

EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS FOR 2018

1 The Principal Changes in the Financial Statements

1.1 The Bank's Balance Sheet

The Bank of Israel's Balance Sheet increased in 2018 by approximately NIS 38 billion (9 percent) and at the end of 2018 amounted to approximately NIS 440 billion. The main increase on the asset side derives from an increase of approximately NIS 39.9 billion in "Foreign current assets abroad" which at the end of 2018 amounted to approximately NIS 434 billion, mainly as a result of positive exchange rate differentials (approximately NIS 25.1 billion) and foreign currency purchases (approximately NIS 11.7 billion). In dollar terms, the scope of foreign exchange reserves¹ increased mainly as a result of foreign currency purchases by the Bank, which were offset by negative exchange rate differentials and revaluation (see Section 3.1, "Foreign Exchange Reserves").

Total liabilities on the Balance Sheet increased by approximately NIS 13.6 billion, as a result of several principal factors: (1) an increase in the net balance of monetary instruments² —*makam* and time deposits—by approximately NIS 9.9 billion, to approximately NIS 296 billion. Part of the increase derived from the need to sterilize the said foreign currency purchases; (2) an increase of approximately NIS 4.9 billion in the monetary base against the backdrop of GDP growth.

Revaluation accounts grew in 2018 by approximately NIS 19.2 billion, amounting to approximately NIS 32.7 billion at the end of 2018, compared with approximately NIS 13.5 billion in 2017. The main change arises from the NIS devaluation in relation to the USD. The Bank's deficit equity was reduced in 2018 by about NIS 5.3 billion, in the amount of the annual profit, and amounted to about NIS 57 billion at the end of the year (see Section 3.6, "the Bank's Equity (Deficit Equity)").

BALANCE SHEETS	
2018	2017
Total balance sheet	
440 NIS billion	401 NIS billion
Foreign exchange reserves	
432 NIS billion	392 NIS billion
Revaluation accounts	
32.7 NIS billion	13.5 NIS billion
Total equity (Deficit equity)	
(57) NIS billion	(62.3) NIS billion

1.2 Statement of Profit and Loss

The profit in the current year amounted to about NIS 5.3 billion, as opposed to a loss of approximately NIS 0.8 billion in 2017. The transition to annual profit was principally affected by gains from exchange rate differentials of approximately NIS 95 million recorded this year, compared with losses from exchange rate differentials of approximately NIS 5.6 billion last year.

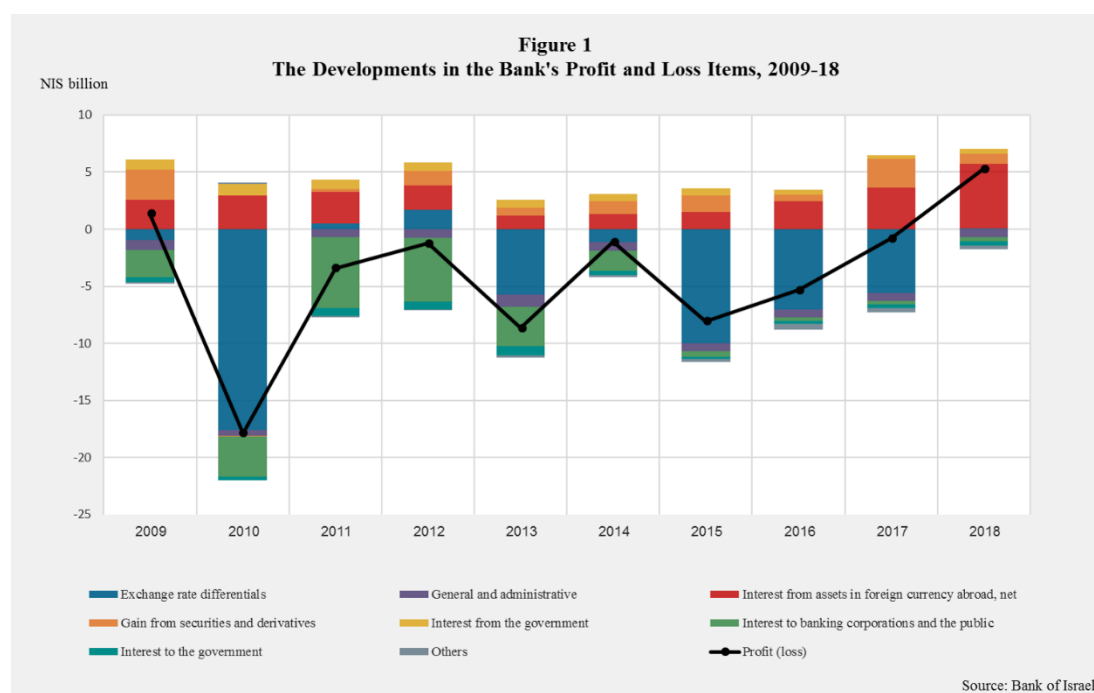
¹ The reference made in these explanatory remarks to foreign exchange reserves is from an economic perspective. The reserves are comprised of "foreign currency assets abroad", less "foreign currency liabilities abroad".

² The balance of *makam* increased by approximately NIS 15.9 billion and the balance of time deposits decreased by approximately NIS 6 billion.

The transition from exchange rate losses to exchange rate gains this year principally derived from the devaluation of the NIS in relation to the USD by about 8.1 percent as opposed to the NIS appreciation by 9.8 percent in 2017. However, the Statement of Profit and Loss does not include unrealized gains from exchange rate differentials totaling some NIS 24.2 billion³, which are reflected in the revaluation account on the Balance Sheet (see Notes 21 and 14 to the financial statements). The increase in profit was also affected by an increase of about NIS 0.4 billion in the Bank's income from investments of foreign exchange reserves: an increase of approximately NIS 1.9 billion in the Bank's income from interest on the investment of foreign exchange reserves, income which amounted to approximately NIS 5.6 billion this year, and a decrease of approximately NIS 1.6 billion in gain from securities and derivative financial instruments, net, which amounted to approximately NIS 0.9 billion this year (Figure 1).

The Statement of Profit and Loss does not include a loss of about NIS 5.4 billion which was offset against gains retained from previous years in revaluation accounts, the majority of which was as a result of the impairment of the investment in stocks this year.

STATEMENTS OF PROFIT AND LOSS	
2018	2017
Interest income from assets in foreign currency abroad, net	
5.6 NIS billion	3.7 NIS billion
Gain from securities and derivative financial instruments, net	
0.9 NIS billion	2.5 NIS billion
Exchange rate differentials	
0.1 NIS billion	(5.6) NIS billion
Profit (loss) for the year	
5.3 NIS billion	(0.8) NIS billion



