Bank of Israel

Accounting, Payment and Settlement Systems Department

FINANCIAL STATEMENTS

FOR 2016

Catalogue 601950
Typesetting and design by the Bank of Israel.
http://www.bankisrael.org.il

CONTENTS

EY
Building a better
working world

Kost Forer Gabbay & Kasierer
3 Aminadav St.
Tel-Aviv 6706703, Israel

Tel: +972-3-6232525
Fax: +972-3-5622555
ey.com

AUDITORS' REPORT

To the Governor and the Supervisory Council of the

BANK OF ISRAEL

We have audited the accompanying Balance Sheets of the Bank of Israel (hereinafter, "the Bank") as of December 31, 2016 and 2015, and the related statements of operations and changes in equity of the Bank for each of the years then ended (hereinafter, "the financial statements") featured on pages 6-33 below. These financial statements are the responsibility of the Bank's Supervisory Council, Governor, Director General and Director of the Accounting, Payment and Settlement Systems Department. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Israel, including those prescribed by the Auditors' Regulations (Auditor's Mode of Performance), 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Bank's management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2016 and 2015, and the results of its operations and changes in its equity for each of the years then ended, in conformity with accounting principles generally accepted in Israel ("Israeli GAAP"), adapted for principles applicable to central banks, as detailed in Note 1a.

Kost Forer Gabbay & Kasierer

Jerusalem
May 15, 2017

KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

Balance Sheets

(TEVET 2, 5777)

	Note	As of December 31 2016	2015
Assets			
Foreign currency assets			
Foreign currency assets abroad	2		
Demand deposits		47,267	*) 4,992
Short-term deposits		3,474	7,216
Tradable securities		325,542	336,985
Reverse repurchase agreements		194	*) 187
Derivative financial instruments		3,501	1,379
Other assets		-	118
The International Monetary Fund	3	4,505	6,372
Total foreign currency assets abroad		**384,483**	**357,249**
Other foreign currency assets			
Credit to the Government	4	127	129
Total foreign currency assets		**384,610**	**357,378**
Local currency assets			
Tradable securities	5	8,662	10,092
Other	6	76	79
Total local currency assets		**8,738**	**10,171**
Other assets			
International financial institutions	7	282	941
Fixed assets	8	393	386
Total other assets		**675**	**1,327**
Total		**394,023**	**368,876**

The accompanying notes are an integral part of the financial statements.
*) Reclassified, see Note 2.

(NIS million, reported amounts)

As of December 31

	Note	2016	2015
Liabilities and equity			
Banknotes and coins in circulation	9	**75,996**	**73,487**
Foreign currency liabilities			
Foreign currency liabilities abroad	2		
Repurchase agreements		2,079	2,335
Derivative financial instruments		204	550
Other liabilities		3,672	941
Total foreign currency liabilities abroad		**5,955**	**3,826**
Other foreign currency liabilities			
Government deposits	10	9,282	9,775
Deposits of banking corporations	11	772	1,136
The International Monetary Fund and others	12	4,697	4,914
Total other foreign currency liabilities		**14,751**	**15,825**
Total foreign currency liabilities		**20,706**	**19,651**
Local currency liabilities			
Government deposits	10	15,134	12,766
Deposits of banking corporations	11	206,503	170,224
Makam	13	104,934	115,934
Other liabilities	14	6,651	6,243
Total local currency liabilities		**333,222**	**305,167**
Total liabilities		**429,924**	**398,305**
Revaluation accounts	15	**25,564**	**26,710**
Equity			
Share capital and general reserve	16	3,985	3,985
Accumulated losses		(65,450)	(60,124)
Total equity (deficit)		**(61,465)**	**(56,139)**
Total		**394,023**	**368,876**

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

Karnit Flug — **Dr. Karnit Flug**, Governor

Uri Galili — **Uri Galili**, Chairman of the Supervisory Council

Kalo — **Hezi Kalo**, Director General

Irit Mendelson — **Irit Mendelson**, Director of the Accounting, Payment and Settlement Systems Department

Date of approval of the financial statements: May 15, 2017.

STATEMENT OF OPERATIONS

(NIS million, reported amounts)

	Note	2016	2015
		FOR THE YEAR ENDED DECEMBER 31	
Interest income			
From assets in foreign currency abroad	18	2,424	1,539
From the government	19	419	605
Other	20	1	1
Total interest income		**2,844**	**2,145**
Interest expenses			
To banks and the public	21	288	510
To the government	22	287	233
Other	23	79	78
Total interest expenses		**654**	**821**
Interest income, net		**2,190**	**1,324**
Other financial income (expenses)			
Securities and derivative financial instruments	24	622	1,417
Exchange rate differentials	25	(7,053)	(9,986)
Miscellaneous	26	(23)	(29)
Total other financial expenses		**(6,454)**	**(8,598)**
Loss from financial transactions		**(4,264)**	**(7,274)**
Expenses of printing banknotes and minting coins		**(202)**	**(70)**
General and administrative expenses	27	**(675)**	**(673)**
Other expenses	28	**(185)**	**(54)**
Loss for the year		**(5,326)**	**(8,071)**

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

STATEMENTS OF CHANGES IN EQUITY (DEFICIT)

(NIS million, reported amounts)

	Share capital and general reserve	Accumulated losses	Total deficit in equity
Balance as of January 1, 2015	3,985	(52,053)	(48,068)
Loss for the year	-	(8,071)	(8,071)
Balance as of December 31, 2015	3,985	(60,124)	(56,139)
Loss for the year	-	(5,326)	(5,326)
Balance as of December 31, 2016	**3,985**	**(65,450)**	**(61,465)**

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

NOTES TO THE FINANCIAL STATEMENTS

1. Significant accounting policies

a. General

The financial statements are prepared in accordance with generally accepted accounting principles in Israel (Israeli GAAP), 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 m below.

2) Statements of cash flows - as detailed in Section t below.

b. Definitions

In these financial statements:

1) **"The Bank"**—the Bank of Israel.

2) **"CPI"**—the Consumer Price Index as published by the Central Bureau of Statistics.

3) "**Adjusted amount**"—the historical nominal 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.

4) **"Reported amount"**—the adjusted amount at the transition date (December 31, 2003), with additional amounts in nominal values that were added after the transition date, less amounts subtracted after the transition date.

5) **"Nominal financial reporting"**—financial reporting based on reported amounts.

6) **"Fair value"**—the amount for which an asset can be acquired or sold (a liability assumed or settled) in a current transaction between independent willing parties.

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, which 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 the purchasing power of the Israeli currency. In

the financial statements for 2005, comparative figures for the year ended December 31, 2003 were recalculated on a historical-cost basis, adjusted for changes in the CPI as required by Accounting Standard No. 12, for purposes of the transition to nominal financial reporting.

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

3) Amounts of nonfinancial assets do not necessarily reflect their realizable value or current economic value, but only the reported amounts of those assets.

4) The term "cost" in these financial statements denotes the reported amount of cost.

d. Reporting principles

1) Balance Sheet:

   a. Nonfinancial items (fixed assets and investments shown at cost) are stated in reported amounts.

   b. Financial items are stated in the Balance Sheet at their nominal values at the Balance Sheet date.

   c. The Balance Sheet is presented in the format generally accepted by central banks worldwide.

2) Statement of Operations:

   a. Income and expenses originating from nonfinancial items (such as depreciation, prepaid expenses and deferred income) or from provisions included in the Balance Sheet, are derived from the movement between the reported amount of the opening balance and the reported amount of the closing balance.

   b. All other items of the Statement of Operations (such as interest income and interest expenses) are stated at their nominal values.

3) Statement of Changes in Equity:

   In accordance with Section 76 of the Bank of Israel Law, 5770–2010, within three months from the end of each year the Bank will transfer its profits to the Government according to the following provisions:

   a. If the equity amounts to 2.5 percent or more of total assets, the Government will receive an amount equal to the net income, less any accumulated losses.

   b. If the equity amounts to more than 1 percent of total assets but less than 2.5 percent of total assets, the Government will receive 50 percent of the net income, less any accumulated losses.

   c. If the equity amounts to 1 percent or less of total assets, the Government will not receive any profits.

The Bank is permitted to record capital funds arising from accounting principles, provided that the balance of net income not transferred to the Government as aforementioned is added to retained earnings and not recognized as another capital item, unless agreed upon otherwise between the Governor and the Minister of Finance.

In accordance with these provisions, as of December 31, 2015 there is no obligation to transfer funds 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 whose final effect on the financial statements cannot be determined with precision at the time the statements are prepared. 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. Revenue recognition

Income and expenditures are charged to the Statement of Operations on an accrual basis.

Realized gains or losses from foreign currency and securities in local and foreign currency are transferred to the Statement of Operations. These gains or losses are calculated on the basis of average cost of the balances of that asset.

Unrealized gains are not transferred to the Statement of Operations but rather are charged to the "Revaluation accounts" line item in the Balance Sheet.

Unrealized losses are transferred to the Statement of Operations after offsetting unrealized gains of the same asset. These losses derive from the difference between the average cost of an asset and its fair value.

Unrealized losses from foreign currency securities, from local currency securities, or a specific foreign currency are not offset against unrealized gains from other securities or foreign currencies.

Losses recognized in the Statement of Operations are not offset against unrealized gains that will accrue in the future.

g. Securities

1) Foreign currency securities

Tradable foreign currency securities are stated in the Balance Sheet at their fair value as of the Balance Sheet date. The fair value of quoted securities is based on market prices. Unquoted securities are revalued on the basis of data obtained from outside sources.

The adjusted cost of securities is their par value plus the 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.

The difference between the original cost of the securities and their par value plus interest and the unamortized balance of the premium or discount in respect of each security is charged to the Statement of Operations.

Unrealized differentials from indexation to an index published abroad which accrued on the principal and the difference between the fair value of the securities and their adjusted cost in respect of each security are charged to the ″Revaluation accounts″ line item in the Balance Sheet.

Interest income and amortization of the premium or discount are charged to the Statement of Operations on an accrual basis, and are stated in the ″Interest income from assets in foreign currency abroad″ line item.

Income from the realization of securities is stated in ″Other financial income (expenses)—Securities and derivative financial instruments″.

The balance of unrealized loss, which is calculated separately in respect of each security, is charged to the Statement of Operations at the end of the year and stated under ″Other financial income (expenses)—Securities and derivative financial instruments″.

2) Local currency securities

Tradable government securities in local currency are stated in the Balance Sheet at their fair value as of the Balance Sheet date. The difference between the original cost of securities and their par value, plus interest and the unamortized balance of the premium or discount is charged to the Statement of Operations.

Unrealized indexation differentials accrued on the principal as well as the difference between the fair value of the securities and their adjusted cost are charged to the "Revaluation accounts" line item in the Balance Sheet.

Interest income and amortization of the premium or discount are stated in the "Interest income from the Government" line item.

The balance of unrealized loss, which is calculated separately in respect of each security, is charged to the Statement of Operations at the end of the year and stated under "Other financial income (expenses) - securities and derivative financial instruments".

h. International financial institutions

1) The International Monetary Fund (IMF)

The International Monetary Fund (IMF) balances are managed in Special Drawing Rights (hereinafter, "SDR") and presented in New Shekels using the representative exchange rates published by the Bank of Israel as of the Balance Sheet date (see Notes 3 and 12 below).

