EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS FOR 2006

The Bank of Israel's balance sheet totaled NIS 156 billion at the end of 2006, compared to NIS 153 billion at the end of 2005, an increase of approximately 2 percent. Its composition, however, changed more markedly. The foreign exchange reserves,[1] which constitute the major element in the Bank's assets, declined by about NIS 5 billion (4.3 percent), while on the liabilities side the balance of the revaluation accounts dropped by some NIS 7 billion. The changes in these two items resulted mainly from the weakening of the dollar—the major currency in the reserves portfolio—against the shekel at an annual rate of 8.2 percent.

The balance of the main monetary aggregates[2] showed very little change in 2006, and totaled about NIS 88 billion, compared with NIS 87 billion in 2005, but here too the composition changed: the balance of *makam* (short-term bills issued by the Bank of Israel for purposes of monetary management), which in 2005 stood at some NIS 84 billion (96 percent of the aggregate), rose to NIS 96 billion in 2006 (109 percent of the aggregate). The balance of *pazak* (resident time deposits), which in 2005 was about NIS 4 billion, was down to zero at the end of 2006.

The overall rise on the liabilities side of the aggregate was one of the factors that prompted the Bank of Israel to revert to the use of monetary loan auctions as an active monetary instrument. Their balance at the end of 2006 was NIS 8 billion, up from zero at the end of 2005.

In the Profit and Loss Account, net profit fell from NIS 1.4 billion in 2005 to a mere NIS 83 million in 2006. This drop was due mainly to the fall of NIS 0.5 billion in interest income from the government, and a rise of NIS 0.8 billion interest paid to the banks and the public.

Total income from the foreign exchange reserves[3] together with "exchange-rate differentials" showed hardly any change, but its composition changed: income from the investment of the reserves, which includes interest and other financial income, rose by NIS 1.5 billion, but a drop of NIS 1.5 billion in income from realized exchange-rate differentials offset that rise.

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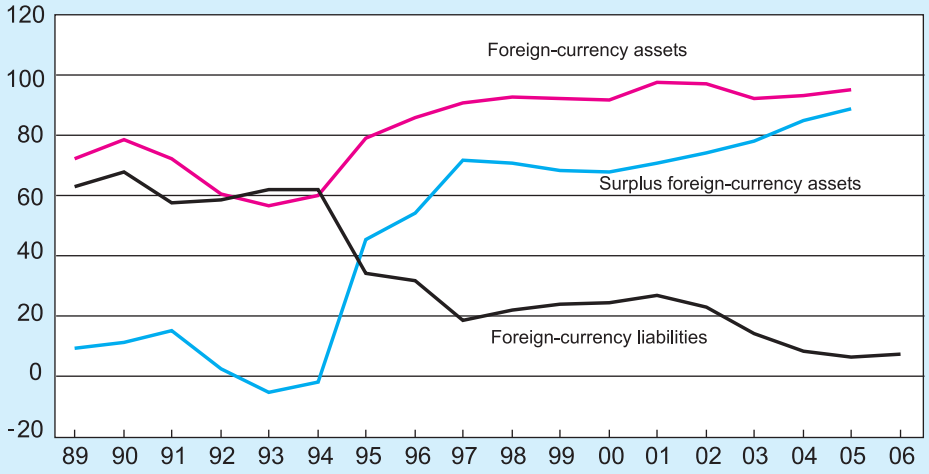
[1] In these explanatory remarks the term foreign exchange reserves has been used in its economic sense, and the reserves are therefore shown after offsetting Repo transactions. The reserves as shown consist of the balance in the "Foreign currency assets abroad" item on the assets side of the balance sheet, minus the balance in the "Financial foreign currency liabilities to abroad" item on the liabilities side. The reserves are used to determine the Bank of Israel's investment policy and its reporting to the various entities, and they are therefore used as the basis for the analysis of developments presented in these explanatory notes. Regarding the composition of the foreign exchange reserves see Note 2 in the Notes to the 2006 Financial Statements.

On the balance sheet the balance of loans is included on the assets side in the item "Foreign currency assets abroad" and the balance of assets transferred is included in the item "Financial foreign currency liabilities to abroad" on the liabilities side. See Note 2 to the 2006 Financial Statements.

[2] *Makam* and *pazak* minus the monetary loans. In the past, the Bank of Israel used other monetary instruments as well—options on the dollar exchange rate, and shekel/dollar swaps. The issue of options ended in 2006, and swap auctions in 2005, because it was assessed that these instruments had achieved their objective of boosting the market for dollar exchange-rate derivatives in Israel.

[3] Net income from the reserves: the balance of the item "Interest income from foreign currency financial assets abroad" minus the balance in the item "Interest paid on foreign currency financial assets abroad" in the Bank's Profit and Loss Account. For the composition of income from the foreign exchange reserves see Note 18 to the Financial Statements.

Figure 1
Foreign-Currency Assets, Liabilities, and Surplus Foreign-Currency Assets of the Bank of Israel, 1989-2006
(percent of balance sheet, end-of-year, at current prices)



1. MAJOR FACTORS THAT INFLUENCED THE BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

The business activity of a central bank is different from that of a commercial entity, because the former derives from the functions it is charged with by law, and is not necessarily aimed at making a profit. The achievement of a central bank's objectives affords economic benefits to the whole economy that are not reflected in its financial statements. Some of the duties imposed on the Bank of Israel by the legislator have significant implications for the financial statements—duties such as conducting monetary policy, managing the country's foreign exchange reserves, acting as the government's banker in Israel, and managing the quantity of money in circulation.

In 2006, as in all the last few years, the most notable aspects of the Bank of Israel's financial statements arose from the fact that the great majority (about 90 percent) of the Bank's assets are either denominated in or indexed to foreign currency, whereas most of its liabilities are in local currency (Figure 1). This currency imbalance was created in the years 1995–97, when the Bank adopted a tight monetary policy to achieve the inflation target set by the government. Import of capital by the private sector, which resulted from that policy, made it necessary for the Bank to buy foreign currency from the public to keep the NIS exchange rate from falling below the lower limit of the exchange rate band, and to re-absorb the shekel injected into the economy for that reason. The foreign exchange reserves swelled from an average of a few billion dollars in the preceding decade to about $23 billion in 1998.

The monetary instruments aggregate, which until 1994 consisted mainly of monetary loans, the usual situation in most central banks, is currently made up mainly of liabilities.

The currency imbalance in the composition of the Bank of Israel's assets and liabilities exposes the Bank to fluctuations in its reported financial results owing to changes in the exchange rate of the shekel against foreign currencies, and to changes in the path of Israel's interest rate relative to those of other countries.

2. MAIN DEVELOPMENTS

In 2006 the rapid economic growth that had started in the second half of 2003 continued, and the stability prevailing in the economy since then was preserved. The effect of the Second Lebanon War in July and August on most areas of economic activity turned out to be moderate and temporary.