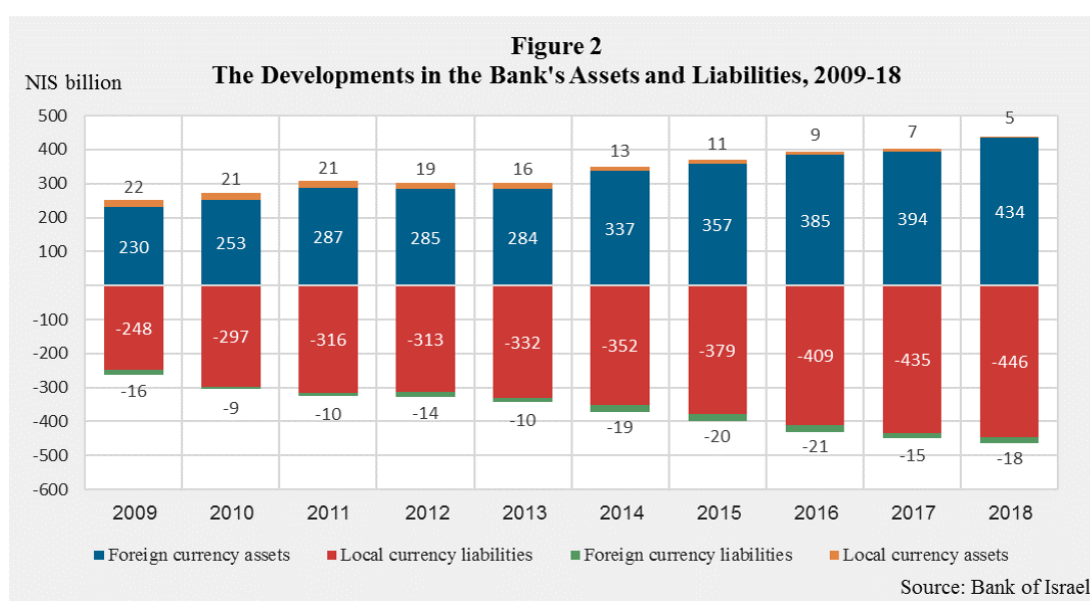
³In accordance with the Bank's accounting policy, gains deriving from holding the reserves as well as other gains are classified as either realized gains, which are included in the Bank's income, or as unrealized revaluation gains, which are carried to the revaluation accounts on the Balance Sheet and 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 Profit and Loss at the end of the year.

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

2.1 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 banks⁴. The Bank carries out its functions⁵ as a central bank and acts to achieve its objectives set forth in the Bank of Israel Law, 5770-2010; Bank's aim is not to retain any profits. Some of the Bank's functions have significant implications on the financial statements while other functions performed by the Bank for meeting its objectives have nationwide economic benefits that are not reflected in these financial statements.

The Bank's financial statements are characterized by considerable currency imbalance⁶ in the composition of the Bank's assets and liabilities. In 2018, about 99 percent of the Bank's assets were denominated in foreign currency, whereas the Bank's liabilities are mostly in shekels; the liabilities in foreign currency account for only about 4 percent of the total Balance Sheet (Figure 2).



Due to the currency imbalance, and due to the fact that the financial statements are presented in shekels, changes in the shekel's exchange rate against the currencies in which the foreign exchange reserves are denominated on the Balance Sheet can generate large fluctuations in the shekel value of the reserves. The Bank

⁴ See Note 2 to the financial statements

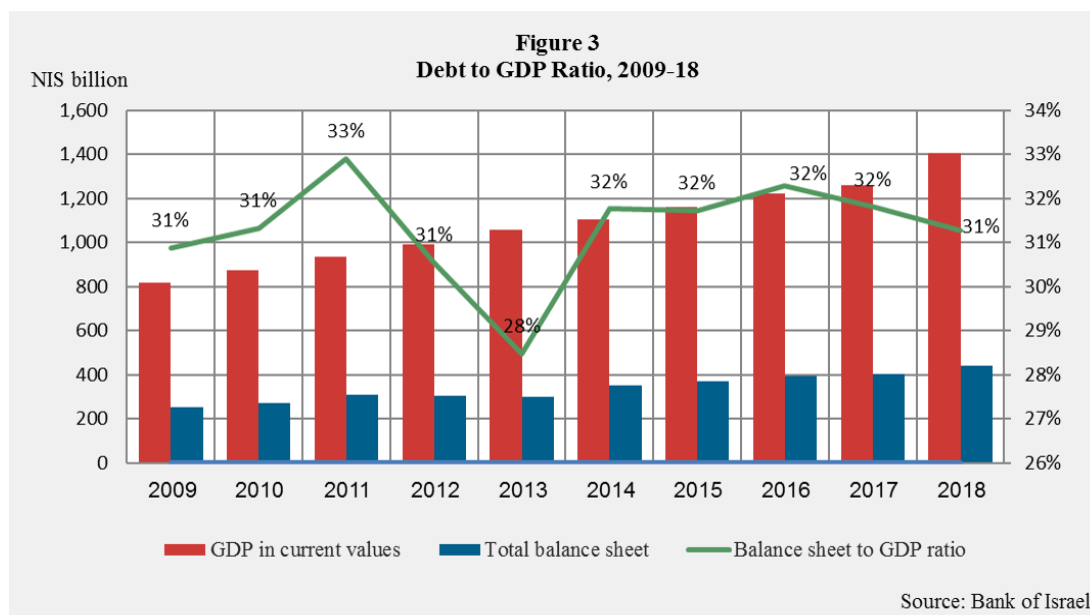
⁵ See Note 1 to the financial statements.

⁶ The currency imbalance was first generated 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 \$115 billion at the end of 2018. 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 2008–18, the balance of liabilities increased to about NIS 296 billion at the end of 2018, as a result of the sterilization of injection using time deposits and *makam*.

does not act to hedge the effect of these changes, and does not act to increase yields in shekel terms, but rather in terms of the numeraire⁷, subject to the guidelines delineated by the Monetary Committee. In recent years, the Bank has gradually increased the share of the foreign exchange reserves invested in equities, which markedly impacted the return on the reserves portfolio. However, profits from the appreciation of shares and profits from other tradable securities in which the reserves are invested have not been included in the Bank's profit and loss statement as long as they have not been realized, but are rather carried to the revaluation accounts. Some of the losses recorded this year as a result of the decline in equity prices were offset by unrealized profits retained in the revaluation accounts. The Bank reports the financial results of the reserves portfolios in the Annual Report of the Investment of the Foreign Exchange Reserves.

The volatility in the operating results presented in the financial statements is affected by exchange rate fluctuations, changes in share indices and changes in Israel's interest rate policy in relation to other markets in which the Bank's foreign exchange reserves are invested.

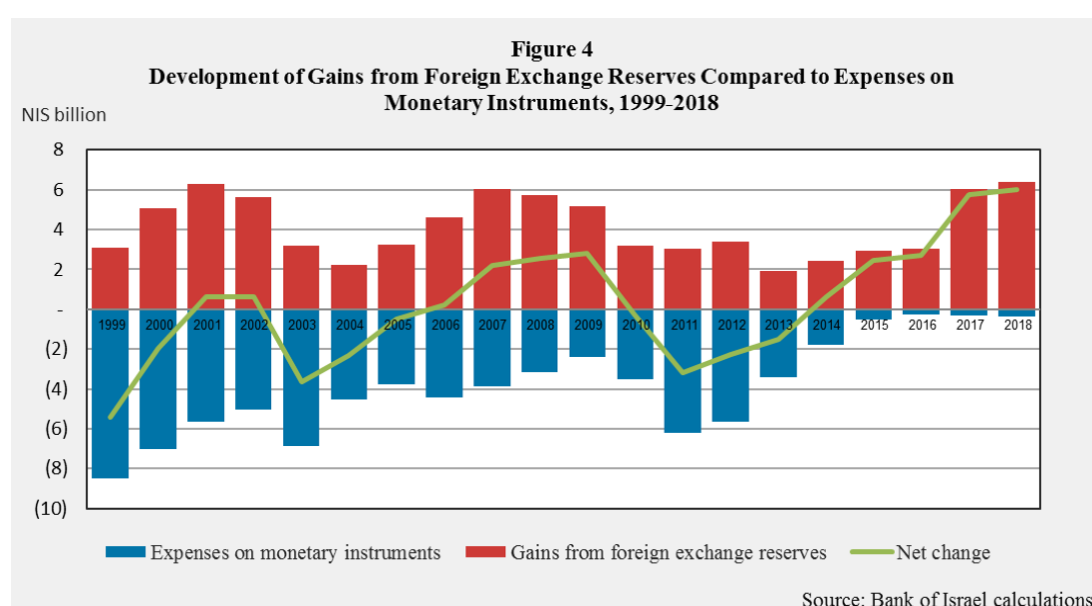
From 2008, foreign exchange reserves grew due to substantial foreign currency purchases carried out in the context of managing the monetary policy. The purchases increased the foreign exchange reserves managed by the Bank, while at the same time increasing the scope of monetary instruments used to absorb the excess liquidity injected in return for these purchases (Figure 11). In 2018, foreign currency purchases were significantly lower than in 2017, amounting to some \$3.3 billion (as opposed to some \$6.6 billion in 2017) (Figure 7). The increase in the Balance Sheet is also affected by the increase in the quantities of banknotes and coins in circulation and the monetary instruments aggregate in view of GDP growth (Figure 3).



