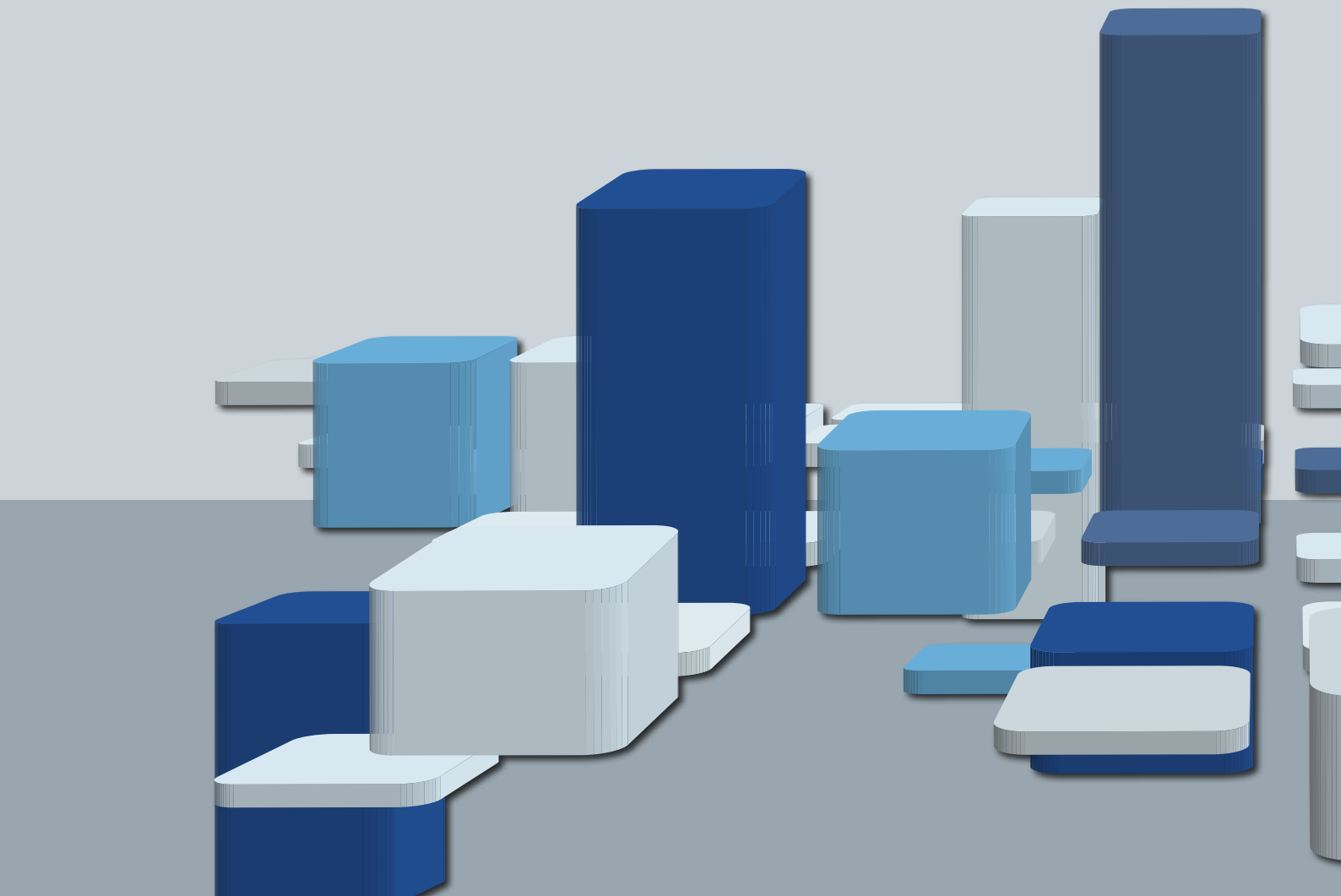
State of Israel
Ministry of Finance
Government Debt Management Unit

ANNUAL REPORT
2011



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Annual Report of the Government Debt Management Unit – Message from the Accountant General

The Government Debt Management Unit in the Accountant General Division is in charge of raising funding for the government's activity, the deficit and the current turnovers, alongside the efficient management of government debt and interest payments. This activity is complex, since the unit acts as an issuer that strives for optimal balance between risk and cost, and also supports the development and increased sophistication of the Israeli capital market.

The amount of the government debt is mainly derived from the government's fiscal policy and the budgetary deficits over the years, coupled with changes in market factors, such as the consumer price index, exchange rates and interest-rate curves. Outlining a strategic policy for the efficient management of the government debt, with emphasis on management of the debt risks, will significantly enhance the State's financial robustness and enable it to cope successfully with economic challenges and other financial crises. Past scenarios and the ongoing financial crisis demonstrate that a country's financial stability can be rapidly undermined, even leading to failure to meet financial obligations. The many challenges facing the State of Israel since its establishment, the geopolitical situation, the ongoing debt crisis and the macroeconomic conditions in Israel and worldwide continue to cast a dark shadow and call for great caution and preparing for every possible scenario.

The raising of the State of Israel's credit rating in a period when we are witness to significant rating downgrades in numerous countries is a badge of honor for the Israeli economy and strengthens investors' confidence in the country's ability to meet its financial obligations. Relying on a strong and stable domestic debt market while simultaneously penetrating the global markets and expanding the investor base will enable the distribution of debt refinancing risks and reducing the government's funding costs. The continuing decline in the debt-to-GDP ratio and in interest payments in recent years will enable reducing the burden of interest payments on the government debt out of the State budget.

At the beginning of 2012, the Unit for the first time issued an unlinked bond with a term to maturity of 30 years. The success of this issuance supports the strategic policy of extending the average term to maturity of debt and reducing the refinancing risk, and could assist in further enhancing the sophistication of the government bond market. The Unit's annual report is an important element in increasing the transparency and certainty of the debt management policy, and it provides broad disclosure enabling a financial analysis of the State's stock of debts and risk factors.

In conclusion, I wish to thank the personnel of the Government Debt Management Unit who work professionally and responsibly for the optimal and effective management of the government debt.

Sincerely,

Michal Abadi-Boiangiu
Accountant General

Section A – Preface

We are pleased to present the tenth annual report of the Government Debt Management Unit in the Accountant General Division for 2011.

In 2011, the world continued to deal with one of the most severe financial crises in modern economic history. The Israeli economy faced considerable challenges in the course of this year: the impact of the global financial crisis on exports, uncertainty regarding tax revenues and funding of government debt at relatively large volumes. We note that this year as well, many countries faced large risks in the area of debt refinancing, and even debt crises, that led to numerous credit rating downgrades by the rating agencies. As distinct from these countries, which registered an increase in the ratio of the public debt to the GDP, Israel experienced a downward trend.
Following is a review of the major economic developments during 2011:

State Budget

At the end of 2011, the State budget deficit had reached a level of 3.3% of GDP, compared to the budget plan of 2.9%. The difference is mainly due to a decrease in tax revenues in the second half of 2011.

Funding through government bonds

The volumes of bond issuances in the primary market were relatively high in 2011, amounting to NIS 92 billion, of which NIS 86.7 billion were issuances in the domestic market and the rest were issuances in foreign markets. This year as well, switch auctions played a major role as a cash flow management tool, and approximately NIS 13.8 billion were raised in their framework. The net amount raised in 2011 was NIS 12.1 billion.

Ratio of public debt to GDP

The ratio of public debt to GDP fell to a level of 74.1% in 2011. It should be noted that most OECD countries recorded a significant rise in this ratio. For the sake of comparison, as of the end of 2011, the debt-to-GDP ratio of the Euro zone countries had risen by 3.1%.

Inflation

During 2011, the consumer price index rose by 2.2%, within the Bank of Israel's target range (1%-3%), compared to an increase of 2.7% in 2010. The main items that affect inflations are food, housing and health.

Bank of Israel interest rate

In the first three quarters of 2011, the Bank of Israel continued the trend of raising the interest rate that had begun at the end of 2009 and continued in 2010. During this period, the interest rate was raised gradually from a level of 2% at the beginning of the year to 3.25% in September. In the fourth quarter of 2011, the Bank of Israeli gradually reduced the interest rate to a level of 2.75% in December 2011. The key factors underlying the cut in the interest rate were the global slowdown and moderation in the growth rate. As of May 31, 2012, the Bank of Israel interest rate stands at 2.5%.

Exchange rate

In 2011, the shekel weakened, registering a depreciation of 7.7% against the dollar (an increase from 3.55 on December 31, 2010 to 3.82 on December 31, 2011) and 4.2% against the euro (an increase from 4.74 to 4.94). As in 2010, in 2011 there was relatively high volatility in the exchange rate: the shekel fell to a minimum level of 3.36 against the dollar and rose to a maximum level of 3.82, the level at which it concluded the year. As of May 31, 2012, the shekel/dollar exchange rate stands at .9 and the shekel/euro exchange rate at 4.82.

The stock market

The increases that characterized the capital markets in 2010 did not continue in 2011, which was characterized by steady declines. The main declines occurred after the downgrading of the U.S. credit rating, which occurred in August (as was the case with most of the world). The TA-25 stock index started the year at a level of 1326, registering a slight drop (1262) by the end of July, after which it dropped sharply down to a level of 1085.59 at the end of the year. The total annual decline in the index was 18% compared to a decrease of 13% in the MSCI index of developed countries and an increase of 7.5% in the S&P 500 index during the same period.
As of the end of May, the TA-25 index stands at 1065.

Government bond market

The government bond market showed price increases in the past year. The government bonds index recorded a 5% (nominal) rise in 2011, the CPI-linked government bonds index recorded a 4.3% (nominal) rise, while the unlinked government bonds index recorded a 5.2% (nominal) rise.

- The first half of the year was marked by an increase in yields, against the background of the Bank of Israel's raising of the interest rate, from a level of 2% to 3.25%, with the ten-year unlinked bond traded at record high levels in 2011, at a yield of 5.41%.
- The second half of the year was marked by a decline in yields, against the background of the worsening of the European debt crisis and the Bank of Israel's return to a course of interest rate cuts, with the ten-year unlinked bond traded at record low levels in 2011, at a yield of 4.53%.

It should also be noted that over the course of 2011, Israel's bonds traded with much smaller fluctuations than in most countries, including the United States. For example, the yields of the nominal ten-year bonds in the United States fluctuated in the range between 3.64% and 1.83% (181 basis points), while the yields of the parallel bonds in Israel fluctuated in a narrower range, between 5.47% and 4.52% (95 basis points).

The corporate bond market

The year 2011 was characterized by a decline in funding compared to 2010, attributable to the second half of 2011, which had low volumes of funding. The total volume of corporate funding in 2011 stood at NIS 31.5 billion, down 21% compared to 2010. Most of the funding took place in the CPI-linked segment (66%), and the rest in nominal bonds (24%) and in floating-rate bonds (10%), a distribution similar to 2010. Approximately 90% of the issuances were carried out in companies with a credit rating of A and up. Towards the end of 2010, the recommendations of the Hodak Committee, which require the issuer to engage in a more transparent process than in the past, became effective. Apart from the decline in the volume of funding in the corporate market, there was a significant increase in bond yields, mainly of companies in the investment and holdings sector.

Government debt policy

The primary market and the secondary market presented many challenges to the government's debt policy in 2010. The focus in 2011 was on funding of government financing through the domestic market. As in past years, the implementation of reforms in the government bonds market and the resulting creation of a liquid and sufficiently deep market contributed to the ability to weather 2011 as well. It should be noted that at the end of 2011 the size of the debt portfolio reached its highest level in absolute terms (NIS 633 billion). Therefore, as in 2010, the central issue in the sphere of government debt management is reduction of financing costs while managing both existing risks and potential risks. At the beginning of 2011, the legal framework enabling the performance of hedge transactions

(ISDA and CSA) with Israeli banks acting as primary dealers in government bonds was completed. The completion of the legal framework has allowed the Government Debt Management Unit to accelerate the rate of hedging transactions. In 2011, hedging transactions were carried out for a total of USD 1,819 million, in accordance with the annual hedging plan, of which USD 1,669 million were dollar/shekel swap transactions and USD 150 million were dollar/shekel forward transactions.

Achievements in the government debt sector in 2011

- **Reduction in the ratio of government debt to GDP** – The government debt amounted to NIS 633 billion. Despite the nominal increase in the government debt, the debt-to-GDP ratio recorded a substantial decrease. This ratio is the most important index for measuring the debt burden of the State and for measuring its financial strength. At the end of 2011, this ratio stood at 72.7% (narrow government), a decrease of 2.1% compared to the previous year.
- **Increase in the State of Israel's credit rating** – In September 2011, S&P rating agency announced an increase in the credit rate of the State of Israel from a level of A to A+. In the opinion of the agency's analysts, the rating increase reflects an improvement in the flexibility of Israel's economic policy, due to high growth and a responsible and cautious macroeconomic policy. The agency's analysts noted that the Israeli economy has weathered the global crisis and is on a viable course to a continued reduction in the debt burden and further improvement in the country's external accounts. The expected production of natural gas starting from the middle of the decade will, in the agency's opinion, increase economic efficiency and strengthen Israel's fiscal position. The previous raise in Israel's credit rating occurred in April 2008, when Moody's raised the Israeli government's credit rating to a level of A1. In February 2008, Fitch raised the State of Israel's credit rating to a level of A. Israel is one of the only countries in the world to enjoy an increase in their credit rating in 2011, after the rating agencies implemented in the past year an unprecedented wave of numerous and sharp credit rating downgrades for developed countries throughout the world, and particularly in Europe.
- **Large volume of fund debt funding** – In 2011, the Government Debt Management Unit has to raise overall a gross sum of NIS 90 billion in order to finance an annual deficit of 3.3% of GDP. This deficit was higher than the deficit target in the budget, which stood at 2.9%, mainly because of a decrease on the revenue side. The total volume of actual government funding in 2011 amounted to NIS 92 billion, of which 85% was raised through debt funding instruments in the tradable domestic segment, including: regular tradable issuances, issuances through switch auctions and issuances in noncompetitive auctions for primary dealers (Green Shoe allocations), 9% through nontradable domestic debt funding from pension funds and insurance companies, and the remainder in foreign currency in foreign markets through the Israel Bonds Organizations and private placements for investors from the East.
- Notwithstanding the high volumes of funding in the domestic issuances market in 2011, the overall demand registered in the auctions was relatively high, amounting to NIS 280.4 billion, 4.9 times more than the overall supply (compared to a ratio of 5.5 in 2010). A coverage ratio lower than 2 (the same as in 2010) was not recorded in any of the issuances that were performed in 2011, neither at the level of bonds nor at the level of the overall issuance.
- **Start of primary dealership in CPI-linked bonds** – In 2011, the primary dealers in government bonds – some 14 banks, of which 8 are local and 6 are foreign – began acting also as primary dealers in the CPI-linked bond market (between 2006-2010, there were primary dealers only in unlinked government bonds). As of the end of 2011, primary dealers are required to quote CPI-

linked bonds on the MTS platform on a daily basis. The average daily volume of trading in CPI-linked government bonds grew in 2011 by 15% compared to 2010 and stands at NIS 950 million.

- **Reduction of refinancing risk** – Despite the many challenges presented by debt funding in large volumes, the average time to maturity (ATM) of the debt portfolio remained stable relative to last year, standing at 6.3 years. The preservation of this range without any change, in spite of the continued shortening of the length of the external debt, was enabled by the lengthening of the domestic debt. Another key indicator that examines the financing risk is the ratio of the short-term debt (which will mature in the coming year) to the total debt (rollover ratio). In 2011, this ratio stood at 12% compared to 11% the year before. Keeping this ratio stable at a level of 10%-12% helps reduce the refinancing risks presented by the government debt.
- **Diversification of government financing sources** – Funding in 2011 was carried out while diversifying the sources of government financing. In particular, the following sources of financing can be noted:
- **Funding through primary dealers:** Each of the primary dealers is required to purchase 4% of the total competitive unlinked and CPI-linked issuances in the domestic market. The Unit raised NIS 65 billion in 2011 through the regular auctions.
- **Extensive use of liquidity management tools:** These tools, which were launched at the end of 2007, provided extensive support to the 2011 funding program, assisted in lowering the rollover risk and contributed to interest expense savings. An amount of NIS 13.8 billion was raised through switch auctions in 2011 (compared to NIS 4.6 billion in 2010), and a net amount of NIS 8.6 billion was raised through short-term bonds. In the course of 2011 there was early repayment of NIS 5.4 billion (compared to NIS 6.9 billion in 2010).
- **Foreign currency funding from foreign institutional investors:** In 2011, two private placements were carried out for a total of USD 24 and 400 million for two large Asian institutional investors. These are strategic investors for whom this was the first investment in bonds of the State of Israel. The Government Debt Management Unit sees supreme importance in exposing the State of Israel's bonds to the global financial markets. These private placements enable exposure to new markets, and specifically the rapidly developing Asian markets. The cost of the funding, after hedging for shekels, was significantly lower than the cost of government funding in the domestic market.
- **Increase in the tradable debt and decrease in the nontradable debt**: In the course of 2011 there was an additional increase in the proportion of tradable debt within domestic debt, while the proportion of the nontradable debt continued to contract. The tradable debt component reached 75% at the end of 2011, a 2% increase compared to the end of 2010, while the nontradable debt component decreased to 27% as of the end of 2011.
- **Continued multi-year trend of reducing the number and enlarging the volume of tradable bonds** – At the end of 2011, 32 series were traded with an average volume of NIS 11.5 billion, in comparison with 32 series with an average volume of NIS 10.9 billion at the end of 2010. This trend as well is a result of a long-term policy to increase the volume of benchmark series issuances.
- **Mitigating counterparty risk resulting from hedging transactions to reduce foreign currency exposure** – Mitigating counterparty risk is now deemed highly important in the wake of the latest financial crisis. In the course of 2011, the formulation of the policy for counterparty risk was completed and ISDA contracts, including CSA annexes, were signed with existing business partners and with potential business partners, mainly domestic Israeli banks. An ISDA contract is a contract that sets forth the rights of the parties to a hedging transaction in the case of insolvency.

The CSA annex ensures the ongoing transfer of collateral between the parties to the hedging transaction in accordance with the market value of the transaction, in order to prevent the creation of overly high losses in the case of insolvency.

- **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 treasury bills and maintains a dominant presence in the short portion of the yield curve. In the first quarter of 2011, the new Bank of Israel Law was passed by the Knesset, and in addition, a memorandum of understanding was formulated and signed between the Bank of Israel and the Ministry of Finance. Among other things, the law, and alongside it the memorandum of understanding, regulates the Ministry of Finance's need to issue short-term bonds in order to improve the management of government cash flow alongside the independence of the Bank of Israel in managing the monetary policy. In accordance with the memorandum of understanding signed between the entities, the Unit conducts one monthly consultation with the Bank of Israel, in the course of which the Bank presents the situation in the international markets and in the domestic market, in addition to the ongoing contact between the entities. The continued growth in liquidity and in the depth of the secondary market for government bonds and the domestic market, in spite of the global economic crisis and especially the European debt crisis, has preserved the continuous and extensive activity of the secondary market for government bonds, and thus, in actuality and regardless of the background conditions, buyers and sellers were always found in the market. The daily average volume of government bonds in the different arenas in 2011 stood at a level of NIS 3.23 billion versus NIS 2.55 billion in 2010, marking a return to the trading levels that characterized the government bond market since the beginning of the reform in this market in 2006. Concurrently, in 2011, the primary dealers increased their commitment to the level of liquidity in the government bond market, including a commitment to quote CPI-linked bonds (starting from January 2011). Today, more bonds than ever, in larger volumes than previously, are being traded on the primary dealer (MTS) platform.

Challenges in the Management of the Government Debt in 2012

- **Efficient management of the government debt after the extensive funding volumes of 2011 and in view of the uncertainty ahead of 2012** – In 2011, there was an increase in nominal debt to NIS 633 billion relative to NIS 608 billion at the end of 2010. In addition, the government balances with the Bank of Israel fell from a level of NIS 14.3 billion to NIS 13.3 billion. The redemptions in 2012 are spread out in a relatively equal manner throughout the year. This fact presents an advantage, on the one hand, in that it reduces the specific risk; however, on the other hand, it constitutes a continuing challenge requiring the ability to redeem large amounts throughout the entire year. In light of the updated collection forecasts, the deficit for 2012 is expected to be higher than the original target of 2%. Therefore, it can be reasonably assumed that there will be a need for additional funding on a scope of NIS 15-20 billion, beyond the deficit of NIS 13.5 billion planned in the budget. The challenge in 2012 is to implement a funding program that maintains management flexibility and takes into account less positive scenarios which could increase financing needs, against the background of the ongoing global crisis and high government deficits in many countries.
- **Management of the trade-off between cost and market risk in the government debt portfolio** – Expanding the scope of government financing in the past two years has increased the government debt portfolio to an unprecedented size of NIS 633 billion. As a result, the government's financing

costs have increased, as has the exposure of the government debt to market risks. Consequently, it is important to focus in the coming years on the correct management of the trade-off between cost and market risk in the government debt portfolio.

- **Broadening the investor base in the domestic market** – At the end of 2011, a slight increase occurred in the volume of holdings by foreign investors in tradable government bonds, reaching a level of 6.6%, which contributed to a reduction in financing costs. Nonetheless, the involvement of foreign investors in the domestic bond market is too low by any measure, and it is important to raise it. Although the current financial crisis has proven, for several countries, that too much involvement by foreign investors can affect the stability of the domestic capital market when the investors withdraw all at once, given the low volume of the holdings in the Israeli market there is still high potential for expanding the investor base and improving the liquidity level of tradable domestic debt. Even though it is not part of the government debt, it is worth noting that the scope of holdings by foreigners of treasury bills issued by the Bank of Israel constitutes 12.2% of the volume of issued capital, equivalent to NIS 14.8 billion in holdings, a sharp drop from 2010 caused by the cancellation of the tax exemption for foreign investors.
- **Developments in the course of 2012:** There were two significant achievements in the course of the year: The one, for the first time a 30-year nominal bond was issued, that will assist in enhancing market sophistication and expand the tools available to the investor public and for the government's financing needs. In addition, in January, the Government Debt Management Unit carried out a sovereign issuance in the global markets in the amount of USD 1.5 billion, which is evidence of flexible funding ability and contributes to the expansion of the investor base.

