Economic Research Department

BBVA

Banking Observatory

July 15th, 2009

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

Transaction deposit growth reaches December highs

- Commercial bank transaction deposits post yoy gains as high as those during peak crisis months of Fall 2008
- Growth in transaction deposits closely tracks the velocity of narrow M1 money supply, signaling less consumer credit use and larger household cash balances
- Total deposit growth remains steady 9.1% yoy May, while time deposits continue to contract due to record-low interest rates

Commercial bank transaction deposit usage

Transaction deposits at commercial banks represent some of the most liquid instruments in the financial system as it consists largely of checkable deposits. Traditionally, people desire liquidity for precautionary, transactional, or speculative reasons. For example, transaction deposit growth may represent consumers' desire to eventually invest in a future rebounding stock market, for increased purchases of goods, or as a result of uncertainty. However, some of these traditional motivations for transaction deposits are increasingly less relevant today due to financial innovation in the form of money market funds, brokerage accounts, and other mechanisms that delink commercial banks' transaction accounts from financial market instruments. Additionally, changes in key investment goods reflecting speculation – 10 year bond yields, gold spot price, and the S&P 500 Index – do not demonstrate a close relationship with transaction deposit growth.

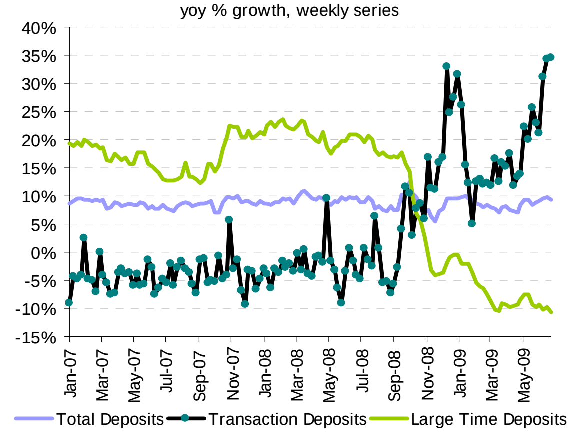
The velocity of money, M1 and deposits

In contrast to financial market conditions, transaction deposits closely track the velocity of M1. A narrow measure of money supply, M1 consists of all checkable deposits, currency, negotiable order of withdrawal (NOW), automatic transfer service (ATS) accounts, credit union share draft accounts, and demand deposits. Money velocity is calculated by dividing the current GDP index by M1. The velocity of money changes when people alter their holdings of money relative to their income. For example, the decreased use of credit cards would increase the desire of households to hold money balances at banks. Alternatively, money velocity tends to decrease when individuals hold larger cash balances as a result of uncertainty. Higher expected inflation will tend to make individuals manage their cash balances more strictly as inflation erodes the value of cash. Financial innovation plays a role as well, as cash-equivalent accounts are created at noncommercial entities. Lastly, cyclical factors affect velocity as well, as velocity tends to decline during periods of declining real income.

Bottom-line: Transaction deposits are growing at a high rate similar to that of the crisis months of fall 2008. This rate reflects concerns about the length of the recession and an increasing preference for less credit usage.

US Bank Deposits

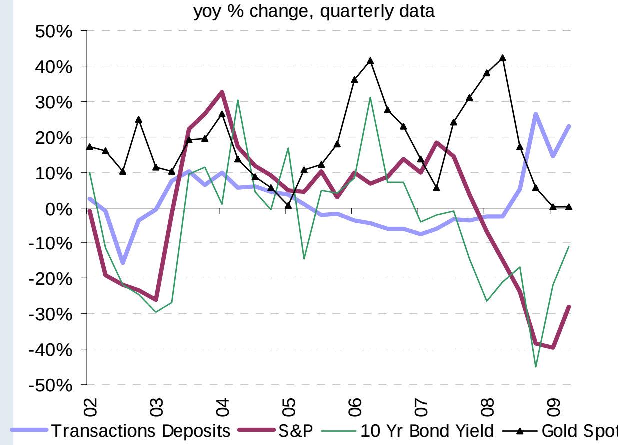
yoy % growth, weekly series



Source: Federal Reserve

Speculative Motives

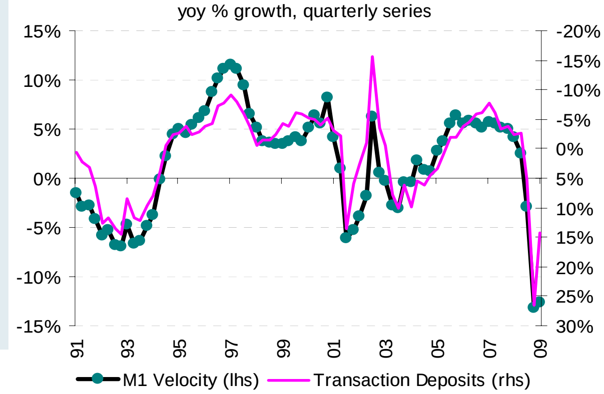
yoy % change, quarterly data



Source: Federal Reserve and Bloomberg

M1 Velocity and Transaction Deposits

yoy % growth, quarterly series



Source: Federal Reserve and Bloomberg