Bank of Israel
Accounting, Payment and Settlement Systems Department

FINANCIAL STATEMENTS

FOR 2017

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AUDITORS' REPORT

To the Governor and the Supervisory Council of the

BANK OF ISRAEL

We have audited the accompanying Balance Sheets of the Bank of Israel (hereinafter, "the Bank") as of December 31, 2017 and 2016, and the related statements of operations and changes in deficit equity of the Bank for each of the years then ended (hereinafter, "the financial statements") featured on pages 6-32 below. These financial statements are the responsibility of the Bank's Supervisory Council, Governor, Director General and Director of the Accounting, Payment and Settlement Systems Department. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2017 and 2016, and the results of its operations and changes in its deficit equity for each of the years then ended, in conformity with accounting principles generally accepted in Israel ("Israeli GAAP"), adapted for principles applicable to central banks, as detailed in Note 1a.

Jerusalem, Israel
March 26, 2018

Kost Forer Gabbay & Kasierer
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

Balance Sheet

		As of December 31	
	Note	2017	2016
Assets			
Foreign currency assets			
Foreign currency assets abroad	2		
Demand deposits		89,071	47,267
Short-term deposits		18,458	3,474
Tradable securities		279,768	325,542
Reverse repurchase agreements		57	194
Derivative financial instruments		361	3,501
Other assets		1,151	-
The International Monetary Fund	3	5,284	4,505
Total foreign currency assets abroad		**394,150**	**384,483**
Other foreign currency assets			
Credit to the government	4	115	127
Total foreign currency assets		**394,265**	**384,610**
Local currency assets			
Tradable securities	5	6,386	8,662
Fixed assets	6	462	393
Other assets	7	381	*) 358
Total local currency assets		**7,229**	**9,413**
Total		**401,494**	**394,023**

The accompanying notes are an integral part of the financial statements.
*) Reclassified, see Note 7.

(NIS million, reported amounts)

	Note	As of December 31 2017	2016
Liabilities and equity			
Banknotes and coins in circulation	8	**82,202**	**75,996**
Foreign currency liabilities			
Foreign currency liabilities abroad	2		
Repurchase agreements		-	2,079
Derivative financial instruments		2,136	204
Other liabilities		202	3,672
Total foreign currency liabilities abroad		**2,338**	**5,955**
Other foreign currency liabilities			
Government deposits	9	7,540	9,282
Deposits of banking corporations	10	724	772
The International Monetary Fund and others	11	4,483	4,697
Total other foreign currency liabilities		**12,747**	**14,751**
Total foreign currency liabilities		**15,085**	**20,706**
Local currency liabilities			
Government deposits	9	19,394	15,134
Deposits of banking corporations	10	234,478	206,503
Makam	12	91,945	104,934
Other liabilities	13	7,149	6,651
Total local currency liabilities		**352,966**	**333,222**
Total liabilities		**450,253**	**429,924**
Revaluation accounts	14	**13,494**	**25,564**
Equity			
Share capital and general reserve	15	3,985	3,985
Accumulated losses		(66,238)	(65,450)
Total equity (Deficit Equity)		**(62,253)**	**(61,465)**
Total		**401,494**	**394,023**

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

Karnit Flug
Dr. Karnit Flug
Governor

J. Shemer.
Prof. Yehoshua (Shuki) Shemer
Chairman
of the Supervisory Council

Kalo
Hezi Kalo
Director General

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

Date of approval of the financial statements: March 26, 2018.

STATEMENT OF OPERATIONS

(NIS million, reported amounts)

		FOR THE YEAR ENDED DECEMBER 31	
	Note	2017	2016
Interest income			
From assets in foreign currency abroad	17	3,668	2,424
From the government	18	330	419
Total interest income		**3,998**	**2,843**
Interest expenses			
To banks and the public	19	315	288
To the government	20	315	287
Other	21	98	78
Total interest expenses		**728**	**653**
Interest income, net		**3,270**	**2,190**
Other financial income (expenses)			
From securities and derivative financial instruments	22	2,474	*) 695
From exchange rate differentials		(5,578)	(7,053)
Miscellaneous	23	(26)	(23)
Total other financial expenses		**(3,130)**	**(6,381)**
Income (loss) from financial transactions		**140**	**(4,191)**
Expenses of printing banknotes and minting coins		**(182)**	**(202)**
General and administrative expenses	24	**(689)**	**(675)**
Other expenses	25	**(57)**	*) **(258)**
Loss for the year		**(788)**	**(5,326)**

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

*) Reclassified, see Notes 22 and 25.

STATEMENT OF CHANGES IN EQUITY (Deficit Equity)

(NIS million, reported amounts)

	Share capital and general reserve	Accumulated losses	Total Deficit Equity
Balance as of January 1, 2016	3,985	(60,124)	(56,139)
Loss for the year	-	(5,326)	(5,326)
Balance as of December 31, 2016	3,985	(65,450)	(61,465)
Loss for the year	-	(788)	(788)
Balance as of December 31, 2017	**3,985**	**(66,238)**	**(62,253)**

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

NOTES TO THE FINANCIAL STATEMENTS

1. Significant accounting policies

a. General

The financial statements are prepared in accordance with generally accepted accounting principles in Israel (Israeli GAAP), adapted for the special activity of a central bank and consistent with the practice of other central banks. The main items presented in accordance with generally accepted accounting principles of central banks are:

1) Revaluation accounts - as detailed in Section m below.
2) Statement of cash flows - as detailed in Section t below.

b. Definitions

In these financial statements:

1) **"The Bank"**—the Bank of Israel.
2) **"CPI"**—the Consumer Price Index as published by the Central Bureau of Statistics.
3) **"Adjusted cost"** "—the adjusted cost of bonds is their par value plus the interest accrued thereon and the balance of the premium or discount not yet amortized. The premium or discount is amortized over the period from the date of purchase of the bond until the date of its redemption.
4) "**Adjusted amount**"—the historical nominal amount adjusted to the CPI in respect of December 2003, in accordance with the provisions of Opinions 23 and 36 of the Institute of Certified Public Accountants in Israel.
5) **"Reported amount"**—the adjusted amount at the transition date (December 31, 2003), with additional amounts in nominal values that were added after the transition date, less amounts subtracted after the transition date.
6) **"Nominal financial reporting"**—financial reporting based on reported amounts.
7) **"Fair value"**—the amount for which an asset can be acquired or sold (a liability assumed or settled) in a current transaction between independent willing parties.

c. Financial statements in reported amounts

1) The term "cost" in these financial statements denotes the reported amount of cost.
2) Amounts of nonfinancial assets do not necessarily reflect their realizable value or current economic value, but only the reported amounts of those assets.

d. Reporting principles

1) Balance Sheet:
   a. Nonfinancial items (fixed assets and investments shown at cost) are stated in reported amounts.
   b. Financial items are stated in the Balance Sheet at their nominal values at the Balance Sheet date.
   c. Investments in tradable securities are stated at fair value.
   d. Investments in derivative financial instruments are stated at amortized cost.
   e. The Balance Sheet is presented in the format generally accepted by central banks worldwide.
2) Statement of Operations:
   a. Income and expenses originating from nonfinancial items (such as depreciation, prepaid expenses and deferred income) or from provisions included in the Balance Sheet, are derived from the movement between the reported amount of the opening balance and the reported amount of the closing balance.
   b. All other items of the Statement of Operations (such as interest income and interest expenses) are stated at their nominal values.
3) Statement of Changes in Equity (Deficit Equity):
   The data of the Share Capital equity and general reserve are presented in the Bank's financial statements in reported amounts (see Note 15).

e. Use of estimates

The preparation of financial statements requires the Bank's management to use estimates and assumptions and exercise judgment regarding transactions or matters whose final effect on the financial statements cannot be determined with precision. Even though the estimates or assumptions are based on management's best judgment, the final effect of such transactions or matters may be different from the estimates and assumptions made in their respect.

f. Revenue recognition

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

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

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

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

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

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

g. Securities

1) Foreign currency securities

a. Bonds

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

The difference between the original cost of the bonds and their adjusted cost, in respect of each security, is charged to the Statement of Operations.

Unrealized differentials from indexation to an index published abroad which accrued on the principal, and the difference between the fair value less indexation differentials of the bonds and their adjusted cost, in respect of each individual bond, are charged to the "Revaluation accounts" line item in the Balance Sheet.

Interest income and amortization of the premium or discount are stated in the "Interest income from assets in foreign currency abroad" line item.

Income from the realization of bonds is stated in "Other financial income (expenses) - securities and derivative financial instruments".

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

b. Shares

Shares are stated in the Balance Sheet at their fair value as of the Balance Sheet date. The difference between the fair value of the shares and their cost is charged to the "Revaluation accounts".

Gains or losses from the exercise of shares and dividend income are charged to the Statement of Operations and stated under "Other financial income (expenses) - securities and derivative financial instruments".

The balance of unrealized loss at year end, which is calculated on externally managed index-tracking share portfolios at the individual portfolio level, is charged to the Statement of Operations and stated under "Other financial income (expenses) - securities and derivative financial instruments".

2) Local currency securities

Tradable government bonds in local currency are stated in the Balance Sheet at their fair value as of the Balance Sheet date. The difference between the original cost of the bonds and their adjusted cost is charged to the Statement of Operations.

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

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

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

h. International financial institutions

1) The International Monetary Fund (IMF)

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

The liability to the IMF in respect of allocated SDRs is stated in "The International Monetary Fund and others" line item in the Balance Sheet.

2) Bank for International Settlements (BIS)

The Bank of Israel's participation in BIS is stated under local currency assets in the "Other assets" line item according to the cost in the currency in which the participation was paid, converted using the exchange rate on the transaction date with the necessary reporting adjustments to reported amounts.

i. Fixed assets

1) Items of fixed assets are stated at cost with the addition of direct acquisition costs, less accumulated depreciation and accumulated impairment losses.
2) Improvements and enhancements are charged to the cost of the assets and depreciated over their useful lives, whereas maintenance and repair expenses are charged to the Statement of Operations as incurred.

3) Depreciation is calculated by the straight-line method on the basis of the estimated useful life of the asset:
Buildings - 50–67 years;
Motor vehicles - 6.5 years;
Computers - 4 years;
Equipment and furniture - 10 years.