This report covers all activity performed by the Government Debt Management Unit in 2011 and provides a detailed description of the debt stock. Section B presents a general outline of the goals of the government debt management policy. Section C presents details of the existing debt stock as well as various indexes for the management of government debt risks. Section D reviews activity in the primary market, including normal issuances activity and activity intended to support management of the government's cash flows. This section also contains a review of the State of Israel's credit rating. Section E details developments in the secondary market.

Sincerely

Eran Heimer
Senior Deputy Accountant General
Head of Finance Division

Goals of the Government Debt Management Policy

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, both as an issuer and as a sovereign. The principal goals of the debt management policy are:

1. Reducing financial risks (refinancing and liquidity risks) and budgetary risks (interest budget volatility), given the macroeconomic background data.
2. Reducing funding costs in line with a desirable risk level.

To examine compliance with these goals, it is necessary to define quantitative indicators that determine the optimal balance between cost and risks. Key indicators for this determination are the proportion of the government/public debt in the GDP (debt-to-GDP ratio) and the amount of funding expenses in the State budget (interest budget).

1. The interest budget is the second largest component in the State budget after the defense budget, and the most important in terms of the prioritization of payments, since failure to meet financial obligations would mean insolvency and serious harm to the Israeli economy. The interest budget is exposed to changes in the consumer price index, to changes in exchange rates and to changes in the level of interest rates. Any slight change in the size of the interest budget will push aside other components of the State budget, and therefore the volatility tolerance level of this budget is low.
2. The debt-to-GDP ratio is an accepted measure for examining the State's financial position. Reducing this ratio helps the State with its future financial obligations.

In addition, there are several secondary goals in the debt management that in most cases serve the primary goals. For example, secondary goals that support the increased sophistication of the domestic debt market and increased tradability and liquidity help reduce the government's funding costs, since the interest on tradable and liquid debt is lower than the interest on nontradable debt. A further example: secondary goals that deal with the reduction of the exposure of the State's liabilities portfolio to market risks are intended to reduce volatility of the interest budget and the debt-to-GDP ratio. Given that in years during which there are, for instance, sharp changes in the rate of the shekel against foreign currencies, sharp changes will also occur in the rates of interest paid on bonds denominated in foreign currency and, consequently, in the interest budget. Furthermore, sharp changes will also occur in the balance of the principal of the bonds denominated in foreign currency and, consequently, in the debt-to-GDP ratio.

At times, the secondary goals may conflict with the primary goals. The State's considerations when wearing the hat of a sovereign are not always compatible with its considerations under the hat of an issuer. Financing considerations may clash with budgetary considerations. For example, the issuance of bonds abroad for the purpose of creating a benchmark for issuances of Israeli companies supports the State's purposes as a sovereign but harms its purposes as an issuer, since this exposes the government debt and interest payments to volatility of exchange rates. Likewise, the issuance of high-coupon designated bonds for pension funds helps the State support its citizens in the field of pension security, but increases the State's funding costs.

Among the secondary goals of the domestic government debt management policy, the following should be noted:

1. Increasing the tradability and liquidity of bonds and focusing on large series with fixed terms to maturity (benchmark), as accepted around the world.
2. Supporting and strengthening the government yield curves, as part of the creation of benchmarks for the business sector.
3. Enhancing the sophistication of the government bond market and developing complementary markets (repo, derivatives).
4. Smoothing out the future redemptions curve.
5. Increasing transparency and the level of certainty.

Among the secondary goals of the external government debt management policy, the following should be noted:

1. Broadening the investor base and lightening the burden on the domestic market.
2. Creating benchmarks for issuances abroad of Israeli companies.
3. Exposing the Israeli economy to foreign investors (investor relationship).
4. Managing the 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.

The primary goals and the secondary goals set out above are covered through the formulation of an issuance policy for the domestic and foreign markets and a government debt risk management policy. The funding policy weights the strategic goals together with tactical considerations that help determine the funding mix. Publication of the funding program in the domestic market helps increase transparency and certainty and strengthens government credibility. The risk management policy focuses on the management of financial risks, such as refinancing, liquidity, market and credit risk.

The principal risk in the management of the government debt portfolio is the refinancing risk. The management policy for this risk is determined on the basis of several indicators, among them the average time to maturity of the debt, and the ratio of the short-term debt (that will mature in the coming year) to the total debt (rollover ratio). Maintaining the stability of these indicators according to the desirable level of risk relative to cost helps the Unit to mitigate this risk. The use of diverse liquidity tools, such as switch auctions (early repayment of bonds by the issuance of long-term bonds) and buyback auctions (early repayment of bonds through monetary payment), supports the liquidity management policy.

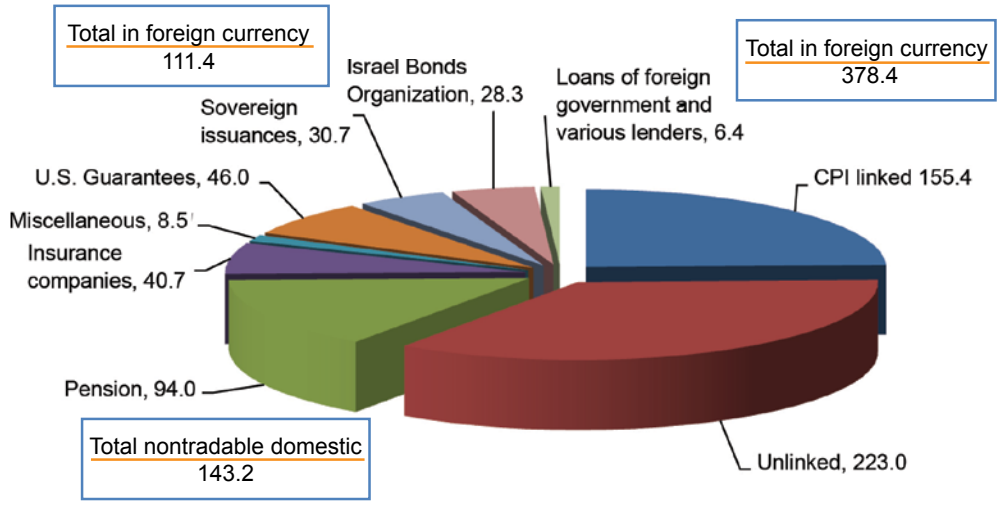
Government Debt Portfolio

Total Debt and Debt-to-GDP Ratio

Total government debt increased by 4% in 2011, to NIS 633 billion, as opposed to NIS 608 billion the year before.

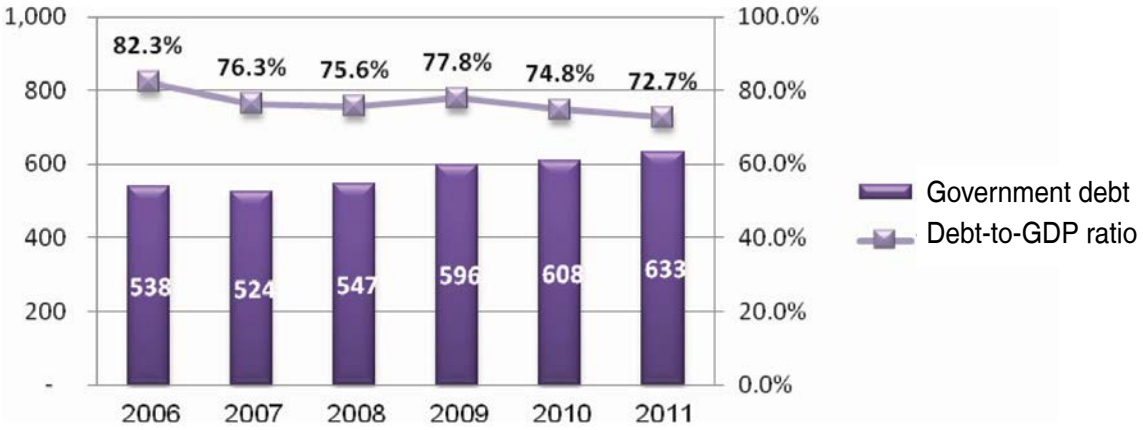
The bulk of the nominal increase in government debt was due to positive net funding of NIS 12 billion, as well as an inflationary environment that added a further NIS 7 billion. The balance of the increase in government debt is attributable to the weakening (depreciation) of the shekel against the US dollar and the euro.

Diagram C-1
Structure of government debt at the end of 2011 (NIS billions)



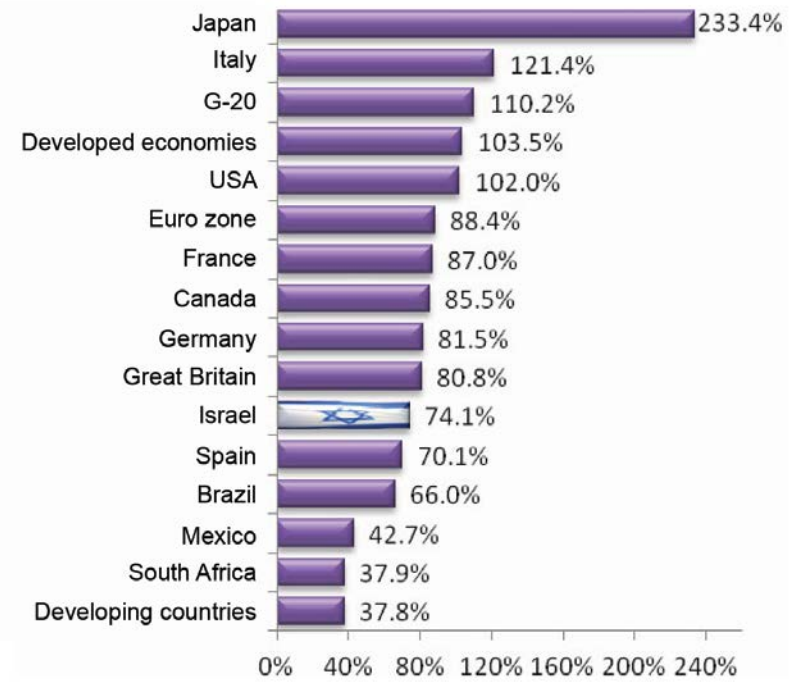
As can be seen in Diagram C-2, at the end of 2011, the government debt-to-GDP ratio decreased by about 2.1% versus the previous year, and comprised 72.7% of the GDP. The debt-to-GDP ratio is one of the most important indicators in determining the credit rating and financial stability of the State. The continuing decline in the debt-to-GDP ratio, particularly against the background of the significant increase in other countries, testifies to the fiscal discipline and economic robustness of the State, as reflected in Diagrams C-3 and C-4.

Diagram C-2
Size of government debt and debt-to-GDP ratio, 2006-2011 (NIS billions)



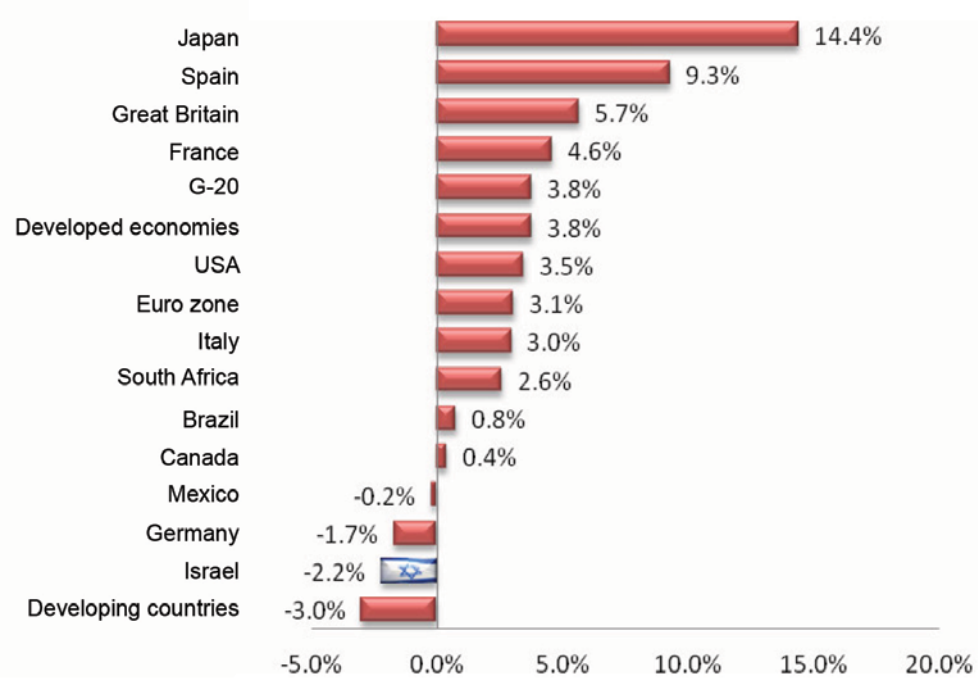
Source: Ministry of Finance, GDP in 2011 based on Central Bureau of Statistics estimate of the national accounts, second estimate for the first quarter of 2012, dated June 17, 2012.

Diagram C-3
Public debt ratio* as a percentage of the GDP, 2011



Source: Other countries – IMF Fiscal Monitor, January 2012, 2011 estimate; Israel – Ministry of Finance and Bank of Israel
GDP in 2011 based on Central Bureau of Statistics estimate of the national accounts, second estimate for the first quarter of 2012, dated June 17, 2012.
* Public debt – including debt of other government bodies, such as local authorities

Diagram C-4
Change in ratio of the public debt to the GDP between 2010 and 2011



Source: Other countries – IMF Fiscal Monitor, January 2012, 2011 estimate; Israel – Ministry of Finance and Bank of Israel
GDP in 2011 based on Central Bureau of Statistics estimate of the national accounts, second estimate for the first quarter of 2012, dated June 17, 2012.

Sensitivity of Government Debt to Market Factors

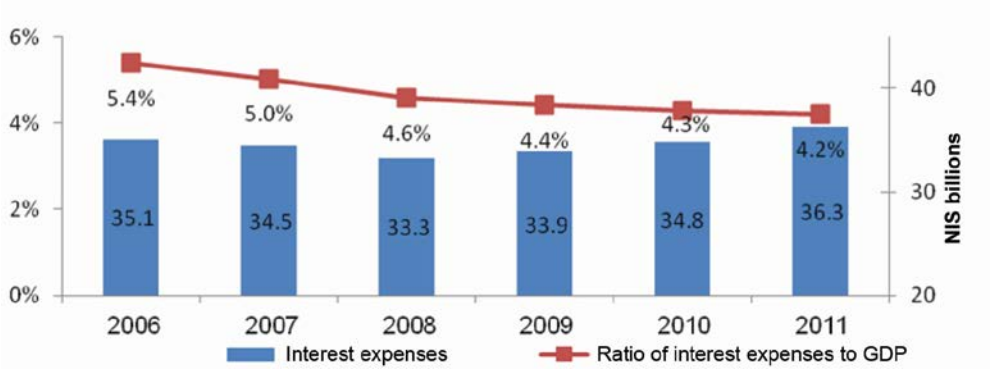
Table C-1 below shows the exposure of government debt and the debt-to-GDP ratio to key risk factors, such as the consumer price index and changes in the exchange rate of foreign currencies as of the end of 2011.

Table C-1

	Change in government debt (NIS millions)	Change in debt-to-GDP ratio (percent of GDP)
Accumulated increase in the consumer price index in percent unit	3,000	0.35%
Increase in dollar-shekel exchange rate in percent unit	950	0.10%
Increase in euro-shekel exchange rate in percent unit	150	0.01%

Interest expenses in 2011 amounted to NIS 36.3 billion. Despite the nominal growth, the ratio of interest expenses to the GDP stood in 2011 at 4.2% compared to 4.3% the year before. Interest expenses are the cost of interest for the government debt and for 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, a decrease in the proportion of the nontradable domestic debt (designated bonds) which are characterized by high interest rates, as well as the continued environment of low interest rates on funding. This decrease is consistent in view of the trend in recent years, and its importance lies in the release of budgetary sources for other government objectives.

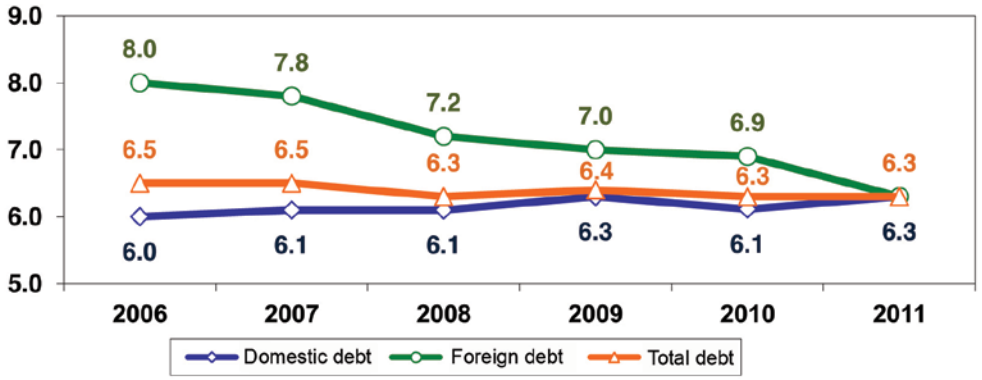
Diagram C-5
Ratio of interest expenses to GDP, 2006-2011 (NIS billions, percentages)



Measures of the Length of Debt

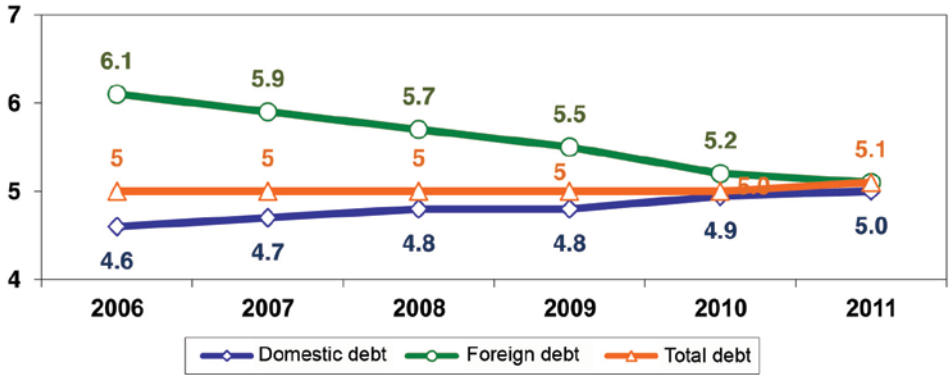
Average term to maturity (ATM) is one of the main measures for determining the length of debt. The length of the debt has an effect on the cost of the debt and on the refinancing risk. The average term of total government debt was 6.3 years at the end of 2011, unchanged from the previous year. An examination of the length of debt by breakdown into domestic debt and foreign debt shows a continued trend of shortening of the length of foreign debt, contrasted with an increase in the length of tradable domestic debt. The decrease in the length of foreign debt is mainly a result of the natural shortening of the debt backed by U.S. government guarantees (which were originally issued for long terms of twenty and thirty years) as well as issuances with short terms to maturity. On the other hand, one can see an increase in the length of domestic debt, mainly in light of the increase in the volume of long-term issuances.

Diagram C-6
Average term to maturity of government debt, 2006-2011 (in years)



Another measure of debt length and of 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-7, the overall duration of government debt maintains its stability and stands at five years. However, it can also be seen that there are opposite trends between the domestic debt and the foreign debt, similar to the ATM

Diagram C-7
Modified duration of government debt, 2006-2011 (in years)



An additional indicator for estimating the refinancing risk is the ratio of the short-term debt (amount of principal redemptions expected in the coming year) to the total debt (rollover ratio). Another measure is the ratio of the short-term debt to the GDP, as seen on the right side of Table C-2.

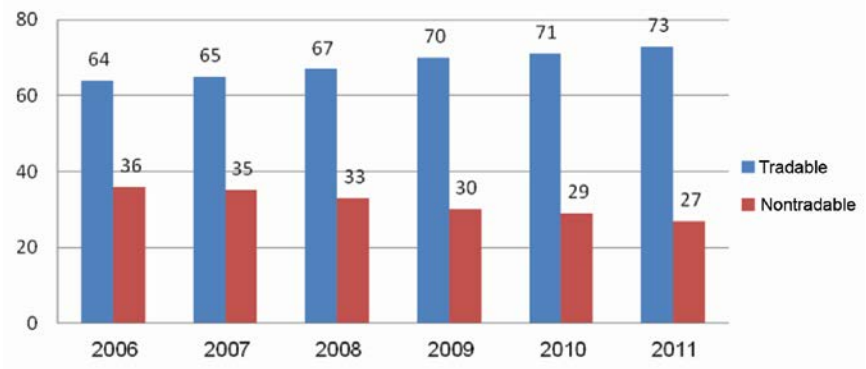
Table C-2
Ratio of short-term government debt to total debt and to GDP, 2006-2011 (in percentages)

	Ratio of short-term debt to total debt (rollover ratio)						Ratio of short-term debt to GDP					
	2006	2007	2008	2009	2010	2011	2006	2007	2008	2009	2010	2011
Total government debt	11	11	11	10	11	12	9	8	8	7	8	9

Domestic Debt

The balance of domestic debt (tradable and non-tradable) stood at NIS 521.6 billion at the end of 2011. Tradable debt grew by 5.5%, to NIS 378.4 billion (compared to NIS 358.5 billion in the previous year), or 73% of total domestic debt, as part of the consistent increase in its share of total domestic debt in recent years. Nontradable debt continued its downward trend and totaled NIS 143.2 billion, comprising 27% of total domestic debt. The consistent decrease in the proportion of nontradable domestic debt is mainly a result of negative net funding from pension funds. Under the reform in the pension market, pension funds are entitled to issue designated bonds only in the event that the proportion of designated bonds out of the total assets of the pension funds has fallen below 30%.

