EXPLANATORY REMARKS TO THE 2015 FINANCIAL STATEMENTS

1. The Principal Changes in the Financial Statements

1.1 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 BOI Law" or "the Law")—maintaining price stability and supporting financial stability and growth. The Bank's activity is not intended to yield profits. The actions taken by the Bank have significant implications for 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 inherently are not reflected in the financial statements.

1.2 The Bank's Balance Sheet

The scope of the Bank of Israel's Balance Sheet in 2015 expanded by NIS 18 billion, amounting to NIS 369 billion (an increase of about 5 percent compared to 2014). The main increase is attributed to the increase in balances of the foreign exchange reserves[1] by NIS 18.6 billion (approximately $4.5 billion) to NIS 353 billion (approximately $90.6 billion) at the end of 2015. This increase was mostly a result of foreign currency purchases by the Bank totaling approximately NIS 34 billion (approximately $9 billion), which were partly offset by the negative revaluation of the balances at year end by approximately NIS 11 billion, mainly due to the appreciation of the shekel vis-à-vis the euro which accounts for a material portion of the balances (Table 5).

Total liabilities in the Balance Sheet increased by NIS 26 billion as a result of several principal factors: (1) an increase in the net balance of monetary instruments—*makam* and time deposits—by approximately NIS 13 billion, to approximately NIS 260 billion, derived from the need to sterilize the excess liquidity injected into the markets, among other reasons due to said purchases of foreign exchange reserves; (2) an increase 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" presented under assets in the Bank›s Balance Sheet, less the balance of "Foreign currency liabilities abroad" under liabilities in the Balance Sheet. The change in the balance of "Foreign currency assets abroad" in 2015 amounted to approximately NIS 20 billion and the change in the balance of "Foreign currency liabilities abroad" in 2015 amounted to approximately NIS 2 billion.

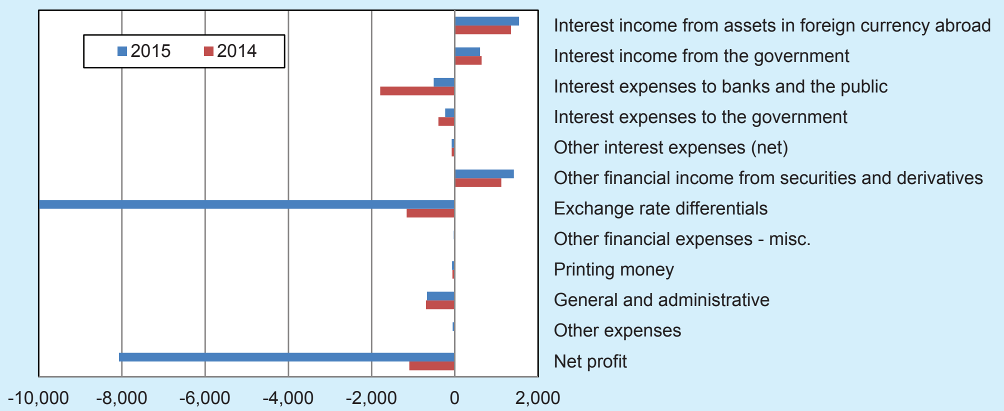
the money base in circulation, consisting of banknotes and coins in circulation and the banks' demand deposits in shekels, which amounted to approximately NIS 8 billion due to the decrease of the BOI interest rate to 0.1 percent during the year; (3) an increase in the government's deposits in the Bank by approximately NIS 7 billion.

The Bank's equity deficit in 2015 increased by about NIS 8 billion—the amount of the annual loss—with a deficit balance of NIS 56 billion at the end of the year (see Section 3.4, "Development of the Deficit in the Bank's Equity").

1.3 Statement of Operations

The loss in the current year amounted to NIS 8.1 billion, compared with a loss of approximately NIS 1.1 billion in 2014 (Figure 1).

Figure 1
The Bank's Profit and Loss Statement, 2014 and 2015 (NIS million)



SOURCE: Bank of Israel.

As indicated in Figure 1 above, the main increase in this year's loss derives from expenses in respect of exchange rate differentials, totaling approximately NIS 10 billion this year, most of which, as mentioned above, resulted from the appreciation of the shekel against the euro by about 10 percent this year. (In 2014, the accumulated exchange rate differentials were positive at approximately NIS 21 billion, the majority of which were carried to the revaluation account. The realized[2] expenses on exchange rate differentials in 2014 amounted to approximately NIS 1.2 billion, the result of a moderate appreciation of the shekel against the euro).

[2] In accordance with the Bank's accounting policy, gains derived 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. The latter 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.

In contrast, interest expenses to banks and the public decreased by approximately NIS 1.3 billion, amounting this year to approximately NIS 0.5 billion only—the outcome of the continued lowering of the Bank's interest rate.

An increase in the Bank's income from investment of the foreign exchange reserves, consisting of interest and other financial gains and excluding exchange rate differentials, from NIS 2.4 billion in 2014 to NIS 2.9 billion in 2015, also contributed about NIS 0.5 billion to reducing the loss.

One of the more prominent factors leading to the increase in income from foreign exchange reserves is the contribution of the equities component in the reserves portfolio and foreign currency derivatives.