4) Software that is not an integral part of the related hardware is shown under fixed assets at cost and is depreciated by the straight-line method over four years.

j. Banknotes and coins in circulation

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

k. Short-term loan

The balance of short-term loans (called *makam*, their Hebrew acronym) in the Balance Sheet reflects the redemption price of the loan held by the public, less the balance of unamortized discount. *Makam* sold by the Government to the Bank of Israel but not yet sold to the public is not included in this balance.
Makam are issued for a period of up to one year. The discount is the difference between the redemption price of the *makam* and the proceeds from their sale to the public.
The discount is amortized over the period from the date of issuance of the *makam* to its date of redemption.
Expenses for amortization of the discount on the balance of the *makam* held by the public are shown in the Statement of Operations in "Interest expenses to banks and the public".

l. Liabilities in respect of employee rights

All liabilities in respect of employer-employee relations have corresponding reserves in accordance with the law, relevant agreements, common practice and management's expectations.
Liabilities in respect of benefits to employees and pensioners (excluding short-term obligations) are measured using the projected "credit unit method" and calculated by an expert actuary using the method of estimation of cumulative benefits with probabilities taken into account on the basis of past experience and mortality rates and other demographic tables published by the Capital Market, Insurance and Saving Authority at the Ministry of Finance for pension funds. The discount rate applicable to the reserves is based on the yield curve of government bonds in Israel, and on the rate of future salary increases as estimated by management and on past experience.

The service cost and interest cost are stated in respect of the liabilities attributable to expenses in respect of benefits to employees and pensioners.
Changes in the value of the liability arising from the difference between actual and estimated experience or from changes in actuarial assumptions represent unrealized actuarial gains or losses that are charged to the revaluation account of "Actuarial gains or losses from benefits to employees and pensioners", excluding benefits which are expected to be utilized during the employment term. The actuarial changes are charged to the Statement of Operations.
Employee benefits liabilities are stated under "Other liabilities" in local currency.

m. Revaluation accounts

The following are the types of revaluation accounts:

1) Revaluation accounts that include unrealized profits from exchange rate differentials on balances denominated in foreign currency and unrealized profits from indexation and the revaluation of tradable securities in local currency and foreign currency to their fair value.
   These revaluation accounts are maintained separately for each item (currency, security) and are recognized in the Statement of Operations when the item is fully or partially realized. No offsetting among different types of items is performed. Revaluation accounts in respect of certain externally managed portfolios are managed at the individual portfolio level.
   Accumulated loss in the revaluation accounts relating to each item (currency, security) that originates from indexation differentials and price differentials in securities in local currency and foreign currency and exchange rate differentials on foreign exchange reserves is charged to the Statement of Operations at the end of the year (see also Section f above).
2) Revaluation accounts that consist of unrealized gains or losses deriving from changes in actuarial assumptions underlying the computation of pension accruals. Accordingly, any accumulated unrealized losses at year end will result in a negative account balance.

n. Foreign currency

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

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

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

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

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

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

	December 31			Rate of Change	
	2017	2016	2015	2017	2016
		(NIS)		(Percent)	
US Dollar	3.4670	3.8450	3.9020	(9.8)	(1.5)
Euro	4.1526	4.0438	4.2468	2.7	(4.8)
Pound Sterling	4.6819	4.7252	5.7840	(0.9)	(18.3)
Special Drawing Rights (SDRs)[a]	4.9374	5.1689	5.4071	(4.5)	(4.4)

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

o. Indexation

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

Following are data on the CPI (based on the 2016 average):

					Rate of change	
		2017	2016	2015	2017	2016
			(Points)		(Percent)	
CPI	For November	100.3	100.0	100.3	0.3	(0.3)
	For December	100.4	100.0	100.2	0.4	(0.2)

p. Interest rates

Some of the interest collected or paid by the Bank of Israel is based on the Bank of Israel interest rate or the Prime interest rate.

Following are data on the interest rates:

	December 31		
	2017	2016	2015
	(Percent)		
Bank of Israel interest	0.10	0.10	0.10
Prime interest	1.60	1.60	1.60

q. Financial instruments

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

1) Activity in financial instruments in Israel

NIS/USD forwards

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

2) Activity in financial instruments abroad

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

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

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

Operations, the results of these transactions are shown in the "Interest income from assets in foreign currency abroad" item.

b. Foreign currency swaps and forwards

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

c. Futures

The fair value of futures contracts on the Balance Sheet date is shown in Note 16 - "Commitments, financial instruments and contingent liabilities". In the Statement of Operations, the change in the value of the contracts is recorded under "Other financial income (expenses)—securities and derivative financial instruments".

r. Offsetting financial balances

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

s. Impairment of assets

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

The Standard applies to all Balance Sheet assets, except for financial assets. The Standard also establishes presentation and disclosure rules for assets that have been impaired. Where the value of the asset in the Balance Sheet exceeds its recoverable amount, the Bank recognizes an impairment loss in the amount of the difference between the asset's book value and recoverable amount. A loss recognized in this manner is reversed only if changes occur in the estimates that were used to determine the recoverable amount of the asset from the date on which the last impairment loss was recognized.

t. Statement of cash flows

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

u. Taxes

According to the Bank of Israel Law, 5770–2010, regarding the payment of taxes, municipal taxes, levies and other mandatory payments, the Bank has the same status as the State of Israel. In addition, regarding the taxation of the Bank's offshore investments, the Bank is tax exempt on the majority of its investments in foreign securities.

2. Foreign exchange reserves

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

The following is the composition of the foreign exchange reserves:

	December 31		December 31	
	2017	2016	2017	2016
	(NIS million)		(USD million)	
Foreign currency assets abroad	394,150	384,483	113,685	99,996
Less: Foreign currency liabilities abroad	(2,338)	(5,955)	(674)	(1,549)
Total foreign exchange reserves[a]	**391,812**	**378,528**	**113,011**	**98,447**

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

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

	December 31		December 31	
	2017	2016	2017	2016
	(NIS million)		(SDR million)	
IMF quota	9,484	9,929	1,921	1,921
Less: Liability for the quota	(8,708)	(9,763)	(1,764)	(1,889)
Reserve tranche	**776**	**166**	**157**	**32**
NAB loans	**186**	**305**	**38**	**59**
Special Drawing Rights (SDRs)	**4,322**	**4,034**	**875**	**780**
Total IMF balance	**5,284**	**4,505**	**1,070**	**871**

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

a. Bank of Israel participation in the IMF

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

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

In 2011, a reform was carried out in the quotas and in the IMF's voting rights, in the context of which Israel's IMF quota was increased in two stages: in the first stage, in 2011, the quota was increased by about SDR 133 million and in the second stage, in 2016, the quota was increased by an additional about SDR 860 million, reaching a total of about SDR 1,921 million.

b. NAB loans

The State of Israel is part of the IMF's arrangement known as NAB (New Arrangements to Borrow).

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

The maximum credit line that the Bank provides the IMF is about SDR 340 million (NIS 1,679 million).

c. Special Drawing Rights (SDRs)

The balance includes SDRs allocated by the IMF to Israel. Against these allocations the Bank has a liability toward the IMF with no repayment date, which is shown under the item of "The International Monetary Fund and others".

The State is not required to hold all the SDRs allocated to it.

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

The IMF has allocated Israel SDRs totaling about SDR 884 million. According to the Voluntary Arrangement for the Purchase and Sale of SDRs, Israel's SDR holdings range from 50 percent to a maximum of 145 percent of total SDRs allocated by the IMF to Israel. The IMF has undertaken to consult with the Bank before making any purchase or sale of SDRs in the context of the plan.

4. Credit to the government

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

5. Tradable securities

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

6. Fixed assets

	Land and buildings[a]	Equipment and furniture, computers, software and vehicles	Total
		(NIS million)	
Cost			
Balance as of January 1, 2017	305	400	705
Additions	74	45	119
Disposals	-	(1)	(1)
Balance as of December 31, 2017	**379**	**444**	**823**
Accumulated depreciation			
Balance as of January 1, 2017	68	244	312
Additions	11	39	50
Disposals	-	(1)	(1)
Balance as of December 31, 2017	**79**	**282**	**361**
Depreciated balance as of December 31, 2017	**300**	**162**	**462**
Depreciated balance as of December 31, 2016	**237**	**156**	**393**

[a] The Bank's property in Jerusalem, the cost of which, including the depreciated cost of the structures thereon, amounts to approximately NIS 265 million as of December 31, 2017 (approximately NIS 211 million as of December 31, 2016). The Bank is not registered as the lessee of the Bank's properties. The lease expired on June 30, 2016. Since then, the Bank has been negotiating the renewal of the lease agreement with the Israel Land Authority (the ILA). Accordingly, the Bank may be required to pay lease fees when the lease is renewed.

7. Other assets

	December 31	
	2017	2016
	(NIS million)	
Investment in BIS shares	282	*) 282
Loans to employees	73	72
Other receivables	26	4
Total other assets	**381**	**358**

*) Reclassified—in the Financial Statements for 2016, the investment in BIS shares was stated in the item of "International financial institutions".

8. Banknotes and coins in circulation

	December 31, 2017		December 31, 2016	
	Quantity	NIS	Quantity	NIS
	(million)		(million)	
Banknotes and coins in circulation				
NIS 20	48.53	971	39.54	791
NIS 50	67.26	3,363	60.62	3,031
NIS 100	173.37	17,337	168.59	16,859
NIS 200	290.92	58,185	265.60	53,120
Coins in circulation		2,339		2,188
Other[a]		2		2
Commemorative banknotes and coins		5		5
Total		**82,202**		**75,996**

[a] special coin items in circulation.

9. Government deposits

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

	December 31		December 31	
	2017	2016	2017	2016
	(NIS million)		(USD million)	
Deposits in foreign currency[a]				
Current deposits	7,174	8,506	2,069	2,212
Other deposits	366	776	106	202
Total deposits in foreign currency	**7,540**	**9,282**	**2,175**	**2,414**
Deposits in local currency[b] - Current deposits	**19,394**	**15,134**		
Total government deposits	**26,934**	**24,416**		

[a] **Government deposits in foreign currency**
The current deposits are used for financing budgetary activity. Some foreign currency government deposits bear interest at the rate paid on US Treasury bills with an average of six months to maturity. The average interest rate in 2017 was 1.02 percent (2016—0.42 percent).

