of Israel Law, and it does not create a precedent for other issues, including any other government debts to the Bank of Israel.”

iii. In effect, most of the government debt (about two-thirds of the principal) to the Bank of Israel was created after the passing of the amendment to section 45 of the Bank of Israel Law (the section relevant to the question of the possibility of cancelling such a debt).

iv. In light of the above, based on the opinion of the Bank’s legal department, and taking into account the fact that the government is making the scheduled repayments, the Bank is of the opinion that the debt will be repaid in full.



## 5. Loans

	December 31	
	2006	2005
	(NIS million)	
Monetary loans <sup>a</sup>	7,501	30
Other loans <sup>b</sup>	819	1,034
<b>Total</b>	<b>8,320</b>	<b>1,064</b>

<sup>a</sup> The balance as of 2006 consisted of monetary loans granted through auction. The balance as of 2005 was comprised of overnight monetary loans. In 2005, for the first time since 1997, the Bank of Israel offered daily auctions for monetary loans. The average rate of interest on the loans in 2006 was 5.1 percent (2005 – 3.6 percent). The average rate of interest on these loans as of December 31, 2006 was 4.6 percent. In September 2005 the Bank of Israel began granting banks overnight loans at an interest rate 1 percent above the Bank of Israel rate. These loans are not limited by quotas, and are granted against appropriate collateral. The average rate of interest on these loans in 2006 was 6.1 percent (2005 – 5.4 percent). The average rate of interest on these loans as of December 31, 2005 was 5.5 percent. Through August 2005, the Bank of Israel had granted loans to banking corporations under the quota system. (The average rate of interest on those loans was 3.2 percent in 2005). In September 2005, the Bank of Israel stopped granting these loans.

<sup>b</sup> The 'Other loans' item includes credit to the Industrial Development Bank of NIS 751 million (December 31, 2005 – NIS 1,023 million). In August 2002 the Industrial Development Bank encountered liquidity problems and could not meet its liabilities. The Bank of Israel responded to a request from the bank and made available to it a special credit line to enable it to continue operating regularly. The credit line was originally NIS 2,200 million; this was reduced from time to time, and was supposed to cease at the end of July 2006. On October 30, 2005 the Bank of Israel agreed to a request from the bank to extend the period of the loan by two years, to July 31, 2008. The Industrial Development Bank pays interest on the utilized part of the credit at the Bank of Israel interest rate. In accordance with the decision of the economic-social cabinet, since July 1, 2005 responsibility for repayment of the credit lies with the government. If at the end of the period there remains a balance of credit to be repaid on this credit line, it will be repaid by the government. This credit is therefore not expected to result in a loss to the Bank of Israel.

## 6. Local currency securities

This item consists of tradable government securities indexed to the last CPI known on the balance sheet date. They are shown at market value.

The yield to maturity on the local currency securities portfolio on December 31, 2006 was 3.8 percent, and the portfolio's average period to maturity was 3.4 years (on December 31, 2005 the yield to maturity was 3.3 percent, and the average period to maturity was 4.2 years).



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	December 31	
	2006	2005
	(NIS million)	
Time to redemption from balance sheet date		
Less than one year	403	240
Between one and two years	501	409
Between two and three years	682	504
Between three and four years	880	689
Between four and five years	73	884
Between five and seven years	483	364
Seven years or longer	121	311
<b>Total</b>	<b>3,143</b>	<b>3,401</b>

## 7. Other assets

	December 31	
	2006	2005
	(NIS million)	
Fixed assets <sup>a</sup>	218	212
Loans to employees	224	229
Sundry receivables <sup>b</sup>	34	185
<b>Total</b>	<b>476</b>	<b>626</b>

<sup>a</sup> See 7a. Fixed asset composition below.

<sup>b</sup> Includes amounts receivable from the official receiver of Trade Bank (in Liquidation) Ltd., – reimbursement of payments made by the Bank of Israel based on the strength of guarantees provided, with government authorization, to depositors in the Trade Bank, following the discovery of embezzlement in the bank in April 2002.



