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Government-Run Payment Systems Are Unsafe at Any Speed

The Case against Fedcoin and FedNow

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For people quarantining during the COVID-19 health crisis, electronic payments proved essential to obtaining needed supplies, from groceries to medicines, while maintaining social distancing and without having to leave their homes—thanks in large part to private innovation. While credit cards and cash transfer systems like PayPal and Venmo today are seamlessly integrated throughout the economy, the payments sector is still a nascent field in which future innovation could yield benefits unforeseen today and enable more robust crisis responses. Government intervention into the field would threaten all that.

Unfortunately, there have been such calls in the area of real-time payments—the instant deposit of money in bank or credit union accounts. While the advocates for government-run payment systems raise some valid concerns, their proposed solutions would hinder future innovation and create new and bigger problems, as this paper explains.

To many people, it seems baffling that cash can be *sent* instantly, but can still take few hours or even a few days for it to be *received* in another party's bank account. "If your payday was Friday, March 1 and you deposited your paycheck, it may not clear until sometime on Tuesday, March 5th," writes Brookings Institution economic analyst Aaron Klein. "Why does it still take multiple days for the money from your check to actually be available in your account when technology has progressed to the point where you can make that deposit from your phone in your house at 5am?"[1]

Klein and other influential commentators and policy makers see this apparent technological gap as a textbook "market failure." They appear to be either uninterested or opposed to removing regulatory impediments to make it easier for private businesses to generate innovations that can lead to faster payments. Instead, they are advocating for government support of real-time payments, through government-run payment systems or even state-backed cryptocurrency, as a solution to address structural disadvantages that stem from perceived public policy shortcomings.[2] Lack of universal real-time payments is one such problem. As Klein notes, it "is one of the many factors making it expensive to be poor."[3]

These advocates scored a victory in August 2019 when the Federal Reserve announced the launch of its FedNow payments system to compete directly with real-time payments in the private sector. Fed Governor Lael Brainard, an Obama appointee, stressed the urgency of the service by implying it would reduce or eliminate bank fees for the poor. She said:

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> Immediate access to funds could be especially important for households on fixed incomes or living paycheck to paycheck, when waiting days for the funds to be available to pay a bill can mean overdraft fees or late fees that can compound.[4]

However, there are two questions that need to be addressed before the Fed is allowed by the executive and legislative branches to go forward with FedNow or an even more ambitious state-backed cryptocurrency project that advocates are calling "Fedcoin," a catchall term for digital fiat currency issued by a central bank. First, what is the urgency for the product in reducing financial harms and inequities? Second, will government-run payment systems bring about faster payments for everyone sooner or slow ongoing private sector innovation in the area?

Real-Time Payments Do Not End Credit Needs. There are many innovations on the drawing board that would be good for society, yet there is no rush for government to embark on ambitious projects to bring many of them about. For instance, several studies have shown that self-driving cars could significantly reduce traffic accidents and fatalities.[5] Yet there is no immediate clamor for a "moonshot" project to bring them to our streets right away.

The mitigation of inequality seems to be one of the driving forces to in the rush to develop a real-time payments system. As Brookings' Klein argues:

> Adopting a real-time payment system is one way to make it less expensive to be poor. This should be low hanging fruit in combating income inequality as it puts money in the hands of those with less without raising taxes, government spending, or cutting any other program.[6]

Yet by Klein's own telling, there is very little data showing that faster payments alone would make a dent in the problems affecting the poor and unbanked—people outside the financial system. In his comments urging the Fed to mandate that banks provide real-time payments, Klein noted an industry estimate of $34 billion for costs of overdraft fees, check cashing, and payday loans to the poor. However, he then conceded: "There is no precise or even rough estimate as to what share of that figure would be fixed by real-time payments."[7]

There are many reasons that people turn to small-dollar credit options, such as payday loans, that have nothing do with delays of a few days in the clearing of checks. Chief among them is the lack of cash flow at a given time, rather than the speed at which this cash flow moves. Many low-income and some middle-income Americans have a recurring need for quick cash due to unexpected expenses such as a car repair or a sick child, income volatility due to unsteady or seasonal work, or a combination of both.[8] Mississippi State University finance professor Thomas Miller, an expert on small-dollar credit, says he has never observed an instance where an individual needed short-term credit because of the lack of a real-time payment.[9]

Then there are the regulations that have helped caused the number of unbanked Americans to soar, with the Durbin Amendment, enacted in 2010 as part of the Dodd-Frank financial overhaul, chief among them. This rule prevents banks and credit unions from earning a profit and fixes costs on the interchange fees these financial institutions change retailers to process debit card transactions. When it was enacted, financial institutions had to shift nearly all debit card costs to consumers, and the poorest consumers paid the biggest price. Before this measure was enacted, 76 percent of U.S. banks offered free checking accounts to consumers with no minimum balance. By 2011, only 45 percent did. And in 2012, that number dropped further to just 39 percent.[10]

