

**Ministry
of Finance**



THE ACCOUNTANT GENERAL



Government Debt Report 2013



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Message from the Accountant General

The Debt Management Unit in the Financial Department of the Accountant General office is responsible for financing for the government's activity, deficit and current turnovers. In addition, the office is responsible for implementing the long-term strategic policy of the Accountant General Office, therein balancing risk level and the cost of funding the government debt.

The unprecedented scope of funding in a period of sustained global uncertainty, alongside geopolitical threats and Israel's macroeconomic situation, calls for a conservative approach and preparations for every possible scenario. The necessity of this approach is underscored by the rapid deterioration we are witnessing in recent years in the economic situation of countries which until lately were thought to enjoy strong and stable economies.

Nonetheless, we can point to quite a few achievements in the area of debt management, including the continuing decrease in the debt-to-GDP ratio, which bolsters the State's credit rating and helps to maintain low funding costs. The ability to extend the term to maturity of the government debt, thereby reducing the refinancing risk, in this troubled period in which many countries are experiencing funding difficulties, supports the fiscal objectives of the Ministry of Finance and increases the State's financial strength. Reliance on a deep and liquid domestic market, while expanding the investor base and achieving penetration of global markets, is helping to diversify the sources of financing and is evidence of foreign investors' confidence in the Israeli economy.

In January 2013, the Debt Management Unit executed for the first time a dual-tranche USD issuance in the global markets for 10.5 and 30 years, in the amount of one billion dollars per tranche.

At the beginning of 2014 the Debt Management Unit issued a 10-year 1.5 Billion euro sovereign bond in the global markets. This issuance was executed after a long absence from the European market and following an extensive roadshow, in which we met with many foreign investors in Europe. The issuance was characterized by the lowest funding cost paid by the State of Israel in a Euro offering.

In conclusion, I wish to thank the Debt Management Unit team, the Head of the Debt Unit, Gil Cohen and my Deputy, Yali Rothenberg, Head of Financing and Credit Division, who work with great professionalism and dedication to meet the many challenges facing them.

Sincerely,
Michal Abadi-Boiangiu
Accountant General

Section A - Preface

We are pleased to present the 12th annual report of the Government Debt Management Unit in the Accountant General Office for 2013.

The year 2013 was characterized by rising stock indices in Israel and globally, with the Nasdaq rising by 38% and the S&P 500 by 30%, while in Europe Germany's DAX index rose by 25% and the FTSE in London by 14%. Domestically, the Tel-Aviv 100 index performed well with an increase of 15%, and the Bonds indices did nicely as well, with the CPI-linked Bonds Index rising 10% and the Government Bonds Index rising 3.5%.

Despite of the aforementioned increases recorded in the stock and bond markets, the global economy has yet to fully recover and return to its pre-crisis state. In the US, programs aimed at stimulating the economy are still being carried out, while European governments face high unemployment rates.

In light of this, maintaining financial stability and effective debt management are ongoing challenges facing the Government Debt Management Unit, and require a responsible and stable strategic policy. Below is a review of the key economic developments in 2013.

Government Budget

At the end of 2013, the government budget deficit reached a level of 3.15% of GDP, compared to the budget plan of 4.33%. The difference compared to the original budget plan is mainly due to higher-than-expected revenues of NIS 5.7 billion, and also to lower expenditures than originally anticipated, in the amount of NIS 6.7 billion.

Debt Funding

Debt funding in 2013 stood at NIS 119 billion, with NIS 107 billion derived from issuances in the domestic market and the balance of NIS 12 billion derived from foreign-currency issuances in overseas markets. The net amount raised in 2013 was NIS 35 billion, compared to NIS 36 billion the year before.

Debt-to-GDP Ratio

The ratio of government debt to GDP continued to fall in 2013, declining by 1.0% to 66.1%. The ratio of public debt to GDP (including debts of the local authorities) declined by 1.0% to 67.4%. The decline in the debt-to-GDP ratio is explained mainly by a significant rise in the nominal GDP relative to the increase in government debt, given the rate of growth in GDP prices as well as the low level of inflation and the strengthening of the shekel against the dollar.

Inflation

During 2013, the consumer price index rose by 1.8%, within the Bank of Israel's target range (1%-3%), compared to an increase of 1.6% in 2012. The main items that recorded an increase during the year were: food, housing, home maintenance and health. In contrast, declines were recorded in home furniture and equipment, clothing and footwear, transport and communications.

Bank of Israel Interest Rate

In 2013, the Bank of Israel continued the trend of reducing the interest rate. During this period, the interest rate was reduced gradually from a level of 1.75% at the beginning of the year to 1% at the end of the year. The key factors underlying the cut in the interest rate were the concerns over the effects of the global slowdown and the moderation in the growth rate.

Exchange Rate

2013 saw a strengthening of the Shekel, registering a 7% appreciation against the Dollar (the Dollar fell from NIS 3.733 at the end of 2012 to 3.471 at the end of 2013), and a 2.80% appreciation against the Euro (a decrease from NIS 4.9206 at the end of 2012 to NIS 4.7819 at the end of 2013).

The Stock Market

Much like 2012, the stock market in 2013 was characterized by rising prices. The TA-25 stock index rose by 12.1% in 2013, with most of the increase recorded in the second half of the year, compared to an increase of 9.2% in 2012. Prices on the leading indexes rose in 2013.

Government Bond Market

The government bond market showed price increases over the past year, with the government bonds index recording a 3.5% rise in 2013, compared to an increase of 7.9% in 2012. The CPI-linked government bond index recorded a 3% (nominal) rise over the past year, compared to an increase of 9.4% the previous year. The nominal fixed-coupon government bond index recorded a 4% (nominal) rise, following an increase of 7% in 2012.

Achievements in the Government Debt Sector in 2013

- **Reduction in the ratio of government debt to GDP** – Government debt amounted to NIS 696.3 billion. Despite the nominal increase in the government debt, the downward trend in the ratio of government debt to GDP continued this year as well. This ratio is among the most important indexes for determining the country's credit rating and is evidence of its financial strength.
- **Credit rating** – In November 2013, Fitch rating agency revised Israel's rating outlook from stable to positive. The country rating remained unchanged.
- **Raising Debt in a large Scope** - In 2013, the debt Management Unit was tasked with raising an overall sum of NIS 119 billion in order to finance a deficit of 3.15% of GDP. The scope of issuances in the domestic market was supported by a favorable interest-rate environment and by a deep and liquid domestic market. Thus, in spite of the large scope of funding, the bid-to-cover ratio (demand versus amount issued) stood at an annual average of 4.6, similar to last year's figure.
- **Reducing refinancing risk and extending the ATM of the debt** – As part of the Accountant General Office's policy in 2013, the Debt Management Unit extended the average time to maturity of the government debt from 6.6 to 7.1 years. The proportion of short-term debt to the total debt remained at 10%.
- **Reduction in interest expenses** – The ratio of interest payments to GDP declined from 3.9% to 3.6% at the end of 2013. Debt refinancing in the past year was carried out at low interest rates, in light of the favorable funding environment. This funding will enable significant savings in interest payments in the coming years.
- **Diversification of government financing sources** – Funding in 2013 was carried out using the following sources of financing:
 - **Funding through primary dealers:** Each of the primary dealers is required to purchase 4% of the total competitive nominal and CPI-linked issuances in the domestic market. The Debt Management Unit raised NIS 66 billion in 2013 through current auctions.
 - **Use of additional liquidity management tools:** These tools, which were launched at the end of 2007, provided support to the funding program, assisted in lowering the refinancing risk and contributed to lowering the budget for interest payments. An amount of NIS 16 billion was raised through switch auctions, and there were early debt repayments in the amount of NIS 10.6 billion.

The massive use of these tools increases the flexibility in the debt management and allows for rapid adjustment to changes in the macro-economic environment.

- **Foreign Exchange Debt – a dual-tranche issuance:** In January 2013, a dual-tranche USD issuance in the global markets was executed for 10.5 and 30 years, in the amount of one billion dollars per tranche. The yield for the 10.5 year bond was 3.213%, reflecting a spread of 125 basis points over the US treasury. The yield for the 30 year bond was 4.588% with a spread of 145 basis points. The issuance was characterized by the lowest funding cost paid by the State of Israel in a dollar offering and historically low spreads.
- **Preservation of cooperation and consultation with the Bank of Israel on issues related to the government bonds market and treasury bills:** In most economies worldwide, the government operates in the issuance market, while the central bank does not manage monetary policy in this market but through open market operations in the secondary market. In Israel, the Bank of Israel issues T-bills and maintains a dominant presence in the short end of the yield curve. The Debt Management Unit holds periodic consultations with the Bank of Israel, in the course of which the Bank presents the situation in the international markets and in the domestic market.

Challenges in the Management of Government Debt in 2014

- **Implementation of a conservative government debt management policy** – The ongoing global economic crisis and the resulting uncertainty pose a significant challenge to the management of the debt. The funding program for 2013 reflects the strategic goals of the debt management and provides support for a reduction in the financial risks of the government debt portfolio and for maintaining flexibility in the management of high financing needs under various pressure scenarios.
- **Designated Bonds** – According to the reform in 2003, the Debt Management Unit issues designated bonds in the amount of 30% of total pension fund assets. The goal of this program is to support retirement savings. However, since these bonds are paying relatively high coupons compared to the tradable government bonds, these issuances indirectly subsidize pension savings through the interest payment budget. This subsidy causes an increase in the country's funding costs and therefore a relative raise in the interest payments, which are high by international comparison. The amount of non-tradable designated bonds issued in 2013 stood at NIS 25 billion (compared to NIS 16 billion in 2012). The increase in designated bonds issuances increases the share of the non-tradable debt at the expense of the tradable domestic debt. For more information, please see Chapter D.
- **Exposure to the CPI** – The percentage of CPI-linked debt stood at approximately 49% of the total debt at year-end 2013. Looking back, we see that the exposure to the CPI-linked debt during the past 3 years varied between 47%-49%, following a significant reduction in previous years. It should be noted that the need for CPI-linked bonds in the capital markets, as these bonds are used as a benchmark for corporate bond issuances, as well as the growing pace of designated bond issuances, make it difficult to minimize the exposure to the CPI and may even increase this exposure in the future.
- **Analysis of the rating methodologies and creating a rating profile for the State of Israel** – Preparing a thorough analysis of the rating methodology of the big 3 rating agencies within the framework of quantitative and qualitative analysis. It remains a challenge preparing Israel's full rating profile and improving the predictability of changes in the macro-economic and geo-political environment on the rating of the country.

Developments in the course of 2014: In January 2014 the Debt Management Unit issued a 10-year 1.5 Billion Euro sovereign bond in the global markets, with a coupon of 2.875% and a yield of 2.93% - the lowest ever in a Government of Israel Euro issuance. The issuance was characterized by a high demand of EUR 5.7 billion by 300 different investors from 30 countries. This is the fifth issuance by the GOI in Europe, and was executed according to the Debt Unit's annual working plan.

The annual report covers all activity performed by the Debt Management Unit in 2013, with emphasis on the primary market, the secondary market and the debt balance. Section B describes the policy goals of the Debt Management Unit. Section C presents the government debt balance with emphasis on value and risk measures, exposure of the government debt to risk factors and ways of managing risk. Section D reviews activity in the primary market, including both domestic and foreign debt, with emphasis on financing sources. Section E details key developments in the secondary market.

Sincerely,

Yali Rotenberg
Senior Deputy Accountant General
Head of Financing and Credit Division

Gil Cohen
Managing Director
Head of Government Debt Management Unit

Section B – Government Debt Management Policy and Goals

The main activity of the Government Debt Management Unit consists of funding the government's activity, the deficit and the current refinancing operations, while serving the long-term goals in the management of the debt.

The principal considerations of the debt management policy are:

1. Issuer considerations, with emphasis on government debt risks.
2. Sovereign considerations and development of the government bonds market.

The volume of issuances and the debt management policy directly affect the Debt to GDP ratio and the burden of interest expenditure in the State budget. The Debt to GDP ratio is an accepted measure for examining the State's financial strength. Reducing this ratio aids the State in its future financial obligations. The interest budget is the second largest component in the State budget after the defense budget, and the most important in terms of prioritization of payments, since failure to meet financial obligations would mean insolvency. Therefore, supreme importance is attached to reducing volatility in the interest budget, especially given the exposure of the interest budget to market changes, such as fluctuations in interest and exchange rates and in the consumer price index, as well as macroeconomic and fiscal policy changes, such as the level of income from taxes and the budget deficit amount.

In addition, there are several secondary goals in debt management that serve the primary goals. For example, increasing government bond tradability and liquidity will help reduce the interest budget burden, since the interest on tradable and liquid debt is lower than the interest on non-tradable debt. However, the secondary goals do sometimes conflict with the primary goals. Therefore, an appropriate balance must be struck between the different considerations.

Below are the secondary goals with respect to domestic debt:

1. Increasing the tradability and liquidity of bonds.
2. Focusing on large series with fixed terms to maturity (benchmark series), as accepted around the world.
3. Enhancing the sophistication of the government bond market and developing new products.

Below are the secondary goals with respect to external debt:

1. Broadening the investor base.
2. Creating benchmarks for issuances abroad of Israeli companies.
3. Exposing the Israeli economy to foreign investors (investor relationships).
4. Managing foreign currency exposure created by the portfolio of liabilities from foreign funding.
5. Improving the credit rating of the State of Israel to the extent possible and reducing the risk premium of the State of Israel abroad.

Pursuant to the 2003 reform, the Debt Management Unit issues designated bonds amounting to 30% of pension fund assets. The main reason for these issuances lies in considerations of the State as a sovereign that supports pension funds. Nonetheless, since these bonds bear a higher coupon rate than tradable government bonds, these issuances indirectly subsidize pension savings through the interest budget. This subsidization boosts the State's funding costs and translates into a higher level of expenses in the interest budget, which compares unfavorably to international standards.

Government Debt Risk Management Policy

The primary goal of the government debt risk management policy is to manage risks at the desirable level (risk appetite), at minimum cost. Proper balancing between the different risks and the risk minimization costs will enable optimal management of the government debt portfolio.

The following are the main financial risks:

1. **Refinancing risk** – The risk that the government will default on its future debt payment obligations. This is the main risk in the government debt portfolio management policy. The risk is estimated by examining the proportion of the short-term debt (debt payable in the next year) to the total debt (rollover ratio) and based on the average time to maturity (ATM). This risk is mitigated by maintaining a consistent policy in which set amounts are issued for fixed terms (benchmark issuances). This policy helps smooth out the redemption curve and reduce refinancing risks.
2. **Liquidity risk** – The risk that the existing sources of financing are insufficient for funding the State's needs. This risk is mitigated by managing liquidity risks based on a central scenario, pressure scenarios and worst case scenarios.
3. As part of the liquidity risk management, a cash account is kept at the Bank of Israel, which is used to absorb changes in the financing needs in the course of the year and as a "liquidity buffer" in the event of an extreme occurrence.
4. **Market risk** – Changes in the government debt and in the interest budget due to changes in market factors (index, interest and exchange rates). This risk is estimated based on government debt sensitivity analyses, as described in Section C.
5. **Credit risk** – The State's activity in hedging transactions with suppliers and customers exposes the government to credit risk in the event of insolvency on the part of the counterparty to the transaction. For this reason, the State operates only vis-à-vis primary dealers who are signed on the ISDA credit support annex (CSA). Under this annex, collaterals are transferred on a weekly basis above a minimum level as a means of reducing exposure to the counterparty.

Section C – Government Debt Portfolio

State of Israel's Credit Rating

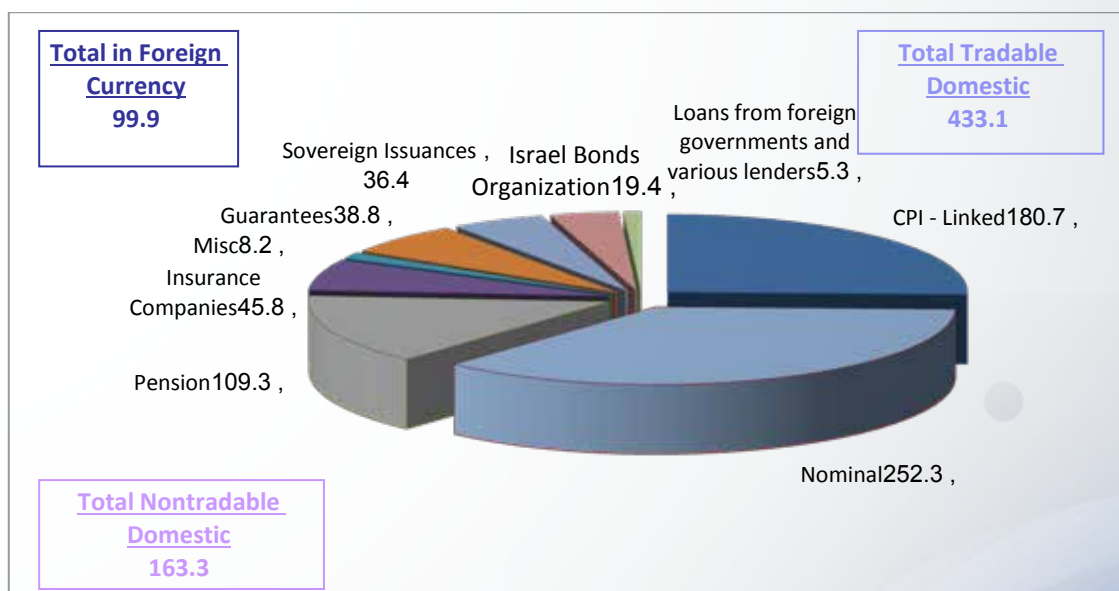
The credit rating is an estimate of the level of risk inherent in an investment and of the issuer's ability to meet its financial obligations.

In the process of determining a sovereign's credit rating, rating agencies examine numerous parameters according to several categories, including: political risk, fiscal stability, fiscal flexibility, monetary stability and external stability. Each parameter is measured by comparison to sovereigns with similar a rating – the "peer group." Israel's peer group mainly consists of medium-sized economies, most of which are peripheral European countries: Poland, Estonia, the Czech Republic, Slovakia, Slovenia, Malta and even Spain. Additional sovereigns in Israel's peer group include Chile and South Korea.

Government Debt

Government debt increased in 2013 by 4.4% to NIS 696.3 billion, compared to NIS 666.8 billion the year before. The bulk of the nominal increase in government debt was due to positive net funding as well as a slight increase of 1.8% in the consumer price index. In contrast, the strengthening (appreciation) of the shekel against the dollar and the euro as well as a decrease in accrued interest, due to, among other things, low funding costs, contributed to lower government debt.

Diagram C-1:
Structure of government debt at the end of 2013 (NIS billions)



Sensitivity of Government Debt to Market Factors

Table C-1 below shows the sensitivity of government debt and the debt-to-GDP ratio to key risk factors, such as the consumer price index and changes in the exchange rate of foreign currencies, as of the end of 2013.

Table C-1

	Change in government debt (NIS millions)	Change in government debt-to-GDP ratio (percent of GDP)
Accumulated increase in the consumer price index in percent unit	3,440	0.32%
Increase in dollar-shekel exchange rate in percent unit	832	0.08%
Increase in euro-shekel exchange rate in percent unit	145	0.01%

Debt-to-GDP Ratio*

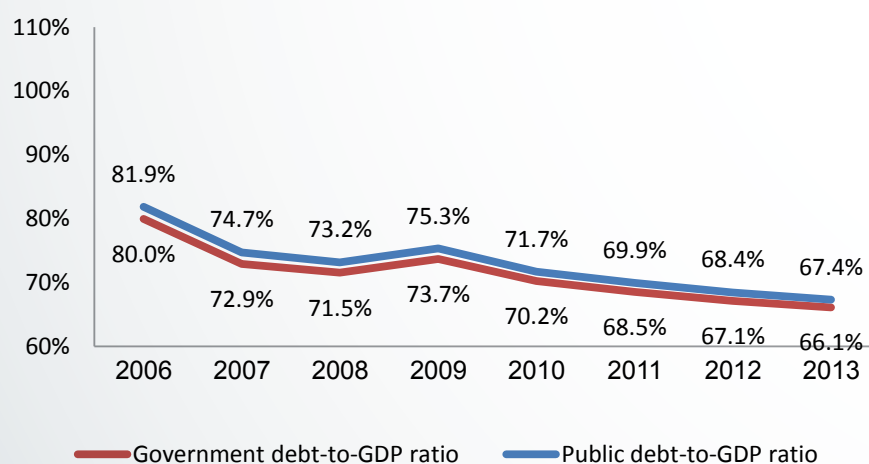
The debt-to-GDP ratio is a key indicator in determining the credit rating and financial stability of the State.