As for unrealized gains, the effect of the changes in the asset revaluation is expressed in the revaluation accounts in the Balance Sheet, and the effect is therefore not included in the Bank's income (see Note 1 to the Financial Statements). This year, the revaluation changes were negative, resulting in a decrease of about NIS 1 billion in the price revaluation account at year end, as opposed to an increase of about NIS 1.9 billion last year.

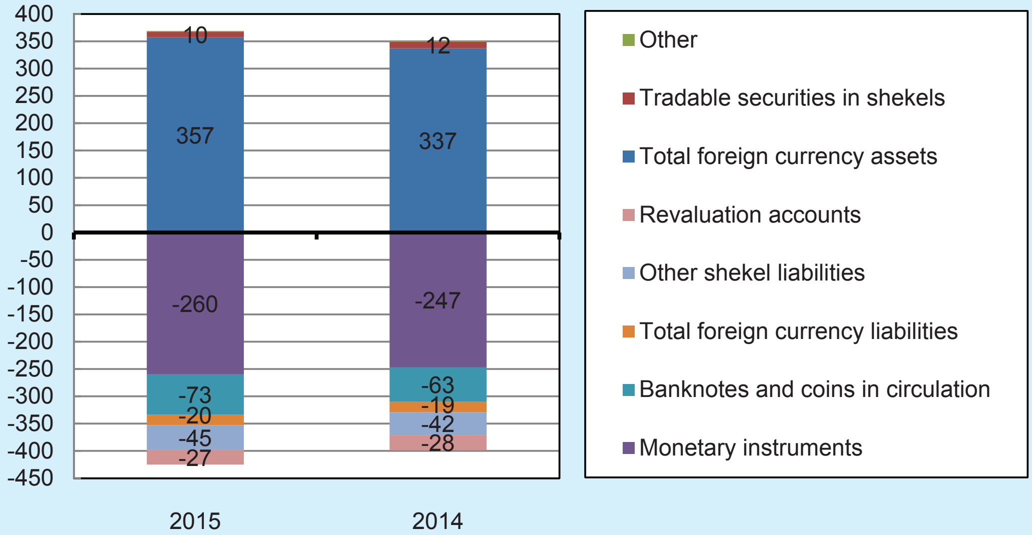
2. Analysis and Explanation of the Principal Changes in the Financial Statements

2.1 Structure of the Reports

The Bank's financial statements are characterized by considerable currency imbalance in the composition of the Bank's assets and liabilities. The vast majority of the Bank's assets are denominated in foreign currency (about 97 percent at the end of 2015), whereas the Bank's liabilities are mostly in New shekels, with foreign currency liabilities accounting for only about 5 percent of the total Balance Sheet (Figure 2).

Purchases of foreign currency in 2008–15 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. This increase in the Bank's Balance Sheet enhances the risk of a decline in the Bank's profits given a negative gap between the yield on the reserves and the expenses in respect of the monetary instruments which now address a larger base. Nevertheless, despite the Bank's foreign exchange purchases, this gap was markedly narrowed in recent years, and in the last two years the trend was reversed, whereby gains on the foreign exchange reserves have exceeded the expenses in respect of the monetary instruments.

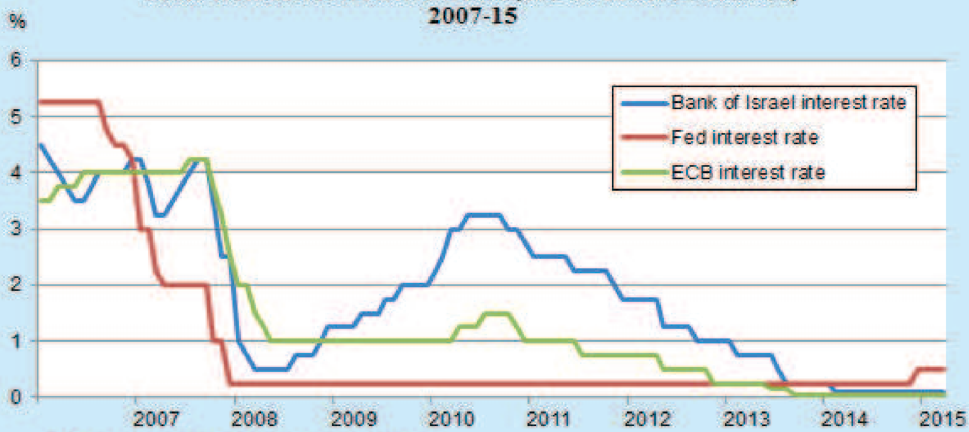
Figure 2
The Bank's Assets and Liabilities, 2014 and 2015 (NIS billion)



SOURCE: Bank of Israel.

The main reason for the reversal is the reduction of the interest rate gaps between Israel and the markets in which the reserves are invested. The interest rate gap between Israel and the United States, which in the late 1990s was in excess of 8 percent, declined significantly, and became positive toward the end of 2015 with the increase of the federal funds rate (Figure 3).

Figure 3
Short-term Interest Rates in Israel, the US and the Eurozone, 2007-15



* Year numbers on the X-axis indicate year-end.

SOURCE: Bank of Israel calculations.

The reduction of the gap was also supported by the sharp drop in yields and the gains from investments in equities which increased the yield on the foreign exchange reserves.

Another impact of foreign currency purchases derives from 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 operates on a higher extent of reserves and therefore might enhance the volatility in the Bank's gains (losses) from this component.