2) Balances in respect of international financial institutions

The Bank of Israel's participation in other international financial institutions is presented under assets in the "International financial institutions" line item according to the cost in the currency in which the participation was paid, translated according to the exchange rate on the transaction date with the necessary reporting adjustments to reported amounts pursuant to Accounting Standard No. 12, "Halting adjustment of financial statements". Liabilities to international financial institutions are presented under liabilities in the "The International Monetary Fund and others" line item.

i. Fixed assets

1) Fixed assets are stated at cost less accumulated depreciation. Cost includes expenses directly attributable to the purchase of the asset.
2) Improvements and enhancements are charged to the cost of the assets and depreciated over their useful lives, whereas maintenance and repair expenses are charged to the Statement of Operations as incurred.
3) Depreciation is calculated by the straight-line method on the basis of the estimated useful life of the asset:
   Buildings - 50–67 years;
   Motor vehicles - 6.5 years;
   Computers - 4 years;
   Equipment - 10 years.
4) Software that is not an integral part of the related hardware is shown under fixed assets at cost and depreciated by the straight-line method over four years.

j. Banknotes and coins in circulation

Banknotes and coins in circulation that were issued by the Bank reflect the Bank's liability to their holders. This liability is shown in the Bank's Balance Sheet at face value.

k. Short-term loan

The balance of short-term loans (called makam, their Hebrew acronym) in the Balance Sheet reflects the redemption price of the loan held by the public, less the balance of unamortized discount. Makam sold by the Government to the Bank of Israel but not yet sold to the public is not included in this balance.

Makam are issued for a period of up to one year. The discount is the difference between the redemption price of the makam and the proceeds from their sale to the public.

The discount is amortized over the period from the date of issuance of the makam to its date of redemption.

Expenses for amortization of the discount on the balance of the makam held by the public are shown in the Statement of Operations in "Interest expenses to banks and the public".

l. Liabilities in respect of employee rights

All liabilities in respect of employer-employee relations have corresponding reserves in accordance with the law, relevant agreements, common practice and management's expectations.

Liabilities in respect of employee pensions and severance pay are calculated by an expert actuary using the method of estimation of cumulative benefits with probabilities taken into account on the basis of past experience. The discount rate applicable to the reserves is set in accordance with a discount rate which is based on the yield curve of government bonds in Israel, and the rate of future salary increases is estimated by management and based on past experience.

The provision for vacation pay is computed on the basis of the accrued vacation and the effective salary for vacation redemption days at October 31. The difference in the liability that derives from the accrual of vacation days between October 31 and December 31 is immaterial (see Note 14).

Employee benefits liabilities are stated under "Other liabilities" in local currency.

m. Revaluation accounts

The following are the types of revaluation accounts:

1) Revaluation accounts that include unrealized profits from exchange rate differentials on balances denominated in foreign currency and unrealized profits from indexation and the revaluation of tradable securities in local currency and foreign currency to their fair value.

   These revaluation accounts are maintained separately for each item (currency, security) and are recognized in the Statement of Operations when the item is fully or partially realized. No offsetting among different types of items is performed. Revaluation accounts in respect of certain externally managed portfolios are managed at the individual portfolio level.

Accumulated loss in the revaluation accounts relating to each item (currency, security) that originates from indexation differentials and price differentials in securities in local currency and foreign currency and exchange rate differentials on foreign exchange reserves is charged to the Statement of Operations at the end of the year (see also Section f above).

2) Revaluation accounts that consist of unrealized gains or losses deriving from changes in actuarial assumptions underlying the computation of pension accruals. Accordingly, any accumulated unrealized losses at year end will result in a negative account balance.

n. Foreign currency

Assets and liabilities denominated in or indexed to foreign currency are shown in New shekels according to the representative exchange rates published by the Bank of Israel at the Balance Sheet date.

Income and expenses in foreign currency are included in the Statement of Operations at the representative exchange rates in effect on the date of each transaction.

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

Realized gains or losses from exchange rate differentials are carried to the Statement of Operations. Unrealized exchange rate differentials are charged to revaluation accounts separately for each foreign currency.

A loss balance in the revaluation accounts at the end of the year is carried to the Statement of Operations and is not offset against future unrealized gains. Unrealized losses in one currency are not offset against unrealized gains in another currency.

Following are data on the shekel exchange rates against other key currencies:

	December 31			Rate of Change	
	2016	2015	2014	2016	2015
		(NIS)		(Percent)	
US Dollar	3.8450	3.9020	3.8890	(1.5)	0.3
Euro	4.0438	4.2468	4.7246	(4.8)	(10.1)
Pound Sterling	4.7252	5.7840	6.0636	(18.3)	(4.6)
Special Drawing Rights (SDRs)[a]	5.1689	5.4071	5.6344	(4.4)	(4.0)

[a] The SDR rate published by the IMF is determined according to a weighted basket of four currencies - the US dollar, euro, Japanese yen, and pound sterling.

o. Indexation

Assets and liabilities linked to the CPI are shown in accordance with the indexation terms determined for each balance.

Following are data on the CPI (based on the 2002 average):

		December 31			Rate of change	
		2016	2015	2014	2016	2015
		(Points)			(Percent)	
CPI	For November	122.8	123.2	124.3	(0.3)	(0.9)
	For December	122.8	123.1	124.3	(0.2)	(1.0)

p. Interest rates

Some of the local currency interest on the Government's and the banks' balances, which are collected or paid by the Bank of Israel, are based on the Bank of Israel interest rate or the prime interest rate.

Following are data on the interest rates:

	December 31			Rate of change	
	2016	2015	2014	2016	2015
	(Percent)				
Bank of Israel interest	0.10	0.10	0.25	-	(60.0)
Prime interest	1.60	1.60	1.75	-	(8.6)

q. Financial instruments

The Bank uses derivatives in its monetary policy and foreign exchange activities, both in Israel and abroad.

1) Activity in financial instruments in Israel

NIS/USD forwards

These transactions are shown net in the Balance Sheet under "Other assets" or "Other liabilities": future receipt of US dollars less future remittance of shekels. In the Statement of Operations, the results of the transactions are shown under "Interest income from assets in foreign currency abroad".

2) Activity in financial instruments abroad

a. Repurchase (Repo) and Reverse-Repurchase (R. Repo) Agreements

The Bank carries out reverse repurchase (R. Repo) agreements. These transactions are treated as a secured debt, and are included in the "Reverse repurchase agreements" item. Securities purchased within the framework of these agreements do not appear in the Balance Sheet. In the Statement of Operations, the results of these transactions are shown in the "Interest income from assets in foreign currency abroad" item.

The Bank also carries out repurchase (Repo) agreements. Such transactions are composed of the sale of securities under an agreement to purchase them in the future. The transactions are treated as a secured debt and accordingly the securities sold under its terms are not subtracted from the Bank's assets. The liability to purchase the securities is included in the "Repurchase agreements" item. In the Statement of Operations, the results of these transactions are shown in the "Interest income from assets in foreign currency abroad" item.

b. Foreign currency swaps and forwards

These transactions are included on the Balance Sheet as the sum of the differences between the foreign currency received and the foreign currency to be remitted in the future, with the addition of the balance of unamortized premium, and are shown in the "Derivative financial instruments" item. In the Statement of Operations, the results of these transactions are included in the "Interest income from assets in foreign currency abroad" item.

c. Futures

The balance of futures contracts at fair value on the date of the financial statements is shown in Note 17 - "Commitments, financial instruments and contingent liabilities". In the Statement of Operations, the change in the value of the contracts is recorded under "Other financial income (expenses)—securities and derivative financial instruments".

r. Offsetting financial balances

Financial assets and liabilities are presented on the Balance Sheet in net amount only when the Bank has a legal and enforceable offsetting right, and when it is intended to settle the asset or liability on a net basis or to realize the asset and settle the liability simultaneously.

s. Impairment of assets

The Bank applies Accounting Standard No. 15 (Revised), "Impairment of Assets" (hereinafter, "the Standard"), which establishes procedures that the Bank must apply to ensure that its assets in the Balance Sheet (to which the Standard applies) are not stated at an amount greater than the recoverable amount, i.e., the net selling price or value in use (the present value of the estimated future cash flows expected to derive from the use and realization of the asset), whichever is higher.

The Standard applies to all Balance Sheet assets, except for financial assets. The Standard also establishes presentation and disclosure rules for assets that have been impaired. Where the value of the asset in the Balance Sheet exceeds its recoverable amount, the Bank recognizes an impairment loss in the amount of the difference between the asset's book value and recoverable amount. A loss recognized in this manner is reversed 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 impairment loss was recognized.

t. Statements of cash flows

These financial statements do not include a statement of cash flows because such statement provides no significant information beyond that presented in the financial statements; this practice corresponds with the general practice among some of the central banks worldwide.

u. Taxes

According to the Bank of Israel Law, 5770–2010, regarding the payment of taxes, municipal taxes, levies and other mandatory payments, the Bank has the same status as the State of Israel.

2. Foreign currency assets and liabilities abroad

Foreign exchange reserves

As presented in the explanatory remarks, the economic analysis refers to foreign exchange reserves which consist of the balance of the ”Foreign currency assets abroad” item less the balance of the ”Foreign currency liabilities abroad” item.
The Bank’s investment policy relates to these balances.

The following is the composition of the foreign exchange reserves:

	December 31		December 31	
	2016	2015	2016	2015
	(NIS million)		(USD million)	
Foreign currency assets abroad	384,483	357,249	99,996	91,555
Less: Foreign currency liabilities abroad	(5,955)	(3,826)	(1,549)	(980)
Total foreign exchange reserves[a]	**378,528**	**353,423**	**98,447**	**90,575**

[a] Foreign exchange reserves include balances in respect of collaterals on futures presented on the assets side under "Other assets" in "Foreign currency assets abroad" and on the liabilities side under "Other liabilities" in "Foreign currency liabilities abroad".

In the comparative figures for 2015, an amount of approximately NIS 3,315 million was reclassified from "Reverse repurchase agreements" to "Demand deposits". These items are presented in the Balance Sheet under "Foreign currency assets abroad".

3. The International Monetary Fund (IMF)[a]

	December 31		December 31	
	2016	2015	2016	2015
	(NIS million)		(SDR million)	
IMF quota	9,929	5,738	1,921	1,061
Less: Liability for the quota	(9,763)	(4,218)	(1,889)	(780)
Reserve tranche	**166**	**1,520**	**32**	**281**
NAB loans	**305**	**261**	**59**	**48**
Special Drawing Rights (SDRs)	**4,034**	**4,591**	**780**	**849**
Total IMF balance	**4,505**	**6,372**	**871**	**1,178**

[a] The balances bear interest pursuant to the IMF's terms.

a. Bank of Israel participation in the IMF

Each member country of the IMF has a quota for its participation in the Fund's capital, a quota which is denominated in the SDR currency. The part of the quota that is paid in cash (the reserve tranche) is transferred to the IMF in foreign currency and may be withdrawn by the country, whereas the rest is deposited with the country's central bank in deposits and notes indexed to SDR.

In 2011, a reform was carried out in the quotas and in the IMF's voting rights. In the first stage, which came into effect in March 2011, Israel's quota was increased by about SDR 133 million to approximately SDR 1,061 million; in February 2016, the second stage was completed, in the context of which Israel's IMF quota was increased by about SDR 860 million, to about SDR 1,921 million.

Since 1999, Israel has been part of the IMF's Financial Transaction Plan. This plan is a mechanism through which an IMF member country may exchange SDRs or foreign currency against its local currency and another country is asked to perform a counter exchange. Executing transactions in the context of the Financial Transaction Plan modifies the quota composition between the Reserve Tranche and the other tranche which consists of deposits and notes placed in the central bank (liabilities for the quota).

b. NAB loans

In 2010, Israel joined the IMF's arrangement known as NAB (New Arrangements to Borrow).