The continuing decline in the debt-to-GDP ratio is a direct result of a responsible economic policy that bolsters the financial robustness of the State, especially considering the significant increase in this ratio in developed countries, as reflected in Diagrams C-3 and C-4.

The government debt ratio decreased by 1% to 66.1%, compared to 67.1% the previous year. The public debt ratio (including local authorities debts) decreased by 1.0% to 67.4%.

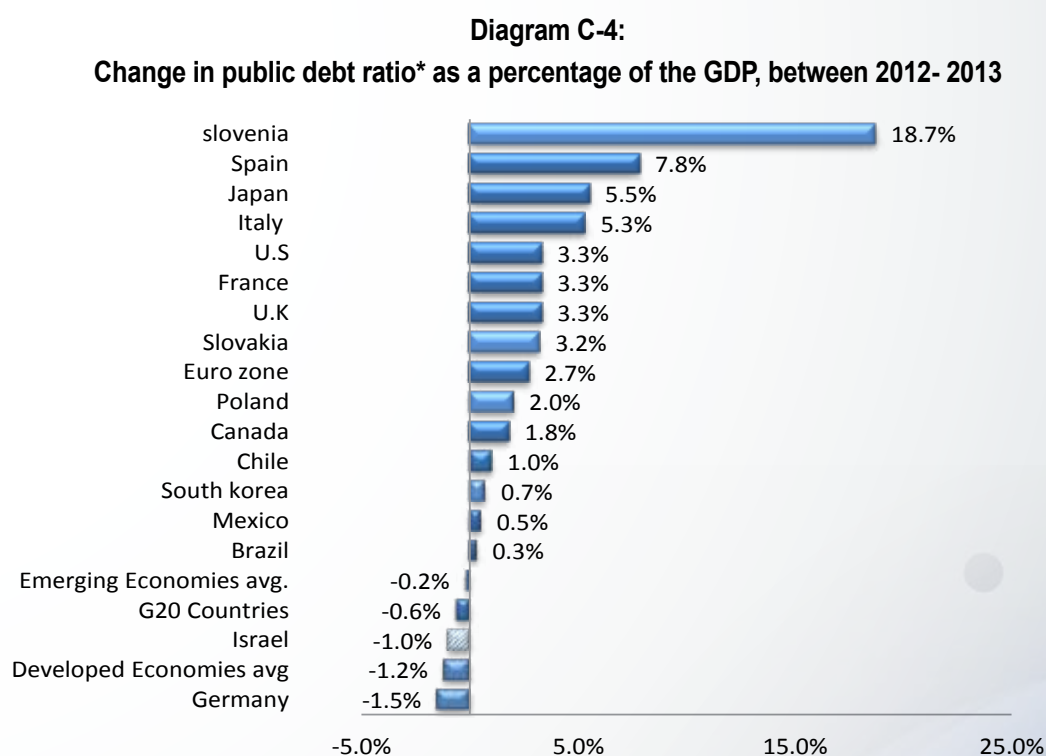
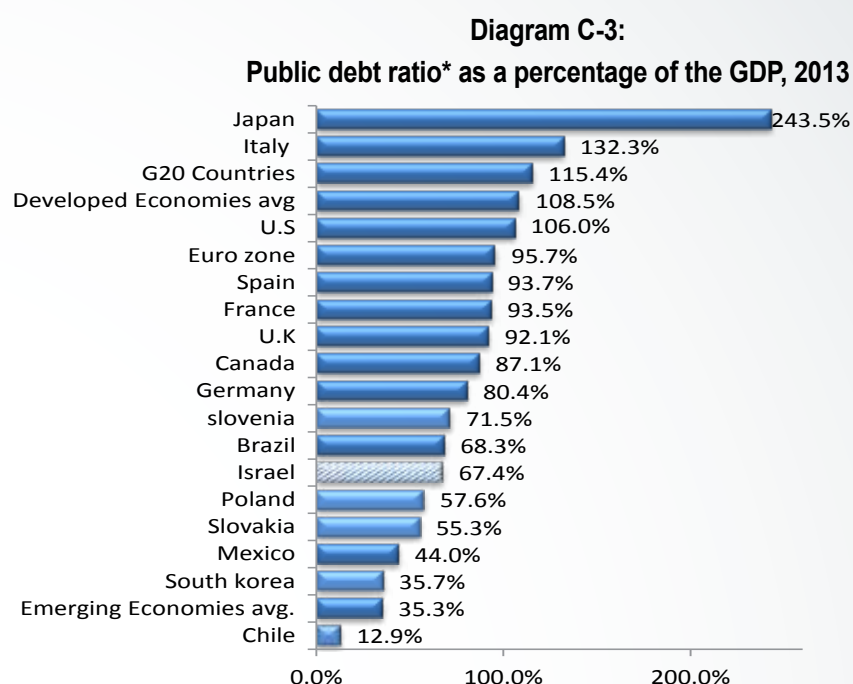
Diagram C-2:

Ratio of government and public debt to GDP, 2006-2013 (percentage)



Source: Ministry of Finance, GDP in 2013 based on Central Bureau of Statistics estimate of the national accounts; first estimate for the second half of 2013, dated February 16, 2014.

*The GDP updated in 2013 according to the SNA 2008



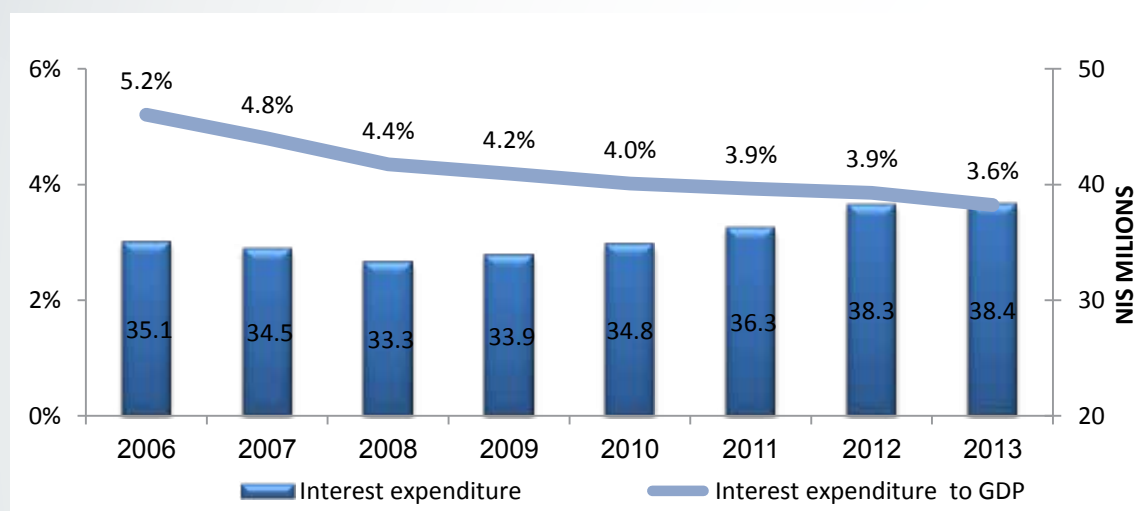
Source: Other countries – Ministry of Finance and Bank of Israel. GDP in 2013 based on Central Bureau of Statistics estimate of the national accounts; first estimate for the second half of 2013, February 16, 2014. Other countries - IMF Fiscal Monitor, October 2013.

* Public debt – including debt of additional government entities, such as local authorities.

Interest expenses

Interest expenses in 2013 amounted to NIS 38.4 billion. Despite the nominal growth, the ratio of interest expenses to the GDP stood in 2013 at 3.6% compared 3.9% the previous year. Interest expenses are the cost of interest for the government debt as well as interest payments to the National Insurance Institute. The decrease in financing costs relative to government debt and National Insurance is due to, among other things, an environment of low interest rates on funding. This decrease is consistent with the trend in recent years, and its importance lies in the release of budgetary sources for other government objectives.

Diagram C-5:
Ratio of interest expenses to GDP, 2006-2013 (NIS billions, percentage)



In light of the strong funding environment in 2013 and the decline in government bond yields, the government debt was refinanced in the past year at lower interest rates than the previous year. This refinancing will make it possible to reduce interest payments on the government debt, thereby freeing up resources in the State budget.

Diagrams C-6 and C-7 show the interest rate on the balance of domestic debt, broken down by the nominal segment and the CPI-linked segment. Compared to 2012, 2013 saw a significant decrease in the balance of debt in the CPI-linked segment paying interest at high rates of 4.8%-6%, and an increase in the balance of debt paying interest at low rates of 0%-4.8%. Furthermore, compared to 2012, in 2013 there was a significant decrease in the balance of nominal debt paying more than 4.8% interest and an increase in the balance of debt paying interest at rates of up to 4.8%.

Diagram C-6:
Interest rates on the balance of CPI-linked domestic debt

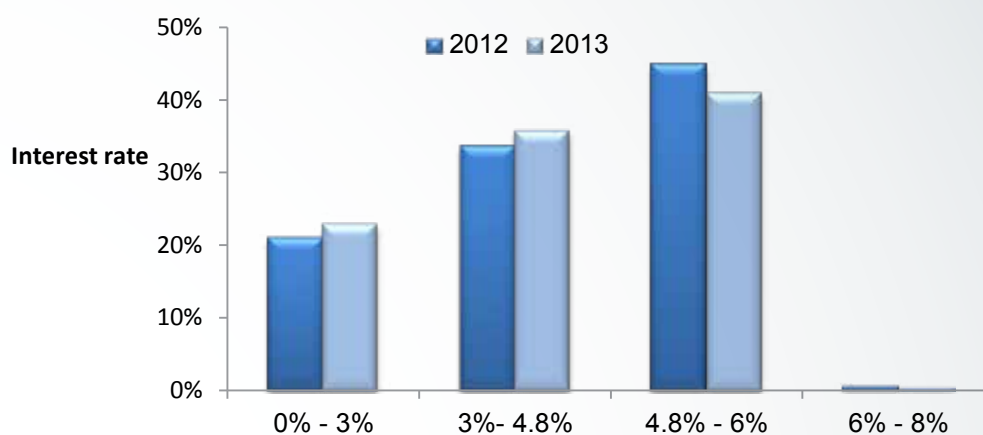
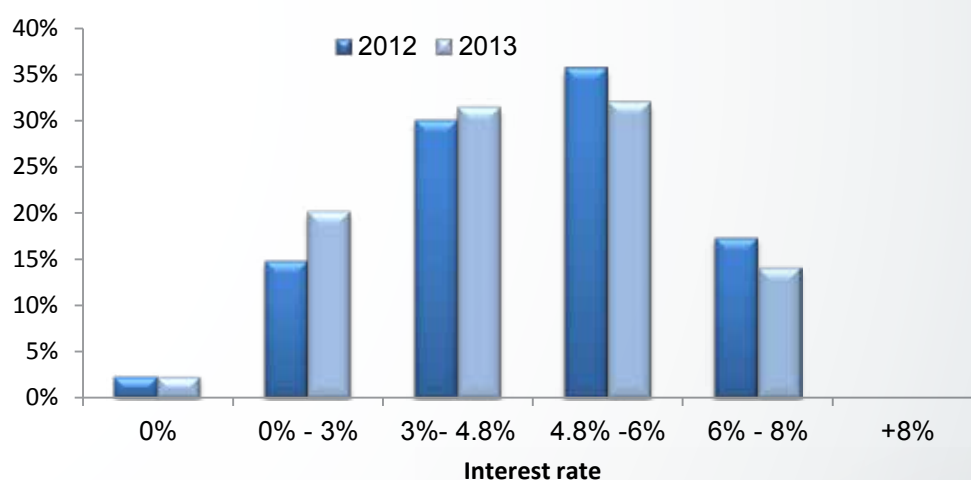


Diagram C-7:
Interest rates on the balance of nominal domestic debt



Diagrams C-8 and C-9 show the interest rate on the balance of foreign debt denominated in USD and euros. A comparison of 2013 to 2012 shows a decrease in the balance of USD-denominated foreign debt paying more than 4.8% interest, and an increase in the balance of debt paying interest at rates of 3%-4.8%. As to the euro-denominated foreign debt, there is a slight increase in the balance of debt paying high interest rates, which stand at 3%-4.8%, and a slight decrease in the balance of debt paying low interest rates, which stand at 0%-3%.

Diagram C-8:
Interest rates on the balance of USD-denominated foreign debt

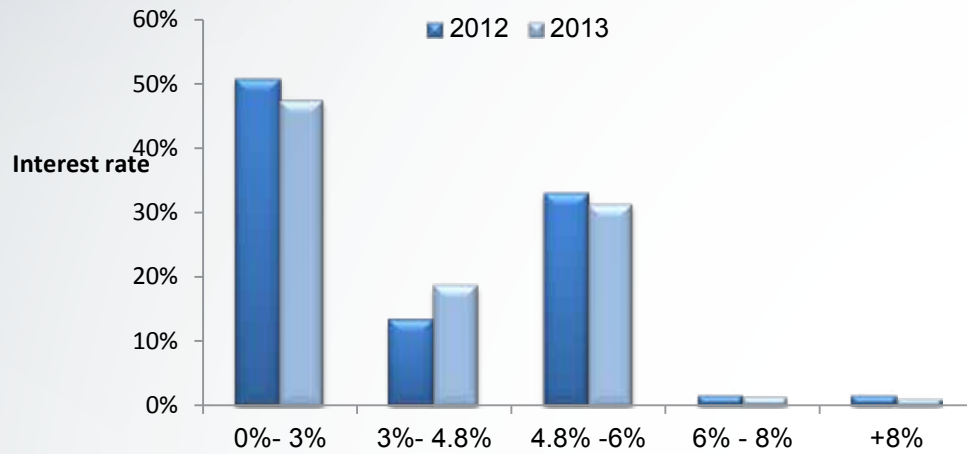
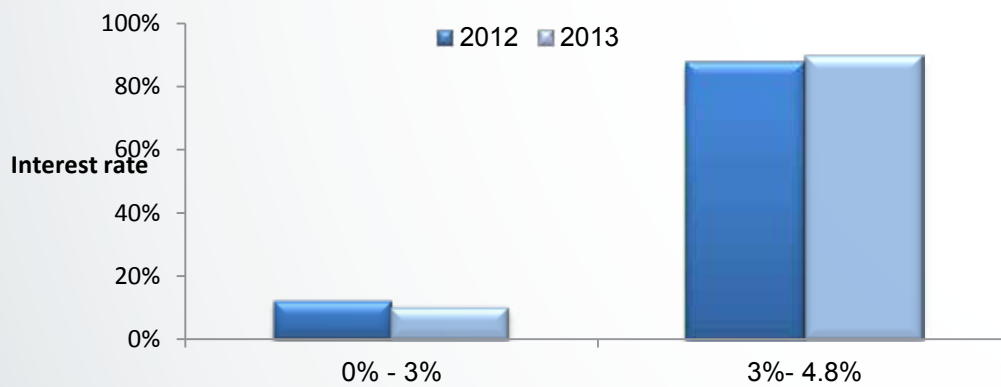


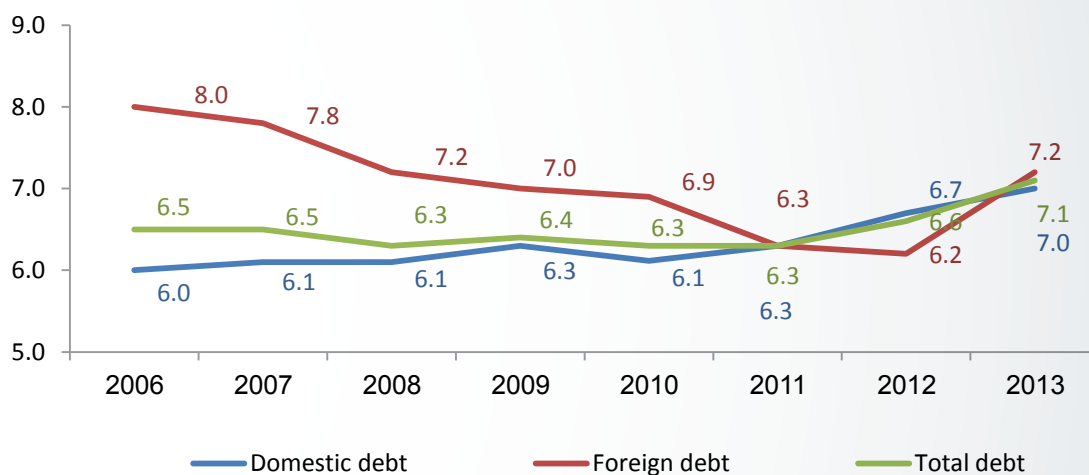
Diagram C-9:
Interest rates on the balance of euro-denominated foreign debt



Measures of the Length of Debt

Average time to maturity (ATM) is one of the main measures for determining the length of debt. The length of the debt has an effect on the cost of the debt and on the refinancing risk. The average term of the total government debt was 7.1 years at the end of 2013, compared to 6.6 the year before; an increase due to the Office's policy of lengthening the debt and reducing the refinancing risk. The low interest-rate environment supports the issuance of long-term debt and enables reducing the refinancing risk in accordance with this policy. Moreover, debt refinancing was carried out at significantly lower interest rates than in previous years, contributing to a reduction in future interest costs.

Diagram C-10:
Average term to maturity of government debt, 2006-2013 (in years)



Another measure for determining the effect of risk factors on the market value of the debt is the modified duration. The duration of bonds is calculated as the average of all payments during the life of the bond, weighted by the capitalized payment. As shown in Diagram C-11, there was also an increase in the overall duration of government debt to 5.5, following several years of stability.

Diagram C-11:
Modified duration of government debt, 2006-2013 (in years)

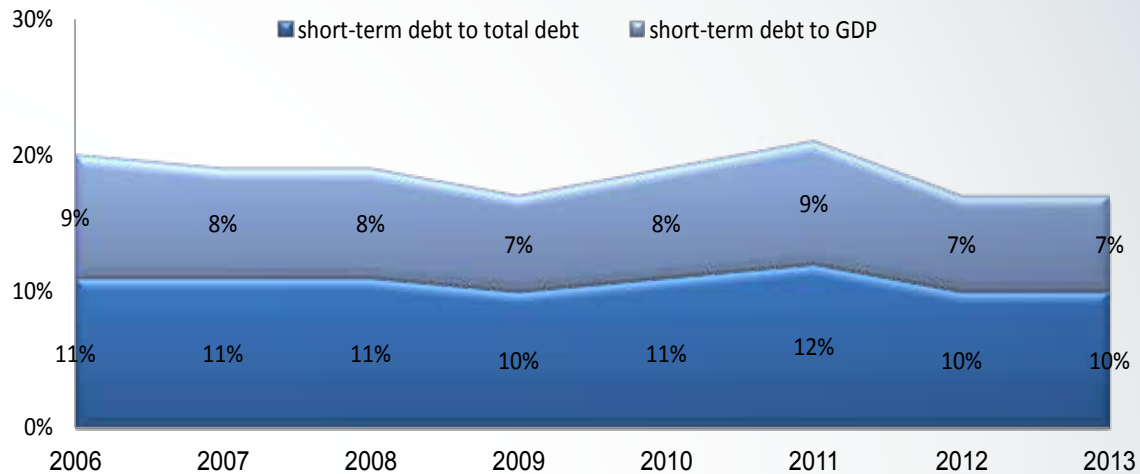


Additional measures for estimating the refinancing risk are:

1. The ratio of short-term debt (amount of principal redemptions expected in the coming year) to total debt (rollover ratio) – as shown in dark blue at diagram C-12.
2. The ratio of short-term debt to GDP – as shown in light blue at diagram C-12.