Contrary to the trend of narrowing the gap between the gains on foreign exchange reserves and the cost of monetary instruments, the increased risk of exchange rate losses due to sharp appreciation is the main factor in the Bank's losses and accumulated deficit—a deficit that at the end of 2015 amounted to approximately NIS 56 billion (see more details in Section 3.4, "The Bank's Equity Deficit"). The balance of the revaluation account, which consists of unrealized gains at year end, amounted to approximately NIS 27 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 29 billion.

2.2 Effect of the Economic Environment on the Financial Statements

In 2015, the extremely low interest rate environment worldwide was sustained due to the continued trend of monetary accommodation in numerous countries. In eurozone countries and in several other countries worldwide, the interest rate was negative. Low interest rates lead to low revenue on bonds which make up the majority of the Bank's reserve portfolio.

The trends of changes in interest rates and yields, however, were uneven. In the eurozone, additional declines in yields were noted over the year, while in the US, yields increased in the fourth quarter, following the repeated deferment of the expected increase of the federal funds rate throughout the year, until it was increased by 0.25 percent in December 2015.

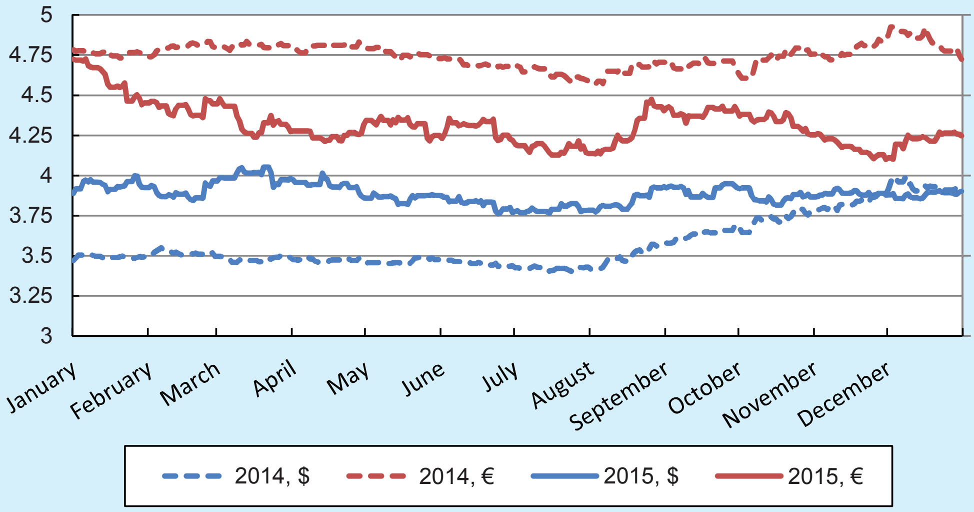
The increase in yields increases the Bank's interest income but reduces its capital gains. A decrease in yields will have the opposite effect.

This year, the shekel appreciated, mainly against the euro (Figure 4), by about 10 percent. The shekel's appreciation leads to recording exchange rate expenses, which, as noted, represented the main cause of the loss in the year.

In stock markets around the world, equity prices increased at the beginning of the year. Later, stock price volatility increased, with a tendency toward price declines. Overall, in 2015, equity investments positively contributed to the Bank's earnings.

The expansion of interest rate margins in foreign currency derivative transactions made these instruments more attractive, allowing growth in their scope and interest income therefrom.

Figure 4
Development of the NIS/$ and NIS/€ Exchange Rates, 2014 and 2015



SOURCE: Bank of Israel.

In Israel, as well, monetary accommodation continued this year with the Bank's interest rate for March reduced to an all-time low of 0.1 percent, in keeping with the reductions that began in late 2011, which contributed markedly to reducing the Bank's expenses in respect of the monetary aggregate. The inflation rate in Israel was negative 1 percent for the year, similar to the global trend of low, and even negative, inflation rates. The decrease was expressed in the decrease in the indexation component in the balance of the Bank's tradable securities in shekels.

2.3 Composition of the Balance Sheet

For the purpose of the economic analysis of the abovementioned changes, the Bank's Financial Statements are presented in Table 1 below in a different manner than in the Financial Statements for accounting purposes. The presentation herein is of the net balances in the Balance Sheet and the net operating results in the Statement of Operations in keeping with the Bank's functions.

Following is an analysis of Financial Statements data, in accordance with economic aggregates and the Bank's functions, in terms of 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	
	2015	2014	2015	2014
	Balances		Income (expenses)	
	NIS million			
Net assets				
Foreign exchange reserves[a]	353,423	334,848	2,924	2,435
Securities portfolio in shekels	10,092	11,968	529	564
Total	**363,515**	**346,816**	**3,453**	**2,999**
Net liabilities and equity				
Monetary aggregate[b]	259,934	247,061	(510)	(1,793)
Monetary base[c]	99,711	91,284	(69)	(55)
Government balances[d]	22,412	15,519	(157)	(320)
Deposits of banking corporations in foreign currency	1,136	3,261	-	-
Other[e]	9,751	*(10,025	(802)	*((770)
Revaluation accounts[f]	26,710	*(27,734	(9,986)	(1,158)
Bank's equity	(56,139)	*(48,068)	-	-
Total	**363,515**	***(346,816)**	**(11,524)**	***(4,096)**
Net loss			**(8,071)**	***(1,097)**

[a] Foreign exchange reserves consist of total "Foreign currency assets abroad" under assets in the Bank's Balance Sheet less total "Foreign currency liabilities abroad" under liabilities in the Balance Sheet.
[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 gain (loss) in respect of this item consists of the exchange rate differentials on foreign exchange reserves. See Notes 1.f and 1.n. Capital gains are presented in accordance with the item from which they were generated.
*) Restated.

