Liquidity trap

Finance

How the banking sector may be affected by the “ liquidity trap” The banking sector is a deposit taking sector, which heavily relies on the deposits taken from the customers of such financial institutions, to be able to perform some of its other functions such as lending (Svensson, 2). Therefore, more than any other sector within the economy, the banking sector is the one poised to be affected very much by any incidence of Liquidity trap. Liquidity trap creates a situation where the increased money supply within the economy does not stimulate a reduction in interest rates, thus the interest rates keeps soaring high, despite the application of the monetary policy tools by the central bank, such that the measures fails to stimulate the economy (Svensson, 7). This creates is insufficient stimulation within the economy, as a result of hoarding of cash by the operators in the economy, with the anticipation of future economic occurrences that are not favorable to cash transactions, such as deflation, insufficient aggregate demand, or the uncontrollable events(Svensson, 1). The concept of liquidity trap will affect the banking sector in various ways. First, the coming into play of the concept of liquidity trap means that the interest rates will have to drop nearly to zero. Since this occurrence creates a scenario where the short-term interest rates are low, while the savings are very high, the banking sector will be affected by insufficient lending, which then means that the revenue generation capability of the banking sector will be low (Svensson, 2). Considering that when the interest rates are low the prices of the bonds is expected to drop in the near future, many consumers avoid utilizing their money to purchase the bonds, with the fear that such bonds will not bring in good returns, and instead opts to keep their money in savings, with an anticipation that the interest rates is going to increase in the near future (Svensson, 13).

Consequently, the liquid trap scenario creates a moment of low business for the economy as well as for the banking sector, thus limiting the returns that the banking sector reaps from the high economy functioning. Thus, the profitability of the banking sector is low, and thus its ability to perform its other functions is highly affected (Svensson, 9). Secondly, the occurrence of a liquidity trap scenario affects the banking sector through increasing the nominal debt value, which in turn means that households and firms that are indebted to the bank might easily become bankrupt, thus unable to meet their debt obligations with the bank (Svensson, 12). This scenario further affects the ability of the banking sector to continue fulfilling its mandate, since it loses money to the bankrupt firms and households, thus causing the banking sector to incur losses. The banking sector is affected negatively by the loss of value of property that is occasioned by the liquidity trap, which means that the value of the collateral the bank holds against the loans granted to firms and households deteriorates (Svensson, 1). The consequence is the loss in the net worth of the banking sector, due to the loss of value occasioned by the flop in the property prices. The turning bad of the loans obligation by both the firms and the households creates a scenario where the banking sector is not even able to acquire the necessary infrastructure, technology and expertise to continue running its operations, meaning that the output performance and the competitiveness of the sector is adversely affected (Svensson, 17). Further, the uncertainty created by the liquidity trap concept regarding the stability of the economy is yet another threat to the wellbeing of the banking sector (Svensson, 3). The concept of uncertainty in the economy is associated with the rise of financial instability, where the exchange rates for foreign currencies may not stabilize, thus could keep fluctuating depending on the expectations of the players in the financial markets. This way, the banking sector's ability to discharge its monetary exchange functions is affected, while the financial gain obtainable from the foreign exchange transactions is reduced (Svensson, 18). This means that the profitability and the ability of the bank to continue discharging its operational mandates is adversely affected. Additionally, the occurrence of liquidity trap means that the banking sector is affected by the unemployment created in the economy, which then means that the population is not able to continue transacting with the banking sector, a factor that introduces low profitability (Svensson, 2). Thus in my opinion, liquidity trap is a harmful occurrence for the banking sector, which requires that the central bank should apply all the available monetary tools or otherwise to avert its occurrence, since the prolonged prevalence of liquidity trap can bring both the banking sector and the economy to halt. Works Cited Svensson, Lars. " Escaping from a Liquidity Trap and Deflation: The Foolproof Way and Others." Journal of Economic Perspectives, 2003. 1-23. Print.