A CRITICAL APPROACH TO CENTRAL BANK INDEPENDENCE: THE CASE OF THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

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ABSTRACT

A CRITICAL APPROACH TO CENTRAL BANK INDEPENDENCE:
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From the 1970s onwards, it is argued that central banks should be independent from politicians since the latter have an interest in seeking populist interventions to the conduct of the monetary policy. Additionally, it is often maintained that the sole aim of a central bank should be to seek price stability. Despite the seemingly neutral and objective tone of these arguments, central bank independence can find its meaning as a part of Neoliberalism, which restructured the economic administration of the state. The main objective of this thesis is to analyse the notion of central bank independence and the case of the Central Bank of the Republic of Turkey in a multidisciplinary manner, in order to reveal its political and administrative implications.

Keywords: Central Bank Independence, Good Governance, Neoliberalism, New Classical Macroeconomics, New Public Management, Public Choice

ÖZ

MERKEZ BANKASI BAĞIMSIZLIĞINA ELEŞTİREL BİR YAKLAŞIM:
TÜRKİYE CUMHURİYET MERKEZ BANKASI ÖRNEĞİ

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1970'ler ile birlikte, politikacıların para politikasına populist müdahaleler yapma amacında olmaları nedeniyle merkez bankalarının bağımsız olmaları gerektiği iddia edilmiştir. Ayrıca, merkez bankalarının tek amaçlarının fiyat istikrarını sağlamak olması gerektiği söylenmiştir. Bu argumanın nötr ve objektif tonuna rağmen, merkez bankası bağımsızlığı anlamını devletin iktisadi yönetimini yeniden yapılandıran Neoliberalism içinde bulmaktadır. Bu tezin temel amacı, merkez bankası bağımsızlığı kavramını ve Türkiye Cumhuriyet Merkez Bankası uygulamasını çok disiplinli bir bakış açısıyla inceleyerek idari ve politik sonuçlarını açığa çıkarmaktır.

Anahtar Sözcükler: İyi Yönetişim, Merkez Bankası Bağımsızlığı, Kamu Tercihi, Neoliberalizm, Yeni Kamu İşletmeciliği, Yeni Klasik Makroiktisat

To the memory of Emine Topluışık

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LIST OF ABBREVIATIONS

ABBREVIATIONS	
CBI	Central Bank Independence
CBRT	Central Bank of the Republic of Turkey
IMF	International Monetary Fund
GNAT	Grand National Assembly of Turkey
NPM	New Public Management
PWC	Post-Washington Consensus
WB	World Bank
WC	Washington Consensus

CHAPTER I

INTRODUCTION

The 1970s can be seen as a decade of both economic and political crisis that ended the post-war configuration of the state. Almost all of the world's welfare states faced fiscal crises, the Bretton Woods international exchange rate arrangement collapsed, two remarkable oil shocks increased the costs of production, and the escalation of wages due to corporatist bargaining began to threaten profits. The coexistence of increasing unemployment and inflation proved the inability of traditional Keynesian remedies to fine-tune the economy through demand management. What has been described by a variety of terms, such as *Keynesian Welfare National State* (Jessop, 2002), *Embedded Liberalism Compromise* (Ruggie, 1982), or *Social-Democratic Consensus* (Barry, 1987), came to an end. The state came to be seen as the 'problem' rather than the 'solution'.

The ideas and practices supporting the primacy of the market vis-à-vis the state, which became predominant from the late 1970s onwards are usually termed as *Neoliberal*.[1] The state's economic role in providing welfare for its citizens, in which full employment was originally of crucial importance, shifted towards enhancing competitiveness and control of inflation became an essential element. Accordingly, reforms were implemented to restructure governments throughout the world, a significant example being the policies of Turgut Özal in Turkey. Neoliberal measures included the deregulation of labour markets, privatisations,

[1] For the sake of defining the stance of this thesis, it should be noted that distinctions such as state/civil society or politics/economics are regarded here as merely methodological rather than organic distinctions. This point is perfectly demonstrated by Antonio Gramsci for *laissez- faire* liberalism. His following statements are equally true for Neoliberalism: "[S]ince in actual reality civil society and State are one and the same, it must be made clear that *laissez-faire* too is a form of State 'regulation', introduced and maintained by legislative and coercive means. It is a deliberate policy, conscious of its own ends, and not the spontaneous, automatic expression of economic facts. Consequently, *laissez-faire* liberalism is a political programme, designed to change –in so far as it is victorious– a State's leading personnel, and to change the economic programme of the State itself – in other words the distribution of national income" (2005, p. 160).

taxation reductions, emphasis on fiscal discipline, encouraging foreign direct investments, and the liberalisation of trade and financial markets. This reform package was named *Washington Consensus* (Williamson, 1994) and the term was often pejoratively used in reference to the agreement on right policies and underlying US interests. Neoliberal reforms, which are usually put into practice with the techniques of *New Public Management*, embody a particular view about the state's legitimate purposes in the economy by means of limiting the discretionary decisions of state authorities, binding them with rules, delegating decisions to independent agencies, or dismantling state control by giving responsibility to markets.

Within this particular context, there emerged a growing interest in *central bank independence* (CBI).[2] Despite its being a latecomer, as its widespread influence was not felt until the 1990s, CBI became a part of the Neoliberal consensus (Fischer, 1995; Pollio & Guillen, 2005). It is defended that securing the long-term targets of central banks from the short-term inflationary biased interventions of self-interested politicians can only be achieved by granting independence to central banks. Additionally, it is contended that since a central bank could not continuously support growth and high employment, the best it can do is to focus on price stability. While constituting a vital tenet of Neoliberal reforms, CBI is usually discussed in a rather technical and apolitical tone. In the literature of CBI, the foremost effort is to define various types of independence, develop indices, and accordingly make country-based comparisons in a technical manner.

Independence of a central bank means the isolation of the government's influence on the bank in certain respects. When this brief definition is put forward, several

[2] Certainly, as Serdengeçti (2005) remarks, we can find arguments that defend the isolation of monetary authority from politicians as early as 1824, when David Ricardo wrote a pamphlet entitled *Plan for the Establishment of a National Bank*. Ricardo points out that: "There would, I confess, be great danger of this, if Government –that is to say, the ministers– were themselves to be entrusted with the power of issuing paper money... If Government wanted money, it should be obliged to raise it in the legitimate way... in no case should it be allowed to borrow from those, who have the power of creating money" (Ricardo, 1962b, p. 282-283). In this thesis, for practical reasons, the scope of investigation is limited exclusively to the last few decades of the twentieth century, where academic debates have explicitly begun referring to the term *central bank independence*.

legitimate questions about independence arise. *Why? For whom? From whom? How? With what consequences?* Answering such questions is of crucial importance in understanding the support of CBI within this particular historical context. Since the central bank stands at the intersection point of economics, politics, and public administration, this thesis will adopt a multidisciplinary approach in order to investigate the different aspects of the CBI phenomenon and to evaluate the case of the CBRT in this light. To be more specific, the review of the case of the CBRT is confined to an evaluation of the governor's speeches, news from the press, books written about the bank, and finally to former Governor Süreyya Serdengeçti's kind acceptance of a private interview.

The main aim of this thesis is to reveal the political and administrative implications of CBI, which is frequently discussed as a merely economic phenomenon. Technical academic efforts for indexation and empirical comparisons in the CBI literature cannot avoid missing the most crucial point; that CBI is a particular political choice about the designation of a state's economic administration. It will be argued that the triumph of CBI should be evaluated as embedded in Neoliberal reforms in order to make sense of the abandonment of the earlier priorities of full employment and concentration on inflation. Indeed, CBI is neither a technical matter of monetary policy nor an apolitical choice. The pursuit of price stability is not equally favourable for all classes and class fractions in society. While financial capital favours low inflation (Chang & Grabel, 2005; Gill, 2000), workers, manufacturers, and farmers are not sympathetic to such policies (Goodman, 1991). This is not to say that inflation *per se* is a desirable phenomenon. Rather, the quest for inflation is not a neutral, apolitical choice, especially when it is considered together with the abandoned strategy of pursuing full employment. Additionally, CBI diminishes the ability of democratically elected politicians to influence monetary policy. This can be regarded not as the elimination of politics from central bank but as the locking of a particular political choice in central bank and defending it by granting independence. In a nutshell, it will be maintained that commitment to CBI and price stability is not a technical concern on the side of central banks, but rather, it is part of the Neoliberal agenda, which is responsive to the interests of financial capital in the restructuring of the states throughout the world.

This exploration will advance in three steps which respectively comprise the following main chapters of this thesis. To begin with, the historical evolution of central banking and the significance of CBI in the Neoliberal era will be explored as the main theme. Examining the issue from the perspective of political economy will hopefully provide us with clues about why and how this phenomenon is related to academic discussions and crucial economic reforms. Various roles assumed by central banks in different contexts will be scrutinised in order to reveal the historically changing pattern of central banking.

Then, within the light of the framework drawn, the CBI literature will be critically reviewed. Theoretical rationale of the issue will be assessed with special attention towards the methodological grounds of the arguments. Thus, the underlying political stances in the defence of the CBI are aimed to be shown. The core definitions, indices, and empirical results of the literature, together with complementary notions of transparency and accountability, will be critically examined.

