

Impact of Economic Policy Uncertainty and Stock Market Liquidity on Bank Liquidity Creation: Evidence from Indian Banks

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Abstract: This study analyses the effect of Stock market liquidity and Economic Policy Uncertainty (EPU) on liquidity created by Indian banks from 2005 to 2019. We use two liquidity creation measures, catfat and catnonfat formulated using the bank-level data from Reserve Bank of India database. Further, Amihud's illiquidity measure is used for stock liquidity and EPU is measured following the work of Baker et al. (2016). The study employs a robust regression method to examine the relationship among liquidity creation, stock market liquidity and EPU. This research finds the application of the "market–bank liquidity enhancement" view, which argues that the liquid stock market enhances the bank's liquidity creation function. The results differ from the traditional view, where liquid stock markets are presumed to put competitive pressures on banks and crowd them out. The development of banking firms and the stock market is not a strictly competitive game. Further, it is observed that EPU harms bank liquidity creation. The liquidity creation function positively impacts the economy. Policymakers, regulators and bank managers should pay adequate focus on stock market liquidity and economic policy uncertainty to frame appropriate policies related to liquidity creation in the Indian banking system. To the best of our knowledge, this is the first study of its kind in the Indian context.

Keywords: Indian Banks, Economic Policy Uncertainty, Liquidity Creation, Stock Market Liquidity, Robust Regression

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