[b] **Government deposits in local currency**
The current deposits and the balances used for bond lending are designated for financing budgetary activity. Until March 31, 2017, local currency current deposits bore (when in debit) or were paid (when in credit) interest at the Prime rate. Effective from April 1, 2017, local currency current deposits bear (when in debit) or are paid (when in credit) interest to the Government at the rate ranging from the Bank of Israel's interest rate plus 1.5% to the Bank of Israel's interest rate on these balances based on certain brackets. The average benchmark interest rate in 2017 remained unchanged from 2016 at 1.6 percent. on the government balances used for bond lending and other government balances for which a different interest rate is paid.

10. Deposits of banking corporations

	December 31		December 31	
	2017	2016	2017	2016
	(NIS million)		(USD million)	
Deposits in foreign currency[a] (*Pamach*)	**724**	**772**	**209**	**201**
Deposits in local currency[b]				
Time deposits	194,003	172,001		
Demand deposits	40,475	34,502		
Total deposits in local currency	**234,478**	**206,503**		
Total deposits of banking corporations	**235,202**	**207,275**		

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

[b] **Deposits in local currency**
1. The Bank of Israel receives time deposits in New Shekels from the banking corporations. The deposits are allocated by auction for terms of one day, one week and one month. The deposits are not considered liquid assets with regard to the banking corporations' reserve requirements. In addition, deposits are received at the (overnight) deposit window available to the banking corporations at an interest rate of 0.1 percentage points below the Bank of Israel interest rate.
   The average interest rate for time deposits by auction on December 31, 2017 was 0.1 percent (on December 31, 2016 - 0.10 percent).
   The average interest rate for time deposits by auction in 2017 was 0.1 percent (in 2016 - 0.1 percent).
   The interest rate for deposits at the window on December 31, 2017 was 0 percent (on December 31, 2016 - 0 percent).
   The average interest rate for deposits at the window in 2017 was 0 percent (in 2016 - 0 percent).
2. The banking corporations' local currency demand deposits serve as a liquid asset against deposits in Israeli currency and Israeli residents' deposits in foreign currency. The reserve requirement applicable to the banking corporations ranges from 0–6 percent, depending on the term of the deposit.

11. The International Monetary Fund and others

	December 31	
	2017	2016
	(NIS million)	
Allocated Special Drawing Rights[a]	4,367	4,568
Other[b]	116	129
Total	**4,483**	**4,697**

[a] Special Drawing Rights (SDRs) are sums of money that member countries in the IMF undertook to purchase from the Fund. No repayment date has been set for this liability and it bears interest according to the IMF's terms. The IMF allocates SDRs to its constituent countries commensurate with the size of their quotas.
As of December 31, 2017, Israel has been allocated approximately SDR 884 million.
[b] The item mainly includes liabilities to binational foundations.

12. *Makam*

	December 31	
	2017	2016
	(NIS million)	
Redemption value of short-term loan sold to the public	92,000	104,999
Less: Discount at time of sale to the public	(126)	(138)
Proceeds from sale of *makam* to the public	**91,874**	**104,861**
Plus amortization of discount difference for the period through the Balance Sheet date	71	73
Total balance of *makam*	**91,945**	**104,934**

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

The balance of *makam* shown in the Balance Sheet reflects the redemption value of bills held by the public, less the balance of the unamortized discount.

13. Other liabilities

	December 31	
	2017	2016
	(NIS million)	
Liabilities in respect of benefits to employees and pensioners	6,334	*) 6,156
Short-term liabilities for employees' and other rights	77	*) 65
Other payables[a]	738	430
Total other liabilities	**7,149**	**6,651**

[a] The balance mainly comprises a liability to entities that manage an account at the Bank of Israel.
*) Reclassified.

a. Liabilities in respect of benefits to employees and pensioners

The liability mainly consists of actuarial obligations in respect of post-employment benefits to employees and pensioners.

Post-employment benefits to employees and pensioners include payment of future annuities to Bank employees who commenced their employment before September 2002, retirement grants and other post-employment benefits, all in keeping with the pension agreement signed with the Bank's employees, pensioners and their survivors.

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

The actuarial calculation is prepared using the projected unit credit method which consists of evaluating the accrued benefits based on various parameters such as: early retirement rates, rates of pension payments to survivors and orphans, the levels of seniority and ranks of employees and the future salary increase rate as estimated by management and based on past experience.

The above calculation is based on mortality rates and other demographic tables published by the Capital Market, Insurance and Saving Authority at the Ministry of Finance for pension funds in Pension Circular 2017-3-6 regarding the preparation of actuarial calculations. The calculation is based on the assumption of an annual real salary increase for employees as of December 31, 2017 according to employee seniority ranging between 1.89 percent and 4.81 percent; as of December 31, 2016 based on employee age ranging between 1.5 percent and 3 percent. The discount rates underlying the liability are based on the yield curve of government bonds in Israel, ranging between 1.715 percent and 2.538 percent. The change in the liability consists of an increase of about NIS 246 million which was charged to the revaluation account of "Actuarial gains or losses from benefits to employees and pensioners" (Note 14), and an increase of about NIS 211 million which was charged to "General and administrative expenses—pension and benefits to employees and pensioners" (Note 24).

b. Short-term liabilities for employees' and other rights

This item includes short-term liabilities in respect of salary and other expenses which are expected to be settled in the course of 2018.

14. Revaluation accounts

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

	December 31	
	2017	2016
	(NIS million)	
Balances denominated in foreign currency	3,150	19,559
Tradable securities in foreign currency	11,853	7,127
Tradable securities in local currency	807	949
Actuarial gains or losses from benefits to employees and pensioners	(2,316)	(2,071)
Total revaluation accounts	**13,494**	**25,564**

15. Share capital and general reserve

The data on the Bank's equity and general reserve in historical nominal values at December 31, 2017 and 2016 are: the Bank's equity—NIS 60 million; the general reserve—NIS 260 million. The general reserve served in the past to increase the Bank's capital in accordance with Section 6 of the Bank of Israel Law, 5714-1954 (see Note 1c).

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

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

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

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

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

In accordance with these provisions, as of December 31, 2017 there is no obligation to transfer funds to the Government

16. Commitments, financial instruments and contingent liabilities

	December 31	
	2017	2016
	(NIS million)	
a. Commitments (off-Balance Sheet)		
Documentary credit	5	41
b. Financial instruments		
Currency swaps and forwards:		
Fair value	(1,703)	3,283
Future receipts of foreign currency	105,058	90,230
Future payments of foreign currency	106,414	86,501
Stock index futures - fair value:		
Long	30	-
Short	(70)	(4)
Interest rate futures - fair value:		
Long	(30)	-
Short	30	-
Bond futures - fair value:		
Long	23	(8)
Short	10	16
c. Contingent liabilities		

1) When investing in international financial institutions, the Bank of Israel is generally required to assume additional undertakings toward these institutions beyond the actual callable capital, which may be exercised by the institutions only in times of need, a scenario which is relatively unlikely.
The balance of the above undertakings as of December 31, 2017 was NIS 59 million (December 31, 2016 - NIS 4,342 million).
2) There are several claims pending against the Bank of Israel. However, no provision has been recorded in the Bank's books in respect of these claims as it is the Bank's opinion, based on the opinion of its Legal Department, that the probability of these claims being upheld is low, or that the sums involved are not significant.

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

	For the year ended December 31	
	2017	2016
	(NIS million)	
Demand deposits	(241)	(24)
Short-term deposits	(37)	(33)
Tradable securities	2,727	1,816
Securities purchased under R. Repo agreements or Repo	(8)	(21)
Derivative financial instruments, net	1,204	682
The IMF	23	4
Total	**3,668**	**2,424**

18. Interest income from the government

	For the year ended December 31	
	2017	2016
	(NIS million)	
Binational foundations[a]	76	76
Tradable securities in local currency	254	343
Total	**330**	**419**

[a] See Note 4 above.

19. Interest expenses to banks and the public

	For the year ended December 31	
	2017	2016
	(NIS million)	
Makam	140	144
Time deposits[a]	175	144
Total	**315**	**288**

[a] See Note 10 above.

20. Interest expenses to the government

	For the year ended December 31	
	2017	2016
	(NIS million)	
Balances in local currency	308	283
Balances in foreign currency	7	4
Total	**315**	**287**

21. Other interest expenses

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

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

	For the year ended December 31	
	2017	2016
	(NIS million)	
Securities in foreign currency[a]	2,504	*) 1,226
Derivative financial instruments in foreign currency[b]	(30)	(531)
Total	**2,474**	**695**

[a] Dividend income, gain (loss) from sale of securities and loss from net impairment of securities at the end of the year.
[b] Including financial income (expenses) from the realization of derivative financial instruments.
*) Reclassified—an amount of approximately NIS 73 million was reclassified to the item of "Other expenses".

23. Other financial income (expenses)—Miscellaneous

	For the year ended December 31	
	2017	2016
	(NIS million)	
In local currency	5	4
In foreign currency	(31)	(27)
Total[a]	**(26)**	**(23)**

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

24. General and administrative expenses

	For the year ended December 31	
	2017	2016
	(NIS million)	
Salaries and employees' rights	331	*) 311
Pension and benefits to employees and pensioners[a]	208	*) 212
General expenses	150	152
Total	**689**	**675**

[a] Expenses in respect of actuarial obligation for post-employment benefits to employees and pensioners and a long-term liability.
*) Reclassified

25. Other expenses

In 2017, this item mainly includes tax expenses on foreign investments and income from various fees. In 2016, this item mainly included a capital loss from the assignment of the State's representation in international financial institutions from the Bank of Israel to the Government.

EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS

1. Introduction

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

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

Owing to the currency imbalance which characterizes the Bank’s Balance Sheet (see Section 3.1 below) and the fact that the financial statements are stated in local currency, the effect of the changes in the shekel exchange rates in relation to the currencies in which the foreign exchange reserves are stated in the Balance Sheet is expressed by large fluctuations in the shekel value of the reserves. The Bank does not take any steps to hedge the effect of these changes nor does it act to optimize the yield in shekel terms but rather in numeraire terms, in keeping with the guidelines of the Monetary Committee. Moreover, in recent years, the Bank has gradually increased the percentage of foreign exchange reserves invested in shares, which significantly influenced the yield on the reserve portfolio. However, the share appreciation gains are not included in the Bank’s Statement of Operations as long as they are not realized but rather only charged to the revaluation accounts. The Bank of Israel reports the reserve portfolio performance in the context of the annual report on the Investment of the Foreign Exchange Reserves.