3. Select Items

3.1 Foreign Exchange Reserves[3]

One of the Bank's functions according to the Bank of Israel Law, 5770–2010, is to hold and manage the State's foreign exchange reserves.[4] In accordance with the BOI Law, the Monetary Committee has various authorities pertaining to the management of the reserves, and the Monetary Committee outlines the reserves' investment policy guidelines.

3.1.1 Changes in Reserves

The foreign exchange reserves account for the bulk of the Bank's assets, making up about 97 percent of the Bank's total Balance Sheet at the end of 2015. The reserves increased in 2015 by about NIS 18.6 billion (approximately $4.5 billion), reaching approximately NIS 353 billion (about $90.6 billion) at the end of 2015.

The main increase in reserves stems from foreign currency purchases, totaling approximately NIS 34 billion (about $9 billion) by the Bank (Table 2). About two-thirds of the purchases were made within the framework of the Bank's intervention in order to moderate exchange rate fluctuations that are not in line with fundamental economic conditions. The remaining third was purchased in the context of the program intended to offset the effects of natural gas production on the current account.

Interest income and capital gains from foreign exchange reserves, excluding exchange rate differentials, contributed approximately NIS 2.9 billion to the increase in reserves (as detailed below) against a negative revaluation of the reserves that decreased them by approximately NIS 11 billion. The majority of this amount arises from negative exchange rate differentials accrued on the reserves due to the appreciation of the shekel vis-à-vis the euro by about 10 percent this year.

Government and private sector transfers to abroad (net) totaled approximately NIS 7 billion (approximately $1.8 billion) in 2015.

[3] See details in the 2015 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.

[4] Foreign exchange reserves are comprised of the balance of "Foreign currency assets abroad" less the balance of "Foreign currency liabilities abroad" in the Bank's Balance Sheet (see Note 2). These balances are used to determine the Bank's investment policy and its reporting to various entities, and therefore form the basis for the analysis of trends in these explanatory remarks.

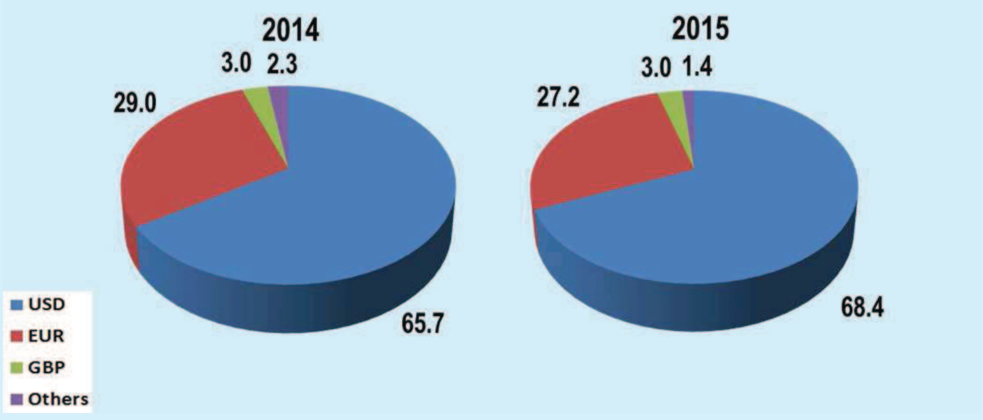
Table 2
Contribution to Foreign Exchange Reserves, by Sector

	2015	2014	2015	2014
	NIS million		USD million	
Change in foreign exchange reserves	**18,575**	**50,957**	**4,474**	**4,311**
Bank of Israel				
Purchases	33,842	24,632	8,770	7,000
Profits	2,924	2,435	748	674
Revaluation and other[a]	-11,153	23,921	-3,218	-3,362
Total Bank of Israel	**25,613**	**50,988**	**6,300**	**4,312**
The government[b]	**-5,056**	**-1,059**	**-1,310**	**-234**
The private sector[c]	**-1,982**	**1,028**	**-516**	**233**

[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 currency composition of the reserves in 2015 was principally similar to that of 2014 (Figure 5): The share of the main currencies in the portfolio—the US dollar, the euro and the pound sterling—remained similar. Nevertheless, the share of the other currencies in the reserves portfolio was reduced (from 2.3 percent in 2014 to 1.4 percent in 2015).