The shekel strengthened by 8.2 percent against the dollar in 2006, in contrast to the situation in 2005 when the dollar strengthened against the shekel by 6.8 percent.

The exchange rates of the shekel against the other major currencies moved in the opposite directions to the above. The euro and pound sterling strengthened against the shekel by 2.2 percent and 4.4 percent respectively, in contrast to 2005 when they weakened by 7.3 percent and 4.4 percent respectively.

The dollar did not change uniformly during the year. In the first quarter the shekel depreciated against it at a rate of 2 percent, and then the trend reversed: from mid-March to the end of December the shekel appreciated against the dollar consistently by about 11 percent, except for a few days when the war broke out. The depreciation at the beginning of the year was partially due to geopolitical uncertainty. The appreciation during the rest of the year was due mainly to the surplus in the current account of the balance of payments, the rise in investment by nonresidents who thus exhibited their confidence in the strength of Israel's economy, and also to the dollar's weakness world wide, mainly related to growing concern over a slowdown in economic activity in the US. The rapid and strong pass-through mechanism between the exchange rate and the rate of price rises led to price reductions, which resulted in the CPI showing a reduction of 0.1 percent over the year.

The Bank of Israel interest rate rose by half a percentage point in total over the year, and at the end of year stood at 5 percent. It did not however follow a straight path during the year: in the first four months of the year it was raised by a cumulative 0.75 percentage points, due to the expectations of rises in interest rates around the world. In August, at the time of the Second Lebanon War, it was raised by a further quarter of a percentage point, because of concern that Israel's sovereign risk premium would be increased. Thereafter the rate was cut by a total of half a percentage point, as the inflation rate fell below the target set by the government. The interest rate continued to drop in 2007, reaching 3.75 percent in May, 1.5 percentage points below the interest rate in the US.

a. The foreign exchange reserves

The foreign exchange reserves grew this year by $1.2 billion, a rise of 4.3 percent, similar to the rate of increase in 2005. Most of the rise in the reserves was due to Bank of Israel profit of about $1.8 billion from investment of the reserves. Most of this came from interest totaling $0.9 billion and cumulative exchange-rate differentials on the non-dollar part of the reserves totaling $0.7 billion in dollar terms due to the weakening of the dollar against the other currencies in which the reserves were invested. In 2005 the opposite trend prevailed: the strengthening of the dollar against the other currencies resulted in negative exchange-rate differentials of $0.8 billion.

The government drew about $1 billion from the reserves, due to its net negative foreign currency borrowing and operational withdrawals, thereby offsetting part of the said increase. The national institutions contributed some $0.3 billion to the reserves.

The shekel value of the portfolio fell from NIS 128 billion at the end of 2005 to NIS 123 billion at the end of 2006. This decline despite the rise in the dollar value of the portfolio was the outcome of the 8.2 percent depreciation of the dollar against the shekel during the year.

b. Exchange-rate differentials

In 2006 exchange-rate differentials totaled a negative NIS 6.7 billion, as a result of the adjustment of the balances denominated in foreign currency on the balance sheet to the representative exchange rate. Most of this, about -NIS 7.3 billion, accumulated on the foreign exchange reserves (Table 1). The exchange-rate differentials accumulated on the balance sheet balances are not fully reflected in the Profit and Loss Account, unless they are recognized as “realized.” Realization with regard to a particular foreign currency is recognized only when the balance held in that currency declines.

Non-realized exchange-rate differentials are recorded in the revaluation accounts of the balance sheet. Future realizations of a particular currency are first offset against the revaluation account of that currency, if such exists, and only then are they imputed to the Profit and Loss Account. A negative balance in a revaluation account of any currency at the end of the year is defined as realized, and is thus imputed to the Profit and Loss Account. Hence the negative exchange-rate differentials arising as a result of the reduced value of the dollar in 2006 were considered as realized. They were not however reflected in the Profit and Loss Account, because they were almost entirely offset by the balance created in the last few years in the revaluation account. This can be seen in the reduction of about NIS 7 billion in the balance of the revaluation account on the balance sheet.

Income from exchange-rate differentials in the Profit and Loss Account, totaling about NIS 0.5 billion, derived mainly from realization in other currencies, in particular the euro.

Table 1
Exchange-Rate Differentials[a] on Foreign-Currency Balances, 2005–06

(NIS million, at current prices)

	2005	2006
Assets		
Foreign-exchange reserves	4,434	-7,323
Credit to the government—binational funds	10	-12
International financial institutions	-24	-19
Liabilities		
Government deposits	-798	582
Banks' foreign-currency deposits	-106	63
International financial institutions	7	29
Deposits of the binational fund	-11	14
Other liabilities—NIS/$ swaps	288	-
Total	**3,800**	**-6,666**
Realized exchange-rate differentials	1,938	451
Unrealized exchange-rate differentials	1,862	–7,117

c. The monetary instruments

The Bank of Israel employs various monetary instruments to implement its monetary policy, and this is reflected in the Bank's balance sheet and Profit and Loss Account.

Up to 1995, the Bank of Israel would inject liquidity into the economy, as a result of which the aggregate of the major monetary instruments consisted principally of monetary loans. Since then, as a result of the need to absorb the surplus liquidity created by the Bank of Israel's activity in the foreign currency market, the share of the monetary loans in the aggregate has fallen and the Bank has become a net borrower from the banking system, mainly through *makam* and time deposits. Until 2001 the Bank's main instrument for absorbing money from the public was time deposits, but with the removal of the ceiling on the issue of *makam* at the beginning of 2002, the Bank started gradually to make greater use of *makam* instead of time deposits, in order to expand the money market and to make more efficient use of the monetary instruments. This was reflected in a rise of NIS 12 billion in the balance of *makam* in 2006 in the course of the year, and a zero balance in time deposits at the end of the year, compared with a balance of about NIS 4 billion at the end of 2005.

The total balance of *makam* and time deposits in 2006 enabled the Bank of Israel to revert to its traditional role as a lender and to use monetary loans as an active monetary instrument for the first time since 1997 (with the exception of a few single days in 2005). The balance of these loans at the end of 2006 stood at about NIS 8 billion.

d. Government accounts

In 2006 the trend which had started at the end of 2004, i.e., the contraction of the government's debit balance in its local currency deposits at the Bank of Israel and the reduction of the credit balance in foreign currency deposits, continued. Although the end-of-year balance of government deposits for financing the budget was a negative NIS 0.7 billion, the annual average switched from a negative NIS 1.2 billion in 2005 to a positive NIS 1.1 billion in 2006. This resulted in the Bank of Israel incurring net interest expenses on local currency government deposits, for the first time since 1996, to the tune of about NIS 57 million, compared with income of NIS 943 million, NIS 342 million, and NIS 52 million in 2003, 2004 and 2005 respectively.

