

ABSTRACT

This research investigates the impact of bank capital on liquidity creation in Pakistan. There is no comprehensive measure of bank liquidity creation. Berger and Bouwman (2009) create four liquidity creations measures. Used one of the preferred measure, created by Berger and Bouwman (2009) and apply that measure to unbalanced panel data of all Pakistani banks from 2004 to 2013. Data has extracted from balance sheets analysis issued by state bank of Pakistan and find that bank liquidity creation increased every year and exceeded Rs. 3990 billion in 2013. Large banks created the most liquidity. Total liquidity creation in Pakistan equals 38% of total assets of banking industry and represents Rs. 4.56 per Rs. 1 of capital. Bank liquidity creation is positively correlated with bank value. Testing recent theories of the relationship between capital and liquidity creation and find that the relationship is positive for large banks which is consistent with "risk absorption" hypothesis. The relationship between bank capital and liquidity creation is negative for small banks and "financial fragility crowding out" hypothesis dominates for small banks. This effect is reduced for medium banks. This study is limited to only one country because liquidity creation requires detailed data. Results suggest that if the regulatory authorities set higher capital requirements for banks, this may result in greater liquidity creation by the large banks but this may decrease the liquidity creation by small banks.

Key Words: Liquidity creation, Bank capital ratio, Financial fragility crowding out, Risk absorption.