Figure 5
Currency Distribution of the Reserves Portfolio, 2015 and 2014
(percent, by end of year NIS)



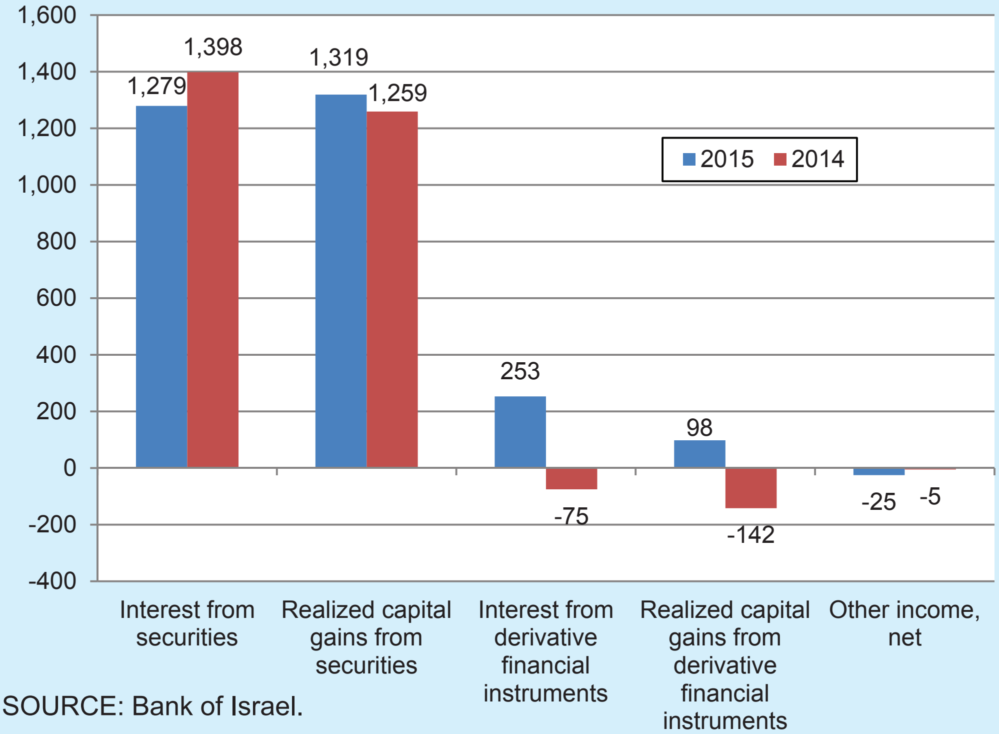
SOURCE: Bank of Israel .

This year, the share of investment in equities was increased, and was diversified into other stock markets. The share of investments in corporate bonds was also increased.

3.1.2 Rate of Return on the Foreign Exchange Reserves

The income from interest and capital gains[5,6] in respect of foreign exchange reserves, excluding exchange rate differentials, amounted to approximately NIS 2.9 billion in 2015, an increase of NIS 0.5 billion compared with 2014 (Table 3). Of this amount, interest income totaled approximately NIS 1.5 billion and capital gains and other income amounted to approximately NIS 1.4 billion (in 2014—NIS 1.3 billion and NIS 1.1 billion, respectively). Figure 6 presents the composition of gains based on the type and source of income.

Figure 6
Composition of Realized Gains from Foreign Exchange Reserves, 2015 and 2014 (NIS million)



SOURCE: Bank of Israel.

In 2015, derivative financial instruments made a positive contribution to gains from foreign exchange reserves. Interest income from derivative financial instruments stems from foreign-currency derivative gains of approximately NIS 253 million, which reflected

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

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

attractive interest margins in these transactions during the year, and their volume increased.

Capital gains from foreign currency derivatives, totaling NIS 98 million, result from stock market index futures which, similar to equities, yielded a positive return this year.

Income from securities, interest and capital gains in 2015 was similar in scope to 2014. There were notable gains from the realization of equity investments, which were somewhat offset by the decrease in gains from bonds due to this year's low yield and interest rate environment.

The opposite trend was noted in the fair value revaluation component of the assets at year end, which is not realized and is not included in the Bank's earnings (Table 3). The change in the revaluation account balance due to the price differentials, reflecting changes in the prices of assets held by the Bank, was expressed in a decrease of NIS 968 million in revaluation in 2015, as opposed to an increase of NIS 1,918 million last year. The decrease in the revaluation account balances in the current year derives mostly from a more moderate increase in stock prices this year and partially from declines in bond prices due to the raising of the dollar interest rate toward the end of the year.

From an overall perspective of realized and unrealized gains from foreign exchange reserves, excluding exchange rate differentials, income declined by approximately NIS 2.4 billion, reflected in a decline in the interest yield and capital gains to 0.65 percent this year, compared with 1.29 percent in 2014 (Table 3).

Table 3 indicates that this yield is the lowest it has been in recent years, due to record low levels of yields to maturity in the countries in which the reserves are invested.

The yield on exchange rate differentials in shekel terms this year was negative at -3.12 percent and reflected the realized and unrealized negative exchange rate differentials accrued during the year.

In dollar terms as well, a similar trend of currency strengthening is evident and the overall yield in dollar terms at the end of 2015 was -2.78 percent.

Financial Statements for 2015

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

		2015	2014	2013*)
Total foreign exchange reserves:			USD million	
End of year		90,575	86,101	81,790
Annual average		87,389	85,973	78,693
Income (expenses) and exchange rate differentials - economic calculation:			NIS million	
Interest and capital gains		2,924	2,435	1,922
Unrealized price differentials[a]		(968)	1,918	2,258
Exchange rate differentials		(10,093)	22,088	(18,167)
Total		**(8,137)**	**26,441**	**(13,987)**
Income (expenses) and exchange rate differentials- economic calculation:			USD million	
Interest and capital gains		748	674	537
Unrealized price differentials[a]		(253)	386	674
Exchange rate differentials		(2,943)	(3,726)	667
Total		**(2,448)**	**(2,666)**	**1,878**
Rates of return[b]:			Percent	
In shekel terms				
	Interest and capital gains	0.65	1.29	1.56
	Exchange rate differentials	(3.12)	7.42	(6.28)
	Total	**(2.47)**	**8.71**	**(4.72)**
In dollar terms				
	Interest and capital gains	0.65	1.29	1.56
	Exchange rate differentials	(3.43)	(4.25)	0.88
	Total	**(2.78)**	**(2.96)**	**2.44**
In numeraire terms of foreign exchange reserves		**0.64**	**1.28**	**0.87**

[a] Unrealized price differentials express the annual change in the revaluation account of foreign currency tradable securities (see Note 15 to the financial statements).
[b] 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.
* Restated.