**a. Fixed asset composition**

	Land and buildings	Equipment, furniture and vehicles	Total
<b>Cost</b>	(NIS million)		
Balance as of January 1, 2006	218	73	291
Additions	3	13	16
Disposals	-	1	1
<b>Balance as of December 31, 2006</b>	<b>221</b>	<b>85</b>	<b>306</b>
<b>Accumulative depreciation</b>			
Balance as of January 1, 2006	21	58	79
Additions	4	5	9
Disposals	-	-	-
<b>Balance as of December 31, 2006</b>	<b>25</b>	<b>63</b>	<b>88</b>
<b>Net book balance as of December 31, 2006</b>	<b>196</b>	<b>22</b>	<b>218</b>
<b>Net book balance as of December 31, 2005</b>	<b>197</b>	<b>15</b>	<b>212</b>

**8. International financial institutions**

	December 31	
	2006	2005
	(NIS million)	
Special Drawing Rights allocated <sup>a</sup>	680	703
Liabilities to international financial institutions <sup>b</sup>	56	64
<b>Total</b>	<b>736</b>	<b>767</b>

<sup>a</sup> Special drawing rights (SDR) are money which member countries of the International Monetary Fund (IMF) have undertaken to buy from it. The Fund allocates SDRs to member countries relative to the size of their quotas. To date Israel has been allocated SDR 106.4 million.

<sup>b</sup> Liabilities in bills or deposits to the following institutions: IDB, MIGA, EBRD, IDA, IBRD (see Note 1.g).



## 9. Banknotes and coins in circulation

	December 31, 2006		December 31, 2005	
	Quantity	NIS	Quantity	NIS
	(million)		(million)	
Banknotes in circulation				
NIS 20	24	471	23	457
NIS 50	46	2,320	48	2,389
NIS 100	127	12,704	125	12,460
NIS 200	44	8,883	40	8,033
<b>Coins in circulation</b>		1,128		1,038
<b>Other</b>		33		33
<b>Total</b>		<b>25,539</b>		<b>24,410</b>

## 10. Deposits of the government

Government deposits comprise deposits for financing its budgetary activity and other deposits.

### Government deposits for financing the budget

These are defined as deposits that the government may use to finance its budgetary and extra-budgetary activity and which are therefor subject to which section 45(b) of the Bank of Israel Law (the "Non-Printing Law"), 5714-1954. Financial movements arising from government budgetary and extra-budgetary activity in Israel and abroad and financial movements with the Bank of Israel are recorded in this item.

### Other deposits

Other deposits include a local currency deposit for stabilizing bond prices, and various 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 expenses. At the request of the Ministry of Finance the bond-price stabilization arrangement was discontinued in January 1993, and the deposit is gradually being reduced against the redemption of such bonds purchased in the past. The redemption of these bonds will end in 2009.



	December 31			
	2006	2005	2006	2005
	(NIS million)		(\$ million)	
<b>Deposits for budget financing</b>				
<b>Local currency<sup>a,c</sup></b>	(652)	(48)		
<b>Foreign currency</b>				
Borrowing under US government guarantee <sup>b</sup>	5,685	5,196	1,346	1,129
US government economic aid <sup>b</sup>	-	1,105	-	240
Current deposit	381	379	90	82
<b>Total foreign currency deposits</b>	<b>6,066</b>	<b>6,680</b>	<b>1,436</b>	<b>1,451</b>
<b>Total deposits for budget financing</b>	<b>5,414</b>	<b>6,632</b>		
<b>Other deposits</b>				
Bond-price stabilization local currency deposit <sup>a</sup>	38	55		
Other foreign currency deposits <sup>b</sup>	630	240	149	52
<b>Total other deposits</b>	<b>668</b>	<b>295</b>		
<b>Total</b>	<b>6,082</b>	<b>6,927</b>		

<sup>a</sup> Most local currency government deposits bear (when in debt) or pay (when in credit) interest at prime. The average prime rate in 2006 was 6.6 percent (2005 – 5.2 percent). A portion of the government deposits used for bond loan activity earn the Bank of Israel rate of interest. The average rate of interest on these deposits in 2006 was 5.1 percent.