2. The Principal Changes in the Financial Statements

2.1 The Bank's Balance Sheet

The Bank of Israel's Balance Sheet at the end of 2017 totaled approximately NIS 401 billion, compared with approximately NIS 394 billion at the end of 2016—an increase of approximately NIS 7 billion (2 percent).

The main increase in the assets side is attributed to the increase in the balance of "Foreign currency assets abroad" by approximately NIS 10 billion, to approximately NIS 394 billion. In dollar terms, the scope of foreign exchange reserves[1] increased by approximately $15 billion, and their balance at year end amounted to approximately $113 billion. The increase is mainly a result of foreign currency purchases by the Bank in a total of approximately $7 billion, and exchange rate differentials, gains and revaluation totaling an additional approximately $7 billion.

Total liabilities on the Balance Sheet increased by approximately NIS 20 billion, as a result of several principal factors: (1) an increase in the net balance of monetary instruments[2]—*makam* and time deposits—by approximately NIS 9 billion, to approximately NIS 286 billion. Part of the increase derived from the need to sterilize the excess liquidity injected into the markets, *inter alia* as a result of said purchases of foreign exchange reserves; (2) an increase of approximately NIS 12 billion in the monetary base, which was mainly affected by the low interest environment and the Bank's intervention in the foreign exchange market; (3) an increase in the Government's deposits in the Bank by approximately NIS 3 billion; (4) a decrease of approximately NIS 4 billion in foreign currency liabilities abroad.

The Bank's Deficit Equity in 2017 increased by about NIS 0.8 billion, in the amount of the annual loss, with a Equity Deficit balance of about NIS 62.3 billion at the end of the year (see Section 4.5, "the Bank's Equity (Equity Deficit)").

2.2 Statement of Operations

The loss in the current year amounted to about NIS 788 million, compared with a loss of approximately NIS 5.3 billion in 2016. The decrease in loss was principally affected by an increase of approximately NIS 3 billion in the Bank's revenues from investments in foreign exchange reserves, including interest and other financial gains which in 2017 totaled approximately NIS 6 billion, and a decrease of approximately NIS 1.5 billion in

[1] In these explanatory remarks, the term "foreign exchange reserves" is used in its economic sense. The foreign exchange reserves are composed of the balance of "Foreign currency assets abroad", less the balance of "Foreign currency liabilities abroad". The change in the balance of "Foreign currency assets abroad" in 2017 amounted to approximately NIS 10 billion and the change in the balance of "Foreign currency liabilities abroad" in 2017 amounted to approximately NIS 4 billion.

[2] The balance of *makam* decreased by approximately NIS 13 billion and the balance of time deposits increased by approximately NIS 22 billion.

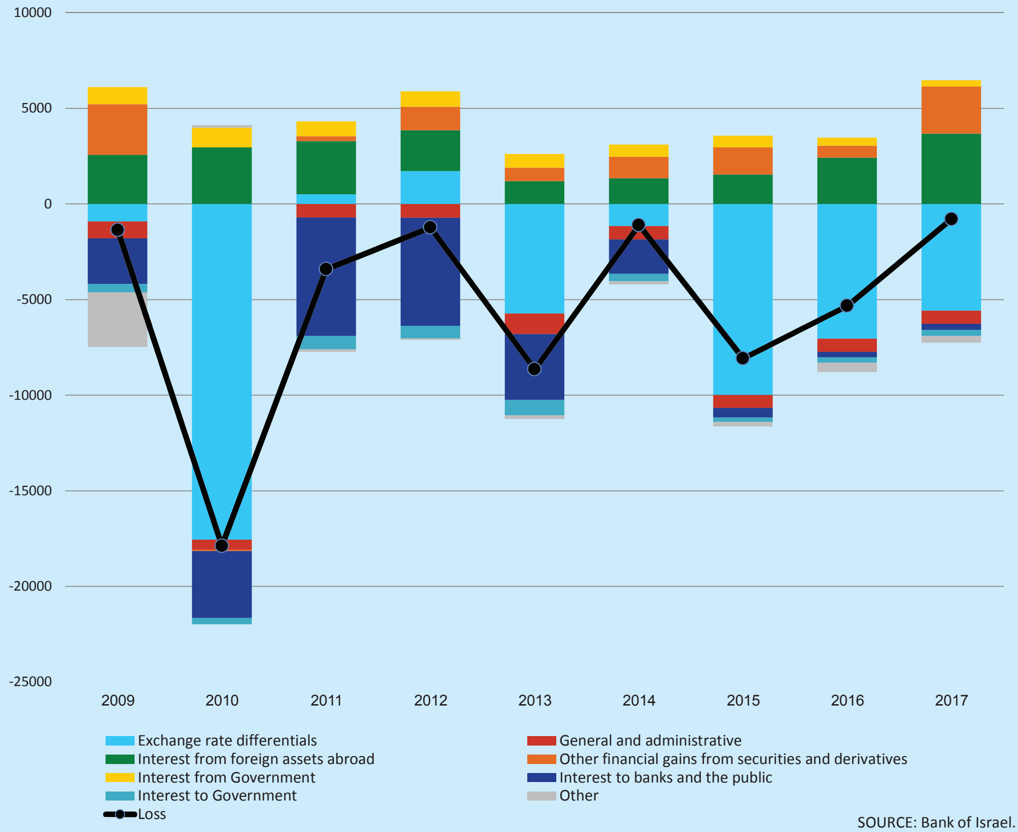
expenses in respect of exchange rate differentials which in 2017 amounted to NIS 5.6 billion (Figure 1). These expenses were mainly affected by the revaluation of the shekel in relation to the dollar at a rate of about 9.8 percent.

The Statement of Operations does not include unrealized gains[3] from exchange rate differentials on foreign exchange reserves totaling approximately NIS 3 billion, which are reflected in the revaluation account on the Balance Sheet (see Notes 1m and 14 to the financial statements). Unrealized losses from exchange rate differentials totaling approximately NIS 19.6 billion, mainly in respect of the dollar, were offset against unrealized retained earnings in the revaluation accounts and were excluded from the Statement of Operations.

The Statement of Operations also does not include unrealized gains from the effect of the changes in the revaluation of tradable securities which are reflected in the revaluation accounts in the Balance Sheet. (See Note 1m to the financial statements). The revaluation of tradable securities in foreign currency (mainly the appreciation of the shares underlying the foreign exchange reserves portfolio) increased the revaluation account in 2017 by about NIS 4.7 billion (as opposed to an increase by about NIS 2.7 billion in 2016). The revaluation of tradable securities in local currency reduced the revaluation account in 2017 by about NIS 0.1 billion (as opposed to a reduction by about NIS 0.3 billion in 2016).

[3] In accordance with the Bank's accounting policy, gains deriving from holding the reserves as well as other gains are classified as either realized gains, and are included in the Bank's income, or as unrealized revaluation gains, which are carried to the revaluation accounts in the Balance Sheet and are not reflected in the Bank's income for the relevant year. The accumulated losses in the revaluation accounts are carried to the Statement of Operations at the end of the year.

Figure 1
The Developments in the Bank's Profit and Loss Items, 2009-2017
(NIS million)



SOURCE: Bank of Israel.

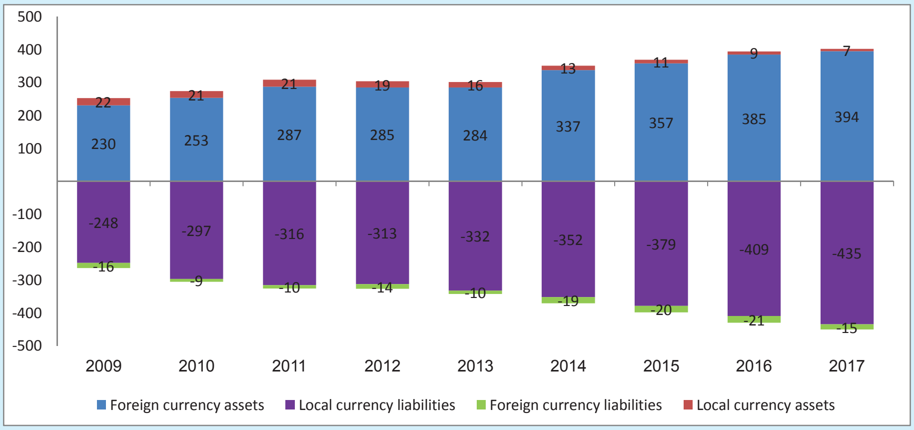
3. Analysis and Explanation of the Principal Changes in the Financial Statements

3.1 Characteristics and Composition of the Financial Statements

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

The Bank's financial statements are characterized by considerable currency imbalance in the composition of the Bank's assets and liabilities. This imbalance persisted in 2017. A large majority of the Bank's assets are denominated in foreign currency (about 98 percent at the end of 2017), whereas the Bank's liabilities are mostly in shekels; the liabilities in foreign currency only account for about 4 percent of the total Balance Sheet (Figure 2).

Figure 2
The Developments in the Bank's Assets and Liabilities, 2009-2017
(NIS billion)



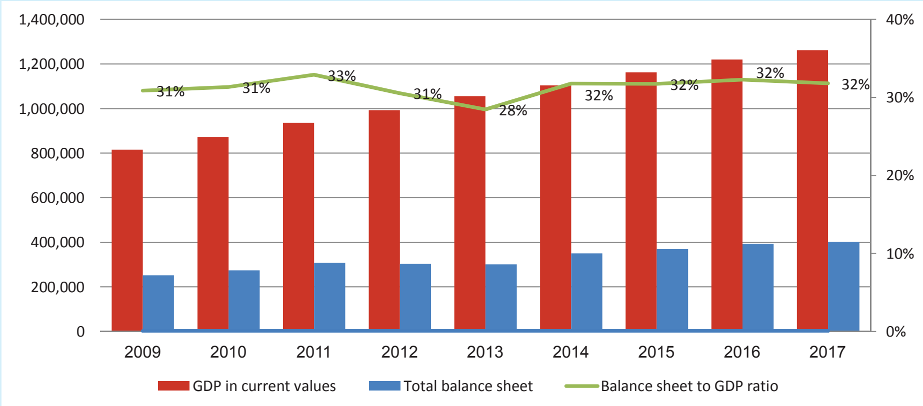
SORCE: Bank of Israel.