As the third step, the case of the CBRT will be assessed in line with this thesis' particular understanding of CBI. The common and exceptional characteristics of the Turkish case, vis-à-vis the general trends, will be identified. This exploration will encompass all of the 78 years of the CBRT's history, from its foundation up to the present. The interrelation between international trends, domestic economic contexts, and the changing laws of the CBRT that guide its implementations will be taken into consideration. Particularly, the attention will be given to the independence reform in 2001 and the implementation of monetary policy by the independent CBRT in the following years. The perceptions of the key actors; namely Kemal Derviş, Süreyya Serdengeçti and Durmuş Yılmaz, with respect to the issue of CBI will also be evaluated.

Finally, the thesis will end with the conclusion chapter, which includes the summary of the conclusions drawn in the previous chapters.

CHAPTER II

THE POLITICAL ECONOMY OF CENTRAL BANK INDEPENDENCE

The foremost aim in this chapter is to *embed* CBI in the historical context and look at the characteristics of its political-economy, so as to make sense of its theoretical support and empirical implementation. Thus, the promotion of CBI and the exclusive focus on price stability as *the only feasible choice* for central banks can be considered as the arguments of a particular political stance. Revealing not only the economic, but also political and administrative implications of the Neoliberal understanding regarding the central banks will be key purposes of this chapter. The chapter is organised as follows. Firstly, key functions and instruments of central banks will be presented in order to elucidate the political significance of central banks' important role in the capitalist economy. A brief review of the changing aims of central banks in different historical contexts will be the following theme. Then, with the goal of clarifying the characteristics of the political-economy of CBI, the Neoliberal context will be evaluated in length.

2.1 Functions and Instruments of Central Banks

Central banks are key institutions in the working of a capitalist economy because they hold responsibility for a variety of roles. A central bank can be defined functionally as being the lender of last resort, the government's bank, and holder of the monopoly of issuing notes (Capie & Goodhart & Schnadt, 1994, p. 4). With their close relation to government, central banks are usually considered as highly political institutions signifying the *sovereignty* of a country (Carruthers & Babb & Halliday, 2001, p. 97). This point is put forward humourously by the reminder that when a nation acquires its independence, establishment of a central bank "will be an early item on the agenda, slightly below the design of the flag, but above the establishment of a national airline" (Capie et al., 1994, p. 91). The significance of central banks is sometimes overstated. For instance, Will Rogers claimed that "[t]here have been three great inventions since the beginning of time: fire, the wheel and central banking" (Rogers cited by Samuelson & Nordhaus, 1985, p. 294).

Central banks retain a privileged position given that they hold the monopoly of issuing money.[3] Since most of their key functions arise from this fact, the various functions should be considered to be interconnected, albeit with some differences according to the development level and institutional arrangements of the countries (Chandavarkar, 1996, p. 9). Vital functions of a central bank can be recognized quite easily.

The power to create banknotes is a traditional function of central banks, so much so that they have even been identified as *banks of issue*. Unifying currency in one bank under the control of the state is considered to be a precondition for having a prestigious note, controlling the credit system, and enjoying the privileges of creating money (De Kock, 1974, p. 18-21). This latter characteristic is a peculiar and critical one. Central banks need not be indebted in the event of the need for resources; they are able to *create* money. Despite the fact that notes are written as liabilities on the balance sheets of central banks, they have no practical counterpart (Eğilmez & Kumcu, 2007, p. 179). The difference between the face value of the notes and their printing costs is known as *seignorage* (p. 436).[4] From this privilege arises a tension: while governments want to enjoy this revenue, central banks aim

[3] However, the central bank is *not the only* institution capable of creating money. As Friedman (1962) remarks, "there remain other governmental authorities, particularly the fiscal authority collecting taxes and dispersing funds and managing the debt, which also have a good deal of monetary power" (p. 232). Especially in developing countries with high budget deficits and heavy indebtedness, the central bank ceases to be the ultimate creator and controller of money.

[4] To be more specific, *seigniorage* describes the government's gain when agents in the economy hold the money that is pressed as liquid. The creation of this revenue can be considered as an implicit tax, since the value of the money that the public holds is reduced by inflation. Yet, the possibility of exploiting this revenue is not unlimited. As agents become aware of the inflation, they will reduce the amount of money that they hold in liquid form (Miller, 1998, p. 438).

to support the value of the money and avoid financing governments in such a manner.

Central banks act as the banker, fiscal agent and advisor of the government. Just like a bank handles its customer’s operations, central banks assume the responsibility of the government’s banking operations, which include transferring funds, making foreign exchanges and gold transactions, holding deposits, and, in earlier times, issuing bills and managing debt (De Kock, 1974, p. 34-38). Additionally, central banks act as the banker for commercial banks, a function sometimes referred to as *bankers’ bank*. A significant consequence is the centralisation of cash reserves in the central bank. This strengthens the position of central banks vis-à-vis commercial banks and increases the capability of the former to control the credit and money supply (p. 65).

As a result of their close relation with commercial banks, central banks fill an additional function as the *lender of last resort*. At times when commercial banks suffer from a loss of confidence or face a crisis, central banks act as the ultimate saviour. Since central banks hold a considerable part of the reserves and have the ability to create more, they can inject liquidity in order to prevent a systemic crisis. Some of the past economic crises, like the Great Depression of 1929, are often viewed as the result of the central bank’s reluctance to act as the lender of last resort (Eğilmez & Kumcu, 2007, 184). At this point, it is useful to make a distinction between the central bank’s roles in avoiding the possibility of a systemic crisis and in avoiding the bankruptcy of a particular institution. While the collapse of a financial system as a whole has severe and real effects, saving a troubled institution is an arbitrary decision which turns out to be a *political* issue (Swinburne & Castello-Branco, 1991, p. 437-438).

Conducting the exchange rate policy and the control of foreign exchange reserves are other important functions of central banks. Various international exchange rate regimes, whether Gold Standard, Bretton Woods, or free floating exchange rates, have different implications, this function is essentially related to monetary policy.

The foreign exchange transactions have a significant effect on the domestic value of the currency and inflation. For instance, a foreign exchange purchase means an injection of liquidity into a financial system. The decision to *sterilise*, i.e., to withdraw the excessive money, is a crucial decision taken to control the money supply (p. 436-437).

The key functions of central banks have just been reviewed. A list made by Chandavarkar (1996, p. 9-10, emphasis mine) can illustrate the additional optional or peripheral functions that are undertaken by central banks:

- Regulation and supervision of banks and/or of the rest of the financial system; deposit insurance and credit guaranteed schemes.
- Development of clearing, payments, and settlements systems and financial infrastructure.
- External financial relations agent; for example, as fiscal agent and/or depository for the International Monetary Fund or in regional clearing and payments arrangements.
- Quasi-fiscal activities; for example, *microallocation of credit, credit subsidies to preferred sectors and so on. The divestiture of these activities may be an important precondition of effective central bank autonomy.*
- Macroeconomic research, collection of monetary and financial data, and balance of payments data; acting as a statistical correspondent for international agencies such as the International Monetary Fund.
- Surveillance of the banking and financial system, including credit card companies; semi-formal and informal finance, and guarding the interests of users of banking and financial services.
- Fostering inter-central bank cooperation, including the international supervisory or prudential entities, such as the Basle Accords of the Bank for International Settlements.

In order to perform their functions, central banks use a range of instruments including interest rates, open market operations, reserve requirements, rediscount window, and moral suasion, which will be outlined here respectively.

Determination of *short-term interest rates* by central banks is a key practice for monetary policy. This rate is a reference point for all market actors in respect to their future plans (Parasız, 2003, p. 21). This rate can be determined with a changeable mixture of emphasis on either inflation or economic growth. A practical demonstration of this point is made by John Taylor for the estimation of the FED's interest rate policy for the years 1987-1992. According to the *Taylor*

Rule, the nominal interest rate is a function of both the divergence of actual GDP from potential GDP and the divergence of the actual inflation rate from the target inflation rate. In the event of an inflationary drive, interest rates should be increased. On the other hand, a recession could be overcome by decreasing the interest rates. According to the Taylor Rule, the weight on price stability and output gaps were estimated for the FED as being the same, positive and equal coefficients (Mansour, 2008, p. 4-7; Parasız, 2003, p. 255). This analysis can be interpreted as the political choice confronting central banks with respect to their emphasis on either growth or price stability in determining interest rates.

The transactions of buying and selling government or private sector securities from or to economic agents in the market are known as *open market operations*. Central banks have a considerable degree of power to control the amount of money exchanged in such operations. For example, if a central bank aims to enlarge reserves of the private sector, the buying of bonds from agents with money can be practised, and this operation also influences interest rates with a downward pressure. The directness, preciseness, and flexibility of open market operations ensure that they are preferred by many central banks (Telatar, 2002, p. 17-19; Parasız, 2003, p. 22-23).

Commercial banks' requirement to hold reserves in central banks in order to remain reliable in a crisis situation can be used as a monetary policy instrument. If a central bank raises the rate of *reserve requirements*, commercial banks must lessen their lending operations in order to adapt to this new condition. Consequently, an increase in reserve requirements brings a decrease in the money supply. However, because of the associated time lags and considerable adjustment requirements, this instrument could not be effective if used frequently (Chandavarkar, 1996, p. 36-37).