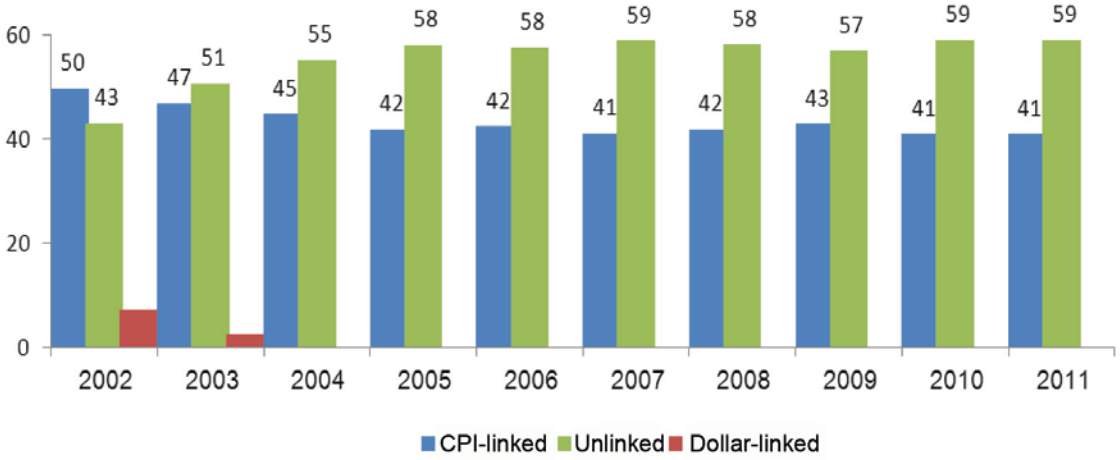
Diagram C-8
Distribution of domestic debt into tradable domestic debt and nontradable debt, 2006-2011 (in percentages)



Tradable Domestic Debt

The distribution of tradable domestic debt between the unlinked segment and the CPI-linked segment remained unchanged. The proportion of CPI-linked tradable domestic debt amounted to 41%. The proportion of unlinked tradable domestic debt stood at 59%. As can be seen, in recent years there has been a gradual increase in the unlinked segment as against a decrease in the CPI-linked segment. This decrease helps reduce the exposure of government debt and interest payments on this debt to the consumer price index.

Diagram C-9
Distribution of tradable debt by linkage type, 2006-2011 (in percentages)



Distribution of Tradable Government Bond Holdings

The proportion of holdings of the pension funds in 2011 amounted to 14.9% as compared to 13.3% in the previous year. This increase is consistent with the trend in recent years of increase in the proportion of holdings of the pension funds in tradable government bonds. In accordance with the pension funds reform, the volume of issuances of designated bonds to these funds fell significantly, thereby redirecting investment sources to tradable government bonds.

Another segment exhibiting an increase in the proportion of holdings of tradable bonds is the provident funds and study funds. In 2011, the proportion of their holdings stood at 19.3% as compared to 18.8% at the end of the previous year.

The proportion of holdings of foreign investors in government bonds rose to a record 6.6% as compared to 3.1% at the end of 2010. Among the reasons for the growth is the shift of foreign investors away from holding treasury bonds (Makam) issued by the Bank of Israel, in view of the steps taken by the Ministry of Finance and the Bank of Israel, such as a change in the tax reform with respect to treasury bills. Another reason is the possibility for a surplus yield on investments in government bonds, in view of the continued growth in the gap between the shekel and dollar interest rates.

The proportion of the public's holdings at the end of 2011 stood at 22.9% of the total stock of the government's tradable bonds, as opposed to 24.0% at the end of 2020. It bears noting that this decrease is consistent with the decline that began in 2009 and stands in contrast to the positive trend prior to the outbreak of the latest financial crisis.

The proportion of the banks' holdings increased and stood, at the end of 2011, at 14.2% as compared to 12.8% in the previous year.

The share of the Bank of Israel in holdings of tradable government bonds in 2011 stood at 4.8% compared to 5.1% in the previous year. This proportion 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.

The proportion of holdings of mutual funds in government bonds decreased to a level of 8.5% from the previous level of 13.2%.

Table C-3
Distribution of holders of tradable government bonds, 2006-2011 (NIS billions, percentages)

Year	Total registered capital (NIS billions)	Public	Mutual funds	Provident and study funds	Pension fund	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	22.9	8.5	19.3	14.9	14.2	8.9	6.6	4.8

(1) Includes holdings of life insurance and general insurance companies and nostro accounts
Source: Bank of Israel, 2011 estimate

Average Size of Series and Number of Series

In recent years, the Ministry of Finance's debt management policy is to restrict the number of government bond series in circulation while increasing their volume. This policy contributes to increasing the tradability and liquidity of bonds, thus helping to lower the costs of funding. This policy continued in 2011, and thus the average series size rose to NIS 11.5 billion. The steep increase in the average series size is mainly due to the continuing policy of large-scale issuances of benchmark series.

In 2011, the Government Debt Management Unit issued eight new series on the tradable domestic market, due to the high funding volumes: four short-term government bonds, three unlinked government bonds (Unlinked Government Bond 122 which matures in 2022, Unlinked Government Bond 816 which matures in 2016, and Unlinked Government Bond 814, which matures in 2014), and one CPI-linked government bond (CPI-Linked Government Bond 922 which matures in 2022).

Eight bond series matured in 2011, and accordingly there has been no change in the stock of existing series.

Diagram C-10
Average series size, 1995-2011 (NIS billions)

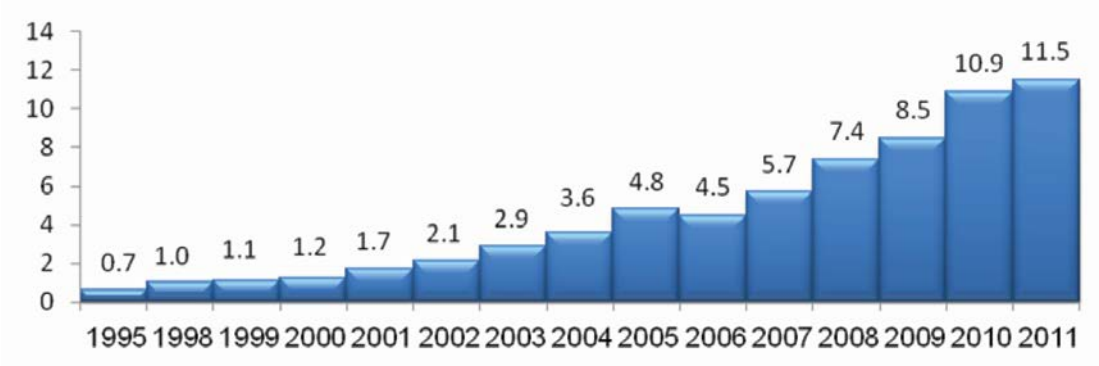
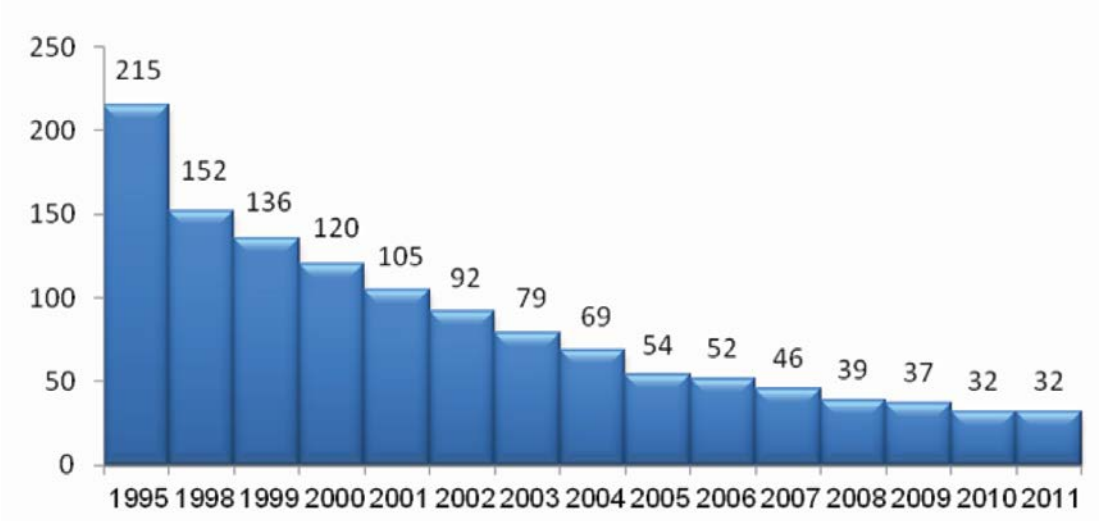


Diagram C-11
Number of tradable series, 1995-2011



Nontradable Domestic Debt

The stock of nontradable domestic debt decreased to NIS 143.2 billion at the end of 2011. The stock of designated bonds issued to the pension funds ("Arad" and "Miron" bonds) was declined, amounting to NIS 94 billion versus NIS 97 billion in the previous year. The stock of designated bonds held by insurance companies ("Chetz" bonds) grew by 5.4% in 2011 and amounted to NIS 40.7 billion. The emissions managed by the Accountant General Division and the balance of compulsory loans managed by the Bank of Israel rose in relation to 2010 to a total of NIS 8.5 billion.

Table C-4
Distribution of nontradable debt by type, 2006-2011 (NIS billions)

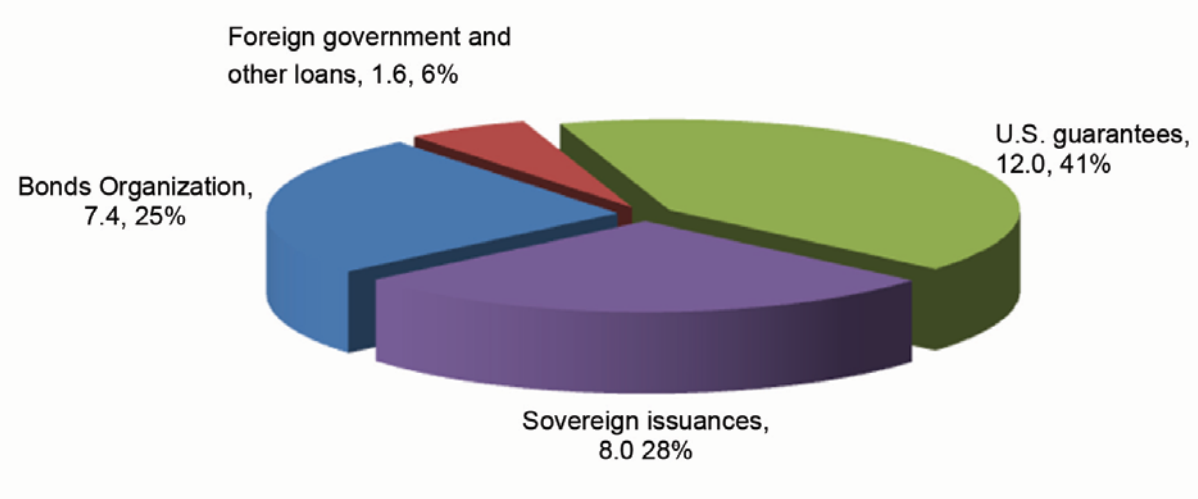
	2006	2007	2008	2009	2010	2011
Total (NIS billions)	145	144	142	144	144	143.2
Pension (Arad & Miron)	105	102	99	99	97	94
Insurance (Chetz)	31	33	35	37	38.6	40.7
Miscellaneous[1]	9	9	8	8	8.4	8.5

(1) Includes compulsory loans managed by the Bank of Israel, and deposits and emissions managed by the Ministry of Finance.

Foreign-Currency Debt

At the end of 2011, the government's foreign-currency debt stood at NIS 111.4 billion (approximately USD 29 billion), comprising 18% of total government debt. Following are details of the composition of the debt by sector:

Diagram C-12
Composition of foreign-currency debt, by debt source (USD billions, percentages)



Issuances Backed by U.S. Government Guarantees

Table C-5 shows the stock of bonds issued with U.S. government guarantees within the second loan guarantee program in 2003 and 2004. 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 loan guarantee program stands at USD 3.8 billion. The bonds backed with U.S. government guarantees 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 2011, these bonds comprised approximately 41% of the total foreign-currency debt.

Table C-5
Issuances under the U.S. loan guarantee program (1)

Issuance date	Amount in USD Millions	Term (years)	Interest to investors (percent) – coupon	Underwriter	Yield (price)	Spread from 30-year US government bond on issuance date (basis points)	Commission from face value to US AID for guarantee
October 2004	$750	20	5.125	Merrill Lynch	5.16% 99.5789-	29	3.90%
April 2004	$1000	20	5.5	Lehman Brothers	5.53% 99.6025-	31	5.10%
December 2003	$750	20	5.5	Lehman Brothers	5.52% 99.7608-	36	4.96%
September 2003	$450	30	5.5	Barclays Capital	5.58% 98.8557-	38	8.27%
September 2003	$1150	20	5.5	Merrill Lynch	5.53% 99.6409-	33	7.00%

(1) All issuances are of fixed-coupon bonds

Sovereign Benchmark Issuances

Between 1995 and 2011, thirteen sovereign issuances were carried out in the United States, Europe, Japan and the global market. In 2011, no sovereign issuance was carried out in the global markets. The last sovereign issuance prior to 2012 was performed in March 2010 in the European market (EMTN)3, amounting to an unprecedented Euro 1.5 billion. As shown in Table C-6, in recent years the size of the issued series has risen, in view of the policy of issuing benchmark series, and due to the high demand for sovereign issuances of the State of Israel in foreign markets.

Below are details of the tradable sovereign benchmark bonds issued by the debt management unit at the Accountant General in the foreign markets in recent years. At the end of 2011, these bonds comprised about 28% of the total foreign-currency debt.

Table C-6
Public sovereign issuances in global financial markets, 1995-2011 (1)

Year	Market	Amount in millions in original currency	Yield	Terms to maturity (years)	Interest to investors (percent) – coupon	Benchmark interest (BM) – government bonds (2)	Spread from BM on issuance date	Spread over SWAP curve in relevant currency on issuance date (3)
2012	Global	$1,500	4.115	10	4	USA	205	194
2010	Euro-pean	€1,500	4.682	10	4.625	Germany	149.2	130
2009	Global	$1,500	5.125	10	5.19	USA	262.5	237
2006	Global	$1,000	5.58	10	5.5	USA	98	45
2005	Euro-pean	€750	3.78	10	3.75	Germany	64	53
2004	Global	$500	5.2	10	5.125	USA	115	75
2003	Global	$750	4.731	10	4.625	USA	153	120
2002	Euro-pean	€400	5.983	7	5.875	Germany	122	100
2000	Global	$500	7.82	10	7.75	USA	144	40
1999(4)	Euro-pean	€400	4.91	7	4.75	France	97	65
1998	Yankee	$250	7.313	30	7.25	USA	225	162
1997(4)	Samurai	¥20,000	3.017	10	3	Japan	48	25
1996(4)	Euro-pean	$200	6.469	5	6.375	USA	50	25
1995(4)	Yankee	$250	6.491	10	6.375	USA	76(3)	38

(1) All issuances are of fixed-coupon bonds.
(2) Benchmark – a bond used as a criterion for yield comparisons.
(3) Basis point (bp) – one hundredth of one percent.
(4) Matured.

Issuances through the Israel Bonds Organization

The nontradable part of the debt is mainly composed of nontradable bonds issued over the years to individuals, companies and institutional entities through the Israel Bonds Organization (State of Israel Bonds). This debt amounted at the end of 2011 to NIS 28.3 billion. At the end of 2011, these bonds comprised 25% of the total foreign-currency debt.

Foreign Government and Other Loans

The remainder of nontradable debt in foreign currency stems from bonds issued to foreign governments, international institutions, foreign banks and bilateral funds. This balance totaled NIS 6.3 billion at the end of 2011. At the end of 2011, these bonds comprised 6% of the total foreign-currency debt.

Private Placements

The stock of private placements at the end of 2011 stood at NIS 3.9 billion, with four placements performed in US dollars and one in pounds sterling. In 2011, two private placements were executed at a total of USD 524 million.

Activity in Derivatives

The composition of the government's current debt portfolio is characterized by a high proportion of liabilities in foreign currency, which constitute 18% of the total government debt. In addition to this, the mix of the foreign-currency debt is characterized by overdominance of dollar-denominated debt. As of the end of 2011, 84% of the foreign-currency debt is dollar denominated, 14% is denominated in euros and the remainder is in other currencies. The Debt Management Unit carries out hedging transactions, short-term dollar-shekel forward transactions and long-term swap transactions. Dollar-shekel swap transactions enable reduction of exposure to foreign currency, and dollar-euro transactions enable diversification of the exposure.

These hedging transactions enable the reduction of market risks (currency risk) but expose the Unit 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 without hedging transactions

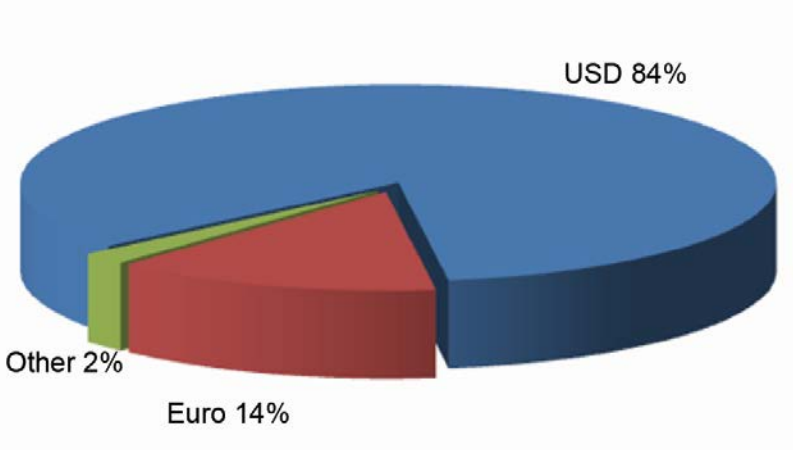
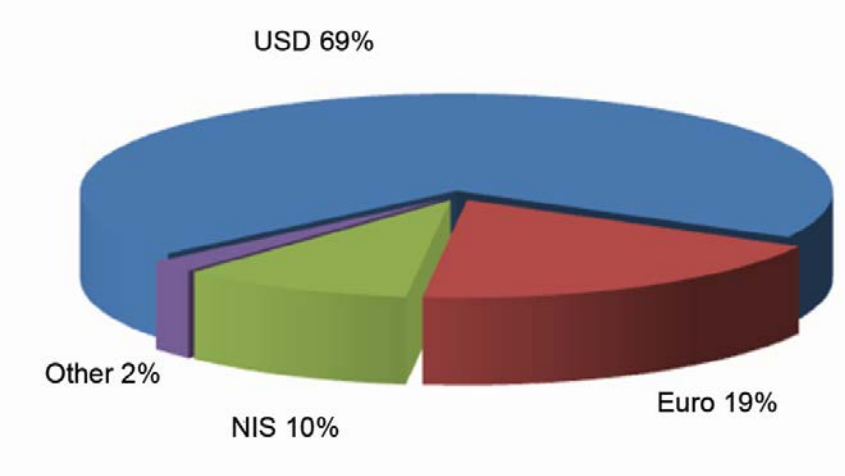
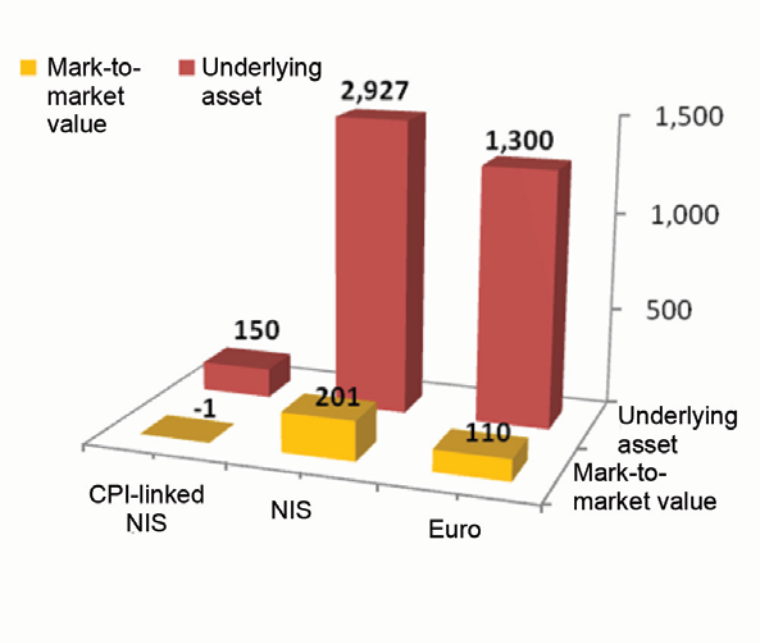


Diagram C-14
Composition of foreign-currency debt by currency including hedging transactions



As of December 31, 2011, the government's stock of swap transactions amounts to USD 4,377 million, of which dollar-euro transactions amount to USD 1,300 million, dollar-shekel transactions amount to USD 2,927 million, and linked dollar-shekel transactions amount to USD 150 million. As of December 31, 2011, the mark-to-market value of all transactions stood at USD 310 million.