In accordance with this arrangement, countries, including Israel, provide a credit line to the IMF, in the context of which loans are extended with maturities of ten years. However, the loans may be repaid to Israel at an earlier date at its request, should it need the money.

As of December 31, 2016, the Bank has provided loans that bear interest at the IMF's terms in an aggregate of NIS 305 million (SDR 59 million).

Simultaneously with the increase in Israel's IMF quota effective from February 2016, the maximum credit line that the Bank provides the IMF was reduced from SDR 500 million (NIS 2,704 million) on December 31, 2015 to SDR 340 million (NIS 1,757 million) on December 31, 2016.

c. Special Drawing Rights (SDRs)

The balance includes SDRs allocated by the IMF to Israel. Against these allocations the Bank has a liability towards the IMF with no repayment date, which is shown in liabilities under the item of "The International Monetary Fund and others". The State is not required to hold all the SDRs allocated to it.

At the end of 2009, Israel joined another IMF plan, "Voluntary Arrangement for the Purchase and Sale of SDRs". Within the framework of this plan, the State of Israel may be asked to buy or sell some SDRs from other IMF members, as instructed by the IMF. These transactions are recorded in the balance of "Special Drawing Rights (SDRs)".

Under this Arrangement, Israel’s SDR holdings may range from 50 percent up to a maximum of 145 percent of total SDRs allocated by the IMF to Israel (the IMF allocated a total of SDR 884 million). The IMF has undertaken to consult with Israel before making any purchase or sale of SDRs in the context of the plan.

4. Credit to the government

The item includes credit on account of binational foundations that was extended to the Government of Israel for investment, in conjunction with the United States government, in binational foundations involved in research, industrial development and science. The foundations deposited these sums with the Bank of Israel and they are shown in foreign currency on the Balance Sheet on the liabilities side under the item of "Other liabilities—the International Monetary Fund and others ". Both the credit and the fund deposits earn either fixed interest of 4–4.125 percent or interest on the basis of LIBOR.

5. Tradable securities in local currency

This item consists of tradable government securities in local currency, indexed to the last CPI level known on the Balance Sheet date, as well as unindexed securities. The securities are shown at fair value.

6. Other assets

	December 31	
	2016	2015
	(NIS million)	
Loans to employees	72	74
Other receivables	4	5
Total other assets	**76**	**79**

7. International financial institutions

	December 31	
	2016	2015
	(NIS million)	
Investment in BIS shares	282	282
Balance of other international financial institutions[a]	-	659
Total	**282**	**941**

[a] The balances are in respect of the following institutions:
i) The World Bank Group:
1. IBRD—International Bank for Reconstruction and Development
2. IDA—International Development Association
3. MIGA—Multilateral Investment Guarantee Agency
4. IFC—International Finance Corporation
ii) EBRD—European Bank for Reconstruction and Development
iii) IDB—Inter-American Development Bank
IIC—Inter-American Investment Corporation

In December 2016, an agreement was signed between the Bank of Israel and the Government of Israel for assigning the State's representation from the Bank of Israel to the Government in the following international institutions: the World Bank Group, the Inter-American Development Bank Group and the European Bank for Reconstruction and Development. As part of the agreement, the Government paid the Bank the fair value of the shares that had been purchased by the Bank in these institutions. The Government also undertook to bear all the payments and obligations in connection with the State's membership in these institutions, including any borne or undertaken by the Bank of Israel.
When investing in international financial institutions, the Bank is generally required to assume additional undertakings toward these institutions beyond the actual callable capital, which may be exercised by the institutions only in times of need, a scenario which is relatively unlikely.
The balance of the above undertakings as of December 31, 2016 was NIS 4,342 million (December 31, 2015 - NIS 4,346 million).
As of the date of publication of these financial statements, the assignment of the liability for the additional obligations to the financial institutions discussed above has not yet been settled and the Bank and the Government are taking steps towards its settlement.

8. Fixed assets

	Land and buildings[a]	Equipment and furniture, computers, software and vehicles	Total
		(NIS million)	
Cost			
Balance as of January 1, 2016	281	365	646
Additions	24	36	60
Disposals	-	(1)	(1)
Balance as of December 31, 2016	**305**	**400**	**705**
Accumulated depreciation			
Balance as of January 1, 2016	56	204	260
Additions	12	41	53
Disposals[b]	-	(1)	(1)
Balance as of December 31, 2016	**68**	**244**	**312**
Depreciated balance as of December 31, 2016	**237**	**156**	**393**
Depreciated balance as of December 31, 2015	**225**	**161**	**386**

[a] The Bank's property in Jerusalem, the cost of which, including the depreciated cost of the structures thereon, amounts to approximately NIS 211 million as of December 31, 2016 (approximately NIS 192 million as of December 31, 2015), is leased from the Israel Land Authority (ILA) through June 30, 2016. As of the date of publication of the financial statements, the Bank is negotiating the extension of the lease agreement with the ILA.

9. Banknotes and coins in circulation

	December 31, 2016		December 31, 2015	
	Quantity	NIS	Quantity	NIS
	(million)		(million)	
Banknotes and coins in circulation				
NIS 20	39.54	791	37.28	746
NIS 50	60.62	3,031	59.72	2,986
NIS 100	168.59	16,859	164.89	16,489
NIS 200	265.60	53,120	255.94	51,189
Coins in circulation		2,188		2,070
Other[a]		2		2
Commemorative banknotes and coins		5		5
Total		**75,996**		**73,487**

[a] The balance consists mainly of special coin items in circulation.

10. Government deposits

Government balances consist of balances in local currency and balances in foreign currency. All the government balances in the Bank of Israel (excluding several extraordinary balances) can be offset against each other.

	December 31		December 31	
	2016	2015	2016	2015
	(NIS million)		(USD million)	
In foreign currency[a]				
Current deposits	8,506	9,040	2,212	2,317
Other deposits	776	735	202	188
Total deposits in foreign currency	**9,282**	**9,775**	**2,414**	**2,505**
In local currency[b]				
Current deposits	15,134	12,766		
Total government deposits	**24,416**	**22,541**		

[a] **Government deposits in foreign currency**
The current deposits are used for financing budgetary activity. Some foreign currency government deposits bear interest at the rate paid on US Treasury bills with an average of six months to maturity. The average interest rate in 2016 was 0.42 percent (2015—0.14 percent).

[b] **Government deposits in local currency**
The current deposits and the balances used for bond lending are designated for financing budgetary activity. Local currency current deposits bear (when in debit) or are paid (when in credit) interest at the Prime rate. The average Prime rate in 2016 was 1.6 percent (in 2015—1.62 percent), other than on the government balances used for bond lending and other government balances for which a different interest rate is collected.

11. Deposits of banking corporations

	December 31		December 31	
	2016	2015	2016	2015
	(NIS million)		(USD million)	
Deposits in foreign currency[a] (*Pamach*)	**772**	**1,136**	**201**	**291**
Deposits in local currency[b]				
Time deposits	172,001	144,000		
Demand deposits	34,502	26,224		
Total deposits in local currency	**206,503**	**170,224**		
Total deposits of banking corporations	**207,275**	**171,360**		

[a] **Deposits in foreign currency**
Foreign currency demand deposits (known by their Hebrew acronym, Pamach) serve as a liquid asset against nonresidents' foreign currency deposits. The reserve requirement ranges from 0 to 6 percent, depending on the term of the deposit.

[b] **Deposits in local currency**

1. The Bank of Israel receives time deposits in New Shekels from the banking corporations. The deposits are allocated by auction for terms of one day, one week and one month. The deposits are not considered liquid assets with regard to the banking corporations' reserve requirements. In addition, deposits are received at the (overnight) deposit window available to the banking corporations at an interest rate of 0.1 percentage points below the Bank of Israel interest rate.
   The interest rate for deposits at the window on December 31, 2016 was 0 percent (on December 31, 2015 - 0 percent).
   The average interest rate for deposits at the window in 2016 was 0 percent (in 2015 - 0 percent).
   The average interest rate for time deposits by auction on December 31, 2016 was 0.10 percent (on December 31, 2015 - 0.1 percent).
   The average interest rate for time deposits by auction in 2016 was 0.1 percent (in 2015 - 0.12 percent).
   The average interest rate for time deposits by auction in 2015 was 0.12 percent (in 2014 - 0.59 percent).
2. The banking corporations' local currency demand deposits serve as a liquid asset against deposits in Israeli currency and Israeli residents' deposits in foreign currency. The reserve requirement ranges from 0–6 percent, depending on the term of the deposit.

12. The International Monetary Fund and others

	December 31	
	2016	2015
	(NIS million)	
Allocated Special Drawing Rights[a]	4,568	4,777
Other[b]	129	*) 137
Total	**4,697**	**4,914**

[a] Special Drawing Rights (SDRs) are sums of money that member countries in the IMF undertook to purchase from the Fund. No repayment date has been set for this liability and it bears interest according to the IMF's terms. The IMF allocates SDRs to its constituent countries commensurate with the size of their quotas.
As of December 31, 2016, Israel has been allocated approximately SDR 884 million.
[b] The item mainly includes liabilities to binational foundations.
*) Reclassified.

13. *Makam*

	December 31	
	2016	2015
	(NIS million)	
Redemption value of short-term loans sold to the public	104,999	116,000
Less: Discount at time of sale to the public	(138)	(161)
Proceeds from sale of *makam* to the public	**104,861**	**115,839**
Plus amortization of discount difference for the period through the Balance Sheet date	73	95
Total balance of *makam*	**104,934**	**115,934**

The Short-Term Loan Law, 5744–1984, authorizes the government to issue short-term bills to be sold only to the Bank of Israel, with the Bank selling them to, and buying them from, the public in order to carry out its functions. The government must deposit all proceeds from sales of these bills with the Bank of Israel and may not use them for any purpose other than repayment of the loan taken under said Law, or payment of the yield thereon. The purchase of bills from the government by the Bank of Israel and the deposit of the proceeds from this purchase with 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 unamortized discount.

14. Other liabilities

	December 31	
	2016	2015
	(NIS million)	
Pension and severance pay liabilities	6,040	5,982
Liability for employees' and other rights	181	187
Other payables[a]	430	74
Total other liabilities	**6,651**	**6,243**

[a] The balance mainly comprises accounts of statutory bodies that are managed at the Bank of Israel.

a. Pension and severance pay liabilities

The pension liability is calculated according to the pension agreements with the Bank's employees and pensioners who commenced their employment before September 2002 and their survivors (on December 31, 2016 - 248 employees and 854 pensioners and survivors; on December 31, 2015 - 271 employees and 842 pensioners and survivors). The pension liability includes future payment of benefits for Bank employees, former Bank employees whose pensions have been frozen, retirees, and survivors. It also includes obligations on account of the cash value of unused sick leave upon retirement and retirement grants.

The Bank's liability is calculated on the basis of salary and pension data for December 2016 and actuarial calculations. The calculation was performed using a method of estimating benefits which are accrued under various parameters: early retirement rates, pension rates for surviving spouses and orphans, employees' seniority and grade, relevant tax rates, etc.

The actuarial calculation is based on foreseen changes in white-collar mortality rates as well as other demographic tables, in accordance with pension circular 2013-3-1 published by the Capital Market, Insurance, and Savings Division of the Ministry of Finance regarding the preparation of actuarial calculations. The calculation assumes a real annual employee salary increase of 1.5 percent or 3 percent based on the employee's age.