In the financial system, numerous valuable papers and bills are discounted by commercial banks because of the need for liquidity. Central banks put forward some conditions to rediscount these bills, so as to provide liquidity to commercial banks. Raising the *rediscount ratio* discourages such transactions and raises the costs of borrowing, which will result in the contraction of the amount of money in the system (Parasız, 2003, p. 13-15). Nevertheless, this instrument is not precise, as it only influences the motives of the commercial banks that have no requirement to appeal in such a way (p. 23).

Last but not least, *moral suasion* is a crucial instrument to ensure cooperation with monetary policies, although it is qualitative and hard to assess. Addressing possible risks and expressing the goals can enhance the plainness of policies. The success of this method depends on the credibility of the central bank (Chandavarkar, 1996, p 50-52).

2.2 Historical Development of Central Banking

Central banking has a history encompassing three centuries and a variety of roles in different contexts. The establishment of the early central banks took place in the countries that led capitalist development at that time (for a list of exact dates, please see *Appendix A*). However, the prominence of central banks began in the 20th century. The evolution of this exceptional institution, which stands at the very intersection of economics and politics and contains private/public and national/international aspects, is worth generally summarizing, without the evaluation of country specific experiences.

In their first stages of development, central banks were established as private rather than public institutions. Nevertheless, as the monopoly position of issuing notes was granted to them by the government, these banks enjoyed a privileged position in relation to other commercial banks. The benefits of establishing central banks, including unification of currency, improvement of the payments system, access to *seignorage* revenue, and further advancement of commercial bank services, can be seen as the driving factors for the acceptance of the early central banks (Capie et al., 1994, p. 4-5; Swinburne & Castello-Branco, 1991, p. 415-416).[5] In due course, their relationship with commercial banks changed. Recognition of the conflicts arising from competitive commercial banking and the state's bank missions led to an abandonment of the actions of central banks that had mirrored the actions of commercial banks (Swinburne & Castello-Branco, 1991, p. 416).

The 1873 establishment of a gold standard exchange rate regime among major industrialised countries was a remarkable event that initiated "the golden era of central banking" (Marcussen, 2007, p. 147). Sustaining the convertibility of the currency to gold became central banks' exclusive mission. Both the internal and external value of currency was mainly tied to the available amount of gold, which was fluctuating in relation to the world's gold production. In this era of *Pax Brittanica*, automaticity of the monetary system was in line with the general trend towards a free market and less government intervention, or namely, *laissez-faire*. This arrangement gave central banks a considerable degree of freedom, notwithstanding the legal framework, and external stability concerns overruled the emphasis on employment and growth (Marcussen, 2007, p. 147-148).

The outbreak of World War I and subsequent depressions were decisive signs of the changing global currents, not only in the role of central banks, but also in the role of the state in the economy. In those years, the gold standard collapsed, exchange controls were introduced, and protectionism triumphed. Regarding central banks, the finances of war became a central concern. After World War I, huge war reparations were imposed on countries like Germany. Within this context, Allied governments demanded that central banks in the countries paying war compensations should be legally independent. To be sure, the conference gathered in Brussels between 24 September 1920 and 8 October 1920 concluded with the

[5] However, the existence of central banks were also criticised, notably by the proponents of the *Free Banking School* (for a distinguished proponent, please see footnote 6). This approach considers government regulation in the banking sector to be the key reason for inflation. The solution proposed is the abolishment of central banks and the free competition of currencies established by commercial banks. Yet, these suggestions were criticised with notification of the risks arising from the nonexistence of supervision and *lender of last resort* functions of central banks (Goodhart, 1995, p. 87-90).

wish to provide independence for central banks (Tekeli & İlkin, 1997, p. 242). However, the legal independence of the *Reichsbank* did not prevent the government from monetising its deficits, and consequently Germany faced the unfortunate experience of hyperinflation in the 1920s (Goodhart, 1996, p. 67; Capie et al., 1994, p. 15-20). A series of attempts to reestablish the gold standard failed and, in 1929, the Great Depression brought domestic stability concerns to the top of the agenda at the expense of international stability.

After World War II, *Pax Americana* promoted the virtues of liberal international trade coupled with an emphasis on domestic stability, often referred to as the *Embedded Liberalism Compromise* (Ruggie, 1982). In this era, central banks' objectives included full employment, growth, and the maintenance of the value of currency (Capie et al., 1994, p. 24). To be sure, the role given to central banks can be demonstrated in textbook terms as follows: "[T]he fundamental business of a central bank is to control the commercial banks in such a way as to support the monetary policy directed by the state" (Carruthers & Babb & Halliday, 2001, p. 98). In respect to exchange rates, fixed but adjustable rates were pegged to the US dollar, which was backed by gold. In order to maintain stabilisation of these rates, there were formal limitations on capital mobility with the exception of the US dollar, which enjoyed the position of reserve money. The genesis of the *Eurocurrency* market, which was initially beneficial for funding opportunities, later began to threaten the stability of the exchange rate with its development (Watson, 2007, p. 108).

The collapse of the Bretton Woods system in 1971, several oil shocks, coexistence of inflation and unemployment (also known as 'stagflation'), and the fiscal problems of developed welfare states were some manifestations of the deep crisis in the world economy. Specifically, the collapse of the dollar's link to gold had remarkable consequences. An *impossible trinity,* also known as the *Mundell-Flemming dilemma*, is argued to exist, as a country can only achieve two of these three goals: financial liberalisation, exchange rate stability, and autonomy of monetary policy. It is pointed out that in the Bretton Woods system, financial liberalisation was sacrificed to control the other two. After the collapse of this system, financial liberalisation was achieved together with autonomy of monetary policy, while leaving the determination of exchange rates to the free markets (Adda, 2003, p. 112; Baker, 2006, p. 85). Additionally, with this collapse, it is stated that: "[T]he world as a whole severed its link with commodity money and adopted fiat money. Since then there have been limitless possibilities for expanding the money supply" (Bordo & Capie cited by Lippi, 1999, p. 7). Certainly, as the limitation of the money supply by its linkage to a valuable commodity ended, monetary policy became virtually unchecked in its creation of money. Thus, the new focus in monetary policy turned exclusively towards preventing inflation. The change in the FED's monetary policy in 1979 under the rule of Paul Volcker can be considered an important manifestation of the beginning of the Neoliberal era (Harvey, 2005, p.1). The analysis of this specific era will be the key concern of the following section of this thesis.

2.3 Rise of Neoliberalism and Central Bank Independence

The rise of *Neoliberalism* can be considered a revival of the belief in the efficiency of the market vis-à-vis the state. Since free market ideas had already been developed in the academic arena, their rising significance in the late 1970s can be considered as reappearance rather than a new construction (Barry, 1987, p. 19). To avoid confusion, it should be pointed out that various economic theories and practices are labelled as 'Neoliberal', though they are neither homogenous nor perfectly consistent with each other.[6] Moreover, referring to Neoliberalism as a broad category of ideas and practices is not to attribute all changes that took place to a transcendental logic operating from above. On the contrary, the whole process

[6] In the field of economics, *Monetarism*, *New Classical Macroeconomics*, *Public Choice*, *Supply-Side Economics*, and *Austrian Economics* are considered to be Neoliberal (Harvey, 2005, p. 54; Barry, 1987, p. 26). Some of the Neoliberal arguments, such as Friedrich Hayek's, will not be examined here because of their lack of relevance to the defence of central bank independence. Hayek questioned the *raison d'etre* of central banking and proposed that state monopoly of money should be abolished and private currencies could compete. He argued that, by *denationalisation of money*; the evils of inflation, instability, undisciplined state expenditure, and economic nationalism could be avoided (Hayek, 1990).

of state reforms can be seen as numerous agents' various trials and errors that accumulated and, to a certain extent, converged in time.

From the mid-1970s onwards, especially in the US and the developed countries, power of the finance and banking sector vis-à-vis manufacturers increased significantly. Rising magnitude of financial motives, financial markets, profitability of financial firms, political and economic power of finance as a class fraction can be clearly traced, all of which are referred to with the term *financialisation* (Epstein, 2005, p. 3-4; Robison, 2006, p. 13). Ideas that promote liberalisation of the economy, namely Neoliberalism, can be considered as "the ideological expression of the reasserted power of finance" (Dumenil & Levy, 2005, p. 17). The state constraints on capital, which constituted the essentials of *Embedded Liberalism,* were dismantled one by one and capital was disembedded from such constrains (Harvey, 2005, p. 11). In a nutshell, as a way out for the economic crisis of the 1970s, the increasing weight of financial capital brought a new era in capitalism, which is usually recalled Neoliberal. The central elements in Neoliberalism are the elimination of the barriers that limit the movement of capital; abandonment of full employment concerns in favour of the fight against inflation, sometimes termed the creation of *sound money*; reform of the state to reduce expenditures; organisation of bureaucracy in accordance with private sector efficiency techniques; privatisation or contracting-out of government controlled industries; promotion of efficient markets; and enhancement of *credibility* (Cerny & Menz & Soederberg, 2006, p. 15-18).