Diagram C-15
Balance of hedging transactions as of December 31, 2011 (in USD millions)



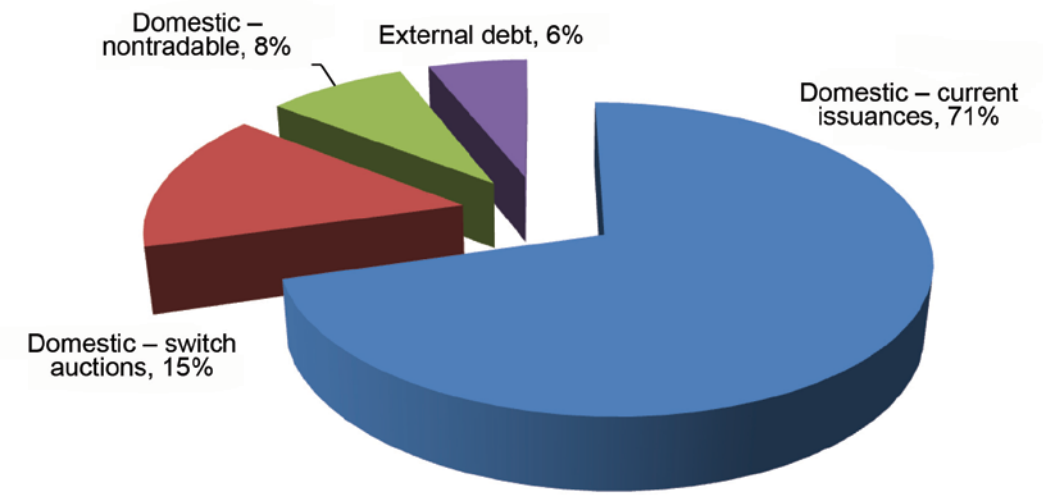
Funding in the Tradable Domestic Market

The year 2011, like its predecessor, was a year of large funding volumes, with the bulk of funding performed in the tradable domestic market. Total funding in 2011 amounted to NIS 92 billion (2010 – NIS 82.6 billion), according to the following breakdown:

- Funding in the tradable domestic market including switch auctions and noncompetitive auctions (Green Shoe) – NIS 78.5 billion
- Nontradable domestic debt funding – NIS 8.2 billion
- External-debt funding (see elaboration in this section) – NIS 5.5 billion

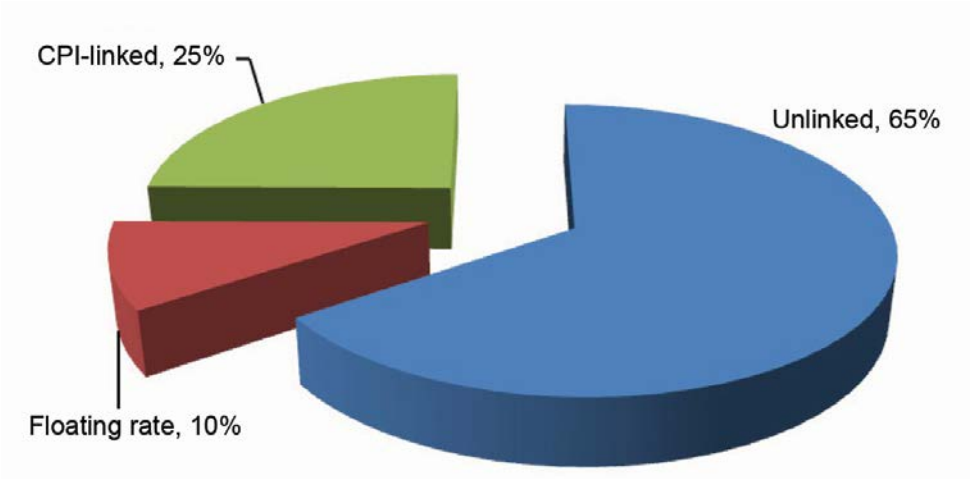
Total redemptions in the domestic market in 2011 amounted to NIS 62 billion, consisting of NIS 42.5 billion in tradable principal redemptions, NIS 13.8 billion in redemptions through switch auctions, and NIS 5.4 billion through buyback auctions. Net funding in the domestic market totaled NIS 16.5 billion in 2011.

Diagram D-1
Distribution of funding, 2011*



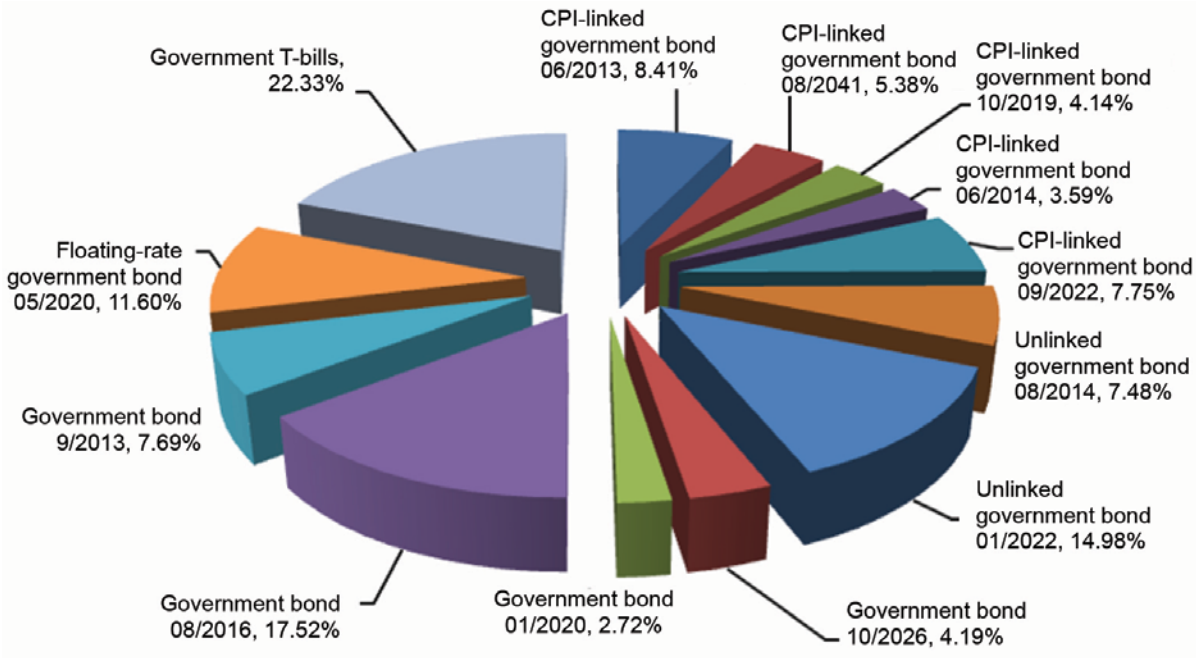
* The amount of funding includes issuances within the framework of Green Shoe allocations

Diagram D-2
Distribution of tradable funding in the domestic market by segment, 2011*



* Including Green Shoe allocations and switch auctions.

Diagram D-3
Distribution of tradable funding by bond, 2011*

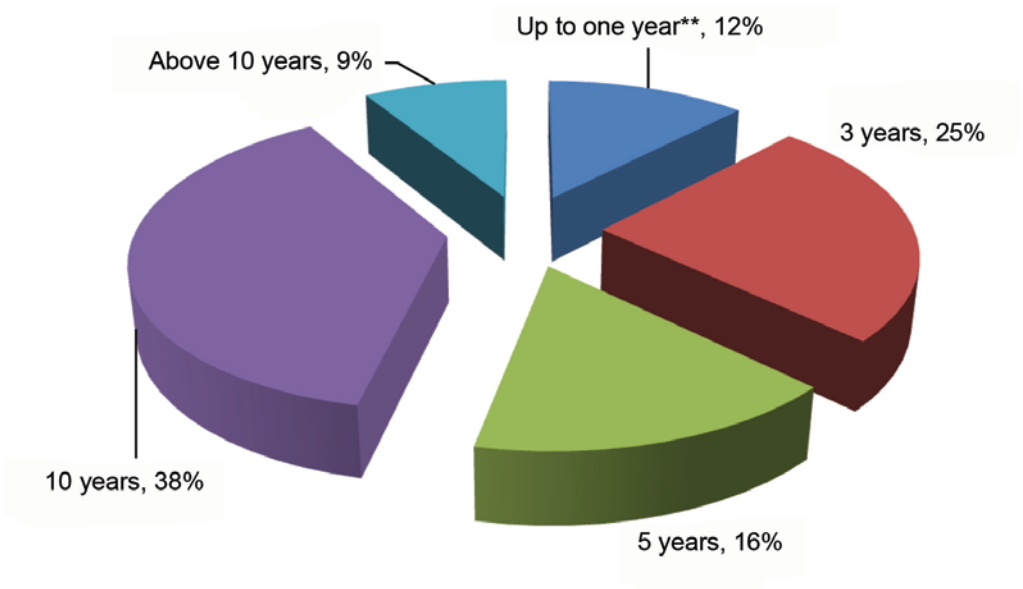


* Excluding Green Shoe allocations

Funding by the Debt Management Unit focuses on benchmark bonds with terms to maturity of 3, 5 and 10 years. Beyond this, the Unit issues bonds for terms to maturity of more than 10 years and short-term bonds (less than a year) that use for liquidity management. The Unit carries out the funding through regular auctions and switch auctions, with the issuances, apart from new bond issuances, in the form of expansions of existing series (tapping).

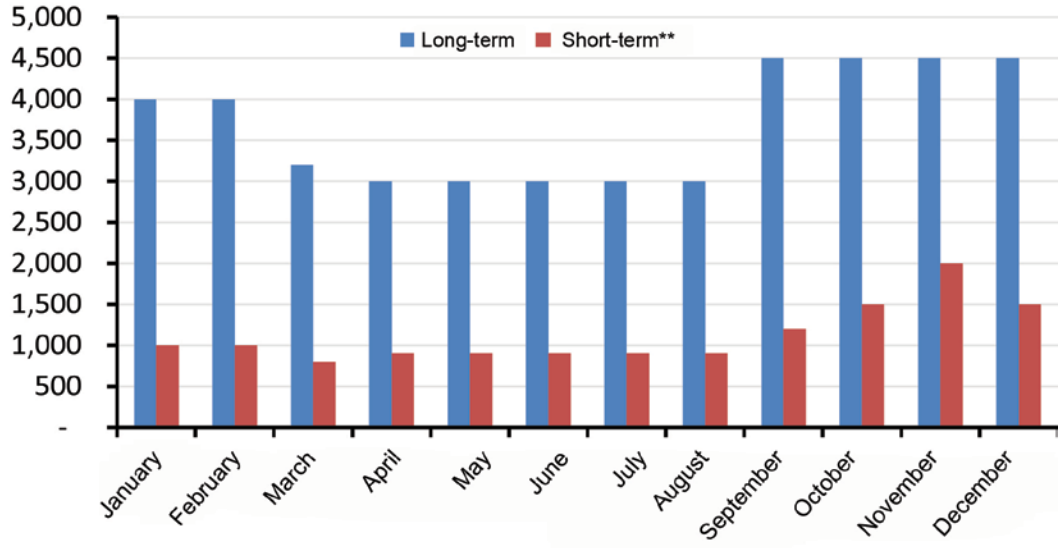
As described in Diagram D-2, the bulk of tradable domestic funding focuses on fixed-coupon unlinked bonds, and only 25% on CPI-linked bonds. This is because 48% of the government's total debt portfolio is linked to the CPI, with the entire stock of nontradable domestic debt linked to the CPI. Therefore, so as not to increase the CPI-linked debt component of the total debt stock, the Unit issues approximately 25% tradable CPI-linked debt in the domestic market, in accordance with the policy that was set in 2010, in which the Unit issued 26% CPI-linked debt. This policy is expected to continue in 2012.

Diagram D-4
Distribution of funding by term to maturity, 2011* (in percentages)



* Including Green Shoe allocations and issuances within the framework of switch auctions.
** Net issuance of short-term bonds.

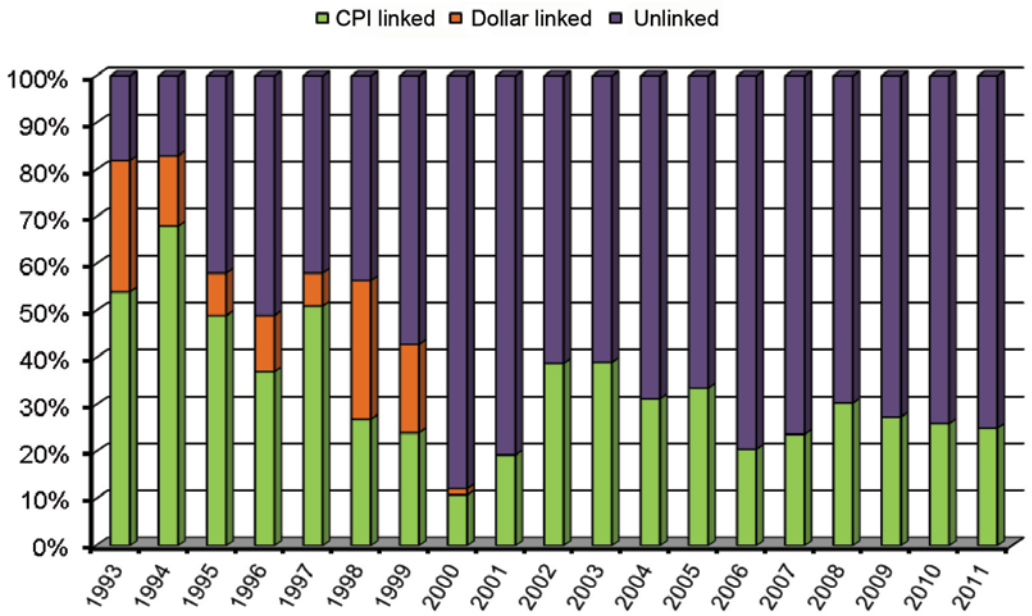
Diagram D-5
Distribution of funding of annual tradable domestic debt, 2011* (face value in NIS thousands, in percentages)



* Excluding Green Shoe allocations and switch auctions
** Less than a year

Total funding through regular auctions in 2011 stood at NIS 65 billion. The funding volume and spread over the year conformed to the monthly deficit and to the balance at hand in the Bank of Israel. In addition, the Government Debt Management Unit makes use of switch auctions that permit flexibility in the volume of funding over the year. In 2011 as well, the Unit made extensive use of short-term bonds as a tool assisting in the management of cash flow, and the Unit intends to continue to act in the short term of the curve.

Diagram D-6
Distribution of tradable domestic funding by segment, 1993-2011* (in percentages)



* Including Green Shoe allocations

Summary of Data on Tradable Bonds Issued in 2011 and Selected Bonds

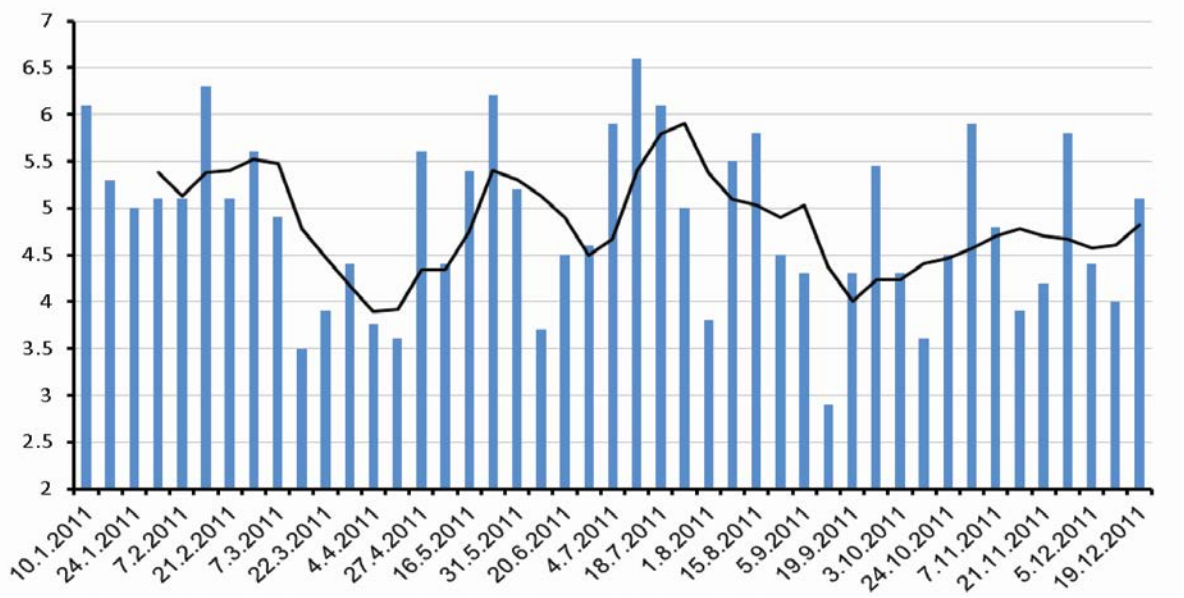
In this part we review the results of regular issuances, with emphasis on the cover ratio and general data and an international comparison with large issuers.
One of the most important parameters in an issuance is the cover ratio, which is calculated by dividing the quantity in demand by the quantity issued. The cover ratio reflects the state's strength and ability to fund its current operations, and may even indicate various economic trends, such as flight to quality. Factors that affect the cover ratio are:

1. Prices and conditions in the domestic markets.
2. Conditions in world markets.
3. The number of primary dealers involved in each issuance.
4. The quantity on offer, etc.

The year 2011, like its predecessor, was overshadowed by the European debt crisis: rating downgrades, debt settlements, assistance funds, partially closed issuances (including of strong issuers) and high volatility in the level of domestic and global yields.
This year as well, the primary market showed great robustness in the face of worldwide economic events in 2011.

The following graph describes the cover ratio of all issuances in 2011 by issuance dates. The average cover ratio of all the issuances in 2011 stood at 4.9, a very high ratio by any measure, as can be seen from the international comparison shown in Diagram D-8.

Diagram D-7
Cover ratio in issuances in 2011 by issuance dates (trend line – moving average 4)



It is apparent also from an international comparison that an average cover ratio of 4.9 is a very high ratio, indicating a good funding capacity. Obviously, as noted above, the cover ratio is derived from the character of the period. For the sake of comparison, the average cover ratio of the U.S. (ten-year bond) in 2011 stood at 3.12, compared to an average cover ratio of 2.5 in 2006, before the subprime crisis.

Diagram D-8
International comparison of the cover ratio of selected countries*

* The comparison was made for bonds with a term to maturity of ten years.

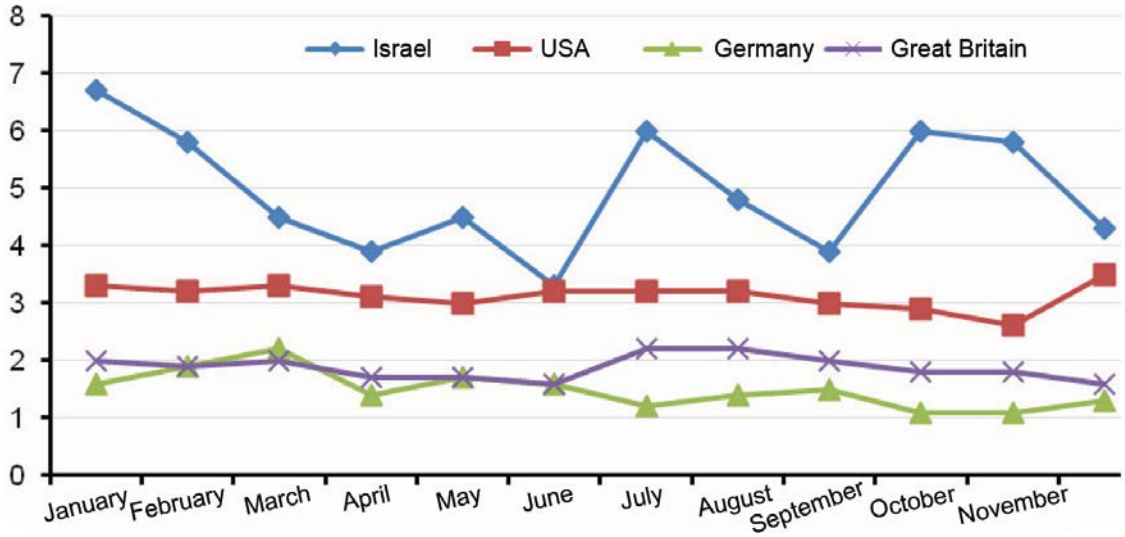


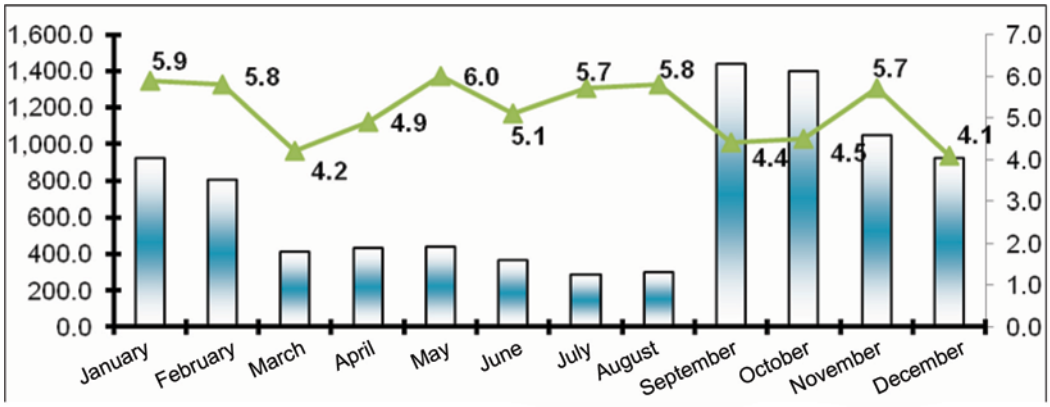
Diagram D-9

The following graphs provide information regarding quantities issued and the cover ratios of benchmark bonds issued in each of the months of the year.

Legend: Quantity issued ▬ Monthly average cover ratio ▲

Three-year unlinked government bond*

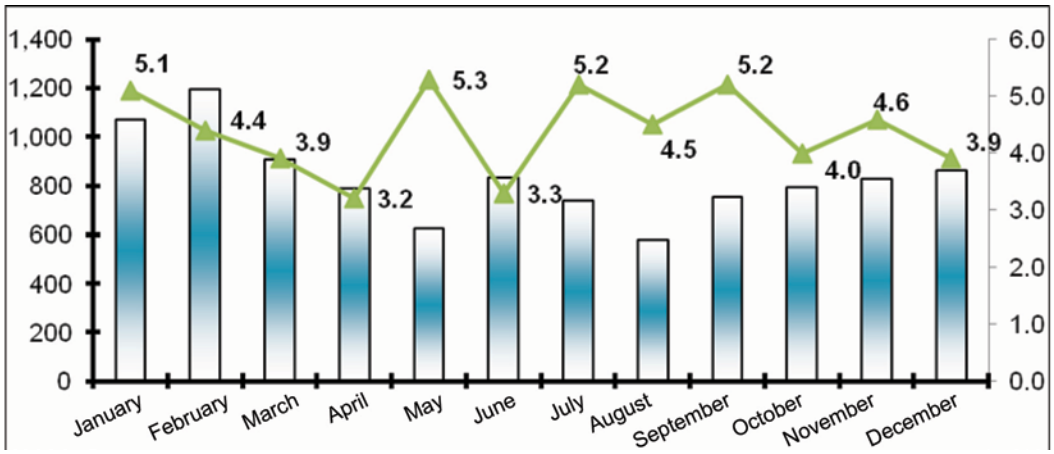
The total quantity of the 3-year unlinked bond issued in 2011 (excluding switch auctions) stood at 8.7 billion face value.