The average balance of government deposits for financing the budget dropped from NIS 9.4 billion in 2005 to NIS 6.5 billion at the end of 2006. In addition to the reason mentioned above, the decline was also due to government expenditure abroad and to negative exchange-rate differentials in shekel terms.

This change in the composition of the government accounts reduces its exposure to changes in the exchange rates of the shekel against other currencies and to changes in the interest rate differential between Israel and the US.

e. The monetary base

The monetary base—banknotes and coins in circulation and the banks' local-currency current-account deposits in the Bank of Israel—declined by about NIS 1.2 billion in 2006. Banknotes and coins increased by NIS 1 billion, a rise of 5 percent, close to the rate of economic growth in 2006, while the banks' local-currency current-account deposits in the Bank of Israel fell by NIS 2 billion.

Underlying the drop in the monetary base was government absorption of NIS 5.2 billion, and Bank of Israel injection of NIS 3.8 billion. The net absorption by the government stemmed from the continued decline in the budget deficit which was due mainly to receipts, mainly tax receipts, exceeding the budget forecast, and to a limited amount of government borrowing.

In January and February government absorption was high, and reached NIS 10 billion, due mainly to the temporary under-performance of budgetary expenses prior to the approval of the 2006 budget. In December there was an exceptional injection of about NIS 6.1 billion for government activity towards the end of the year.

The Bank of Israel injection, via the different monetary instruments—*makam*, time deposits and monetary loans—offset the greater part of the government absorption.

f. The Profit and Loss Account

The Bank of Israel's profit fell from NIS 1.4 billion in 2005 to a mere NIS 83 million in 2006.

The Bank of Israel's income from the foreign exchange reserves, excluding exchange-rate differentials, rose by NIS 1.5 billion, from NIS 3.2 billion in 2005 to NIS 4.6 in 2006 (Table 4). Expenses on the monetary aggregate rose by NIS 0.7 billion, from NIS 3.7 billion in 2005 to NIS 4.4 billion in 2006.

Net interest income from the government went down by NIS 0.5 billion, from NIS 0.7 billion in 2005 to NIS 0.2 billion in 2006.

Income from exchange-rate differentials fell sharply, by about NIS 1.5 billion, from NIS 1.9 billion in 2005 to NIS 0.5 billion in 2006. This is explained below.

Income

The main element in the Bank's income is the various items of income from the foreign exchange reserves. Interest income on the foreign reserves increased by 19 percent, from NIS 3.4 billion in 2005 to NIS 4 billion in 2006. The increase in dollar terms was even greater, 27 percent, arising from the increase of about 3 percent in the average amount of the reserves and from the rise of 1.8 percentage points in the interest rate in the US, from 3.2 percent in 2005 to 5 percent in 2006.

The drop of 8.2 percent in the exchange rate of the dollar against the shekel reduced the shekel value of the interest income, and the rise in dollar terms therefore exceeded the rise in shekel terms.

Other financial income from the reserves increased by NIS 0.8 billion, moving from expenses of NIS 0.2 billion in 2005 to income of about NIS 0.6 billion in 2006. Most of this switch was due to the realization of assets with a year to maturity.

Income from exchange-rate differentials dropped from NIS 1.9 billion in 2005 to NIS 0.5 billion in 2006. Most of the realization in both 2005 and 2006 was in foreign currencies other than the dollar included in the reserves portfolio, particularly the euro. Realization of exchange-rate differentials are checked monthly, so that a temporary decline in the balance in a particular portfolio at the end of the month may lead to considerable realization of the resulting exchange-rate differentials, even if the balance rises again in the next few days.

Interest income from the government fell from NIS 1 billion in 2005 to NIS 0.5 billion in 2006. Most of the reduction was in the indexation component in the local currency securities portfolio. Income from this portfolio are recorded on a cash basis. Indexation is received on redemption, so that indexation income depends on the extent of redemptions in the year. The fall of 0.1 percent in the CPI in 2006 acted to reduce the rate of indexation.

Table 2
Indicators of the Bank of Israel Profit, 1990–2006

	Profit (loss)	Realized exchange-rate differentials[a]	Net foreign-currency assets end-of-year	Change in currency-basket exchange rate during year	Treasury bills plus time deposits minus monetary loans 31 Dec.	Average interest, annual rates	
						Time deposits	Monetary loans
	NIS billion		$ billion		NIS billion		
	(at current prices)			percent	(at current prices)	percent	
1990	1.5	0.5	1.5	10.6	-		14.4
1991	1.9	0.8	2.0	11.2	-1		15.5
1992	1.7	0.6	0.3	16.3	-5		12.1
1993	1.3	-0.2	-0.8	6.3	-10		10.7
1994	1.8	0.4	-0.3	5.7	-8		12.7
1995	2.5	1.4	6.0	6.3	9		14.9
1996	-0.5	0.5	8.6	1.6	21	16.2	14.9
1997	-1.1	2.1	17.5	4.1	51	13.9	13.5
1998	10.9	13.1	18.4	20.4	63	11.9	11.5
1999	-8.7	-3.5	17.7	-3.2	73	12.2	11.8
2000	-6.7	-3.7	18.0	-5.5	80	9.4	8.9
2001	0.9	0.1	18.7	7.0	79	6.9	6.5
2002	1.7	0.9	20.2	13.0	77	7.0	6.6
2003	0.3	2.5	23.0	-1.6	84	7.5	7.1
2004	-0.8	0.9	25.4	0.8	87	4.3	3.8
2005	1.4	1.9	26.7	1.7	87	3.7	3.2
2006	0.1	0.5	27.4	-5.2	88	5.0	5.1

[a] Until 1999 all exchange-rate differentials were defined as realized.

Expenses

The major component of the Bank's expenses is the interest payments on monetary instruments, and principally on *makam*. Net expenses on the monetary aggregate increased from NIS 3.7 billion in 2005 to NIS 4.4 billion in 2006. This NIS 0.7 billion rise derived from an increase of NIS 1.1 billion in "expenses on *makam*," which was partially offset by a reduction of about NIS 0.2 billion in expenses on time deposits, and an increase of NIS 0.1 billion in income from the monetary loans.

The rise in expenses on *makam* was due to both a rise in their average yield and an increase in their balance. The drop in expenses on time deposits, despite the rise in the shekel interest rate, came from a marked reduction of about NIS 7 billion in their average balance, against the background of the preference for the use of *makam* rather than time deposits. The rise in income from the monetary loans was mainly the result of the increase of about NIS 3 billion from their level in 2005 to that in 2006, due to the more intensive use of the monetary loan auctions. In 2005 the balance consisted mainly of loans under the quota system, which ended in September 2005.