The most well-known set of prescriptions concerning reform of the state's economic administration is the *Washington Consensus* (WC), a term often used interchangeably with the term *Neoliberalism* (Chang & Grabel, 2005, p. 30).[7] The central elements of the WC are fiscal discipline, public expenditure priorities, tax reform, financial and trade liberalisation, foreign direct investment, privatisation,

[7] Williamson uses this term to refer to the "conventional wisdom of the day among the economically influential bits of Washington, meaning the US government and the international financial institutions" (Williamson, 1993, p. 1329). However, he explicitly rejects interpreting the WC as Neoliberal (Williamson, 1993, p. 1334).

deregulation, exchange rates, and protection of property rights (Williamson, 1994, p. 26-28). It is clear that there are serious interrelations among the key WC elements. For instance, the emphasis on fiscal discipline means that budget deficits should not be financed with inflation tax (Williamson, 1994, p. 26). Tight fiscal policy prescription is closely bound to tight monetary policy. Moreover, since a central bank could not reach price stability alone, tight fiscal policies are also closely associated with the goal of price stability (Kumcu, 2008). These examples demonstrate that all the reform prescriptions could only be meaningful when analysed together. Thus, it can be argued that the adoption of these prescriptions implies no less than a wholesale restructuring of a state's economic administration.

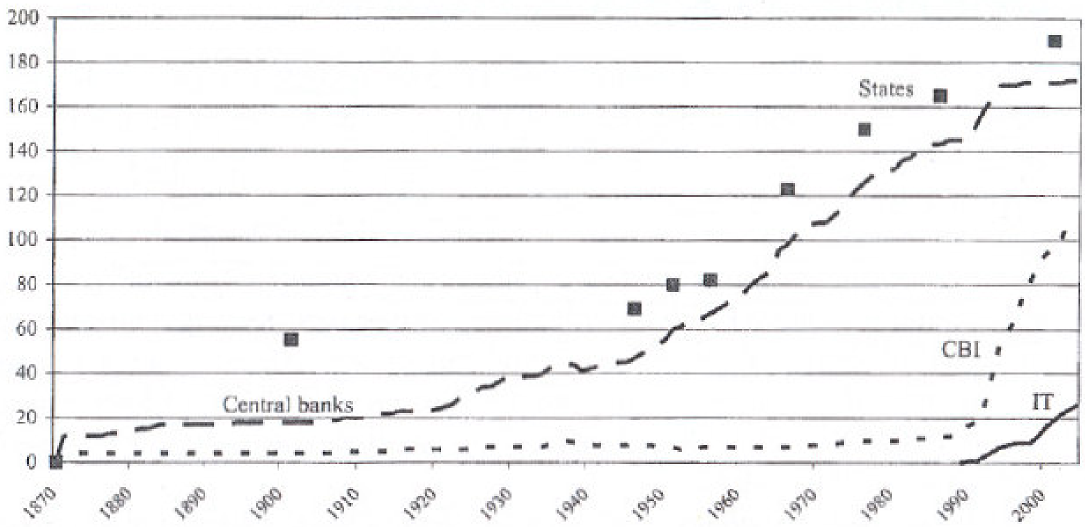

Figure 1. The Diffusion of International Standards in the Years 1870-2003: Central Banks, Independent Central Banks, and Inflation Targeting

Source: Marcussen, 2007, p. 136

Though not included in the original WC, as Stanley Fischer (1995, p. 201) points out, CBI should be considered as "becoming part of the Washington orthodoxy". As *Figure 1.* makes clear, the triumph of CBI coincides with the 1990s, the heyday of the Neoliberal era. Within the context of increasing flows of capital and expansion of international capital markets, often celebrated with the buzzword *globalisation*,[8] the implementation of CBI became critical for countries "as a signal of macroeconomic nominal *responsibility* to domestic and international investors" (Cukierman, 2005, p. 8-9, emphasis mine). For this quest, the IMF actively promoted CBI as a conditionality to developing countries and former socialist countries. Additionally, as integration in Europe advanced, the *Maastricht Treaty* required CBI reforms as a precondition for membership in the *European Monetary Union* (EMU).[9] Finally, the academic literature on CBI, which will be reviewed in the next chapter, is argued to have significant influence on central banking reforms (p. 9).

The vital point in the defence of CBI is the anxiety against inflation. The intellectual roots of the abandonment of full employment concerns in favour of low inflation and the rejection of the Phillips Curve analysis[10] comes from *Monetarism,* also known as the *Chicago School* (Baker, 2006, p. 73). Scholars like George Stigler, Gary Becker, and Milton Friedman revitalized the *Quantity Theory of Money* and developed the idea of the *natural rate of unemployment*.[11] Inflation is considered to be the result of excessive monetary expansion, demonstrated in Friedman's authoritative statement: "inflation is always and everywhere a

[8] Rather than reifying globalisation, it is more appropriate to focus on the series of tendencies produced by conscious human action (Watson, 2005, p. 204). If globalisation is considered as a 'thing' acting in its own right above politicians, then it can be used as a scapegoat for unpopular political measures. "[B]y restoring active and strategic subjects to the process of globalisation we can not only contribute to the demystification of this process without a subject, we can also contribute to the *repoliticisation* of political and economic debate" (Hay, 2001, p. 12, emphasis mine).

[9] The 5th clause in the Article 109/E points that: "each Member State shall, as appropriate, start the process leading to the independence of its central bank" (Maastricht Treaty, 1992)

[10] Originally, according to data between the years 1861 and 1957, A.W. Phillips argued that there was a trade-off between nominal wages and the unemployment rate in England. Nevertheless, in the economics literature, inflation is frequently used in the place of nominal wages (Tunca, 2001, p. 267). Thus, the Phillips Curve denoted that there is a trade-off between inflation and unemployment. This meant that governments could intervene in the economy to achieve full employment at the expense of certain rates of inflation.

[11] It is argued that there is a *natural rate of unemployment* in the economy that is determined by institutional and structural factors, such as competitiveness or effectiveness of the labour market. Monetarist arguments support the idea that the long-run Phillips Curve is vertical and coincident with this natural rate. In other words, it is connoted that, in the long-run, there is no way to sustain an unemployment rate lower than the natural rate by means of either fiscal or monetary policies (Bulutay, 1984; Barry, 1987).

monetary phenomenon" (Friedman cited by Mishkin, 2004b, p. 632). Friedman considered central bank independence to be a "very appealing idea that it is essential to prevent monetary policy from being a day-to-day plaything at the mercy of every whim of the current political authorities. The device is rationalized by assimilating it to a species of *constitutionalism*" (Friedman, 1962, p. 224, emphasis mine). However, Friedman explicitly preferred simple monetary rules, which limit the annual expansion of money with the x-percent (x is projected to be between 3-5), for several reasons. First, concentration of power in the hands of a limited number of people is a threat to democracy. Second, reminding his audience of the considerable money creation effects of fiscal policy, Friedman denoted that dispersal of responsibility could be harmful for coordination. Third, personalities and mistakes of monetary policymakers can profoundly influence economy, as Friedman considers the 1929 depression as an example of monetary mismanagement. Finally, central bankers can overemphasise the well-being of the financial sector (p. 227-238).

Monetarist exercise in the 1980s was more challenging than expected because the link between a certain base amount of money and the general level of prices was proved to be inconsistent. Despite the fact that Monetarism soon gave way to *New Classical Macroeconomics* (Lapavitsas, 2005, p. 34), its emphasis on *rules* instead of *discretion* and the futility of government interventions to produce real effects in the economy were shared by its replacement. In fact, the abandonment of full employment concerns in favour of the fight against inflation and the means through which this latter goal is accomplished can be considered as a process that includes a variety of exercises and failure. Friedman, when proposing his famous x-percent rule, said that he did not "regard this proposal as a be-all and end-all of monetary management…to be written in tablets of gold and enshrined for all future time" (Friedman, 1962, p. 243). In time, as expected by Friedman, control of the money base ceased to be influential and gave way to the arguments defending CBI, which are also directed towards the same goal: controlling inflation. In fact, the triumph of CBI can be considered as the *institutionalised* solution to secure and preserve such policies (Cerny et al., 2006, p. 27). As the specific arguments for CBI will be reviewed in the next chapter, hereby relationship between the increasing significance of financial capital and the mounting concern against inflation and CBI should be explored further.

Why financial capital, which became evermore dominant with Neoliberalism, favours low inflation is subtly outlined in the *World Development Report 2005*:

> Macroeconomic instability increases the volatility of interest rates, exchange rates, and relative prices, imposing additional costs and risks on financial institutions and their clients. *High inflation erodes the capital of financial institutions* and makes it difficult to mobilize savings or to expand services (p. 119, emphasis mine).

It is clear that inflation is detrimental to financial capital because it results in the loss of the real value of financial assets. The aim to guarantee low inflation by granting independence to central banks can be taken into consideration in relation to *financial opposition to inflation* (Posen, 1993). With this term, Posen connotes that in the quest for and reaching of low inflation, well-organized and influential *interests* of the financial sector matter.[12] Thus, Posen rejects the vast literature that draws a causal link *from* CBI *to* low inflation. Alternatively, it is argued these two are the reflections of a third factor, which is the powerful financial opposition to inflation in a society (Posen, 1993, p. 47). Additionally, there are close connections between the financial community and central banks. Since the functioning of financial markets is an important concern for central banks, they are anxious to preserve price stability (Goodman, 1991, p. 329). In summary, it can be safely argued that an inflationary environment is not favourable for finance, be it considered as a class fraction or an interest group, which became evermore significant in the last few decades.