These measures, together with the ATM, provide a complete picture of the level of refinancing risk, with emphasis on the immediate term. As part of the risk management policy and with the aim of reducing the refinancing risk in 2013, the rollover ratio stood at a level of 10% and the ratio of the short-term debt to the GDP stood at a level of 7%.

Diagram C-12:
Ratio of short-term government debt to total debt and to GDP, 2006-2013
(percentage)

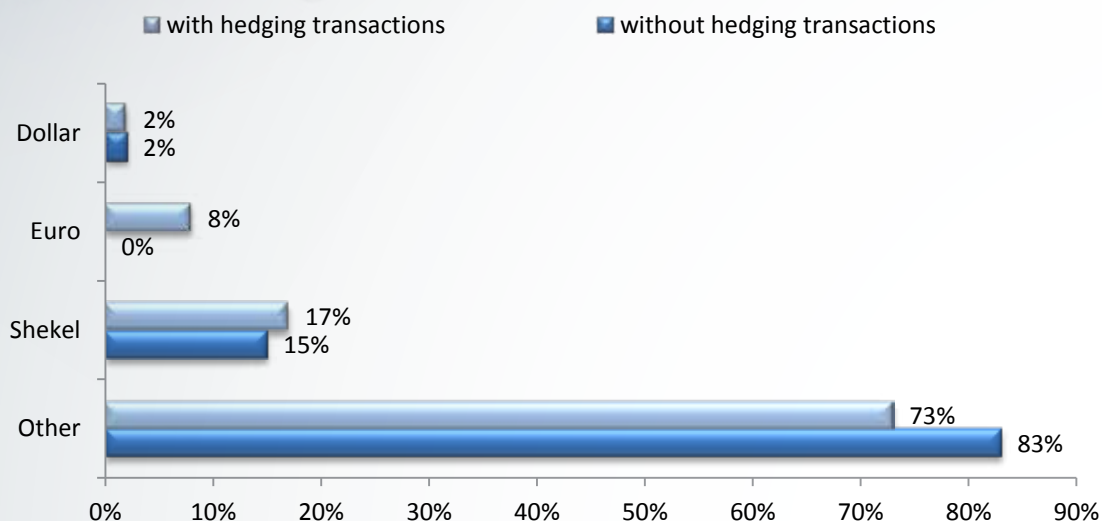


Hedging of Government Debt Risks

The composition of the government's current debt portfolio is characterized by a high proportion of foreign-currency obligations, which constitute 14% of the total government debt. In addition, the foreign-currency debt portfolio is characterized by over-dominance of dollar-denominated debt. As of the end of 2013, 83% of the foreign-currency debt was dollar-denominated, 15% was denominated in euros and the remainder was in other currencies. The Debt Management Unit executes hedging transactions, short-term dollar-shekel forward transactions and long-term swap transactions. Dollar-shekel swap transactions enable the reduction of exposure to foreign currency, and dollar-euro transactions enable diversification of that exposure.

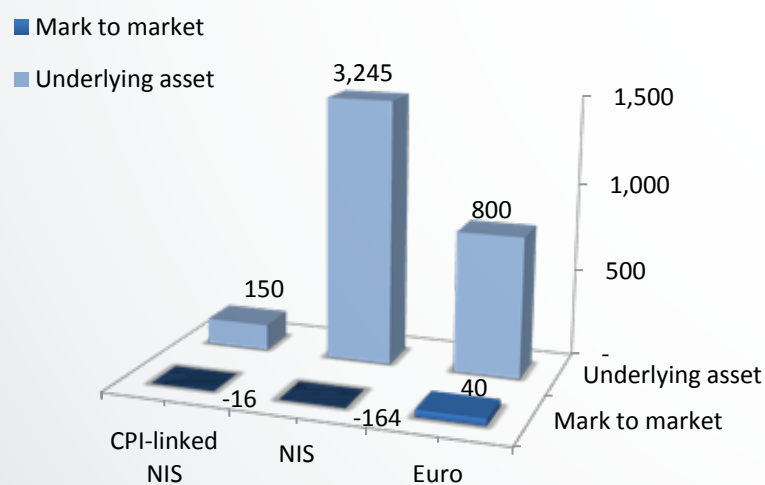
These hedging transactions enable the reduction of market risks (currency risk), but expose the Office to credit risks, particularly counterparty risk. Credit risks are managed within the framework of shelf agreements of the International Swap and Derivative Association (ISDA), which regulates the legal processes for the transfer of guarantees. In accordance with the Credit Support Annex (CSA), a margin call is carried out according to the fair value of the transaction (mark to market) and the threshold set forth in the agreement.

Diagram C-13:
Composition of foreign-currency debt by currency with and without hedging transactions
(percentage)



As of December 31, 2013, the government's stock of swap transactions totaled USD 4,195 million, of which dollar-euro transactions amounted to USD 800 million, dollar-shekel transactions amounted to USD 3,245 million, and dollar to CPI- linked shekel transactions amounted to USD 150 million. As of December 31, 2013, the mark-to-market value of all the positions stood at USD -140 million.

Diagram C-14:
Balance of hedging transactions as of December 31, 2013 (USD millions)

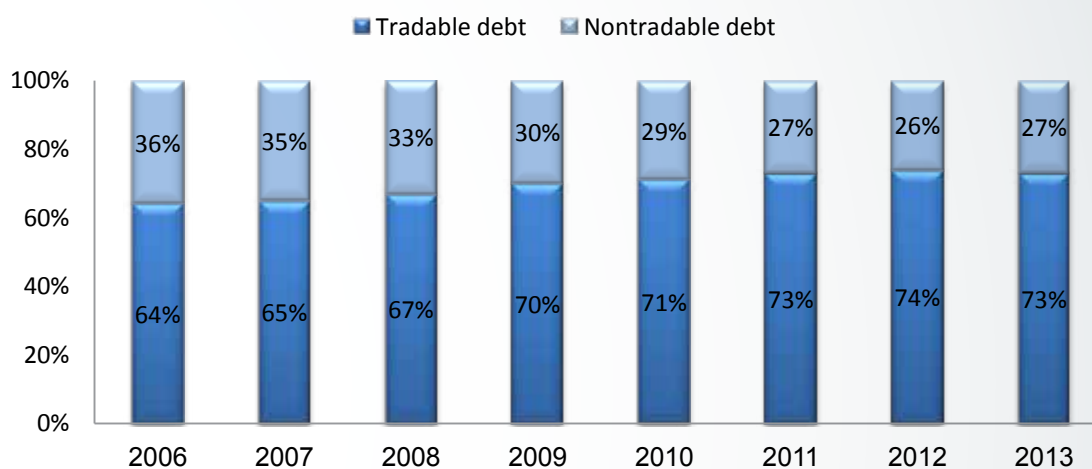


Domestic Debt

The balance of domestic debt (tradable and non-tradable) stood at NIS 596.4 billion at the end of 2013. Tradable debt grew by 5.2% to NIS 433.1 billion (compared to NIS 411.6 billion the year before), or 73% of total domestic debt. Non-tradable debt totaled NIS 163.3 billion, comprising 26% of total domestic debt.

Diagram C-15:

**Distribution of domestic debt by tradable domestic debt and non-tradable debt, 2006-2013
(percentage)**

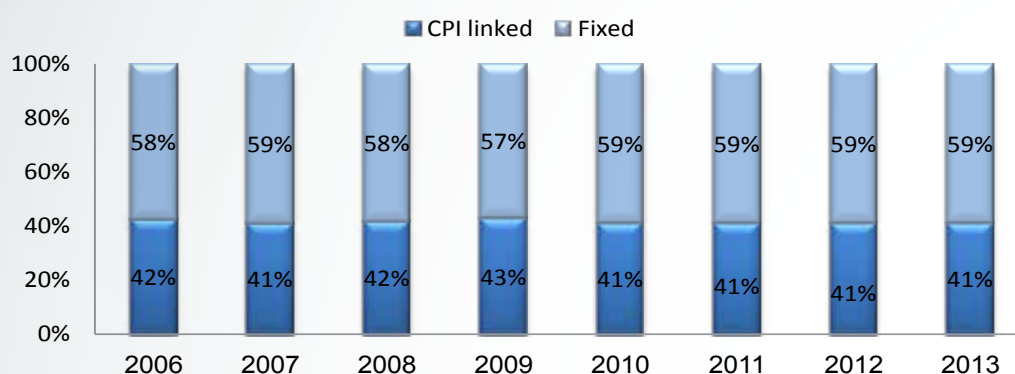


Tradable Domestic Debt

The distribution of tradable domestic debt between the nominal segment and the CPI-linked segment remained unchanged from 2012. The proportion of CPI-linked tradable domestic debt amounted to 41%, and that of nominal tradable domestic debt stood at 59%. As can be seen in the diagram below, in the last four years the distribution between the CPI-linked segment and the nominal segment has remained stable.

Diagram C-16:

Distribution of tradable debt by linkage type, 2006-2013 (percentage)



Distribution of Tradable Government Bond Holdings

The rate of holdings of pension funds in tradable government bonds in 2013 stood at 15.9% compared to 15.5% the year before, continuing the trend in recent years of an increase in the rate of pension fund holdings in tradable government bonds.

Provident funds and study funds are another segment exhibiting an increase in the rate of holdings in tradable bonds; the rate of their holdings standing in 2013 at 20.3% compared to 19.8% at the end of 2012.

The proportion of holdings of mutual funds in government bonds rose to 11.8% from a previous level of 9.6%. The proportion of holdings by foreign investors in government bonds dropped to 3.7%, compared to 5.6% and 6.6% the previous years.

Among the reasons for the relative increase in the last two years is the shift of foreign investors away from holding T-bills (Makam) issued by the Bank of Israel, in light of steps taken by the Ministry of Finance and the Bank of Israel, such as a change in the tax reform with respect to T-bills. Another reason is the possibility for a surplus yield on investments in government bonds, in light of continued growth in the gap between the shekel and dollar interest rates. Last year's decrease in foreign investor holdings could be explained by the decrease in the aforementioned gap.

The proportion of the public's holdings at the end of 2013 stood at 19.8% of the total stock of tradable government bonds, as opposed to 21.6% at the end of 2012. It is worth noting that this decrease is consistent with the decline that began in 2008 and stands in contrast to the uptrend prior to the outbreak of the latest financial crisis.

The proportion of the banks' holdings increased at the end of 2013 to 13.1% compared to 12.8% the year before.

The share of the Bank of Israel in holdings of tradable government bonds in 2013 stood at 3.1% compared to 3.7% the year before. This percentage stems from the program for the purchase of government bonds in the secondary market that the Bank of Israel put into operation in 2009. In accordance with the Bank of Israel's announcement, these bonds will be held until their redemption date.

Table C-2:
Distribution of holders of tradable government bonds, 2006-2013 (NIS billions, percentage)

Year	Total registered capital (NIS billions)	Public	Mutual funds	Provident funds and study funds	Pension funds	Banks	Insurance companies (1)	Foreign investors	Bank of Israel
2005	261.4	16.7	15.9	28	9.8	17	10.1	1.3	1.3
2006	265.1	19.5	12.4	24.1	10.6	17.8	9.7	4.7	1.2
2007	269.4	23.9	14.2	18.4	11	18.4	8.9	4.2	1.1
2008	312.9	28.0	11.5	20.5	12.8	14.6	10.2	1.6	0.8
2009	367.5	26.4	13.0	17.9	12.3	12.9	9.3	2.7	5.5
2010	388.7	24.0	13.2	18.8	13.3	12.8	9.7	3.1	5.1
2011	408.8	22.1	8.5	19.3	14.9	14.1	9.8	6.6	4.8
2012	459.5	21.6	9.6	19.8	15.5	12.9	11.2	5.6	3.7
2013	480.7	19.8	11.8	20.3	15.9	13.1	12.3	3.7	3.1

Source: Bank of Israel, 2013 estimates

(1) Includes holdings of life insurance and general insurance companies and nostro accounts.

Average Size of Series and Number of Series

The Accountant General Office's debt management policy is to reduce the number of government bond series in circulation while increasing their volume over time. This policy contributes to increasing the tradability and liquidity of the bonds, thus helping to lower funding costs. This policy continued in 2013, in which the average series size rose to NIS 13.2 billion. The increase in the average series size is mainly due to the continuing policy of large-scale issuances of benchmark series.

In 2013, the Debt Management Unit issued six new series on the tradable domestic market: three short-term government bonds, two CPI-linked government bonds (ILCPI 1016 maturing in 2016, ILCPI 923 maturing in 2023), and one FRN government bond (ILFRN 1121 maturing in 2021).

Seven bond series matured in 2013, and accordingly the stock of existing series has fallen to 32.

Diagram C-17:
Average series size, 1995-2013 (NIS billions)

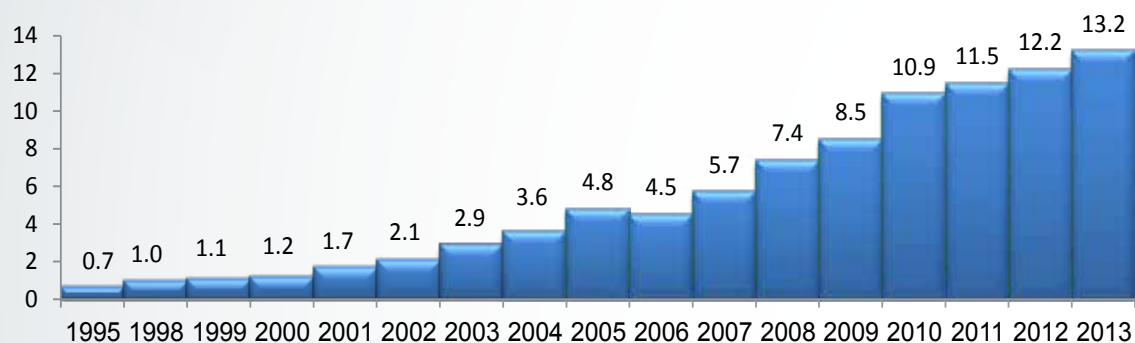
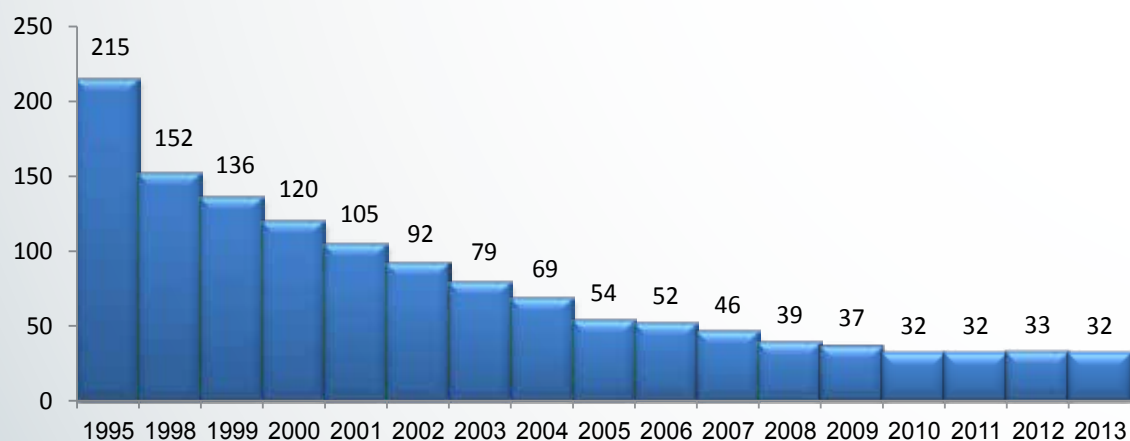


Diagram C-18:
Number of tradable series, 1995-2013



Non-Tradable Domestic Debt

The balance of non-tradable domestic debt increased to NIS 163.3 billion at the end of 2013. The stock of designated bonds issued to the pension funds ("Arad" and "Miron" bonds) increased, amounting to NIS 109.3 billion versus NIS 96.6 billion the year before. The stock of designated bonds held by insurance companies ("Chetz" bonds) grew by 7% in 2013 and amounted to NIS 45.8 billion. The emissions¹ managed by the Accountant General Office and the balance of compulsory loans managed by the Bank of Israel remained stable and totaled NIS 8.2 billion.

In the coming years, the stock of bonds is expected to grow due to the renewed entitlement of the old pension funds to designated bonds.

Table C-3:
Distribution of non-tradable debt by type, 2007-2013 (NIS billions)

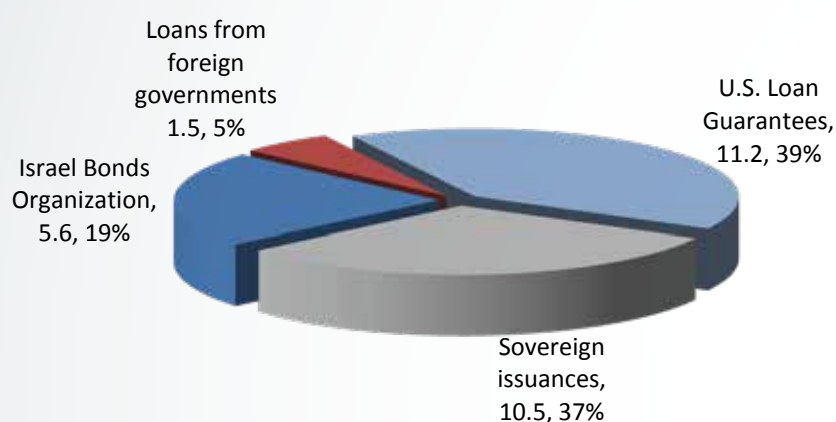
	2007	2008	2009	2010	2011	2012	2013
Total (NIS billions)	144	142	144	144	143.2	147.8	163.3
Pension (Arad & Miron)	102	99	99	97	94	96.6	109.3
Insurance (Chetz)	33	35	37	38.6	40.7	42.8	45.8
Miscellaneous ²¹	9	8	8	8.4	8.5	8.4	8.2

¹ Loans and deposits taken in the 1950s from various entities (banks, the Ports and Railways Authority, etc.).

Foreign-Currency Debt

At the end of 2013, the government's foreign-currency debt amounted to NIS 99.9 billion (approximately USD 29 billion), comprising roughly 14% of total government debt. Details of the distribution of the debt by sector are as follows:

Diagram C-19:
Composition of foreign-currency debt by debt source
(USD billions, percentage)



Issuances under the U.S. Loan Guarantee Program

As set forth in Section D, the Israeli government has not issued new bonds under the U.S. Loan Guarantee Program since 2004. To date, bonds totaling USD 4.1 billion have been issued. The balance of the second guarantee program has been extended to September 2015 (with an option for extension to September 2016) and stands at USD 3.8 billion. Bonds under the U.S. Loan Guarantee Program are issued at a relatively low interest rate, because they are assigned a high credit rating (Aaa/AA+/AAA) which is higher than the Israeli government's credit rating (A+/A/A1). At the end of 2013, these bonds comprised 39% of the total foreign-currency debt. Appendix B shows all the bonds issued under the second guarantee program in 2003 and 2004.

Sovereign Benchmark Issuances

Between 1995 and 2013, 15 sovereign issuances were carried out in the United States, Europe, Japan and the global markets. In 2013, a sovereign issuance was executed of two government USD bonds. The bonds were issued in two tranches: a 10.5 year bond amounting to USD 1 billion, with a yield of 3.213%, and a spread of 125 basis points (BP) over the US government 10 year bond and a 30 year bond amounting to an additional USD 1 billion, with a yield of 4.588% and a spread of 145 BP over the US Benchmark..

At the end of 2013, these bonds comprised roughly 37% of the total foreign-currency debt.

Issuances through the Israel Bonds Organization

The non-tradable component of the debt is mainly comprised of bonds issued over the years to individuals, companies and institutional entities through the Israel Bonds Organization (State of Israel Bonds). At the end of the year, these bonds comprised roughly 19% of the total foreign-currency debt.