Administrative and general expenses maintained their level of 2005, and totaled NIS 0.6 billion in 2005 and in 2006.

g. The Bank of Israel's capital

In 2005 for the first time, the Bank of Israel's financial statements applied Accounting Standard 12 of the Accounting Standards Institute, which dealt with a one-time adjustment (to financial statements not adjusted for inflation) of non-monetary items to the Consumer Price Index for the month of December 2003. This adjustment increased the value of the Bank's share capital and general reserve to NIS 4 billion, compared with the previous figure of NIS 320 million.

The Bank of Israel has an accumulated loss of NIS 15.6 billion. The minimal profit in 2006 hardly affects this balance. According to the Bank of Israel Law, the Bank must transfer its profits to the government at the end of the business year, but losses are not covered by the government. Losses are accumulated in the Bank's accounts, and are offset against future profits.

The Bank of Israel's loss balance was created in the years 1999 and 2000. The loss was the result of the fact that interest expenses incurred in managing monetary policy exceeded interest receipts on the foreign exchange reserves, and negative exchange-rate differentials.[4]

3. MAIN ITEMS

a. The foreign exchange reserves

The foreign exchange reserves make up the largest part of the Bank of Israel's assets, and some of the Bank's other assets are indexed to foreign currency (together making up about 90 percent of the Bank's total assets).[5] This asset composition explains why the Bank's financial statements are greatly affected by exchange-rate fluctuations and changes in interest rates in the global economy.

The foreign exchange reserves serve as a source of liquidity when necessary, and they are also intended to be of benefit to the economy because the fact that the country has reserves of a certain size lowers the probability of a crisis in Israel's foreign currency market and improves its standing in the international financial arena.

[4] Until 1999 the policy regarding the recognition of exchange-rate differentials was different from what it is today. All accumulated exchange-rate differentials were recognized as realized in the financial statements, and were transferred to the government at the end of the year. In 1998 exchange-rate differentials totaling about NIS 15 billion were recorded in the statements, the outcome of the marked depreciation of the shekel. A large part of these differentials was offset as early as the beginning of 1999 as a result of the price drops, but as the balance of the profit had already been transferred to the government, they increased the accumulated loss. If the system in use currently had been used in 1998, the accumulated loss would be much lower than it is today.

[5] This composition of assets was created, as stated, in the years 1995–97, when the Bank of Israel bought the economy's surplus capital import in order to implement the exchange-rate policy adopted by the government, i.e., to maintain the lower limit of the exchange-rate band.

Table 3
Composition of Changes in the Monetary Base and Foreign Reserves, 1998–2004
injection (+)/absorption(–)

(current prices)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2005 IV	2006 I	2006 II	2006 III	2006 IV
NIS million														
1.Change in monetary base (1) = (2 + 3 + 4 + 5)	242	3,927	311	4,364	1,437	3,567	966	7,357	-1,176	4,623	-2,810	-829	1,833	630
2. Government and National Institutions	1,901	4,067	-2,729	-2,611	-6,065	3,479	1,601	-1,452	-3789	4,816	-2,073	-1,160	404	-960
3. Bank of Israel	-2,664	-365	2,729	7,675	9,265	1,425	1,070	9,920	3,797	136	-522	321	1,743	2,256
4. Foreign-currency conversions at Bank of Israel	1,746	-	-	-	-	-	-	-	-	-	-	-	-	-
5. Adjustments[a]	-741	225	311	-700	-1,763	-1,337	-1,705	-1,111	-1,184	-329	-215	10	-314	-665
$ million														
Banks' foreign-currency activity with the Bank of Israel														
6. Foreign-currency sales (–) to Bank of Israel (6) = (8 – 9 – 7)	-492	-	-	-	-	-	-	-	-	-	-	-	-	-
7. Public-sector transfers to banks[b]	-163	-259	-345	-20	183	335	342	-1,003	270	213	94	-1	-19	197
8. Change in deposits with Bank of Israel	-369	585	-462	91	-982	-896	-232	-133	291	25	-17	-22	16	312
9. Transfers to (–)/from (+) rest of world	286	844	-117	111	-1,165	-1,231	-574	870	20	-188	-111	-20	36	116
10. Adjustments[c]	-343	-197	-275	-216	-186	27	-57	156	5	145	48	1	-89	44
Contribution to reserves														
11. Private sector[d] (11) = (9 + 10)	-57	647	-392	-105	-1,351	-1,204	-631	1,026	25	-43	-63	-19	-53	160
12. Public sector[e]	2,399	-806	1,041	122	1,840	3,322	1,475	200	1,172	578	101	-532	323	1,280
13. Change in reserves[f] (13) = (11 + 12)	2,342	-159	649	17	489	2,118	844	1,226	1,197	535	38	-551	2,701	1,440

[a] Adjustments include: transfers from abroad by the National Institutions through the banks, defined as public-sector injection (in row 2). Government and Bank of Israel domestic foreign-currency receipts from and payments to the private sector (e.g., 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 and on the other they are defined as the private sector's contribution to the foreign reserves (without going via the Bank of Israel's trading-room floor).
[b] NIS/$ swaps and other domestic foreign-currency payments.
[c] Transfers from abroad by the public sector through the banks, e.g., by the National Institutions.
[d] Including income tax payments in foreign currency by the private sector.
[e] Transfers by the government and the National Institutions, and Bank of Israel income from the foreign reserves (interest income, capital gains and cross-rate differentials).
[f] Including the change in accrued interest on the foreign reserves.

Defining the roles of the reserves is not merely a theoretical exercise, but it provides a basis for determining the desired level of the reserves, a method for managing them, and a basis for setting the currency numeraire, i.e., the currency composition used as a guideline for managing the reserves. Since December 2003, this composition has been derived from the distribution by currency of the reserves' possible uses.

The foreign exchange reserves are managed in accordance with the Bank of Israel Law, 5714–1954 and the relevant legal interpretations which have been added over the years. These determine the guidelines for the Bank's foreign exchange activities, and impose limitations on the types of assets in which it may invest. In areas where the Bank is not restricted by the Law it acts within a framework that expresses its priorities and limits the various risks to which the reserves portfolio is exposed.

The yields on the reserves

The Bank of Israel invests the foreign exchange reserves mainly in tradable securities with a relatively short average duration, to ensure an appropriate level of liquidity and to avoid the danger of wide swings in the value of the portfolio which could occur in the wake of fluctuations in the financial markets.

