The Role of the Central Bank in the Growing Industry of Internet Payments

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What role could, or should, Central Banks play in the Internet payments industry ? It is a difficult question, as it is not yet clear how, and to what extent, such industry will develop, and whether governments will allow such developments. According to some, Internet payments are a matter of private initiative, and the Central Bank should play no role at all. They dream of an unregulated world, where multiple currencies, as well as baskets of currencies and other assets, are equally accepted as means of payment. Others point out at the risks of such a scenario, and at the increased volatility and unpredictability of financial prices that it could cause.

Economic theory is not helpful either. Even though the payment system as a whole is crucial to economic stability, and is, indeed, one of the main concerns of Central Banks, it is seldom taken into account in economic models. It is normally considered as part of the institutional context or analysed through its effects, mainly on the banking system, the monetary and financial markets, the instruments of monetary policy. The problem with this approach is that it is static, as it considers the payment system and the institutional context as given. Furthermore, if the traditional Central Banking institutional model is clearly becoming rapidly outdated, elaborating a new one poses several problems. Globalization and the growing integration of national payment systems, as well as the increasing amounts of payments handled through private clearing houses requires an international approach, at least on a G10 level. However, as Mr. Padoa Schioppa, of the Bank of Italy, says, "*the road to define a new institutional model must be different from the ones adapted in the past. At the beginning of this century, an agreement on how to manage a monetary system based on currency and deposits was only reached after a financial and monetary crisis. It would be extremely dangerous to pass through a similar learning process today, not least because payment systems in the industrialised world would amplify the problems of any single market operator, diffusing its effects to the whole economy*".

Traditionally, Central Banks have four duties: they manage monetary policy, they supervise the payment system, they promulgate regulations, and, in many countries, they supervise the banking system as a whole. Each of there roles is going to be affected, in a way or another.

As a **monetary authority**, the Central Bank will have to adapt its procedures to the new context. I believe that its ability to control monetary aggregates will not be seriously thwarted, at least in the short and medium run. Internet payment instruments are indeed a new financial instrument, significantly different from traditional ones, but many innovations have changed and are changing the banking and financial industry. Furthermore, current and projected volumes for the next few years are not large enough to have significant macroeconomic effects. Probably changes and adaptations will be required in the econometric models used to predict the trends of economic variables, as variables such as the velocity of money, capital mobility, etc. could be affected.

Other effects could derive as a result of the current trend of institutional de-specialisation. Today the monopoly held by banks over the payment industry is increasingly being threatened by non banks. Department store credit cards are an example of such new competitors. Internet payment instruments, if provided by non banking institutions, could increase this tendency. As Central Banks enforce monetary policy through their "special" relationship with banks, a decreased importance of such institutions could decrease its effectiveness.

The role of the Central Bank as **supervisor of the payment system** will be affected too. Central banks can take part in the payment system in three ways :

- through consulting and moral suasion it can spur market operators to adopt certain behaviours, which it believes to be positive for efficiency and stability
- it can promulgate rules which bind market operators to certain behaviours (ex. legal reserve requirements)
- it can choose to offer directly certain services, if the other two options are impossible or too costly (ex. the supply of currency).

It is yet unclear what approach the Central Banks will adapt towards Internet payment instruments. It is likely that, as long as Internet payment instruments are growing, Central Banks will refrain from imposing limits and regulations, to avoid impairing growth. And it is quite unlikely that Central Banks will ever offer Internet payment services. Before deciding to what extent Central Banks should be involved, a serious analysis of the effects of such instruments on the international settlement system should be done. Even if Internet payment instruments target the retail sector of the payment market, and therefore do not imply the same systemic risk of large value payments, at an aggregate level they could still become relevant. Furthermore, current international settlement systems are not made to handle vast amounts of small payments. In the medium term, new ways of settling such payments should be devised.

As a **regulator**, and as an advisor to the government, the Central Bank is faced with several significant questions :

- how to preserve the integrity of the payment system ? Who is responsible for settlement ? What settlement system should be provided ?
- How to protect customers from bankruptcy of a supplier of payment instruments ? How to treat, from a legal point of view, the new digital instruments ?
- How to deal with the international implications of the Internet ?
- How to ensure competition and transparency ?
- What, if any, standards should payment instruments meet ?
- How to avoid that the new instruments be used for tax evasion or money laundering ?

As a **supervisor of the banking system**, the Central Bank has to rethink its special relationship with banks. As already said, institutional de-specialisation currently implies that banking institutions face more and more competition from non-banks. The industry of Internet payments is a typical example, as most of the companies who are offering payment services are non-banks. Whereas, in the past, it was sufficient to monitor banking institutions to guarantee the stability of the payment system, today too many payments are not being intermediated by banks any more. Therefore, the scope for offering settlement services and credit of last resort only to banks is becoming less and less relevant. In the future, if Internet payment instruments, as well as several other payment instruments managed by non-banks, are going to take off, it is foreseeable that the regulations applied to banks will be extended to all the companies who wish to operate in the payment industry. This would avoid unfair competition (if non-banks are not subject to the same rules as banks, they have an unfair advantage) and instability. This is the opinion expressed by the Payment System Task Force of the EU.

Furthermore, traditionally Central Banks only monitor national banks. The development of Euromarkets has pushed the Central Banks of G10 Countries to extend their supervision to foreign subsidiaries of national banks. Internet payment instruments are a further step forward, being completely independent of physical location. It is possible for national companies to sell their products abroad, and for foreign ones to compete in the national market just like national operators. Suppose a European Bank located in Cayman Island starts selling US$ denominated payment instruments to customers in Japan. Which Central Bank, if any, should be responsable?

The problem is even more serious than for other international assets and financial instruments, as Internet payment instruments target families and consumers, and not just financial operators. This means that there is a stronger "*need for protection*" from risks.

It is, however, difficult for a Central Bank to extend its powers to foreign companies, as this would infringe the sovereignty of other States. There are, however, ways to exert some kind of control. For instance, Central Banks can use their powers of moral suasion. In the case of Internet payment instruments, Central Banks could decide to provide those operators who accept to submit themselves to Central Bank controls with a digital certificate proving the stability of the operator. Such certificates would tell customers anywhere in the world that they are accepting a payment instrument which has been declared secure by an independent, non-profit driven institution such as the Central Bank. Users would quickly learn how to distinguish between certified suppliers and uncertified ones. Such certification would prove to be extremely useful in the process of reputation building, essential to any payment instrument supplier, and could contribute in avoiding crisis of confidence.

To conclude, Internet payment instruments will significantly affect Central Bank operating procedures. For the moment, there are no risks of systemic instability, but as these new instruments take off Central Banks will have to adapt their behaviour to take them into account, to avoid that certain behaviours become customs. Such changes will have to take place early enough to avoid that some crisis of one operator gives rise to an overall crisis of confidence in Internet payments.