<sup>b</sup> Government foreign currency deposits derived from borrowing under US government guarantee or from US government economic aid and a portion of the other foreign currency deposits earn interest at the rate paid on US Treasury bills with an average of 6 months to maturity. The rate of interest on December 31, 2006 was 5.1 percent (December 31, 2005 – 4.3 percent).

<sup>c</sup> The balance includes the balance of the Postal Bank, which commenced operations on March 1, 2006 through the Israel Postal Company, which is a corporation fully owned by the state.

## 11. *Makam* deposit

The Short-Term Loan Law, 5744–1984, authorizes the government to issue short-term bills (called *makam*) to be sold only to the Bank of Israel, with the Bank selling them to, and buying them from, the public to regulate the money supply and to carry out its functions. The government must deposit the entire proceeds from sales of these bills in the Bank of Israel and may not use the proceeds except for repaying the loan in accordance with this Law or paying the yield on it. The purchase of bills from the government by the Bank of Israel and the deposit of the proceeds of this sale in the Bank of Israel are not reflected in the Bank's balance sheet.

The balance of *makam* shown in the balance sheet reflects the redemption value of bills held by the public less the balance of the discount not yet amortized.



## NOTES TO FINANCIAL STATEMENTS

The following is the composition of the balance of *makam*:

	December 31	
	2006	2005
	(NIS million)	
Redemption value of <i>makam</i> sold to the public	97,953	85,491
Less discount at time of sale to public	5,016	3,459
Proceeds of sale of <i>makam</i> to the public	92,937	82,032
Plus reduction in discount for period to balance sheet date	2,603	1,700
<b>Total balance of <i>makam</i></b>	<b>95,540</b>	<b>83,732</b>

## 12. Deposits of banking corporations

	December 31	
	2006	2005
	(NIS million)	
Demand and other deposits (see a. below)	14,096	15,255
Local currency time deposits (see b. below)	-	3,561
<b>Total</b>	<b>14,096</b>	<b>18,816</b>

### a. Demand and other deposits

The banking corporations' local currency demand deposits in the Bank of Israel serve as liquid assets against residents' local currency and foreign currency deposits.

Foreign currency demand deposits (Pamach) serve as a liquid asset against nonresidents' foreign currency deposits.

The reserve requirement ranges from 0 percent to 6 percent, according to the term of the deposit.

	December 31		December 31	
	2006	2005	2006	2005
	(NIS million)		(\$ million)	
<b>Local currency demand deposits</b>	<b>11,846</b>	<b>14,151</b>		
<b>Foreign currency deposits</b>				
Foreign currency demand deposits	820	1,066	194	232
Unrestricted deposits	1,430	38	338	8
<b>Total foreign currency deposits</b>	<b>2,250</b>	<b>1,104</b>	<b>532</b>	<b>240</b>
<b>Total</b>	<b>14,096</b>	<b>15,255</b>		



**b. Time deposits**

The Bank of Israel receives local currency time deposits from the banking corporations. The deposits are allocated by auction for periods of a day or a week. The deposits are not considered liquid assets for the purpose of fulfilling the banking corporations' reserve requirements.

In September 2005 the Bank of Israel began receiving overnight deposits from the banks at a rate of interest of 1 percentage point below the Bank's policy rate. Through August 2005, the Bank of Israel paid a rate of interest on surplus liquidity that was 3.2 percentage points below the Bank's policy rate. The balance of these deposits was zeroed on December 31, 2005 and December 31, 2006.

The average rate of interest on time deposits in auction in 2006 was 5 percent (2005 – 3.7 percent).

The average rate of interest on overnight deposits in 2006 was 4.1 percent (2005 – 3.1 percent).



### 13. Other liabilities

	December 31	
	2006	2005
	(NIS million)	
Pension and severance pay liabilities <sup>a,c</sup>	3,175	3,068
Other liabilities on employees' rights <sup>b,c</sup>	149	112
Deposits of US-Israel binational funds <sup>d</sup>	162	176
Accounts payable <sup>e</sup>	60	82
Total	3,546	3,438

<sup>a</sup> The pension liability is calculated according to the pension agreements with the Bank employees and pensioners who commenced their employment before May 2002. (As of December 31, 2006 this included 517 workers and 712 retirees and surviving spouses and orphans). The pension liability includes future payment allocations for bank employees, former employees whose pensions have been frozen, retirees and others. In addition, the liability includes payment of the cashing-in of sick days at the time of cessation of employment.

