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Endogenous selection of monetary institutions: With the case of discount windows and bureaucratic discretion

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Abstract

Institutional or regulatory selection can often be endogenous in that the selection is made by state authorities mainly to serve their own interests. We apply this law-and-economics proposition to representative monetary institutions: "open market operation" versus "discount windows". Both instruments have been dominantly treated as "indifferent" either in traditional macroeconomic theory or in existing central banking laws. Nonetheless, we observe fairly differing degrees of the relative reliance on discount windows across 71 countries. This paper is the first-time attempt to empirically explain these country-specific differences by means of our multi-dimensional proxies of the bureaucratic discretionary power. It confirms that the monetary authority's discretionary power *per se*, rather than the conventional factors such as economic development or the central bank's independence, plays a far more important role in explaining the relative reliance on discount windows.

JEL classification: K29; D78; E58

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1. Introduction: indifference among monetary institutions?

Law and economics scholars recognize that legislation vis-à-vis common laws can more frequently be the outcome of a political market dominated by narrowly focused interest groups. Thus, one can submit that institutional selections are "endogenous" in that they are manipulated mainly by institution-enforcers, usually bureaucrats. They act as agents to the legislature, but, sometimes, with significant institution-selecting discretion, attempt to capture some of the wealth. Given that law and economics studies on macroeconomic or monetary laws have somehow been relatively scarce, this paper applies the aforementioned endogeneity perspective to the selection of the two representative central-banking institutions: discount windows versus open market operation.

We all are familiar with, and have taught to students, the popular statement: "*The Fed has three tools in the monetary toolbox: open market operations, reserve requirements, and the discount rate*" (Mankiw, 2001, p. 619). The three institutions are assumed to be "indifferent" and/or "simply substitutable". Except for the case of the reserve requirement, an indifferent treatment of open market operation and discount windows underlies most macroeconomics textbooks, too.[1] In fact, the case is overwhelming for this indifference assumption in most macroeconomic theories and major monetary policy debates.

This indifference presumption is also reflected in the central bank laws of many countries. According to our random survey of 30 countries, as shown in Appendix A, all three monetary instruments are listed in the central bank acts of 20 countries. In 29 countries, open market operation and discount windows are used. Nevertheless, we were not able to find a statutory provision explicitly indicating any difference or preference concerning these listed instruments.

In spite of this indifference treatment in both economics textbooks and statutory provisions, observing a significance difference in their actual uses rendered us suspicious of it. We express doubt about it particularly since we encountered a claim by a prominent macroeconomist himself (Poole, 1990, p. 266): "*A subsidy discount rate serves no monetary policy purpose, and so it is worth exploring the advantages to the Fed of providing subsidies to banks through the discount window*". Since then, as will be summarized in Section 3, we have been able to find a group of economic literature criticizing varying inefficient features and opportunistic incentives embedded in discount windows. We have also figured out that the discount window is likely to confer more benefits upon monetary authorities than does open market operation. In a related context, we believe, it is the bureaucrats' discretionary power that mainly allows the central bank to lean back toward the discount window despite its inferiority.[2]

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[1] Again, the representative example of the differentiating views on the reserve requirement is: "*The Fed uses changes in reserve requirement only rarely because frequent changes would disrupt the business of banking*" (Mankiw, 2001, p. 620). Mainly for this reason, that instrument was repealed in England (1981), New Zealand (1985), and Canada (1994), to name a few. Nonetheless, one can still easily find the indifference treatment in many famous macro textbooks such as Barro (1987, p. 435), Dornbusch, Fischer, and Startz (2001, p. 379), or Samuelson and Nordhaus (2001, p. 199).

[2] Our belief of this endogeneity in institutional selection was reinforced by Chant and Acheson's contemplation (1972, p. 14) that "*The theory of bureaucracy traditionally assumes that a bureau is concerned with prestige and*