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ECONOMICS OF MONEY & PAYMENT SYSTEMS

22 December 2014 | Australia, Brisbane, Melbourne, Perth, Sydney
Legal Briefings

The economics of money and of payment systems has perplexed and engaged economists and lawyers alike for centuries. The most fundamental question, 'What is money?', is still the subject of contention at a commercial and regulatory level. The legal and economic aspects of money are closely connected.

WHAT IS 'MONEY'?

At a fundamental level 'money' performs a number of different economic functions.

It is a:

- medium of exchange,
- measure of value or a standard for contractual obligations,
- store of value, and
- unit of account.

Which definition is correct from a legal point of view depends upon the particular context. Debate continues with respect to whether or not the 'state theory of money' (emphasising the role of the state in establishing and regulating the monetary system) or the 'institutional theory of money' (emphasising the institutional arrangements for acceptance of money as a means of payment and its ability to settle monetary obligations) is the correct way of considering money. This is far from an esoteric debate, as the controversy over digital currency and its taxation and regulatory status shows. Some of the regulatory issues arising from the nature of “money” are referred to [in the section on regulation].

WHAT IS A 'PAYMENT SYSTEM'?

Commonly, definitions of a payment system refers to the concept of a 'funds transfer system' that 'facilitates the circulation of money'.

A funds transfer occurs between two accounts held by different beneficiaries within the same institution. Central banks facilitate the settlement of interbank obligations. In central banking systems, central bank exchange settlement accounts held by, or on behalf of, banking participants is the final step in payment obligation being settled and real value being transferred between financial institutions. A central exchange settlement account is therefore the paradigm of a 'payment system'.

Such systems are often systemically important parts of the overall monetary system and are regulated by central monetary authorities.

The surrounding contractual and institutional arrangements for acceptance of payment, authorisation, clearing and settlement are essential features of any country’s monetary system.

ECONOMIC FEATURES OF PAYMENT SYSTEMS

The institutional arrangements for payments have a number of distinct economic features:

- **Complexity:** They consist of a number of different contractual instruments including rules, transfer mechanisms and a legal framework to guarantee irrevocable and unconditional transfer. The contracts are often part of a network of contractual arrangements that cannot be analysed in isolation.
- **Jointness:** Neither the supply nor demand side of a payment system is dominant because those who wish to pay must necessarily involve those who wish to be paid. There is a complex interrelationship between these groups, resulting in the next feature.

- **Multi-sidedness:** The 'multi-sided' nature of payments products generate externalities (unpriced benefits and detriments) due to these products inability to internalise them without an intermediary (the essential role played by a payments network company). Although the products are often called 'two-sided markets', on any network there are frequently more than two interests and they are not 'markets' in an antitrust/competition law sense.

These features mean that no simple conclusions can be drawn about the economic or competitive impact of both public and private rules or practices. Some of those rules and practices, although on their face restrictive, may be solving (by means of a form of private regulation) an economic problem, such as that of an unpriced effect. Given the need for the 'balancing' of both sides of the network, it is common for there to be incentives to get consumers or merchants 'on board'. Nor can the setting or 'prices' such as 'interchange' between financial institutions that are otherwise competitors be necessarily characterised as price fixing.

These issues have been an economic and legal battleground that has been raging for decades and they continue to be the subject of regulatory proceedings and private law suits.

The work on two-sided payment markets was commenced by William Baxter in the early 1980s in examining the interchange of transactional paper. It was ignited in the economic field by Jean Tirole of the Toulouse School of Economics, whose work in this areas has, in part, resulted in the award to him of the 2014 Nobel Prize in Economics.

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