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The Federal Reserve Should Drop FedNow And Any Plans To Launch A CBDC

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Just before Thanksgiving, the Fed announced it still plans to launch its new real-time payments system in the middle of 2023. More surprisingly, it also plans to waive the fees to participate in the new system.

One report notes that the Fed plans to launch the new system, known as FedNow, after "years of work on the project." But it doesn't mention that for most of those years the Fed claimed it had no interest in launching its own instant payments network. Or that the private sector did most of the work.

Initially, the Fed assured everyone that it wanted private firms to build and run the system. It did so publicly in 2013, 2015, and again in 2017.

Yet, in 2019, *after* the private sector created one, the Fed announced that it would launch its own real-time settlement system.

Given the long-running love-hate relationship between the federal government and the banking sector, it's difficult to feel sympathy for the banks. Small banks, unsurprisingly, are supporting FedNow. Regardless, the Fed clearly shafted the big banks, and things might not work out as well for the smaller banks as they're hoping.

Some might be tempted to view the Fed's latest move as good old-fashioned competition, but nobody can compete with the Fed. It's the government agency responsible for supplying U.S. dollars. (My colleague George Selgin has multiple Twitter threads on the Fed's statutory requirements for pricing its services and recovering its costs, and how historically difficult it has been to hold the Fed accountable to those requirements.)

This whole thing is an avoidable mess.

Set aside the below-cost/predatory pricing issue and whether the Fed disingenuously pushed the private sector into creating an instant-payments network. Also ignore whether the Fed truly recovers its costs, *and* whether the Fed itself is to blame for a host of a payments system problems throughout history. The basic question remains: Should the government be running payments systems?

In general, the government should not provide a good or service unless there is some sort of market failure. And there is clearly no market failure in the payments industry.

Payments services are not public goods, and the private sector has regularly provided such services. The Fed does not have to take over the payment system–or even part of it–to implement monetary policy or to regulate financial firms. It has no mandate to provide the technology for people to make commercial transactions, and it could easily change its policies to speed up settlement times on existing systems.

All these reasons have informed Congress's efforts to limit the Fed's ability to compete with the private sector, and rightfully so. There is little room for the private sector when a government entity, least of all the Federal Reserve, competes directly for customers. FedNow will surely keep private firms out of the industry.

Moreover, the same negative implications–and some that are worse–apply with central bank digital currencies, or CBDCs. I received some flak for being a scare monger when I said it, but I stand behind my original argument:

If the tide continues to move in this direction, with central banks providing retail bank accounts to the general public and controlling every aspect of money, there will be little room left for a private banking industry.

For anyone who thinks this position is extreme, here's a passage from a Roosevelt Institute paper (Central Banking for All: A Public Option for Bank Accounts) by Morgan Ricks, John Crawford, and Lev Menand:

FedAccounts would offer all the functionality of ordinary bank accounts with the exception of overdraft coverage. They would also have all the special features that banks currently enjoy on their central bank accounts—including unlimited secure balances, instant in-network payments, and a higher interest rate—as well as some additional, complementary features. The FedAccount program would bring genuinely transformational change to the monetary-financial system, in ways both obvious and unexpected. Perhaps most obviously, it would foster financial inclusion.

….

FedAccounts, properly structured, would be a money-and payments safety net for such households, lessening their reliance on expensive and subpar alternatives. But FedAccounts would have benefits across the income and wealth spectrum. For small and large businesses as well as individuals, the boost in interest paid on central bank accounts, the immediate clearing of payments, and (for those exceeding the deposit insurance limit) the nondefaultable status of balances would be transformative. Consumers and retailers would also benefit because the Federal Reserve would not charge interchange fees on debit card transactions.

They want the government to pay customers a higher interest rate than private banks and charge little to no fees, resulting in "transformational change to the monetary-financial system." Yet, somehow, CBDCs are supposed to complement private banks?

Many supporters, instead, argue that a CBDC should be considered as a limited public option, perhaps only for the "unbanked or underbanked." These arguments are weak.

For starters, the supposed benefits of a CBDC depend on widespread adoption. Worse, though, is the basic fact that only about 5 percent of U.S. households don't have a bank account. And nearly half of those folks say that they don't have an account because they do not have enough money to meet minimum balance requirements. (For other explanations, see here.) Not having enough money is a broader economic problem, one that creating a "free" public option for banking does almost nothing to solve.

Furthermore, people can still participate in the American economy without a bank account. Check cashing services, prepaid cards, and payment apps such as Venmo are available to anyone who wants them. Of course, CBDC supporters don't like those check cashing services, so they refer to anyone with a bank account who uses them as "underbanked," thus fluffing up the "financial inclusion" problem.

There is also absolutely no doubt where the political pressure will push even a severely limited public option CBDC. The CBDC's availability will inevitably expand to more people and businesses, thus crowding out more and more private firms. Just look at the above passage from the Roosevelt Institute and listen to what most of the CBDC supporters already promote.

Finally, there is the issue of how CBDCs fit into the existing anti-money laundering (AML) framework. Anyone who thinks CBDC users will get a privacy pass compared to bank customers is in for a rude awakening, and there is clearly further potential for abuse of power with CBDCs relative to existing means of payment. (For more on CBDC issues, check out this working paper coauthored with my Cato colleague, Nick Anthony.)

Just like FedNow, CBDCs should be left on the drawing board. Both usurp the private sector. Supporters of both ignore the many harms that the government has already done to financial markets and assume that the government will provide better solutions this time.

If Congress really wants to provide more access to financial markets and ensure more innovation in financial services, members should support more private innovation and competition. At the very least, they should work to lessen government monopoly and regulation while ensuring that the Fed cannot issue a retail CBDC. Then they can start getting the government out of the payments system business.

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