

Q&A on the Foreign Exchange Markets

1. What is the essence of the policy which the Bank of Israel announced on the 3rd August 2009?

The Bank of Israel will act in the foreign exchange markets in cases where changes in the exchange rate of the shekel are inconsistent with underlying economic conditions or when the foreign exchange markets are not functioning properly.

2. What are the "underlying economic conditions" that the Bank of Israel takes into account?

The Bank of Israel weighs a number of factors in determining its policy in the foreign exchange markets. These include: the level of economic activity in general and the export situation in particular, the level of inflation, financial stability and the functioning of the foreign exchange markets. The Bank examines the development of the exchange rate of the shekel not just against the dollar but also against other currencies. These developments, along with additional factors, are examined over a period of time and not just over the short term.

3. What is the difference between the intervention of the Bank of Israel on the 13th and 14th March 2008 and the new policy announced on the 3rd August 2009?

One of the central functions of the Bank of Israel is to intervene in the case of market failure in the foreign exchange markets (market failure is a situation in which the market is not functioning properly regardless of the level of the exchange rate). In March 2008 the Bank of Israel intervened in the foreign exchange markets after identifying a failure in the functioning of the market. In the policy which commenced on the 3rd August 2009 the Bank of Israel has widened the conditions in which it will act in the market. From now the Bank of Israel will act in the foreign exchange market also in situations where changes in the exchange rate of the shekel are inconsistent with underlying economic conditions or when the foreign exchange markets are not functioning properly.

4. Until when with this policy continue?

This policy does not have a time limit.

5. Why was the fixed daily \$100m USD purchase stopped?

The daily program was originally targeted to increase the level of foreign currency reserves, a target that has been achieved. Later on, the program was part of the response to the global crisis. Currently, the new operating policy of the Bank of Israel in the foreign exchange market will provide a better response to the economy's needs.

6. Is this not a case of printing money?

The Bank of Israel sets an interest rate which is the price of credit. In order to support the implementation of this interest rate, the Bank of Israel operates tools within its

authority in order to regulate the amount of money that corresponds to the level of interest that has been set. Within this framework, the Bank of Israel injects or withdraws money according to requirements. By purchasing foreign exchange the Bank of Israel injects shekels into the economy. Each shekel that leaves the Bank of Israel's account increases the money supply by a shekel. Each shekel that enters the Bank of Israel's account, for example when the Bank of Israel sells *Makam* (short-term bills) or accepts daily deposits, decreases the money supply by a shekel. But, to ensure that the money supply does not exceed the amount required by the interest rate set by the Bank of Israel, **the Bank of Israel absorbs the money that has been injected into the market and therefore its actions in the foreign exchange markets do not result in "printing money"**. Amongst the tools that the Bank of Israel uses in order to regulate the money supply are the *Makam*, and the deposits and loans to the commercial banks.

7. **Will this not lead to inflation?**

In so far as the Bank of Israel absorbs the shekels which are circulated due to its foreign currency purchases, there will be no impact on inflation from the purchases.

8. **But what about the impact of the change in the exchange rate on inflation?**

In general the Bank of Israel gives priority to achieving its inflation target over the coming 12 months. This is reflected in the Bank's monetary policy.

9. **What will the Bank do with all the dollars it has purchased? Will they be sold at a later date?**

The dollars which the Bank is purchasing become part of the Bank's foreign exchange reserves. The policy which began on August 3rd does not define a specific direction of activity. This means that the Bank of Israel can both buy and sell foreign currency in response to exchange rate movements. While current policy involves foreign exchange purchases, this can change.

10. **How much foreign currency is the Bank of Israel purchasing each day?**

The Bank of Israel will announce the change in its holdings as part of the monthly publication of the amount of foreign exchange reserves held by the Bank. This publication is released around the 5th of every month.

11. **Is the Bank of Israel only buying dollars or also other currencies?**

The Bank of Israel buys dollars against shekels, but simultaneously converts a fixed percentage of those dollars into other reserve currencies according to the currency composition that is set for the holdings of foreign exchange reserves.

12. **If so, how does this activity impact for example the euro/shekel foreign exchange rate?**

The foreign exchange markets establish all currency cross rates. Therefore a change in the exchange rate of the shekel against the dollar will result in a change in the exchange rate of the shekel against the euro in accordance with the exchange rate of the euro versus the dollar.

13. The Bank of Israel held over USD 50 Billion in reserves at the end of July 2009. What is the benefit of holding such large reserves? Moreover, in November 2008 the Bank of Israel announced that the level of adequate reserves was between 40 and 44 billion USD.

After reaching the desired level of foreign exchange reserves, the Bank of Israel continued its dollar purchasing program in light of the increased uncertainty of the international economic situation. Now the Bank of Israel is announcing a change in its operating policy in the foreign exchange markets.

14. Does the Bank of Israel believe that it is able to control the market forces that determine the Shekel exchange rate?

The Bank of Israel has no intention to operate against global exchange rate trends.

15. Does the Bank of Israel have a target exchange rate it wishes to achieve?

The Bank of Israel does not have a specific target for the exchange rate. However, the Bank will act in the foreign currency market in cases where changes in the exchange rate of the shekel are inconsistent with underlying economic conditions or when the foreign exchange markets are not functioning properly.