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Retail Sweep Programs and Money Demand

Since January 1994, the Federal Reserve has allowed depository institutions to "sweep" retail customer transaction deposits, which are subject to statutory reserve requirement ratios as high as 10 percent, into savings deposits that have a zero percent reserve requirement ratio. As of August 2002, an estimated $517.6 billion of transaction deposits, on a monthly average basis, was being so reclassified.[1] Recently, some economists have asked if retail sweep programs might affect the demand for M1, that is, the amount of transaction deposits held by households and businesses. Initially, at least, this seems unlikely. Generally, the sweeping of transaction deposits into saving deposits is invisible to customers, except perhaps for a fine-print insert with their monthly statement. As a result, a retail-deposit sweep does not change the amount of transaction deposits that a household perceives itself to own and, hence, it seems unlikely that the sweeping activity would affect money demand. But, this assertion could be incorrect. Reclassifying the deposit reduces the implicit reserve-requirement tax. Competitive market pressures might induce banks to pass the tax savings along to the customer. If so, the amount of transaction deposits demanded, ceteris paribus, could be larger.

Retail sweep programs should not be confused with banks' traditional business-oriented sweep programs in which checkable business deposits are converted, usually overnight, into savings deposits or off-balance sheet items such as repurchase agreements and shares in money market mutual funds. It seems likely that these sweeps *do* affect money demand because the business customer is an active participant and receives a significant part of the transaction's net earnings. Annual surveys published by the consulting firm Treasury Strategies, for example, suggest that business-oriented sweep activity increased tenfold during the 1990s, to approximately $270 billion in 2000. The surveys also conclude that business customers have received two-thirds, or more, of the earnings resulting from such sweep activity.[2]

Under provisions of the 1989 FIRREA legislation, the Federal Reserve Board has published each year since 1990 an annual survey of changes in retail banking fees.[3] In 1989, the Congress was concerned that banks would pass along to consumers higher deposit-insurance premiums. Today, because the estimated amount of transaction deposits involved in retail sweep programs is only slightly less than the amount of transaction deposits reported in M1 (in August, $555 billion), these same surveys might reveal whether reductions in the reserve-requirement tax were passed along to consumers. The survey data are consistent with this view: Since 1994, fees and minimum balance requirements for checkable accounts have increased somewhat less than the economy's overall rate of inflation, as measured by the chain-price index for personal consumption expenditure.

Yet, there must be substantial uncertainty regarding how much of these modest decreases in the real prices of retail banking services can be attributed to retail sweeps. The prices charged by depository institutions for retail banking services are affected by several factors, including input costs, productivity, and the competitiveness of banking markets. Also, some banks may have used earnings from retail sweep activity to increase offering rates on time deposits—thereby affecting the demand for the non-M1 component of M2, but not for M1. Finally, even though available surveys are consistent with the view that retail sweep programs perhaps have moderated increases in retail banking fees, the size might have been too small to affect significantly the quantity of transaction deposits demanded by households. At a 10 percent reserve-requirement ratio and, say, a 4 percent federal funds rate, the reserve-requirement "tax rate" on a $1,000 transaction deposit is 0.4 percent, or $4.00 per year.

—Richard G. Anderson

[1] Richard G. Anderson and Robert H. Rasche, "Retail Sweep Programs and Bank Reserves," Federal Reserve Bank of St. Louis *Review*, January/February 2001. For sweep-account data, see <http://research.stlouisfed.org/aggreg/swdata.html>.

[2] <www.treasurystrategies.com>.

[3] Timothy H. Hannon, "Retail Fees of Depository Institutions," *Federal Reserve Bulletin*, September 2002, pp. 405–13. <http://www.federalreserve.gov/pubs/bulletin/2002/0902lead.pdf>.

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