President's Message: Digital currencies – A system upgrade or 'Problems 2.0?'

by: Esther L. George

April 12, 2020

This message is based on remarks President Esther George made Feb. 10 in Washington, D.C.

Technology and innovation have a long history of joining forces to disrupt existing conventions.

We certainly see this dynamic playing out in today's financial system as it relates to how we think about money and its role in facilitating payments.

Well before the Federal Reserve's creation in 1913, the United States had already been through multiple periods of what might be considered "financial experimentation." In the early 1800s, as commercial banks issued their own unique currencies, values could fluctuate wildly creating an impediment to commerce for both sides of a transaction.

Still, the motivation for creating many of these early private currencies was in response to demand from a population seeking access to a medium of exchange that would improve the flow of commerce. Today's landscape is different, but the questions facing policymakers strike me as having similar refrains. New privately issued digital currencies seek to bring money into the digital world with improvements in speed and cost, and with the scale and scope to provide broad access. The ability to send money with the speed and convenience of an email is appealing and understandably gaining rapid adoption.

The Federal Reserve has heard from the industry for a number of years that payments need to be faster. However, one of the reasons processes have not been updated is that the underlying infrastructure is not designed to be instantaneous. As a result, it can take up to a few days for someone to receive funds in a personal account, regardless as to whether the payment was by check, ACH, card, or one of the increasingly popular payment apps. This can be especially problematic for many Americans who are living paycheck to paycheck. It also matters to small businesses and their ability to manage cash flow.

The cost of payments is another pain point that is potentially amplified by multiple intermediaries in a payments transaction. For example, some providers of digital currencies highlight what they view as excessive interchange fees—an issue the Kansas City Fed has been studying for more than 15 years—as a reason that merchants may be interested in adopting this new medium

of exchange over current systems. The reach of payment capabilities also is an important aspect of today's landscape. Globalization has led to an increase in cross-border payments. Yet because infrastructure, currency, standards, laws and regulations are domestic and not international, there are many efficiency and coordination challenges with cross-border payments. As a result, the location and jurisdiction of payment participants matters, and raises the question of whether digital currencies can address these challenges.

Finally, digital currencies have been touted as better facilitating access to the financial system for the unbanked population. According to the World Bank, 1.7 billion people still do not have access to useful and affordable financial products and services. As commerce and payments have become more digitalized, those who rely solely on physical cash for transactions may run the risk of limiting the transactions they can conduct.

Questions for policymakers

Each of these are legitimate problems that digital currencies seem well suited to address. Yet we can't overlook that despite efforts to make payments faster, less costly, and broadly accessible, today's privately issued digital currencies operate largely outside our existing institutional and regulatory frameworks. This raises important questions for policymakers.

Digital currencies and other private nonbank financial innovations challenge the notion of the traditional bank business model. Our institutional frameworks have for some time regarded commercial banks as foundational, even special, to our financial system in three particular aspects. No other type of financial company and its funding has access to the public safety net of federal deposit insurance and the Federal Reserve's discount window; banks are regulated and supervised because of this safety net and their key role in the economy; and only banks have direct access to the Federal Reserve's payments rails.

The adoption of private digital currencies at scale also has implications for monetary policy. Should digital currencies lead to a large share of financial transactions taking place outside of the current system, then digital currencies may challenge current operating frameworks. For instance, the Federal Reserve implements monetary policy by engaging with a limited number of primary dealers. This centralized framework could be challenged should a decentralized medium of exchange develop which facilitates financial settlement outside of the markets in which primary dealers operate.

In addition, one of the most basic functions of the central bank is to supply liquidity in times of crisis. However, without a clearly defined set of counterparties, the benefit of this function could be limited. More generally, the proliferation of digital currencies may challenge the ability of central banks to achieve their longer-run macroeconomic objectives to the extent it erodes the ability of monetary policy to influence broad financial conditions confronting households and businesses.

Finally, the stability of the financial system is foundational to the ability of central banks to achieve their objectives. Events that trigger a loss of confidence or incite a classic banklike run may not find remedies in the existing regulatory and policy toolkit, including the Federal Reserve's discount window.

How are central banks addressing these problems?

The accelerating pace of change has implications for financial systems around the world and for the way central banks conduct their business to meet their objectives. To that end, the Bank for International Settlements (BIS) has organized an Innovation Hub where global central banks can collaborate and experiment. Additionally, more than 50 central banks are engaged in digital currency work, according to the BIS. Countries like Sweden and Uruguay are evaluating digital currency prototypes.

Although the Federal Reserve has no plans to issue a digital currency, we are carefully monitoring and studying global developments. A more immediate priority has been to modernize our own payment rails to meet the demand for reliable, real-time payments. We are currently developing a new retail payment service called FedNow to support widespread adoption of faster payments in the United States. This service will operate alongside a private sector service to provide real-time, payment-by-payment, settlement of interbank obligations through debits and credits to banks' balances in accounts at the Reserve Banks while incorporating clearing functionality, thus allowing for end-to-end faster payments. We expect FedNow will be able to address the concerns that we've heard from the public about the need for a real-time payments infrastructure.

As it relates to the costs of today's payment system, central banks are responding in different ways. Some countries allow central banks and other public authorities to directly regulate the payments system and often have the authority to regulate certain fees associated with making a payment. Central banks such as the Federal Reserve operate retail payment systems to achieve its objectives for efficiency, accessibility and safety.

Finally, access to financial services remains an important policy goal. This is an important consideration for the United States as well, although access to technology itself has been noted as a barrier with some 45 percent of unbanked households having neither a smartphone nor internet access at home. This means almost half of the unbanked may not be able to use these new payment solutions. Providing a foundational infrastructure such as broadband internet service will be essential for this population. The Federal Reserve has viewed such investments favorably for purposes of the Community Reinvestment Act.

Payments digitalization, new entrants and new business models will continue to disrupt and reshape the financial services industry. Digital currencies may well have the potential to address pain points in the current payments system. At the same time, however, we should be mindful of lessons from the past.