The apparent costs or benefits of inflation should also be evaluated with respect to other fractions of capital and classes. A very high rate of inflation is not a desirable phenomenon, since it distorts relative price signals, raises costs of adapting menu prices and blurs future expectations, results in social demoralisation, and

[12] It should be noted that Posen's view of politics as the rival of different interest groups is not in line with the class-based position of this thesis. Nevertheless, these arguments are quite valuable for grasping the fundamental opposition of finance to inflation.

discourages economic agents from undertaking long-term contracts (Telatar, 2002, p. 8-10; Miller, 1998, p. 436). However, a recent study points out that inflation rates near 10 percent can be positively related to higher economic growth rates in middle- and low-income countries (Pollin & Zhu, 2005, p. 11). Likewise, compared to zero inflation, low inflation is positively associated with economic performance (Stiglitz, 1998, p. 4). Workers, manufacturers, and farmers prefer expansionary policies, which could sustain industrial profits and assist employment, as deflation is worse for them. Financial capital's obsession with inflation is not found among industrial capitalists especially in export-oriented sectors. Since the fight against inflation is realised by means of high interest rates, the international capital coming for this interest rate results in an overvalued exchange rate and impairs export-oriented sectors (Chang & Grabel, 2005, p. 234; Goodman, 1991, p. 333; Bağımsız Sosyal Bilimciler, 2007, p. 38). The whole issue can be summed up as follows:

> *Low inflation is not a neutral value-free policy objective*. It involves the protection of the value of money and existing wealth, and sometimes this objective has been pursued to the detriment of those at the lower end of the income scale and often at the expense of growth and employment… Prioritizing low inflation ensures that creditors can reclaim the full value of their investments, but it can also exacerbate the costs of debtors, leading to bankruptcies and rising unemployment…At the same time, *neither is the contemporary notion of macroeconomic credibility an impartial concept*. This becomes particularly apparent if we pose the question of credibility for whom (Baker, 2006, p. 78, emphases mine).

The stress on credibility can be understood as the assurance of governments that they will not prevent the pursuit of sound macroeconomic policies. As financial markets become dominant and foreign exchange dealers prefer to possess *sound money*, governments that emphasise their credibility benefit from such investments (Burnham, 1999, p. 46). It is not surprising that in the WB report mentioned above, central bank independence is regarded as an example of a formal institutional mechanism to improve the *credibility* of a country (World Bank, 2005, p. 49). It can be safely concluded that the emphasis on credibility is actually about providing confidence to international financial capital (Bağımsız Sosyal Bilimciler, 2007, p. 39).

At the highest level, national constitutions are proposed to be shaped in a way that limits the discretion of governments. This state of affairs is critically called *the new constitutionalism of disciplinary neo-liberalism* (Gill, 2000, p. 2).

> [I]deal-typical neo-liberal state formation incorporates legal and quasi-legal, indeed constitutional "mechanisms of restrain" in to lock not only macroeconomic but also microeconomic policy in ways that involve a clear *separation of the economic and the political to lessen the possibility for democratic accountability*. This links to what has become a significant trend in economic governance- the way that monetary policy is increasingly placed in the hands of (more) independent central banks (p. 16, emphasis mine).

The rise of the constitutional attitude can be considered in broad terms as the separation of *the political* and *the economic*. Treating genuinely political issues as merely economic or technical problems diminishes democratic accountability. The imposition of political and legal mechanisms that constrain the democratic control of certain critical decisions and the disciplinary market mechanisms of *credibility* and *consistency* are the key elements of this process. Moreover, providing legal guarantees of property rights and confidence for investors on the international scale is essential. As Gill brilliantly points out, the worldwide implementation of CBI, especially in the case of the *European Central Bank* (ECB) is an example *par excellence* of *new constitutionalism.*

This process is also described as a shift from *discretion-based* to *rules-based,* or from *politicised* to *depoliticised*, economic management. However, depoliticisation should not be understood here as the removal of politics, since "the act of depoliticisation is itself highly political" (Burnham, 1999, p. 44). Teivainen similarly reminds us of the trend towards the relocation of certain political issues to the sphere of economics and thus the limitation of democratic accountability. What he calls *economism,* or the *politics of economic neutrality,* is actually a political agenda to depoliticise certain issues and present them as universal truths above any power struggle (Tievainen, 2002, 1-12).[13]

[13] Chang's illustration of the issue can be helpful as a summary: "[T]he 'market rationality that the neo-liberals want to rescue from the 'corrupting' influences of politics can only be meaningfully defined with reference to the existing institutional structure, which is itself the product of politics. And if this is the case, what neo-liberals are really doing when they talk of de-politicisation of the market is to assume that the particular boundary between the market and the state *they* wish to draw

Up to now, the Neoliberal understanding of economics and politics were scrutinized. Present concern is the review of the Neoliberal public administration arguments, namely the New Public Management.

2.3.1 New Public Management

New Public Management (NPM) can be considered as a manifestation of the management techniques in public administration that gained strength in the 1980s and 1990s. Notwithstanding the ontological difference between the public and the private sectors, this body of literature explicitly supported bringing private sector *management* techniques to public *administration*, often in a pragmatic manner (Üstüner, 2000, p. 15-20).[14] This position has serious implications about the way in which state and bureaucracy are related to each other and considered in the eyes of the public. The suggestions of the NPM approach can be understood as a wholesale transformation of the state towards market-orientation (Güzelsarı, 2004, p. 96).

The main criticism of NPM was directed towards the Weberian model of bureaucracy, which NPM considered to be outdated, rigid, excessively centralised and hierarchical, and inefficient. Instead, the practical reform propositions of NPM were supposed to build a flexible, creative, efficient, decentralised, and market-oriented public administration (Ömürgönülşen, 2003, p. 15-17).[15] This rather technical, apolitical, and neutral tone should not obscure the fact that NPM propositions are closely related to the administrative reforms that took place in the

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is the 'correct' one, and that any attempt to contest that boundary is a 'politically minded' one" (2002, p. 500, emphasis original)

[14] Certainly*, Managerialism* can be considered as one of the key theoretical roots of *New Public Management*. Private sector notions like customer and results orientation, performance criterias, principles like economy-efficiency-effectiveness, and total quality management are significant elements of *Managerialism* (Güler, 2003, p. 6; Güzelsarı, 2004, p. 97-98).

[15] However, it is argued that NPM's underlying philosophy is in line with Max Weber. NPM can even be considered as a momentous expression of precision and calculability (Gregory, 2007, p. 222). Notwithstanding the problems of realisation, Weber's following words have much in common with NPM: "Bureaucracy develops the more perfectly, the more it is 'dehumanized', the more completely it succeeds in eliminating from official business love, hatred, and all purely personal, irrational, and emotional elements which escape calculation" (Weber, 2004, p. 249).

Neoliberal era (Üstüner, 2000, p. 25). Generally speaking, none of the attempts to reform public administration can be disconnected from political agendas (Gregory, 2007, p. 223). Specifically, reforms in the Anglo-American world, the US, the UK, New Zealand, and Australia, were considerably influenced by NPM arguments (Ömürgönülşen, 2003, p. 26-27). Furthermore, values of the market, around which NPM aims to reform public administration, are far from neutral. It may be helpful to examine a well-known book from this literature that aimed to *reinvent* government. *The entrepreneurial spirit* that transformed the public sector attributed ten major qualities to the government. Accordingly, government should be: catalytic, community-owned, competitive, mission-driven, results-oriented, customer-driven, enterprising, anticipatory, decentralised, and market-oriented (Osborne & Gaebler, 1992). It can be safely argued that these qualities are neither neutral nor disinterested. This point is summarised perfectly as follows:

> The values that support the operation of the marketplace, such as individualism, pragmatism, and profitability, are assumed to have universal utility and applicability… Most important, the illusion has been created successfully that the market is autonomous, and therefore this regulatory mechanism is neutral, beyond politics, and basically fair. And when the market is allowed to function without political interference, any outcomes are thought to reflect reality, as opposed to some narrow social agenda (Choi & Murphy & Caro, 2004, p. 3-9).

With respect to the reform suggestions of NPM, the main themes can be listed as: privatisation; provision of explicit standards for performance; the turning of public servants into public managers; emphasis on decentralisation, flexibility, and customer orientation; enhancement of competition in the public sector; empowerment of citizens; and agencification (Ömürgönülşen, 2003, p. 22-24; Kjaer, 2004, p. 26-31). In relation to central banking, agencification and the introduction of performance standards are particularly important.

Agencification "refers to the establishment of semi-autonomous agencies responsible for operational management…The logic is that by isolating agency from political pressures, it can be run more efficiently" (Kjaer, 2004, p. 27-28). This administrative logic corresponds with delegating independence to central banks so that they can run monetary policy without political interference.

