Office of the Comptroller of the Currency

ON POINT

ECONOMIC AND POLICY ANALYSIS FROM THE OCC

Bank Deposit Growth to Remain Sluggish Through 2025

A January 2022 analysis, "On Point: Deposit Growth Likely Slowing but Abundance of Low-Cost Funding Could Endure Through 2022," noted that after surging in 2020-2021, bank deposit growth would slow sharply. And in fact, after peaking at a 21 percent year-to-year pace in the fourth quarter of 2020, deposit growth decelerated, falling to just a 1 percent rate by the second quarter of 2024.[1] This projection assumed that the personal saving rate would come down substantially from its elevated level of 10 percent at that time. Deposits surged in 2020-2021 in part because households received large government transfers and saved a substantial portion of them. Households then spent that excess savings, placing downward pressure on deposits.

This On Point article updates our outlook for bank deposits, given the consensus view through 2025 of declining interest rates accompanied by modest growth in nominal and real GDP and a relatively stable saving rate.[2]

Bank deposits typically grow faster when interest rates fall and more slowly when the economy's growth pace is cooling. In most business cycles these two countervailing forces occur at the same time, though historically the rate effect tends to dominate (boosting deposit growth). Given the current consensus outlook, which does not call for either a large decline in interest rates nor a sharp deceleration in economic growth, the historically typical outcome for deposit growth is unlikely to be the case through 2025. According to the consensus view, any decline in interest rates this year and next is expected to be relatively modest, providing little support to deposit growth. Moreover, the ratio of noninterest-bearing and other cheap deposits to household incomes is unusually high by historical standards. This could restrain the pace of deposit inflows as interest rates come down. Low-cost deposits are the most sensitive to changes in interest

[1] The analysis also maintained that high deposit levels relative to loans would support bank net interest margins (NIM) for a time even once interest rates began to increase. In fact, NIMs surged from the first quarter of 2022 through the fourth quarter of 2022 as interest rates climbed from near zero in February 2022 to close to 5.5 percent in August 2023.The analysis also suggested that once inflationary pressures began to fade NIMs would stabilize, which has indeed been the case.

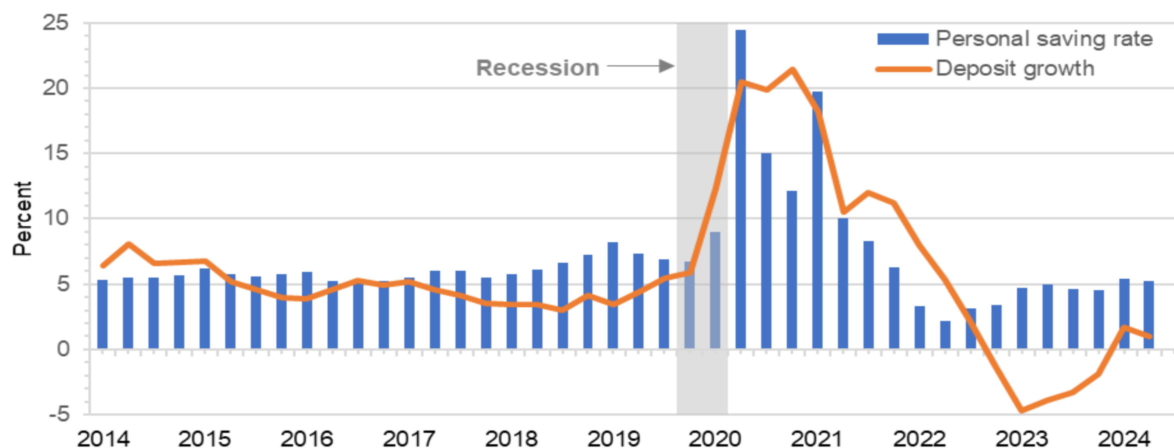
[2] This reflects the Blue Chip Consensus forecast as of September 2024, which calls for the 3-month Treasury bill rate to decline from the current 4.6 percent rate to 3.5 percent by the end of next year. Personal consumption expenditures (PCE) inflation is projected to fall from 2.2 percent to 2.0 percent. Real GDP is expected grow at a modest 1.9 – 1.5 percent in the final two quarters of this year and 1.8 percent for all of 2025. Nominal GDP is projected to rise 5.1 percent this year and 4.0 percent in 2025 on a full-year-over-full-year basis.

rates. In past cycles, when rates declined, reintermediation into low-cost deposits was a significant factor contributing to expansion in total deposits. But with low-cost deposits at elevated levels, the public could prove resistant to holding additional deposits of this type. As a result, total deposit growth may remain lackluster through 2025, perhaps staying in the 4 to 4.5 percent range. This is well below the pace in previous Federal Reserve easing cycles when deposit growth typically peaked at between 8 and 17 percent.

