Box 1 The effects of Central Bank monetary policy on the financial system

The first effects of monetary policy actions are on financial markets, particularly those where short-term financial assets are traded, e.g. the domestic money market.

As with the monetary policy transmission mechanism in general, the time it takes Central Bank of Iceland actions to have an impact within the financial system is subject to uncertainties. The lags may depend on factors such as the extent to which market participants foresaw the actions, how they interpret their impact on future economic prospects and their predictions of the Central Bank's future actions. Thus the time lags probably vary from one period to another.

To give some idea of how policy actions work through the financial system, the figure below shows the impact of an unexpected 1% increase in the policy rate on money market interest rates (3-month treasury bills), indexed treasury bond interest rates (5-year treasury bonds) and bank lending rates (average interest rate on indexed lending). The estimation is based on a VAR analysis, see Pétursson, 2001b). It represents an estimation of a typical response by these market rates to an unexpected rise in the policy rate over the past ten years and should not be interpreted as a forecast of responses to the Bank's actions in the future.

According to this analysis, money market rates immediately rise by 0.7% following a 1% rise in the Central Bank rate. The effect peaks during the first months after the rise, then gradually fades out. Bond rates also rise immediately by roughly 0.2%, an impact transmitted through money market rates. The effect peaks during the first months after the rise, then gradually fades out. The analysis shows that indexed lending rates do not rise immediately, but have risen by roughly 0.3% when the effect peaks around four months after the policy rate rise, largely transmitted through the bond market. The effect gradually wanes after that and fades out after around a year, based on the statistical confidence bands.

Impact on the financial system of an unexpected 1% increase in Central Bank interest rate

Percentage deviation from baseline with 90% confidence bands