Foreign Government and Other Loans

The remainder of non-tradable debt in foreign currency stems from bonds issued to foreign governments, international institutions, foreign banks and bilateral funds. The balance of the debt on these bonds totaled NIS 5.3 billion at the end of 2013, comprising 5% of the total foreign-currency debt.

Private Placements

The stock of private placements at the end of 2013 stood at NIS 1.3 billion. Currently, there are two existing placements, one in pounds sterling and another in U.S. dollars that was issued in 2012 in the amount of USD 200 million.

Section D – The Primary Market

Funding in the Tradable Domestic Market

In 2013, the market continued to exhibit strength; increases were recorded in all government bonds, with emphasis on the nominal curve. This provided support to government issuances in the domestic market, which enjoyed a total bid-to-cover ratio of 4.6 on the annual volume of funding.

The yield on the domestic 10 year bond stood at the beginning of the year at 3.84% and closed the year at 3.64%, compared to 1.55% of the parallel CPI benchmark.

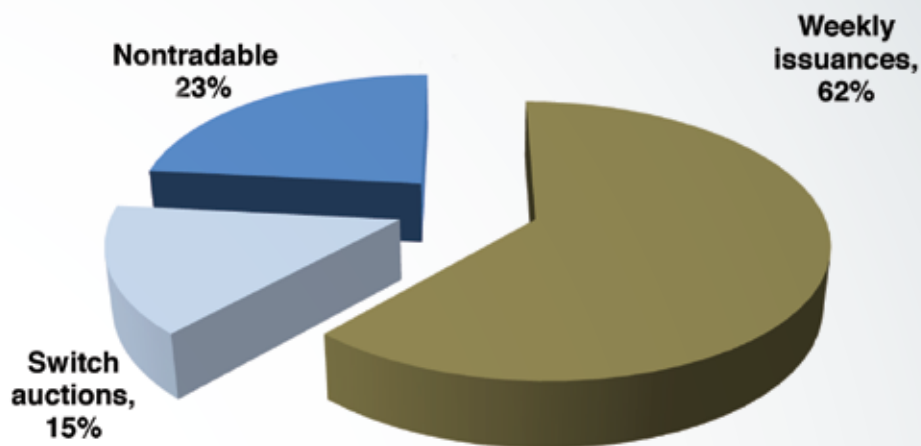
This year as well, the Debt Management Unit used all the financing tools available to it, enabling the smoothing of funding throughout the year.

The year 2013, like its predecessor, was a year of large funding volumes, with the bulk of funding performed in the tradable domestic market. Total funding in the domestic market in 2013 amounted to NIS 107 billion (2012 – NIS 113 billion), according to the following breakdown:

- Funding in weekly issuances, including Green Shoe allocations – NIS 66 billion
- Funding through switch auctions – NIS 16 billion.
- Non-tradable domestic funding – NIS 25 billion

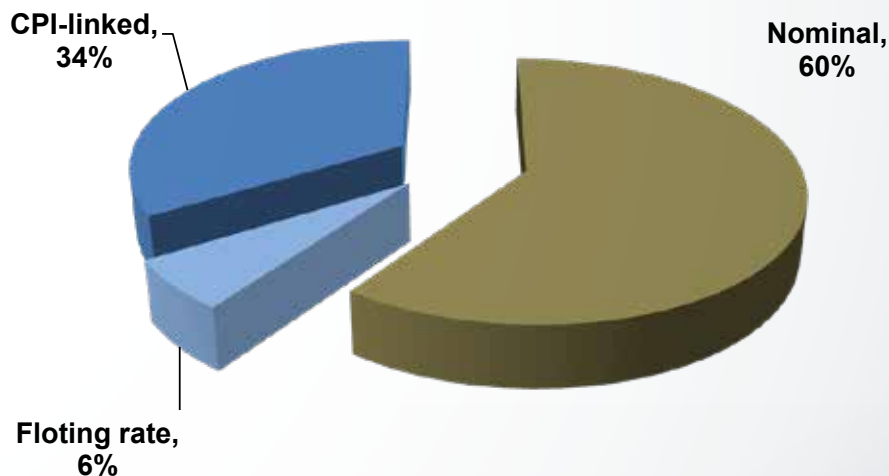
Total redemptions in the tradable domestic market in 2013 amounted to NIS 61 billion, consisting of NIS 34 billion redemptions through current redemptions, NIS 16 billion through switch auctions, and NIS 10.6 billion through buyback auctions. Net funding in the tradable domestic market totaled NIS 21 billion in 2013.

Diagram D-1:
Distribution of funding, 2013*



* The amount of funding includes issuances within the framework of Green Shoe allocations.

Diagram D-2:
Distribution of tradable funding in the domestic market by segment, 2013* (percentage)



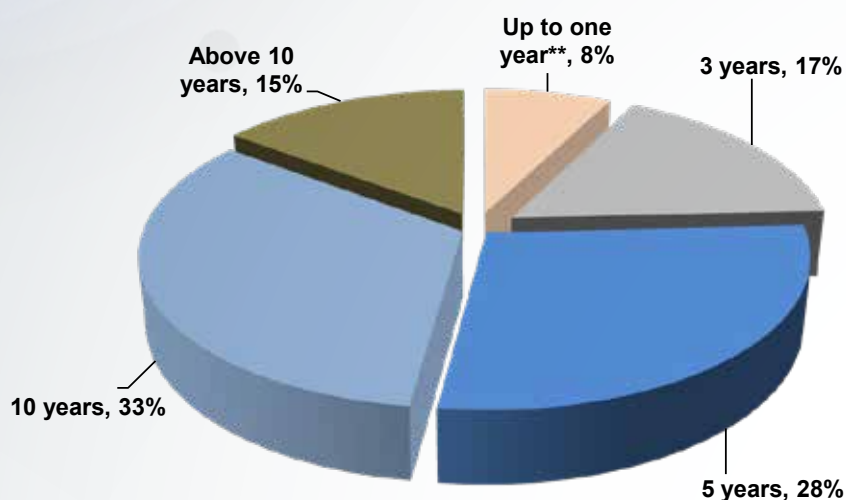
* Including Green Shoe allocations and switch auctions.

Funding by the Debt Management Unit focuses on benchmark bonds with terms to maturity of 3, 5, 10 and 30 years.

The Office carries out the funding through weekly auctions and switch auctions, with the issuances, apart from new bond issuances, in the form of expansions of existing series (tapping).

As described in Diagram D-2, the bulk of tradable domestic funding focuses on nominal fixed-coupon bonds,

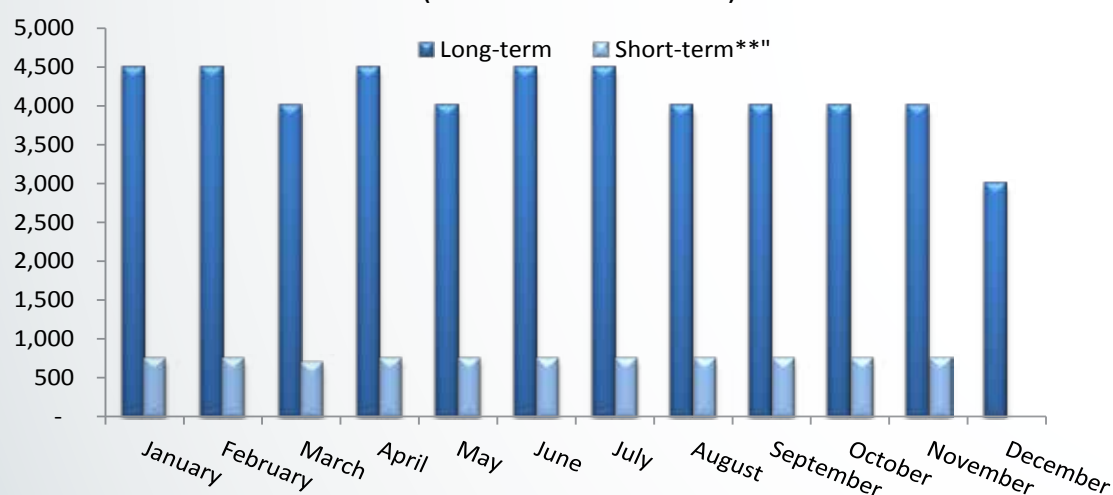
Diagram D-3:
Distribution of funding by term to maturity, 2013* (percentage)



* Including Green Shoe allocations and issuances within the framework of switch auctions.

** Not including T-bills raised and paid within the year.

Diagram D-4:
Distribution of funding of annual tradable domestic debt, 2013*
(face value in NIS Millions)

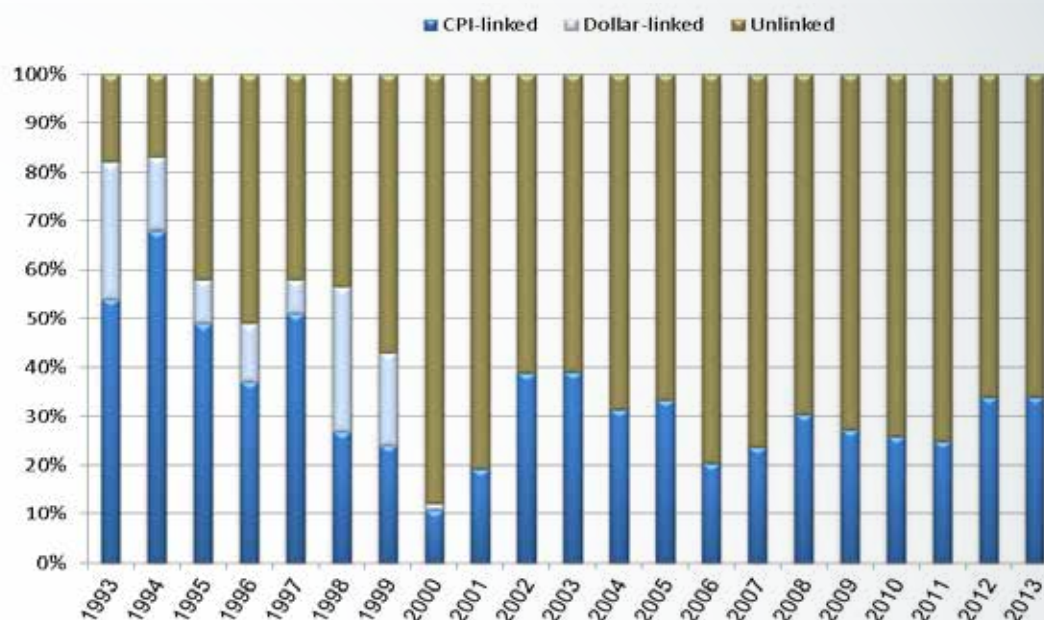


* Excluding Green Shoe allocations and switch auctions

** Less than a year

Total funding through weekly auctions in 2013 stood at NIS 60 billion. The funding volume and spread over the year conformed to the monthly deficit and to the balance at the Bank of Israel. In addition, the Debt Management Unit makes use of switch auctions that permit flexibility in the volume of funding over the year. In 2013 as well, the Office made use of T-bills, on a more limited scope than in 2012, as a tool assisting in liquidity management.

Diagram D-5:
Distribution of tradable domestic funding by segment, 1993-2013* (percentage)



* Including Green Shoe allocations

Summary of Data on Tradable Bonds Issued in 2013 and Selected Bonds

In this part we review the results of weekly issuances, with emphasis on the bid-to-cover ratio and general data, as well as an international comparison with large issuers.

One of the most important parameters in an issuance is the bid-to-cover ratio, which is calculated by dividing the quantity in demand by the quantity issued. The bid-to-cover ratio reflects the State's strength and ability to fund its weekly operations, and may even indicate various economic trends, such as flight to quality. Factors that affect the bid-to-cover ratio are:

1. Prices and conditions in the domestic markets.
2. Conditions in world markets.

The number of primary dealers involved in each issuance.

The offered amount.

The following graph describes the bid-to-cover ratio of all issuances in 2013 by issuance dates. The average bid-to-cover ratio of all the issuances in 2013 stood at 4.6, a high ratio by international standards, as shown in Diagram D-7.

Diagram D-6:
Bid-to-cover ratio in issuances in 2013 by issuance dates
(Trend line – moving average 4)

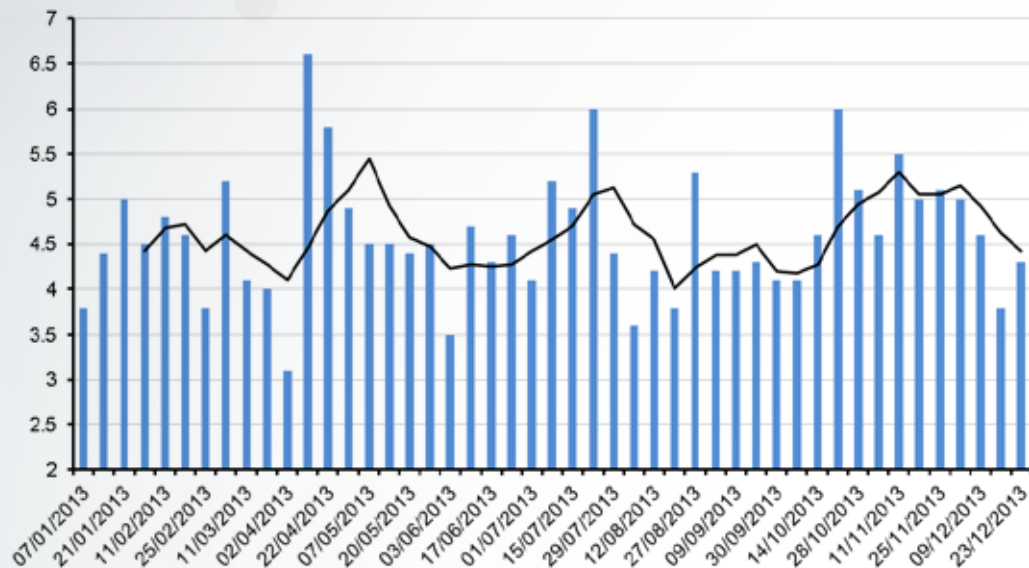
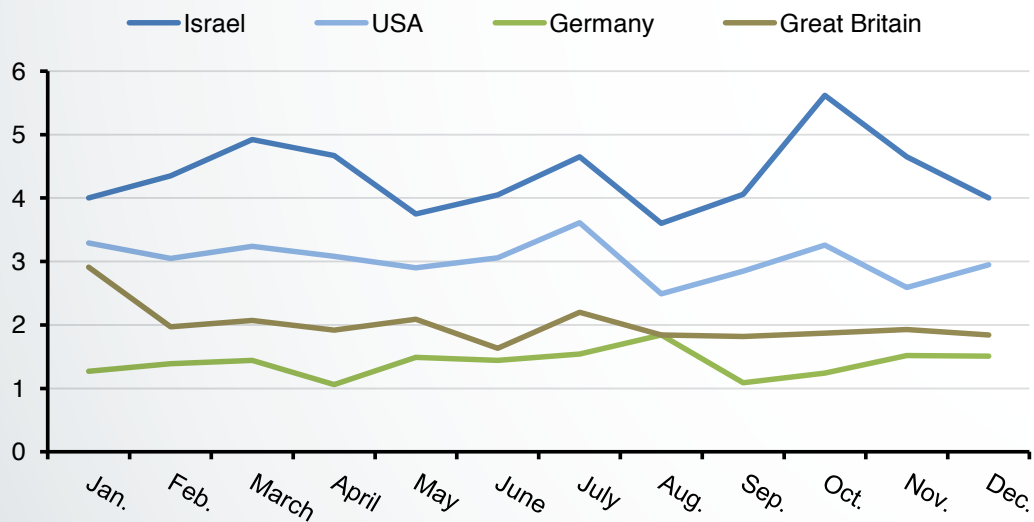


Diagram D-7:
International comparison of the bid-to-cover ratio of selected countries*



* The comparison was made for 10 year bonds.

The following graphs provide information on quantities issued and on the bid-to-cover ratios of benchmark bonds issued in each of the months of the year.

Diagram D-8

Issued quantities and bid-to-cover ratios in government bonds issued in 2013

3 year nominal government bond*

The total quantity of the 3 year nominal bond issued in 2013 (excluding switch auctions) stood at 9 billion face value.

▲ Monthly average bid-to-cover ratio ■ Quantity issued

3 year nominal government bond*

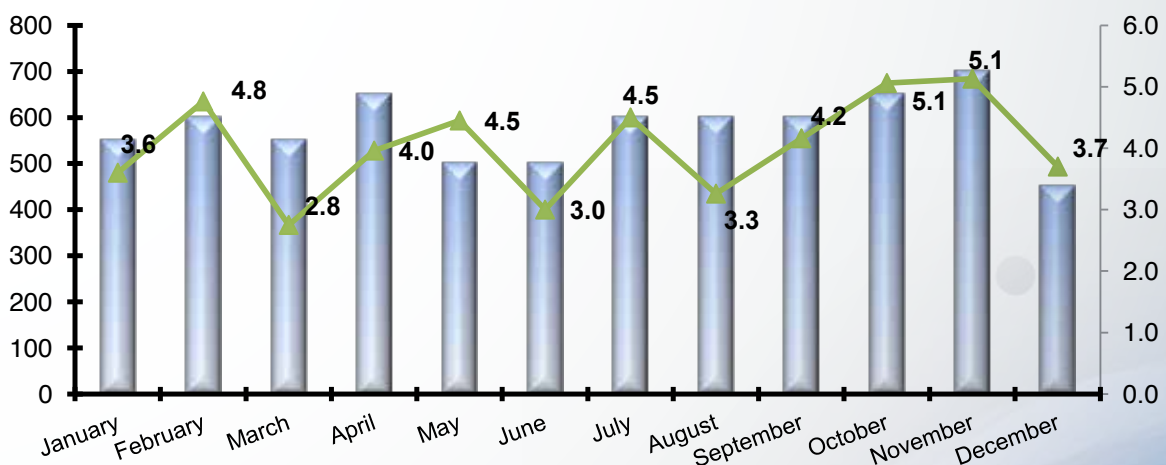
The total quantity of the 3 year nominal bond issued in 2013 (excluding switch auctions) stood at 9 billion face value.



* Throughout the year the issued bond is Nominal Government Bond 0516.

5 year nominal government bond*

The total quantity of the 5 year nominal bond issued in 2013 (excluding switch auctions) stood at 6.95 billion face value.



* Throughout the year the issued bond is Nominal Government Bond 0118.

10 year nominal government bond*

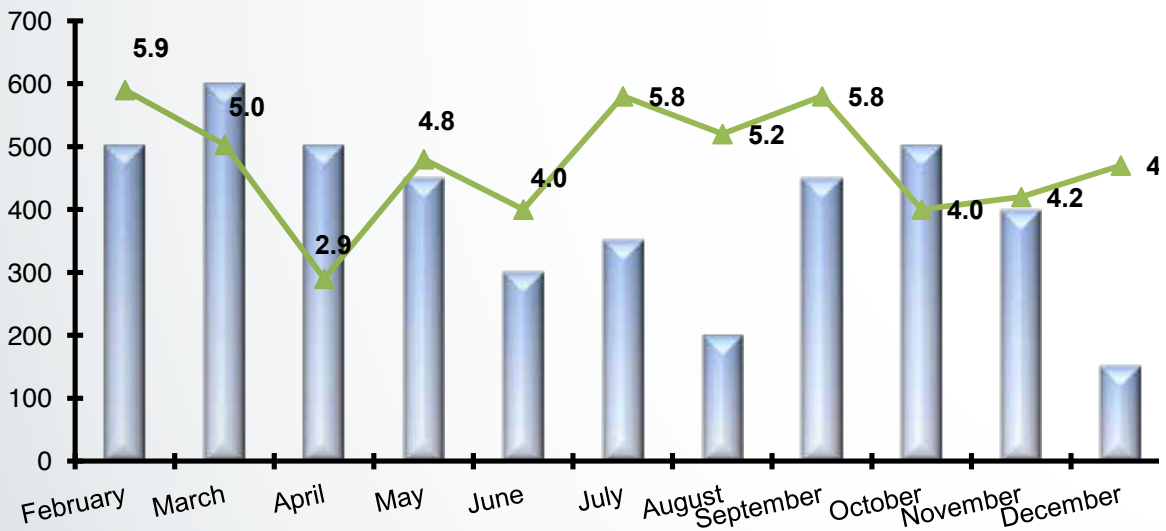
The total quantity of the 10 year nominal bond issued in 2013 (excluding switch auctions) stood at 10.05 billion face value.