I. Deposit Growth Surged During the Pandemic

Deposits surged in 2020-2021 in part because households received large government transfers and saved a substantial portion of them (figure 1). In addition, large nonfinancial companies that drew from lines of credit as a precautionary measure during the pandemic initially placed the money in banks that had extended the loans. Loans made under the paycheck protection program also initially ended up in the deposit accounts of businesses that borrowed the funds through banks.[3] Near zero interest rates also fostered deposit inflows. Deposit rates tend to hover well below market rates throughout most of the business cycle. But banks will not levy negative deposit rates as market rates approach zero because that would mean banks were charging customers to hold their funds, potentially damaging long-term customer relationships.[4] As a result, as market rates fall to near zero, deposit rates get closer to or may even hover above market rates. This increases the relative attractiveness of deposits (figure 2).[5] [6]

Figure 1: Total Deposit Growth and Personal Saving Rate



Source: Financial Accounts of the United States - Z.1

Note: Deposit growth is the percent change from year earlier for private depository institutions, which include U.S.-chartered depository institutions, foreign banking offices in U.S., banks in U.S.-affiliated areas, and credit unions. The personal saving rate is seasonally adjusted.

[3] Andrew Castro, Michele Cavallo, and Rebecca Zarutskie, "Understanding Bank Deposit Growth During the COVID-19 Pandemic," FEDS Notes, Board of Governors of the Federal Reserve System, June 3, 2022.

[4] Banks do charge maintenance fees.

[5] Bill Nelson, "QE May Raise Deposits at Banks Immediately, but Not Permanently," Bank Policy Institute (BPI), April 6, 2021.

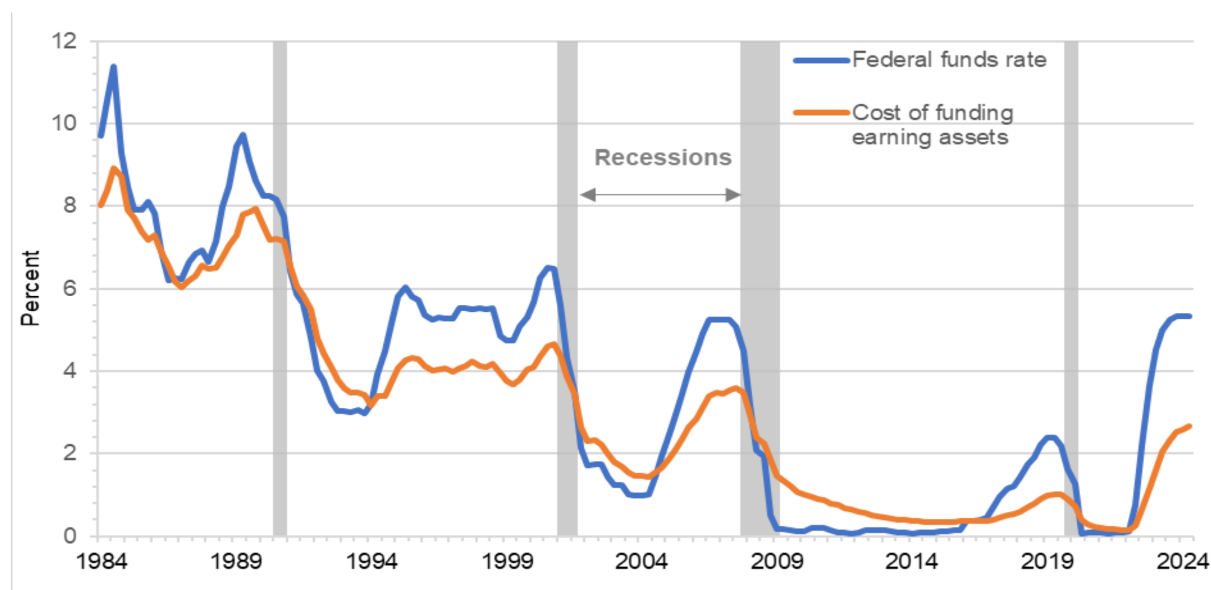
[6] All of these factors boosted deposits but only in an immediate accounting sense. Ultimately, the preferences of the public determine the level of deposits in the banking system. These preferences are determined by the income and wealth of the public, and the relative rates of return on deposits vs alternative savings and investment vehicles. See James Tobin, "Commercial Banks as Creators of 'Money," Cowles Foundation for Research in Economics at Yale University, July 24, 1963.