The yield achieved on the investment of the foreign exchange reserves is compared with a benchmark yield. The benchmark is a hypothetical portfolio made up of various assets selected according to pre-set rules, that reflects the Bank's long-term investment strategy. The holding period return of the assets included in the benchmark, in all currencies, are weighted by the weights of the assets in the basket of uses (the numeraire). The average duration of the benchmark since 1999 has been set at 16 months,[6] based on the shortfall approach.[7] In 2006:Q3 the parameters were changed to reflect more closely the assessment of the trade-off between yield and risk according to the approach of the Bank's management. For the time being the new parameters are being applied only in the dollar portfolio, and their application has changed the duration of the benchmark to a constant 24 months. The duration of the benchmarks of the other currencies have been left at 16 months.

The actual annual yield on the reserves was 3.9 percent this year, higher than the 3.8 percent yield on the benchmark. The difference reflects the contribution of investment decisions, taken by utilizing the degrees of freedom in active management of the reserves, decisions expressed by deviations of the portfolio from the composition of the benchmark. These degrees of freedom are relatively limited and are restricted by a

[6] From the beginning of 2003 to mid-2005, the duration of the dollar part of the benchmark was temporarily reduced to 11 months due to the very low level of yields to maturity in the US market and the rise in the probability that they would increase. The duration of the non-dollar part of the benchmark remains at about 16 months.

[7] According to this approach, the target duration is set such that the annual holding period return of the portfolio will not drop below the desired minimum threshold with the desired degree of certainty. The parameters from which the duration is derived are determined according to the risk preferences of the owner of the reserves portfolio.

regime of regulations, part of the investment policies of the reserves. The added value of the management of the reserves is expressed in the difference between the yield on the reserves portfolio and that of the benchmark, a difference of 0.1 percent in 2006, and an average of 0.1 percent over the past decade.

The yield on the reserves this year was greatly affected by the rising trend of yields to maturity in the US and euro markets. These took place against the background of the continued tight monetary policy in the US, which started in 2004, and which carried into the first half of 2006. The US Federal Reserve raised the interest gradually from 4.25 percent to 5.25 percent. The tight policy of the European Central Bank (ECB), which began to raise the interest rate towards the end of 2005, with the rate increasing from 2.25 percent at the beginning of 2006 to 3.5 percent at the end of the year, affected the rise in yields to maturity in the eurozone markets. The rise in yields on short- and medium-term bonds boosted the current interest income component of the holding period return of the reserves, but was reflected in a drop in the price of those bonds, which was recorded as a capital loss and reduced the holding period return.

Table 4
Foreign Reserves—Total, Income, Exchange-Rate and Cross-Rate Differentials and Yields, 2004–06

		2004	2005	2006
Total foreign reserves			$ million	
End of year		26,632	27,858	29,055
Annual average		25,987	27,035	27,955
Income and exchange-rate and cross-rate differentials			NIS million	
Total		**2,224**	**7,584**	**-2,707**
Interest and capital gains		2,100	3,150	4,616
NIS/$ exchange-rate differentials		-1,906	7,852	-10,455
Cross-rate differentials ($/other currencies)		2,030	-3,418	3,132
			$ million	
Total		**938**	**-76**	**1,771**
Interest and capital gains		470	688	1,062
Cross-rate differentials ($/other currencies)		468	-764	709
Yields[a]			Percent	
In terms of NIS	Total	1.8	6.5	-2.3
	Interest and capital gains	1.7	2.6	3.9
	NIS/$ exchange-rate differentials	0.1	3.9	-6.2
In terms of euro	Total	-4.1	14.9	-4.3
In terms of $	Total	3.5	-0.3	6.5
	Interest and capital gains	1.7	2.6	3.9
In terms of use[b] **of foreign reserves**		**1.7**	**2.6**	**3.8**
Benchmark yield		**1.7**	**2.4**	**3.7**

[a] Yields (annual, compounded daily) refer to income from the foreign reserves, including profit or loss arising from changes in market prices.
[b] See note 2 to the financial statement.

The yield on investing the reserves is measured in terms of the currency component of the reserves' uses (the numeraire), and not in terms of any specific currency. The arbitrariness of measuring yield in terms of any specific currency is highlighted by looking at the yield in dollar terms (6.5 percent in 2006), and in euro terms (–4.3 percent), and the high volatility of these yields over the years (Table 4).

The yield in terms of shekel in 2006 was negative, –2.3 percent, reflecting the weakening of the shekel against the dollar by 8.2 percent during the year—which was partially offset by the strengthening against the shekel of the other currencies in which the reserves are invested, and by interest income and capital gains on the reserves. In the past decade, the holding-period rate of return in shekel terms was 7.2 percent a year, and discounted for the rise in domestic prices during this period, was 4.6 percent a year.

The Bank's financial statements, shown in shekel, give expression to changes in the exchange rate of the shekel against other currencies, changes which are not taken into consideration in managing the portfolio.

Causes of the changes in the foreign exchange reserves

The rise of about $1.2 billion in the reserves in 2006 consisted of $1.8 billion from the Bank of Israel, a negative $1 billion from the government, a contribution of $0.3 billion from the national institutions, and a modest $25 million from the private sector.

Most of the increase was imputed to the Bank of Israel's contribution from investing the reserves; this included about receipts of interest of $0.9 billion, and exchange-rate differentials of $0.7 billion.

The weakening of the dollar against the other currencies in which the reserves are invested led to positive exchange-rate differentials, in dollar terms, on the non-dollar part of the reserves. In 2005 the opposite trend prevailed, with the dollar strengthening against the other currencies, and this resulted in negative exchange-rate differentials of $0.8 billion and a low Bank of Israel contribution to the reserves of about $0.1 billion.

The government drew down about $1 billion in 2006, compared with negative withdrawals totaling –$0.2 billion in 2005.

The foreign currency cash flow of government activity does not pass in its entirety through its accounts at the Bank of Israel, and some movement takes place directly vis-à-vis its accounts abroad. Hence some of the government's foreign currency activity does not directly affect the foreign exchange reserves at the Bank of Israel.

Government foreign currency receipts consist mainly of grants from the US government and from borrowing abroad.

Government foreign currency payments include expenses on defense imports, payment of the country's debts (principal and interest), and expenses of various ministries.

Raising capital

In 2006, as in 2005, the government's net borrowing was negative, consistent with its objective of reducing Israel's external and internal debts.

In November and December 2006 the government raised $1.5 billion, about $1 billion in November in the global market, and about $0.5 billion in a private issue indexed to the Brazilian real. The capital raised in November was reflected in a positive government contribution to the reserves in that month, to the amount of about $0.8 billion. In 2005 the government raised only about $0.9 million abroad, in euro.

In addition, every year the government raises money via State of Israel Bonds.

State of Israel Bonds

In 2006 the government raised about $1.3 billion from issues of State of Israel Bonds, compared with about $1 billion in 2005. A significant part of the money raised via the Bonds is used for payments abroad, and only a small part is deposited in the Bank of Israel. Israel continues to issue these Bonds despite the higher cost incurred, to maintain an additional avenue of raising money in times of need.