* The issued bond up to August is unlinked government bond 0913, and from September unlinked government bond 0814.

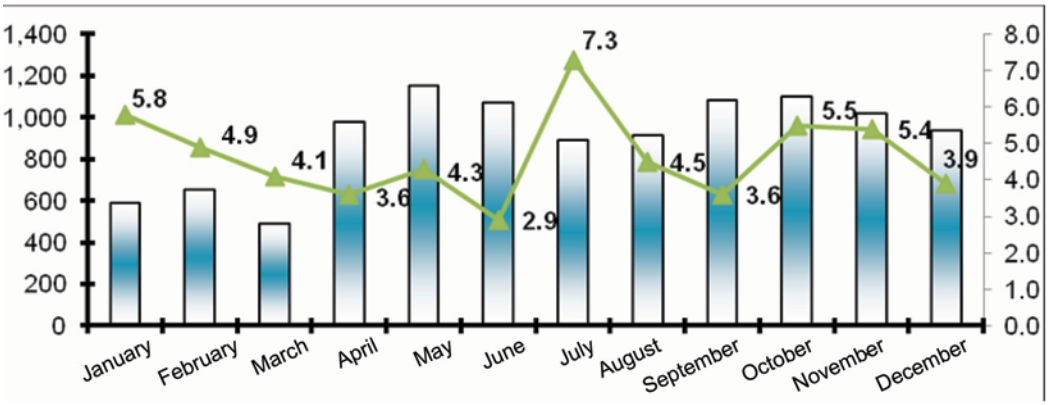
Five-year unlinked government bond*

The total quantity of the 5-year unlinked bond issued in 2011 (excluding switch auctions) stood at 9.96 billion face value.



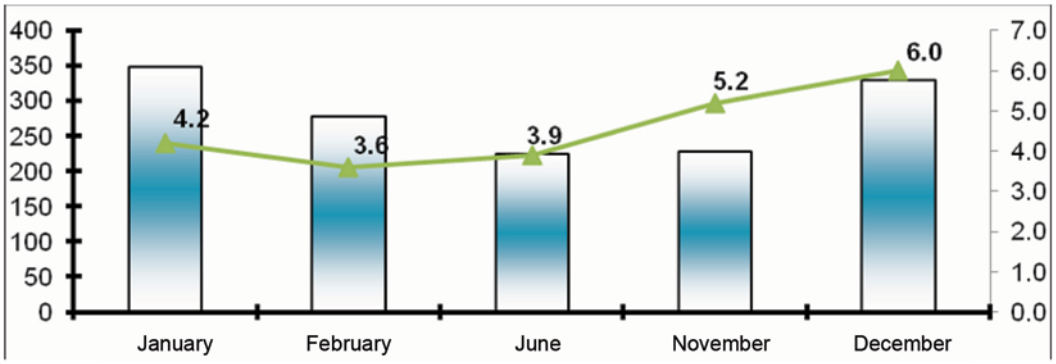
* Throughout the year the issued bond is unlinked government bond 0816.

Ten-year unlinked government bond*
The total quantity of the 10-year unlinked bond issued in 2011 (excluding switch auctions) stood at 10.9 billion face value.



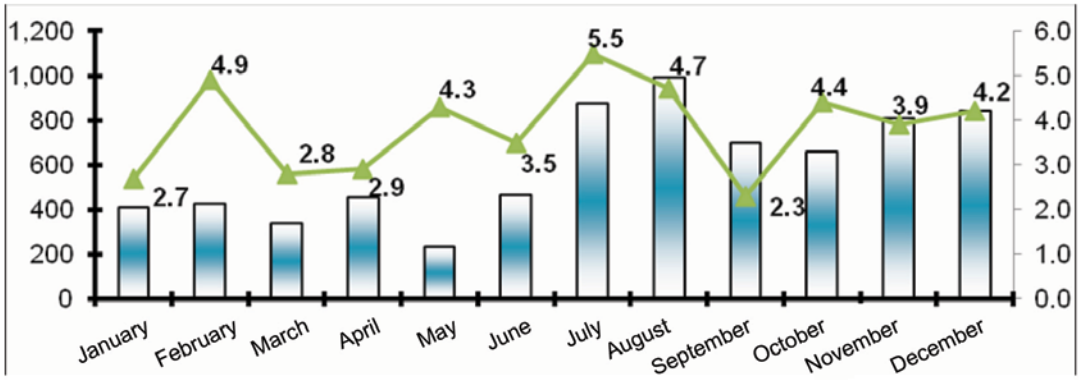
* The issued bond up to March is unlinked government bond 0120, and from April unlinked government bond 0122.

Floating-rate government bond*
The total quantity of the floating-rate bond issued in 2011 (excluding switch auctions) stood at 1.4 billion face value.



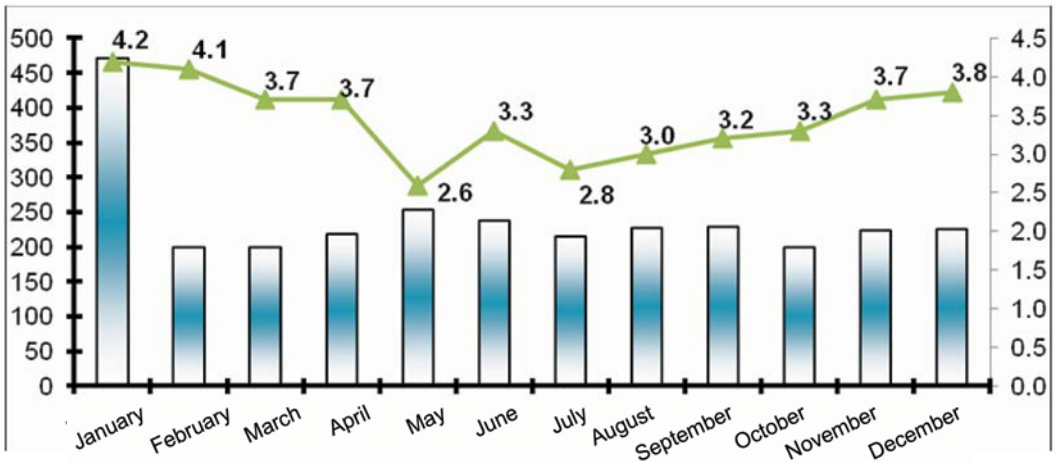
* Throughout the year the issued bond is floating-rate government bond 0520.

Ten-year CPI-linked government bond*
The total quantity of the 10-year CPI-linked bond issued in 2011 (excluding switch auctions) stood at 7.2 billion face value.



* The issued bond up to June is CPI-linked government bond 1019, and from July CPI-linked government bond 0922.

Thirty-year CPI-linked government bond*
The total quantity of the 30-year CPI-linked bond issued in 2011 (excluding switch auctions) stood at 2.9 billion face value.



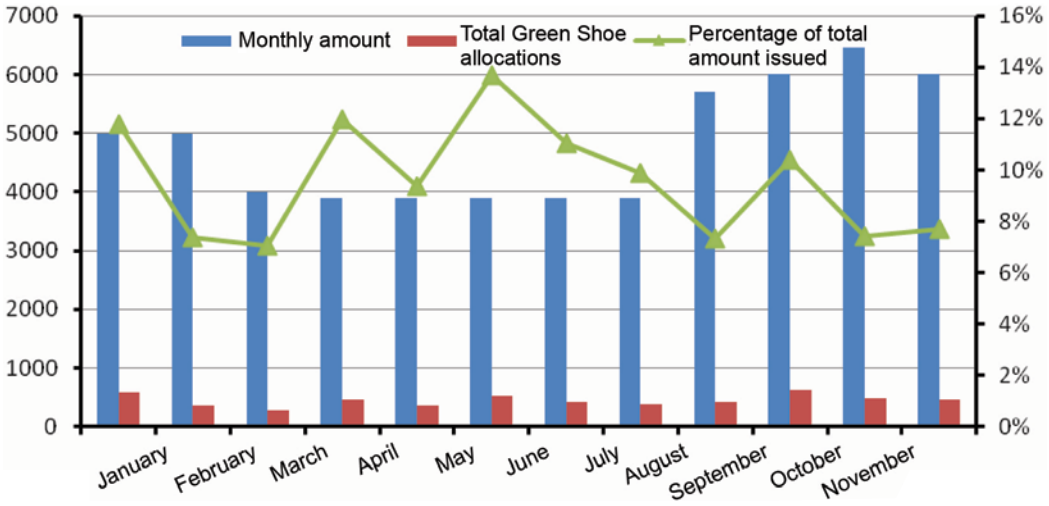
* Throughout the year the issued bond is CPI-linked government bond 08/41.

Green Shoe Allocations

Within the framework of the 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 the first places 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 2011, the total amount raised in this segment stood at NIS 5.4 billion face value, approximately 9% of the total amount issued through normal auctions (excluding switch auctions).

Diagram D-10
Purchases in Green Shoe allocation auctions as percentage of monthly amount issued



The most important factor for purchase/non-purchase in Green Shoe allocation auctions is the market prices of the relevant bonds, near 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

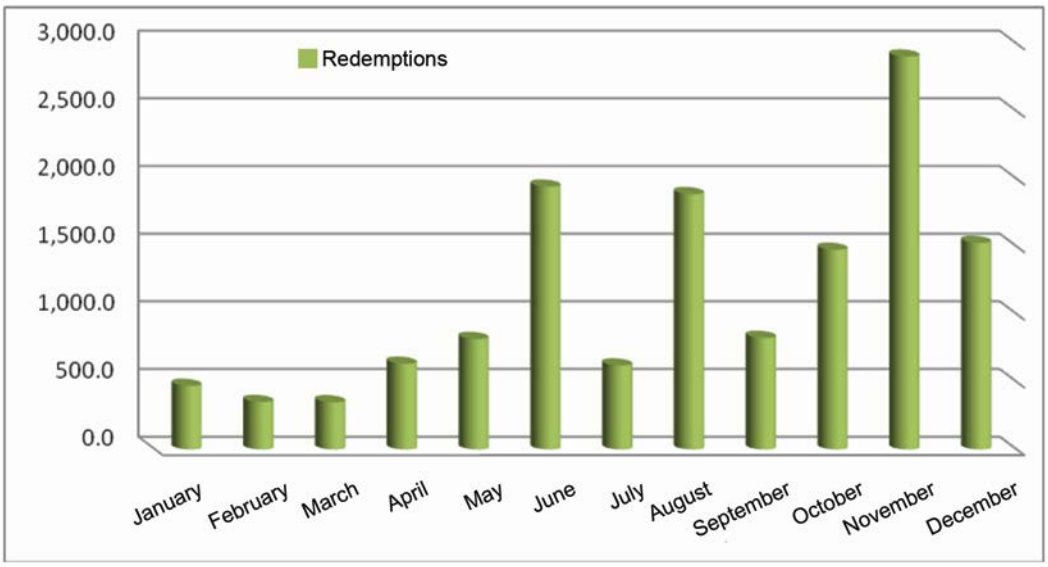
In 2011, the Government Debt Management Unit continued funding through switch auctions. Within the framework of these auctions, a total of NIS 13.8 billion was issued versus an amount of NIS 4.6 billion in 2010.

The main objectives of the switch auctions are:

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

In addition, this year a new switch auction of a different type was added – switch auctions of government bonds with a low outstanding amount. Unlike the auctions carried out by the Unit until today, and their objectives as described above, the objective of this type of switch auction is to improve the level of service to capital market players, in general, and to institutional entities, in particular. In these auctions, government bonds with a longer term to maturity, which are characterized by small volumes and a low outstanding amount, were exchanged for more tradable bonds with a higher outstanding amount. The auctions were carried out with Galil bonds.

Diagram D-11
Distribution of redemptions through switch auctions by month of payment (NIS millions)



* Including Green Shoe allocations

Buyback Auctions

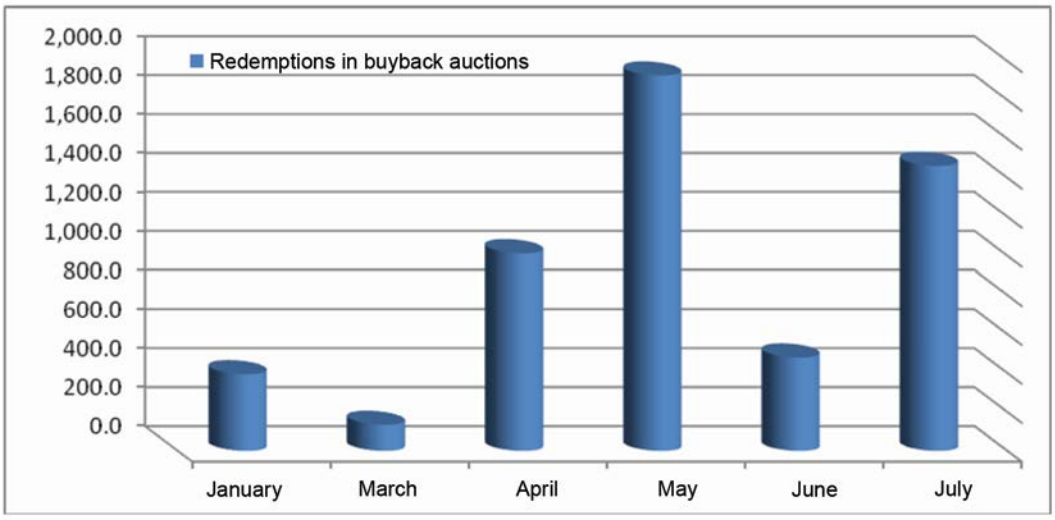
With effect from October 2008, the Debt Management Unit began making use of buyback auctions in order to perform early redemption of tradable government bonds. Within the framework of these auctions, the Unit transfers a monetary payment against the bonds being redeemed. This is different from the mechanism 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 cash flows by means of:

1. Mitigating debt rollover risk
2. Saving interest expenses

In 2011, total early purchases through buyback auctions amounted to NIS 5.4 billion.

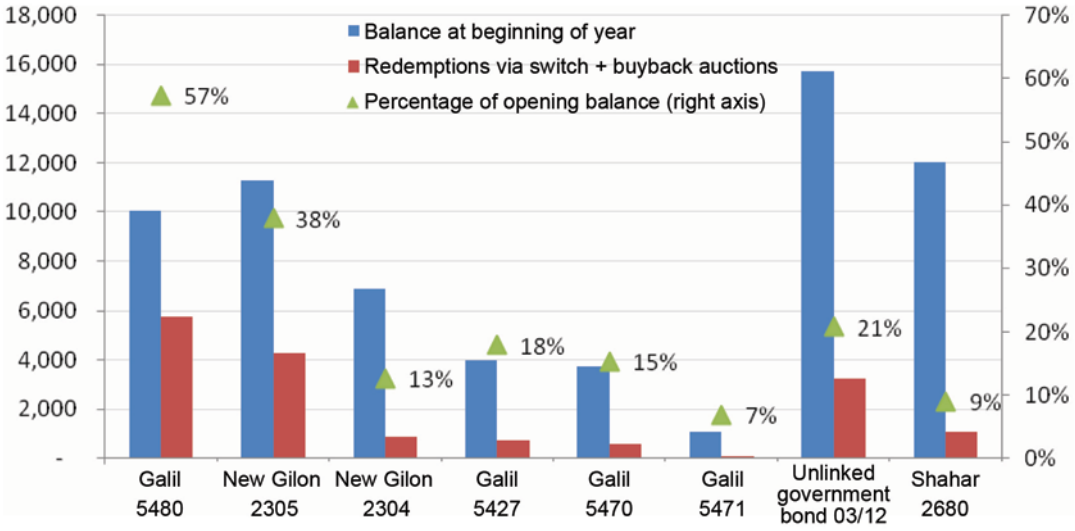
Diagram D-12
Distribution of redemptions through buyback auctions by month of payment (NIS millions)*



* Including Green Shoe allocations

The following diagram shows the balances of bonds purchased in switch auctions and buyback auctions compared to the balances at the beginning of the year, indicating the rate of reduction of the series via those auctions.

Diagram D-13
Reduction of series through switch auctions and buyback auctions at bond level, 2011 (NIS millions, percentages)



Funding in the Nontradable Domestic Market

Nontradable domestic funding totaled NIS 8.2 billion in 2011. This funding was carried out through the following instruments: designated bonds for pension funds ("Arad"), designated bonds for insurance companies ("Chetz"), and emissions managed by the Ministry of Finance and compulsory loans managed by the Bank of Israel.

This year, designated Arad bonds in the amount of NIS 4.3 billion were issued for pension funds. Due to the continuing implementation of the reform in pension funds, no designated Miron bonds were issued at all in 2011.

In the coming year, mainly new pension funds, with high growth rates and relatively low rates of designated bonds, are expected to purchase designated Arad bonds. This is due to the continuation of the reform in pension funds, which set a limit of 30% on the proportion of designated bonds in the asset portfolio of each pension fund. The proportion of designated bonds in the portfolios of the veteran pension funds is higher than this, and therefore their volume of purchases is negligible. In the coming years (the date cannot be predicted), the veteran pension funds are expected to resume buying designated bonds, because the trajectory of redemptions will bring the volume of designated bonds to a level of 30% of their assets, a volume that will entitle them to turn to the government and purchase Arad bonds. Total net funding in 2011 in designated bonds for pension funds was negative, in the amount of NIS 5.4 billion.

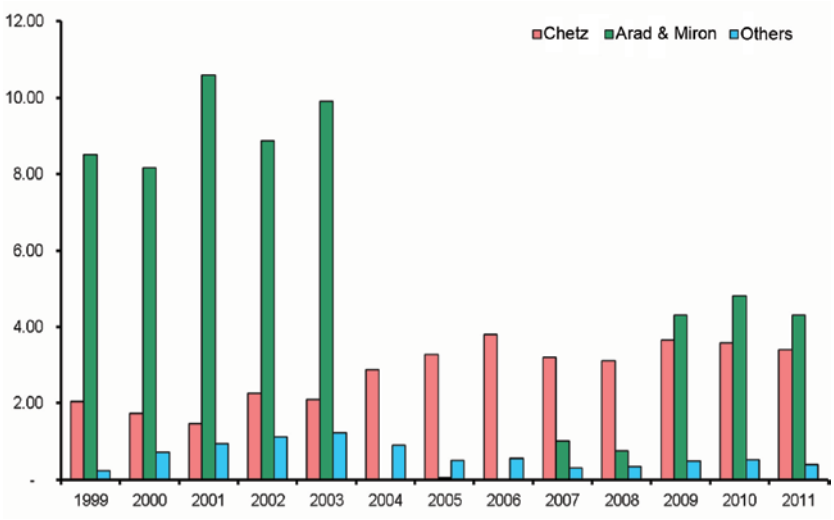
The amount of issuances of CPI-linked Chetz bonds for insurance companies remained almost without change and stood at NIS 3.4 billion, similar to the previous year. Total net funding in designated bonds for insurance companies stood at NIS 1.3 billion in 2011.

Funding through emissions managed by the Accountant General Division amounted to NIS 409 million. Total net funding in this segment was negative in the amount of NIS 301million.

Diagram D-14
Funding and redemptions in nontradable debt, 2011

Funding segment	Principal funding		Principal redemptions		Net funding
	NIS millions	% of total	NIS millions	% of total	NIS millions
Arad & Miron	4348	54	9793	75	-5,445
Chetz	3396	40	2100	19	1,296
Others	409	6	710	6	-301
Total	8153	100	12603	100	-4,450

Diagram D-15
Composition of nontradable funding, 1999-2011 (NIS billions)



Funding in Foreign Currency

Tradable Sovereign Benchmark Issuances

Policy established by the Government Debt Management Unit stipulates that the government will carry out a sovereign public issuance at least once in every year, one year in the global market (U.S.) and the following year in the euro market (Europe). The issuance of debt in foreign currency in the international markets serves several strategic goals:

- The creation of a benchmark for funding overseas for the business sector
- The solidification of an additional funding source to finance the government deficit
- Expansion of Israel's investor base

Despite the original plan to carry out an issuance in the global market in 2011, no sovereign public issuance in foreign currency was carried out in that year, due to the ongoing global crisis, which caused great volatility in the international bond markets and instability in the global markets. The stock of sovereign bonds in foreign currency stands as of December 2011 at NIS 30.7 billion, constituting 28% of the foreign-currency debt (NIS 111.4 billion).

In January 2012 the Unit carried out a sovereign issuance in the amount of USD 1.5 billion for a term of ten years. The issuance was characterized by high demands of USD 6 billion, attesting to investors' great interest in the bond. In addition, the cost of funding stood at 4.1% - the lowest ever paid by the State of Israel in a dollar-denominated issue in the global markets.

Public Issuances Backed by U.S. Government Guarantees

In April 2003, the U.S. Congress approved a grant of guarantees to the Israeli government for the purpose of funding abroad, in the amount of USD 9 billion face value, for three years. Bonds issued by the Israeli government and backed by U.S. government guarantees enjoy a credit rating similar to that of the U.S. government; in fact, the bonds are sold at a yield that is only slightly higher than the yield of U.S. government bonds.

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

Israel issued bonds with a face value of USD 4.1 billion through the guarantees program in 2003-2004 (years of substantial deficits in the country's budget). The Israeli government has not used the guarantees program since November 2004. At the end of 2011, the unutilized balance within the framework of the program amounted to USD 3.8 billion.

The U.S. guarantees program serves the Israeli government as a financing "safety cushion," and there is no intention of using it other than in the case of real financing need. The preservation of the guarantees rather than the use thereof is a strategic goal of the debt management, since it has a positive effect on the State of Israel's access to the international markets.

No bonds were issued under this program in 2011. The stock of bonds backed by U.S. government guarantees was NIS 46 billion as of December 2011 and it constitutes 41% of the foreign-currency debt (NIS 111 billion).

Private Placement

The State of Israel carried out two private placements to Asian investors in 2011, as part of the work program of the Accountant General Division for 2011.

In March 2011 a private placement was carried out to two Thai institutional investors in the amount of USD 124 million (NIS 472 million) for a term of one year at a fixed interest rate of 1.57%. In addition to the issuance of the bond itself, the placement included a swap transaction through which the government converted the obligation from foreign currency to NIS at a fixed shekel interest rate. Following the performance of the swap transaction, the cost of funding in the private placement was 0.56% lower than the return on the unlinked government bond for the corresponding period.