II. Deposit Growth Slowed Sharply Beginning in Q2 2021

After peaking at a 21 percent year-to-year pace in the fourth quarter of 2020, deposit growth decelerated, falling to just a 1 percent rate by the second quarter of 2024.[7] This occurred as households spent the excess saving accumulated during the pandemic, placing downward pressure on deposits (figure 1).[8]

In addition, banks—particularly large banks—were flush with deposits entering the Federal Reserve's current tightening cycle in March 2022 and so were not under pressure to hike deposit rates. Partly as a result, the spread between the federal funds rate and deposit rates reached an all-time high in 2023 (figure 2). This created an incentive for depositors to shift funds to alternative vehicles that offered market or near market rates such as money market mutual funds (MMMFs). For example, from the second quarter of 2022 through the second quarter of 2023, household holdings of bank deposits fell by $1.153 trillion, while their holdings of MMMF shares increased by $777 billion.

Figure 2: Federal Funds Rate and Cost of Funds at FDIC Insured Institutions



Source: Federal Reserve Board, Haver Analytics

Note: Cost of funds is for earning assets at all FDIC insured institutions.

When households and other sectors transferred deposits into MMMFs, these MMMFs parked their money in the Federal Reserve's overnight reverse repurchase (ON RRP) facility.[9] MMMFs

[7] In absolute dollar terms, deposits actually fell by $1.127 trillion from the first quarter of 2022 through the third quarter of 2023 or 5.3 percent, before increasing by $239.6 billion or 1.2 percent from the third quarter of 2023 through the first quarter of 2024.

[8] The pace of deposit outflows increased temporarily during March 2023, triggered by the collapse of Silicon Valley Bank and Signature Bank. This prompted federal regulators to guarantee all deposits at both institutions.

[9] The ON RRP facility allows MMMFs and other large financial firms to earn interest by parking spare cash at the Federal Reserve in exchange for low-risk securities.

also buy large blocks of Treasury bills, but that would place downward pressure on yields, reducing their attractiveness. By contrast, when MMMFs lend to the Federal Reserve via ON RRPs, yields for ON RRPs are not impacted since the ON RRP rate is an administered rate. This made the ON RRP facility particularly attractive to MMMFs. As MMMFs transferred their deposits held at their correspondent commercial banks to the ON RRP facility, this reduced the level of deposits in the banking system.[10]

While MMMFs have always drawn money away from deposits at banks, much of those funds often found their way back to the banking system, either directly—as the MMMF invested in repos with banks or in bank savings deposits/CDs—or indirectly—as the MMMF fund bought commercial paper or other security issues from nonbanks, which was subsequently deposited back into bank deposits. By contrast, placing money with the Federal Reserve through its ON RRP facility results in a drain on bank deposits.[11] [12]

III. Deposit Growth May Remain Sluggish Through 2025

What are the implications for bank deposits of a further cooling of inflation accompanied by a decline in interest rates and modest real and nominal GDP growth? There are a number of conflicting influences that will shape the deposit outlook through next year:

- ***Continued quantitative tightening (QT) on the part of the monetary authorities may have little impact on deposit growth.*** In April 2022 the Fed ceased large scale asset purchases and soon after began allowing securities to run off its balance sheet, which is known as quantitative tightening or QT. The Federal Reserve announced that as of June 1, 2024, it would reduce the cap on Treasury securities it allows to mature and not be replaced to $25 billion per month from its previous cap of up to $60 billion, but the QT program would continue for now. Total securities held outright by the Fed fell by $32 billion in September from the previous month, or a little under 1 percent. When the Federal Reserve runs off reserves under QT by allowing Treasury securities to run off its balance sheet, the balancing items on the liability side of banks' balance sheets are primarily market-rate liabilities. Retail deposit liabilities at banks are not impacted to a significant degree because new Treasuries issued by the federal government are typically purchased by primary dealers, non-primary dealers, hedge funds, pension funds, mutual funds, insurers, banks, and the foreign sector, which do not typically pay for Treasuries with bank deposits.[13]

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[10] Samuel J. Hempel, Calvin R. Isley, R. Jay Kahn, and Patrick E. McCabe, "Money Market Fund Repo and the ON RRP Facility," FEDS Notes, Board of Governors of the Federal Reserve System, December 15, 2023.