* Throughout the year the issued bond is Nominal Government Bond 0323.

Floating-rate government bond*

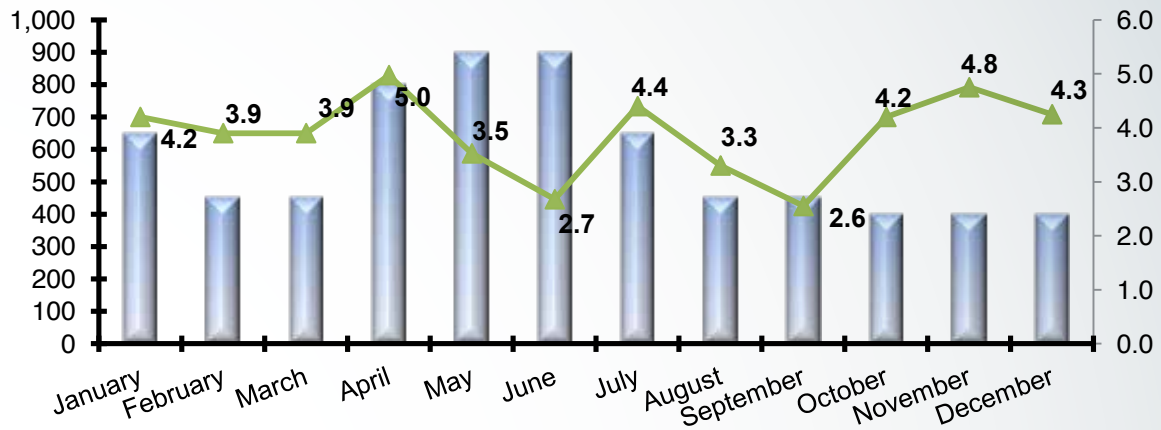
The total quantity of the floating-rate bond issued in 2013 (excluding switch auctions) stood at 4.4 billion face value.



* Throughout the year the issued bond is Floating-Rate Government Bond 1121.

10 year CPI-linked government bond*

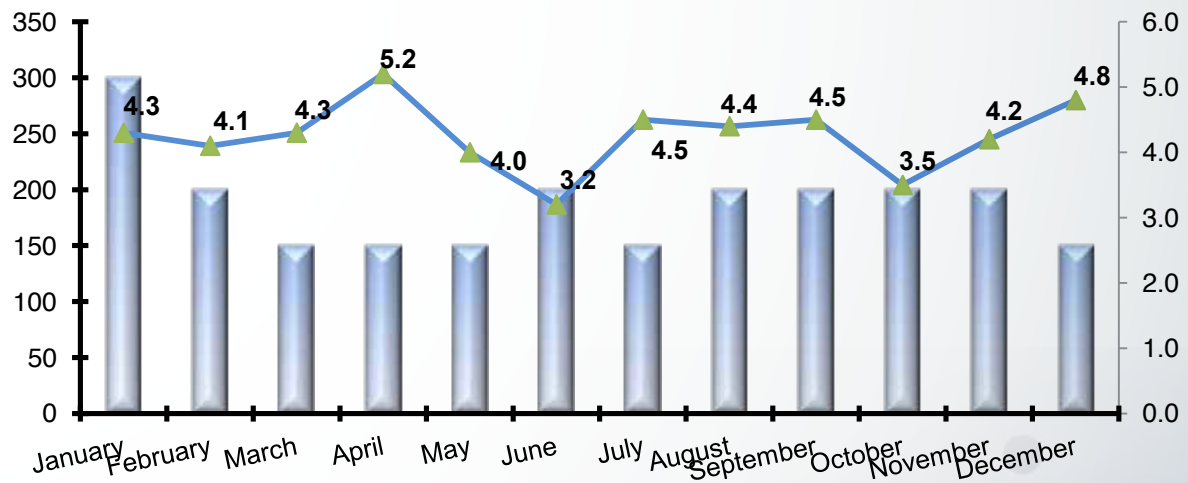
The total quantity of the 10 year CPI-linked bond issued in 2013 (excluding switch auctions) stood at 6.9 billion face value.



* Up to March the issued bond is ILCPI 0922 and from April ILCPI 0923

30 year CPI-linked government bond*

The total quantity of the 30 year CPI-linked bond issued in 2013 (excluding switch auctions) stood at 2.25 billion face value.



* Throughout the year the issued bond is ILCPI 0841.

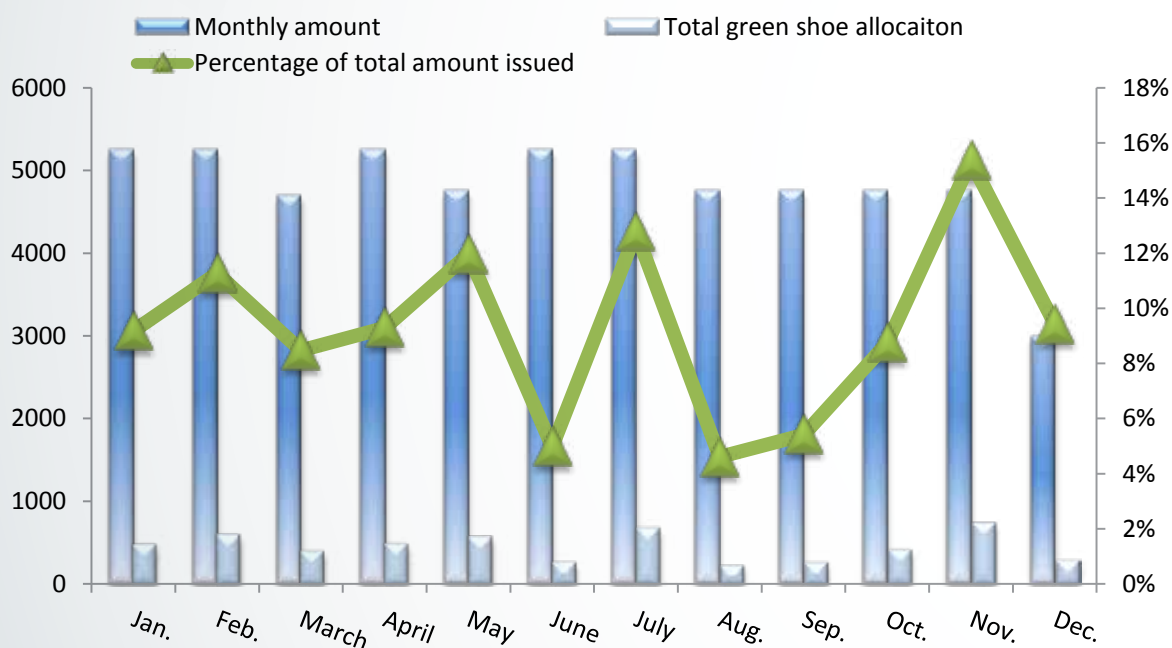
Green Shoe Allocations

Within the framework of Green Shoe allocations, the primary dealers who won the competitive auction may purchase, in the 24 hours after its closing, an amount in addition to the amount awarded to them, at the average auction price. With the aim of supporting the secondary market, it was decided to link the additional amount to which the primary dealers are entitled, to their performance in the secondary market, so that the primary dealers ranked in first place in the monthly ranking will receive a larger additional amount in the following manner: The six primary dealers ranked first are entitled to an additional amount of 20% of the Green Shoe allocation, and the remainder of the primary dealers will be entitled to an additional amount of 10% of the amount awarded to them.

In 2013, the total amount raised in this segment stood at NIS 5.3 billion face value, approximately 9% of the total amount issued through regular auctions (excluding switch auctions).

Diagram D-9:

Purchases in Green Shoe allocation auctions as a percentage of the monthly amount issued (NIS millions, percentage)



The most important factor for purchase/non-purchase in Green Shoe allocation auctions is the market price of the relevant bonds near the closing time of the Green Shoe allocation auction: If the market price is higher than the average price set at auction, it is likely that the primary dealers will purchase the additional amount in the framework of the Green Shoe allocation, and vice versa.

Switch Auctions

In 2013, the Debt Management Unit continued funding through switch auctions. Within the framework of these auctions, a total of NIS 16 billion was issued versus an amount of NIS 15 billion in 2012.

The main objectives of the switch auctions are:

1. More efficient management of government liquidity, particularly reducing the debt refinancing risk.
2. Management of the current debt portfolio in accordance with long-term policy.
3. Enhancing of tradability and liquidity.

Buyback Auctions

Starting in October 2008, the Debt Management Unit began making use of buyback auctions in order to perform early redemption of tradable government bonds. Within the framework of these auctions, the Office transfers a cash payment against the bonds being redeemed. This is different from the mechanism in switch auctions, wherein the bonds that are being redeemed are exchanged for other bonds.

The main objective of the buyback auctions is the more efficient management of government liquidity by means of:

1. Reducing the debt refinancing risk
2. Saving interest expenses

In 2013, total early purchases through buyback auctions amounted to NIS 10.6 billion, compared to NIS 2.4 billion in 2012.

Funding in the Non-Tradable Domestic Market

Non-tradable domestic funding totaled NIS 25 billion in 2013. This funding was carried out through the following instruments: designated bonds for pension funds ("Arad"), designated bonds for insurance companies ("Chetz"), and various emissions and deposits managed by the Ministry of Finance.

This year, designated Arad bonds in the amount of NIS 20.7 billion were issued for pension funds – an increase of 79% over 2012. Due to the continuing implementation of the reform in pension funds, no designated Miron bonds were issued at all in 2013.

Total net funding in 2013 in designated bonds for pension funds amounted to NIS 10.6 billion.

The amount of issuances of Chetz designated bonds for insurance companies remained almost unchanged from the previous year, standing at NIS 3.9 billion. Total net funding in 2013 in designated bonds for insurance companies stood at NIS 2.2 billion.

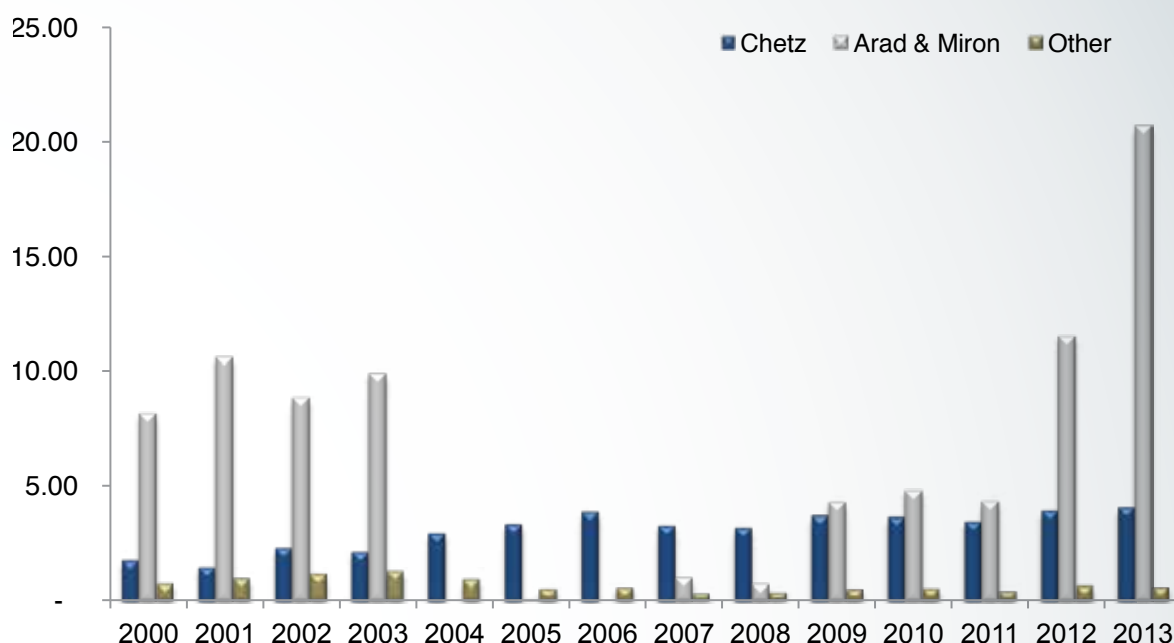
Funding through emissions amounted to NIS 579 million. Total net funding in this segment was negative in the amount of NIS 247 million.

Diagram D-10:

Funding and redemptions in non-tradable debt, 2013

Funding segment	Principal funding		Principal redemptions		Net funding
	NIS millions	% of total	NIS millions	% of total	NIS millions
Arad & Miron	20,653	82	10,048	79	10,605
Chetz	3,989	16	1,818	14	2,171
Others	579	2	826	7	-247
Total	25,221	100	12,692	100	12,529

Diagram D-11:
Composition of non-tradable funding, 2001-2013 (NIS billions)



Funding in Foreign Currency

Tradable Sovereign Benchmark Issuances

The policy of the Government Debt Management Unit provides for the implementation of a sovereign public issuance once per year; one year in the global market (U.S.) and the following year in the euro market (Europe), subject to market conditions.

- The issuance of debt in foreign currency in international markets serves several strategic goals:
- The creation of a benchmark for funding in the international market by the business sector
- Expansion of Israel's investor base
- The establishment of an additional funding source to finance the government deficit

In January 2013, the government of Israel completed the issuance of Israel government USD bonds. The bonds were issued in two tranches: a 10.5 year bond amounting to USD 1 billion, with a yield of 3.213%, and a spread of 125 BP (basis points) over the US government 10 year bond and a 30 year bond amounting to an additional USD 1 billion, with a yield of 4.588% and a spread of 145 BP over the US Benchmark. This was the first dual tranche issuance in the global market for the State of Israel. The issue was characterized by the lowest funding cost ever paid by the State of Israel in a USD issue and by historically low spreads.

In January 2014, the government of Israel completed the issuance of Israel government EUR bonds. The bonds were issued for 10 years, amounting to EUR 1.5 billion, with a yield of 2.932%. The issue took place after the Government Debt Management Unit conducted a series of meetings with investors in Europe. The high demand for the issue, which amounted to over EUR 5.7 billion, came from approximately 300 investors in 30 countries, including: the UK, Germany, France, Switzerland, Hong Kong and others. This is the State of Israel's fifth EUR issue, in accordance with the long term work plan of the Debt Management Unit, and

was characterized by historically low spreads, as well as the lowest funding cost ever paid by the State of Israel in a EUR issue.

The stock of sovereign bonds in foreign currency stands, as of December 2013, at NIS 36.

Public Issuances under the U.S. Loan Guarantee Program

In April 2003, the U.S. Congress approved a program for the grant of guarantees to the Israeli government for the purpose of funding abroad, which stood at USD 9 billion face value for three years. Bonds issued by the Israeli government under the loan guarantee program have a credit rating similar to that of the U.S. Government. In fact, the bonds are sold at a yield only slightly higher than that of the U.S. Treasury bonds.

In 2005, the program was extended through 2008, and in 2006 it was extended through 2011, with a carryover option for 2012. In 2012, the program was extended again, until 2015, with a carryover option for 2016. Under the program, the U.S. government provides a full guarantee for principal and interest payments of bonds issued by Israel through the program.

Under the Loan Guarantee Program, the Israeli government issued in 2003-2004 (years of substantial deficits in the State budget) bonds with a face value of USD 4.1 billion. The Israeli government has not used the guarantee program since November 2004. At the end of 2011, the unutilized balance under the program amounted to USD 3.8 billion.

The U.S. Loan Guarantee Program provides the Israeli government with a financing “safety cushion,” and there is no intention to use it other than in case of real financing need. Preserving the guarantees rather than using them is a strategic debt management goal, since this has a positive effect on the State of Israel’s access to international markets.

The stock of bonds under the U.S. Loan Guarantee Program was NIS 38.8 as of December 31, 2013.

Private Placements

No private placements were issued in 2013. The most recent private placement was issued in June 2012, and was a two year private placement made to an Asian institutional investor for a total of USD 200 million at a LIBOR-based floating rate. In addition to the bond itself, the issuance included a swap transaction through which the government converted the liability from foreign currency into shekels at a fixed nominal rate. The issuance was performed under the Israeli government’s EMTN shelf program.

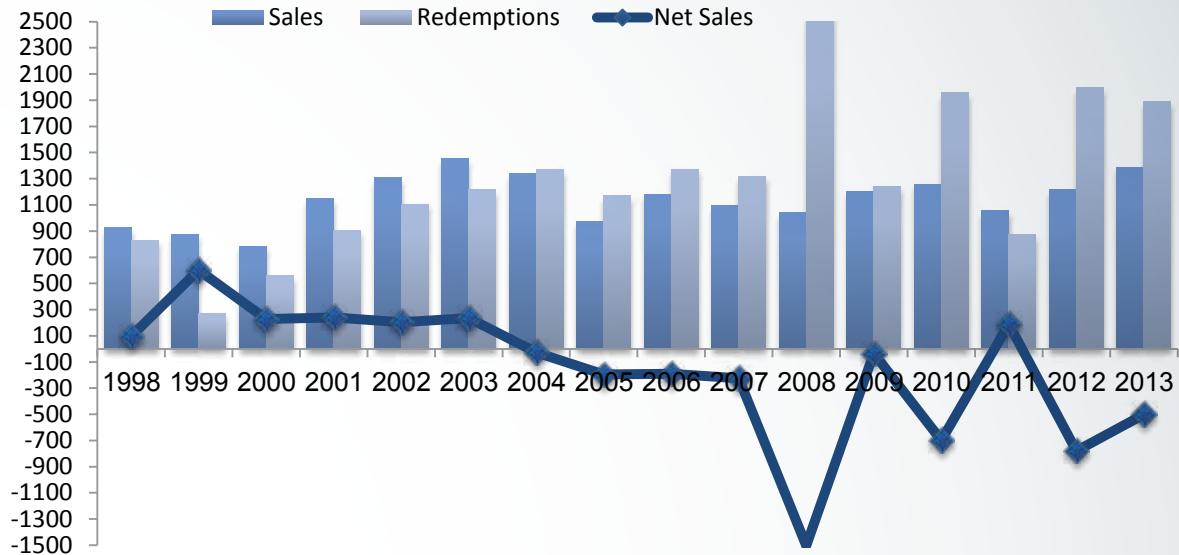
The Israel Bonds Organization

The Israel Bonds Organization is one of the State’s channels of communication with Jews in the diaspora. Over the years, the Israel Bonds Organization has demonstrated an anti-cyclical nature, meaning that in difficult times, such as times of recession or geopolitical tension, the volume of funding through the Israel Bonds Organization has increased.

In 2013 the Israel Bonds Organization raised USD 1.39 billion. This amount is 7% higher than the annual funding goal of USD 1.3 billion and represents an increase of 14% in the Organization’s sales volume relative to 2012, in which the volume of funding stood at USD 1.21 billion. Total net funding through the Israel Bonds Organization in 2013 was negative in the amount of USD 500 million.

The stock of bonds issued through the Israel Bonds Organization stood at NIS 19.3 billion as of December 2013.

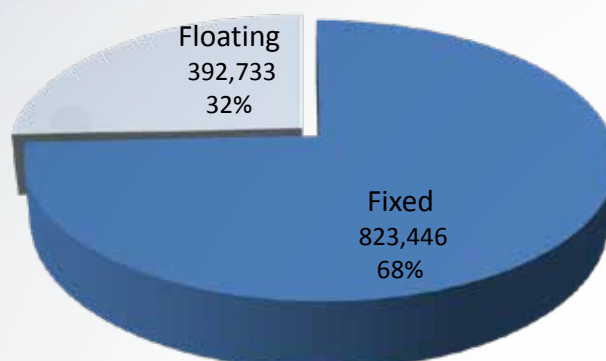
Diagram D-12:
Issuance and redemption volumes of the Israel Bonds Organization, 1998-2013 (USD millions)



In 2013, 74% of the IBO's funding was raised using fixed-coupon instruments, while the remainder was issued at floating rates. The fixed-coupon component increased in 2013 compared to 2012, in which fixed-coupon instruments accounted for only 68% of the Organization's funding, while the remainder were floating-rate instruments.