3.2 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.

Effective from 2015, this item also includes a revaluation account arising from changes in actuarial assumptions underlying the calculation of the pension allowance, see details in Section 3.2.4 below.

3.2.1 Revaluation Account of Balances Denominated in Foreign Currency

The balance of the revaluation account of balances denominated in foreign currency (in respect of exchange rate differentials) at year end amounted to approximately NIS 23 billion, similar to its level in 2014 (approximately NIS 22.7 billion).

In 2015, negative exchange rate differentials were accrued in respect of the adjustment of the balances denominated in foreign currency to the representative exchange rates, totaling approximately NIS 9.6 billion. This was a result of the appreciation of the shekel in relation to the major currencies in the foreign exchange reserves portfolio, mainly against the euro (Table 4). At the end of the year a negative revaluation balance was obtained in the euro and in several other currencies in the reserves portfolio, which depreciated. In line with the Bank's accounting policies, these losses are carried to the Statement of Operations, where losses totaling approximately NIS 10 billion from exchange rate differentials were therefore recorded. The remaining income/amount of NIS 0.3 billion was carried to the revaluation account.

The opposite trend was recorded in 2014, in which gains from exchange rate differentials totaling approximately NIS 21 billion were accrued, mainly as a result of the strengthening of the US dollar, the pound sterling and other currencies in relation to the shekel. Most of these exchange rate differentials were carried to the revaluation account. Realized losses from exchange rate differentials in 2014 amounted to approximately NIS 1.2 billion, also resulting from a decline of about 1.2 percent in the euro's exchange rate against the shekel, although the decline was much more moderate than in 2015.

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

	2015	2014
	NIS million	
Assets		
Foreign currency balances	(10,093)	22,088
Credit to the government—binational foundations	-	14
Liabilities		
Government deposits	230	(662)
Foreign currency deposits of banking corporations	21	(131)
International financial institutions	201	(247)
Binational foundation deposits	-	(14)
Total	**(9,641)**	**21,048**
Realized exchange rate differentials	(9,986)	(1,158)
Unrealized exchange rate differentials	345	22,206

3.2.2 Revaluation Account of Tradable Securities in Foreign Currency

The balance of the revaluation account of tradable securities in foreign currency at the end of 2015 was approximately NIS 4.4 billion, compared with approximately NIS 5.4 billion in 2014. The decrease of approximately NIS 1 billion arises mainly from the decrease in the revaluation account in respect of investment in equities due to the price declines in global stock markets toward the end of 2015 and, to a lesser extent, the decline in bond prices due to the raising of the US federal funds rate by 0.25 percent at year end.

3.2.3 Revaluation Account of Tradable Securities in Local Currency

The balance of the revaluation account of tradable securities in local currency at the end of 2015 was approximately NIS 1.2 billion, a decrease of approximately NIS 420 million compared with 2014. The decrease is mostly due to the reduced scope of the portfolio due to redemptions, and due to the decline in the CPI-indexation component of the revaluation account following the decrease in Israel's CPI in the current year.

3.2.4 Revaluation Account of Changes in Actuarial Assumptions for Computing Pension Accruals

In 2015, the Bank modified the accounting policy underlying the recognition and calculation of the pension and severance liability.

Until 2014, the Bank's actuarial obligation was calculated based on a fixed discount rate of 4 percent in accordance with the public reporting directives previously issued by the Supervisor of Banks. These directives were repealed and superseded by new guidelines. Accordingly, the Bank studied the issue and decided to change the calculation method to one that uses a discount rate based on the government-interest yield curve.[7] In its financial statements for 2015, the Bank adopted this policy retroactively. The effect on the balance of the obligation for 2014 is an increase in pension and severance pay accruals of approximately NIS 1.7 billion (see Note 1v to the Financial Statements).

The Bank concurrently modified the accounting treatment of pension accruals and adapted it to generally accepted accounting principles for central banks worldwide. In the past, the increase in the balance of accrued payroll and employee benefits was entirely recorded in general and administrative expenses.

According to the new policy, changes in the accrual arising from changes in actuarial assumptions[8] are carried to the revaluation account in the Bank's Balance Sheet. Other changes are carried to the Statement of Operations. As opposed to the other revaluation accounts mentioned above, this account may have a debit balance recorded at year end.

This change was also adopted retroactively and its effect on the balance of the revaluation accounts in 2014 is a decrease in the revaluation balance of approximately NIS 2 billion. The effect on the Bank's retained earnings in 2014 is an increase of approximately NIS 0.3 billion.

[7] A series of yields to maturity of Israeli government bonds with different maturities.

[8] Actuarial assumptions consist of demographic assumptions on future characteristics of current and former employees such as mortality tables, early retirement rates, etc.; financial assumptions such as discount interest rate, and deviation of the reporting period's experience from the former period's assumptions.