This situation is reflected in fluctuations in the Bank's reported financial results due to changes in the shekel's exchange rate in relation to foreign currencies (since the financial statements are stated in shekels) and to changes in local interest rates in relation to other economies.[4]

In 2008–17, foreign exchange reserves grew due to substantial purchases in the context of managing the monetary policy. These purchases increased the foreign exchange reserves managed by the Bank, while at the same time increasing the scope of monetary instruments used to absorb the excess funds injected in return for the purchase of foreign currency. 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 product growth (Figure 3).

[4] The currency imbalance was first experienced in 1995–97 during which period the Bank adopted a tightening monetary policy to achieve the Government's inflation target. As a result of the ensuing capital inflows by the private sector, the Bank of Israel was forced to purchase foreign currency from the public to maintain the exchange rate at the lower end of the currency band and reabsorb the shekels injected to the market accordingly. The foreign exchange reserves grew from an average of a few billion dollars in previous decades to about $113 billion at the end of 2017. 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 2008–17, the balance of liabilities gradually increased to about NIS 286 billion at the end of 2017, as a result of the sterilization of injection using time deposits and *makam*.

Figure 3
Balance sheet to GDP Ratio, 2009-2017
(NIS million)



SOURCE: Bank of Israel.

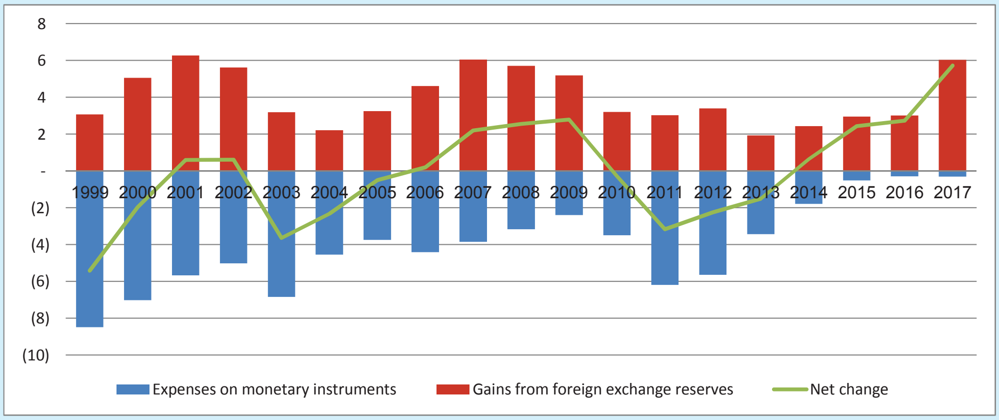
This increase in the Bank's Balance Sheet enhances the fluctuations in the Bank's profits given the gap between the yield on the reserves and the expenses in respect of the monetary instruments which now address a larger base. However, the negative gap between the yields narrowed markedly in recent years (Figure 4) and even reversed the trend: gains on the foreign exchange reserves have exceeded the financial expenses of foreign currency purchases using monetary instruments (*makam* and time deposits), a trend that continued in 2017. The main reason for the reversal in recent years is the reduction of the interest rate gaps between Israel and the markets in which the reserves are invested and the change in the risk profile of the investment portfolio due to the increase in the shares component. The interest rate spread between Israel and the United States, which in early 2008 was 1.25 percent, was reversed and in late 2017, the U.S. interest rate exceeded the Israeli interest rate by 1.4 percent (Figure 6).

The minimization of the gap between the yields on the reserves and expenses on the monetary instruments also contributed increased gains from foreign exchange reserves.

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

A direct result of the enhanced scope of foreign exchange reserves in the Bank's Balance Sheet is the increased risk of exchange rate losses caused by the appreciation of the shekel which is a main factor in the Bank's losses and accumulated deficit—a Equity Deficit that at the end of 2017 amounted to approximately NIS 62.3 billion (see Section 4.5, "The Bank's Equity (Equity Deficit)"). The balance of the revaluation account which

Figure 4
Development of Gains from Foreign Exchange Reserves compared to Expenses on monetary Instruments, 1999-2017
(NIS billion)



SOURCE: Bank of Israel.

consists of unrealized gains at year end amounted to approximately NIS 13.5 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 48.8 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 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 in the Balance Sheet and the net operating results in the Statement of Operations 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

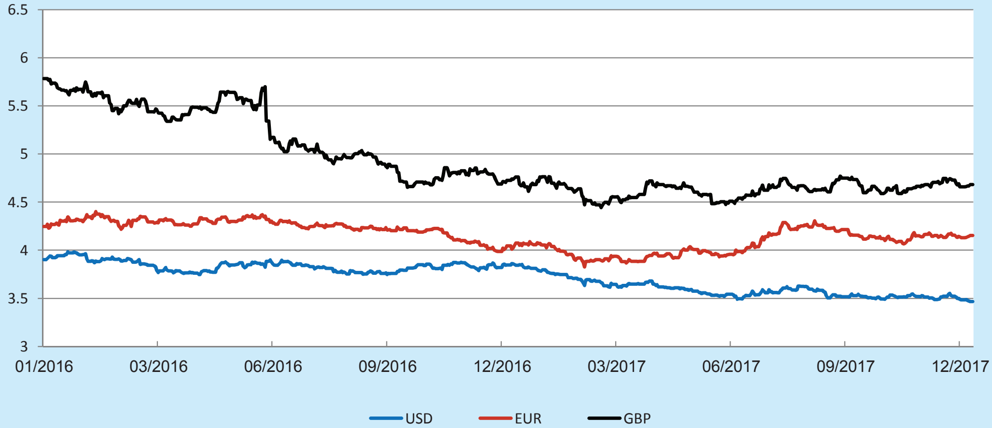
	December 31		Year ended December 31	
	2017	2016	2017	2016
	Balances		Income (expenses)	
	NIS million			
Net assets				
Foreign exchange reserves[a]	391,812	378,528	6,044	3,015
Securities portfolio in shekels	6,386	8,662	254	343
Total	**398,198**	**387,190**	**6,298**	**3,358**
Net liabilities and equity				
Monetary aggregate[b]	285,948	276,935	(315)	(288)
Monetary base[c]	122,677	110,498	(181)	(201)
Government balances[d]	26,819	24,289	(239)	(211)
Deposits of banking corporations in foreign currency	724	772	-	-
Other[e]	10,789	10,597	(773)	(931)
Revaluation accounts[f]	13,494	25,564	(5,578)	(7,053)
Bank's equity	(62,253)	(61,465)	-	-
Total	**398,198**	**387,190**	**(7,086)**	**(8,684)**
Net loss			**(788)**	**(5,326)**

[a] Foreign exchange reserves consist of total "Foreign currency assets abroad" less total "Foreign currency liabilities abroad".
[b] The balance of *makam* (central bank bills) and time deposits in local currency less monetary loans.
[c] The balance of banknotes and coins in circulation with the addition of the balance of the shekel demand deposits of banking corporations in the Bank. The expenses in respect of this item include money printing expenses and the income is from banks' local currency demand deposits.
[d] The balance of government deposits in foreign currency with the addition of the balance of government deposits in local currency less the outstanding credit to the government.
[e] The "Other" item consists of other balances in local currency with the addition of total other assets (fixed assets and international financial institutions) less the balance of other liabilities in local currency and other liabilities in foreign currency in respect of the IMF and international financial institutions.
[f] The item consists of exchange rate differentials on foreign exchange reserves (see Notes 1f and 1n to the financial statements. The capital gains are presented in the item from which they derive).

3.2 Effect of the Economic Environment on the Financial Statements

The year 2017 was characterized by an accelerated growth rate in the global economy compared to 2016. The continuing accommodative monetary policy adopted worldwide was expressed in 2017 by low and even negative interest rates in certain economies. The opposing trend in the United States also persisted: the federal funds rate was raised throughout the year three times to a level of 1.5 percent, improving the Bank's gains from the dollar interest component.

Figure 5
Developments in Shekel Exchange Rates vs. Foreign Currencies, 2017 and 2016

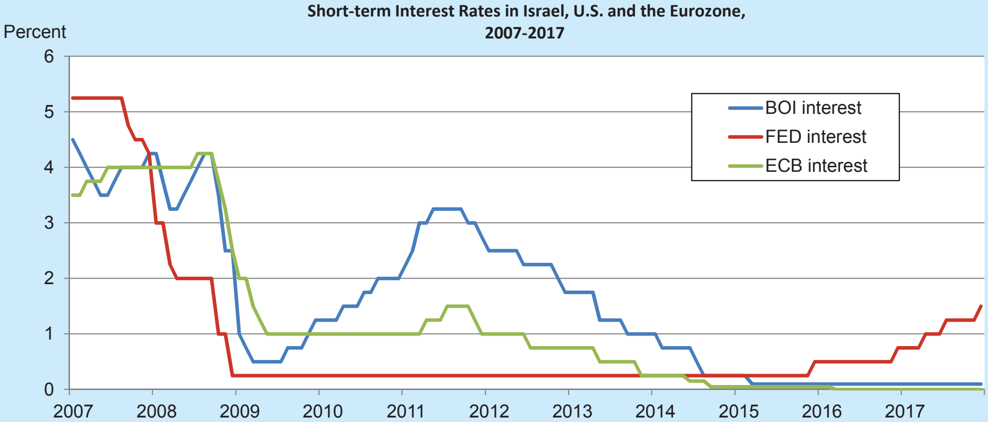


SOURCE: Bank of Israel.

Global stock markets experienced sharp increases in the year mainly in emerging markets with government yields remaining low, reduced corporate bond margins and risk parameters kept steady at a low level. The rise in yields improved the Bank's profits from the interest component but at the same time reduced its capital gains. In 2017, the investment in equities made a positive contribution to the Bank's profits with the main contribution arising from appreciation of shares in U.S. stock markets by about 21.3 percent in the year.

The dollar, which is the principal currency in which the reserves are held, weakened this year in relation to most currencies, and the shekel appreciated against the dollar by about 9.8 percent. Following the appreciation, exchange rate expenses were recorded, which, as discussed above, were a major contribution to the loss in the year (Figure 5).

Figure 6
Short-term Interest Rates in Israel, U.S. and the Eurozone, 2007-2017



SOURCE: Bank of Israel.