In addition, in July 2011 the State of Israel carried out another large private placement in the amount of USD 400 million (NIS 1,524 million) to a large strategic Asian institutional investor. The placement was made for a period of one year at a fixed coupon of 1.59%. The cost of funding in this placement was 0.3% lower than the T-bill yield for the corresponding period. The two placements were performed as part of the Israeli government's EMTN shelf program.

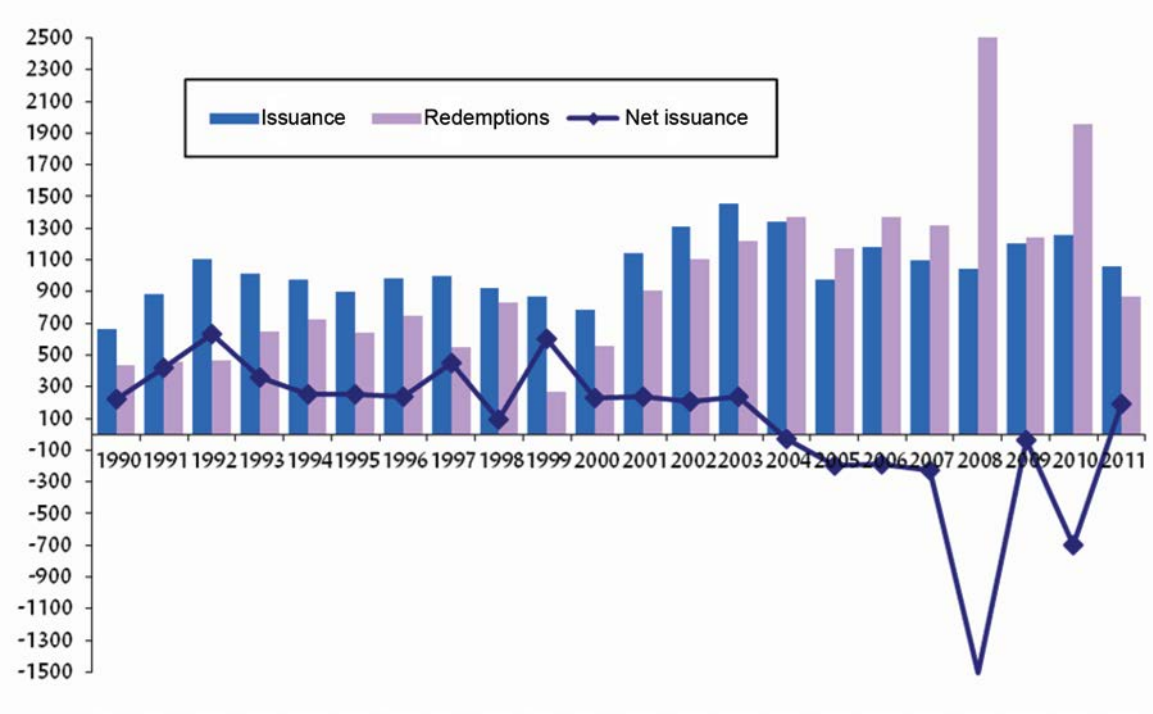
These private placements contributed to a significant decrease in funding costs and to a reduction of interest payments in the budget, without increasing the exposure of government debt to exchange-rate risk. Private placements enable the government to moderate funding in the domestic market and demonstrate the financing flexibility and the possibilities available to the government for its funding needs.

The Israel Bonds Organization

In 2011, the Israel Bonds Organization raised USD 1.06 billion. This amount is 6% higher than the annual funding target of USD 1 billion and represents a decrease of 15% in the Organization's sales relative to 2010, in which the volume of sales stood at USD 1,255 billion. Total net funding through the Israel Bonds Organization in 2011 stood at USD 188.9 million.

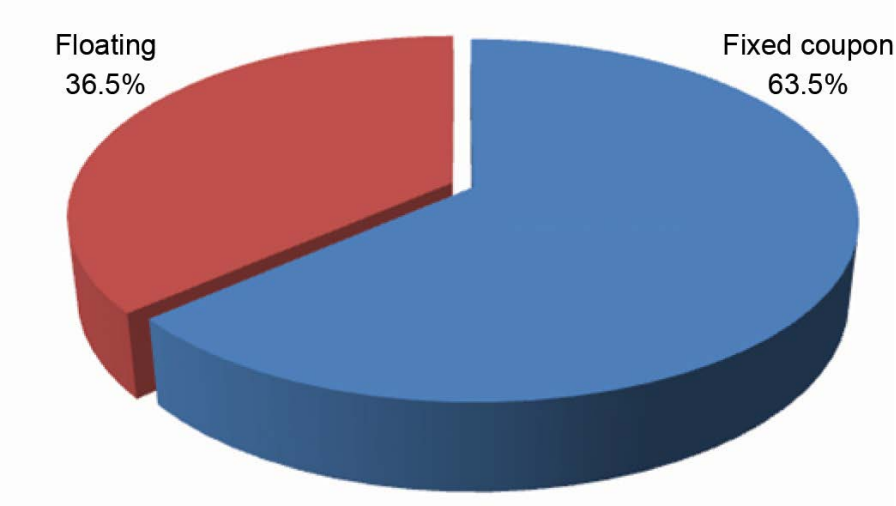
The stock of bonds issued under the Israel Bonds Organization stands, as of December 2011, at NIS 27.85 billion and constitutes 25% of the foreign-currency debt (NIS 111.4 billion).

Diagram D-16
Issuance and redemption volumes of the Israel Bonds Organization, 1990-2011 (in USD thousands)



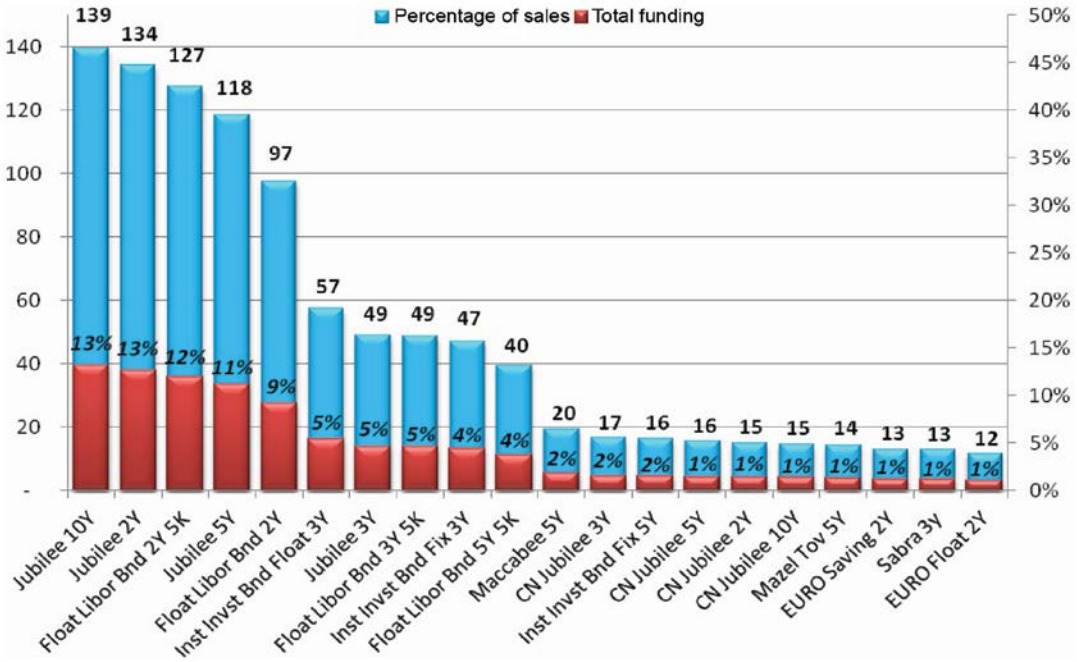
In 2011, 64% of the Organization's funding was raised using fixed-coupon instruments, while the remainder was issued at floating rates. One can see that the fixed-coupon component has decreased compared to 2009 and 2010, when fix-coupon instruments accounted for 75% and 70%, respectively, of the Organization's funding, while the remainder were floating-rate instruments.

Diagram D-17
Distribution of Israel Bonds Organization funding by interest type, 2011



Funding instruments – The significant sales in 2011 were of Jubilee bonds for ten years (13%), for two years (13%), for five years (11%) and for three years (5%). The Jubilee series accounts for 42% of total sales (compared to 46.7% in 2010). Sales of the Float Libor Bond 5K series (minimum purchase USD 5,000) for two, three and five years account for 21% of total funding in 2011, while the two-year Float Libor Bond accounts for 9% of the total funding.

Diagram D-18
Distribution of Israel Bonds Organization sales by funding instrument, 2011



Funding Costs

In the course of 2011, there was a clear decrease in the base interest rates in relation to which the funding interest of the Israel Bonds Organization was determined. Owing to a general decline in global interest rates, and in order to meet the funding target of USD 1 billion set for 2011, it was necessary to increase the spreads for the different funding instruments.

One can see in Diagram D-15, which describes the development of the spreads in funding instruments from the benchmark Jubilee series for 2, 3, 5 and 10 years, that the spreads were increased in three main stages during the year: in the course of April, at the beginning of September and at the end of November.

Diagrams D-13 and D-14 show that despite the increase in the spreads, the bond yields remained at a similar level throughout the year, the yield on the 10-year Jubilee bond decreasing by 50 basis points and on the 5-year Jubilee bond by 30 basis points at the end of 2011 compared to the beginning of the year, while the yields on 3- and 2-year Jubilee bonds increased by 20 basis points and 45 basis points, respectively.

Costs of Israel Bonds Organization Funding – Yield on the Bonds Relative to the Benchmark (%)

Diagram D-19
Yield on 3- and 10-year Jubilee bonds

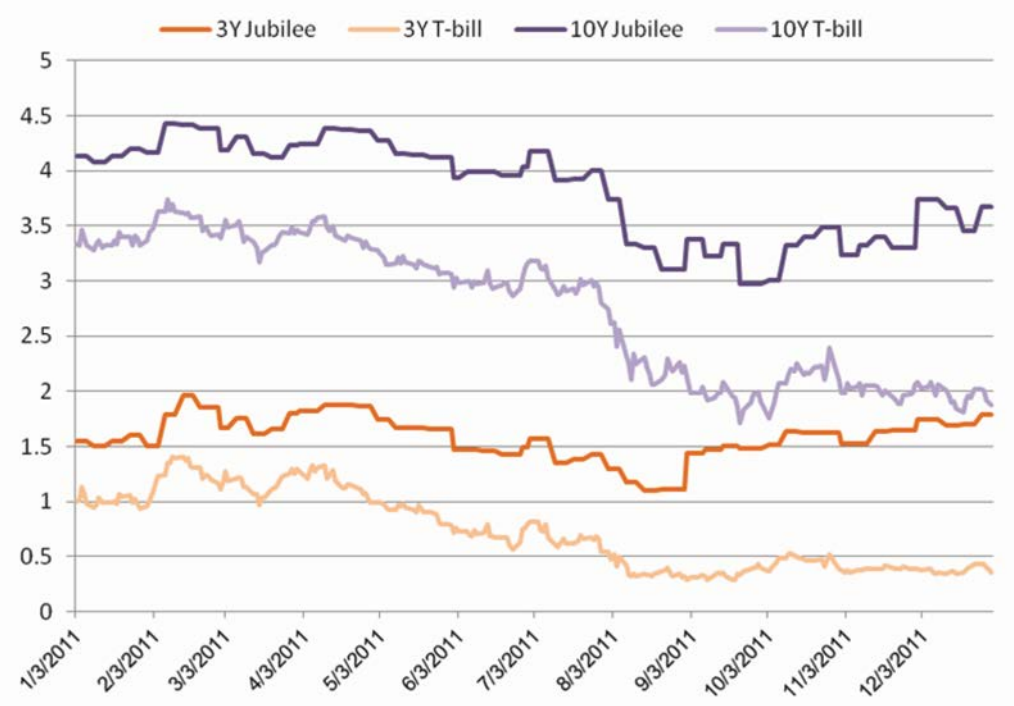


Diagram D-20
Yield on 2- and 5-year Jubilee bonds

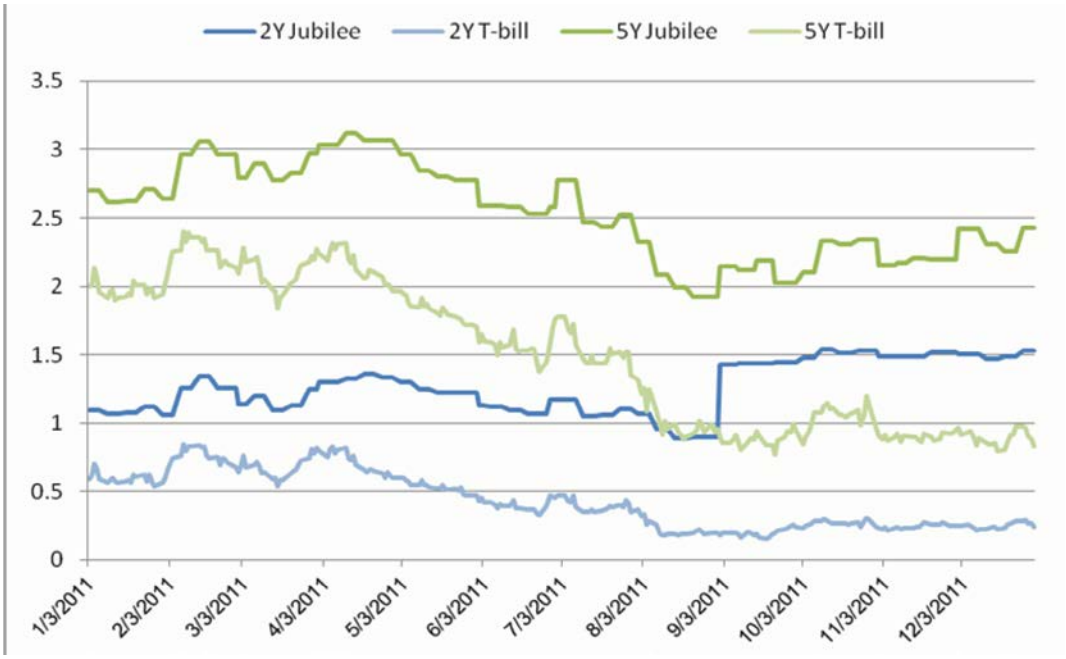


Diagram D-21
Development of spreads of Israel Bonds Organization 2-, 3-, 5- and 10-year Jubilee bond, 2011 (in basis points)

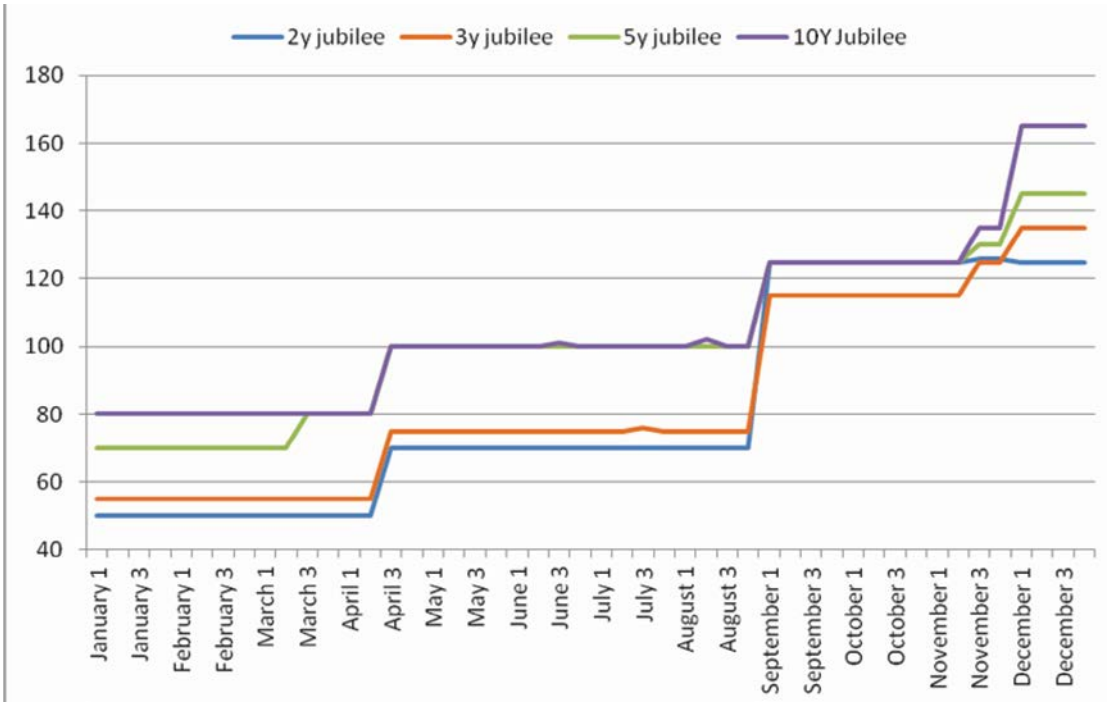
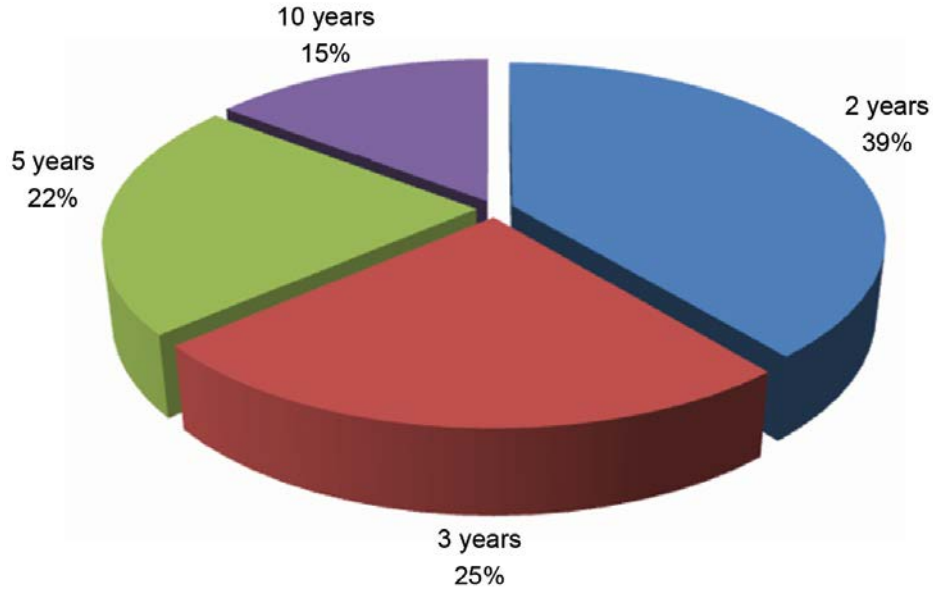


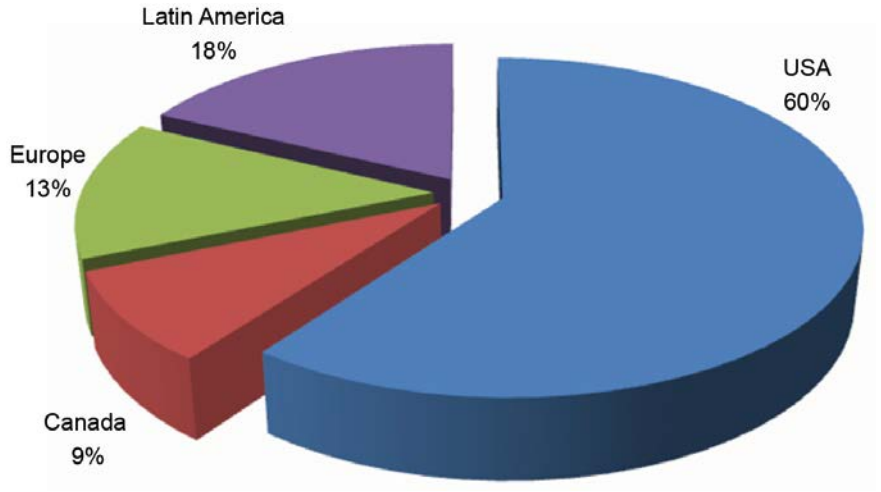
Diagram D-22
Distribution of Israel Bonds Organization sales by funding terms, 2011



Geographic Distribution

Sales in the United States continued to be dominant in 2011, standing at 60% (compared to 50% in 2010). Sales in Europe declined slightly in relation to 2010 (approximately 15%), standing at 13%. In Latin America there was a decline in the percentage of sales from total funding, due to the increase in sales in the United States, with 18% of bonds sold there compared to 25% in 2010. Sales in Canada accounted for 9% of total sales, compared to 8% in the previous year.

Diagram D-23
Geographic distribution of Israel Bonds Organization sales, 2011



The State of Israel's Credit Rating

General

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

In the process of determining a country'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 countries with similar ratings – 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 countries in Israel's peer group are Chile and South Korea.

Significant changes have taken place in the credit rating of countries since the fall 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 reaction of the rating agencies was not long in coming, and they embarked on an extensive lowering of ratings, lowering the rating of many countries such as Iceland, Ireland, Japan, Portugal, Greece and other countries, most of which had in common a financing system that was severely hit in the credit crisis and increasing government deficits and debts. The year 2011 was characterized by political and economic instability in Europe and, accordingly, by numerous and sharp rating cuts. The European debt crisis worsened in the course of the year, up to an almost total loss of market faith in the Euro-zone 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+ following disagreement over the debt ceiling established in law and over the cutbacks required for reducing the government's debt. At the end of 2011, it can be said that Israel is in better condition than Western European countries such as Italy and Portugal.

In the past, governments' credit ratings also served as a "ceiling" for the credit rating of domestic companies; 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 Credit Rating of the State of Israel in 2011

In 2011, three rating agencies published a full report on the Israeli economy. Whereas Moody's and Fitch left Israel's credit rating intact – Moody's at A1 stable and Fitch at A stable – S&P raised the rating of the State of Israel, for the first time since 2007, to A+ with stable outlook. In the three reports published by the agencies on the Israeli economy, they praised the economic policy, the handling of the global crisis, the budgetary restraint led by the Ministry of Finance, and the fact that the Israeli government entered the global crisis in a good starting condition and exited it relatively quickly. In addition, the rating agencies were positively impressed by the remarkable growth of the economy in recent years and the fact that domestic debt increased very moderately during the crisis as compared to many countries worldwide. However, despite the relatively moderate increase in government debt in 2009 and the decrease in the debt-to-GDP ratio recorded in 2010 and 2011, the volume of the debt remains a weak point, as it is still high compared to other countries in the peer group.