This increase in the Bank's Balance Sheet over the years has enhanced the Bank's currency imbalance and the fluctuations in its profits. The profit volatility is affected by the gap between the yield on the reserves and the expenses in respect of the

⁷ The numeraire is a multi-currency component that reflects the potential uses of the reserves.

monetary instruments. This gap narrowed markedly greatly reduced in recent years (Figure 4), and since 2014, the gains on the foreign exchange reserves have exceeded the financing expenses of foreign currency purchases using monetary instruments (*makam* and time deposits). This trend continued in 2018, and the Bank's profits were mainly affected by the returns on foreign exchange reserves, against the backdrop of the low shekel interest environment. The return on the foreign exchange reserves is impacted by interest rates in the markets in which the reserves are invested and the change in the risk profile of the investment portfolio. The interest rate spread between Israel and the United States, which in early 2008 was 1.25 percent, was reversed since then and in late 2018, the U.S. interest rate exceeded the Israeli interest rate by 2.25 percent, as opposed to a gap of 1.4 percent in 2017 (Figure 6).



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 on the Bank's Balance Sheet, the rate of change in the exchange rate applies to higher reserves and therefore might enhance the volatility in the Bank's gains from this component.

A direct result of the enhanced scope of foreign exchange reserves on the Bank's Balance Sheet is the increased risk of exchange rate valuation losses caused by the appreciation of the shekel which in previous years was one of the main factors for the Bank's losses and accumulated deficit—a deficit that at the end of 2018 amounted to approximately NIS 57 billion (see Section 3.6, "The Bank's Equity (Deficit Equity)"). The balance of the revaluation account which consists of unrealized gains at year end amounted to approximately NIS 32.7 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 24.3 billion. However, as discussed above, while this situation affects financial reporting, it is not taken into consideration in managing the policy which is based on fulfilling the Bank's functions and not for the purpose of minimizing the risk of losses in shekel

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

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

	As of December 31		Year ended December 31	
	2018	2017	2018	2017
	Balances		Income (expenses)	
	NIS million			
Net assets				
Foreign exchange reserves ¹	432,067	391,812	6,394	6,044
Tradable securities in local currency	4,369	6,386	376	254
Total	436,436	398,198	6,770	6,298
Net liabilities and equity				
Monetary aggregate ²	295,878	285,948	(368)	(315)
Monetary base ³	127,603	122,677	(176)	(181)
Government balances ⁴	26,167	26,819	(255)	(239)
Deposits of banking corporations in foreign currency	672	724	-	-
Other ⁵	10,402	10,789	(779)	(773)
Revaluation accounts ⁶	32,680	13,494	95	(5,578)
Bank's equity	(56,966)	(62,253)	-	-
Total	436,436	398,198	(1,483)	(7,086)
Net profit (loss) for the year			5,287	(788)

¹ Foreign exchange reserves consist of total "foreign currency assets abroad" less total "foreign currency liabilities abroad". The profit and loss items presented in this table do not include unrealized gains retained in the foreign exchange reserve portfolio.

² The balance of *makam* (central bank bills) and time deposits in local currency less monetary loans.

³ 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 are mostly money printing expenses and the income is from banks' local currency demand deposits.

⁴ 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.

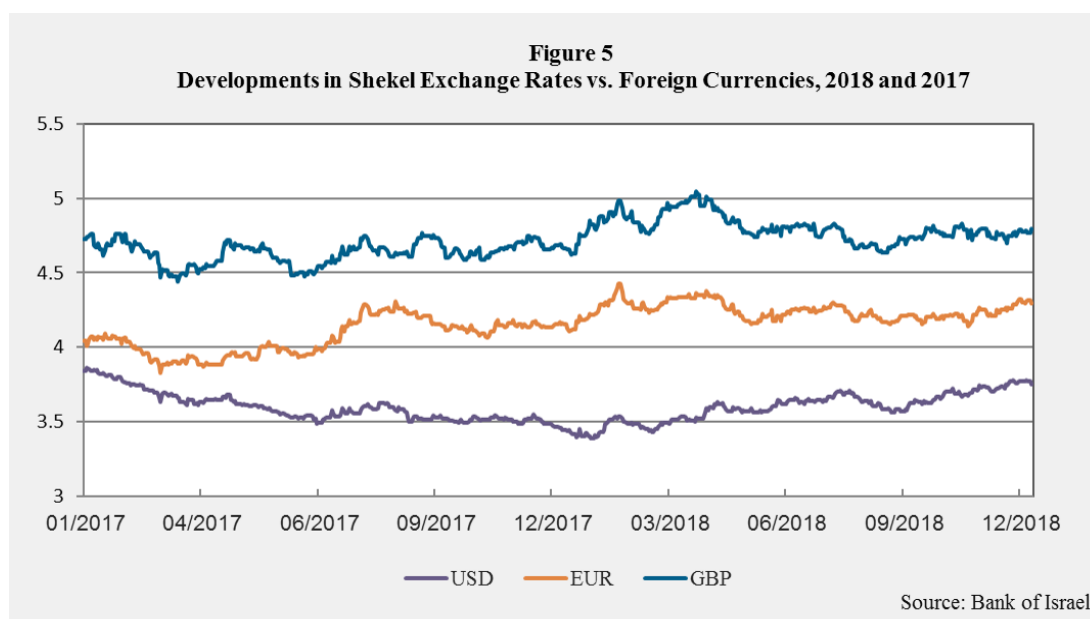
⁵ The "other" item consists of the balance of fixed assets and intangible assets, and the balance of other assets in local currency less the balance of other liabilities in local currency and other liabilities in foreign currency in respect of the IMF and others.

⁶ The income (expenses) in this item consist of exchange rate differentials on foreign exchange reserves (see Notes 2J and 2K to the financial statements. The capital gains are presented in the item from which they derive).

2.2 Effect of the Economic Environment on the Financial Statements

The global economy's growth rate slowed slightly this year, with a relatively moderate inflationary environment. Monetary policy remained accommodative in 2018, with low and even negative interest rates in some economies. The opposing trend in the United States also persisted: the federal funds rate was raised throughout the year four times to a level of 2.5 percent, resulting in increased yields on bonds and increasing the Bank's gains from the dollar interest component, but at the same time reducing the Bank's capital gains. Global stock markets experienced increased volatility in the year. The investment in shares made a smaller positive contribution to the Bank's profits in 2018 compared with 2017, mainly due to the decline in U.S. stock markets towards the end of the year.

The strengthening of the dollar, which is the main currency in which the foreign exchange reserves are held, during the year was reflected in the depreciation of the shekel by about 8.1 percent (compared with a appreciation of about 9.8 percent last year). The devaluation of the shekel resulted in a major increase in foreign exchange reserves in shekel terms and in valuation gains from exchange rate differentials (mainly unrealized gains) as opposed to exchange rate valuation losses in 2017 (Figure 5).



The Bank of Israel's interest rate remained at 0.1 percent for most of the year (unchanged since March 2015) but was raised at the end of the year to 0.25 percent. The Bank's expenses on the monetary aggregate, which are affected by the Bank's interest, remained similar in level to 2017 (Figure 12).