The Bank's liability is calculated based on salary and allocation data for the month of December 2006 and actuarial calculations. The method is based on assessing accrued benefits under certain parameters: rate of early retirement, pension rates for surviving spouses and orphans, employees' seniority and grade, relevant tax rates, etc.

The actuarial calculation is based on forecast changes in mortality rates, in accordance with instructions of the Chief Actuary in the Ministry of Finance in October 2005, based on a policy paper published by the Capital Market, Insurance and Savings Department in April 2005. Hence the effect of the change in retirement age according to the Retirement Age Law, 5764-2004, has been taken into account.

The Bank's actuarial liability was calculated based on the discount rate of 4 percent, in accordance with the instructions of reporting to the public issued by the Supervisor of Banks. Reflecting prior experience, the calculation was carried out based on an assumption of real annual wage increases of up to 2 percent a year.

Regarding Bank employees that commenced their employment subsequent to May 2002, the Bank's liability for pension and compensation payments is covered by current deposits made in the name of the individual employee in a recognized pension and compensation fund. Such sums deposited are neither controlled nor managed by the Bank, and therefore they, nor the liabilities against which they have been deposited, are reflected in the balance sheet.

<sup>b</sup> Includes a sum of NIS 123.6 million in respect of employees' vacation entitlement (2005 – NIS 97.5 million). Bank employees are entitled by law and labor agreements to annual vacation days and advanced training days. The provision for 2006 was calculated based on the wage for determining redemption of vacation and vacation days accrued through December 31, 2006. In 2006, the estimate for vacation liability for Bank employees was changed. The change in the overall estimate was generally due to the move from using average data to using individual-specific data in respect of Bank employees.

<sup>c</sup> In calculating the liabilities, changes that may take place due to the new wage agreement, expected to be signed in 2007, were not taken into account, as the impact of this agreement on the balance of liabilities cannot be estimated, inter alia, because the details have yet to be agreed upon.

<sup>d</sup> Includes deposits of the US-Israel Binational Industrial Research and Development (BIRD) Foundation and a deposit of the US-Israel Binational Science Foundation.

<sup>e</sup> Includes commemorative coins of about NIS 5 million (2005 – about NIS 5 million).



## 14. Revaluation accounts

Revaluation accounts include unrealized profits from the revaluation of the following items (see also Notes 1.f, 1.l, and 1.m):

	December 31	
	2006	2005
	(NIS million)	
Foreign currency balances	4,135	11,252
Tradable foreign currency securities	21	16
Tradable local currency securities	734	816
<b>Total</b>	<b>4,890</b>	<b>12,084</b>

## 15. Share capital and general reserves in historical nominal values

Data on the Bank's share capital and general reserves appear in the financial statements in reported values. (See Note 1.c). The following shows the data in historical nominal values:

	December 31	
	2006	2005
	(NIS million)	
Share capital	60	60
General reserve <sup>a</sup>	260	260
<b>Total Bank capital in historical nominal values</b>	<b>320</b>	<b>320</b>

<sup>a</sup> The general reserve is in accordance with Section 6 in the Bank of Israel Law, 5714-1954, and has been applied in the past to increase the Bank's capital.