Highlights of the three agencies' announcements in 2011

Standard & Poor's:

On September 9, 2011, Standard & Poor's announced that it was raising the credit rating of the State of Israel to A+ with stable outlook. In its announcement, the agency noted favorably Israel's strong growth in recent years, the state of its external accounts and the fact that Israel is a net lender to the world. The agency also notes favorably the responsible fiscal policy that supports a reduction in the debt-to-GDP ratio and the natural gas discoveries which are expected to bolster these favorable trends. In the agency's opinion, the social protest in Israel is not expected to affect the continued lowering of the public debt.

According to the agency, the increase in the rating reflects the improved flexibility of Israel's economic policy due to strong growth and a responsible and cautious macroeconomic policy. The agency notes the fact that the Israeli economy has weathered the global crisis and is on a viable course to further reducing the debt burden and improving the country's external accounts. In the agency's opinion, the expected gas production starting from the middle of the decade will increase the country's economic efficiency and strengthen its fiscal position.

The agency's decision is also supported by the fact that the Israeli economy is stable and flourishing and, has strong institutions and proven, ongoing fiscal discipline. The broad political agreement on the need for budgetary restraint and fiscal discipline has also helped to reduce the government debt from its high historical levels to 75% of the GDP at the end of 2010. S&P believes that the social protest will not affect the responsible economic policy for reducing the debt-to-GDP ratio and maintaining continued budgetary discipline.

Despite of the increase in housing prices, S&P sees no threat to the financial system and notes favorably the close supervision and relatively conservative management of Israeli banks. S&P notes that the geopolitical risk continues to overshadow Israel's economic ranking, but this risk is partly countered by the support of the US government.

Moody's

On April 28, 2011, Moody's published its annual report on the State of Israel, leaving the rating at A+ with stable outlook. The .long-term foreign currency rating ceiling remained at Aa1. The main points noted by the analysts are as follows:

Israel's A1 rating is supported by the strength of its economy, institutions and finances. In other cases, these assessments would confer on the country an Aa rating, however, according to Moody's, Israel's rating reflects the geopolitical risks facing the country.

The Israeli economy is flexible and dynamic, with a clear and consistent macroeconomic policy. Following the relaxation in the fiscal and monetary policy introduced in the course of the global crisis with the aim of supporting economic activity and preventing a recession, the Bank of Israel quickly withdrew the monetary incentives in order to ensure a sustained recovery and prevent inflationary pressures. The high-tech-export-oriented economic model supports positive growth forecasts in the medium term. The new amendment to the Bank of Israel Law and the additional restrictions on expenditures and on the level of the deficit have strengthened the already strong institutions. The deterioration in the government's debt indices was relatively limited during the global crisis, with the debt-to-GDP ratio reaching a lower level at the end of 2010 than before the crisis.

Nevertheless, the recent political unrest in the Middle East underscores the geopolitical risks in the region. In summary, while the economic and financial risks inherent in the Israeli economy are low, the geopolitical risk, particularly the security situation, is more serious and significantly affects the country's credit rating.

Fitch

On May 27, 2011, Fitch confirmed the credit rating at A with stable outlook. The State of Israel's credit-rating ceiling remained at AA-. The main points of the agency's announcements are:

The confirmation of the rating reflects the return of the government deficit and the debt-to-GDP ratio to a downward course, high growth forecasts and strengthening of the country's external accounts. These positive trends moderate the concerns over the heating up of the housing market and the difficult geopolitical environment.

The agency added that the improvement in the fiscal position reflected an increase in the State's revenues deriving mainly from the growth in the GDP as well as in control on the expenditure side, attributable to the new fiscal rule and to the renewed tightening of fiscal policy, following a degree of relaxation that was required to cope with the global crisis. All this was ultimately reflected in a decrease in the deficit to 3.8% of the GDP in 2010, compared to 5.2% of the GDP in 2009, and in a decrease in the debt-to-GDP ratio of the extended government to 76.6% in 2010 from 79.3% in 2009.

Despite the decline in the debt-to-GDP ratio to below its level immediately before the outbreak of the economic crisis (77.3% in 2008), this ratio is still considered high in the "A" rating group. In this connection, the agency's analysts are encouraged by the fact that the State of Israel has adopted a fiscal rule that defines a target debt-to-GDP ratio of 60%, as well as the fact that the State of Israel has a proven history of coping with upheavals and a impeccable record of debt repayment. They are also encouraged by the fact that in the long term, the Israeli economy will be positively impacted by the significant natural gas discoveries as well as the fact that the liability for budgetary pensions in the State of Israel is lower than in other OECD countries. Nevertheless, according to Fitch, in order to upgrade its rating the State of Israel must continue to reduce the debt-to-GDP ratio, which will of course entail fiscal discipline and high growth rates.

Further on in its announcement, Fitch also relates to the high added value of the high-tech industry for the Israeli economy and to the flexibility demonstrated by the industry during the economic crisis. This flexibility helped the high-tech industry come out of the crisis in a relatively good condition and to maintain high growth rates. The agency's analysts also attribute the high growth rates to the Bank of Israel's aggressive interest rate policy during the crisis and to the foreign currency purchases made by the bank to help maintain exchange rate levels. In addition, Fitch mentions the "heating up" of the housing market, but notes that the steps that are being taken by the Bank of Israel and the Ministry of Finance on both the demand and supply side are beginning to make their mark.

Fitch's analysts also related to the recent unrest in the Middle East and the geopolitical risks inherent in it, noting that the State of Israel's rating will continue to be restricted in light of the geopolitical situation. The agency's analysts also referred to the revolution in Egypt and expressed the concern that additional revolutions in the region could cause an increase in the security costs of the State of Israel. The analysts stressed that because of Israel's special geopolitical situation, it must maintain a lower debt-to-GDP ratio than its peer countries.

Table D-5
Israel's Credit Rating by the three rating agencies

Rating Agency	Term	Domestic Bonds	Forecast	Foreign Bonds	Last Rating Change
		Rating		Rating	
Moody's	Long-term	A1	Stable	A1	The rating outlook was upgraded in April 2008 to "Stable
	Short-term	-		P-1	
Standard & Poor's	Long-term	AA-	Stable	A+	The rating outlook was upgraded in September 2011 to "Stable
	Short-term	A-1+		A-1	
Fitch	Long-term	A+	Stable	A	The rating outlook was upgraded in February 2008 to "Stable
	Short-term	1F		F1	

Section E – The Secondary Market

The economic crisis affecting the global economy since 2008 persisted in 2011, which was characterized by a continuation of the low interest rate environment in most markets and by debt problems in many economies throughout the world. Data from the bond market indicate a return to the trading-volume levels prevailing since the introduction of the primary dealer reform in 2006, with the exception of 2010, in which trading turnovers declined. In 2011, government bonds generated a higher return than stocks, which recorded negative returns. During the past year, primary dealership began in inflation-linked government bonds, in addition to primary dealership in nominal fixed-coupon government bonds. Trade in government bonds is carried on simultaneously in several trade arenas: the Tel Aviv Stock Exchange (TASE), MTS (a platform on which only primary dealers in government bonds operate) and over-the-counter trade.

Trading Turnovers in Government Bonds

Trading turnovers in 2011 rose to NIS 3,230 million compared to NIS 2,550 million in 2010. The increase is explained by the higher returns generated by government bonds compared to the less solid channels; for example, the turnover of trading in stocks fell by 15% in 2011 compared to 2010. In addition, trading turnovers grew in all government bond trading arenas, average daily trading turnovers on the MTS platform rose from NIS 290 million to NIS 530 million, and the share of trading on the MTS platform out of all trading platforms increased.

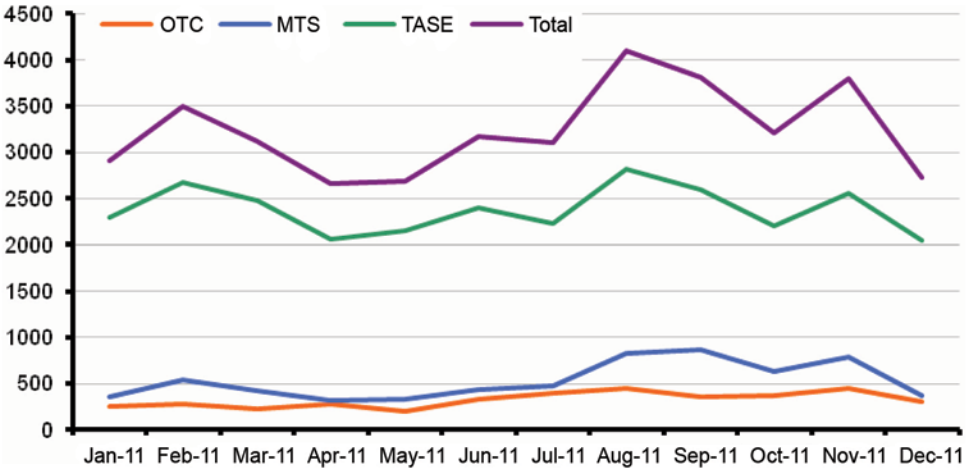
Breakdown of trading turnovers by trading platform:

TASE – 73.5% of trading (2010 – 81%)

MTS – 16.5% of trading (2010 – 11%)

OTC – 10% of trading (2010 – 8%)

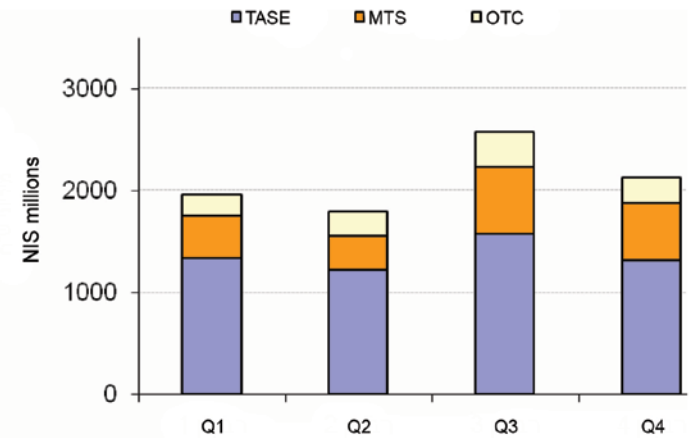
Diagram E-1
Average daily trading turnover of government bonds in NIS millions



Nominal Fixed-Coupon Bonds

Primary dealership in government bonds began in September 2006 and was carried on until December 2010 only in the unlinked segment. MTS is a trading platform that is used only by primary dealers in Israeli government bonds of the State of Israel.
Ratio between the different trading platforms:
TASE – 65% of trading (2010 – 71%)
MTS – 23% of trading (2010 – 20%)
OTC – 12% of trading (2010 – 9%)

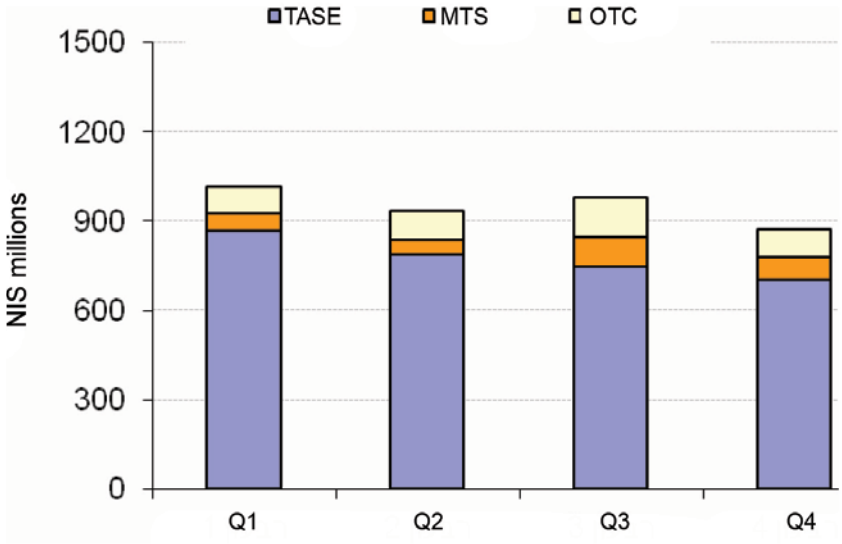
Diagram E-2:
Average daily trading turnover in nominal fixed-coupon bonds (NIS millions)



CPI-Linked Bonds

In January 2011 primary dealership began in CPI-linked government bonds, after primary dealers had begun quoting voluntarily in the linked segment in the last quarter of 2010. As of the end of 2010, all primary dealers are required to quote three bonds daily on the MTS platform: ILCPI 0.5% 06/2013, ILCPI 1.5% 06/2014 and ILCPI 3%10/2019.
Ratio between the different trading platforms:
TASE – 82% of trading (2010 – 87%)
MTS – 7% of trading (2010 – 5%)
OTC – 11% of trading (2010 – 8%)

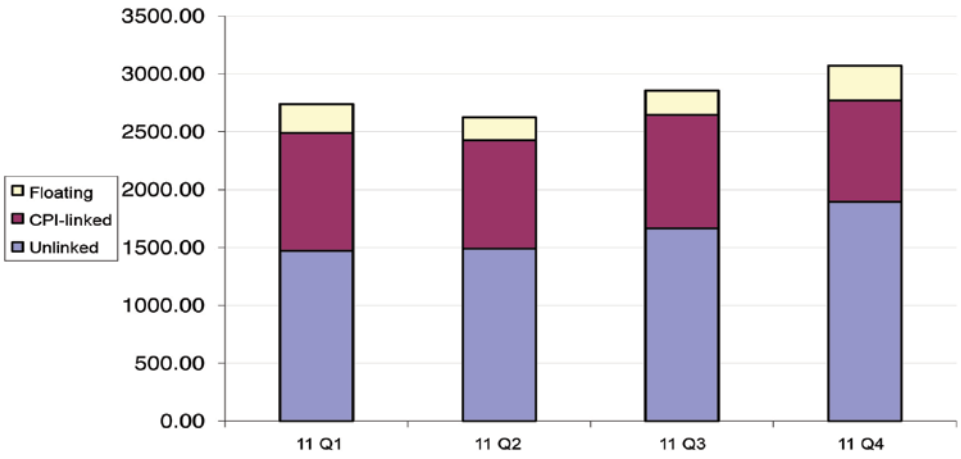
Diagram E-3
Average daily trading turnover in CPI-linked bonds (NIS millions)



Trade Breakdown by Segment

In 2011, as in the previous year, most of the trading in government bonds was in the unlinked segment. Nevertheless, an increase is apparent in the share of the linked segment at the expense of the unlinked segment. This can be explained by the start of primary dealership in the linked segment in 2011.
Ratio between the different segments during 2011:
Unlinked segment – 58% of trading (2010 – 61%)
Linked segment – 34% of trading (2010 – 30%)
Floating-rate segment – 8% of trading (2010 – 9%)

Diagram E-4:
Breakdown of average daily trading turnover in the different segments, 2011 (NIS millions)



Average Daily Turnover on the MTS Platform by Bond Type

As of the end of 2011, primary dealers are required to quote in the MTS system 10 nominal fixed-coupon bonds (Shahar/ILGOV) and three CPI-linked bonds (5 hours net per day, with the size of the quote and the spread, which they are required to quote, differing from bond to bond, according to the term to maturity).

The bonds for which there was a quoting commitment as of the end of 2011 are:

Nominal fixed-coupon bonds:

ILGOV 3.5% 09/2013, Shahar 2682, ILGOV 4.5% 01/2015, Shahar 2683, ILGOV 4.25% 08/2016, ILGOV 5.5% 02/2017, ILGOV 6% 02/2019, ILGOV 5% 01/2020, ILGOV 5.5% 01/2022 and ILGOV 6.25% 10/2026.

CPI-linked bonds

ILCPI 0.5% 06/2013, ILCPI 1.5% 06/2014 and ILCPI 3%102019.

The bond with the highest trading turnover in the course of the year was ILGOV 5.5% 01/2022, which served as the ten-year benchmark security.

Diagram E-5:
Average daily turnover on MTS platform by nominal fixed-coupon bond, 2011 (NIS millions)

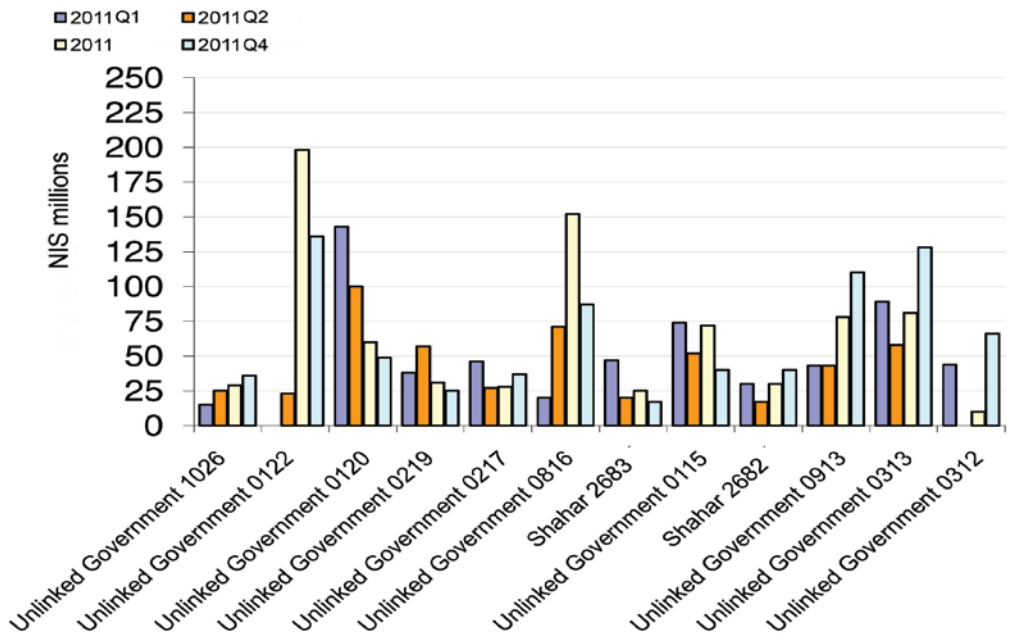
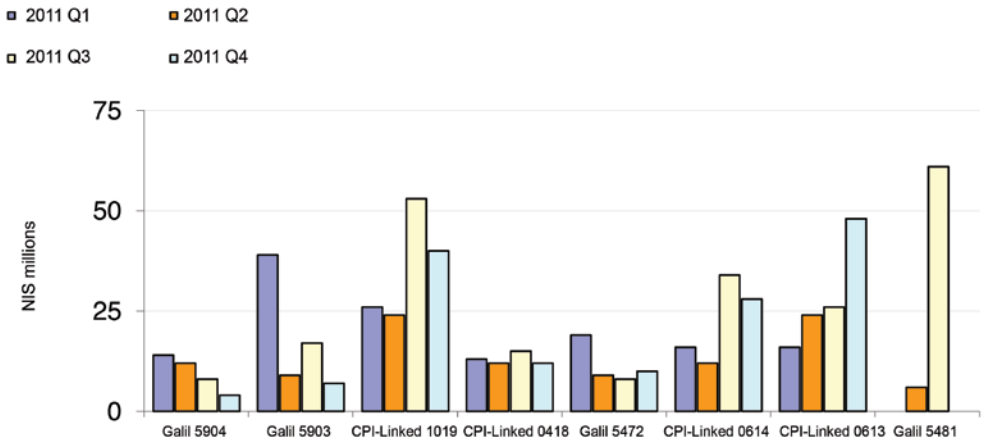


Diagram E-6:
Average daily turnover on MTS platform by CPI-linked bond, 2011 (NIS millions)



Yield on Ten-Year Nominal Fixed-Coupon Bonds

In 2011, as in 2010, government bonds were characterized by low yields, although not the record low yields of 2010. Simultaneously, the interest rate environment continued to be low.

The first half of the year was characterized by an increase in yields, concurrently with a rise in the Bank of Israel interest rate from 2% to 3.25%, as well as encouraging economic data in and outside Israel. The second half of 2011 was characterized by a decline in yields on government bonds, against the background of the worsening of the debt crisis in Europe and concerns about its effects on the Israeli economy and investors' preference for investing in solid channels. In addition, in the last quarter of the year the Bank of Israel interest rate returned to the track of interest cuts.

The graph below shows the yield on ten-year bonds (ILGOV 5% 01/2020, and in the course of the year a change to ILGOV 5.5% 01/2022, which is the new ten-year benchmark), which was also the most traded security in 2011.

Diagram E-7:
Yield on ten-year bonds

Yield Curves

In the first half of the year, the steepness of the curves (both the unlinked and the linked curve) moderated, a process that was accompanied by an increase in the Bank of Israel interest rate

In the second half of the year, the steepness of the curve in the unlinked shekel segment increased, while in the linked segment it decreased, a process accompanied by a decrease in the Bank of Israel interest rate and a decline in inflationary expectations.