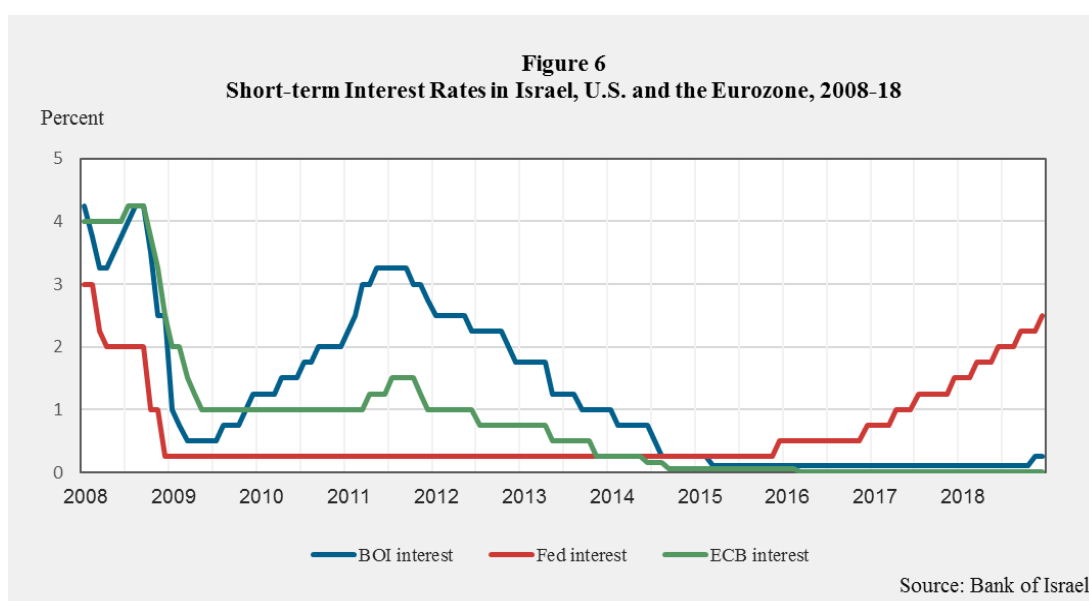
In 2018, the annual inflation was positive and the Israeli CPI increased by 0.8 percent, as opposed to a positive rate of 0.4 percent in 2017. The inflation in Israel remains relatively low compared to OECD countries but the gap between the countries has been contracting owing to local factors, and specifically due to the proximity to full employment rate, the tight labor market and salary increases.

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

3 Selected Items

3.1 Foreign Exchange Reserves⁸

One of the Bank's functions according to the Bank of Israel Law is to hold and manage the State's foreign exchange reserves⁹. In accordance with the Law, the Monetary Committee, headed by the Governor, and whose members include representatives from among the public, was granted various authorities pertaining to managing the reserves, outlining the reserves' investment policy guidelines and monitoring the implementation of the policy. In these explanatory remarks, the reference to the foreign exchange reserves is in respect of their economic implications. The reserves consist of the balance of "foreign currency assets abroad", less "foreign currency liabilities abroad".



In 2018, foreign exchange reserves increased by about NIS 40.3 billion (an increase of about 10.3 percent), reaching a total of about NIS 432.1 billion (about \$115.3 billion). The increase in reserves mainly derived from exchange rate valuation gains totaling some NIS 25.3 billion, mainly accrued due to the depreciation of the shekel against the dollar at a rate of about 8.1 percent (Figure 5). Other causes for the increase in foreign exchange reserves include foreign exchange purchases by the Bank of Israel totaling approximately NIS 11.7 billion and interest income and realized capital gains, excluding exchange rate differentials, of approximately NIS 1.4 billion.

In dollar terms, the reserves grew by about 2.3 billion, mainly as a result of purchases totaling some \$3.3 billion, interest income and realized capital gains (excluding exchange rate differentials) of approximately \$1.8 billion. In contrast, the reserves decreased stemming from a decline of about \$1.8 billion, mostly from negative exchange rate differentials arising from the weakening against the dollar of the euro and pound sterling, currencies in which more than 30 percent of the reserves are

⁸ See details in the 2018 Investment of Foreign Exchange Reserves Report, which is published separately.

⁹ The investment management policy of foreign exchange reserves is determined by the Bank and reported to various entities, and therefore these reserves form the basis for the analysis of trends in these explanatory remarks.

invested, and a decline of about \$1.6 billion from the negative revaluation of the prices of the reserves (Table 2).

Table 2
Contribution of sectors to foreign exchange reserves

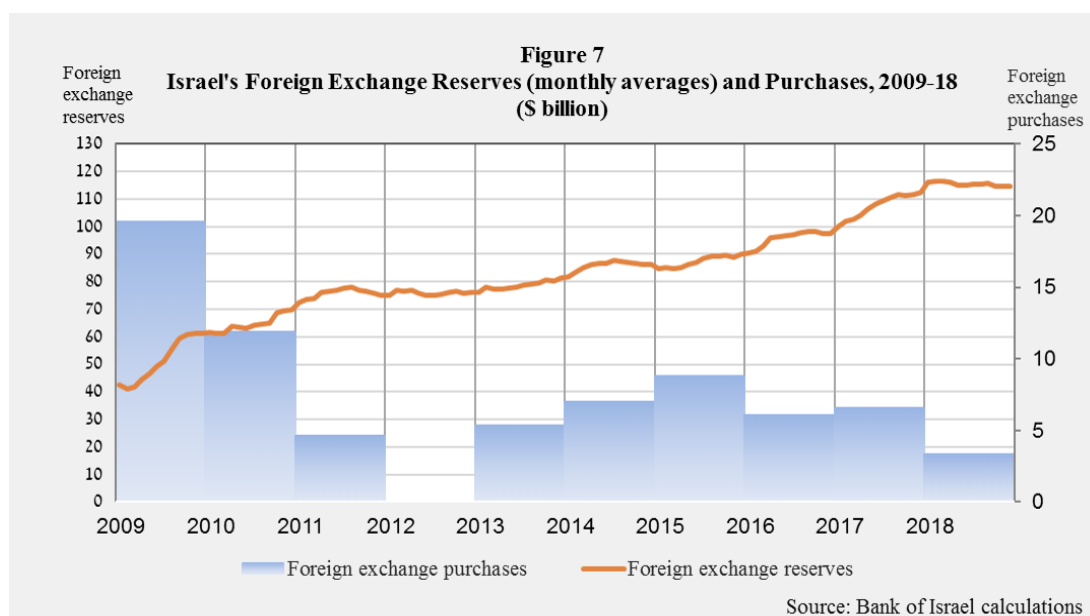
	2018	2017	2018	2017
	NIS million		USD million	
Change in foreign exchange reserves	40,255	13,284	2,268	14,564
Bank of Israel				
Purchases	11,669	24,030	3,319	6,600
Profits	6,394	6,044	1,819	1,643
Price revaluation	(5,031)	4,726	(1,598)	1,565
Exchange rate differentials and other ¹	25,106	(23,618)	(1,826)	4,268
Total Bank of Israel	38,138	11,182	1,714	14,076
The Government²	2,192	2,000	578	464
The private sector³	(75)	102	(24)	24

¹ Includes the Bank's payments and receipts in foreign currency.

² Transfers from abroad by the Government and national institutions.

³ Includes the sector's income tax payments in foreign currency.