## 16. Assets and liabilities by indexation bases

	December 31, 2006				December 31, 2005			
	In local currency	In foreign currency <sup>a</sup>	Non- financial items	Total	In local currency	In foreign currency <sup>a</sup>	Non- financial items	Total
(NIS million)								
<b>Assets</b>								
Foreign currency financial assets abroad <sup>b</sup>		139,860		<b>139,860</b>		142,543		<b>142,543*</b>
International financial institutions		530	827	<b>1,357</b>		947	822	<b>1,769</b>
Credit to the government <sup>c</sup>	498	2,307		<b>2,805</b>	581	2,850		<b>3,431</b>
Loans	8,320			<b>8,320</b>	1,064			<b>1,064</b>
Local currency securities <sup>d</sup>	3,143			<b>3,143</b>	3,401			<b>3,401</b>
Other assets	258		218	<b>476</b>	414		212	<b>626</b>
<b>Total assets</b>	<b>12,219</b>	<b>142,697</b>	<b>1,045</b>	<b>155,961</b>	<b>5,460</b>	<b>146,340</b>	<b>1,034</b>	<b>152,834</b>
<b>Liabilities</b>								
Foreign currency financial liabilities abroad		17,103		<b>17,103</b>		14,314		<b>14,314*</b>
International financial institutions		736		<b>736</b>		767		<b>767</b>
Banknotes and coins in circulation	25,539			<b>25,539</b>	24,410			<b>24,410</b>
Deposits of the government	(614)	6,696		<b>6,082</b>	7	6,920		<b>6,927</b>
Makam deposit	95,540			<b>95,540</b>	83,732			<b>83,732</b>
Deposits of banking corporations	11,846	2,250		<b>14,096</b>	17,712	1,104		<b>18,816</b>
Other liabilities	3,365	181		<b>3,546</b>	3,244	194		<b>3,438</b>
Revaluation accounts	4,869	21		<b>4,890</b>	12,068	16		<b>12,084</b>
Bank of Israel capital			(11,571)	<b>(11,571)</b>			(11,654)	<b>(11,654)</b>
<b>Total liabilities</b>	<b>140,545</b>	<b>26,987</b>	<b>(11,571)</b>	<b>155,961</b>	<b>141,173</b>	<b>23,315</b>	<b>(11,654)</b>	<b>152,834</b>
<b>Surplus assets (liabilities)</b>	<b>(128,326)</b>	<b>115,710</b>	<b>12,616</b>	<b>-</b>	<b>(135,713)</b>	<b>123,025</b>	<b>12,688</b>	<b>-</b>

\* Reclassified.

<sup>a</sup> Including those indexed to foreign currency.<sup>b</sup> In 2006 the balance of this item includes NIS 1,459 million indexed to the US Consumer Price Index.<sup>c</sup> Foreign currency credit to the government includes long-term advances totalling NIS 2,168 million denominated in shekels and indexed to the exchange rate against the first currency basket (December 31, 2005 – NIS 2,698 million).<sup>d</sup> Local currency securities indexed to the Consumer Price Index.



**17. Contingent liabilities and special commitments**

	31 December	
	2006	2005
	(NIS million)	
1. Contingent liabilities <sup>a</sup>		
Documentary credits and guarantees for government imports and exports		
Documentary credits	25	29
Guarantees	198	241
Other contingent liabilities		
Liabilities to pay international financial institutions on demand	3,488	3,800
2 Special commitments		
Derivative financial instruments in activity in Israel		
\$/NIS purchase options	-	1,436
\$/NIS sales options	-	1,436
Future remittances of <i>makam</i> (at par)	640	640
Derivative financial instruments in activity abroad		
Currency swaps and forward transactions		
Future receipts of foreign currency	3,802	10,641
Future payments of foreign currency	3,763	10,327
Repurchase agreements (Repo) and Reverse Repo (RRepo)		
Repo	17,049	14,283
Reverse Repo	2,887	4,879
Futures		
Sales commitments	6,246	363
Purchase commitments	4,700	-
<sup>a</sup> Several claims are pending against the Bank of Israel. However it is the Bank's opinion based on the opinion of Bank's Legal Department that the probability of these claims being successful is low, and therefore no provisions have been recorded in respect thereof.		



**18. Interest income from financial assets in foreign currency abroad**

	For the year ended December 31	
	2006	2005
	(NIS million)	
Tradable securities	3,735	2,644
Short-term deposits	938	743
Demand deposits	46	58
Securities purchased as part of the RRepo Agreements	98	138
Derivative financial instruments <sup>a</sup>	66	91
<b>Total</b>	<b>4,883</b>	<b>3,674*</b>

\* Reclassified.

<sup>a</sup> Expenses on interest on derivatives is shown net.

**a. Interest income from foreign exchange reserves**

The following shows the composition of interest income from the foreign exchange reserves (See Notes 2 and 22):

	For the year ended December 31	
	2006	2005
	(NIS million)	
Interest income from foreign currency financial assets abroad	4,883	3,674
Interest paid on foreign currency financial liabilities abroad <sup>a</sup>	(871)	(299)
<b>Total income from foreign exchange reserves</b>	<b>4,012</b>	<b>3,375</b>

<sup>a</sup> See Note 22.

