Christopher J Waller: What roles should the private sector and the Federal Reserve play in payments?

Speech by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the Clearing House Annual Conference 2024, New York City,12 November 2024.

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Thank you for inviting me to speak here today.[1] The Clearing House is a great place to talk about the evolution of clearing and settlement of payments in the United States. The key question I want to address today is, what roles should the private sector and the Federal Reserve play in payments?

As a strong believer in the benefits of a capitalist system, I hold the view that it is generally the private sector that can most reliably and efficiently provide goods and services to the economy. And I apply this view to the payments ecosystem.

It is that perspective that underlies a question I often ask when forming my positions on the appropriate role the Federal Reserve should play in a wide variety of initiatives: What is the fundamental market inefficiency that would be solved by government intervention and can only be solved by government intervention? If there isn't a satisfactory answer, then I believe government shouldn't intervene in private markets. Does this mean I believe the Federal Reserve should not be involved in payments? No. While I generally believe that government shouldn't directly compete with the private sector, there are situations where government involvement is needed to solve for market inefficiencies that may arise because of things like incomplete markets, coordination problems, or a lack of resilience.

As a policymaker, I have applied that same question to issues ranging from bank regulation to monetary policy. For an example in the payments area, three years ago there was an increase in public discussion about creating a new payment instrument called a central bank digital currency (CBDC). The Federal Reserve Board was compiling a report and seeking public comment on the potential benefits and risks of the idea. In a speech I gave in August 2021, I asked, what problem would a CBDC solve? In other words, what market failure or inefficiency demands this specific intervention?[2] In more than three years, I have yet to hear a satisfactory answer as applied to CBDC.

Given today's audience and my position serving as the chair of the Board's payments committees, I want to focus on the important roles the private sector and the Federal Reserve play in our ever-evolving payment system. To set the stage for that discussion, I think it is helpful to recap some history around payments and clearing in the United States.[3]

In the early decades following the country's founding, banks generally had state charters. While state banknotes and checks circulated locally as payment instruments, there were difficulties clearing and settling checks across states. One way of describing this is to say that the early U.S. payment system suffered from incomplete markets. The Second Bank of the United States was created in 1816 and, due to its federal charter, it

was able to create a national system for clearing checks and banknotes. This in turn led to a more complete national clearing and settlement process.

When the charter for the Second Bank lapsed, clearing and settlement of banknotes and checks fell back to state-chartered banks. Many of the earlier inefficiencies resurfaced. For example, porters in New York City would deliver checks and exchange them for gold or other coins and then transport that "specie" to the payee. Hauling these money bags around New York posed obvious risks, and these risks multiplied by the mid-19th century when the number of banks in New York grew rapidly. As this audience is well aware, the New York Clearing House Association (NYCH) was founded in 1853 and served as a central location for the clearing process, which soon evolved, with certificates replacing coins. Furthermore, by being part of a common infrastructure, all members had a reasonably good idea of the quality of each other's balance sheets. In modern economic language, the NYCH became a coordination mechanism that improved clearing by getting banks to clear and settle payments in a well-organized manner. It also reduced asymmetric information about the quality of member balance sheets. By performing this function for New York banks, which constituted a relatively large share of the U.S. financial system, the clearing and settling of payments improved nationally. In this sense, the NYCH was the closest thing the United States had at that time to a central bank.[4]

While this was an improvement, not all important financial intermediaries were members of the NYCH or other such private arrangements. That is, there were gaps. And financial panics, sometimes driven by gaps and problems in check clearing, were a regular feature of the latter 19th and early 20th century.

The Panic of 1907 was a classic example of that. Depositors and investors lost confidence in certain New York banks that had been combined into large, complex, and opaque trust companies that were not members of the NYCH. This resulted in runs on those trusts, which led to broader liquidity problems. Although the NYCH had the ability to provide liquidity to those trusts, the provision of that liquidity was delayed. It appears that at the time, the NYCH was, reasonably, observing some form of Bagehot's dictum when deciding whether to provide liquidity. Under that dictum, you want to know that the institution to which you're providing liquidity is solvent. If it isn't, then the liquidity extension could be akin to throwing good money after bad. But because the trust companies at the time weren't member institutions, the clearinghouse didn't have a good enough understanding of their balance sheets to know whether they were solvent.[5] Some banks refused to clear checks from other institutions, which led to an erosion of depositor confidence and more failures. This historical example points to another aspect of a payment system that is important-resilience of the system.

These problems highlighted by the 1907 panic-coordination failures and a lack of resilience-could have been mitigated with the help of a central bank. Paul Warburg, an influential banker at the time, argued that such a central bank could "establish and maintain a perfect system of credit, enabling the general banks to transform cash credits into actual cash with such absolute ease and certainty that the use of cash credit, instead of actual cash, will not cease, no matter what may happen."[6]

In 1913, Congress agreed and created the Federal Reserve. It positioned the Federal Reserve at the center of the banking system by establishing a nationwide check-

clearing system and a telegraph wire transfer service that is now known as Fedwire®. The Fed was also intended to function as a lender of last resort so that suspension of payments would no longer be necessary. In the 1970s, the Fed promoted more efficient check-clearing by adding the automated clearinghouse service. Our job in providing these services and carrying out our responsibilities was and continues to be to make sure the payment system functions efficiently and resiliently, promoting the kind of confidence that is vital for a modern economy.