For Bank employees who commenced their employment after September 2002, the Bank's liability for pension and severance pay is covered by regular deposits to a recognized pension and severance pay fund on behalf of the individual employee. Since sums deposited in said manner are neither controlled nor managed by the Bank, neither they nor the liabilities against which they were deposited are recorded in the Balance Sheet.

b. Liability for employees' and other rights

This item includes a liability for employees' vacation pay of approximately NIS 116 million (in 2015—approximately NIS 111 million). The liability at December 31 is calculated on the basis of the accrued vacation days due and the effective salary for vacation redemption at October 31. The difference in the liability that derives from the accrual of vacation days between October 31 and December 31 is immaterial.

15. Revaluation accounts

Revaluation accounts include unrealized profits from the revaluation of the following items (see Notes 1g, 1m and 1n above):

	December 31	
	2016	2015
	(NIS million)	
Balances denominated in foreign currency	19,559	23,025
Tradable securities in foreign currency	7,127	4,393
Tradable securities in local currency	949	1,231
Changes in actuarial assumptions for computing pension accruals	(2,071)	(1,939)
Total revaluation accounts	**25,564**	**26,710**

16. Share capital and general reserve in historical nominal values

Data on the Bank's share capital and general reserve appear in the financial statements in reported amounts (see Note 1c above).

The data in historical nominal values are: NIS 60 million in share capital and NIS 260 million in the general reserve at December 31, 2016 and 2015.

The general reserve served in the past to increase the Bank's capital in accordance with Section 6 of the Bank of Israel Law, 5714-1954.

17. Commitments, financial instruments and contingent liabilities

	December 31	
	2016	2015
	(NIS million)	
a. Commitments (off-Balance Sheet)		
Guarantees for government exports	-	4
Documentary credit	41	42
b. Financial instruments		
Currency swaps and forwards:		
Fair value	3,283	730
Future receipts of foreign currency	90,230	86,043
Future payments of foreign currency	86,501	84,950
Stock index futures - fair value:		
Purchase obligation in dollars	-	4
Purchase obligation in euros	-	35
Sale obligation in dollars	9	-
Sale obligation in euros	(13)	-
Interest rate futures - fair value:		
Sale obligation in dollars	-	24
Bond futures - fair value:		
Sale obligation in dollars	16	-
Purchase obligation in dollars	(8)	-
c. Contingent liabilities		

There are several claims pending against the Bank of Israel. However, no provision has been recorded in the Bank's books in respect of these claims as it is the Bank's opinion, based on the opinion of its Legal Department, that the probability of these claims being upheld is low, or that the sums involved are not significant.

18. Interest income (expenses) from assets in foreign currency abroad

	For the year ended December 31	
	2016	2015
	(NIS million)	
Demand deposits	(24)	5
Short-term deposits	(33)	2
Tradable securities	1,816	1,279
Securities purchased under R.Repo agreements	(21)	(3)
Derivative financial instruments, net	682	253
The IMF	4	3
Total	**2,424**	**1,539**

19. Interest income from the government

	For the year ended December 31	
	2016	2015
	(NIS million)	
Binational foundations[a]	76	76
Securities in local currency	343	529
Total	**419**	**605**

[a] See Note 4 above.

20. Other interest income

This item consists of interest income from banks in respect of balances bearing the Bank of Israel interest rate.

21. Interest expenses to banks and the public

	For the year ended December 31	
	2016	2015
	(NIS million)	
Makam	144	362
Time deposits	144	148
Total	**288**	**510**

22. Interest expenses to the government

	For the year ended December 31	
	2016	2015
	(NIS million)	
Balances in local currency[a]	283	232
Balances in foreign currency	4	1
Total	**287**	**233**

23. Other interest expenses

This item consists mainly of interest expenses in respect of deposits of the US-Israel Binational Industrial Research and Development Foundation, a deposit of the US-Israel Binational Science Foundation and international financial institutions.

24. Other financial income (expenses)—securities and derivative financial instruments

	For the year ended December 31	
	2016	2015
	(NIS million)	
Securities in foreign currency[a]	1,153	1,319
Derivative financial instruments in foreign currency[b]	(531)	98
Total	**622**	**1,417**

[a] Dividend income, gain (loss) from sale of securities and loss from net impairment of securities at the end of the year.
[b] Including financial income (expenses) from the realization of derivative financial instruments.

25. Other financial income (expenses)—exchange rate differentials

This item consists of exchange rate differentials in respect of balances denominated in foreign currency (see Notes 1f, 1m and 1n).

26. Other financial income (expenses)—miscellaneous

	For the year ended December 31	
	2016	2015
	(NIS million)	
In local currency	4	-
In foreign currency	(27)	(29)
Total[a]	**(23)**	**(29)**

[a] This item includes income (expenses) from commissions from the Bank's financial activities, from international financial institutions and from loans to employees.

27. General and administrative expenses

	For the year ended December 31	
	2016	2015
	(NIS million)	
Salaries and employees' rights[a]	316	302
Pension and severance pay[b]	207	242
General expenses	152	129
Total	**675**	**673**

[a] In respect of salaries and provision for employees' vacation (753 employee posts on December 31, 2016 and 754 employee posts on December 31, 2015).
[b] In respect of defined benefit pension payments to retirees and an update of the Bank's liability for pension payments (see Note 14 above).

28. Other expenses

In 2016, this item mainly includes a capital loss from the assignment of the State's representation in international financial institutions from the Bank of Israel to the Government (see Note 7 above). In 2015, this item mainly included capital losses from the disposal of fixed assets.

EXPLANATORY REMARKS TO THE 2016 FINANCIAL STATEMENTS

1. Introduction

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

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

2. The Principal Changes in the Financial Statements

2.1 The Bank's Balance Sheet

The Bank of Israel's Balance Sheet at the end of 2016 totaled approximately NIS 394 billion, compared with approximately NIS 369 billion at the end of 2015 (an increase of approximately NIS 25 billion, 7 percent).

The main increase in the assets side is attributed to the increase in the balance of "Foreign currency assets abroad" by approximately NIS 27 billion to approximately NIS 384 billion. In dollar terms, the scope of foreign exchange reserves[1] increased by approximately $8 billion, and their balance at year end amounted to approximately $98.4 billion. The increase is mainly a result of foreign currency purchases by the Bank in a total of approximately $6 billion, and transfers by the Government totaling approximately $2 billion.

[1] In these explanatory remarks, the term "foreign exchange reserves" is used in its economic sense. The foreign exchange reserves are composed of the balance of "Foreign currency assets abroad", less the balance of "Foreign currency liabilities abroad". The change in the balance of "Foreign currency assets abroad" in 2016 amounted to approximately NIS 27 billion and the change in the balance of "Foreign currency liabilities abroad" in 2016 amounted to approximately NIS 2 billion.

Total liabilities on the Balance Sheet increased by approximately NIS 32 billion, as a result of several principal factors: (1) an increase in the net balance of monetary instruments[2]—makam and time deposits—by approximately NIS 17 billion, to approximately NIS 277 billion. Part of the increase derived from the need to sterilize the excess liquidity injected into the markets, mainly as a result of said purchases of foreign exchange reserves; (2) an increase of approximately NIS 11 billion in the monetary base in circulation, consisting of banknotes and coins in circulation and the banks' demand deposits in NIS. This increase was affected by the reduction of the BOI interest rate to 0.1 percent in 2015; (3) an increase in the Government's deposits in the Bank by approximately NIS 2 billion.

The Bank's equity deficit in 2016 increased by about NIS 5 billion, in the amount of the annual loss, with a deficit balance of about NIS 61.5 billion at the end of the year (see Section 4.5, "the Bank's Equity").

2.2 Statement of Operations

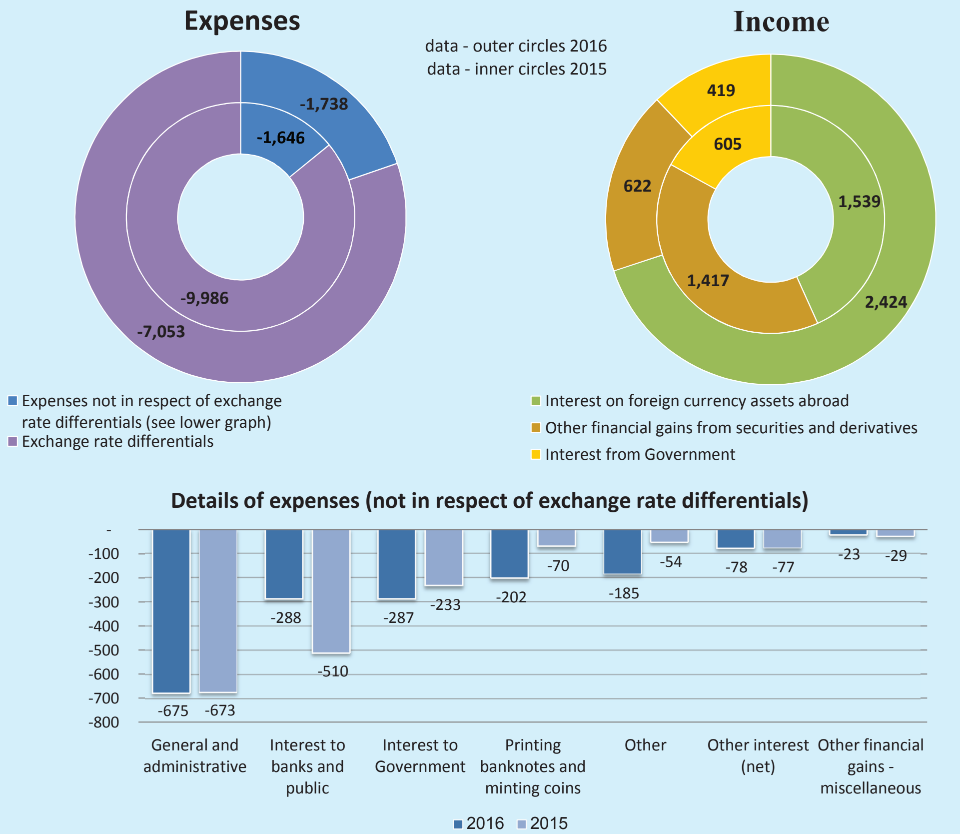
The loss in the current year amounted to about NIS 5.3 billion, compared with a loss of approximately NIS 8.1 billion in 2015. The annual loss was principally affected by expenses in respect of exchange rate differentials, totaling approximately NIS 7.1 billion this year, most of which resulted from the depreciation of the euro and the pound sterling against the shekel. In contrast, there was a decrease by about NIS 2.9 billion in expenses in respect of exchange rate differentials compared with 2015 (Figure 1). Most of the decrease was a result of the decline in expenses in respect of exchange rate differentials due to the appreciation of the shekel against the euro by a lower rate this year (about 4.8 percent this year compared with 10.1 percent in 2015). In contrast, there was an increase in expenses in respect of exchange rate differentials mainly due to the appreciation of the shekel against the pound sterling by a higher rate this year (about 18.3 percent this year compared with 4.6 percent in 2015).

The Statement of Operations does not include unrealized gains[3] from exchange rate differentials on foreign exchange reserves, which are reflected in the revaluation account on the Balance Sheet (see Notes 1 and 15 to the financial statements). Unrealized losses from exchange rate differentials, mainly in respect of the dollar at a scope of about NIS 3.5 billion, were offset against retained earnings in the revaluation accounts and were excluded from the Statement of Operations.

