Bank liquidity creation can influence the fragility of the financial system

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How does bank liquidity creation affect the overall fragility of the banking sector and the systemic risk posed by individual financial institutions? Does bank liquidity creation influence technological

innovation? And what are the real consequences of bank supervision to financial regulators?

According to Sara Yasar's doctoral dissertation to be examined at the University of Vaasa on December 8, 2021, bank liquidity creation decreases systemic risk at the individual bank level in the U.S. Nevertheless, the results also indicate that liquidity creation can strengthen the systemic linkage of individual banks to severe shocks in the financial system.

In addition, Yasar shows that liquidity creation by the U.S. banks can stymie firms' technological innovation as measured by patent quantity and quality, meaning that bank liquidity creation, on average, has a negative impact on innovation. However, this finding depends on the firm's industry and the amount of tangible assets.

When examining how different supervisory practices affect bank liquidity creation in 27 European countries, she finds that the traditional approach to bank supervision that entails strengthening official supervisory authorities tends to decrease bank liquidity creation. Moreover, a supervisory strategy that strengthens private sector monitoring of banks lowers bank liquidity risk.

"Putting all banks under common regulatory and supervisory practices is difficult, as banks operating in certain environments may be exposed to higher risks," says Sara Yasar who is currently working at the European Central Bank.

More information: Thesis: osuva.uwasa.fi/handle/10024/13158

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