The markets for short-term securities such as Treasury bills and commercial bank bills are an important factor in monetary policy conduct and its transmission throughout the financial system. These markets' effectiveness is also important for the reliability of the information that can be extracted from them as regards expectations about the future policy stance. Ineffective price formation in money market securities can therefore impede the transmission of monetary policy through the financial system and dilute the information on market expectations that can usually be inferred from interest rate formation.

In general, the interbank market plays an important role in the management of banking system liquidity, as commercial banks use it to deposit or withdraw funds for varying lengths of time, generally ranging from overnight to twelve months. Over the years, interbank market turnover in Iceland has been low, and concentrated primarily in the shortest maturities. It contracted sharply after the collapse of the banking system, most likely because of abundant market liquidity, but perhaps also due to a lack of trust in the market and a tendency among banks to meet temporary liquidity needs internally rather than in the market. A similar trend has been discernible in neighbouring countries' interbank markets.

From the beginning of 2009 to the beginning of 2011, the Central Bank's collateralised lending rate fell by 13.75 percentage points, to 4.25%. Then, from August 2011 to November 2012, it was raised to 6% in six increments and has remained unchanged since. Market liquidity has been ample, and in order to reduce it, the Bank began issuing certificates of deposit (CD) in September 2009, so that short-term market rates would be consistent with the intended monetary stance. CD issuance now totals just over 111 b.kr. Since that time, overnight interbank rates have developed more or less in line with Central Bank rates. Because of abundant deposit money bank (DMB) liquidity, they have remained below the centre of the Bank's interest rate corridor since the latter half of 2009, apart from a few days when they moved up to the upper half of the corridor due to temporary changes in market liquidity. Short-term interbank market rates have therefore developed broadly in line with the level the Monetary Policy Committee (MPC) considers desirable at any given time.

Interest rates on issued Treasury bills have not been consistent with developments in Central Bank rates, however. Interest rates in Treasury bill auctions kept pace with Central Bank rates during the period of monetary easing, but since the MPC began raising rates again, they have diverged. For instance, rates in Treasury bill auctions have been somewhat below the floor of the interest rate corridor in the recent term, and they are just over half the rate in a recent commercial bank bill issue.[1] At the same time, participation in Treasury bill auctions has dwindled, and non-residents, once keenly interested in Treasury bills, are moving farther out the yield curve. This shift can be interpreted in a variety of ways. It could mean that non-residents locked in by the capital controls have become more patient, but it could imply that they expect the liberalisation process to be delayed still further. Another possibility is that they consider the terms offered in Treasury bill auctions unacceptable in comparison with terms available in the market. According to Government Debt Management's (GDM) *Prospect* for the fourth quarter of 2013, GDM is considering compensating for reduced Treasury bill issuance by issuing more Treasury bonds, which could prove more

1. This is not the first time that Treasury bill interest rates and interbank market rates have diverged. See, for example, Appendix 1 in *Monetary Bulletin* 2005/1.

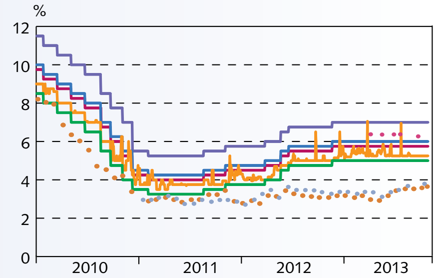
Box III-1

Effects of money market inefficiencies on monetary policy transmission and reliability of indicators of market expectations

Chart 1

Central Bank of Iceland interest rates and short-term market interest rates

Daily data 1 January 2010 - 1 November 2013



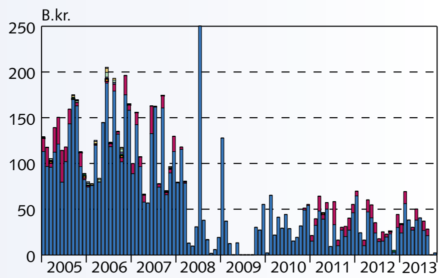
Overnight CBI rates
Collateralised lending rate
Maximum rate on 28-day CDs
Overnight interbank rates
CBI current account rates
Accepted bids at issuance of three-month Treasury bills (yield)
Accepted bids at issuance of six-month Treasury bills (yield)
Accepted bids at issuance of six-month Íslandsbanki bills (yield)

Sources: Íslandsbanki, Central Bank of Iceland.

Chart 2

Turnover on interbank market for krónur

January 2005 - October 2013



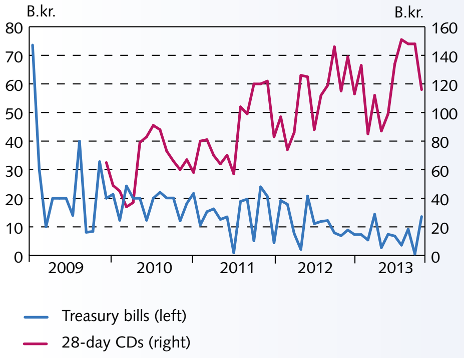
ON
1 week
2 weeks
1 month
2 months
3 months
6 months
9 months
12 months

Source: Central Bank of Iceland.

Chart 3

Issuance of Treasury bills and 28-day CDs

December 2008 - October 2013

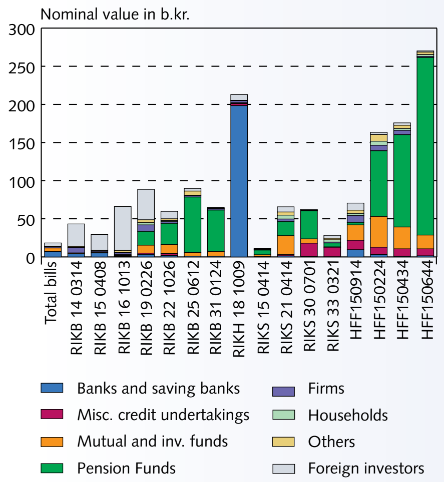


Source: Central Bank of Iceland.

Chart 4

Owners of Government securities and HFF bonds

Balance as of 30 September 2013



Source: Central Bank of Iceland.

economical for the Treasury than accepting higher Treasury bill interest. On the other hand, reduced Treasury bill issuance weakens the foundations of the short end of the yield curve, making the pricing of short-term obligations more difficult and possibly impeding monetary policy transmission.

Reduced Treasury bill issuance and limited interbank market turnover greatly complicate the interpretation of the short end of the yield curve. Consequently, the Central Bank obtains a cloudier view of market expectations concerning the future policy rate path, and it has responded to this uncertainty by conducting questionnaires. Such surveys can never take the place of effective price formation in the market, however. In order to enhance the effectiveness of the market for short-term securities, improve price formation, and strengthen monetary policy transmission, it would be desirable for the Treasury to maintain an efficient benchmark yield curve and support effective price formation for money market securities in its debt management planning.