[2] The balance of makam decreased by approximately NIS 11 billion and the balance of time deposits increased by approximately NIS 28 billion.

[3] In accordance with the Bank's accounting policy, gains deriving from holding the reserves as well as other gains are classified as either realized gains, and are included in the Bank's income, or as unrealized revaluation gains. 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.

Figure 1
Income and Expenses in 2016 and 2015
(NIS million)



Source: Bank of Israel.

The Bank's net income from investment of the foreign exchange reserves, consisting of interest and other financial gains and excluding exchange rate differentials, remained practically unchanged at about NIS 3 billion in 2016 (in 2015 - about NIS 2.9 billion). This net income, however, was affected by two contrasting trends: the increase of about NIS 0.9 billion in interest income on foreign exchange reserves in 2016 against a decrease of about NIS 0.8 billion in other financial gains from foreign exchange reserves.

The Statement of Operations also does not include unrealized gains from the effect of the changes in the revaluation of tradable securities which are reflected in the revaluation accounts in the Balance Sheet. (See Note 1 to the financial statements). The revaluation of readable securities in local currency reduced the revaluation account in 2016 by about NIS 0.3 billion (as opposed to a reduction by about NIS 0.4 billion in 2015).

Interest expenses to banks and the public this year totaled only about NIS 0.3 billion (a decrease of about NIS 0.2 billion compared with 2015) - the result of the decrease in issuances of makam and the reduction of the Bank of Israel's interest to 0.1 percent in March 2015.

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

3.1 Characteristics and Composition of the Financial Statements

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

The Bank's financial statements are characterized by considerable currency imbalance in the composition of the Bank's assets and liabilities. This imbalance persisted in 2016. A large majority of the Bank's assets are denominated in foreign currency (about 98 percent at the end of 2016), whereas the Bank's liabilities are mostly in shekels; the liabilities in foreign currency only account for about 5 percent of the total Balance Sheet (Figure 2).

This situation exposes the Bank to fluctuations in the reported financial results due to changes in the shekel's exchange rate in relation to foreign currencies and to changes in local interest rates in relation to other economies.[4]

In 2008–16, foreign exchange reserves grew due to substantial purchases; partly as a result of the plan designed to moderate extreme exchange rate fluctuations that are not in line with economic fundamentals, and later as part of the plan to moderate the effect of natural gas production on the exchange rate, a plan which was put into practice in May 2013. These purchases increased the foreign exchange reserves managed by the Bank, while at the same time increasing the scope of monetary instruments used to absorb the excess funds injected in return for the purchase of foreign currency. This increase in the Bank's Balance Sheet enhances the risk of fluctuations in the Bank's profits given the gap between the yield on the reserves and the expenses in respect of the monetary instruments which now address a larger base. However, the negative gap between the yields narrowed markedly in recent years and even reversed the trend whereby gains on the foreign exchange reserves have exceeded the financial expenses of foreign currency purchases using monetary instruments. The main reason for the reversal in the last decade is the reduction of the interest rate gaps between Israel and the markets in which the reserves are invested, specifically the United States, and the change in the risk profile of the investment portfolio due to the increase in the share component.

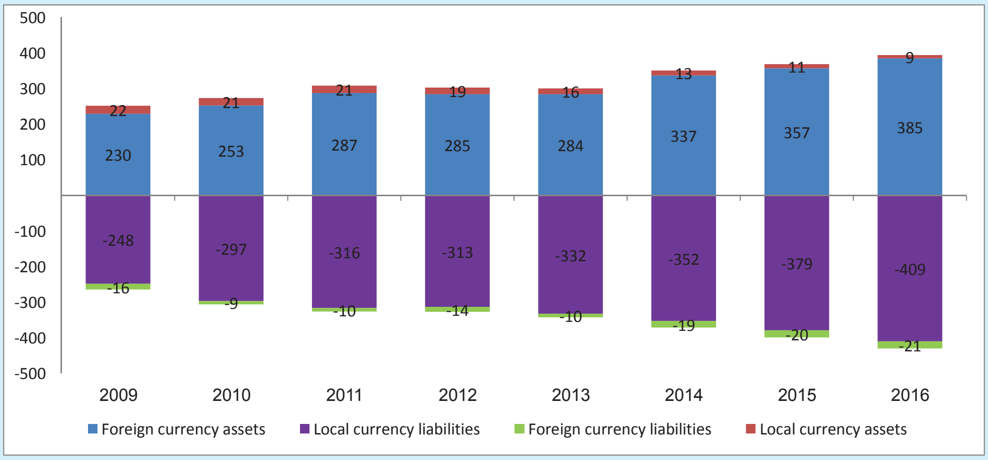
[4] The currency imbalance was first experienced in 1995–97 during which period the Bank adopted a tightening monetary policy to achieve the Government's inflation target. As a result of the ensuing capital inflows by the private sector, the Bank of Israel was forced to purchase foreign currency from the public to maintain the exchange rate at the lower end of the currency band and reabsorb the shekels injected to the market accordingly. The foreign exchange reserves grew from an average of a few billion dollars in previous decades to about $98.4 billion at the end of 2016. Simultaneously, the balance of monetary instruments, which until 1994 was substantially composed of monetary loans, as customary in central banks around the world, has been since composed of liabilities. In 2008-2016, the balance of liabilities gradually increased to about NIS 277 billion at the end of 2016, as a result of the sterilization of injection using time deposits and makam.

The interest rate spread between Israel and the United States, which in early 2008 was 1.25 percent, reached -0.65 percent in late 2016, with the raising of the US federal funds rate (Figure 4). In addition to the changes in interest rates, which resulted in the minimization of the gap between the yields on the reserves and expenses on the monetary instruments, the decrease in yields and the gains from the investment in shares also contributed to increasing the yield on foreign exchange reserves.

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

In contrast to the trend of the narrowing of the gap between the gains on foreign exchange reserves and the cost of monetary instruments in recent years, there is an increased risk of exchange rate losses caused by sharp appreciation, which is a main factor in the Bank's losses and accumulated deficit—a deficit that at the end of 2016 amounted to approximately NIS 61.5 billion (see more details in Section 4.5.2, "The Development of the Bank's Equity Deficit"). The balance of the revaluation account which consists of unrealized gains at year end amounted to approximately NIS 25.6 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 35.9 billion.

Figure 2
The Development in the Bank's Assets and Liabilities, 2009-2016
(NIS billion)



Source: Bank of Israel.

The changes in the Bank's Financial Statements are presented in Table 1 below in a different manner than in the Financial Statements for the purpose of economic analysis. The net balances are presented in the Balance Sheet and the net operating results are presented in the Statement of Operations, in accordance with economic aggregates and the Bank's functions, for analyzing their effect on the Financial Statements for accounting purposes.

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

	December 31		Year ended December 31	
	2016	2015	2016	2015
	Balances		Income (expenses)	
	NIS million			
Net assets				
Foreign exchange reserves[a]	378,528	353,423	3,015	2,924
Securities portfolio in shekels	8,662	10,092	343	529
Total	**387,190**	**363,515**	**3,358**	**3,453**
Net liabilities and equity				
Monetary aggregate[b]	276,935	259,934	(288)	(510)
Monetary base[c]	110,498	99,711	(201)	(69)
Government balances[d]	24,289	22,412	(211)	(157)
Deposits of banking corporations in foreign currency	772	1,136	-	-
Other[e]	10,597	9,751	(931)	(802)
Revaluation accounts[f]	25,564	26,710	(7,053)	(9,986)
Bank's equity	(61,465)	(56,139)	-	-
Total	**387,190**	**363,515**	**(8,684)**	**(11,524)**
Net loss			**(5,326)**	**(8,071)**

[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 item consists of exchange rate differentials on foreign exchange reserves (see Notes 1f and 1n to the financial statements. The capital gains are presented in the item from which they derive).

3.2 Effect of the Economic Environment on the Financial Statements

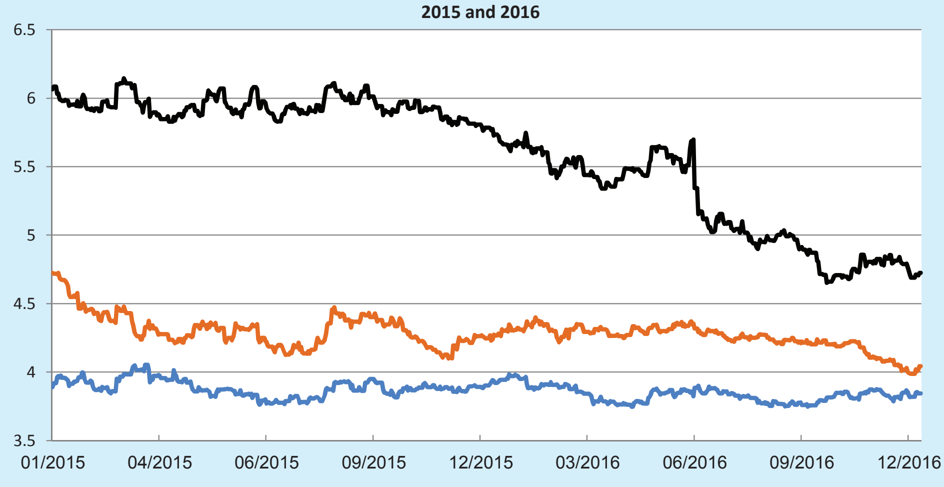
The trends which characterized 2015 continued throughout most of 2016—sluggish growth in the global economy, and the continuing accommodative monetary policy worldwide and its enhancement in some countries (as opposed to a reversed trend in the United States). These trends were expressed in extremely low interest rates around the world, even reaching negative levels in several countries, including the eurozone countries.

However, the developments in global yields were inconsistent: in contrast to the continuing declines in yields in the eurozone countries in the course of the year, US yields increased in 2016 with the US federal funds rate reaching 0.75 percent at the end of the year, continuing the trend of 2015.

The rise in yields improves the Bank's profits from the interest component but at the same time reduces its capital gains. A decline in yields has an opposite effect.

This year the shekel appreciated in relation to the main currencies in which the foreign exchange reserves are held: about 1.5 percent against the dollar, about 4.8 percent against the euro and about 18.3 percent against the pound sterling (Figure 3). The appreciation of the shekel leads to recording expenses in respect of exchange rate differentials, which as noted above accounted for the majority of the loss in the year.

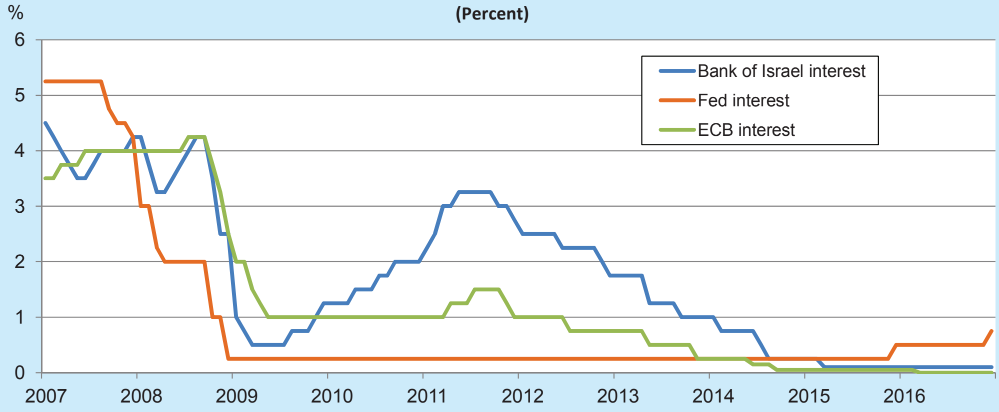
Figure 3
Development of Shekel Exchange Rates in relation to the US Dollar, Euro and Pound Sterling
2015 and 2016



Source: Bank of Israel.

