Cyclical Behavior of Bank's Liquidity Holdings

As changes in asset prices have recently proved to be one of the factors worsening financial crises, the importance of liquidity holdings has been highlighted for the maintenance of stability in the overall financial system. Unless banks hold sufficient liquidity, they come to dump non-liquid assets for the purpose of securing liquidity. This may drive down the value of assets dramatically and may eventually lead to a greater possibility of insolvency. Particularly, given that financial crisis mostly occur during the early stage of an economic recession, it is necessary to prevent bank liquidity from being reduced excessively in times of economic expansion.

Judging that the level of liquidity of bank assets is closely related to long-term financial stability, the author of this paper analyzed the dynamic behavior of the ratio of banks' liquid assets to their total assets. More specifically, this study set out to assess the dynamic adequacy of the ratio of banks' liquid assets through an empirical study on whether counter-cyclicality is found, which refers to a situation where a bank's liquid asset ratio falls during a period of economic expansion and rises during economic recession, even when all the economic factors related with liquidity holdings are taken into consideration.

According to an empirical analysis based on quarterly data of commercial banks for the period of the first quarter of 1999 to the third quarter of 2004, banks' liquid asset ratio shows counter-cyclicality, which is estimated as inappropriate in terms of financial system stability: if banks reduce their liquidity excessively during a period of economic expansion, they face

liquidity constraints in the event of a liquidity crisis, and if banks dump non-liquid assets, the value of bank assets falls dramatically and this might eventually worsen the financial crisis.

It is difficult to draw a clear-cut conclusion, since study of the adequacy of banks' liquidity holdings is still in its infancy both at home and abroad. However, based on the result of this study, it is vital to strengthen regulatory measures concerning bank's liquid assets in the follow manner, for the maintenance of the stability in the entire financial system: first, it is necessary to use the ratio of liquid assets to total assets as a monitoring index. In addition, from a long-term perspective, it is advisable to make it mandatory for banks to conduct stress testing on liquidity risk and report the findings to the supervisory authorities on a regular basis.