**19. Interest income from loans**

	For the year ended December 31	
	2006	2005
	(NIS million)	
From monetary loans	167	20
From other loans <sup>a</sup>	46	43
<b>Total</b>	<b>213</b>	<b>63</b>

<sup>a</sup> Mostly deriving from interest on credit advanced to the Industrial Development Bank (see Note 5).



**20. Interest income from the government**

	For the year ended December 31	
	2006	2005
	(NIS million)	
Long-term advances		
Indexed	216	255
Unindexed	52	49
From binational funds	69	67
From government deposits	-	56
From local currency securities	201	615
<b>Total</b>	<b>538</b>	<b>1,042</b>

**21. Other interest income**

This item consists of interest income from the IMF.

**22. Interest expense on financial assets in foreign currency abroad**

This item consists of interest expense in respect of securities sold in the framework of the repurchase agreements (see Note 18).

**23. Interest expense to banks and the public**

	For the year ended December 31	
	2006	2005
	(NIS million)	
<b>In local currency</b>		
On <i>makam</i> deposit	4,449	3,358
On local currency time deposits	132	342
On swaps <sup>a</sup>	-	65
Other	-	2
<b>Total in local currency</b>	<b>4,581</b>	<b>3,767</b>
<b>In foreign currency</b>		
On banks' deposits	9	14
<b>Total</b>	<b>4,590</b>	<b>3,781</b>

<sup>a</sup> In July 2005 the Bank of Israel stopped conducting auctions of NIS/US\$ swaps.



## 24. Interest expense to the government

	For the year ended December 31	
	2006	2005
	(NIS million)	
On local currency deposits <sup>a</sup>	57	4
On foreign currency deposits	318	352
<b>Total</b>	<b>375</b>	<b>356</b>
<sup>a</sup> Local currency interest expense to the government includes interest expense on the bond-price stabilization deposit and on government deposits for financing the budget. In 2006 the balance also includes interest expense related to the Israel Postal Company (see Note 10).		

## 25. Other interest expense

This item consists mainly of interest expense:

- a. To international financial institutions;
- b. On deposits of the US–Israel Binational Industrial Research and Development (BIRD) Foundation and a deposit of the US–Israel Binational Science Foundation.

## 26. Other financial income (expense) from securities and derivatives

	For the year ended December 31	
	2006	2005
	(NIS million)	
<b>Foreign currency securities<sup>a</sup></b>	<b>611</b>	<b>(234)</b>
<b>Derivative financial instruments<sup>b</sup></b>		
In foreign currency	10	23
In local currency	(50)	7
<b>Total derivative financial instruments</b>	<b>(40)</b>	<b>30</b>
<b>Total</b>	<b>571</b>	<b>(204)</b>
<sup>a</sup> Including gain (loss) from the realization of securities and from reduction in their value at the end of the year.		
<sup>b</sup> Consisting mainly of financial income (expense) from the realization of derivative financial instruments.		

## 27. Other financial income from exchange-rate differentials

This item consists of realized exchange-rate differentials in respect of balances denominated in foreign currency, principally in euro and pounds sterling. (See Notes 1.l and 1.m).



**28. Other financial income—miscellaneous<sup>a</sup>**

	For the year ended December 31	
	2006	2005
	(NIS million)	
In local currency	6	3
In foreign currency	5	29
<b>Total</b>	<b>11</b>	<b>32</b>

<sup>a</sup> Consisting mainly of income from fees and fines deriving from the Bank of Israel's financial activities.

**29. Administrative and general expenses**

	For the year ended December 31	
	2006	2005
	(NIS million)	
Staff wages and employees' rights <sup>a</sup>	554	544
General expenses	59	66
<b>Total</b>	<b>613</b>	<b>610</b>

<sup>a</sup> This item consists mostly of employees salaries (on December 31, 2006, there were 727 staff) and updated pension and vacation liabilities to the employees. (See Note 13)

**30. Other income**

This item consists of dividend income from the BIS.