Global stock market indices increased in 2016 with the US stock market recording a better yield than most major stock markets around the globe. The investment in equities in 2016 yielded positive returns for the Bank. The expansion of interest rate spreads on foreign currency derivatives enhanced the attractiveness of these instruments, increasing the scope of their use and the interest gains therefrom.

Figure 4
Short-term Interest Rates in Israel, the U.S and the Eurozone, 2007-2016
(Percent)



Source: Bank of Israel.

The Bank of Israel's interest rate remained unchanged during the year at 0.1 percent, the result of the reductions which began in late 2011. This level contributed to a significant reduction in the Bank's expenses on the monetary aggregate in relation to previous years (Figure 10). In early 2015, Israeli inflation reached a low point of -1 percent. Since then, it has remained negative, reaching -0.2 percent in 2016, the highest rate in the last two years. The negative inflation was reflected in the decrease in the indexation component of the balance of NIS tradable securities in the Balance Sheet compared with last year.

4. Selected Items

4.1 Foreign Exchange Reserves[5]

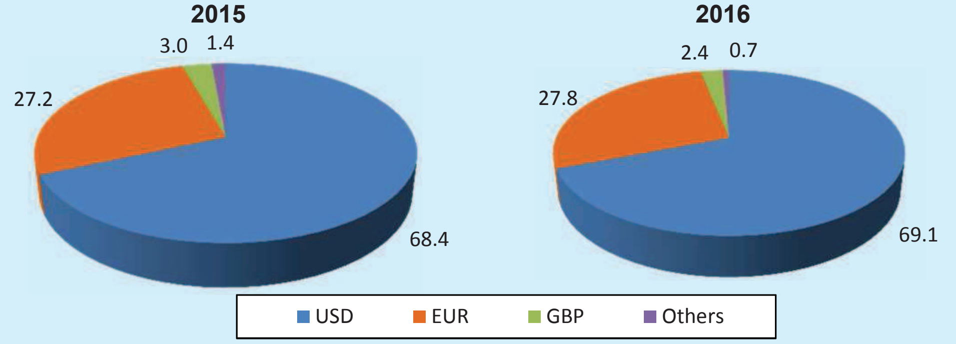
One of the Bank's functions according to the Bank of Israel Law, 5770-2010, is to hold and manage the State's foreign exchange reserves.[6] In accordance with the BOI Law, the Monetary Committee, headed by the Governor, was granted various authorities pertaining to managing the reserves, outlining the reserves' investment policy guidelines and monitoring the implementation of the policy. The investment made in keeping with this policy is reflected in the distribution of the reserve portfolio assets and currencies. The reserves portfolio currency distribution at the end of 2016 was similar to that of the end of 2015 (Figure 5). The shares of the main currencies in the portfolio—US Dollar,

[5] See details in the 2016 Investment of Foreign Exchange Reserves Report, which is published separately. In this report, the yield on holding the reserve portfolio is measured in currency basket terms—the numeraire. The numeraire represents the multicurrency composition of the basket which reflects the potential uses of the reserves.

[6] 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 to the financial statements). These balances are used to determine the Bank's investment policy and are reported to various entities, and therefore form the basis for the analysis of trends in these explanatory remarks.

Euro and Pound Sterling—were mostly unchanged. However, the weight of the other currencies in the reserve portfolio was reduced (from 1.4 percent in 2015 to 0.7 percent at the end of 2016).

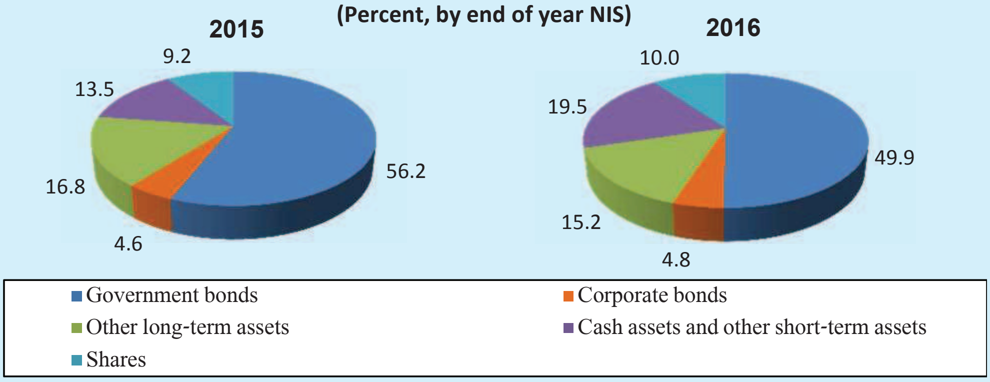
Figure 5
Currency Contribution of the Reserves Portfolio, 2016 and 2015
(Percent, by end of year NIS)



Source: Bank of Israel calculations.

The investment policy is reflected in the asset distribution of the reserves at the end of 2016 and 2015. Towards the end of 2016, the short-term spread assets in the portfolio increased at the expense of the investments in short-term Government bonds which decreased against the background of the yield spread that opened between them. The percentage of the investment in shares and corporate bonds also increased (Figure 6).

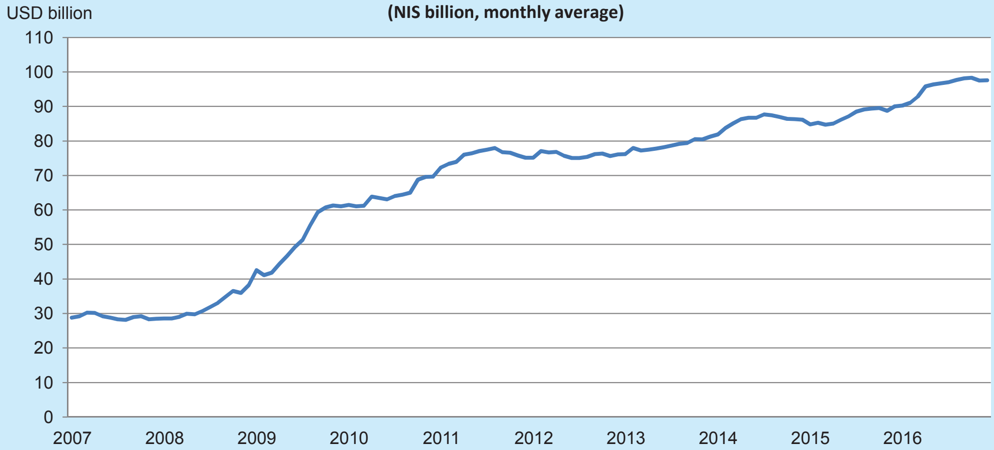
Figure 6
Asset Distribution of the Foreign Exchange Reserves Portfolio, 2016 and 2015
(Percent, by end of year NIS)



Source: Bank of Israel calculations.

As discussed above, the foreign exchange reserves increased mainly due to large scale purchases between 2008 and 2016[7] and their balance at the end of 2016 was approximately $98.4 billion (approximately NIS 379 billion). The developments in foreign exchange reserves during those years are presented in Figure 7.

Figure 7
Israel's Foreign Exchange Reserves, 2007-2016
(NIS billion, monthly average)



Source: Bank of Israel calculations.

This year, foreign exchange reserves increased by about NIS 25 billion (about $8 billion). The increase derives mainly from foreign exchange purchases by the Bank of Israel totaling approximately NIS 23 billion (about $ 6 billion) (Table 2). About two-thirds of the purchases were made within the framework of the Bank's intervention designed to moderate exchange rate fluctuations that are not in line with fundamental economic market conditions. The remaining third was purchased in the context of the plan intended to offset the effects of natural gas production on the current account.

Interest income and realized capital gains from foreign exchange reserves, excluding exchange rate differentials, contributed approximately NIS 3 billion to the increase in reserves (approximately $ 0.8 billion). Moreover, the price revaluation contributed approximately NIS 2.7 billion (approximately $ 0.7 billion) to the increase in reserves. In contrast, negative exchange rate differentials were a main factor in the decrease of approximately NIS 11.3 billion (approximately $ 1.6 billion) in reserves. The negative exchange rate differentials were mainly accrued as a result of the appreciation of the shekel by about 1.5 percent against the dollar, about 4.8 percent against the euro and about 18.3 percent against the pound sterling (Figure 3).

[7] Partly as a direct result of the plan designed to moderate atypical exchange rate fluctuations that do not correspond to the economic fundamentals and later as a result of the adoption of a plan to moderate the effects of natural gas production on the exchange rate which was put into practice in May 2013.

Government and private sector transfers to abroad (net) totaled approximately NIS 8 billion (approximately $ 2 billion) in 2016.

Table 2
Contribution to Foreign Exchange Reserves, by Sector

	2016	2015	2016	2015
	NIS million		USD million	
Change in foreign exchange reserves	**25,105**	**18,575**	**7,872**	**4,474**
Bank of Israel				
Purchases	23,086	33,842	6,040	8,770
Profits	3,015	2,924	785	748
Price revaluation	2,734	(968)	728	(253)
Exchange rate differentials and other[a]	(11,289)	(10,185)	(1,604)	(2,965)
Total Bank of Israel	**17,546**	**25,613**	**5,949**	**6,300**
The government[b]	**7,532**	**(5,056)**	**1,920**	**(1,310)**
The private sector[c]	**27**	**(1,982)**	**3**	**(516)**

[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.

4.1.1 Income from the Foreign Exchange Reserves

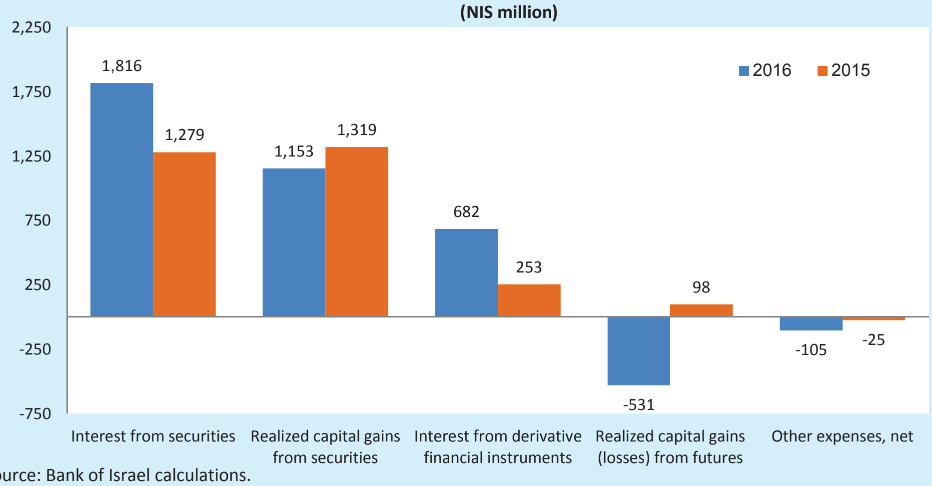
The income from interest and capital gains[8],[9] in respect of foreign exchange reserves, excluding exchange rate differentials, amounted in 2016 to approximately NIS 3 billion (Table 3). The income is comprised of: interest income of approximately NIS 2.4 billion and income from capital gains and other income of approximately NIS 0.6 billion (in 2015—NIS 1.5 billion in interest and NIS 1.4 billion in capital gains).