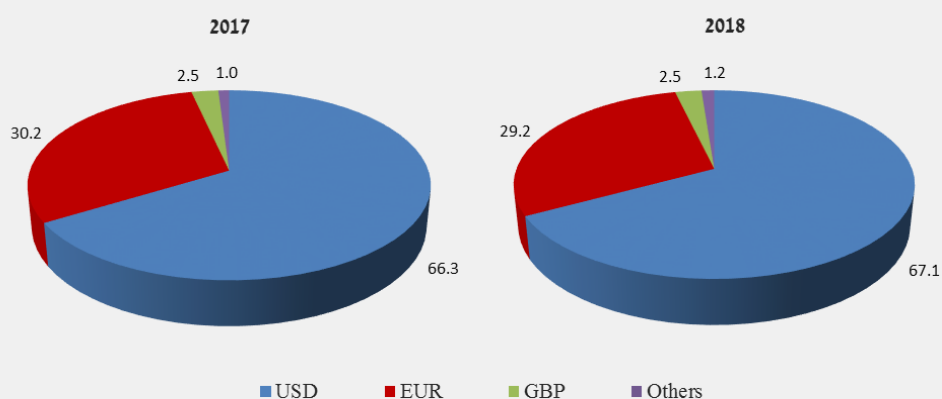
The scope of foreign exchange purchases not included in the context of the gas plan¹⁰ in the year dropped significantly against the backdrop of the relative stability in the shekel nominal effective exchange rate. The developments in foreign exchange reserves are shown in Figure 7.



The investment policy underlying the reserves is reflected in the asset and currency distribution of the reserves portfolio. The reserves currency distribution at the end of 2018 was essentially similar to the distribution at the end of 2017 (Figure 8).

¹⁰ A plan to mitigate irregular fluctuations in exchange rates which are not commensurate with the market's fundamental economic conditions which was followed by a plan to mitigate the effect natural of gas production on the exchange rates, put into practice from May 2013 until late 2018.

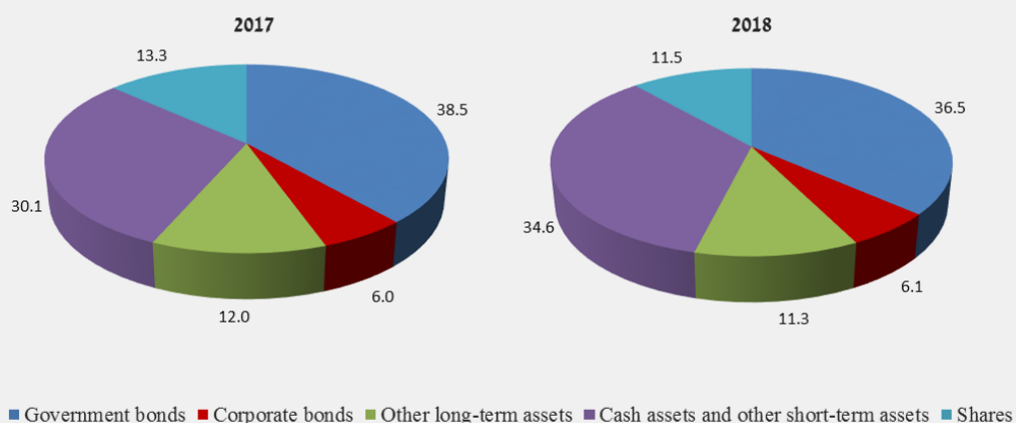
Figure 8
Currency Distribution of the Foreign Exchange Reserves Portfolio,
2018 and 2017 (Percent, by end of year)



Source: Bank of Israel calculations

At the end of 2018, the short-term spread assets in the portfolio grew at the expense of investments in short-term government bonds in view of the gap in their yields, and the investment in cash and in other short-term spread assets was 34.6 percent (an increase of about 4.5 percentage points). In addition, the rates of investment in shares declined by about 1.8 percentage points. In contrast, investment in government bonds declined by about 2 percentage points and in long-run margin assets by about 0.7 percentage points (Figure 9).

Figure 9
Asset Distribution of the Foreign Exchange Reserves Portfolio,
2018 and 2017 (Percent, by end of year)

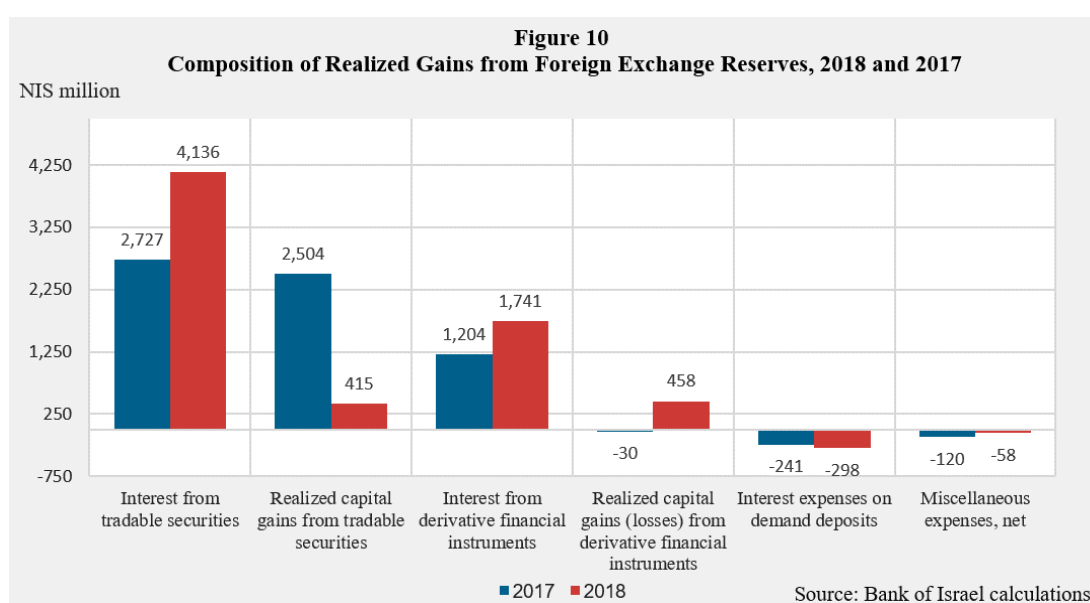


Source: Bank of Israel calculations

3.2 Income from the Foreign Exchange Reserves

The income from interest and capital gains in respect of foreign exchange reserves, excluding exchange rate differentials^{11,12}, amounted in 2018 to approximately NIS 6.4 billion, compared with approximately NIS 6 billion last year (Table 3). The income is comprised of: interest income of approximately NIS 5.6 billion and income from capital gains and other income of approximately NIS 0.8 billion (in 2017—NIS 3.7 billion in interest income and NIS 2.3 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 4.1 billion and capital gains totaling approximately NIS 0.4 billion (In 2017—approximately NIS 2.7 billion in interest and approximately NIS 2.5 billion in capital gains). Figure 10 below presents the composition of gains based on their type and source.



An analysis of realized gains from foreign exchange reserves indicates that compared with last year, income from interest on securities increased by approximately NIS 1.4 billion. The main increase in interest income derives from dollar bonds which were affected by the increase in the U.S. interest rate.

Income from realized capital gains from securities decreased by about NIS 2.1 billion in the year, principally as a result of sharp declines in the share indices underlying the reserves portfolio and a decrease in yields on dollar bonds.

As a whole, derivative financial instruments made a significant positive contribution to gains from foreign exchange reserves this year. Interest income from derivative financial instruments and gains on investments in foreign currency derivatives totaled approximately NIS 1.7 billion in 2018 (as opposed to NIS 1.2 billion in 2017), reflecting attractive interest rate spreads in derivative transactions in the year in growing numbers. In addition, capital gains from foreign currency derivatives were recorded in the year in a total of approximately NIS 458 million (as opposed to

¹¹ 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 on the Balance Sheet and are not expressed in the Bank's income for the year.