For many people, checking accounts became so costly to maintain that they dropped out of the banking system altogether. In a recent study, George Mason University law professor Todd Zywicki and Geoffrey A. Manne and Julian Morris of the International Center for Law and Economics found that the Durbin Amendment is responsible for more than 1 million Americans being unbanked.[11]

Central Banks vs. Private Sector Innovation. Despite all this, banks, credit unions, and financial technology (FinTech) startups have been developing innovative solutions to expedite payments and help lower-income consumers tackle whatever problems lack of real-time payments may cause. The Clearing House (TCH), a bank-held cooperative that has been routing interbank payments in one form or another since 1853, began clearing digital real-time payments through its owner banks in 2017. By the end of 2018, TCH's real-time service was covering 50 percent of the deposit base in the country. Its goal was to have close to 100 percent by mid-2020, but it has been undermined by FedNow's entry into the industry, as many banks are now waiting to see what the Fed will offer [12]

FinTech products also are working to address the problems of slow payments indirectly. Take the example of "Dave," a mobile app that monitors customers' financial accounts and analyzes their spending habits. Dave builds customers a budget to help them better predict when they are at risk of overdrawing their account. If a customer is about to overdraw her account, Dave will advance up to $75, interest-free, to cover the shortfall—a small dollar loan to be paid back from the consumer's next paycheck. Rather than charging relatively high interest rates, as done by a typical payday lender, Dave is a subscription-based service that charges only $1 per month. Dave also receives interchange revenue when customers use its affiliated debit card.[13]

Then there is the promise of faster payments through cryptocurrency. Digital currency and mobile payments systems are offering many Americans an alternative to the Fed, and many across the world an alternative to central banks. Blockchain, an operational feature of most cryptocurrencies, is allowing peer-to-peer networks to clear transactions at a rapid pace without the need for a financial institution to act as an intermediary. Blockchain works as a distributed ledger, in which multiple users keep encrypted records of a transaction. Each "block" of the chain stores numerous transactions with all relevant data, which are linked to the previous block.[14]

However, Fed Governor Brainard seems to perceive any cryptocurrency or payment system that can settle transactions as a problem, because she wants the government-created Federal Reserve to have the fastest payment system around. In her August 2019 speech, Brainard singled out Libra, a new cryptocurrency launched in June 2019 by Facebook, saying, "Facebook's Libra project raises numerous concerns that will take time to assess and address." She added, "It is important for the Federal Reserve, working with the payment industry, to act quickly in finalizing the initial business requirements of the FedNow Service," she said.[15] Yet the Fed admits in the Federal Register notice for FedNow that the service will not be available until "2023 or 2024."[16]

Others are making similar arguments. "Go Slow On Libra; Speed Up On Faster Payments," was the headline of a July 17 *Forbes* op-ed that Sen. Chris Van Hollen (D-MD) entered into the Congressional Record.[17] Former Federal Deposit Insurance Corporation (FDIC) Chairman Sheila Bair, appointed by President George W. Bush, has become a prominent voice advocating for Fedcoin.[18] On the day of Facebook's launch of Libra in June, she told CNBC, "They need a lot of transparency, more explanation around that." Fedcoin, she said, "would democratize monetary policy" and "would give people a very safe way to make payments." Why would it be so safe? Because, Bair said: "We don't have to worry about the Fed defaulting. They can print their own money."[19]

Go Slow on Fedcoin and FedNow. The historical experience of central banks printing their own money or using other methods to massively inflate the money supply—from Weimar Germany a century ago to Venezuela in recent years[20]—suggests that is exactly what we should worry about. Many of the potential problems cited by critics of Libra would be magnified if the Federal Reserve-operated a cryptocurrency or payments system. Below are some of the main reasons to be concerned about FedNow and proposals for Fedcoin.

Both Fedcoin and FedNow are likely illegal. Since Congress created the Fed in 1913, it has competed in clearing checks and settling payments with private clearing houses among certain banks, such as the California banks that set up the Calwestern Automated Clearing House Association in the 1960s.[21] When the process began to be computerized in the 1970s, the Fed set up its own automated clearing house, known as ACH, even though private banks were already automating their check clearing. Brainard said in her speech launching FedNow that "since they opened for business around the country in 1914, as directed by the Congress, the Federal Reserve Banks have provided payment and settlement services—in healthy competition with private-sector providers—to achieve public benefits."[22]

However, Brainard glosses over the fact that in 1980 President Jimmy Carter signed bipartisan legislation to restrict new payment services and technologies from the Fed if they already existed in the private sector. The Depository Institutions Deregulation and Monetary Control Act, as interpreted by a Fed policy statement issued in 1984 and revised in 1990, bars the Fed from offering a new payments service or product unless it is "one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity."[23] Efforts to get the Fed to engage in these services—in order for it to not be surpassed by private-sector firms—is at odds with the statutory mandate the Fed lays out in this policy statement.