Enhancing *credibility* for investors and blaming these agencies for unpopular decisions are other important factors in this delegation (Coen & Thatcher, 2005, 332). This argument is developed using the *Principal-Agent* approach. The authority to conduct monetary policy is delegated by government or parliament (the principal) to the central bank (the agent). The latter has a set of determined tasks and enjoys a certain degree of independence from the pressures of the former. In the implementation, the agent is encouraged with specific incentives to reach the target and has the advantage of holding special information to implement the policy that is predetermined by the principal (Lippi, 1999, p. 12; Telatar, 2004, p. 132-133).

The rationale of performance standards comes from the need to hold people accountable for reaching a target goal; it is argued that without such a mechanism, inefficiency and waste prevail in the public sector. Performance measures are legitimised with mottos such as "what gets measured gets done," or "if you can't recognise failure, you can't correct it" (Osborne & Gaebler, 1992, p. 146-152). The emphasis on performance standards is a decisive point for central banking, since inflation targeting and CBI can be considered interwoven. Starting with New Zealand in 1990, most of the developed countries have adopted *inflation targeting* together with CBI reforms. Providing a clear target that can be followed and consequently judged by economic agents is a perfect example of a performance criterion. The implementation of monetary policy, it turned out, proclaimed a certain point or level of inflation as a target *ex ante*. This target is typically a reflection of the central bank's expectations about the path of inflation for the next couple years (Telatar, 2002, p. 207). The advantages of inflation targeting can be listed as follows: simplicity compared to other methods, enhanced transparency in the monetary policy, increased credibility in reaching the targets. On the other hand, the disadvantages are: should be implemented without compromises, possible inefficiency and limitations to the production and economic growth especially in supply shocks, likelihood of raising unemployment (Değirmen, 2008, 142-143).

2.4 Inclusive Neoliberalism and Post-Washington Consensus

The exercise of Neoliberal reforms throughout the world has proved to be problematic in many respects. A series of economic crises, including those in Turkey (1994), Mexico (1995), Asia (1997), Russia (1998), and Argentina (1999), caused devastating poverty in many regions of the world. These crises opened an influential debate about the conventional wisdom of Neoliberal policies as implemented by international institutions. Interestingly enough, the foremost criticism directed against the IMF came from the Senior Vice President of the WB, Joseph Stiglitz, who is the pioneering figure of the *Post-Washington Consensus* (PWC).[16] In a noteworthy speech, Stiglitz argued that:

> The Washington consensus held that good economic performance required liberalized trade, macroeconomic stability, and getting prices right...To be sure, all of these are important for markets to work well…But the policies advanced by the Washington consensus are not complete, and they are sometimes misguided. Making markets work requires more than just low inflation; it requires sound financial regulation, competition policy, and policies to facilitate the transfer of technology and to encourage transparency, to cite some fundamental issues neglected by the Washington consensus (Stiglitz, 1998, p. 1).

Especially after the Asian financial crisis, it became harder to maintain the Neoliberal belief about the efficiency of the market vis-à-vis the state. It was clear that markets failed more often than had been assumed by mainstream economic wisdom. Thus, market imperfections, especially with regard to informational asymmetries, become a crucial field of investigation (Fine, 2001, p. 4). Stiglitz, being a significant proponent of *New Institutional Economics* (NIE),[17] broadened the focus of the PWC from economic policies to the institutional setting in which

[16] Stiglitz criticized the IMF in a sharp tone: "Experience has shown that the IMF is a fair-weather friend: it will stick with you when things are going well, but when things look bad, all kinds of criticisms are advanced: what you did was incomplete, insufficient, the crisis was your own fault and you deserved it!" (Stiglitz, 2004, p. 48). Specifically, Stiglitz argued that the IMF deviated from its Keynesian intellectual roots and that its defence of contractionary policies in the Asian crisis was seriously mistaken (Stiglitz, 2006, p. 314).

[17] NIE differs from *Old Institutional Economics* (OIE) in the significance of methodological individualism in its analysis. Surely, NIE offers new insight by arguing that institutions constrain individual behaviour. However, OIE considers institutions as "constitutive of individual motivations" rather than simply "constraining individual behaviour", and is much more critical than NIE (Güler, 2003, p. 4; Chang, 2002, p. 557).

transactions take place (Saad-Filho, 2005, p. 117). In its key reform propositions, in addition to retaining the fundamental elements of WC precepts like liberalisation and privatisation, the PWC "has added civil society, social capital, capacity building, governance, transparency, a new international economic architecture, institution building and safety nets" (Higgot, 2006, p. 431).

It should be emphasised that the PWC does not reject any fundamental prescriptions of the WC. To be sure, notwithstanding the rhetorical and intellectual influence of the PWC, World Bank practices still more closely resemble the principles of WC (Fine, 2001, p. 19, Kjaer, 2004, p. 183). Practices like providing an appropriate legal environment for transactions or enhancing transparency for better information sharing are not very far from the economic reductionism and individualism of the WC (Saad-Filho, 2005, p. 118). Starting from an individualist perspective, the aim is merely to provide a fruitful institutional environment for the right policies. In a nutshell, institutional analysis could not avoid reducing politics "to a relationship of exchange, that is, a transaction which has certain 'costs'" (Yalman, 2007, p. 401).

The question now coming into the forefront is how to come to terms with the changing tone of Neoliberalism. As *Table 1.* illustrates, there are several differences between the early practices and PWC exercises. Thus, it is not surprising to see new terms such as *Social Neoliberalism*, *Neoliberal Sociability,* or *Two Faces of Neoliberalism* (Cerny, 2004; Robison, 2006; Gamble, 2006), all of which emphasise the "social" dimensions of Neoliberalism. Obviously, the early conservative tendency to overcome state intervention in the economy with the vision of a minimal state has undergone a transformation.[18] Moreover, the WB's emphasis on poverty reduction, participation, civil society, and good governance

[18] An intellectual *tour de force* of this change was the *World Development Report 1997,* which pointed towards the decisive role of the state. It is accepted that "development requires an effective state, one that plays a catalytic, facilitating role, encouraging and complementing the activities of private businesses and individuals…History and recent experience have also taught us that development is not just about getting the right economic and technical inputs. It is also about the underlying, institutional environment" (p. iii). It goes without saying that the early belief in the efficiency of the market vis-à-vis the state is somehow changed.

seems to be particularly legitimate, responsive, and inclusive (Craig & Porter, 2006, p. 4).

Table 1. Conservative versus Inclusive Neoliberalism

Conservative neoliberalism	*'Inclusive' (neo)liberalism*
Getting the state out of markets	State must create institutions to enable markets
Markets deregulated, a law unto themselves	Markets need to be embedded in institutions and community by 'smart' re-regulation
Countries open up and conform to global market rules: sink or swim	Countries 'own' reforms, commit to good governance, enable markets
People participate/are included in markets: sink or swim	'Enabling' people to participate/be 'included' in markets and community, through basic services
State/others as funder of services, market as provider	'Joined-up' co-production of services, central and local state, markets, civil society: 'soft' institutions
Poverty reduction through market integration (structural adjustment)	Poverty reduction through markets, 'enabling' services and empowering partnerships
Market and fiscal discipline: IFI loan conditionalities	Market, fiscal and moral discipline: the obligation to participate, govern through efficient incentives
'Thatcherism', neoclassical economics, Structural Adjustment	'Third Way' social democracy (Blair/ New Labour); IFI/multilateral-led PRSP and Poverty Reduction

Source: Craig & Porter, 2006, p. 93

However, it should again be remembered that the fundamental *consensus* upon which both the WC and the PWC converge is that "[t]hey are both highly conservative in fiscal and monetary policy, and support 'free' trade, privatisation, liberalisation and deregulation" (Saad-Filho, 2005, p. 118). Thus, the latter's institutional reforms can be viewed as complementary to the economic policies of the former.

Following the main trend, the foremost contributions of PWC arguments to central banking have to do with the institutional aspects of these administration units. Besides the continuing commitment to *sound money*, refinement of institutional design, and specifically the WB's emphasis on *good governance* notions such as transparency and accountability, has gained significance in central banking.

2.4.1 Good Governance

Good governance is a concept first introduced by the WB.[19] Like most other notions in the social sciences, though 'good governance' has also been used by many other international institutions, such as the IMF, the Organization for Economic Cooperation and Development, the United Nations, and the World Trade Organization, it can be argued that its initiator has had the key weight in shaping the meaning of the term (Çulha-Zabcı, 2002, p. 152-155). First officially mentioned in a report entitled *Sub-Saharan Africa: From Crisis to Sustainable Growth* in 1989, the term was used to explain the failures of these African countries in spite of their implementation of Neoliberal reforms. It was argued that the trouble came from *bad governance*: namely corruption, patronage practices, clientelism, and the actions of self-serving officials (Kjaer, 2004, p. 138-139). Thus, the WB suggested that while the policies were correct, these states failed to deliver them successfully. In other words, "[f]ailure was still not to be attributed to the model, but again to the state, which was failing to enable the embedding of market reforms" (Craig & Porter, 2006, p. 69). Consequently, the reform agenda is broadened to include not only economic policies, but also the enhancement of institutional organisation. In brief, it complements economic liberalisation with political liberalisation (Çulha-Zabcı, 2002, p. 156).