The lesson from this history, as relevant now as ever, is that the payment system has been one of those areas in which the best efforts of the private sector have sometimes fallen short. The decentralized and diverse nature of banks in the United States is a feature that goes back to the 1800s and has the merits of promoting competition and a vibrant economy. However, when engaging in clearing and settling payments, coordination problems and information asymmetries across banks can be, and were, destabilizing. While the private sector made advances in resolving those issues, the Panic of 1907 showed that those steps were not sufficient. As successful as the NYCH was for its members, it could not protect its members and the economy from risks in the growing share of finance occurring outside its walls. This contributed to the motivation to establish the Federal Reserve and its role in payments.

Fast forward to today, and we are once again in an era of rapid change and innovation in money and payments. Some of this will not pan out. Some of this change is about delivering services already available but doing so with new technologies. And some of it is leveraging new technology to rethink existing payment, clearing, and settlement structures. How will all of this come together? And what will be the respective roles of the private sector and the Federal Reserve? Let's break it down, keeping in mind my principle that the Federal Reserve should focus on addressing issues that the private sector cannot address alone and, in doing so, promote an efficient and resilient U.S. payment system.

I'll start by discussing the important roles that the private sector now plays in the payment system and in the evolution of payments under way. The private sector connects consumers and businesses to the payment system, with financial institutions competing to provide services to their customers. Such competition can lead to better products and services for consumers as profit-seeking competitors look for opportunities to win over customers including through the adoption of new technologies. I have noted my concern that some see these new technologies as an opportunity for the public sector to play a *bigger* role in payments, which may crowd out private investment. I believe this would be a policy mistake and a better approach is one in which the private sector continues to have a significant footprint, with the role of government limited.

One important reason for that is that the private sector, through competition, is typically best situated to sort out good ideas from bad ideas, rather than central banks or other public-sector institutions choosing winners and losers. At the early stages of innovation, the true value-added of the application of new technologies is murky. Market competition helps sort that out and typically leads to a wider range of products that can be better suited to the needs of consumers.

But just as was the case in the time of Warburg, there remain problems in payments that can't be fully resolved by the private sector. And just as we have done throughout history, the Federal Reserve stands ready to support the evolution in payments and do so primarily through our operational role in the payment system, by providing core clearing and settlement infrastructure on which the private sector can innovate. Notably, the Fed has the unique ability to provide the infrastructure to reliably settle interbank obligations using balances at the central bank, which enhances the stability of the banking system and the broader economy, reflecting the lessons learned in 1907 and through earlier banking panics.

Compared with many other countries where a small number of large banks dominate, the United States has thousands of banks and credit unions. Connecting those many organizations to a payment network requires a significant amount of coordination. One recent example of an area in which we're playing such a coordination role is in instant payments. The role we're playing with FedNow is to help with that coordination problem using our existing connections to those thousands of institutions. And that approach is consistent with my overall view of the appropriate role of government-to narrowly address problems like those of coordination that can't always be efficiently solved by the private sector alone. In doing so, we complement the private sector and promote responsible and efficient innovation in the broader market.

With respect to new and emerging technologies in finance, I can think of two ways in which the private sector is uniquely positioned to develop and deploy them while the government is not well suited to do so. First is the question of innovation risk-the investment in new payment technologies is large and comes with risk of failure. Private-sector entities, risking their own funds and seeking to turn a profit, will have a greater incentive to accurately gauge demand for these technologies and bring those products to market faster. Second, despite the current fascination around the world with industrial policy, rarely can the government match the ability of the private sector to efficiently allocate resources and explore how well new technologies can address actual shortcomings in the current payment system. It is too early to tell whether some of the new technologies will relieve significant frictions in the payment system, but it is going to be the private sector, betting with its own money, that is best positioned to explore this question.

If problems emerge, as they did with check clearing in the 19th century, then government can play a constructive role in overcoming them. Well before this point, however, it makes sense for the public and private sectors to look down the road together and engage in dialogue about potential issues and opportunities that might arise. For example, through the Bank for International Settlements, the Fed is engaged with the private sector to explore how tokenization technology might be used to facilitate cross-border payments in a faster and cheaper manner. This project brings together multiple central banks and private-sector financial firms in collaboration to potentially facilitate a better-functioning monetary system.[7] That process of working together to promote the efficiency and safety of the payment system, as the Federal Reserve has done for decades, can lead to outcomes that benefit households, businesses, and the overall economy.

American entrepreneurship and technical prowess have generated exciting innovations in payments, and they will continue to do so. The role of the Federal Reserve is to support that initiative and engage with the private sector to promote innovation while guarding against risks to financial stability. We've managed this balancing act before and will continue to do so. And, together, we will ensure that the payments ecosystem continues to move forward for the benefit of households and businesses.

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[1] The views expressed here are my own and are not necessarily those of my colleagues on the Federal Reserve Board.

[2] See Christopher J. Waller (2021), "CBDC: A Solution in Search of a Problem?" speech delivered at the American Enterprise Institute, Washington (via webcast), August 5.

[3] I am drawing on material in Stephen Quinn and William Roberds (2008), "The Evolution of the Check as a Means of Payment: A Historical Survey," Federal Reserve Bank of Atlanta, *Economic Review,* vol. 93 (4), pp. 1–28.

[4] See Eugene Nelson White (2016), *The Regulation and Reform of the American Banking System, 1900–1929* (Princeton, N.J.: Princeton University Press).

[5] See Jon R. Moen and Ellis W. Tallman (1999), "Why Didn't the United States Establish a Central Bank until after the Panic of 1907?" Working Paper Series 99-16 (Atlanta: Federal Reserve Bank of Atlanta, November)

[6] See Paul M. Warburg (1911), "A United Reserve Bank of the United States," *Proceedings of the Academy of Political Science in the City of New York,* vol. 1 (January), pp. 302–42.

[7] See Bank for International Settlements (2024), "Private Sector Partners Join Project Agorá," webpage, September 16.