Central banks vs. private-sector payment systems – a fair battle?

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Some spheres of activity like defense and law enforcement are naturally provided by the state. They're public goods. Most goods and services, however, are best supplied by the private sector. Payment systems like Visa, Mastercard, American Express, PayPal, Discover, Zelle, Cash App, Swift, Fedwire, and cash are essential for commerce, indeed for modern life. People take them for granted. They can be operated by the government, the private sector, or both.

The US payment system is mixed. Retail, person-to-person, and bill payment systems are run by the private sector. The Fed plays an important albeit less visible role in serving banks. It operates interbank payment systems such as ACH and Fedwire, which compete with banks' cooperative processor The Clearing House, which, ironically, is regulated and supervised by the Fed. It also issues cash (Federal Reserve Notes) distributed by commercial banks.

In 2023 the US central bank will launch an instant-payments system FedNow, which will compete with TCH's RTP, Visa, Mastercard, Zelle, Fiserv, FIS, and Discover. The Fed's offering banks up to 2,500 fee-free payments per month to incent use. The Monetary Control Act requires the Fed to recover its costs 'over the long run', but the long run is whatever the Fed decides it is. While the Fed has typically measured long-run cost recovery for mature services to be over ten years, it declared 'it expects FedNow to achieve its first instance of long-run cost recovery beyond 10 years. Private capital doesn't enjoy that kind of luxury.

If a private-sector payment system offered free payments to build network critical mass, all well and good. However, unlike private payment networks, the Fed enjoys unlimited resources and can't become insolvent. Nobody assumes government should make wine, mobile phones, airplanes, or movies, or run restaurants, gyms, and hotels. While a case can be made for it to operate payment systems, the bar should be set high. The Fed should only play roles that the private sector cannot, and it shouldn't be permitted to use unlimited government resources to unfairly subsidise its offerings in competition with the private sector.

Concerns over national security, systemic importance to the financial system and economy, efficiency, or needs the private sector can't address, might be used to justify government running payment systems. No government wants to rely on payment systems subject to control by potentially hostile powers. Governments may, therefore, operate critical payment networks, insist they're run by national players, or if they're foreign networks, that they process in-country.

After Putin's 2014 Ukraine invasion, Russia was subjected to limited financial sanctions including US-domiciled Mastercard, Visa, and PayPal cut off Crimea, but not Russia. Reminded of its vulnerability Moscow mandated foreign networks process domestic payments in-country and its central bank launched a national card network, Mir.

China and India mandate foreign payment systems process in-country. China's payment policies are baldly autarkic. Notwithstanding Beijing's 2001 WTO commitment to open up its domestic payments market by 2006, the Middle Kingdom prevented global networks like Mastercard and Visa from competing in its domestic market. While Delhi favours national players, its payments market is open and competitive.

Greater efficiency may be an excuse for a public payments' utility. The idea a single well-designed state system would be more efficient than multiple competing private-sector systems with redundant costs is superficially appealing. Policymakers are more likely to argue greater efficiency justifies a single government or regulated private payment system for core infrastructure. Even core payments infrastructure, however narrowly defined, benefits from competition-driven innovation and market discipline and intelligence.

Central planners can't match the market's vast dynamic distributed intelligence. Competing systems' inherent dynamism, innovation, and continuous reallocation of resources to players delivering better value have enormous benefits.

A monopoly card network or digital wallet run by the post office, or the Fed wouldn't deliver better value and be more innovative and accountable to customers than Visa, Mastercard, American Express, Discover, PayPal, Apple Pay, or Google Pay. The market is the most ruthless regulator of value, not enlightened government bureaucrats superintending payment systems. Where scale advantages are significant, markets will naturally consolidate. A monopoly, however, is never optimal. But private-sector monopolies are rarely if ever sustainable unless privileged by the state.

The contention some payment systems are so systemically important government must run them doesn't bear scrutiny. Critical national payments infrastructure owned and operated by the private sector can be regulated as such, subject to prudential reviews of capital adequacy, ownership, and management. Bank-owned The Clearing House operates an ACH system, an interbank large0value funds transfer system, CHIPS, and an instant-payment system RTP. The Clearing House is regulated as a systemically important financial market utility.

Central banks' contention that only they can deliver certain payment systems should be viewed through the lens of Nobel Laureate James Buchanan's Public Choice Theory which holds self-interested public bureaucrats act to maximise their own utility, prestige, and power. They are rarely the indispensable actor. The Fed insists only it can and will equitably serve all banks. The ECB on its own prerogative decided to build an instant-payment system TIPS, on the premise only it could adequately provide instant payments across the euro area.

And Brazil's central bank contended only it could provide instant payments ubiquity. Yet the private sector provides instant payments in the US, EU, and Brazil. The Fed regulates and supervises TCH and also competes with it. The EU central bank oversees EBA Clearing's shareholding banks and payment systems like RT1 with which it competes. Central banks aren't subject to the same financial constraints and often can use regulation to privilege themselves. Brazil's central bank used its authority to kneecap a competitor. Facebook has roughly 147 million WhatsApp users in Brazil. In June 2020 it launched WhatsApp Pay. It was fee-free for P2P payments and charged merchants 3.99%. The central bank put the kibosh on it. And Brazil's antitrust regulator Cade blocked WhatsApp's partnership with processor Cielo because of competitive concerns. Lo, in November 2020 Brazil's central bank launched its instant-payments system Pix. It mandated that large payment service providers participate, a prerogative for building network critical mass and therefore value and relevance that no private-sector payment system enjoys.