Good governance can be considered as insights for building a fruitful institutional environment, in which market transactions can take place without corruption or rent-seeking behaviour of public officials. These measures belong to the *second generation reforms* and became conditionality for lending operations to developing

[19] Since the 1990s, *governance* has become a catchphrase in various disciplines, including political science, public administration, law, economics, sociology, and international relations (Kersbergen & Waarden, 2004, p. 143). Various explanations of the implications of this new word have been developed. While some argue that governance is "governing without government" (Rhodes, 1996, p. 667), others support the idea that it is "governing with more than government" (Kjaer, 2004, p. 44). According to Rhodes (1996), the word *governance* has six different usages, referring to; the minimal state, corporate governance, socio-cybernetic systems, self-organising networks, *New Public Management*, and *good governance* (p. 653). For present purposes, the meaning of good governance for public administration will be explored in relation to NPM.

and transition countries (Rhodes, 1996, p. 656; Kersbergen & Waarden, 2004, p. 145).[20] Specifically, good governance consists of four pillars:

> *Public sector management* entails civil service reform and privatization initiatives. *Legal framework for development* is about making and enforcing rules that can make a market work, such as private property rights. *Accountability* aims at strengthening institutions to hold the government accountable, as for example an ombudsman, the Auditor General or parliamentary public accounts committees. Finally, *transparency and information* are keywords for programmes that support a free media or help the government publicize statistics, such as publishing the public budget annually (Kjaer, 2004, p. 173 emphases original).

Some of these reforms are quite familiar Neoliberal prescriptions. However, the implementation of early Neoliberal reforms, mostly guided by NPM techniques, was proved to cause severe problems with respect to accountability, as they favour performance. NPM focused exclusively on the inner structures and objectives of organisations, neglecting the network of public administration units (Kersbergen & Waarden, 2004, p. 160; Rhodes, 1996, p. 663). Good governance notions such as transparency and accountability are argued to have mended these problems with respect to democracy. In Rhodes' words, "'good governance' marries the new public management to the advocacy of liberal democracy" (1996, p. 656). Nevertheless, an explanation from the *World Development Report 2002* could be enlightening about the paradigm's real stance towards democracy:

> Political institutions such as *constitutional rules*, the division of power among levels of government, *independent agencies*, mechanisms for citizens to monitor public behavior, and rules that inhibit corruption all succeed in *restraining officials of the state from arbitrary action*, and *good governance* will likely take root (p. 115, emphases mine).

A reminder of Gill's (2000) term *new constitutionalism of disciplinary neoliberalism,* which is the isolation of key issues from democratic accountability and an emphasis on market discipline, can be very helpful for understanding the transparency and accountability notions that are also incorporated in central banking. The *constitutionalism* aspect is apparent in good governance, due to the

[20] It should be noted that good governance is not merely an agenda imposed by international institutions. Rather, it is composed of various partners, and local civil society organisations play a significant part. To be sure, the Turkish Economic and Social Studies Foundation's good governance bulletins provide wholehearted support. Implementation of good governance notions is even considered as the *antidote* to almost all problems, inefficiencies, and corruption in Turkey (Argüden, 2006, p. 1).

aims to limit *discretion* with tools such as constitutional rules or independent agencies. *Market discipline* is also included within the emphasis on transparency. As IMF Managing Director Michel Camdessus pointed out in 1997, "Greater transparency will help strengthen *market discipline* and avoid market surprises that can lead to disruptive market reactions" (Camdessus cited by Rodan, 2006, p. 207, emphasis mine). The promotion of transparency by publishing information bulletins and holding press meetings could overcome imperfect information distribution and thus could reduce transaction costs, an obviously NIE-style of analysis.

Although these arguments sound technical and depoliticised, the underlying aim is highly political (Craig & Porter, 2006, p. 70). To be sure, some commentators argue that governance is a model that isolates crucial issues from democratic scrutiny and is favourable to capital (Güler, 2003, p. 17; Bayramoğlu, 2005, p. 20). Likewise, Rodan (2006) delicately states that the "neo-liberal reform agenda is not about the removal of politics from public administration, but the establishment of a new politics that attempts to contain challenges to market relationships and privileges the interests associated with those relationships" (p. 215). In summary, good governance is by no means a technical, apolitical agenda, but rather a continuation of Neoliberal economic reform processes through the restructuring of administration units with specific attention to institutional aspects.

CHAPTER III

CENTRAL BANK INDEPENDENCE

The literature on CBI, which will be explored in this chapter, is usually highly technical and ignorant about the essentially political nature of central banks. Most of the academic effort is concentrated on the development of indices and country comparisons. This is also the case for the theoretical articles that rationalise CBI, most of which are impossible to understand without advanced knowledge of econometric modelling. It should be kept in mind that the arguments defending CBI were developed within the specific historical context that was reviewed in the previous chapter. That framework was drawn to offer some guidance regarding *why* and *for whom* the independence of central banks is advantageous. Thus, the arguments for CBI can be appraised within this particular framework. This chapter is arranged in the following manner. The evaluation of theoretical foundations of CBI is the first concern. To this end, *Public Choice* and *New Classical Macroeconomics*, both of which are distinctively Neoliberal, will be critically assessed. Core aspects of CBI literature will then be scrutinised. Various definitions, indices, and empirical evidence will be reviewed respectively. It should be noted that the division of these parts is merely analytical, as the literature usually deals with these aspects simultaneously. Finally, complementary notions like *central bank transparency* and *accountability* will be presented.

3.1 Theoretical Foundations of Central Bank Independence

3.1.1 Public Choice

Public Choice was developed from the 1950s onwards, usually by scholars with economics backgrounds, such as James Buchanan, Gordon Tullock, Mancur Olson, Anthony Downs, and William Niskanen. It is also known as *New Political*

Economy. This approach can be caricaturised as the application of mainstream economic analysis to the sphere of politics, and specifically to the areas of interest groups, bureaucracy, political business cycles and legislature. Though there are several distinct schools, namely Virginia, Rochester, and Chicago, which do not necessarily provide a unitary whole (Rowley, 1993, p. x-xiv), Public Choice's overarching arguments about politics and bureaucracy will be identified first. The exploration will then advance with the analysis of *Political Business Cycles*, an approach which carries the distinctive features of Public Choice.

Public Choice views about political processes carry the characteristic feature of economic analysis. This can be easily inferred from the foundations of the approach; methodological individualism, homo economicus, and politics-as-exchange (Buchanan, 1987, p. 243).[21] First, analysis takes the individual choices as a meaningful starting point in explaining political action. Second, the individual is assumed to be a utility maximiser who moves according to self-interest rather than altruism. Finally, politics is conceptualised as an arena in which politicians exchange policies for votes with certain interest groups in order to win the elections. Against the usually embraced benign conceptualisation of politicians and the state, Public Choice explicitly emphasised the prevalence of rent-seeking behaviour, interest groups, and inefficient practices, suggesting that it was analysing "politics without romance" (Buchanan, 1979, p. 217).

With respect to bureaucracy, Public Choice disregarded Max Weber's emphasis on officials' commitment to public interest and argued that self-serving behaviour prevailed, not only in politics, but also in bureaucracy (Rowley, 1993, p. xvii).[22]

[21] The appropriateness of the label *New Political Economy* is dubious when the foundations of this approach are compared to the *Political Economy* that developed before the 1870s. It is interesting that David Ricardo explicitly stated that the aim of *Political Economy* was to analyse the distribution of wealth among *classes* (Ricardo, 1962a, p. 5). Thus, it is curious to find a methodological individualist approach assuming to be the *new* proponent of an originally class-based analysis.

[22] Tullock demonstrates this point as follows: "Man does not simply cease to exist because he is submerged in an administrative hierarchy. He remains an individual, with individual motives, impulses, and desires" (Rowley, 2005, p. 4).

For Public Choice, unlike in the private sector, there is no competition in the public sector that guarantees efficiency. On the contrary, bureaucrats enjoy a monopoly position in certain respects and, consequently, for public officials, it is preferable to expand their budgets. If they could not expand their budgets, they would try to reduce their workloads (Gamble, 2006, p. 28; Self, 1993, p. 33; Kjaer, 2004, p. 24).

Buchanan and Wagner (1977) contended that the political implications of Keynesianism are usually overlooked. They remarked that "the political legacy of Keynes may be summarized in a regime of continuing and apparently mounting budget deficits, inflation, and an expanding public sector" (p. 112). The practical inferences of these arguments are the restriction of state involvement in the economy, privatisation, and liberalisation, all of which guided governments through various channels in the Neoliberal era (Grindle, 1991, p. 58; Self, 1993, p. 64-67). The conceptualisation of politicians and bureaucrats as self-interested agents can be seen as discrediting democratic politics and questioning the efficiency of bureaucracy. It goes without saying that a key institution like a central bank should be isolated from political pressures. At this point, the arguments of *Constitutional Political Economy*, developed by James Buchanan, a leading Public Choice scholar, can be useful for demonstrating the emphasis on limiting government action. It is argued that:

> [T]he fallacy of nineteenth- and twentieth-century political thought lay in an implicit faith that electoral constraints would alone be sufficient to hold the Leviathan-like proclivities of government in check…we are now seeking to reimpose *constitutional limits* on government over and beyond these exercised through democratic electoral constraints (Buchanan, 1979, p. 11, emphasis mine).