Economic aid from the US

Aid from the US shown in the Bank of Israel books consists of civilian aid and that part of defense aid that is convertible. Civilian aid is being reduced by $120 million each year, and the aid in 2006 is meant to be the last payment. The $120 million for 2006 was received at the beginning of 2007. In 2005 $0.6 billion was received for the years 2004 and 2005.

Convertible defense aid totaled $0.8 billion in 2006, compared with $0.5 billion in 2005. This was reflected in a positive government contribution to the reserves in July and December.

Government foreign currency payments

Repayment of Israel's debts and interest payments, which constitute the major part of the government's foreign currency expenses, totaled $4.8 billion in 2006, just over $1 billion more than in 2005 ($3.7 billion).

These expenses represented a large negative government contribution to the reserves in June of about $0.7 billion; some $0.5 billion of this was used to repay a debt in euro whose repayment date had been reached.

The government's foreign currency payments exceeded receipts, so that the overall government contribution to the reserves was a negative one of about $1 billion, compared to a negative contribution totaling –$0.2 billion in 2005.

The contribution of the private sector came to only $25 million, but was not spread uniformly over the year: until November the cumulative contribution was a negative $ 0.25 billion, but in December the commercial banks made short-term deposits of $0.3 billion, which were used as collateral for the monetary loans they took.

The private sector's contribution to the reserves in 2005 was about $1 billion. In that year the banks had to import $1.2 billion to repay the swap auctions totaling about $1.4 billion which the Bank of Israel was discontinuing.

b. Government accounts

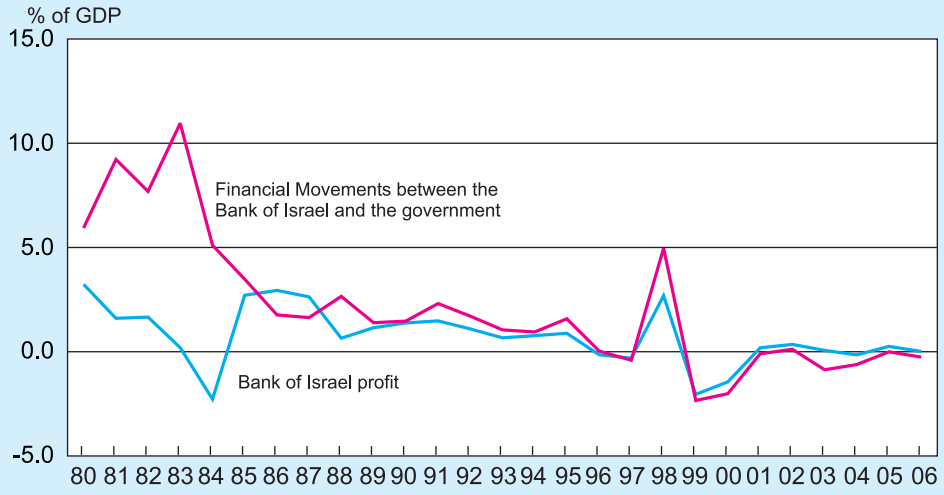
According to Section 57(a) of the Bank of Israel Law, 5714–1954, "The Bank shall be the sole banker and fiscal agent in Israel of the Government." Hence, the government holds all its local-currency accounts and some of its foreign-currency accounts in the Bank of Israel.

The government's deposits are divided into two categories: deposits for financing the budget, and other deposits.

The average of the government deposits fell from about NIS 11 billion in 2005 to NIS 8 billion in 2006. Most of the reduction was due to the decline in the balance of other foreign currency deposits.

The balance of the government deposits for financing the budget fell in 2006 by

Figure 2
Total Financial Movements between the Bank of Israel and the Government, and the Bank of Israel Profit, 1989-2006
(percent of GDP, at current prices)



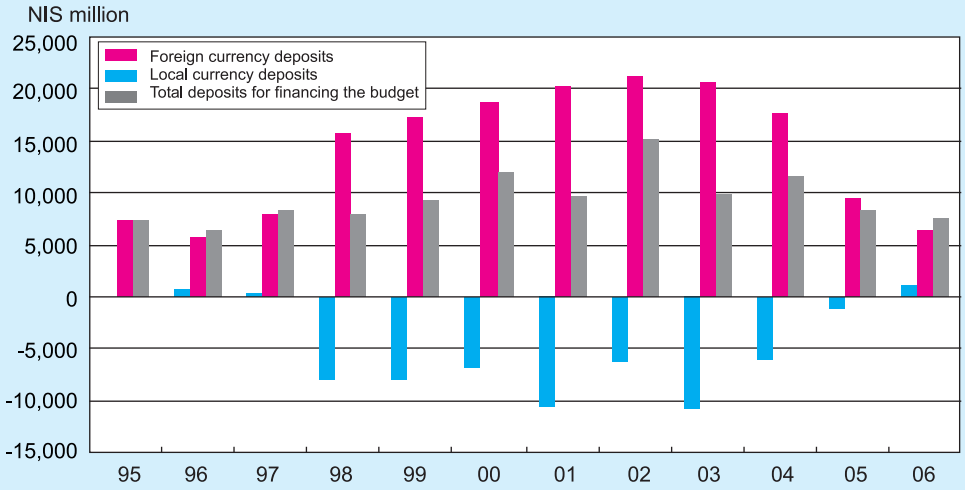
NIS 1 billion on average but beyond that the composition of the balance altered significantly, as shown below.

According to Section 45(b) of the Bank of Israel Law, "the Bank of Israel may make to the Government . . . a provisional advance to bridge temporarily gaps in the government's cash flow in the implementation of the budget . . . , provided that the total of the temporary advance shall not exceed, at any time, 1.6 percent of the total

ordinary annual budget at that time ...."[8] This was the reason for the government's defining the deposits for financing the budget.

Since 1998 the shekel deposits have usually shown a considerable debit balance,

Figure 3
The Government's Local- and Foreign-Currency Deposits for Financing the Budget, 1995-2006
(annual average, NIS million, at current prices)



which was exceeded by the credit balance in the foreign currency deposits (Figure 3). Although the total balance of the government deposits for financing the budget had a credit balance, and satisfied the requirements of the Law, this type of management incurs costs, and causes currency exposure.

On the debit balances in its shekel accounts the government pays interest at prime, whereas on the interest paying foreign currency accounts it receives the rate of interest payable on six-month US T-bills. The interest rate differential between the dollar and the shekel caused the government net interest expenses in those years. In 2003, for example, the government paid a net NIS 0.7 billion in interest payments, although the overall balance of its deposits was in credit.