[11] Bill Nelson, "QE May Raise Deposits at Banks Immediately, but Not Permanently", BPI, April 6, 2021.

[12] Deposits can also leave the banking system if, for example, a household uses its deposits at a bank to buy shares in a MMMF, which then uses those deposits to buy bank assets or debt issued by the bank, or to buy Treasuries directly from the U.S. Treasury. See Andrew Castro, Michele Cavallo, and Rebecca Zarutskie, "Understanding Bank Deposit Growth during the COVID-19 Pandemic", FEDS Notes, Board of Governors of the Federal Reserve System, June 3, 2022.

[13] When a Treasury security on the Federal Reserve's balance sheet matures and the Fed does not roll over the security, the U.S. Treasury uses the balances in the Treasury General Account at the Federal Reserve to pay off the security. At that point, however, the Treasury will typically need to replace the Fed's redeemed securities by issuing new securities to the public to maintain a sufficient cash balance at the Federal Reserve. See Jane Ihrig, Lawrence Mize, and Gretchen C. Weinbach, "How Does the Fed Adjust its Securities Holdings and Who is Affected?" Finance and Economics Discussion Series 2017-099. Washington: Board of Governors of the Federal Reserve System.

Bank deposits declined from April 2022 through April 2023, and Federal Reserve security holdings shrunk. Deposit growth also weakened in 2018 during the initial phases of the Federal Reserve's previous QT program. This was largely happenstance. In fact, deposits have been rising since the third quarter of 2023, albeit at a sluggish pace, despite the continuation of QT. Deposit inflows weaken during QT in part because the Federal Reserve only engages in QT actions when short-term rates are already rising or are maintained at elevated levels.[14] Higher interest rates result in disintermediation of bank deposits. As discussed previously, the decline in deposits in 2022-2023 was also due to reduced saving and the use of the ON RRP facility, not QT.

These factors only make it appear as if QT is depressing deposits. If QT did have an impact on deposits, it would be through the interest rate channel whereby higher long-term rates could result in greater disintermediation of deposits. Unlike Federal Reserve large scale asset purchases, however, so far QT does not appear to have had a significant influence on long rates.[15]

Figure 3: Low-Cost Deposits

Source: Bureau of Economic Analysis, Financial Accounts of the United States – Z.1, Haver Analytics

Note: Low-cost deposit liabilities are for private depository institutions, which include U.S.-chartered depository institutions, foreign banking offices, banks in U.S.-affiliated areas, and credit unions.

- ***Low-cost deposit levels are near historical highs relative to GDP and household incomes, which could restrain total deposit growth.*** Despite some pullback, the ratio of

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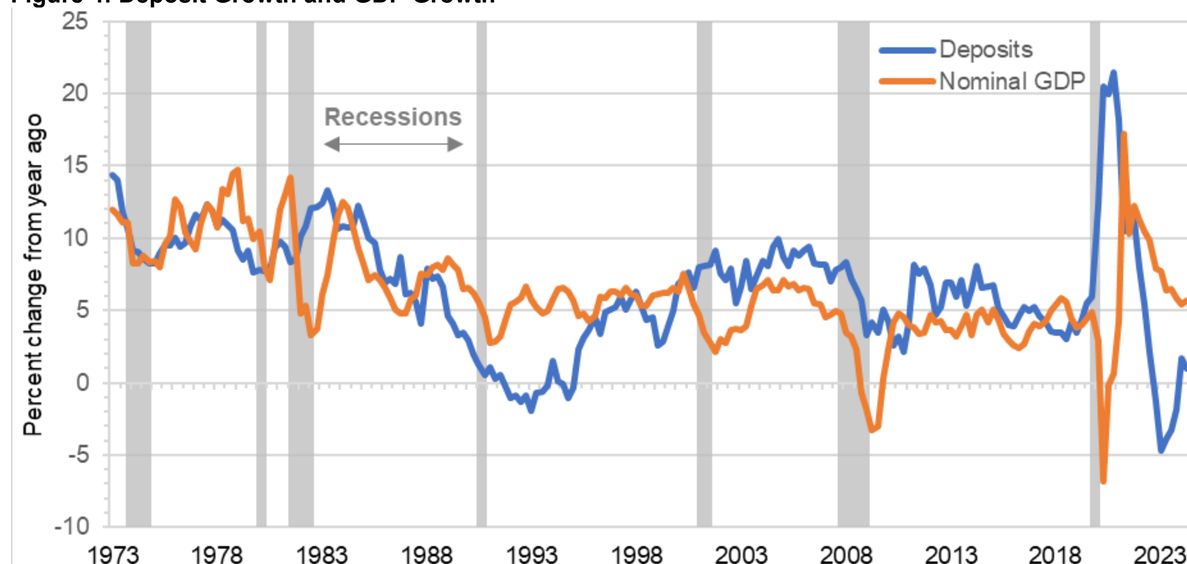
[14] Bill Nelson, QE May Raise Deposits at Banks Immediately, but Not Permanently, BPI, April 6, 2021`.