Diagram D-13:

Distribution of Israel Bonds Organization funding by interest type, 2013 (USD thousands, percentage)



Determination of Spreads for Bonds of the Israel Bonds Organization

The Debt Management Unit determines the spreads on a regular basis, while continuously tracking, monitoring and analyzing developments in the global markets.

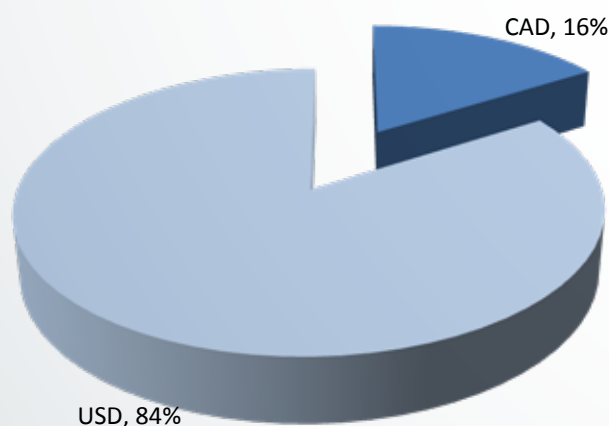
At the end of 2012, spreads for 2 and 3 year instruments were substantially reduced in order to meet the goals for 2012. As a result, in the beginning of 2013, graduated steps were taken to increase these spreads. Contrarily, spreads for 5 and 10 year instruments were raised in 2012 to relatively high levels in order to meet the goals for 2012. As a result, in the beginning of 2013, these spreads were reduced. In the last quarter of 2013 the trend of reducing the spreads to all tenors was continued due to the high sales pace of the IBO, and the need to limit these sales in order to meet the annual goals. As for the Canadian organization, in the last quarter of 2013 there was also a continued trend of reducing the spreads to all tenors in order to limit its sales.

Currency Distribution

In 2013 the Government of Israel issued instruments in USD, Canadian dollar, Euro and GBP. As of the end of 2013, approximately 84% of sales were in USD, and 16% were in other currencies. In order to increase sales in non-USD currencies, spreads of Canadian, Euro and GBP bonds are routinely examined and compared in order to maintain the attractiveness of these instruments.

Diagram D-15:

Currency Distribution of Sales for 2013 (percentage)



The State of Israel's Credit Rating

Significant changes have taken place in the credit rating of sovereigns since the collapse of the Lehman Brothers investment bank in September 2008, when accusatory fingers were pointed at the rating agencies for “overrating” many of the toxic assets, thus significantly contributing to the outbreak of the crisis. The response of the rating agencies was not long in coming, and they embarked on an extensive round of rating downgrades, lowering the rating of many countries such as Iceland, Ireland, Japan, Portugal, Greece and others, most of which had in common a financing system that was severely hit in the credit crisis, and increasing government deficits and debts. Most downgrades took place in 2011, with some taking place in 2012, as the European debt crisis worsened up to an almost total loss of market faith in the eurozone governments. This loss of faith, reflected among other things in the replacement of all the heads of government in the PIIGS countries and in concern over the fate of the monetary union, was also apparent in the credit rating arena, with the downgrading of almost all the zone's countries, including France, Italy, Spain, Austria and Belgium, while many other countries were put on a negative credit watch. In the United States, Standard & Poor's for the first time in history cut the country's perfect credit rating to AA+ in August 2011.

2013 was a year of stabilization in the credit ratings. 2013 saw no downgrades of significant consequence, and even experienced several upgrades amongst EM Eastern European countries such as Estonia, Latvia, Lithuania and the Czech Republic, as well as Brazil, Panama, Uruguay and Peru experiencing upgrades among Latin American countries.

Two notable rating downgrades in 2013 were the UK and France. The UK saw their ratings drop from Aaa/AAA/AAA (Moody's, S&P, Fitch, respectively), to Aa1/AAA/AA+. France was downgraded from Aa1/AA+/AAA to Aa1/AA/AA+.

At the end of 2013, it can be said that Israel is in better condition compared to Western European countries such as Italy, Spain and Portugal.

In the past, governments' credit ratings also served as a “ceiling” for the credit rating of domestic corporations; in other words, domestic entities in a particular country could not obtain a higher credit rating than their government. In recent years, some rating agencies have started to separately rate the “country ceiling,” which denotes the highest potential credit rating attainable by domestic entities within the country. In many cases, particularly against the background of globalization processes, the country ceiling is higher than the government's credit rating, so that the government's rating is not an effective barrier to domestic entities. Nonetheless, the government's credit rating clearly has an influence on, and is highly correlated with, domestic credit ratings, and is of great importance for the economy as a whole.

The State of Israel's Credit Rating in 2013

In 2013 there was no change in the credit rating of the government of Israel, however in November 2013, Fitch revised Israel's outlook from Stable to Positive. The three rating agencies visited Israel during 2013 and published a rating report shortly after their visit. The three reports published by the agencies on the Israeli economy noted the strong points of the Israeli economy, including the economic policy, the strength and diversity of the economy supported by strong institutions, the low deficit as percent of GDP in 2013 and the continued decline in the public debt-to-GDP ratio. Additionally, the rating agencies positively noted the relative stabilization of geopolitical threats and the introduction of natural gas production as a source of future growth and government revenues. The agencies also noted the weak points of the Israeli economy, including the fact that despite the decrease in the debt-to-GDP ratio over the last few years, the volume of the debt remains a weak point, as it is still high compared to other countries in the peer group. The rating agencies also acknowledged the fact that geopolitical risks still represent a constraint on Israel's credit rating.

Highlights of the three agencies' announcements in 2013

Standard & Poor's

On September 27, 2013, Standard & Poor's ("S&P") Ratings Services affirmed its credit rating of A+, along with a stable outlook. S&P cites a prosperous and diverse economy, considerable monetary flexibility and a positive medium-term impact of natural gas production on the external accounts among the reasons for Israel's strong rating. Other strengths highlighted by S&P include:

- Strong external fundamentals, including a current account surplus in 2013 that continues to rise
- Flexible monetary policy
- Generally effective Israeli institutions
- Fiscal consolidation, including a modest decline in the general government debt burden

S&P considers geopolitical risks and relatively weak government finances to be the major rating constraints. Other constraints S&P points to include:

- A pressured shekel, complicating the Bank of Israel's task of containing inflation and tempering credit flows to the housing market
- A political system prone to instability and lacking in policy predictability
- External security threats and geopolitical risks

S&P states, regarding relations with Palestinians, the war in Syria, and the instability in Sinai, that such tensions signal possibilities for deterioration in the medium term, and should any significant armed conflict with Israel commence, such a conflict could have a negative ratings impact.

That said, should Israel make material progress in defusing external risk, S&P would consider raising the rating, as S&P believes progress would have positive repercussions for domestic stability, economic growth, and investor confidence.

Conversely, S&P believes that a significant setback in reducing the government's high debt burden, a significant decline in growth prospects or a substantial deterioration of the security situation in Israel could put downward pressure on the rating.

Regarding S&P's stable outlook rating, S&P cites the government's commitment to fiscal consolidation and the reduction of government debt. S&P projects real GDP per capita growth of 1.2% for 2013, which

is similar to 2012, but due to the contribution of natural gas, this suggests overall economic activity is weakening. For 2014-2016, S&P forecasts per capita growth to again gradually increase. S&P also expects the impact of security risks on the Israeli economy to remain contained.

Moody's

On August 28, 2013, Moody's published its annual report on the Israeli economy. The report noted that the State of Israel's A1 rating with a stable outlook reflects a high level of economic resiliency and competitiveness, flexibility, effective governance and ample funding. Other strengths cited by Moody's:

- High income country with a dynamic growth model
- An increasingly market-oriented economy
- Low external debt and a net creditor position vis-à-vis the rest of the world
- Loyal and deep global and domestic investor base
- A dynamic and vibrant high-tech sector as well as an entrepreneurial culture that makes the country an attractive target for foreign capital investments

Another key driver affirming Israel's rating is the continued reduction in the government's debt-to-GDP ratio, which contrasts sharply against trends in many other advanced country peers. Moreover, debt metrics have improved substantially over the past decade and Israel is one of only a handful of advanced countries that has a lower debt-to-GDP ratio now than before the crisis.

Moody's cites several factors as inhibiting Israel's credit rating, most notably the extensive geopolitical challenges, including territorial disputes with Palestinians, intensive civil strife in Egypt and Syria, and the stand-off with Iran over its nuclear capabilities, all of which represent a perpetual constraint on the government's ratings. Other challenges include:

- A large, but shrinking government debt burden (as referenced above)
- Fragmented and fractious political system
- Moderation in growth since the second half of 2011, due to weakened global economic conditions weighing heavily on Israeli export demand
- Low education and earning levels amongst the fastest growing population sectors – Arabs and Jewish ultra-orthodox

That said, positive trends related to the challenges are forecasted by Moody's. Moody's predicts real GDP to expand this year with the production from the Tamar natural gas field, and the recovery in global demand in the coming year. Regarding underrepresentation amongst Arabs and ultra-orthodox Jews, public policy strategy aimed at raising the participation rate has registered success, and is expected to make further progress as military exemptions and social welfare grants are scaled back under the new government that took office in March 2013. As for the geopolitical challenges facing Israel, Moody's believes that even incremental progress on the renewed peace negotiations with Palestinians could have some positive ramifications by helping to reduce Israel's international isolation.

Several factors are indicated by the report as having an influence on whether Israel's rating is raised or lowered. A significant diminution of risks coming from the geopolitical environment and/or substantial further reduction in the government's debt levels would be credit positive, as well as increased competition deriving from a reduction in the concentration of ownership of the economy. On the flip side, a waning commitment to fiscal discipline, or any geopolitical events that are seen as posing heightened challenges to Israel's economic stability could render a lowered ratings outlook.

Fitch

In November 2013, Fitch Ratings affirmed Israel's A rating and revised the Outlook on Israel's Long-Term Foreign-Currency IDR to Positive from Stable, reflecting the turnaround in the fiscal position and commitment to a credible medium-term path for further deficit reduction, combined with economic benefits that will follow the smooth start to gas production.

Fitch also points to measures aimed at encouraging greater labor force participation from ultra-orthodox men and Arab women, and reducing concentration in the private sector as other areas of improvement. Other strengths cited by Fitch include:

- Strong and well-developed institutions and education systems, leading to a diverse and advanced economy
- GDP per capita, human development and governance indicators all above the peer median
- Highly flexible domestic and external financing, with a deep and liquid debt market
- The birth of gas production that reduces imports and solidifies the current account surplus
- An external balance sheet much stronger than those of its peers

The report indicates that there are several factors limiting Israel's rating, including high debt-to-GDP ratios and general government deficit-to-GDP indicators, as high debt interest payments and defense spending limits fiscal flexibility. Fitch does note that both debt-to-GDP and general government deficit-to-GDP are falling. Other factors inhibiting growth include:

- Political risks, both external and domestic
- Private sector activity concentrated in a small number of conglomerates that often have cross-holdings in financial institutions
- Shekel appreciation, challenging Israeli export competitiveness

Regarding these inhibiting factors, Fitch states that continued progress in reducing the debt-to-GDP ratio towards the peer median, accompanied by sustainable reduction of the fiscal deficit would be positive for the ratings. Conversely, a deterioration of the debt ratio would have a negative impact on the ratings. Additionally, the report states that a significant easing of geopolitical risk would be ratings positive, while a serious encroachment of the Syrian conflict or renewed intensification of hostilities with Iran would put downward pressure on the rating.

Overall, Fitch affirms Israel's A rating, pointing to an economy benefitting from gas production that lifted GDP in 2013, but also saw sluggish non-gas growth in 2013, though non-gas growth is expected to pick up in 2014. In addition, Fitch cites consolidation measures and one-off factors for Israel's improved fiscal position in 2013. While Israel is hindered by a volatile region with substantial geopolitical challenges, Fitch acknowledges an evolving regional political climate, including the recent deal between the P5+1 and Iran that has diminished the prospect of renewed engaged hostilities between Israel and Iran at the present time. Fitch also cites stable domestic politics as a factor in its affirmation of Israel's rating.

Table D-1:
Israel's credit rating by the three rating agencies

Rating Agency	Term	Domestic Bonds Rating	Forecast	Foreign Bonds Rating	Last Rating Change
Moody's	Long-term	A1	Stable	A1	The rating was upgraded in April 2008 "Outlook: "Stable"
	Short-term	-		P-1	
Standard & Poor's	Long-term	+A	Stable	+A	The rating was upgraded in September 2011 "2011 Outlook: "Stable" The Local Currency rating was downgraded to A+/A-1 in May 2013
	Short-term	A-1		A-1	
Fitch	Long-term	+A	Positive	A	The rating outlook was revised in November 2013 to "Positive"
	Short-term	F1		F1	

Section E – The Secondary Market

2013 was characterized by a continuation of the low interest-rate environment in most markets, which according to statements from central banks should continue in the following year. Data from the government bond market indicate a slight increase in trading volumes compared to 2012 and a return to the levels prevailing since the introduction of the primary dealer reform of 2006 – with the exception of 2010, in which trading volumes declined. Trade of government bonds is carried on several trading platforms simultaneously: the Tel Aviv Stock Exchange (TASE), MTS (a platform on which only primary dealers in government bonds, i.e. large and stable financial entities that undertake to quote buying and selling prices for government bonds, operate) and over-the-counter trade (OTC).

Trading Volumes in Government Bonds

Trading volumes rose to a daily average of NIS 3,640 million in 2013 compared to a daily average of NIS 3,575 million in 2012. During 2013 the trading volume that took place on the Tel Aviv Stock Exchange grew while the average daily volume on the MTS platform decreased from NIS 665 million in 2012 to NIS 465 million.

Below is the breakdown of trading volumes by trading platform:

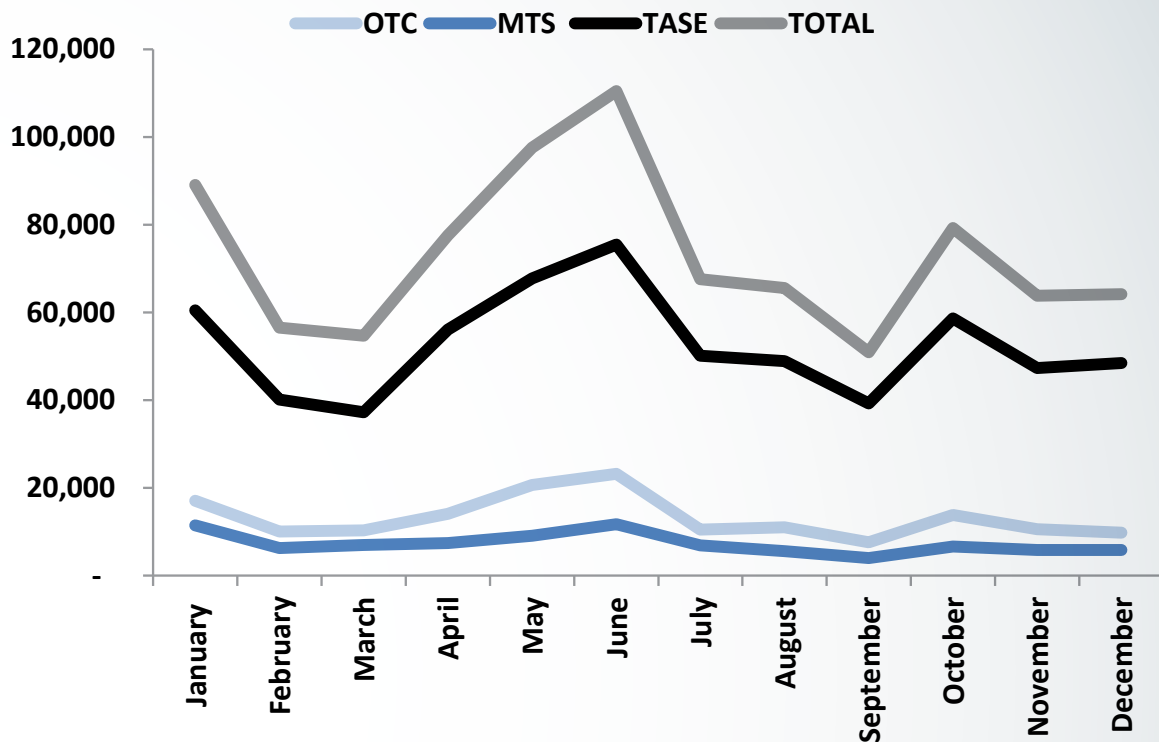
TASE – 71.83% of trading (2012 – 68.41%)

MTS – 10.04% of trading (2012 – 14.76%)

OTC – 18.12% of trading (2012 – 16.83%)

(Trading on the MTS platform is carried between Monday and Thursday, while on the other trading platforms it is carried between Sunday and Thursday).

Diagram E-1:
Trading volumes of government bonds, 2013 (NIS millions)



Nominal Fixed Coupon Bonds

Primary dealership in government bonds began in September 2006 and was carried out until December 2010 only in the nominal segment. As of the end of 2013, primary dealers are required to provide daily quotes on the MTS system for nine bonds.

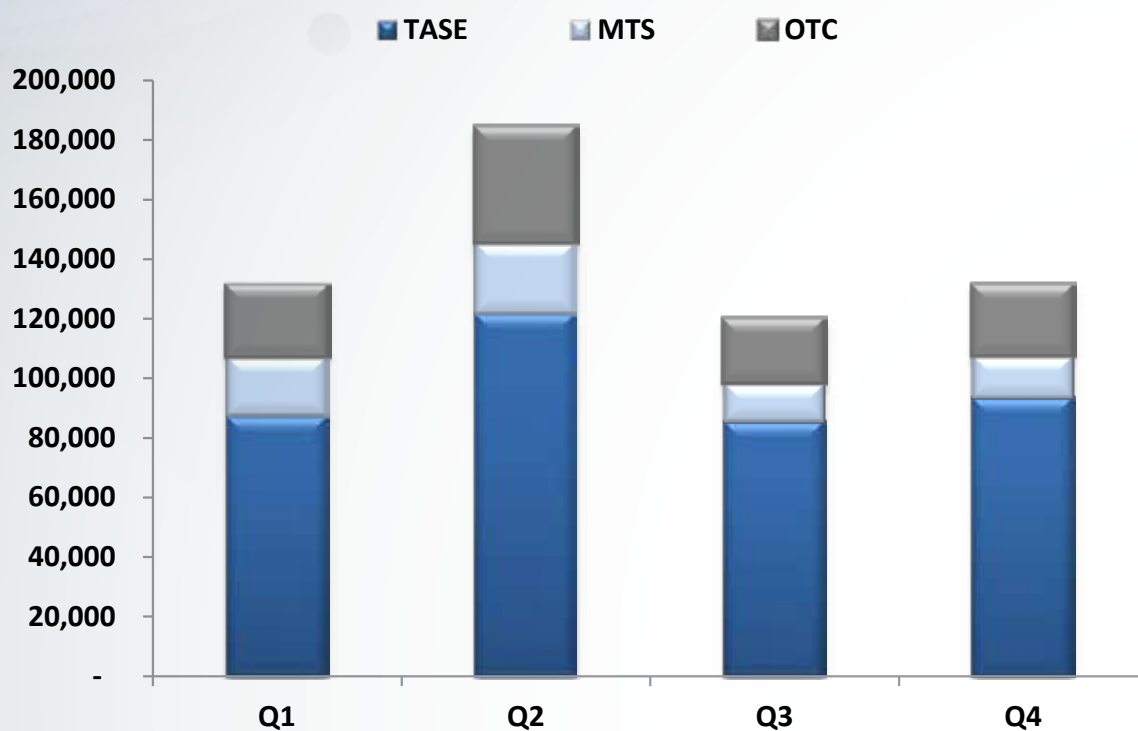
Market share by trading platform:

TASE – 68.34% of trading (2012 – 63.4%)

MTS – 12.54% of trading (2012 – 19.14%)

OTC – 19.12% of trading (2012 – 17.46%)

Diagram E-2:
Trading volumes in nominal fixed-coupon bonds (NIS millions)



CPI-Linked Bonds

Primary dealership in CPI-linked government bonds began in January 2011. As of the end of 2013, primary dealers are required to provide daily quotes on the MTS system for five bonds.