3.3 The Monetary Base and Aggregate of Monetary Instruments[9]

In 2015, the monetary base, which is comprised of the total banknotes and coins in circulation and the demand deposits of the commercial banks in the Bank[10], increased by approximately NIS 8.4 billion, further to the growth of NIS 11.7 billion recorded in 2014. The monetary base is determined according to the liquidity demand at the Bank's given interest rate. In 2015, the monetary base increased, among other reasons due to the Bank's repeated lowering of the interest rate in recent years.

The monetary base is affected both by factors which are not under the control of the Bank, such as government accounts[11], and by factors which are controlled by the Bank, such as purchases of foreign currency and bonds with the aim of achieving the various objectives of 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[12], in accordance with their liquidity needs.

In 2015, the Bank made the largest injection to the monetary base, totaling approximately NIS 34 billion, as a result of the Bank's intervention in the forex market (Table 5). The Bank absorbed the excess liquidity and offset the effects of its transactions on the monetary base to avoid the pressure of short-term interest being lowered to a lower level than that determined by the Bank. The main absorption was carried out through an increase in the banks' term deposits, reflected in an increase of approximately NIS 27 billion in their balance in 2015. The balance of makam decreased by approximately NIS 14 billion and consequently, the balance of the monetary aggregate increased by approximately NIS 13 billion.

Despite the increase in the balance of monetary instruments, as described above, the interest expenses in respect thereof ("Interest expenses to banks and the public") were reduced in the current year to about NIS 0.5 billion, less than one-third of their balance in the previous year (approximately NIS 1.8 billion) due to the reduction of the interest rate for March 2015 to a record low of 0.1 percent.

9 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 2015 and 2014 was zero.
10 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.
11 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).
12 Since they are not recognized for the purpose of compliance with the reserve requirement.

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				
2010	11,509	1,418	(32,962)	43,752	(699)
2011	6,078	(2,142)	(7,494)	16,170	(456)
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**

[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 are defined through the end of 2012 as public sector injections (in column 2). Foreign currency domestic receipts and payments by the Bank of Israel and the government to the private sector, such as income tax receipts in foreign currency, do not change the monetary base as they are transferred directly from the private sector to the government; they are defined as government absorption, yet at the same time they are defined as the private sector contribution to the foreign exchange reserves.

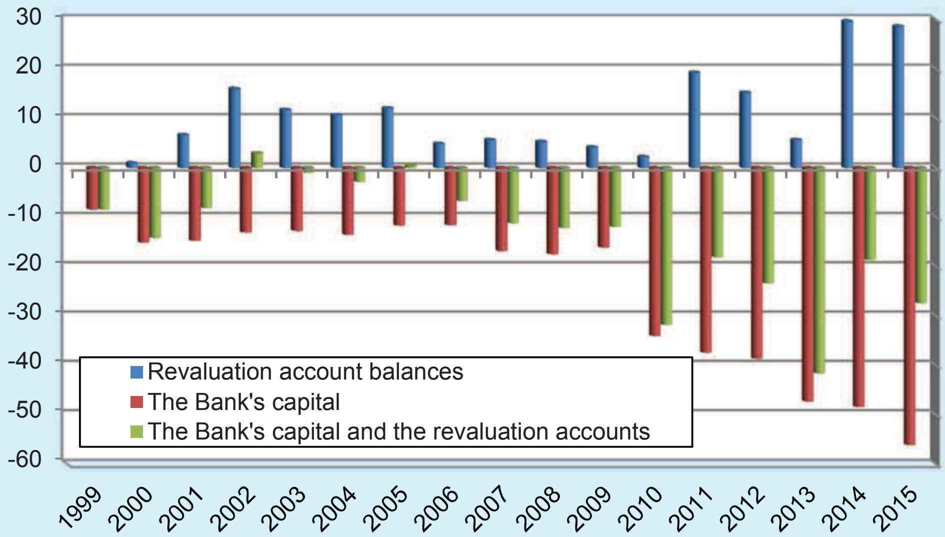
3.4 The Bank's Equity Deficit

Development of the Deficit in the Bank's Equity

At the end of 2015, the Bank has an equity deficit of approximately NIS 56 billion. The balance of revaluation accounts as of that date amounts to NIS 27 billion. Therefore, the Bank's overall equity balance, with the addition of revaluation accounts, amounts to only NIS 29 billion. Figure 7 demonstrates the development of the Bank's deficit simultaneously with the development of the balance of revaluation accounts and the overall underlying trend.

The Bank's equity deficit was initially sustained in 1999, after the Bank in 1998 had transferred to the government about NIS 9 billion in unrealized gains, the vast majority of which were from exchange rate differentials created by the shekel's depreciation against the dollar. The Bank ultimately recorded losses of NIS 8.8 billion in 1999, which partly offset the gains from exchange rate differentials recorded in the previous year. These losses represented the beginning of a deficit in the Bank's Balance Sheets which has continued to date.[13] The main component contributing to the Bank's deficit are losses on exchange rate differentials in an aggregate of NIS 42 billion during said years. The gains from foreign exchange reserves in those years amounted to NIS 67 billion, whereas expenses involving the use of monetary instruments amounted to NIS 76 billion, bringing the gap between the gains from foreign exchange reserves and expenses on monetary instruments, excluding the losses on exchange rate differentials, to approximately only NIS 9 billion.[14]