[15] Many economists estimate that large scale asset purchase (LSAPs) of long-term Treasury and agency securities caused interest rates on those securities to fall by about 100 basis points more than otherwise would have been the case. Fed purchases of longer-term Treasuries and agencies have significant ripple effects. In other words, Federal Reserve asset purchases have measurable effects in the long-term Treasury and agency markets. But there were sizeable effects in other similar markets as well. Those ripple effects impact the macroeconomy in turn. However, QT, doesn't appear to have the large signaling or market functioning impacts of LSAPs. QT still impacts the portfolio balance channel, but the effects are probably smaller than with LSAPs. There is an asymmetry in the impact of QT and LSAPs. QT still represents a tightening action because it is reducing Fed accommodation and is tightening financial conditions somewhat. But the impact of QT appears to be significantly smaller than the impact of LSAPs.

bank noninterest-bearing and other low-cost deposits-to-GDP remains at near record levels currently (figure 3).[16] The ratio of bank noninterest-bearing and other low-cost deposits-to-income, whether measured as share of national income or personal income, is also elevated. This may limit reintermediation of low-cost deposits if interest rates continue to fall. Low-cost deposits are the most sensitive to changes in interest rates. In past cycles, when interest rates declined, shifts into low-cost deposits were a significant factor contributing to increased growth in total deposits. Households hold about 67 percent of low-cost deposits.[17] With low-cost deposits at elevated levels, households could prove resistant to absorbing additional deposits of this type.[18]

- ***The magnitude of the decline in interest rates in 2024 through 2025 is not expected to be large relative to past easing cycles.*** The Blue Chip Consensus projects that short-term rates will decrease by about 115 basis points through the end of next year. Long-term interest rates are expected to decline only marginally. This is similar to the modest rate declines in the mid-1990s and prior to the pandemic in 2019. During both of those earlier periods, reintermediation of low-cost deposits was limited.

Figure 4: Deposit Growth and GDP Growth



Source: Bureau of Economic Analysis, Financial Accounts of the United States - Z.1, Haver Analytics

Note: Deposit growth is for total deposit liabilities at private depository institutions, which include U.S.-chartered depository institutions, foreign banking offices, banks in U.S.-affiliated areas, and credit unions.

- ***Easing inflation and sluggish nominal GDP growth will restrain deposit expansion.*** Banks deal in nominal financial instruments, so, other things being equal, nominal deposit growth would slow as inflation eases. During most previous post-WWII economic cycles, increases and decreases in bank deposits have been closely aligned with the trajectory of nominal GDP (figure 4). The unprecedented surge in excess saving and associated deposits

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[16] By contrast, time and savings deposit liabilities at commercial banks are more in line with historical experience.

[17] Data is from the Financial Accounts of the United States - Z.1.

[18] In the modern banking era, there is no previous, concrete experience to accurately gauge household deposit behavior under these circumstances. Therefore, these conclusions should be interpreted with caution.

during the 2020-2021 pandemic period[19] was an exception. If nominal GDP growth remains sluggish under the disinflationary scenario assumed here, then the pace of bank deposit growth would also be proportionally weaker than if inflation and nominal GDP growth were higher.

The Point?

Bank deposit growth may remain sluggish in line with the expected trajectory of inflation, nominal GDP, and income. Lower interest rates could boost deposits somewhat. But low-cost deposits remain elevated relative to GDP, which would counter somewhat any positive influence from lower rates.[20]

[19] The Covid-19 pandemic in the United States came to a close on April 10, 2023 when the Covid19-Public Health Emergency was terminated, see H.J.Res. 7.

[20] The views expressed in this article are the author's own and do not represent the views of the Office of the Comptroller of the Currency, the Department of the Treasury, nor the United States government.