The income from interest and capital gains is mainly in respect of securities and is comprised of interest income totaling approximately NIS 1.8 billion and income from capital gains totaling approximately NIS 1.2 billion. (In 2015—approximately NIS 1.3 billion in interest and approximately NIS 1.3 billion in capital gains). Figure 8 below presents the composition of gains based on the type and source of income.

The analysis of realized gains from foreign exchange reserves demonstrates that income from securities, from interest and from capital gains increased by approximately NIS 371 million compared with last year. Significant gains were recorded in respect of interest on bonds.

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

Figure 8
Composition of Realized Gains from Foreign Exchange Reserves, 2016 and 2015
(NIS million)



Source: Bank of Israel calculations.

Derivative financial instruments made a positive contribution to gains from foreign exchange reserves this year. Interest income was recognized from derivative financial instruments and there were gains on investments in foreign currency derivatives in a total of approximately NIS 682 million, which reflected attractive interest rate spreads in these transactions in the year in growing numbers.

In contrast, capital losses from foreign currency derivatives were recorded in a total of NIS 531 million (in 2015 - capital gains of approximately NIS 98 million), which resulted from stock market index futures in euros and dollars. These investments are a small part of the overall equity investment, in which gains were recorded.

In 2016, unrealized gains from foreign exchange reserves increased, as reflected by the fair value of the assets in the revaluation account at year end. The balance of this account, which is unrealized and not included in the Bank's profits, increased by approximately NIS 2.7 billion in 2016, compared with a decrease of approximately NIS 968 million last year (Table 3). The increase in the revaluation account this year was mostly derived from the rise in share prices.

From an overall perspective of realized and unrealized gains from foreign exchange reserves, excluding exchange rate differentials, income grew by approximately NIS 3.8 billion (compared with a decline of approximately NIS 2.4 billion in 2015), reflected in the increase in yield from interest and capital gains to 1.64 percent this year, compared with 0.65 percent in 2015 (Table 3). Nevertheless, since the reserve portfolio comprises multiple currencies, measuring the yield in specific currency terms is greatly arbitrary, as expressed by the difference between the yield measurements of the various currencies and the measurements over the years. The yield on exchange rate differentials in shekel terms in the year was negative at -3.05 percent and reflected the realized and unrealized negative exchange rate differentials accrued in the year which resulted from the appreciation of the shekel in relation to the principal currencies underlying the reserves. In dollar terms, the yield rate on exchange rate differentials at the end of 2016 was -1.59 percent, compared with -3.43 percent at the end of 2015.

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

		2016	2015	2014
Total foreign exchange reserves:			USD million	
End of year		98,447	90,575	86,101
Annual average		95,777	87,389	85,973
Income (expenses) and exchange rate differentials - economic calculation:			NIS million	
Interest and capital gains		3,015	2,924	2,435
Unrealized price differentials[a]		2,734	(968)	1,918
Exchange rate differentials		(11,069)	(10,093)	22,088
Total		**(5,320)**	**(8,137)**	**26,441**
Income (expenses) and exchange rate differentials-economic calculation:			USD million	
Interest and capital gains		785	748	674
Unrealized price differentials[a]		728	(253)	386
Exchange rate differentials		(1,552)	(2,943)	(3,726)
Total		**(39)**	**(2,448)**	**(2,666)**
Rates of return[b]:			Percent	
In shekel terms	Interest and capital gains	1.64	0.65	1.29
	Exchange rate differentials	(3.05)	(3.12)	7.42
	Total	**(1.41)**	**(2.47)**	**8.71**
In dollar terms	Interest and capital gains	1.64	0.65	1.29
	Exchange rate differentials	(1.59)	(3.43)	(4.25)
	Total	**0.05**	**(2.78)**	**(2.96)**
In numeraire terms of foreign exchange reserves		**1.56**	**0.64**	**1.28**

[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.

The annual yield on the portfolio in numeraire terms[10] in 2016 amounted to 1.56 percent, exceeding the yield of 0.64 percent in 2015, and approximating the average yield in the years following the global financial crisis (2009–16).

4.2 Revaluation Accounts

The revaluation accounts are composed of unrealized gains from exchange rate differentials on balances denominated in foreign currency and of unrealized gains from indexation and revaluation of tradable securities in local and foreign currency to their fair value. Effective from 2015, this item also includes a revaluation account arising from changes in actuarial assumptions underlying the calculation of the pension allowance (see Notes 1m and 15 to the financial statements).

4.2.1 Revaluation Account of Balances denominated in Foreign Currency

The balance of the revaluation account of balances denominated in foreign currency at year end was approximately NIS 19.6 billion, compared with approximately NIS 23 billion in 2015, a decrease of approximately NIS 3.5 billion.

In 2016, negative exchange rate differentials were accrued in respect of the adjustment of the balances denominated in foreign currency to the representative exchange rates in a total of approximately NIS 10.5 billion (Table 4). This was a result of the appreciation of the shekel in relation to the major currencies in the foreign exchange reserves portfolio (Figure 3). Since at the end of the year a negative revaluation balance was obtained, mainly due to the decline of the exchange rates of the euro and pound sterling, losses totaling approximately NIS 7.1 billion from exchange rate differentials were recorded in the Statement of Operations. The remaining amount of approximately NIS 3.5 billion was carried to the revaluation account and offset against a retained credit right. The weakening of the euro was mainly a result of the widening of the accommodative monetary policy in the eurozone. The pound sterling weakened due to the Brexit, the UK's withdrawal from the European Union.

There was a similar trend in 2015, in which losses from exchange rate differentials in a total of approximately NIS 9.6 billion were accrued, mainly as a result of the weakening of the euro, at about 10.1 percent, and of other currencies in relation to the NIS. Nearly all the losses from exchange rate differentials were carried to profit and loss. Realized losses from exchange rate differentials in 2015 amounted to approximately NIS 10 billion. The remaining amount of approximately NIS 0.4 billion was offset against the revaluation account.

[10] See details in the separately issued report on investment of the foreign exchange reserves for 2016. In that report, the yield of holding the reserve portfolio is measured in numeraire terms. The numeraire is a multi-currency composition which reflects the potential uses of the reserves.

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

	2016	2015
	NIS million	
Assets		
Foreign currency balances	(11,069)	(10,093)
Credit to the government—binational foundations	(2)	-
Liabilities		
Government deposits	306	230
Foreign currency deposits of banking corporations	33	21
International financial institutions	211	201
Binational foundation deposits	2	-
Total	**(10,519)**	**(9,641)**
Realized exchange rate differentials	(7,053)	(9,986)
Unrealized exchange rate differentials	(3,466)	345

4.2.2 Revaluation Account from Tradable Securities in Foreign Currency

The balance of the revaluation account from tradable securities in foreign currency at the end of 2016 was approximately NIS 7.1 billion, compared with approximately NIS 4.4 billion in 2015. The increase of approximately NIS 2.7 billion derived mainly from the increase in the revaluation account in respect of the investments in equities due to the rise in global stock markets at the end of 2016.

4.2.3 Revaluation Account from Tradable Securities in Local Currency

The balance of the revaluation account from tradable securities in local currency at the end of 2016 was approximately NIS 0.9 billion, a decrease of approximately NIS 0.3 million compared with 2015. The decrease was mostly affected by the drop in market prices of tradable securities in local currency.

4.2.4 Revaluation Account from Changes in Actuarial Assumptions for Computing Pension Accruals

In 2015, the Bank modified its accounting policy underlying the recognition and calculation of the pension and severance liability. According to the new policy, the Bank uses a discount rate based on the government-interest yield curve.[11] The Bank concurrently modified the accounting treatment of pension accruals and adapted it to

[11] A series of yields to maturity of Israeli Government bonds with different maturities.

generally accepted accounting principles for central banks worldwide. According to the new method, changes made to the pension accruals arising from changes in actuarial assumptions are carried to the revaluation account in the Balance Sheet. This account may also represent a debit balance at year end, contrary to the other revaluation accounts described above.

The revaluation account from changes in actuarial assumptions underlying the calculation of pension accruals at the end of 2016 had a debit balance of approximately NIS 2.1 billion, similar to the balance in 2015 (approximately NIS 1.9 billion). The change was a result of updating the accrued pension due to changes in actuarial assumptions.[12] Other changes to pension accruals are carried to the Statement of Operations.

4.3 Monetary Base

The monetary base is comprised of the total banknotes and coins in circulation and the demand deposits of the commercial banks in the Bank of Israel[13] and is determined according to the liquidity demand at the Bank's given interest rate. The monetary base is affected both by factors which are not under the control of the Bank, such as government accounts[14], and by factors which are controlled by the Bank, such as purchases of foreign exchange and bonds[15], as a means of achieving the various objectives of the monetary policy (Table 5). The Bank either absorbs liquidity from the markets or injects liquidity to the commercial banks to satisfy demand for the monetary base based on the BOI's interest rate.

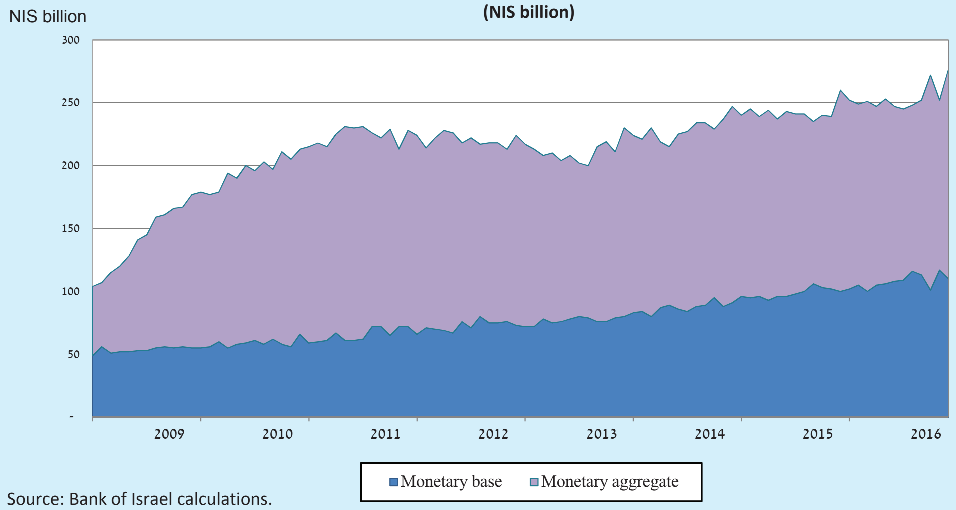
The Bank adapts the monetary base to the interest rate using monetary instruments—by issuing makam and by using auctioned interest-bearing deposits or loans of the banks, which are not included in the monetary base[16], in accordance with their liquidity needs. In 2013, the Bank renewed its intervention in the foreign exchange market in accordance with its policy to operate in this market when the shekel exchange rate is not in line with the fundamental economic conditions underlying its development. In this context, in 2013, the Bank declared a plan for the purchase of foreign currency to offset the effect of natural gas production on the exchange rate.

In keeping with the trend of the last few years, the monetary base grew in 2016 by about NIS 10.8 billion, reaching approximately NIS 110 billion at the end of the year

[12] 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.
[13] 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.
[14] 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).
[15] In 2009, the Bank purchased Government bonds at a scope of about NIS 18 million.
[16] Since they are not recognized for the purpose of compliance with the reserve requirement.