The Bank of Israel's interest rate has remained unchanged since March 2015 at 0.1 percent. The Bank's expenses on the monetary aggregate, which are affected by the Bank's interest, remained similar in level to previous years (Figure 12).

In 2017, the annual inflation rate was positive for the first time since 2014. The Israeli CPI increased in the year by 0.4 percent, as opposed to a negative rate of 0.2 percent in 2016. The increase in inflation in Israel corresponded to the inflation rate in the majority of OECD countries as an indication of global factors.

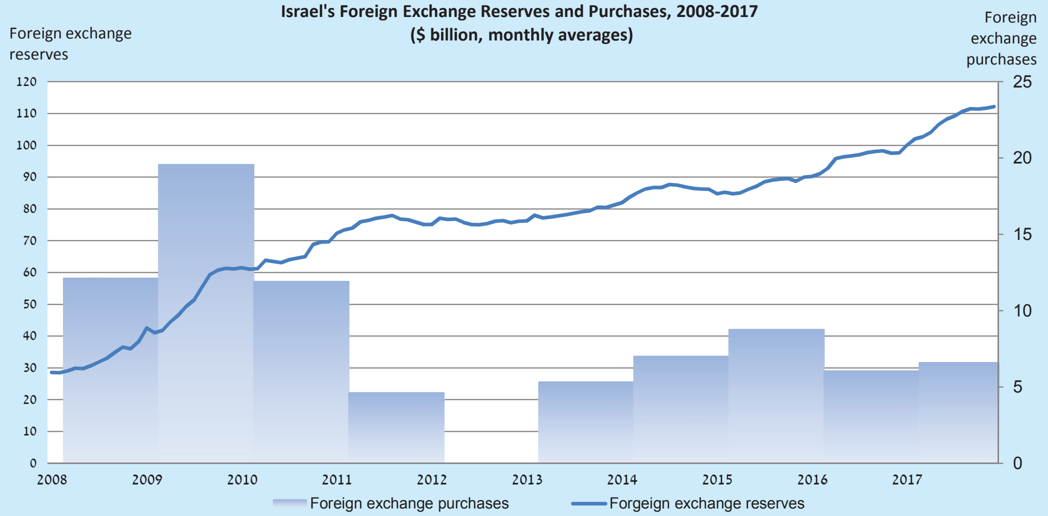
The increase in the CPI had a positive influence on the indexation component of local currency tradable securities. This influence, however, is low due to their relatively low share of the Bank's total investments.

4. Selected Items

4.1 Foreign Exchange Reserves[5]

One of the Bank's functions according to the Bank of Israel Law is to hold and manage the State's foreign exchange reserves.[6] In accordance with the Law, the Monetary Committee, headed by the Governor, was granted various authorities pertaining to managing the reserves, outlining the reserves' investment policy guidelines and monitoring the implementation of the policy.

Figure 7
Israel's Foreign Exchange Reserves and Purchases, 2008-2017
($ billion, monthly averages)



Source: Bank of Israel calculations.

[5] See details in the 2017 Investment of Foreign Exchange Reserves Report, which is published separately. In this report, the yield on holding the reserve portfolio is measured in currency basket terms—the numeraire. The numeraire represents the multicurrency composition of the basket which reflects the potential uses of the reserves.

[6] 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 (see Note 2 to the financial statements).

In 2017, foreign exchange reserves increased by about NIS 13.3 billion (an increase of about 3.5 percent), reaching a total of about NIS 391.8 billion (about $113 billion). The increase in reserves derived from foreign exchange purchases by the Bank of Israel totaling approximately NIS 24 billion, interest income and realized capital gains, excluding exchange rate differentials, of approximately NIS 10.8 billion against negative exchange rate differentials which were a main factor in the decrease of approximately NIS 23.6 billion in reserves. The negative exchange rate differentials were mainly accrued as a result of the appreciation of the shekel by about 9.8 percent against the dollar (Figure 5).

In dollar terms, the reserves grew by about NIS 14.6 billion, mainly as a result of purchases totaling some $6.6 billion and an amount of approximately $4.3 billion mostly deriving from positive exchange rate differentials due to the weakening of the dollar in relation to the euro and pound sterling, currencies which account for about 30 percent of the reserves. The increase in reserves was also supported by interest income, capital gains and revaluation of prices in a total of some $3.2 billion (Table 2).

Table 2
Contribution to Foreign Exchange Reserves, by Sector

	2017	2016	2017	2016
	NIS million		USD million	
Change in foreign exchange reserves	**13,284**	**25,105**	**14,564**	**7,872**
Bank of Israel				
Purchases	24,030	23,086	6,600	6,040
Profits	6,044	3,015	1,643	785
Price revaluation	4,726	2,734	1,565	728
Exchange rate differentials and other[a]	(23,618)	(11,289)	4,268	(1,604)
Total Bank of Israel	**11,182**	**17,546**	**14,076**	**5,949**
The government[b]	**2,000**	**7,532**	**464**	**1,920**
The private sector[c]	**102**	**27**	**24**	**3**

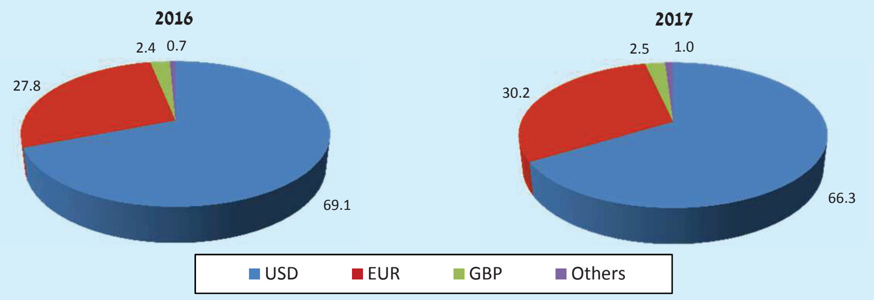
[a] Includes the Bank's payments and receipts in foreign currency.
[b] Transfers from abroad by the Government and national institutions.
[c] Includes income tax payments of the sector in foreign currency.

The scope of foreign exchange purchases in the year was dictated by the trend of large scope purchases dating back to 2008.[7] The developments in foreign exchange reserves from 2008 to date are shown in Figure 7.

[7] Partly as a direct result of a plan to mitigate irregular fluctuations in exchange rates which are not commensurate with the market's basic economic principles which was followed by a plan to mitigate the effect of gas production on the exchange rates, put into practice in May 2013.

The investment policy underlying the reserves is reflected in the asset and currency distribution of the reserve portfolio. The reserve currency distribution at the end of 2017 was essentially similar to the distribution at the end of 2016 (Figure 8): the weight of the main portfolio currencies–dollar, euro and pound sterling–was not significantly changed.

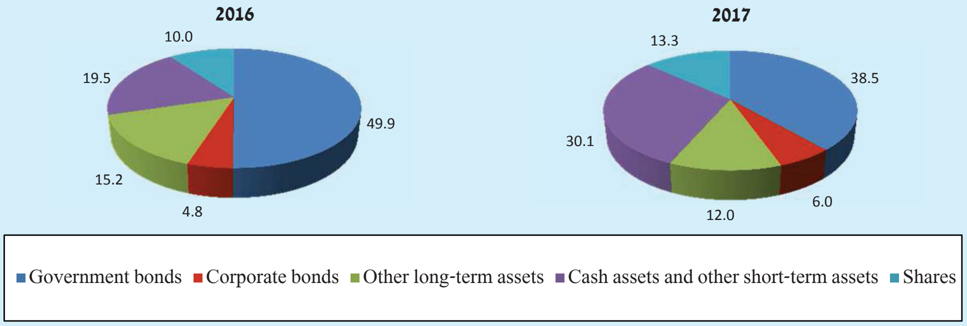
Figure 8
Currency Distribution of the Foreign Exchange Reserves Portfolio, 2017 and 2016 (Percent, by end of year)



SOURCE: Bank of Israel calculations.

In 2017, the trend of increased investments in the short-run spread assets in the portfolio at the expense of investments in short-term government bonds continued against the backdrop of their yield gap as a result of which at year end the investment in cash and in other short-run margin assets was 30.1 percent (an increase of about 10.6 percent points). In addition, the rates of investment in shares were raised by 3.3 percent points against reduced investment in government bonds by about 10.4 percent points and in long-run spread assets by about 3.2 percent points (Figure 9).

Figure 9
Assets Distribution of the Foreign Exchange Reserves Portfolio, 2017 and 2016 (Percent, by end of year)



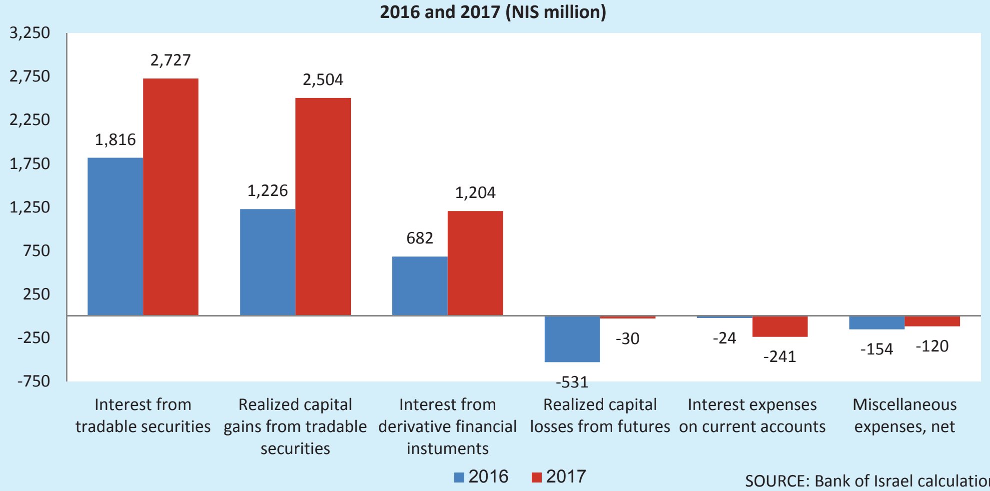
SOURCE: Bank of Israel calculations.