Diagram E-8:
Unlinked yield-to-maturity curve

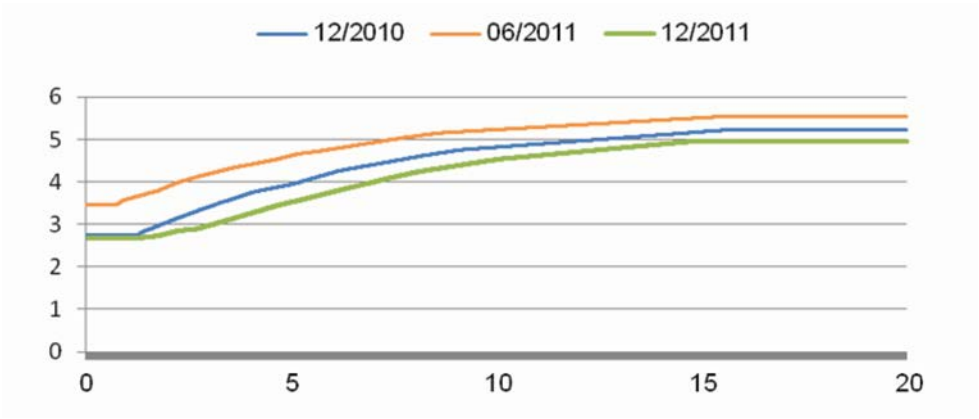
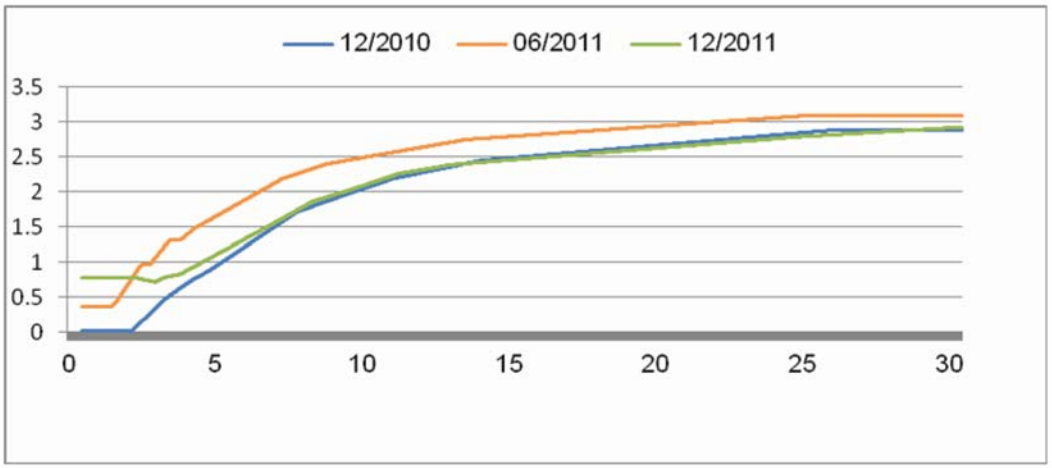


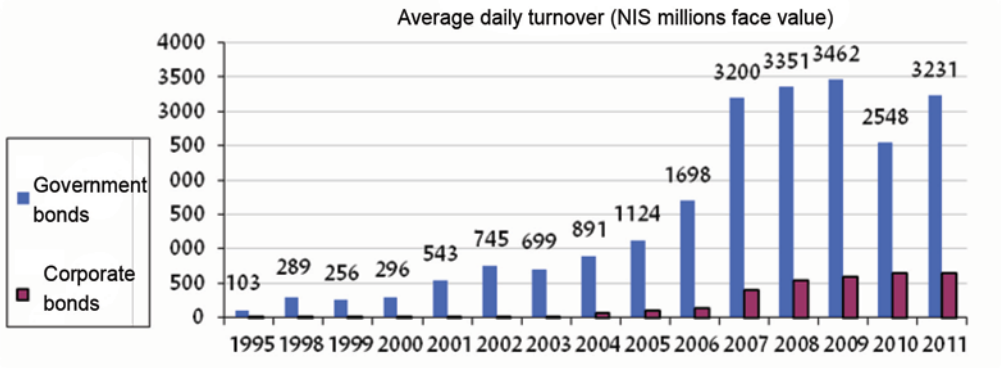
Diagram E-9:
CPI-linked yield-to-maturity curve



Average Daily Turnover in Historical Perspective

Trading turnovers in 2011 rose 27% compared to 2010, returning to the levels characterizing the government bond market from the start of the primary dealer reform (in 2006). Government bond trading turnovers have been trending upward in recent years, except for 2010, with the biggest jump in the turnovers recorded in 2006 following the implementation of the government bonds primary dealer reform. Simultaneously with the growth in turnovers in the government bond market, one can see a significant increase in recent years in trading turnovers in the corporate bond market. Corporate bond trading turnovers remained stable in 2011 compared to 2010.

Diagram E-10:
Average Daily Turnover in Historical Perspective (NIS millions)



Average Volume of 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) contact the TASE Clearing House to borrow the bonds, in return for which they transfer financial collaterals to the Clearing House on which they receive interest. Operation of the bond lending facility began in September 2006.

In the past year the facility ranged between NIS 3 to 6 billion.

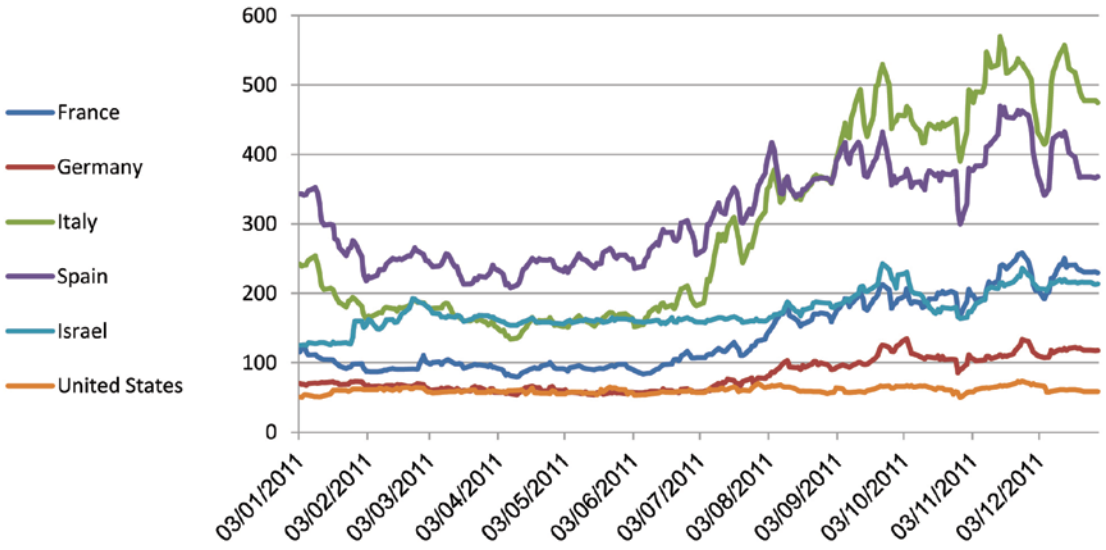
The distribution of bond lending into segments at the end of 2011 was 40% in the unlinked segment and 60% in the linked segment.

Diagram E-11:
Average daily volume of 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 a (partial) indication of the faith that purchasers invest in a third party's redemption ability, which serves as the underlying asset for the transaction.
The graph presented below compares the development of the CDS spreads of the State of Israel and other countries in the course of 2011.
One can see that in the course of 2011, the CDS spreads of European countries that suffered from the debt crisis, such as Italy and Spain, rose sharply. The CDS spreads of the State of Israel also rose in 2011, although at a more moderate rate, standing at the end of the year at a level of 210 base points.

Diagram E-12:
Development of the ten-year CDS spreads of Israel and selected peer countries, 2011 (in base points)



Appendix A – Forecast of Principal Redemptions and Interest Payments

Diagram App-1
Principal redemptions and interest payments on tradable domestic debt, 2012-2041 (NIS millions)

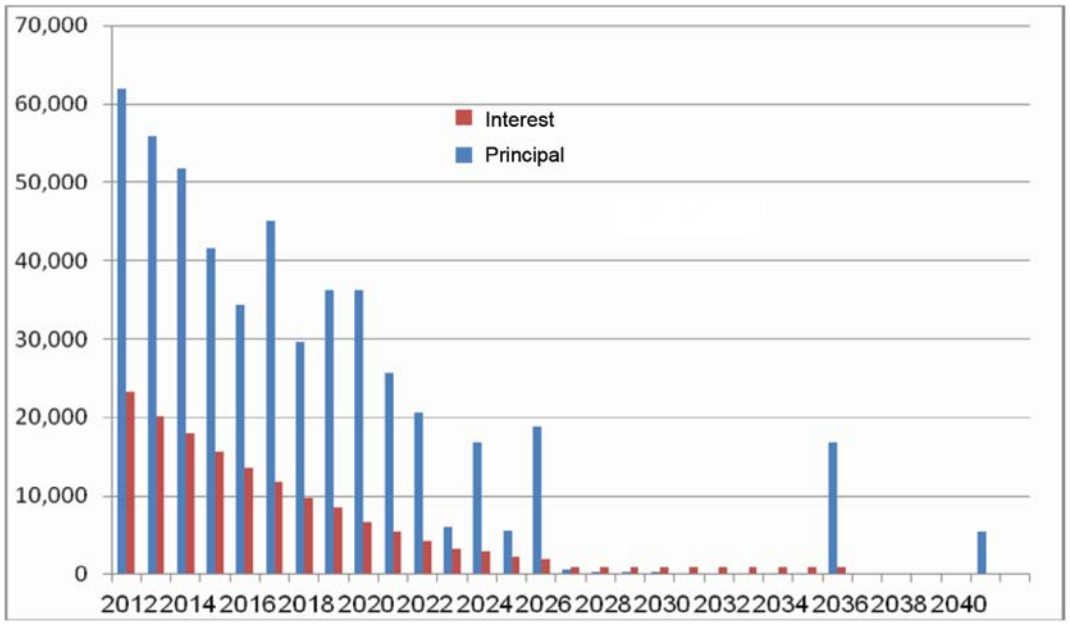


Diagram App-2
Principal redemptions and interest payments on non-tradable domestic debt, 2012-2036 (NIS millions)

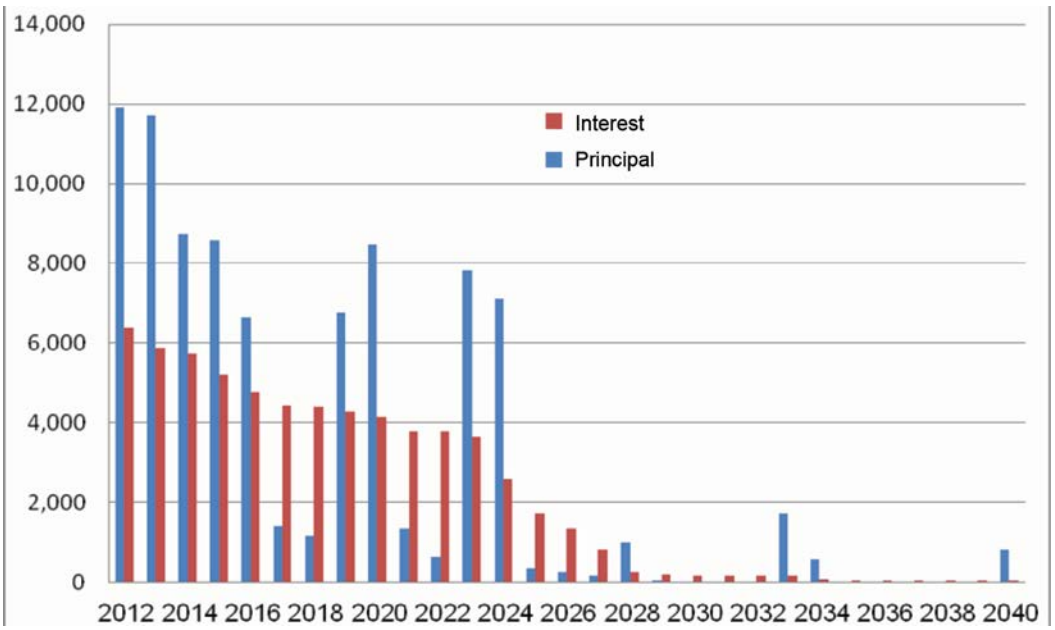


Diagram App-3
Principal redemptions and interest payments on external debt, 2012-2041 (NIS millions) at an exchange rate of NIS 3.821/USD 1

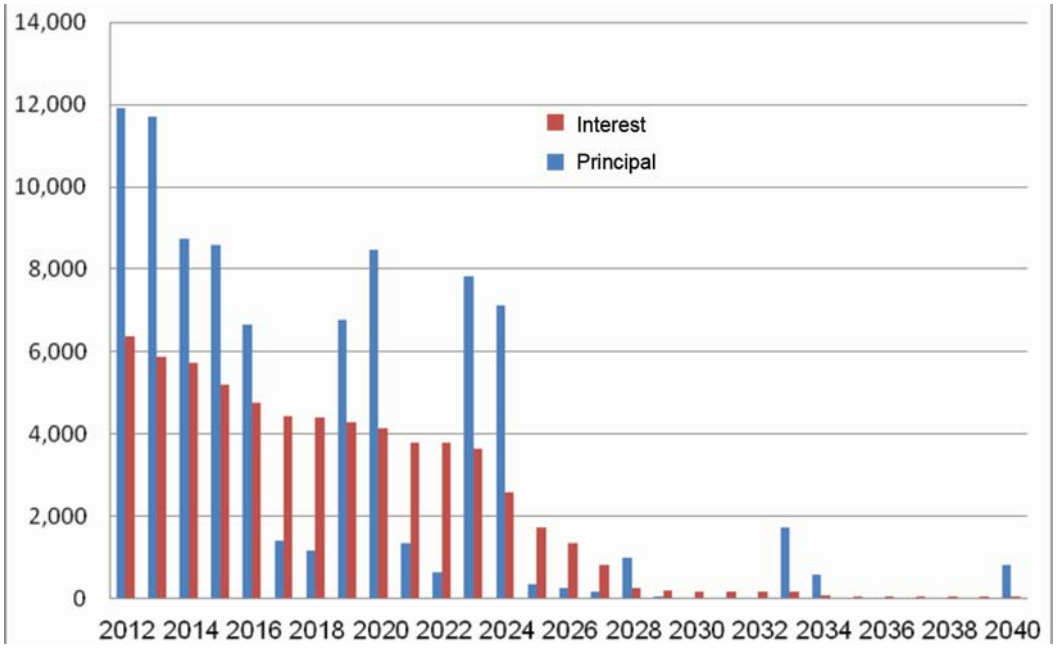
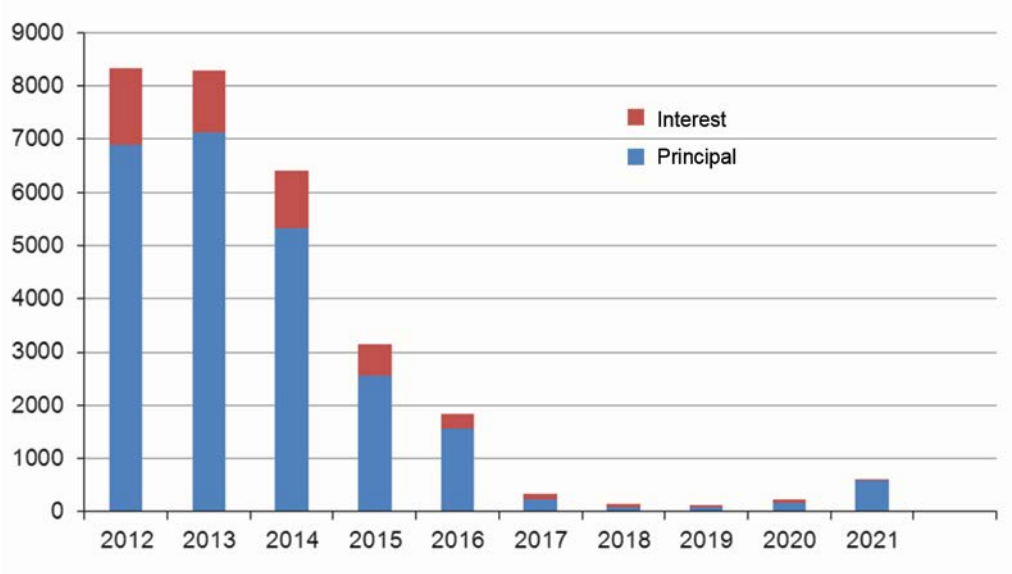


Diagram App-4
Principal redemptions and interest payments on Israel Bonds Organization Bonds (as of December 31, 2011)



Appendix B – Features of Tradable Bonds in the Domestic Market

Bond	First Issuance Date	Interest	Interest Payment
CPI-linked			
Galil*	Dec. 31, 1984	Fixed – as determined by the Ministry of Finance	Annually
Linked Government Bond	Jun. 26, 2006	Fixed – as determined by the Ministry of Finance	Annually
Unlinked			
New Gilon*	Apr. 28, 1999	Floating – based on Makam yields for 3-12 months	Once every three months
Floating-Rate Government Bond	Jan. 8, 2008	Floating – based on Makam yields for 12 months	Once every three months
Shahar*	Aug. 24, 1995	Fixed – as determined by the Ministry of Finance	Annually
Unlinked Government Bond	Nov. 6, 2006	Fixed – as determined by the Ministry of Finance	Annually

* This bond is no longer issued.

Appendix C – Features of Bonds Issued by the Israel Bonds Organization

The Bonds Organization in the United States (DCI)

Name of Bond	Interest Payment	Min./Max. Purchase	Interest Formula	Redemption Period (in years)	Benchmark
2Y Jubilee	Semi-annual May 1, November 1	Minimum purchase: $25,000 Multiples of $5,000	TB2y + spread	2	2Y Treasury
3Y Jubilee			TB3y + spread	3	3Y Treasury
5Y Jubilee			TB5y + spread	5	5Y Treasury
10Y Jubilee			TB10y + spread	10	10Y Treasury
2Y Maccabbee	Semi-annual May 1, November 1	Minimum purchase: $5,000 Multiples of $1,000	TB2y + spread	2	2Y Treasury
3Y Maccabbee			TB3y + spread	3	3Y Treasury
5Y Maccabbee			TB5y + spread	5	5Y Treasury
3Y Sabra Zero Coupon	At end of period	Minimum purchase: $1,000 Multiples of $500	Strip3y + spread	3	Strip Govt. 3Y
5Y Savings – Mazel Tov Zero Coupon	At end of period	Minimum purchase: $100 Multiples of $50 Maximum purchase: $2,500	Strip5y + spread	5	Strip Govt. 5Y
2Y Floating – Financing for Institutional Investors Only	Semi-annual June 1, December 1	Minimum purchase: $100,000 Multiples of $25,000	Libor6M + spread	2	Libor 6M
2Y Floating	Semi-annual June 1, December 1	Minimum purchase: $5,000 Multiples of $25,000	Libor6M + spread	2	Libor 6M
3Y Floating			Libor6M + spread	3	Libor 6M
5Y Floating			Libor6M + spread	5	Libor 6M
Institutional Bond – 3Y Fixed			TB3y + spread	3	3Y Treasury
Institutional Bond – 5Y Fixed			TB5y + spread	5	5Y Treasury
Institutional Bond – 3Y Floating			Libor + spread	3	Libor
Institutional Bond – 5Y Floating			Libor + spread	5	Libor

The Bonds Organization in Canada (CISL)
(Data in Canadian dollars)

Name of Bond	Interest Payment	Min./Max. Purchase	Interest Formula	Redemption Period (in years)	Benchmark
2Y Jubilee – CAD	Semi-annual May 1, November 1	Minimum purchase: $25,000 Multiples of $5,000*	Canadian TB2y + spread	2	2Y CAD Sovereign
3Y Jubilee – CAD			Canadian TB3y + spread	3	3Y CAD Sovereign
5Y Jubilee – CAD			Canadian TB5y + spread	5	5Y CAD Sovereign
10Y Jubilee – CAD			Canadian TB10y + spread	10	10Y CAD Sovereign
2Y Maccabbee – CAD	Semi-annual May 1, November 1	Minimum purchase: $1,000 Multiples of $500*	Canadian TB2y + spread	2	2Y CAD Sovereign
3Y Maccabbee – CAD			Canadian TB3y + spread	3	3Y CAD Sovereign
5Y Maccabbee – CAD			Canadian TB5y + spread	5	5Y CAD Sovereign
3Y Sabra – CAD Zero Coupon	At end of period	Minimum purchase: $1,000 Multiples of $500	Canadian Strip3y + spread	3	Strip CAD 3Y
5Y Savings – Mazel Tov Zero Coupon	At end of period	Minimum purchase: $100 Multiples of $50 Maximum purchase: $2,500	Canadian Strip5y + spread	5	Strip CAD 5Y
CND Institutional Bond – 3Y Fixed			Canadian TB3y + spread	3	3Y CAD Sovereign
CND Institutional Bond – 5Y Fixed			Canadian TB5y + spread	5	5Y CAD Sovereign

* Purchases in the above multiples may be made within one year from the purchase of the bond.

The Bonds Organization in Latin America and Europe (IBI)

Name of Bond	Interest Payment	Min./Max. Purchase	Interest Formula	Redemption Period (in years)	Benchmark
2Y Floating Euro	Semi-annual May 1, November 1	Minimum €5,000	Euribor + spread	2	Euribor 6M
3Y Floating Euro			Euribor + spread	3	Euribor 6M
2Y Euro – Savings Zero Coupon			2YBund + spread	2	2Y Bund
3Y Euro – Savings Zero Coupon			3YBund + spread	3	3Y Bund
5Y Euro Savings – Mazel Tov Zero Coupon	At end of period	Minimum €100 Multiples of €50 Maximum €2,500	5YBund + spread	5	5Y Bund
2Y Sterling Savings Zero Coupon			UKstrip2y + spread	2	2Y UK Strip
5Y Sterling Savings – Mazel Tov Zero Coupon			UKstrip5y + spread	5	5Y UK Strip
2Y Sterling Jubilee	Semi-annual May 1, November 1	Minimum £1,000	UK TB26 + spread	2	2Y GBP Benchmark
3Y Reinvestment Bond			Strip3y + spread	3	3Y Govt. Strip

Appendix D – Primary Dealer Rankings (at the end of 2011)

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

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:

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

Appendix E – Personnel of the Government Debt Management Unit in the Accountant General Division (at the end of 2011)

The Unit's offices in Jerusalem: 1 Kaplan St., Jerusalem Tel.: +972-2-531-7555 Fax: +972-2-566-9827	The Unit's offices at Airport City: Arava St., Airport City Tel.: +972-3-977-8777 Fax: +972-3-979-5370 E-mail: gdmu@inbal.co.il

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Lior David-Por	Head of Risk Management Department	+972-2-531-7077	liorda@mof.gov.il
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Nimrod Etzioni	Risk Management Department	+972-2-531-7984	nimrode@mof.gov.il
Max Friedenberg	Foreign Currency Transactions and External Debt Department	+972-2-531-7919	maxf@mof.gov.il
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Einat Cohen-Tzur	Back-Office Department	+972-3-977-8783	einatc@mof.gov.il
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State of Israel
Ministry of Finance
Government Debt Management Unit

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