¹² Capital gains are included on the Statement of Profit and Loss in the line item "income from securities and derivative financial instruments, net".

capital losses of approximately NIS 30 million in 2017), mainly resulting from dollar bond futures and stock market index futures in dollar and yen.

Unrealized gains from tradable securities in foreign currency—presented in the revaluation account at fair value—decreased in late 2018 by about NIS 5 billion (compared with an increase of about NIS 4.7 billion last year, see Table 3). The majority of the decrease in the revaluation account this year was derived from the drop in share prices. The revaluation account balance is not realized and is not included in the Bank's earnings.

From an overall perspective of realized and unrealized gains from foreign exchange reserves, excluding exchange rate differentials, overall income dropped significantly, by approximately NIS 9.4 billion (as opposed to an increase of approximately NIS 5 billion in 2017). The investment in stocks greatly affected the decrease in income, which reflects the materialization of the short term risk inherent in equity investments as opposed to investments in government bonds. The annual yield on the portfolio in numeraire terms in 2018 amounted to 0.18 percent, lower than the yield of 3.03 percent in 2017. This year's yield is the lowest in the past decade.

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

	2018	2017	2016
Total foreign exchange reserves:	USD million		
End of year	115,279	113,011	98,447
Annual average	115,398	107,567	95,777
Income (expenses) and exchange rate differentials-economic calculation:	NIS million		
Interest and capital gains	6,394	6,044	3,015
Unrealized price differentials ¹	(5,031)	4,726	2,734
Exchange rate differentials	25,343	(23,403)	(11,069)
Total	26,706	(12,633)	(5,320)
Income (expenses) and exchange rate differentials-economic calculation:	USD million		
Interest and capital gains	1,819	1,643	785
Unrealized price differentials ¹	(1,598)	1,565	728
Exchange rate differentials	(1,746)	4,316	(1,552)
Total	(1,525)	7,524	(39)
	Percent		
Rates of return² of foreign exchange reserves in numeraire terms	0.18	3.03	1.56

¹Unrealized price differentials express the annual change in the revaluation account of foreign currency tradable securities (see Note 14 to the financial statements).

²Rates 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.

3.3 Revaluation Accounts

The balance of the revaluation accounts on the Balance Sheet are composed of unrealized gains from exchange rate differentials on balances denominated in foreign currency and of unrealized gains from indexation and revaluation of tradable securities in local and foreign currency to their fair value. This item also includes a revaluation account in respect of actuarial gains or losses arising from changes in actuarial assumptions underlying the calculation of the pension allowance in respect of benefits to employees and pensioners (see Notes 2J and 14 to the financial statements).

3.3.1 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 27.4 billion, compared with approximately NIS 3.2 billion in 2017, an increase of approximately NIS 24.2 billion. The increase in this revaluation account mostly derives from unrealized exchange rate differentials, carried to this revaluation account on the Balance Sheet, mainly as a result of a depreciation of the shekel by about 8.1 percent in relation to the dollar, compared with the smaller impact of the depreciation of the shekel by about 3.3 percent in relation to the euro.

Overall, in 2018, there were positive exchange rate differentials in respect of the adjustment of the balances denominated in foreign currency to shekel balances in a total of approximately NIS 24.3 billion (Table 4). In contrast, in 2017, there were negative exchange rate differentials of about NIS 22 billion (Table 4), mainly as a result of the appreciation of the shekel in relation to dollar at a rate of about 9.8 percent (Figure 5). Approximately NIS 16.4 billion of negative exchange rate differentials was carried to the revaluation account and offset against a retained credit right. The balance of negative exchange rate differentials, totaling approximately NIS 5.6 billion, was charged to the Statement of Profit and Loss as expenses from exchange rate differentials.

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

	2018	2017
	NIS million	
Assets:		
Foreign exchange reserves	25,343	(23,403)
Credit to the Government - binational foundations	9	(12)
Liabilities		
Government deposits	(709)	1,117
Deposits of banking corporations	(42)	93
The IMF	(271)	205
Binational foundation deposits	(9)	13
Total	24,321	(21,987)
Realized exchange rate differentials in profit and loss	95	(5,578)
Unrealized exchange rate differentials	24,226	(16,409)

3.3.2 Revaluation Account from Tradable Securities in Foreign Currency

The balance of the revaluation account from tradable securities in foreign currency dropped by about NIS 5 billion to approximately NIS 6.8 billion in 2018, compared with approximately NIS 11.9 billion in 2017. The decrease derived mainly from the negative revaluation of shares due to falling global stock market prices in the course of 2018.

3.3.3 Revaluation Account from Tradable Securities in Local Currency

The balance of the revaluation account from tradable securities in local currency dropped in 2018 by approximately NIS 381 million, totaling approximately NIS 426 million, mostly affected by the drop in market prices of tradable securities in local currency and by redemptions.

3.3.4 Revaluation Account from Actuarial Gains or Losses from Benefits to Employees and Pensioners

At the end of 2018, the revaluation account consisted of a debit balance of approximately NIS 1.9 billion (approximately NIS 2.3 billion in 2017).

According to the Bank's accounting treatment method, any change in the Bank's liability¹³ in respect of benefits to employees and pensioners arising from changes in actuarial assumptions¹⁴ or from the gap between estimates and actual results is carried to the revaluation account on the Balance Sheet. The account may also have a debit balance at year end, contrary to the other revaluation accounts described above. Any other changes in the Bank's liability in respect of benefits to employees and pensioners are carried to the Statement of Profit and Loss.

3.4 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 Israel¹⁵ and is determined according to the demand for liquidity 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 accounts¹⁶, and by factors which are controlled by the Bank, such as purchases of foreign exchange and *makam* issuances, as a means of achieving the various objectives of the monetary policy (Table 5). The Bank either absorbs liquidity from the markets or injects liquidity to the commercial banks to satisfy demand for the monetary base based on the BOI's interest rate.

The Bank adapts the monetary base to the interest rate using monetary instruments—by issuing *makam* and by using auctioned interest-bearing deposits

¹³ The Bank uses a discount rate based on the yield curve of government interest (the series of yields to maturity of government bonds in Israel with different maturities).

¹⁴ The actuarial assumptions consist of: demographic assumptions on the future characteristics of employees and on former employees such as mortality tables, early retirement rates etc. and financial assumptions such as the discount interest rate and deviation for experience in the reporting period compared with the assumptions used last year for the reviewed period.

¹⁵ 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.

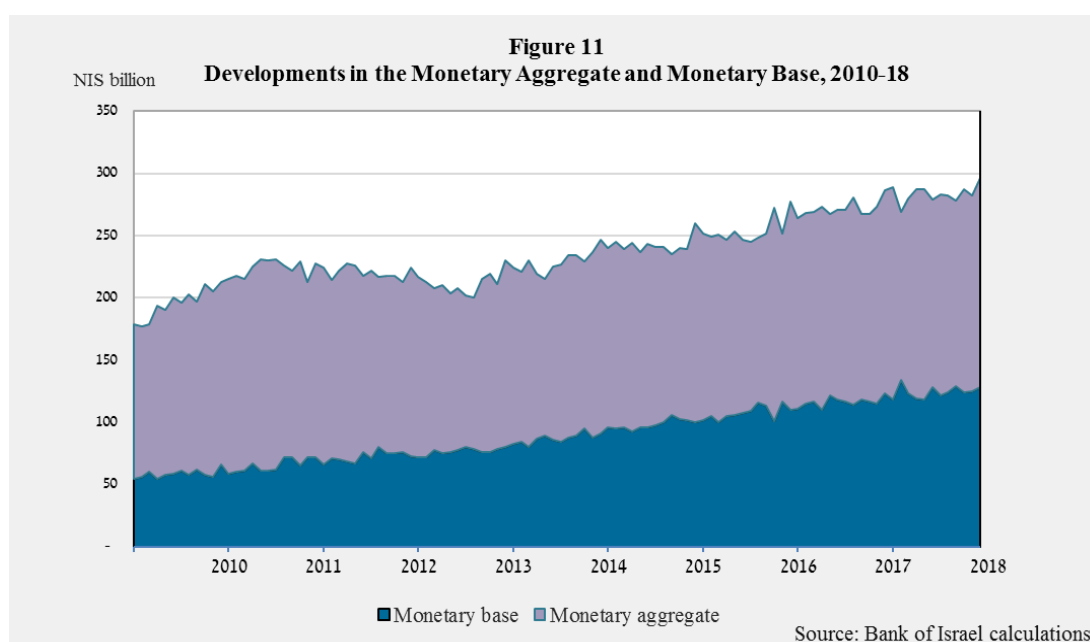
¹⁶ The Government's actions also affect the monetary base since the Government's accounts are managed at the Bank (in conformity with the Bank of Israel Law, 5770–2010).

