An Empirical Analysis of Excess Interbank Liquidity: A Case Study of Pakistan

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Abstract

We investigate the drivers of excess interbank liquidity in Pakistan, using weekly data for December 2005 to July 2011. We find that the financing of the budget deficit by the central bank and non-banks leads to persistence in excess liquidity. Moreover, we identify a structural shift in the interbank market in June 2008. Before June 2008, low credit demand was driving the excess liquidity holdings by banks. After June 2008, banks" precautionary investments in risk-free securities drive excess liquidity holdings. This permanent shift of the banking sector towards holding government securities is not healthy for long term growth. Moreover, monetary policy is less effective if banks hold excess liquidity for precautionary reasons.

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Key words: Excess liquidity, interbank money market, Pakistan, structural breaks, bound test, Autoregressive Distributed Lag approach