(Figure 9). The largest injection to the monetary base made by the Bank this year—a total of approximately NIS 23 billion—was a result of the Bank's intervention in the foreign exchange market (Table 5), compared with approximately NIS 34 billion in 2015. The Bank absorbed the excess liquidity and partially 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 absorption was carried out through the monetary instruments aggregate (makam and time deposits) in the amount of approximately NIS 17 billion, which was offset by the injection of approximately NIS 1.2 billion, partly from payments in respect of the monetary instruments.[17]

Figure 9
Developments in the Monetary Aggregate and Monetary Base, 2009-2016
(NIS billion)



Source: Bank of Israel calculations.

In 2016, the Government injected into the market approximately NIS 4 billion (as opposed to absorbing approximately NIS 14 billion in 2015).

[17] Payments which were reduced due to the lowering of the interest rate for March 2015 to a historic low of 0.1 percent.

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				
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
2016	**10,787**	**3,538**	**(15,814)**	**23,086**	**(23)**

[a] The Government's injection also includes injections by the National Insurance Institute and by the Postal Bank.
[b] Adjustments include: transfers by the national institutions from abroad via the banks but which were defined as public sector injections until the end of 2012 (in column 2). Foreign currency domestic receipts and payments by the Bank and the Government to the private sector, such as income tax receipts in foreign currency, do not change the monetary base as they are transferred directly from the private sector to the Government; on the one hand they are defined as government absorption, while on the other they are defined as the private sector contribution to the foreign exchange reserves.

4.4 Aggregate of Monetary Instruments[18]

Monetary policy in Israel in 2016 was implemented against the background of negative inflation alongside stable growth which gradually strengthened in the course of the year. The global environment was characterized by inflation and interest rates that were extremely low, even negative in certain countries (Figure 4). Israeli monetary policy in recent years was accommodative and acted to support activity and exports and restore the low inflation to its target range. The interest rate in 2016 remained historically low at 0.1 percent since its lowering in March 2015.

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

[18] 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 2016 and 2015 was zero.

of Israel, the Bank injects or absorbs the needed funds into/from the market, in line with its own determined interest rate. This is done through extending loans to banking corporations or receiving deposits from banking corporations and through the issue of makam and Repo transactions, as applicable.

In keeping with the trend of recent years, the balance of monetary instruments remains composed of solely liabilities, amounting to approximately NIS 277 billion in late 2016, compared with approximately NIS 260 billion at the end of 2015 (an increase of about 7 percent). This increase was derived from the need to sterilize the surplus funds injected into the markets as a result of forex purchases (Figure 9). In 2016, the monetary aggregate consisted of approximately NIS 172 billion in time deposits, accounting for about 62% of total monetary instruments (compared with approximately NIS 144 billion in 2015 - about 55 percent), and approximately NIS 105 billion in makam, accounting for about 38 percent of total monetary instruments (compared with approximately NIS 116 billion in 2015, about 45 percent).

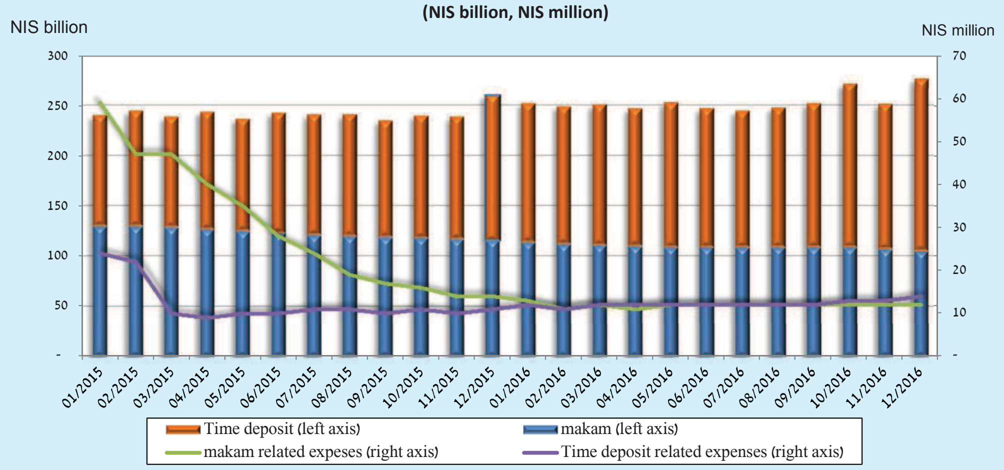
4.4.1 Expenses in respect of Monetary Instruments

Interest expenses in respect of the aggregate of monetary instruments in 2016 amounted to approximately NIS 288 million, compared with approximately NIS 510 million in 2015. The decrease in interest expenses, despite the growth in the monetary aggregate, mostly stemmed from the decrease in the volume of makam issued and the lowering of the BOI interest rate from 0.12 percent on average in 2015 to 0.1 percent on average in 2016. The total expense in respect of the monetary aggregate in 2016 was evenly distributed between makam and time deposits (approximately NIS 144 million each). In contrast, in 2015, the substantial portion of interest expenses in respect of monetary instruments consisted of interest expenses totaling approximately NIS 362 million in respect of makam whereas the interest expenses in respect of time deposits amounted to approximately NIS 148 million (Figure 10).

Figure 10

Balances of Monetary Agregate and related Expenses, 2016 and 2015

(NIS billion, NIS million)



Source: Bank of Israel calculations.

4.5 The Bank's Equity

4.5.1 The Bank's Equity (Deficit)

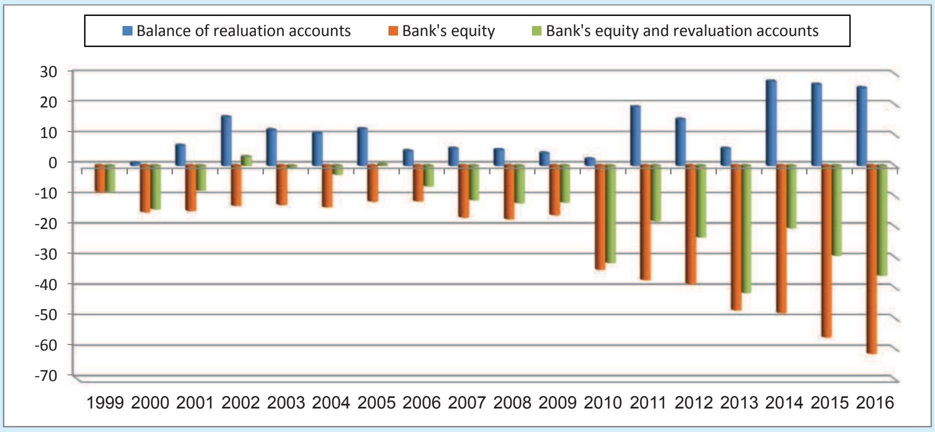
The Bank's equity is comprised of share capital and the general reserve less the accumulated losses. At the end of 2016, the Bank had an equity deficit of approximately NIS 61.5 billion. The accumulated losses, which played a major part in the creation of an equity deficit, began forming in 1999 and have remained such to date.

4.5.2 Development of the Deficit in the Bank's Equity

As discussed above, the Bank's equity deficit was initially sustained in 1999 after the Bank had transferred to the Government in 1998 some NIS 9 billion in gains, which were recognized then as realized gains, the vast majority of which deriving from exchange rate differentials due to the shekel's depreciation. In 1999, however, it became clear that the bulk of the gains were unrealized gains which, had they not been transferred to the Government, would have been offset against the losses of 1999. This is because in that year, negative exchange rate differentials were recorded following the shekel's appreciation, which resulted in a loss of NIS 8.8 billion. The loss sustained in 1999, as mentioned above, first created an equity deficit in the Bank's Balance Sheet, which has been sustained to date. In 2000, the Bank of Israel revised the accounting policy of revenue recognition and began to treat realized and unrealized gains differently, as customary in central banks around the world. Unrealized gains are carried to revaluation accounts in order to prevent the recurrence of transferring unrealized gains, mainly arising from exchange rate differentials, in years in which the shekel significantly depreciates (see Note 1f to the financial statements).

The balance of revaluation accounts at the end of 2016 amounted to approximately NIS 25.6 billion. Overall, the net balance of the Bank's equity with the addition of revaluation accounts amounts to approximately NIS 35.9 billion. Figure 11 presents the Bank's equity deficit and revaluation accounts and their general trend.

Figure 11
The Bank's Equity and Revaluation Accounts, 1999-2016
(NIS billion)



Source: Bank of Israel calculations.

4.5.3 Composition of the Equity Deficit

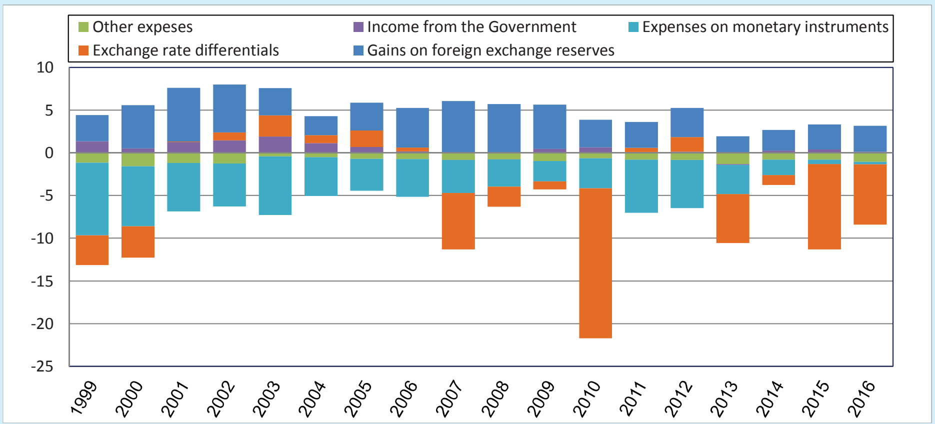
The analysis of the Bank's equity deficit indicates that the main components that contributed to the deficit are expenses in respect of exchange rate differentials which over said years aggregated approximately NIS 50 billion and expenses in respect of using monetary absorption instruments which aggregated approximately NIS 76.5 billion. In contrast, gains from foreign exchange reserves in said years totaled approximately NIS 70 billion, bringing the gap between gains from foreign exchange reserves and expenses in respect of monetary absorption instruments, excluding losses on exchange rate differentials, to some NIS 6 billion only[19]. This trend of reducing the gap between the gains from foreign exchange reserves and the cost of monetary instruments has continued in recent years with the growth in the portfolio's volume (and related income), the increase in the portfolio's equity component whose yield is higher, and the decrease in interest expenses on the monetary instruments as a result of the reducing of BOI's interest rate in recent years to 0.1 percent in the context of the accommodative monetary policy. The effect of the exchange rate differentials is large and volatile and due to the appreciation

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

of the shekel in 2016 has continued to contribute to increasing the Bank's equity deficit.

Other results, which mainly comprise various interest expenses, general and administrative expenses and banknote printing expenses, contributed approximately NIS 16.5 billion to the deficit. In contrast, income from the Government (bonds and deposits) mitigated the accumulated deficit by approximately NIS 10.4 billion. Figure 12 presents the development of the main loss components of the deficit on an annual basis, from 1999 when the deficit was first created.

Figure 12
Principal Loss Components, 1999-2016
(NIS billion)



Source: Bank of Israel calculations.