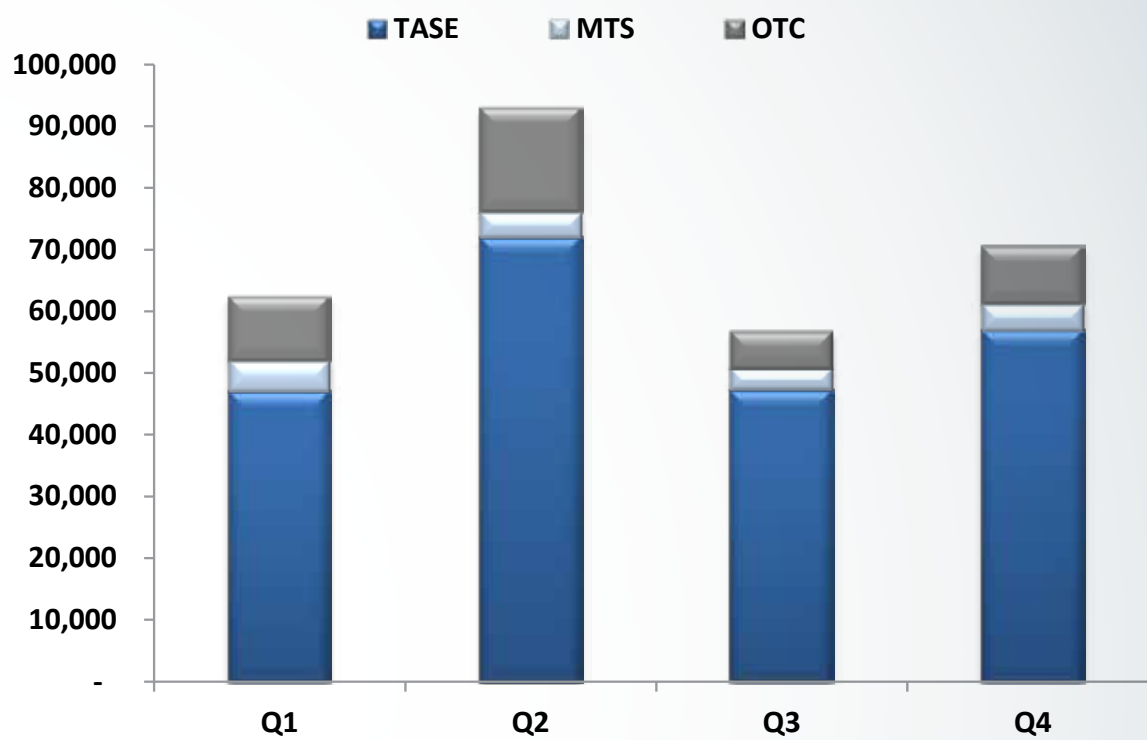
Ratio between the different trading platforms:

TASE – 78.9% of trading (2012 – 78.79%)

MTS – 6.03% of trading (2012 – 8.23%)

OTC – 15.07% of trading (2012 – 12.98%)

Diagram E-3:
Trading volumes in CPI-linked bonds (NIS millions)



Distribution of Trading by Segments

In 2013, as during the previous year, government bond trading was taking place mostly in the nominal segment.

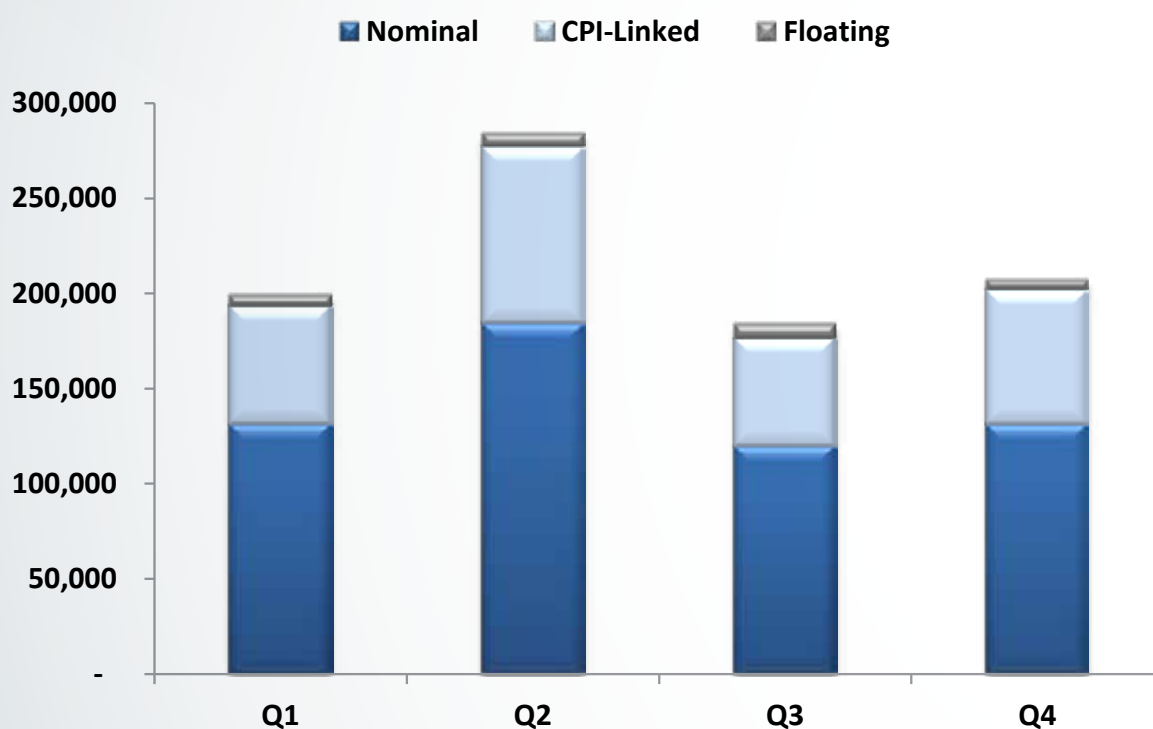
Market share by segments during 2013:

Nominal segment – 64.88% of trading (2012 – 63.31%)

CPI-linked segment – 32.33% of trading (2012 – 34.47%)

Floating-rate segment – 2.79% of trading (2012 – 2.22%)

Diagram E-4:
Breakdown of trading turnover in the different segments (NIS millions)



Turnover on the MTS Platform by Bond Type

As of the end of 2013, primary dealers are required to quote on the MTS system 9 nominal fixed-coupon bonds (ILGOV) and 5 CPI-linked bonds (GALIL/ILCPI). The quoting obligation is for net five hours per day, with the sizes of the quotes and the spreads varying according to the term to maturity.

The bonds for which there was a quoting obligation as of the end of 2013 are:

Nominal fixed-coupon bonds:

ILGOV 0516, ILGOV 0816, ILGOV 0217, ILGOV 0118, ILGOV 0219, ILGOV 0120, ILGOV 0122, ILGOV 0323 and ILGOV 1026.

CPI-linked bonds:

GALIL 5472, ILCPI 0517, ILCPI 1019, ILCPI 0922 and ILCPI 0923.

The bond with the highest trading turnover in the course of the year was ILGOV 0323, which served as the 10 year benchmark security.

Diagram E-5:
Trading turnover on the MTS platform by nominal fixed-coupon bond (NIS millions)

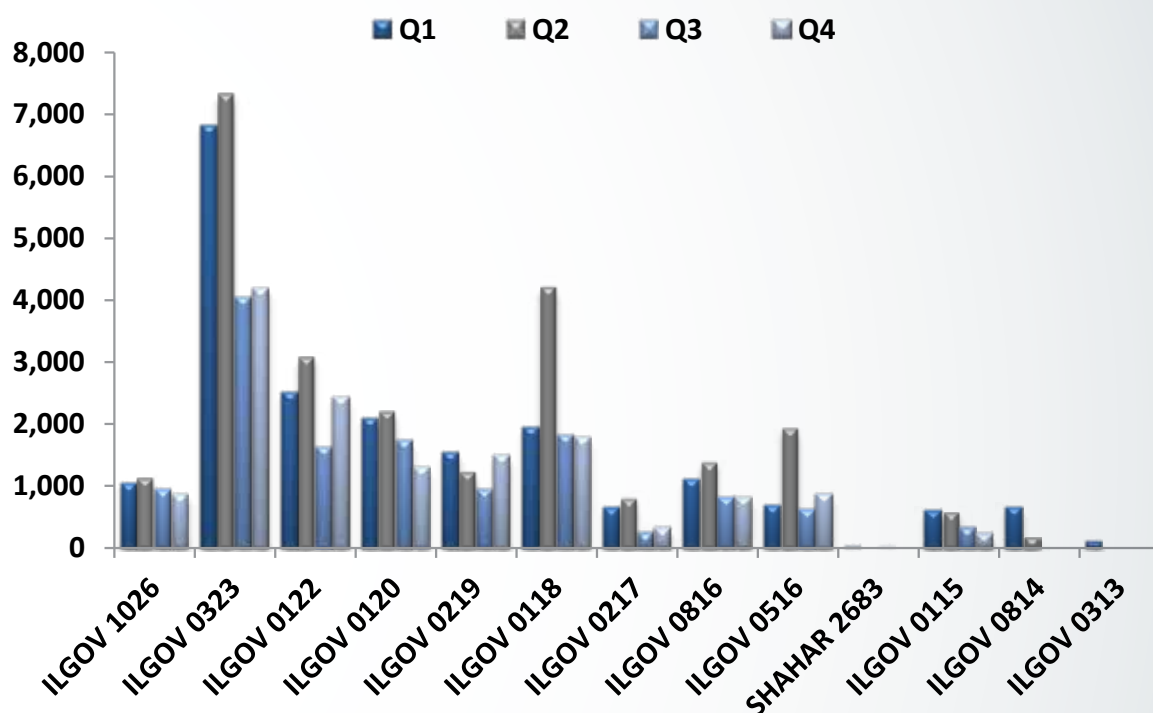
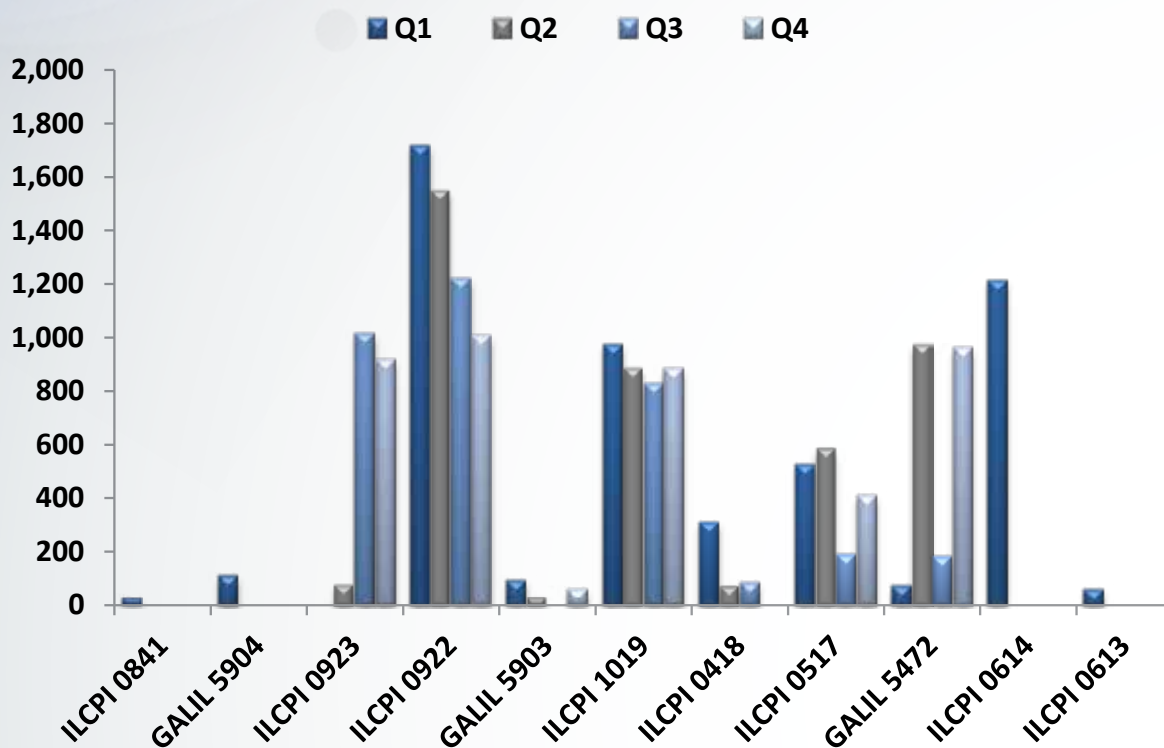


Diagram E-6:
Trading turnover on the MTS platform by CPI-linked bond (NIS millions)



Yield on the 10 Year Nominal Fixed-Coupon Bond

In 2013, as in previous years, government bonds were characterized by low yields. The yields reached record lows in the course of the year, while the low interest-rate environments continued in Israel and around the world.

The Bank of Israel continued lowering its interest rate, from 1.75% at the beginning of the year down to a level of 1%, which supported the low yields.

The graph below shows the yield on the ILGOV 0323, which was the 10 year benchmark security.

Diagram E-7:
Yield on 10 year bond

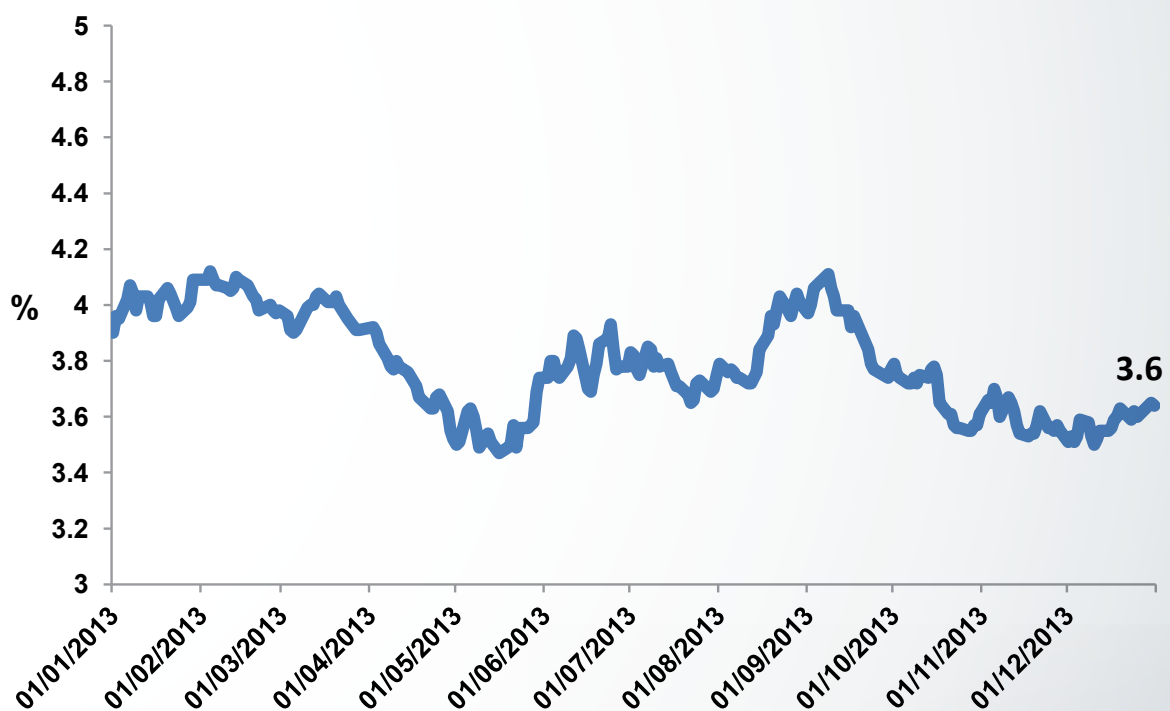
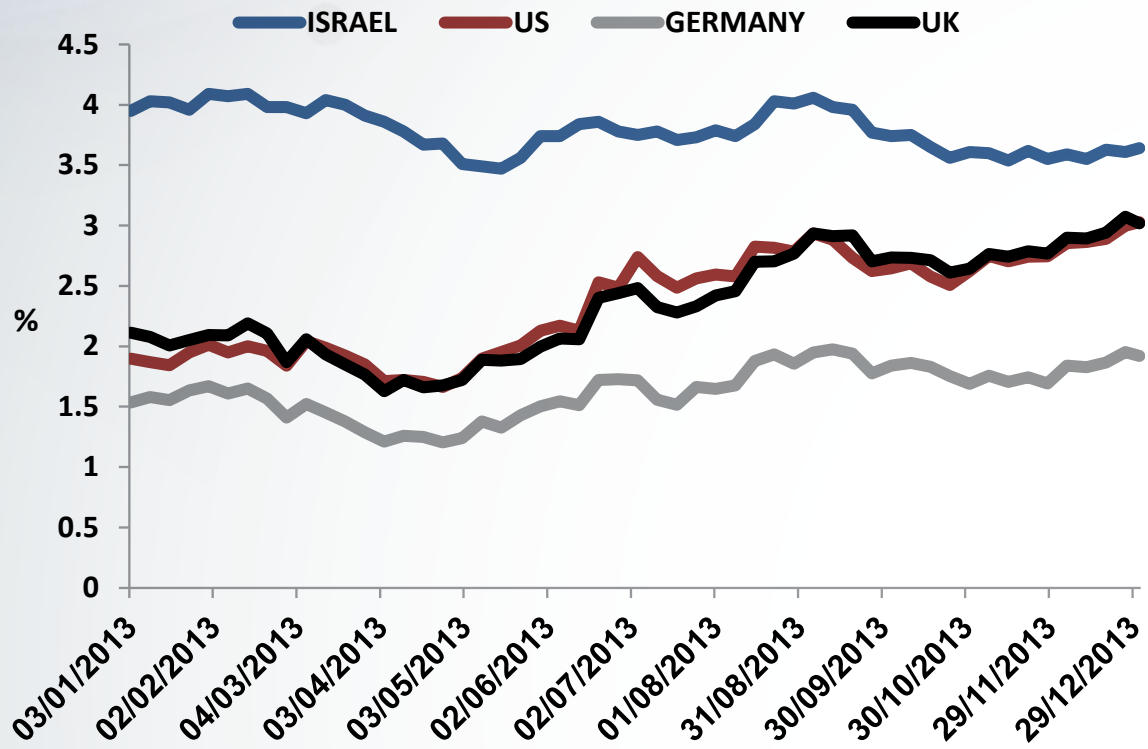


Diagram E-8:
10 year bond yields in selected peer countries



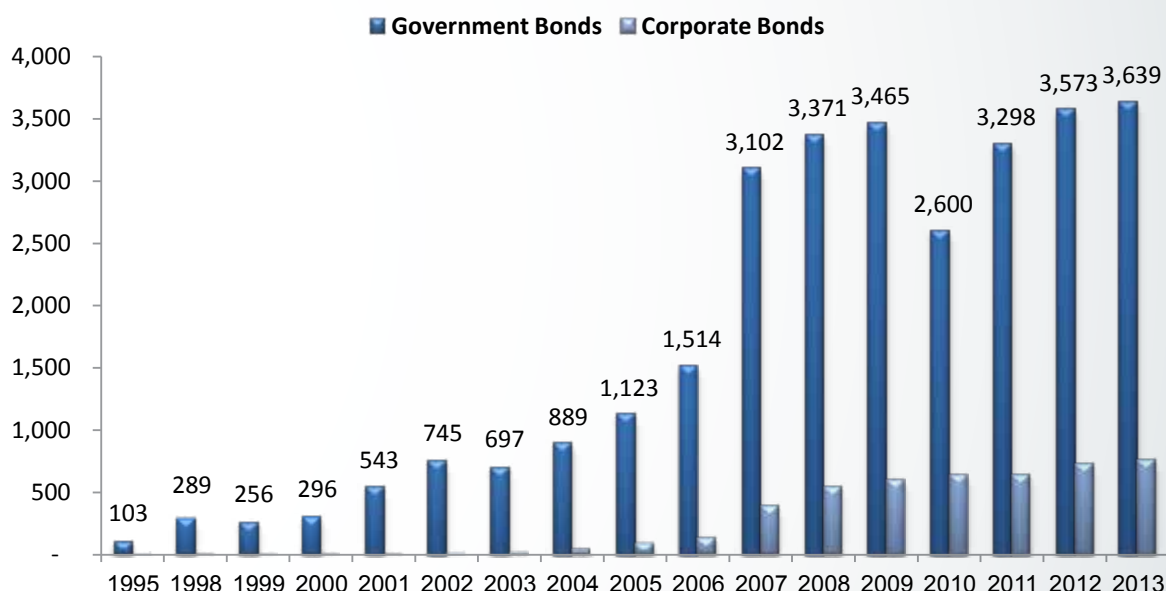
Average Daily Turnover in Historical Perspective

Trading volumes in 2013 rose 2% compared to 2012, following an increase of 8% from 2011. Government bond trading volumes have been trending upward in recent years, except for 2010, with the biggest jump in volume recorded in 2007 following the implementation of the government bonds primary dealer reform.

