Opinion

A New Payments Role for the Fed?

BY JOHN A. WEINBERG

Some have argued that the U.S. payment system has not kept up to date with technology and that it is, as a result, too slow and too expensive. A white paper published by the Fed in January advocates adding a new option to the payment system: a real-time electronic payment mechanism that would enable consumers and businesses to make payments instantly, cheaply, and safely. The white paper suggests a collaborative effort to create such an option, with a leadership role for the Fed itself.

The potential role described for the Fed — initially that of "leader/catalyst," possibly later "service provider" — raises interesting questions. Historically, the adoption of new payment technology in the United States has been driven primarily by market forces. The role of the Fed in payments has been focused on payments among banks and, to a lesser degree, other financial institutions. Since both economic theory and our own experience tell us that private competition usually brings about the most efficient provision of goods and services, what is the basis for the Fed to take the lead in establishing a real-time payment network? What is the market failure that weighs against relying on market forces in this setting?

One possible objection to a purely market-based approach is the potential for monopoly, which arises because of economies of scale or the network aspects of a payment service. But if monopoly power is a concern, regulatory actions to maintain a competitive market are a more modest form of intervention. And with the rise of smartphones and other such devices, barriers to entry into the payments market may be declining. Still, much of the entry we've seen has been on the "front end," bringing new ways of interfacing at the point of sale. By contrast, the processes of clearing and settlement may continue to have the network characteristics that tend to favor small numbers of large providers.

An alternative objection, one raised by proponents of a greater Fed role, is just the opposite — namely, in the words of the white paper, the risk of "further fragmentation of payment services." But fragmentation is what we would expect to see in the early years of a relatively new market, such as electronic real-time payments. Even in the longer term, some degree of fragmentation may be desirable both to maintain competitive pressure and to avoid a payments monoculture that would render the entire payment system vulnerable if it were successfully hacked. To the extent that there is value in having a small number of platforms for payment services, it is reasonable to assume that competitive forces and network effects will lead to appropriate consolidation of the industry without the intervention of public policy.

These opposing concerns do suggest that there may be a tension in payment services between competition and cooperation. Ultimately, the establishment of standards that can make for efficient, broadly available payment services can require some coordination among a range of market participants. And as a significant participant in payments clearing and settlement, the Fed has a role to play in this coordination. But I am skeptical of the existence of market failures that would justify the Fed creating and providing a new payment system; there is good reason to believe markets can efficiently provide this service.

To be sure, the Fed has had a longtime role as a provider of payment services, for instance in the check-clearing system. But as Jeffrey Lacker, Jeffrey Walker, and I documented in a 1999 article in *Economic Quarterly*, the Fed's entry into check clearing was primarily based on a desire to increase bank membership in the Fed — not on any insurmountable deficiency in the private, decentralized system of check clearing. In particular, the Fed used its legal privileges in the market for check clearing to reallocate common costs in a way that made Fed membership more attractive.

Not only is it unnecessary for the Fed or another public institution to drive the development of a real-time payment system, there is a risk that it could lead to inefficient outcomes. Payment networks are, in large part, communication networks; as with other communication networks, much of the costs of payment networks are common costs that must be allocated among participants. In a payment network that is public or is effectively a public-private partnership, cost allocation can be driven as much by political concerns as by economic forces. Much as the Fed sought to use its power to allocate the costs of check clearing to induce banks to join, the leadership of a public or public-private payment network will have an incentive to allocate costs in the interest of one or more groups of constituents.

Without a doubt, new technologies present an opportunity to improve the speed, cost, and security of our payment system. The Fed can play a valuable role by carrying out research, among other activities. But there does not seem to be a market failure for the Fed to solve by taking an organizing or operational role. Unless such a failure can be demonstrated, those roles are best left to private institutions and private consortia. As the Fed deliberates whether and how to proceed with a new electronic payments option in the interest of efficiency, it will be important to bear in mind the risk that in some circumstances, the politics of cost allocation may drive decision-making more than efficiency. **EF**

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