or loans of the banks, which are not included in the monetary base¹⁷, in accordance with their liquidity needs. The Bank normally adopts a monetary policy that allows it to intervene in the foreign exchange market when the shekel exchange rate is not commensurate with the basic economic conditions needed for the market's development; however, this year, the Bank hardly intervened in the foreign exchange market, apart from purchases of some \$3.3 billion, of which some \$1.5 billion were in the context of the plan to offset the effect of natural gas production on the Current Account, which was discontinued in 2018.

The Bank's intervention in the foreign exchange market remains one of the tools used by the Bank to achieve its objectives. The minimal use of this tool in 2018 derived from the prevailing market conditions that did not require such intervention on a broader scale.

The monetary base grew in 2018 by about NIS 4.9 billion, compared with an increase of about NIS 12.2 billion in 2017, reaching approximately NIS 127.6 billion at the end of the year (Figure 11). Similarly to last year, the largest injection to the monetary base was made by the Bank in a total of approximately NIS 11.7 billion (approximately NIS 24 billion in 2017) as a result of the Bank's intervention in the foreign exchange market (Table 5). The Bank absorbed the excess liquidity beyond the demand for the monetary base to avoid the downward pressure on the short-term interest to a lower level than that determined by the Bank. The absorption was carried out through the monetary instruments aggregate (*makam* and time deposits) in the amount of approximately NIS 9.9 billion, which was offset by the injection of approximately NIS 1.2 billion, of which some NIS 0.4 billion from payments in respect of the monetary instruments.

In 2018, the Government injected approximately NIS 1.8 billion to the market (as opposed to absorbing approximately NIS 3.9 billion in 2017).



¹⁷ Since they are not recognized for the purpose of compliance with the reserve requirement.

Table 5
The Monetary Base—Changes and their Sources

Year	Change in monetary base	Injection (+) / absorption (-) by the Government and national institutions ¹	Absorption by the Bank of Israel	Injection from foreign currency conversions at the Bank of Israel	Adjustments ²
	(1)=(2)+(3)+(4)+(5)	(2)	(3)	(4)	(5)
NIS million					
2013	6,443	(10,452)	(2,414)	19,037	272
2014	11,699	1,171	(14,190)	24,632	86
2015	8,427	(14,036)	(11,543)	33,842	164
2016	10,787	3,538	(15,814)	23,086	(23)
2017	12,179	(3,864)	(7,819)	24,030	(168)
2018	4,926	1,808	(8,693)	11,669	142

¹The Government's injection also includes injections by the National Insurance Institute and by the Postal Bank.

²Adjustments include: transfers by the national institutions from abroad via the banks. 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; they are defined as government absorption, but at the same time they are defined as the private sector contribution to the foreign exchange reserves.

3.5 Aggregate of Monetary Instruments ¹⁸

In 2018 inflation was positive in Israel. The Israeli CPI increased this year by 0.8 percent compared to 0.4 percent last year. The increase in inflation corresponded to the increase in most OECD countries. Israeli monetary policy in recent years was accommodative and acted to support activity and exports and return the low inflation to within its target range taking into account financial stability considerations in the context of the sharp rise in home prices and the low margin level in the corporate market. The interest rate throughout most of 2018 remained low at 0.1 percent and was only raised at the end of the year to 0.25 percent .

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 impacts on individuals' consumption and savings, the scope of investment in the economy and the exchange rate, and through the latter—the profits and activity of exports and import substitutes sector and the balance of payments. All these are factors through which the interest rate impacts prices.

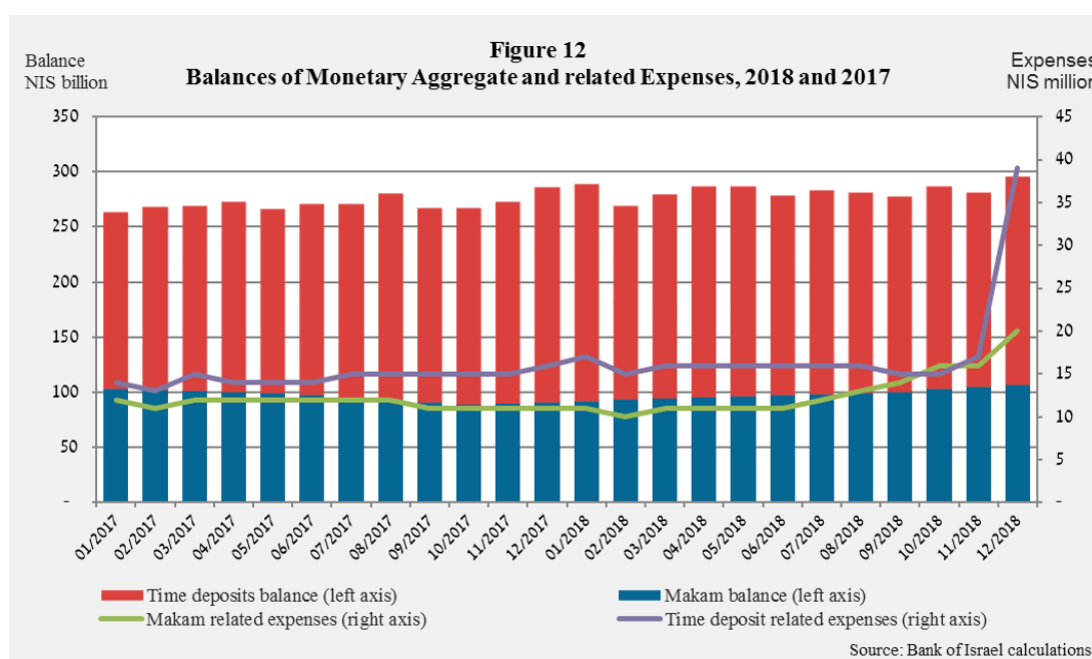
To effectively implement the interest rate declared by the Bank of Israel, the Bank injects or absorbs the needed funds into/from the market, in line with its own determined interest rate. This is done through extending loans to banking

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 2018 and 2017 was zero.

corporations or receiving deposits from banking corporations and through the issue of *makam*, as applicable. This is particularly relevant in the event of sterilization of the positive contribution of foreign exchange purchases to the monetary base.

The balance of monetary instruments at the end of 2018 remained composed of solely liabilities, amounting to approximately NIS 296 billion, compared with approximately NIS 286 billion at the end of 2017 (an increase of about 3 percent) (Figure 12). Among others, this increase was derived from the need to sterilize the surplus funds injected into the markets as a result of foreign exchange purchases. In 2018, the monetary aggregate consisted of approximately NIS 188 billion in time deposits, accounting for about 64 percent of total monetary instruments (compared with approximately NIS 194 billion at the end of 2017—about 68 percent), and approximately NIS 107.9 billion in *makam*, accounting for about 36 percent of total monetary instruments (compared with approximately NIS 91.9 billion at the end of 2017—about 32 percent).