In less than two years Pix enrolled 126 million individuals and 11 million businesses and surpassed the number of debit-card transactions. After Pix had picked up a head of steam, in March 2021 the central bank greenlighted WhatsApp Pay, but only for P2P, not retail payments.

The central bank competing with the payments industry (and further regulating and supervising that very same industry) is a bald conflict of interest and a deterrent to private-sector investment. Nobody wants to compete with their regulator or a central bank with unlimited resources.

The National Payments Corporation of India, owned by the state and private-sector banks, and guided by the central bank, operates a national card network Rupay and the major national interbank payment systems including real-time payment systems IMPS and UPS.

China’s central bank (PBOC) forced private payment systems like Alipay and WeChat Pay to use its clearing system Netsunion. Protected monopoly card network UnionPay is owned by state and commercial banks, run by PBOC alumni, and takes direction from the central bank. Payment systems run by the Fed, ECB, Banco Central do Brasil, and PBOC aren’t subject to the same financial constraints as even private-sector titans, which can fail and go bankrupt. Central banks print money and can’t become insolvent.

Central banks’ electronic payment systems could be spun off with regulatory guardrails.Private-sector payment systems have enormous advantages. While individual players may disappoint, private-sector payment systems must ultimately satisfy the market to remain in business. And even if individual players fail, the self-correcting private payment system continuously improves.

The payments industry is more adaptive than public utilities. The most brilliant central planners can’t design a perfect payment system, much less adapt it to changing conditions. There’s no payment infrastructure that wouldn’t benefit from genuine competition and ruthless regulation by the market rather than by the administrative state or politicians.

Private-sector systems dynamically self-correct. In competitive free markets incumbents and challengers vie for shares by trying to deliver better payments. The market continually votes on what’s better. Resources are allocated away from payments enterprises that don't satisfy or delight their users, to those that do. Payment systems run by central banks, no matter how thoughtfully engineered and successful out of the gate, aren't subject to the same market discipline, nor enjoy private systems' innovative vigour. Underperforming government systems often get more resources.

Most payment innovation comes from the private sector, which invented cash, checks, interbank clearing, credit cards, global bankcard networks, electronic bill and P2P payment systems, e-wallets, and digital currencies.

In the 9th century, Chinese merchants invented paper money. In the 19th century, Scottish banks created two-sided banknotes. In 1950 NYC financier Frank McNamara invented the general-purpose payment card Diners Club. US banks created global bankcard networks Mastercard and Visa. In 1981 fitness club operator Pete Kight launched what became America's leading electronic bill payment system Checkfree. In 1998 Peter Thiel started PayPal. In 1999 radio DJ Steve Streit created the first general-purpose prepaid card.

Computer scientist David Chaum invented the first digital currency Digicash. Entrepreneurs Jeremy Allaire and Sean Neville with Circle and Brock Pierce and Craig Sellars with Tether were stablecoin pioneers. Pony Ma's Tencent developed digital currency Q Coin and WeChat Pay. Jack Ma's Alibaba created Alipay. Competing against stodgy state banks and state-protected monopoly card network China UnionPay, given latitude by Chinese regulators, such as liberaliser PBOC governor Zhou Xiaochuan, Tencent and Alibaba revolutionised payments in China. While the Sino-liberalisation window is closed, Alipay and WeChat Pay are well-established and many outside China seek to emulate their 'super-app' model.

It’s assumed central banks issuing cash is the natural state of affairs, notwithstanding historically in many countries competing commercial banks issued banknotes (cash). While cash issuance could be returned to commercial banks, in most countries it would be politically difficult. Digital fiat currencies bring the issue of state versus private-sector payment systems to the fore. More than a hundred central banks are working on digital currencies. Central banks are predisposed to issue CBDCs, have vast resources, and often regulate potential private-sector issuers of digital cash.

There’s a danger central bank digital currencies will stifle the development of and innovation in private digital currencies by banks and fintechs. A Fed digital dollar would reduce if not eliminate banks’ and fintechs’ appetite for issuing and innovating in stablecoins – effectively digital banknotes. New government payment systems should bear a high burden of proof. Existing state-run payment systems should be privatised, unless there’s a compelling national interest not to.

About Eric Grover

Eric Grover is the Principal at Intrepid Ventures, providing corporate development and strategy consulting to financial services, payment network, and processing businesses, principally in North America and Europe. He’s a payment thought leader with a comprehensive understanding of the global payment network and processing space, including each stage in the payments value chain: credit, debit and prepay issuing, issuer processing, payment networks, and merchant acquiring and processing. His prior experience includes Visa International, GE Consumer Finance, BofA, NationsBank, Transamerica, and serving as a director on Nordstroms credit card A/R subsidiary’s board.