Impacts on liquidity - eco316

Business

The Federal Reserve (Fed) increases or contracts the monetary base through open market operations. Fed’s involvement with the open market operations has a significant impact on the liquidity in the financial markets. Federal Reserve (Fed) had to decide what level of liquidity was demanded by the financial markets and how that level could be achieved.

However, Federal Reserve (Fed) followed a low interest rate policy to ensure there was sufficient liquidity in the financial market. The low interest rate policy allowed excessive spending and caused inflation to occur. This consequently led to the financial crisis and eventually a shortage of liquidity due to wrong policies. Excessive savings were required to fight the crisis and ensure that no financial institution faced liquidity issues.

United States first followed the expansionary policy where it experienced an increase in the monetary base. To avoid excessive liquidity in the market, US implemented contractionary policy to control the rate at which the monetary base was increasing. The financial markets yet had liquidity and were not insolvent.

Adding the role of government, the budget deficits have been soaking up the savings. Consequently, this has hindered the growth of the market and economy. The government budget deficits have created solvency issues not only for the government but also for the whole nation.

The impact of government spending is less productive as compared to the measures undertaken by the central bank, Fed. Government budget deficits do lead to difficulties in getting investments, and it does cause solvency issues, but that can be fought with a right monetary policy by the central bank, Fed.

Falling government budget deficits do support and strengthen the fact that

there was too much liquidity in the financial markets. However, it does not mean the government’s declining budget deficits had stronger influence on increasing liquidity.

Federal Reserve (Fed) has the strongest ability to influence the monetary base which consequently determines the level of liquidity available in the financial markets. By 2006, Federal Reserve (Fed) had been able to increase liquidity in the financial markets. In fact, there was too much liquidity, and to control the liquidity level, by the fall of 2006, Federal Reserve (Fed) introduced contractionary monetary policy. This is when US budget deficits started declining.

The rapidly increasing monetary base and levels of liquidity were consequences of the monetary policy and measures taken by the Federal Reserve (Fed). The declining government budget deficits implied that national savings and revenue were being utilized to cover the deficits rather than boosting the liquidity in the nation.

The impact of government spending is not of a large extent. Increasing budget deficits lead to solvency issues because of lack of foreign investments. Declining budget deficits enable a country to attract foreign investments and, consequently, increase the liquidity, but the extent of the impact is not that strong. The expansionary measures undertaken by Federal Reserve (Fed) and declining government budget deficits together work to increase the liquidity and fight the solvency issues. Once the government budget deficits decline, the country is not considered as over-indebted and foreign investors consider it as a potential profit-making opportunity. This consequently adds to the liquidity in the financial markets.