4.1.1 Income from the Foreign Exchange Reserves

The income from interest and capital gains[8,9] in respect of foreign exchange reserves, excluding exchange rate differentials, amounted in 2017 to approximately NIS 6 billion, compared with approximately NIS 3 billion in 2016 (Table 3). The income is comprised of: interest income of approximately NIS 3.7 billion and capital gains and other income of approximately NIS 2.3 billion (in 2016—NIS 2.5 billion in interest and NIS 0.5 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 2.7 billion and realized capital gains totaling approximately NIS 2.5 billion. (In 2016—approximately NIS 1.8 billion in interest and approximately NIS 1.2 billion in capital gains). Figure 10 below presents the composition of gains based on the type and source of income.

Figure 10
Composition of Realized Gains from Foreign Exchange Reserves, 2016 and 2017 (NIS million)



SOURCE: Bank of Israel calculations.

The analysis of realized gains from foreign exchange reserves demonstrates that compared with last year, income from interest on securities increased by approximately NIS 0.9 billion. The main increase in interest income derives from dollar-denominated bonds which were affected by the increase in the U.S. interest rate.

Income from realized capital gains from securities, deriving mainly from the shares portfolio, increased by about NIS 1.3 billion this year, affected by the increased investment in shares and the appreciation of the share indices underlying the reserves portfolio.

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

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

Derivative financial instruments made a positive contribution to gains from foreign exchange reserves. Interest income was recognized from derivative financial instruments and gains on investments in foreign currency derivatives totaling approximately NIS 1.2 billion (as opposed to NIS 0.7 billion in 2016), which reflected attractive interest rate spreads in these transactions this year, and their volume increased.

In contrast, capital losses from foreign currency derivatives totaling NIS 30 million (in 2016—approximately NIS 531 million) were recorded, which mainly resulted from stock market index futures. Dollar transactions in the year incurred capital losses, offset by capital gains from transactions in euro and Japanese yen. These investments, however, represent a small part of the overall equity investment, in which gains were recorded.

In 2017, unrealized gains from foreign exchange reserves increased, as reflected by the fair value of the assets in the revaluation account at year end. The balance of this account, which is unrealized and not included in the Bank's profits, increased by approximately NIS 4.7 billion in 2017 (an increase of approximately NIS 2.7 billion from last year) (Table 3). The increase in the revaluation account this year was mostly derived from the rise in share prices.

From an overall perspective of realized and unrealized gains from foreign exchange reserves, excluding exchange rate differentials, overall income grew by approximately NIS 5 billion (in keeping with an increase of approximately NIS 3.8 billion in 2016). The annual yield on the portfolio in numeraire terms in 2017 amounted to 3.03 percent, exceeding the yield of 1.56 percent in 2016.

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

	2017	2016	2015
Total foreign exchange reserves:		USD million	
End of year	113,011	98,447	90,575
Annual average	107,567	95,777	87,389
Income (expenses) and exchange rate differentials - economic calculation:		NIS million	
Interest and capital gains	6,044	3,015	2,924
Unrealized price differentials[a]	4,726	2,734	(968)
Exchange rate differentials	(23,403)	(11,069)	(10,093)
Total	**(12,633)**	**(5,320)**	**(8,137)**
Income (expenses) and exchange rate differentials- economic calculation:		USD million	
Interest and capital gains	1,643	785	748
Unrealized price differentials[a]	1,565	728	(253)
Exchange rate differentials	4,316	(1,552)	(2,943)
Total	**7,524**	**(39)**	**(2,448)**
Rates of return[b]:		Percent	
In numeraire terms of foreign exchange reserves	**3.03**	**1.56**	**0.64**

[a] Unrealized price differentials express the annual change in the revaluation account of foreign currency tradable securities (see Note 14 to the financial statements).
[b] Rates of return, which are shown in annual terms, are based on daily calculations, and relate to income from the foreign exchange reserves, including gains or losses resulting from market price changes.

4.2 Revaluation Accounts

The revaluation accounts are composed of unrealized gains from exchange rate differentials on balances denominated in foreign currency and of unrealized gains from indexation and revaluation of tradable securities in local and foreign currency to their fair value. This item also includes a revaluation account in respect of unrealized 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 1m and 14 to the financial statements).

4.2.1 Revaluation Account of Balances denominated in Foreign Currency

The balance of the revaluation account of balances denominated in foreign currency at year end was approximately NIS 3.2 billion, compared with approximately NIS 19.6 billion in 2016, a decrease of approximately NIS 16.4 billion.

In 2017, negative exchange rate differentials were accrued in respect of the adjustment of the balances denominated in foreign currency to the representative exchange rates in a total of approximately NIS 22 billion (Table 4), mainly as a result of the appreciation of the shekel against the dollar at a rate of about 9.8 percent this year (Figure 5). In keeping with the Bank's accounting policy, an amount of approximately NIS 16.4 billion out of negative exchange rate differentials was carried to the revaluation account and offset against a retained credit right (this amount is comprised of offsetting the majority of the dollar revaluation reserve accrued at the end of 2016 in a total of approximately NIS 19.5 billion and the accrual of positive exchange rate differentials this year, mainly owing to the revaluation of the euro by about NIS 3.2 billion). The balance of negative exchange rate differentials, totaling approximately NIS 5.6 billion, was charged to the Statement of Operations as expenses from exchange rate differentials.

In 2016, negative exchange rate differentials totaling approximately NIS 10.5 billion arising mainly from the weakening of the euro and pound sterling were accrued, of which approximately NIS 7.1 billion was charged to profit and loss and the balance of approximately NIS 3.5 billion was offset from the revaluation account.

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

	2017	2016
	NIS million	
Assets		
Foreign currency balances	(23,403)	(11,069)
The IMF	-	-
Credit to the government—binational foundations	(12)	(2)
Liabilities		
Government deposits	1,117	306
Foreign currency deposits of banking corporations	93	33
International financial institutions	205	211
Binational foundation deposits	13	2
Total	**(21,987)**	**(10,519)**
Realized exchange rate differentials in profit and loss	(5,578)	(7,053)
Unrealized exchange rate differentials	(16,409)	(3,466)

4.2.2 Revaluation Account from Tradable Securities in Foreign Currency

The balance of the revaluation account from tradable securities in foreign currency at the end of 2017 was approximately NIS 11.9 billion, compared with approximately NIS 7.1 billion in 2016. The increase of approximately NIS 4.8 billion derived mainly from the increase in the revaluation account in respect of the investments in equities due to the rise in global stock markets in the course of 2017.

4.2.3 Revaluation Account from Tradable Securities in Local Currency

The balance of the revaluation account from tradable securities in local currency at the end of 2017 was approximately NIS 0.8 billion, a decrease of approximately NIS 0.1 billion compared with 2016. The decrease was mostly affected by the drop in market prices of tradable securities in local currency.

4.2.4 Revaluation Account from Actuarial Gains or Losses in respect of Benefits to Employees and Pensioners

At the end of 2017, the revaluation account consisted of a debit balance of approximately NIS 2.3 billion (approximately NIS 2.1 billion in 2016).

According to the Bank's accounting treatment method, any change in the Bank's liability in respect of benefits to employees and pensioners[10] arising from changes in actuarial assumptions[11] or from the gap between estimates and actual results is carried to the revaluation account in the Balance Sheet. The account may also represent 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 Operations.

4.3 Monetary Base

The monetary base is comprised of the total banknotes and coins in circulation and the demand deposits of the commercial banks in the Bank of Israel[12] and is determined according to the liquidity demand at the Bank's given interest rate. The monetary base is affected both by factors which are not under the control of the Bank, such as government

[10] 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).

[11] 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.

[12] 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.

accounts[13], 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.

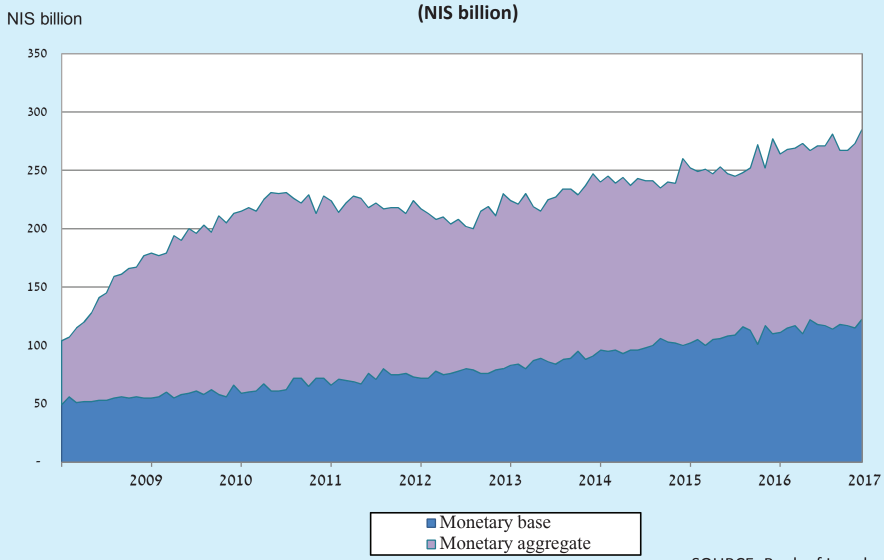
The Bank adapts the monetary base to the interest rate using monetary instruments—by issuing *makam* and by using auctioned interest-bearing deposits or loans of the banks, which are not included in the monetary base[14], in accordance with their liquidity needs. This year, the Bank pursued its intervention in the foreign exchange market in accordance with its policy to operate in this market when the shekel exchange rate is not in line with the fundamental economic conditions underlying its development.

In keeping with the trend of the last few years, the monetary base grew in 2017 by about NIS 12.2 billion (in 2016 by approximately NIS 10.8 billion), reaching approximately NIS 122.7 billion at the end of the year (Figure 11). Similarly to last year, the largest injection to the monetary base made by the Bank in a total of approximately NIS 24 billion (approximately NIS 23 billion in 2016) was 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 pressure of short-term interest being lowered to a lower level than that determined by the Bank. The absorption was carried out through the monetary instruments aggregate (*makam* and time deposits) in the amount of approximately NIS 9 billion, which was offset by the injection of approximately NIS 1.2 billion, partly from payments in respect of the monetary instruments.

In 2017, the Government absorbed approximately NIS 4 billion from the market (as opposed to injecting approximately NIS 4 billion in 2016).

[13] 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).
[14] Since they are not recognized for the purpose of compliance with the reserve requirement.

Figure 11
Developments in the Monetray Aggregate and Monetary base, 2009-2017
(NIS billion)



SOURCE: Bank of Israel calculations.