Beyond the expenses incurred on interest, the method of managing the government accounts causes high volatility in the shekel value of the foreign exchange reserves, due to the high dependence on the dollar exchange rate. Thus, for example, in 2006 negative cumulative exchange-rate differentials on the government accounts totaled about –NIS 0.6 billion, compared with positive differentials of NIS 0.8 billion in 2005 (Table 1).

Since the end of 2004 the trend has been to reduce the debit balance in the shekel

[8] The Law permits an increase in the temporary advance to 3.2 percent of the budget during two periods in the course of the fiscal year, neither of which shall last longer than 30 days.

Table 5
Government Deposits with the Bank of Israel, 2004–2006

(NIS million, current prices)

	2004	2005	2006
End-year balances			
Government deposits for budget financing			
Local-currency deposits	-7,407	-48	-652
Foreign-currency deposits	13,215	6,680	6,066
Total government deposits for budget financing	**5,808**	**6,632**	**5,414**
Other deposits[a]	706	295	668
Total	6,514	6,927	6,082
Net change in government deposits	**-1,804**	**413**	**-845**
Sources of change			
Government contribution (+) to foreign reserves[b]	776	-840	-4,588
Government absorption (+)	-247	2,677	5,234
Government–Bank of Israel financial flow[c]	-2,384	-1,457	-1,582
Adjustments[d]	51	33	91

[a] Including the local-currency deposit to stabilize bond prices, another deposit in foreign currency, and interest accrued on government deposits (see note 10 on Deposits of the Government).
[b] Government income and expenses abroad, loans received and loan repayments abroad.
[c] Interest payments and redemption of government bonds held by the Bank of Israel; commission from the government; interest payments, repayment of principal and payment of indexation differentials on credit to the government, and interest payments by the Bank of Israel on government deposits (in local and foreign currency); exchange-rate differentials on government foreign-currency deposits; and transfer to the government of Bank of Israels profit.
[d] Including accrued interest on government deposits to the end of the year; interest payments by the government on credit from the Bank of Israel for binational funds (these payments are included under 'Government injection,' but in this table they are also included under 'Government–Bank of Israel financial flow'); State of Israel Bonds redemptions by tourists in Israel (these redemptions reduce the government's local-currency deposits, but are not included in 'Government injection').

accounts, and to reduce the credit balance in the foreign currency accounts.

The average balance in the shekel accounts increased from a negative NIS 1.2 billion in 2005 to a positive balance, for the first time since 1998, of NIS 1.1 billion. This change resulted in the Bank of Israel recording, for the first time since 1996, net interest expenses on the government's shekel deposits, which came to about NIS 57 million, compared with income of NIS 943 million, NIS 342 million and NIS 52 million in 2003, 2004 and 2005 respectively.

Interest expenses on foreign currency deposits dropped from NIS 0.35 billion in 2005 to NIS 0.32 billion in 2006 despite the rise in the dollar rate of interest; this was due to the decline in the average balance in the guarantees deposit and the aid deposit, which zeroed out at the beginning of the year.

Reform of the government bond market

In 2006 a comprehensive reform of the government bond market took place. Following Amendment 14 to the State Loan Law, 5739–1979, the management of the issue of

tradable government bonds and bonds earmarked for pension funds was transferred in June 2006 from the Bank of Israel to the Government Debt Management Unit in the Ministry of Finance, which was established by the Accountant General for that purpose.

As part of the reform, main market makers were appointed, and they are obliged to quote buying and selling prices for bonds on a continuous basis; this is intended to enhance the financial markets and to reduce the government's borrowing costs.

Concurrently, in September a bond lending pool was established for the primary market makers, with the intention of assisting them in their obligation to quote. Primary market makers in need of bonds borrow them from the pool, in exchange for interest-bearing cash. This money is imputed to the government deposits, and bears interest at the Bank of Israel rate.

Credit to the government

Most of this credit consists of long-term advances granted to the government in the 1980s to finance the budget deficits.

All the loans were granted before the Non-Printing Law was passed in 1985, except for one exceptional loan given in 1988 to redeem part of the commercial banks' shares.

The advances given before 1985 are indexed to the first-currency-basket exchange rate and bear interest of 8 percent, also indexed to the basket, while the 1988 loan bears interest of prime plus 2 percent. These advances are being repaid by annual payments, the last of which will be in 2012.

In 2006 the government repaid about NIS 0.6 billion, similar to the amount repaid in 2005, and the balance of credit to the government dropped by NIS 2.8 billion. The government paid NIS 0.3 billion in interest, similar to the level of repayments in 2005, and indexation zeroed out due to the fall in 2006 in the exchange rate of the first currency basket which followed its decline in 2005.

Securities portfolio

The Bank of Israel's securities portfolio includes CPI-indexed government bonds that the Bank bought in the past as part of its monetary policy and its involvement in the bond market. A considerable amount of the purchases were made in 1995 and 1996, but the Bank continued to make purchases until 2002.

The income on the portfolio is included in the Profit and Loss Account on a cash basis. The interest is paid once a year, and indexation is paid when the security reaches redemption.

Interest income from this portfolio amounted to NIS 0.2 billion in 2006, compared with NIS 0.6 billion in 2005. Most of the reduction derived from the indexation component, as in 2005 there were large-scale bond redemptions. The fall in the CPI in 2006 also acted to lower the indexation element in bonds, as it reduced the rate of indexation.

c. Monetary instruments

The Bank of Israel employs various instruments to implement its monetary policy. Until 1995 the monetary loans made up the major part of the monetary aggregate, as is the case in most advanced economies. In the years 1995–97 the Bank of Israel intervened in the foreign currency market to offset the effect of the inflow of capital on the exchange rate. That activity injected liquidity into the economy, which the Bank of Israel was obliged to absorb. As a result, the structure of the aggregate altered, and the Bank became a net borrower from the banking system, mainly via *makam* and time deposits.

Until 2001 the Bank used mainly time deposits for purposes of absorbing liquidity, but since the removal of the ceiling on the issue of *makam* at the beginning of 2002, it gradually moved to the use of *makam* at the expense of time deposits, with the intention of enhancing Israel's money market and improving the effectiveness of monetary policy. One of the aims of the Bank of Israel in expanding the use of *makam* is to reach a degree of absorption that will bring the commercial banks to a position in which they have a basic liquidity deficit, so that interest will be determined by means of the monetary loan auctions which the Bank offers the banks to cover that deficit. This trend persisted in 2006, and the balance of *makam* rose by about NIS 12 billion. This rise, together with the increase in the yield on *makam* in 2006, raised the expenses on *makam* from NIS 3.4 billion in 2005 to NIS 4.4 billion in 2006.

Concurrently, expenses on time deposits declined from NIS 0.3 billion in 2005 to NIS 0.1 billion in 2006. The reduced use of time deposits cut their average balance from NIS 9.3 billion in 2005 to NIS 2.6 billion in 2006.

