

liabilities of depository corporations and so convey information on the extent of risk-taking in the financial system and overall financial conditions (Shin and Shin, 2010).

The rationale for funding markets as a signal of financial conditions derives from their status as the balance sheet counterpart to intermediated lending. Adrian and Shin (2010) highlight the role of measured risks, and in particular the bank's Value-at-Risk (a measure of potential losses for the bank) as a key determinant of the expansion or contraction of the intermediary sector. A good rule of thumb is that banks adjust lending in order to keep their probability of failure constant in the face of changing financial conditions. In periods of market stress, banks contract lending and shed risky exposures, while in tranquil conditions, banks expand lending.

One source of funding available to the banks is the retail deposits of the household sector. Core liabilities could thus be defined as the funding that banks draw on during normal times. What constitutes core funding will depend on the context and the economy in question, but retail deposits of the household sector would be a good instance of core liabilities. Put it differently, as our analysis focuses on the liability side of the balance sheet, households are the suppliers of core liquidity; their decision to supply funding to banks depend in large part on the opportunity costs of deposits as well as their risk appetite for potentially higher yielding, but less stable alternatives. Meanwhile, commercial banks and depository institutions are the consumers of core liquidity. Their reliance on deposit funding reflect, in part, the availability of alternative funding sources and the opportunity costs of accessing these funding elsewhere.

When credit is growing rapidly in a booming economy and funding demand exceeds those supplied by retail deposits, financial institutions may turn to other sources of funding to support the growth of their asset portfolio. In recent years, capital markets, including wholesale as well as collateral-based financing have become a greater source of funding. For these sources of funding, known as “noncore” liabilities in our analysis, financial institutions can be both suppliers and consumers of “noncore” liabilities. For these financial institutions, their financial innovations create new instruments that increase the pool of potential collateral for funding; meanwhile, their needs to finance collateral-based transactions increase demand for noncore funding. In this way, pro-cyclical components of bank liability aggregates will reflect incremental bank lending during episodes of rapid credit growth that may reverse when the cycle turns and financial conditions deteriorate. More generally, bank liability aggregates may be expected to convey information on the degree of risk-taking in the economy giving insights on the vulnerability of the financial system to a reversal.

Our analysis explores the information value of “core” and “noncore” liabilities (quantity measures), as well as related price measures (based on funding costs). As advanced economy financial systems have moved beyond traditional deposit-taking banks toward increased dependence on capital markets, in order to capture liquidity conditions more accurately, traditional monetary aggregates will need to be supplemented with other items from bank and