Table 5
The Monetary Base—Changes and their Sources

Year	Change in monetary base	Injection (+) / absorption (-) by the government and national institutions[a]	Injection (+) / absorption (-) by the Bank of Israel	Injection from foreign currency conversions at the Bank of Israel	Adjustments[b]
	(1)=(2)+(3)+(4)+(5)	(2)	(3)	(4)	(5)
	NIS million				
2012	748	(9,130)	10,047	-	(169)
2013	6,443	(10,452)	(2,414)	19,037	272
2014	11,699	1,171	(14,190)	24,632	86
2015	8,427	(14,036)	(11,543)	33,842	164
2016	10,787	3,538	(15,814)	23,086	(23)
2017	**12,179**	**(3,864)**	**(7,819)**	**24,030**	**(168)**

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

4.4 Aggregate of Monetary Instruments[15]

Israel experienced a positive inflation rate in 2017 for the first time since 2014. The Israeli CPI increased this year by 0.4 percent compared to a negative rate of about 0.2 percent last year. The increase in inflation corresponded to the increase in most OECD countries. The Israeli monetary policy in recent years was accommodative and acted to support activity and exports and restore the low inflation to its target range taking into account financial stability considerations in the context of the sharp rise in housing prices and the low margin level in the corporate market. The interest rate in 2017 remained low at 0.1 percent since its lowering in March 2015.

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

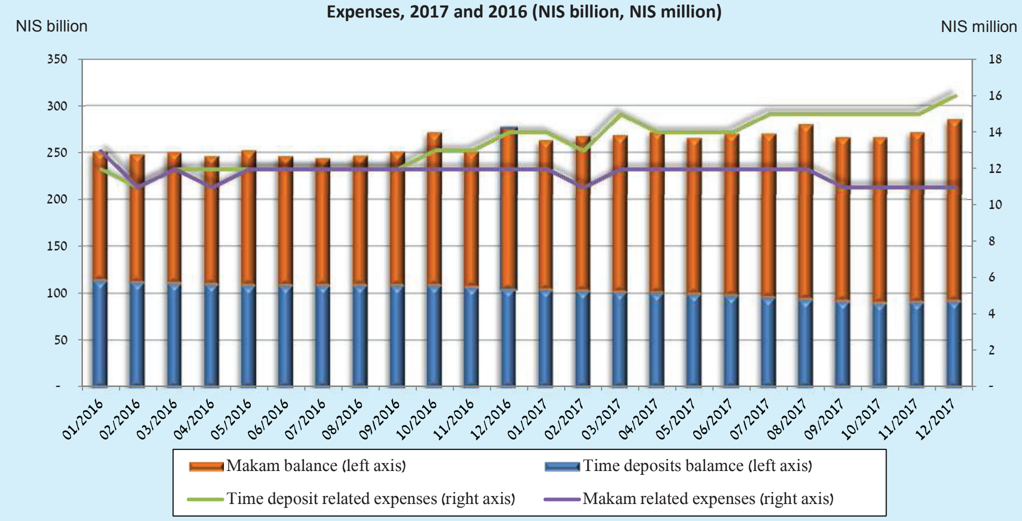
To effectively implement the interest rate declared by the Bank of Israel, the Bank injects or absorbs the needed funds into/from the market, in line with its own determined interest rate. This is done through extending loans to banking corporations or receiving deposits from banking corporations and through the issue of *makam*, as applicable. This is particularly relevant in the event of sterilization of the positive contribution of foreign exchange purchases to the monetary base.

In keeping with the trend of recent years, the balance of monetary instruments remains composed solely of liabilities, amounting to approximately NIS 286 billion in late 2017, compared with approximately NIS 277 billion at the end of 2016 (an increase of about 3 percent). This increase was derived from the need to sterilize the surplus funds injected into the markets as a result of forex purchases (Figure 12). In 2017, the monetary aggregate consisted of approximately NIS 194 billion in time deposits, accounting for about 68% of total monetary instruments (compared with approximately NIS 172 billion in 2016 - about 62 percent), and approximately NIS 92 billion in *makam*, accounting for about 32 percent of total monetary instruments (compared with approximately NIS 105 billion at the end of 2016, about 38 percent).

[15] 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 2017 and 2016 was zero.

Interest expenses in respect of the aggregate of monetary instruments in 2017 amounted to approximately NIS 315 million, compared with approximately NIS 288 million in 2016. The increase in interest expenses mostly stemmed from the increase in the monetary aggregate (Figure 12).

Figure 12
Balance of Monetary Aggregate and related Monthly Expenses, 2017 and 2016 (NIS billion, NIS million)



SOURCE: Bank of Israel calculations.

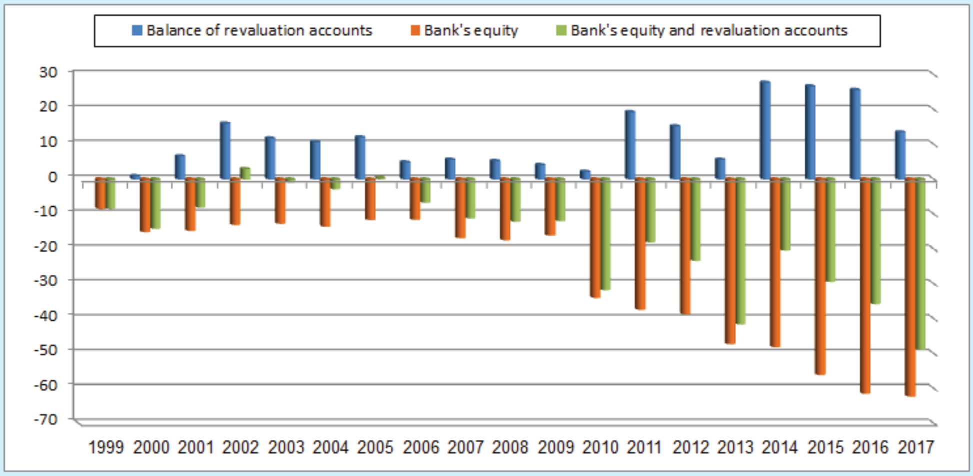
4.5 The Bank's Equity (Deficit Equity)

The Bank has an Deficit Equity of approximately NIS 62.3 billion. The accumulated losses, which played a major part in the creation of an 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. This is because in 1999, negative exchange rate differentials were recorded following the shekel's appreciation, which resulted in a loss in said year. The loss created an unprecedented Deficit Equity in the Bank's Balance Sheet, which has been sustained to date.

In 2000, the Bank of Israel revised the accounting policy of revenue recognition and began to treat realized and unrealized gains differently, as customary in central banks around the world. Unrealized gains are carried to revaluation accounts in order to prevent the recurrence of transferring unrealized gains, mainly arising from exchange rate differentials, in years in which the shekel significantly depreciates (see Note 1f to the financial statements).

The balance of revaluation accounts at the end of 2017 amounted to approximately NIS 13.5 billion. Overall, the net balance of the Bank's equity with the addition of revaluation accounts amounted to approximately NIS 48.8 billion. Figure 13 presents the Bank's Deficit Equity and revaluation accounts and their general trend.

Figure 13
The Bank's Equity and Revaluation Accounts, 1999-2017
(NIS billion)



SOURCE: Bank of Israel calculations.

4.5.1 Composition of the Deficit Equity

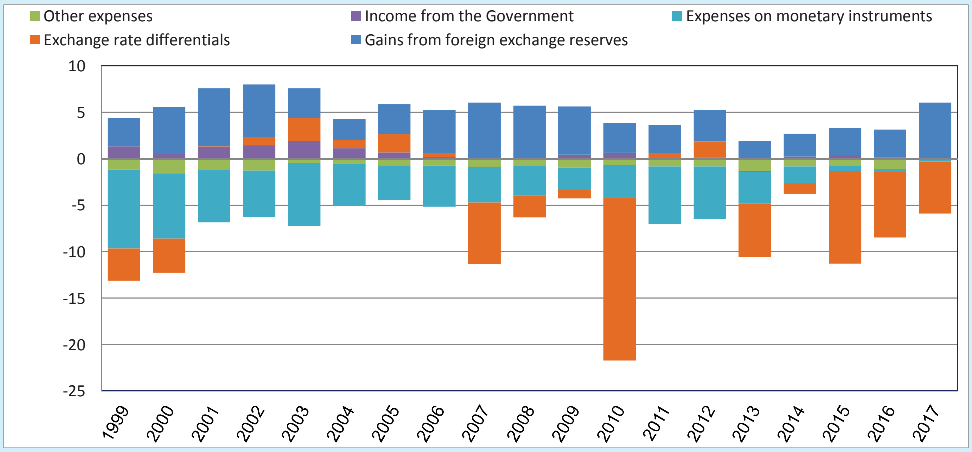
The analysis of the Bank's Deficit Equity indicates that the main components that contributed to the deficit are expenses in respect of exchange rate differentials which over said years aggregated approximately NIS 55 billion and expenses in respect of using monetary absorption instruments which aggregated to approximately NIS 76.8 billion. In contrast, gains from foreign exchange reserves in said years totaled approximately NIS 76.2 billion, minimizing the gap between gains from foreign exchange reserves and expenses in respect of monetary absorption instruments, excluding losses on exchange rate differentials, to about NIS 600 million only.[16] This trend of minimizing the gap between the gains from foreign exchange reserves and the cost of monetary instruments has continued in recent years. There has been growth in the foreign exchange reserve portfolio's volume (and related income) and an increase in the portfolio's equity component whose yield is higher, while at the same time there has been a decrease in interest expenses on the monetary instruments. The decrease in interest expenses is a result of the reducing of the BOI's interest rate in recent years to 0.1 percent in the context

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

of the accommodative monetary policy. The effect of the exchange rate differentials is large and volatile, and due to the appreciation of the shekel in 2017 has continued to contribute to increasing the Bank's Deficit Equity.

Other results, which mainly consist of various interest expenses, general and administrative expenses and banknote printing expenses, contributed approximately NIS 17.5 billion to the deficit. In contrast, net income from the Government (bonds and deposits) mitigated the accumulated deficit by approximately NIS 10.4 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.

Figure 14
Principal Loss Components, 1999-2017
(NIS billion)



SOURCE: Bank of Israel calculations.

EXPLANATORY REMARKS TO THE FINANCIAL STATEMENTS FOR 2017