FedNow and Fedcoin will stifle competition and innovation. The American tradition of permissionless innovation—the light-touch regulation responsible for innovations from the light bulb to the Internet—has a long record of success. And while we may have never seen innovations quite like Bitcoin or Venmo before, systems like clearing houses and tokens for payments have long existed both alongside and before the Fed.[24]

By contrast, when the government decides to compete with the private sector, it has many advantages over its private sector competitors. It does not need to worry about losses, as it gets money from taxpayers. And it is often not subject to the regulations burdening the private firms that compete with it. All these factors can discourage competition, particularly on a large-scale project that requires lots of investment. For example, the creation of the government-owned Tennessee Valley Authority during the New Deal may have delayed electrifying parts of the American South as companies that were already building power lines pulled out when the TVA entered the sector.[25]

Comments from bankers and FinTech entrepreneurs indicate this could also be the case with a Fed-run payments system or cryptocurrency. The American Bankers Association (ABA) wrote to the Fed as it was contemplating FedNow that some of its member banks believed "that the Federal Reserve's entrance into the marketplace could inhibit the ability of existing private sector solutions to meet the demand for faster payment services."[26] The ABA commented that banks awaiting the Fed to create a real-time payments system could delay investments in technology out of worry that they may not be in compliance with the new Fed system. "Banks waiting for a Federal Reserve solution will be at a disadvantage in the marketplace if implementation is delayed and the goal of achieving ubiquity of faster payments will not be realized," the ABA warned.[27]

The Fed will have a conflict of interest in regulating firms it competes with. In addition to printing money and clearing checks, the Federal Reserve has vast regulatory power over banks and other financial firms. Having a Fed-run real time payments system would create a conflict of interest that could bias the Fed to impose more regulatory barriers on potential rivals that come under its jurisdiction. As noted, FedNow proponents both inside and outside the Fed have expressed the desire to "go slow" in regulatory approvals for Libra and other cryptocurrencies. The fact that these firms would be directly competing with the Fed could reinforce those stances.

The Fed will have access to many data points, potentially compromising privacy and security. Many of the concerns expressed about Libra have been related to Facebook's collection and uses of data. These concerns would be magnified in FedNow and Fedcoin. In processing real-time payments through FedNow, the Federal Reserve would have access to intimate data about the most personal transactions. If the Fed were to issue Fedcoin, it presumably would be able to have access to the transactions stored on the blockchain ledger underlying the cryptocurrency. Under some Fedcoin or Fed-issued "digital dollar" proposals, consumers would even deposit their money directly with the Fed, bypassing their community banks and credit unions.[28]

This means the Fed, a government entity, would have access to this data without a warrant and be able to share it with law enforcement agencies. The data would also likely be vulnerable to hacking, as the government's record on data breaches is certainly no better than that of the private sector.[29] Drew Johnson, national director of Protect Internet Freedom and Senior Fellow at the Taxpayers Protection Alliance, notes that under these types of schemes, "the federal government could learn how much a mother paid for her son's piano lesson, how friends chose to split a dinner bill, where an individual traveled using a rideshare app, how much a couple spent on concert tickets for their anniversary, and billions of other nuggets of information the government, frankly, has no right to know."[30]

And as bank regulators showed with Operation Choke Point during the Obama administration, they are not shy about targeting business and consumers operating in politically disfavored industries. During Operation Choke Point (which was largely abandoned during the Trump administration), bank regulators such as the FDIC and the Consumer Financial Protection Bureau targeted nearly 30 industries, from firearms to fireworks. Regulators told banks that providing services to these industries put them at "reputational risk" that could put them under stricter regulatory scrutiny. Several small businesses and consumers lost access to financial services, as banks stopped lending to and accepting deposits from these customers.[31] A coin that gives bank regulators direct knowledge of individual transactions has the potential for similar politically motivated abuse.

Fedcoin could aid government manipulation of currency. Former FDIC Chairman Bair has argued that one of the virtues of Fedcoin is that central banks like the Fed "can print their own money." Actually, that is a reason for extreme caution.

The United States does not have to become a dictatorship like Venezuela for harmful monetary policy to occur.[32] Modern Monetary Theory (MMT) is an approach currently being bandied about by progressives as a way to pay for massive spending projects like the Green New Deal. MMT posits that as long as the government controls its own sovereign currency, it can print what it needs to guarantee full employment without worrying about inflation. MMT has attracted sharp criticism from many respected economists, who warn it could destabilize currency and lead to runaway inflation.[33] If a central bank were to take such an approach, as Venezuela has shown, it would be even easier to create massive amounts of money through a handful of computer clicks than by running a printing press.

Conclusion. Private sector innovation in cryptocurrency and payment systems is creating products and services to improve people's lives by giving them access to a wide array of goods and services from wherever they may be located. And, as the COVID-19 crisis has shown, such access is crucial in a crisis. The last thing policy makers should do is to meddle with this success.

If there is any failure in the area of payments, it is not market failure, but a failure of government to allow the market to work. All the government needs to do for society to reap the benefits is to pursue its traditional functions of preventing fraud and protecting intellectual property rights. That remains as true in times of crisis.

FedNow and Fedcoin are solutions in search of a problem that could create many new problems.[34] The correct policy for the Fed and other government actors is to sit back and leave citizens to experiment and innovate with private options in currency, payments, and other sectors.

Notes

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