Figure 7
The Bank's Capital and the Revaluation Accounts, 1999–2015 (NIS billion)



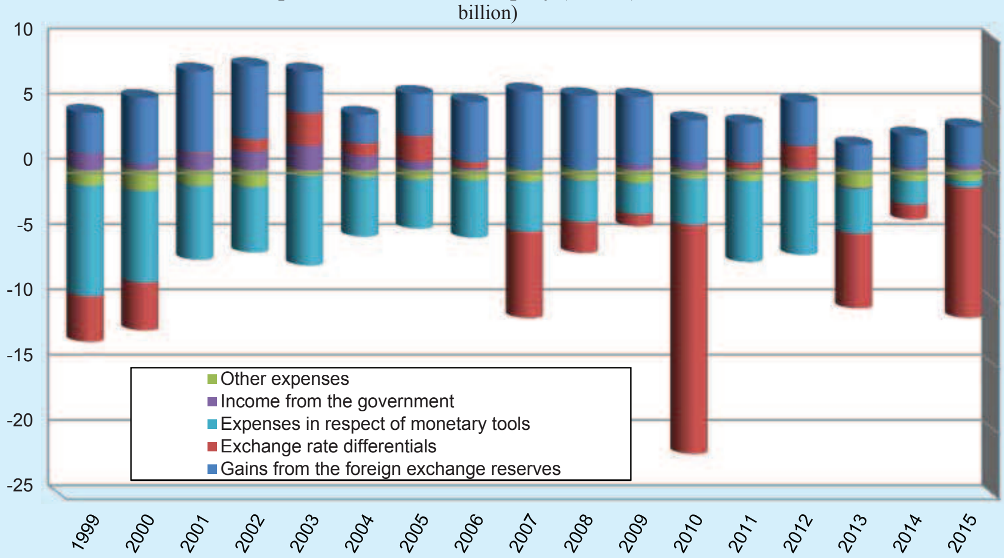
SOURCE: Bank of Israel.

"Other expenses", mainly comprised of various interest expenses, general and administrative expenses and banknote printing expenses, contributed approximately NIS 15 billion to the deficit. The government's income (bonds and deposits) mitigated the accumulated deficit by approximately NIS 10 billion. Figure 8 presents the development of the principal loss components of the deficit on an annual basis, from 1999 when the deficit was first created.

[13] In 2000, the Bank revised the method of recognizing its profit and loss by adding the use of revaluation accounts, which include unrealized gains. This method of recognition is likely to prevent the recurrence of the transfer of paper profits in the years in which the shekel depreciates sharply.

[14] The calculation mentioned here includes realized gains only. When taking into account the unrealized price revaluation differentials, the gap is reduced to NIS 5 billion.

Figure 8
Main Components of the Bank's Equity (Deficit) , 1999–2015 (NIS billion)



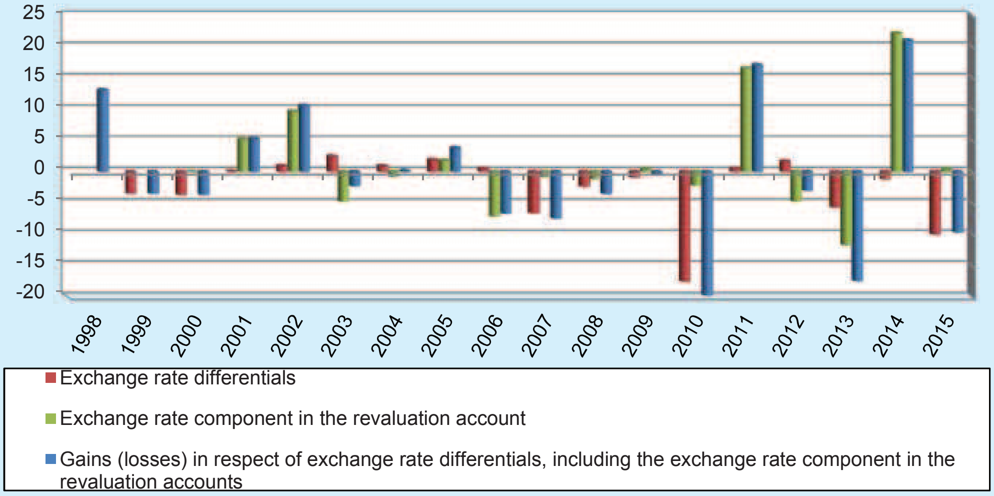
SOURCE: Bank of Israel.

It is evident that the difference between the component of gains on foreign exchange reserves and the cost of monetary instruments in the last two years was positive despite the growth in the portfolio's scope. The reason for this is the decrease in interest rate gaps between the Israeli market and the markets in which the reserves are invested; this until the trend is reversed and a positive interest rate gap is created for some of the currencies as a result of the accommodative monetary policy and the lowering of interest rates in numerous countries. The Bank's growing exposure to equities, whose expected return is higher, also contributed to reducing this gap.

In contrast, the effect of exchange rate differentials is highly volatile and large, and due to the appreciation of the shekel in 2015, it continued to contribute to increasing the Bank's deficit (Figure 9).

Figure 9

Gains (Losses) in Respect of Exchange Rate Differentials, Including the Change in the Revaluation Accounts, 1998–2015 (NIS billion)



SOURCE: Bank of Israel.