Interest expenses in respect of the aggregate of monetary instruments in 2018 increased by about 17 percent, to approximately NIS 368 million at year end, compared with approximately NIS 315 million in 2017. The increase in interest expenses mostly stemmed from the increase in the monetary aggregate and the raising of the interest rate (Figure 12).

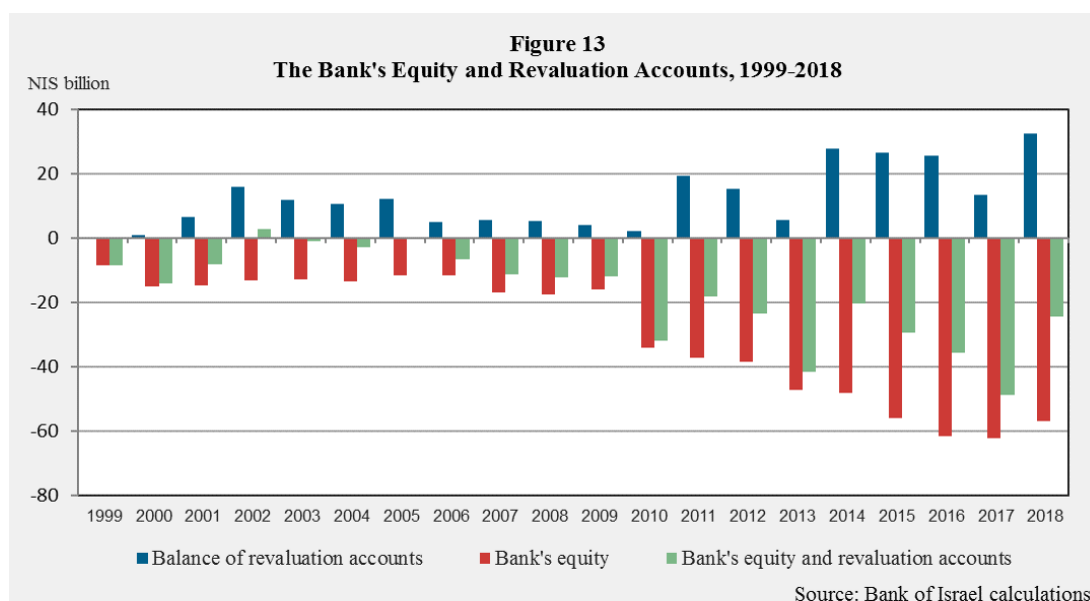


3.6 The Bank's Equity (Deficit Equity)

The Bank's deficit equity¹⁹ decreased in 2018, amounting to approximately NIS 57 billion at year end (approximately NIS 62.3 billion at the end of 2017). The accumulated losses, which played a major part in the creation of deficit equity, began forming in 1999, after the Bank had transferred to the Government in 1998 some NIS 9 billion in gains, the vast majority of which derived from exchange rate differentials due to the shekel's depreciation. In 1999, however, it became clear that the bulk of the gains were unrealized gains which, had they not been transferred to the Government, would have been offset against the losses of that year. The loss created an unprecedented deficit equity on the Bank's Balance Sheet, which has been sustained to date.

In 2000, the Bank of Israel adopted the accounting policy of revenue recognition that is practiced by central banks around the world. According to this accounting policy, a different accounting treatment is applied for realized and unrealized gains: realized gains are stated on the Statement of Profit and Loss whereas unrealized gains are carried to revaluation accounts on the Balance Sheet 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 2J to the financial statements).

The balance of revaluation accounts at the end of 2018 was approximately NIS 32.7 billion (as opposed to approximately NIS 13.5 billion in 2017). Overall, the net balance of the Bank's equity with the addition of revaluation accounts amounted to approximately NIS 24.3 billion (as opposed to approximately NIS 48.8 billion in 2017). Figure 13 presents the Bank's deficit equity and revaluation accounts and their general trend.

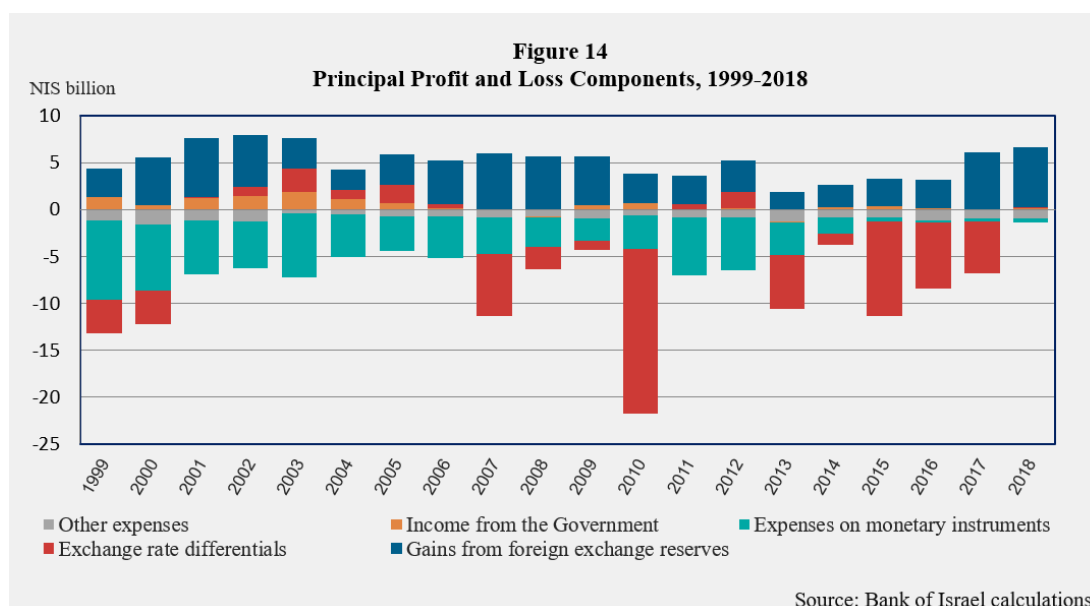


¹⁹ The deficit equity is comprised of the Bank's equity and the general reserve less the accumulated losses, see Note 15 to the financial statements.

3.6.1 Composition of the Deficit Equity

The analysis of the Bank's deficit equity indicates that from 1999 to date, the main components that contributed to the deficit equity are expenses in respect of using monetary absorption instruments which added up to approximately NIS 77.2 billion during those years, and expenses in respect of exchange rate differentials which over said years added up to approximately NIS 55 billion. In contrast, gains from foreign exchange reserves in said years totaled approximately NIS 82.6 billion. This trend of minimizing the gap between the gains from foreign exchange reserves and the cost of monetary instruments has continued in recent years and in 2018, the gap between gains from foreign exchange reserves and expenses in respect of monetary instruments, excluding losses on exchange rate differentials, was about NIS 5.4 billion²⁰. The changing trend stemmed from the growth in the foreign exchange reserves portfolio and related income and the increase in the portfolio's equity component whose yield is higher, yet at the same time there was a decrease in interest expenses on the monetary instruments as a result of the lowering of BOI's interest rate in recent years in the context of the accommodative monetary policy. At the end of 2018, the BOI's interest rate was 0.25 percent.

Other results, mainly various interest expenses, general and administrative expenses and banknote printing expenses, contributed approximately NIS 18.5 billion to the deficit since 1999. In contrast, net income from the Government (bonds and deposits) mitigated the accumulated deficit by approximately NIS 10.5 billion. Figure 14 presents the development of the main loss components of the deficit on an annual basis, from 1999 when the deficit was first created.



²⁰ This calculation only consists of realized gains and excludes unrealized price revaluation differentials.