The trading volumes in the corporate bond market have been trending upward as well. Corporate bond trading volumes grew by 4% in 2013, following a 13% increase in 2012 compared with 2011.

During 2013 the spreads between corporate bonds and both CPI-linked and nominal fixed-coupon government bonds have narrowed.

Diagram E-10:
Average daily turnover in historical perspective (NIS millions)



* Trading on the MTS platform is carried between Monday and Thursday, while on the other trading platforms it is carried between Sunday and Thursday.

** In September 2006 the government bonds primary dealer reform was implemented, which introduced the MTS platform as trading arena for primary dealers only.

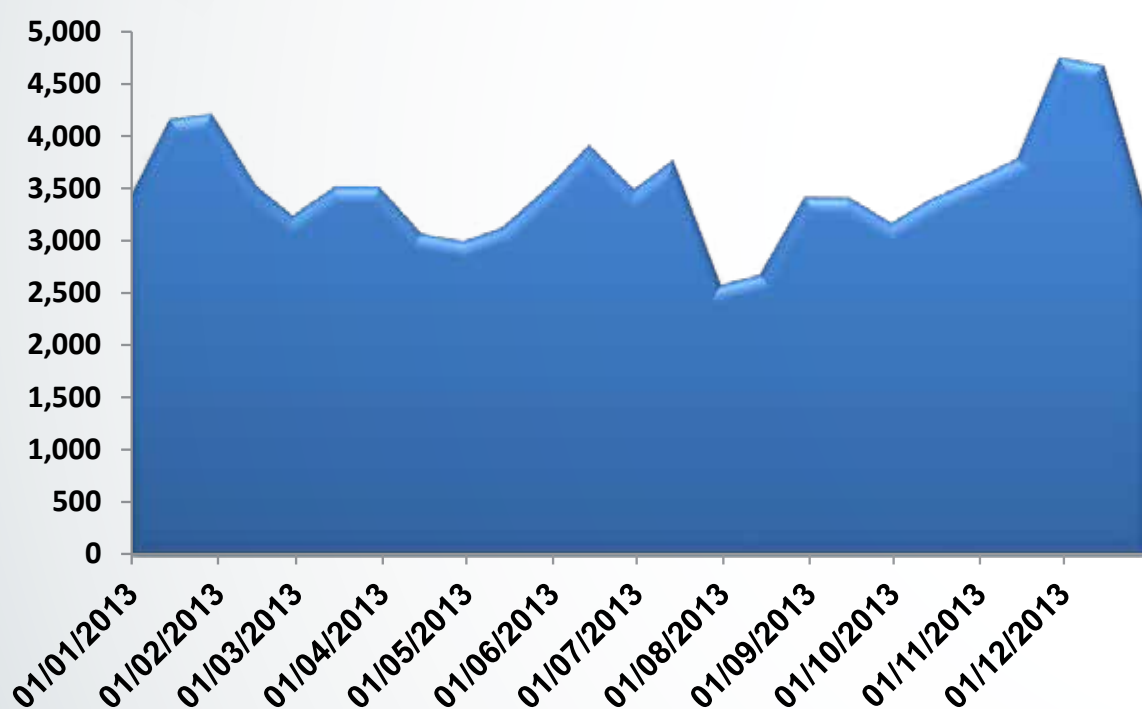
Bond Lending Facility

As part of the capital-market reform, the Ministry of Finance in cooperation with the TASE Clearing House established a bond lending facility allowing primary dealers to borrow government bonds of all types. Primary dealers who wish to borrow bonds (within the current limit of NIS 1 billion per primary dealer) may contact the TASE Clearing House. In return for borrowing the bonds, the primary dealers transfer financial collaterals to the Clearing House, on which they receive interest. The bond lending facility began operating in September 2006.

In the past year the facility ranged between NIS 2.5 and 4.5 billion.

The distribution of bond lending into segments at the end of 2013 was 58% in the nominal segment and 42% in the CPI-linked segment.

Diagram E-11:
Borrowing from the bond lending facility (NIS millions)



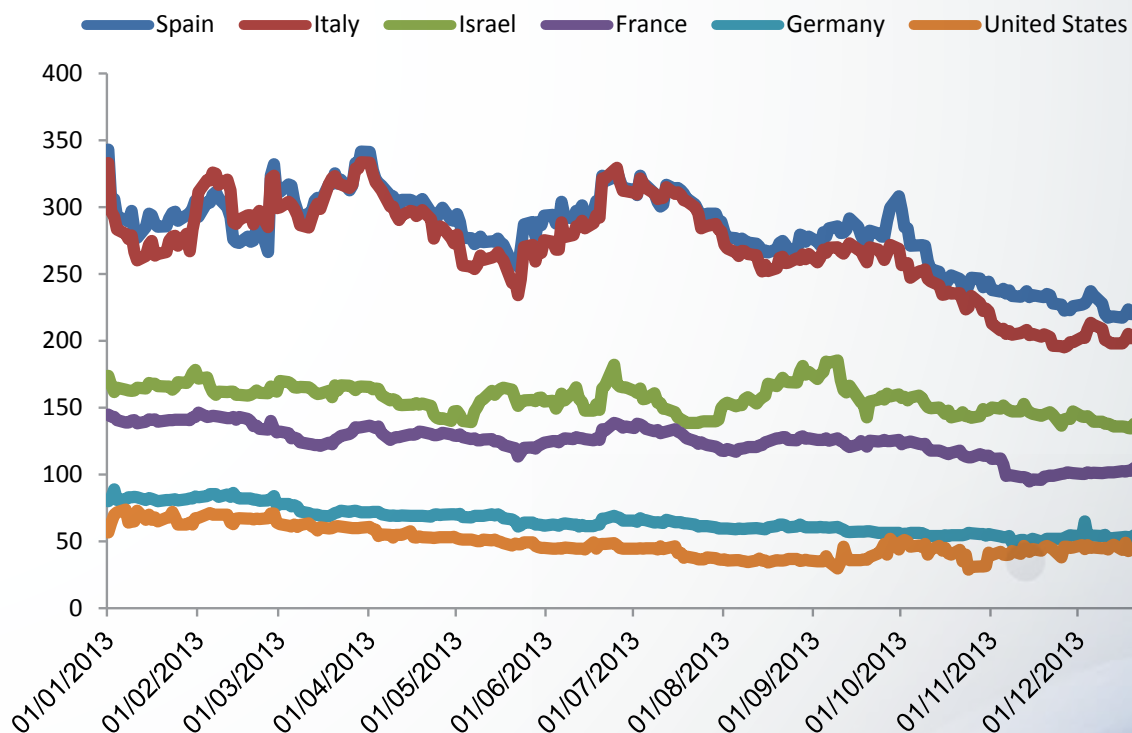
Development of the CDS Spreads of the State of Israel

CDS (Credit Default Swap) transactions are agreements that enable two parties to transfer a third party's credit risk from one to the other. In practice, such transactions represent the sale of bankruptcy insurance. The CDS spreads are customarily regarded as an (partial) indication of the investors' confidence in the third party's redemption ability, which serves as the underlying asset for the transaction.

The graph below compares the CDS spreads of the State of Israel and other countries during the course of 2013.

One can see that during the second half of 2013, the CDS spreads of European countries that suffered from the debt crisis, such as Italy and Spain, decreased sharply, due to the sentiment that the crisis was beginning to stabilize. The CDS spreads of the State of Israel also decreased in 2013, especially in the last months of the year, ending the year at a level of 140 basis points compared to 170 basis points at the beginning of the year.

Diagram E-12:
Development of 10 year CDS spreads of Israel and selected peer countries, 2013



Appendices Appendix A – Bond Characteristics

Characteristics of tradable bonds in the domestic market

Bond	First Issuance Date	Interest	Interest Payment
CPI-linked			
*Galil	31.12.1984	Fixed – as determined by the Ministry of Finance	Annually
CPI-linked government bond	26.6.2006	Fixed – as determined by the Ministry of Finance	Annually
Nominal			
Floating-rate government bond	8.1.2008	Floating – based on T-bill yields for 12 months	Once every 3 months
*Shahar	24.8.1995	Fixed – as determined by the Ministry of Finance	Annually
Nominal government bond	6.11.2006	Fixed – as determined by the Ministry of Finance	Annually
T-bill	13.8.2007	Zero coupon	-

*The bond is no longer issued.

Characteristics of non-tradable bonds in the domestic market

Bond	First Issuance Date	Interest	Interest Payment
CPI-linked			
*Miron	30.11.1983	fixed 5.5%	Once every 6 months
Arad	2.7.1995	fixed 4.8%	Once every 6 months
Chetz	1.5.1962	fixed 4%-6.2%	Once every 6 months

*The bond is no longer issued.

Appendix B – Details of External Debt Issuances

Issuances under the U.S. loan guarantee program in 2003-2013⁽¹⁾

Issuance date	Amount in USD millions	Term (in years)	Coupon rate	Underwriter	Yield/ price	Spread from US 30 year Treasury note on the issuance date (basis points)	Fee to USAID on face value of the guarantee
October-04	\$750	20	5.125	Merrill Lynch	5.16%	29	3.90%
					-99.5789		
April-04	\$1000	20	5.5	Lehman Brothers	5.53%	31	5.10%
					-99.6025		
December-03	\$750	20	5.5	Lehman Brothers	5.52%	36	4.96%
					-99.7608		
September-03	\$450	30	5.5	Barclays Capital	5.58%	38	8.27%
					-98.8557		
September-03	\$1150	20	5.5	Merrill Lynch	5.53%	33	7.00%
					-99.6409		

(1) All issuances are of fixed-coupon bonds.

Sovereign Issuances in Global Financial Markets, 1995-2013

Year ⁽⁴⁾	Market	Amount in millions in original currency	Yield	Term to maturity (in years)	Coupon rate	Reference interest rate – benchmark government bond ⁽¹⁾	Spread from BM on the issuance date (basis points) ⁽²⁾	Spread above swap curve in the relevant currency on the issuance date
2014	European	€ 1,500	2.932	10	2.875	Germany	117	90
2013	Global	\$1,000	3.213	10.5	3.15	US	125	115
		\$1,000	4.588	30	4.5		145	157
2012	Global	\$1,500	4.115	10	4	US	205	194
2010	European	€ 1,500	4.682	10	4.625	Germany	149.2	130
2009	Global	\$1,500	5.125	10	5.19	US	262.5	237
2006	Global	\$1,000	5.58	10	5.5	US	98	45
2005	European	€ 750	3.78	10	3.75	Germany	64	53
⁽³⁾ 2004	Global	\$500	5.2	10	5.125	US	115	75
⁽³⁾ 2003	Global	\$750	4.731	10	4.625	US	153	120
⁽³⁾ 2002	European	€ 400	5.983	7	5.875	Germany	122	100
⁽³⁾ 2000	Global	\$500	7.82	10	7.75	US	144	40
⁽³⁾ 1999	European	€ 400	4.91	7	4.75	France	97	65
1998	Yankee	\$250	7.313	30	7.25	US	225	162
⁽³⁾ 1997	Samurai	¥20,000	3.017	10	3	Japan	48	25
⁽³⁾ 1996	European	\$200	6.469	5	6.375	US	50	25
⁽³⁾ 1995	Yankee	\$250	6.491	10	6.375	US	⁽³⁾ 76	38

(1) Benchmark – A bond serving as a benchmark for comparing yields.

(2) Basis point – One hundredth of one percent.

(3) Redeemed bonds

Appendix C – 2013 Ranking of Primary Dealers in the Government Bond Market

Primary Market (Issuances on the Bloomberg Platform)

Ranking is based on the volume of purchases in government bond auctions.

The rankings are listed from highest to lowest volume of purchases:

1. Bank Leumi
2. Mizrahi Bank
3. Israel Discount Bank
4. Bank Hapoalim
5. First International Bank of Israel
6. Deutsche Bank
7. U-Bank
8. Goldman Sachs International
9. Barclays Bank
10. Citibank
11. Union Bank
12. Morgan Stanley
13. Clal Finance

Secondary Market (Trading on the MTS Platform)

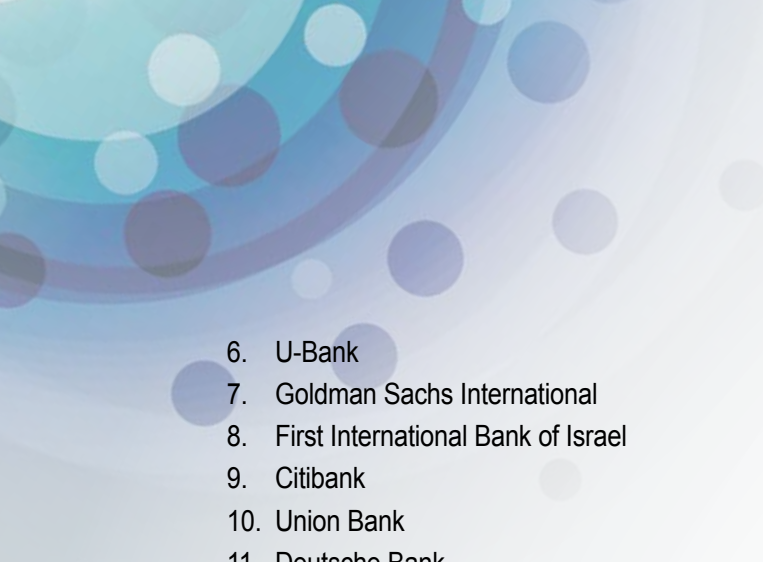
Ranking is based on the weighting of several parameters: trading volume, quote order size, quote spreads and quote time on the MTS platform.

The rankings are listed from highest to lowest volume of activity, and there is also a separation between the ranking in the nominal segment and the ranking in the CPI-linked segment.²

Trading on the MTS Platform – Nominal Segment

1. Bank Leumi
2. Israel Discount Bank
3. Bank Hapoalim
4. Barclays Bank
5. Mizrahi Bank

² * Details on the ranking method can be found on the website of the Debt Management Unit in the Accountant General Office, at: <http://www.ag.mof.gov.il/AccountantGeneral/GovDebt>.

- 
6. U-Bank
 7. Goldman Sachs International
 8. First International Bank of Israel
 9. Citibank
 10. Union Bank
 11. Deutsche Bank
 12. Morgan Stanley
 13. Clal Finance

Trading on the MTS Platform – CPI-Linked Segment

1. Bank Leumi
2. Israel Discount Bank
3. Mizrahi Bank
4. U-Bank
5. Citibank
6. First International Bank of Israel
7. Bank Hapoalim
8. Barclays Bank
9. Goldman Sachs International
10. Deutsche Bank
11. Union Bank
12. Morgan Stanley
13. Clal Finance

Appendix D – Table of Developments in 10 Year CDS Spreads of Israel and Selected Peer Countries, 2013

Date	Spain	Italy	Israel	France	Germany	United States
31/12/2013	218.0	200.0	139.7	102.0	53.3	40.5
29/11/2013	225.8	198.9	147.1	101.0	54.4	45.6
31/10/2013	244.3	222.0	148.1	113.9	55.5	41.5
30/09/2013	308.1	268.7	160.0	126.0	56.5	44.0
30/08/2013	278.0	265.0	176.9	127.0	60.5	35.8
31/07/2013	289.0	281.9	149.9	117.9	59.5	36.2
28/06/2013	313.9	311.9	165.2	136.0	65.5	44.7
31/05/2013	293.6	275.2	154.6	123.7	61.7	45.0
30/04/2013	289.6	272.9	147.2	129.1	70.4	53.5
29/03/2013	341.5	333.5	165.8	135.3	71.8	60.2
28/02/2013	310.3	299.1	162.0	131.6	76.7	64.0
31/01/2013	304.8	293.2	178.2	143.0	83.6	67.4
01/01/2013	342.9	333.1	173.9	144.7	80.1	56.5

Appendix E – Personnel of the Debt Management Unit in the Accountant General Office (at the end of 2013)

Offices in Jerusalem: 1 Kaplan St., Jerusalem Tel.: +972-2-531-7555 Fax: +972-2-566-9827	Offices at Airport City: Arava St., Airport City Tel.: +972-3-977-8777 Fax: +972-3-979-5370 Email: gdmu@mof.gov.il
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Name	Position	Tel.	Email
Yali Rotenberg	Senior Deputy Accountant General	+531-7555-972-2	yaliro@mof.gov.il
Gil Cohen	Head of Government Debt Unit	+531-7536-972-2	gilco@mof.gov.il
Lior David-Pur	Head of Risk Management Department	+531-7077-972-2	liorda@mof.gov.il
Edi Terner	Head of Back-Office Department	+977-8785-972-3	edit@inbal.co.il
Shlomi Katchko	Head of Trading Supervision Department	+977-8790-972-3	shlomik@inbal.co.il
Shay Zafran	Head of Domestic Debt and Issuances Department	+977-8796-972-3	shayz@mof.gov.il
Maoz Shaharbani	Head of Foreign Currency and External Debt Department	+531-7470-972-2	maozsh@mof.gov.il
Hana Sela	Deputy Head of Back-Office Department	+977-8784-972-3	hanas@inbal.co.il
Shani Federman	Deputy Head of Domestic Debt and Issuances Department	+977-8782-972-3	shani@mof.gov.il
Nimrod Etzioni	Risk Management Department	+531-7984-972-2	nimrode@mof.gov.il
Ayelet Perlstein	Foreign Currency and External Debt Department	+531-7580-972-2	ayeletp@mof.gov.il
Adi Goldstein	Domestic Debt and Issuances Department	+977-8795-972-3	adig@inbal.co.il
Jordan Barpal	Foreign Currency and External Debt Department	+531-7919-972-2	jordanb@mof.gov.il
Orna Arad	Back Office Department	+977-8786-972-3	ornaa@inbal.co.il
Gennady Naiman	Back Office Department	+977-8781-972-3	genadin@inbal.co.il
Einat Cohen-Tzur	Back Office Department	+977-8783-972-3	einatc@inbal.co.il
Ariel Kimhi	Back Office Department	+977-8788-972-3	arielk@inbal.co.il

New York Office

Name	Position	Tel.	Email
Sigalit Siag	Head of Economic Delegation in New York	1-212-499-5710	sigis@emus.gov.il
Amnon Krauss	Deputy Head of Economic Delegation in New York	1-212-499-5710	amnon@emus.gov.il
Chia Agadi	Legal Advisor	1-212-499-5727	chiaagadi@emus.gov.il



2013