The continued increase in the overall total of makam and time deposits in 2006 was one of the reasons for the Bank of Israel's return to the use of monetary loan auctions for the purposes of conducting day-to-day monetary policy.

Monetary loan auctions had not been used since 1997, and the balance of monetary loans on the balance sheet consisted mainly of monetary loans under the quota system. These loans were granted to banks, with quotas fixed for every rate of interest in accordance with each bank's share of the average liquidity debt in the system. The balance of these loans was fairly constant throughout the period, at about NIS 0.8 billion, with the exception of short periods when the banks tended to avail themselves of the loans even at unattractive interest rates, to cover a temporary liquidity shortage.

In 2005 monetary loan auctions were held on only a few isolated occasions, but in 2006 widespread use was made of them, reflected by the rise in their average balance from NIS 0.6 billion in 2005 to NIS 3.3 billion in 2006, with a corresponding increase in income from this source.

d. The banking corporations' deposits

The banking corporations' shekel deposits at the Bank of Israel are used to cover their liquidity debt, in accordance with the Bank of Israel's directives, and to settle various

payments carried out via the banks. A few government payments are performed via the Postal Bank. On the other side, the Postal Bank handles a large share of the collection of payments to the government.

The balance of the banks' shekel current accounts fell from NIS 14.2 billion in 2005 to NIS 11.8 billion in 2006. The annual average balance increased from NIS 9.8 billion in 2005 to NIS 10.2 billion in 2006 (Table 7).

Table 6 shows that in 2006 the government injected about NIS 4.5 billion via the commercial banks.[9] The public withdrew some NIS 10.4 billion in cash from the banks. Most of the withdrawals from the commercial banks, about NIS 9.3 billion, was intended for payments to the government via the Postal Bank, many of which are made in cash.

The Bank of Israel absorbed a net NIS 3.6 billion from the commercial banks by means of the various monetary instruments—*makam*, time deposits, and monetary loans.

The banks' foreign currency deposits rose in 2006 by about NIS 1.1 billion, equivalent to about $ 0.3 billion. Most of the rise occurred at the end of the year.

The increase in the balance of the monetary loans made it necessary for the banks to provide appropriate collateral. This collateral was likely to include, in addition to a floating lien on the *makam* held by the banks, also foreign currency deposits at the Bank of Israel. The banks therefore imported foreign currency into their accounts at the Bank.

[9] Overall, the government absorbed a net NIS 5.2 billion in 2006. This was the result of absorption of about NIS 9.3 billion via the Postal Bank, which exceeded the injection via the commercial banks.

Table 6
Deposits of the Banking Corporations with the Bank of Israel, 2004–06

(NIS million, current prices)

	2004			2005			2006		
	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total	In NIS	In foreign currency	Total
Change in banking corporations' deposits[a]	**-680**	**-1,033**	**-1,713**	**3,725**	**-488**	**3,237**	**-2,305**	**1,146**	**-1,159**
Activity with the government[b]	8,553	1,504	10,057	6,382	1,796	8,178	4,511	1,167	5,678
Withdrawal (–) of banknotes from Bank of Israel	-10,230	-	-10,230	-12,457	-	-12,457	-10,435	-	-10,435
Activity with Bank of Israel[c]	890	-29	861	9,747	-6,200	3,547	3,637	-54	3,583
Transfers from (+) and to (–) abroad	-	-2,534	-2,534	-	3,907	3,907	-	21	21
Foreign-currency conversions at Bank of Israel	-	-	-	-	-	-	-	-	-
Adjustments	107	26	133	53	9	62	-18	12	-6
Deposit of banknotes by Post Office Bank in Bank of Israel[d]	**8,539**		**8,539**	**8,767**		**8,767**	**9,295**		**9,295**

[a] This does not include the change in time deposits.
[b] Government injection via the banking corporations' demand deposits.
[c] Depositing time deposits, the purchase of *makam*, the sale of goverment bonds, and various interest payments.
[d] Deposits of banknotes mainly by the Post Office Bank; these deposits are a government absorption, and are included under 'Government injection.'

Table 7
Accounts of the Banking Corporations with the Bank of Israel, 1998–2006

(daily average, current prices)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2005 IV	2006 I	2006 II	2006 III	2006 IV
Local-currency deposits and credit[b]														
NIS billion														
1. Demand deposits	4.5	5.5	6.6	7.8	8.3	8.3	9.0	9.8	10.2	9.9	10.2	10.1	10.1	10.3
2. Time deposits	36.9	44.1	46.0	46.5	33.5	30.5	21.0	9.3	2.6	6.4	3.9	4.0	2.0	0.7
3. Loans														
3.1 Monetary	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.6	3.3	0.0	2.8	0.9	2.0	7.4
3.2 Other	–	–	–	–	0.6	2.1	1.7	1.2	0.9	1.0	1.0	0.9	0.9	0.8
4. Net deposits (= 1 + 2 – 3)	40.6	48.8	51.8	53.4	40.4	36.0	27.5	17.4	8.7	15.3	10.3	12.4	9.1	2.9
5. Net deposits plus swaps	45.9	54.6	57.5	59.3	47.0	42.4	33.8	21.0	8.7	15.3	10.3	12.4	9.1	2.9
6. Net deposits plus swaps and *Makam*[c]	67.1	78.6	83.3	89.8	85.3	91.4	97.8	97.5	97.0	96.6	92.8	99.5	99.7	95.9
Foreign-currency deposits and credit[b]														
$ billion														
7. Deposits	1.9	2.0	2.2	2.4	2.1	0.5	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.3
8. Net deposits less swaps[d]	0.5	0.6	0.8	1.0	0.7	-0.9	–1.1	-0.5	0.2	0.2	0.2	0.2	0.2	0.3
NIS billion														
9. Net deposits less swaps[d]	1.8	2.4	3.3	4.0	3.5	–4.1	–4.7	-2.1	1.0	1.1	1.1	0.9	0.9	1.2
10. Total net deposits plus swaps and *Makam* (= 6 + 9)	68.8	81.0	86.5	93.8	88.8	87.3	93.1	95.4	98.0	97.7	93.9	100.4	100.7	97.1
Rates of interest (percent)[e]														
11. Monetary loans	11.5	11.8	8.9	6.5	6.6	7.1	3.8	3.2	5.1	5.5	4.8	5.3	5.5	5.1
12. Time deposits	11.9	12.2	9.4	6.9	7.0	7.5	4.3	3.7	5.0	4.1	4.6	5.1	5.4	5.4

[b] Items 1–10 include accrued interest.
[c] Net deposits plus NIS swaps for remittance and *Makam* deposit (excluding the part of the deposit arising from the replacement of government bonds by *Makam*).
[d] Deposits less loans and less dollar swaps to be received.
[e] Annual rate, based on quarterly and yearly calculations respectively.