Buchanan's lack of trust in democratic procedures leads him to defend *constitutional* limits on political action.[23] To be sure, his stance is a perfect manifestation of aim to limit democratic accountability in certain issues; a state of affairs which is termed critically by Gill (2000) as *new constitutionalism of disciplinary neoliberalism*. The paradox is evident where early Public Choice

[23] Interestingly enough, a central figure of *New Classical Macroeconomics*, Robert Lucas (1987), embraces these views: "[T]he most useful way to think about government policy is as a choice of rules of the game to which government is commited for some length of time...We need, in Buchanan and Wagner's useful terminology, an '*economic constitution*'" (p. 104, emphasis mine).

arguments aimed to shake the autonomy of politics by means of economic analysis; the aim later turned out to be the identification of ways for the establishment of an autonomous state. The state, especially the taking of economic decisions, is intended to be *depoliticised* by Public Choice, since the democratic processes lead to the expansion of 'populist' political agendas. The problem here is that when the Public Choice stance is accepted, there will be no agent left to initiate the economic reforms except enlightened technocrats or disinterested statesmen (Grindle, 1991, p. 59-60; Yalman, 2007, p. 405-406).

Starting from the mid-1970s, scholars like William Nordhaus, Assar Lindbeck, Douglass Hibbs, Alberto Alesina, and Alex Cukierman began to develop a literature that links the individual vote motive with politicians' actions to win elections. Operating within the Public Choice line of thought, politicians are viewed as utility maximisers and it is argued that they aim to stay in office by manipulating the economy before election times. Thus, the frequent fluctuations in the economy are said to originate from political processes, which provide the label for this kind of analysis: *Political Business Cycles* (Telatar, 2004, p. 386-391). There are two distinct positions in this analysis; politicians are said to be either *opportunistic* (Political Business Cycles) or *partisan* (Partisan Theory).

The seminal work of Nordhaus (1975) maintained that all politicians seek to provide a fruitful economic environment just before the elections so as to maximise their chances for re-election, despite the fact that these expansionary policies will have unpleasant results afterwards. One underlying assumption is that voters are short-sighted and backward-looking, and thus they only consider the condition of the economy preceding the elections. Thus, *opportunistic* actions of politicians can constantly deceive the public. Additionally, an exploitable short-run Phillips Curve, or the possibility of a trade-off between unemployment and inflation, is a crucial assumption (Alesina, 1989, p. 63). From this analytical stance, it is obvious that the practical implications for reform include isolating the pressures of politicians in the economy. As Nordhaus points out, the *remedy* could be the handing over of monetary policy to people who are not influenced by politics, a typical example of this being CBI (1975, p. 188). Indeed, a strong case for CBI comes from this approach, since this solution carries the virtue of overcoming unpleasant effects of political business cycles like uncertainty and fluctuations (Alesina & Roubini & Cohen, 1997, p. 222-223; Hayo & Hefeker, 2001, p. 5-6).

The second approach in Political Business Cycles is led by Hibbs' study (1977), which emphasised the *partisan* impetus in politics. Both the public and politicians are assumed to vote according to their ideological preferences and adhere to these choices. Accordingly, right- and left-wing parties make different choices concerning the trade-off between inflation and unemployment (Alesina et al., 1997, p. 2). It is maintained that "macroeconomic outcomes have important redistributive consequences. As a low unemployment/high inflation outcome is favourable to the lower middle class…left-wing parties choose points on the Phillips curve with higher inflation and lower unemployment" (Alesina, 1989, p. 58). The reason why lower classes support such policies is clarified by Hibbs: "unemployment falls most heavily on the lower classes and…postwar inflations have generally redistributed income and wealth away from the rich" (1987, p. 7). Thus, while parties with a leftward orientation consistently try to reduce unemployment to be re-elected, conservative parties aim to reduce inflation.[24]

The theoretical assumptions and empirical results of Political Business Cycle approaches are criticised in several respects, the most prominent being *Rational Expectations*' emphasis on the futility of the manipulation of the economy. Since the central tenets of this position will be reviewed in the next part of the thesis, it

[24] Hibbs' contribution is very valuable because of the emphasis given to ideologies and the class-based redistributive conflicts arising from macroeconomic decisions. It is clearly demostrated that macroeconomics is not a neutral, value-free arena. Following this line, the politically conservative implications of the persistent aim to reduce inflation at the expense of unemployment becomes obvious. Moreover, CBI and the obsession against inflation can be assessed as the institutional solution to continuously safeguard right-wing policies. Despite these important arguments, this analysis is peculiar because of the tension with respect to its methodological grounds. This approach is argued have its basis in Marxist analysis (Telatar, 2004, vii). Certainly, as Hibbs points out, the motivation in his analysis is "concern with class-based cleavages and political conflicts over macroeconomic and distributional policies and outcomes" (1987, p. 1). However, the broad usage of the utility maximising individual casts doubts about how to come to terms with the methodological stance of this analysis.

will only be noted here that fluctuations of the size predicted by Business Cycles arguments are explicitly rejected. As agents are not considered to be backward-looking and naïve, and the exploitable trade-off in the Phillips Curve is only possible in the short-run and is sometimes even non-existent, there will not be a persistent deception or manipulation of the economy. In due course, both of the original Political Business Cycles approaches were modified by incorporating a rational expectations framework (*Rational Political Business Cycles* and *Rational Partisan Theory*). Thus, some authors (Alesina, 1989) continued to analyse the relationship between monetary policy and business cycles within a rational expectations framework.

3.1.2 New Classical Macroeconomics

New Classical Macroeconomics is the school of thought from which key economic and technical arguments in defence of CBI arise. Developed in the 1970s by scholars such as Robert Lucas, Thomas Sargent, Neil Wallace, Robert Barro, and Finn Kydland, this school is also sometimes named after its core assumption, *Rational Expectations*. The impact of these arguments was considered to invoke no less than a *revolution* in macroeconomic thought, econometric modelling, and policymaking (Mishkin, 2004b, p. 658).[25] It is maintained that an agent's information concerning both the past course of events and possible future changes are included in his or her expectations. This is not to say that agents do not make mistakes in their expectations. Rather, they cannot be deceived *systematically* (Bulutay, 1984, p. 10). While this school has certainly been inspired by *Monetarism* (Hoover, 1992, p. xiv; Sargent, 1981, p. 188), some of Friedman's propositions, like the x-percent rule, are rejected as suboptimal (Sargent &

[25] A significant aspect of New Classical Macroeconomics is the triumph of *technique*. The excessive usage of mathematical modelling became commonplace in macroeconomics with the leading contributions of this school (Hoover, 1992, p. xx). This development can be interpreted as the *scientization* of monetary policymaking. As Marcussen rightly argues, "central banking is now so esoteric that it is only understood by a small number of people with specialized knowledge. Fundamentally politically contentious issues are being reified, rationalized, objectified and intellectualized…Political intrusion is considered to be not only highly inappropriate but downright irrelevant" (Marcussen, 2007, p. 150).

Wallace, 1981a, p. 200-201). Taken as a whole, New Classical Macroeconomics is undoubtedly *classical,* much like Monetarism, in its belief in the self-equilibrating virtues of the market and the futility of government intervention.[26]

A vital distinction between anticipated and unanticipated government interventions is put forward by Lucas in his Nobel Lecture, entitled *Monetary Neutrality* (1996, p. 679). He argues that agents endowed with rational expectations have the ability to act in such a manner as to counterweigh the possible effects of anticipated policies, a situation referred to as the *policy ineffectiveness proposition*.[27] On the other hand, unanticipated policies can have some real effects on production. In addition to the *surprises* of government, problems like imperfect information and rigid labour contracts, which are considered to be *distortions*, can be the reason for the short-term real effects of these monetary policies. However, since agents have rational expectations, this temporary divergence between expectations and actual policy implementation is soon corrected, because the economy cannot systematically be in a state below the natural rate of unemployment (Lippi, 1999, p. 9-10).

From these arguments, it follows that a long-run trade-off between inflation and unemployment, one that is denoted by the Phillips Curve, is not possible. Regarding the long-run Phillips Curve as vertical is crucial for CBI since it implies "that the best sustainable outcome that the authorities can achieve through monetary policy is price stability" (Goodhart, 1994, p. 1427). Once it is accepted

[26] It should be remarked that Keynes' emphasis was on involuntary unemployment, absence of clearing markets, and lack of monetary neutrality, which necessitated government intervention in the economy for equilibrium (Hoover, 1992, p. xiii). Moreover, Keynes argued that "human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist" (Keynes, 1998, p. 162-163). *New Classical Macroeconomics* is in stark contrast to these arguments. It can be argued that when the central tenets of Public Choice and New Classical Macroeconomics are taken together, active government intervention is certainly seen as unfavourable (Backhouse, 2005, p. 383).

[27] In explaining this proposition, Mishkin (2004b) asks with a sense of humour: "Where does this lead us? Should the Fed and other policymaking agencies pack up, lock the doors, and go home? In a sense, the answer is yes. The new classical model implies that discretionary stabilization policy cannot be effective and might have undesirable effects on the economy" (p. 665).

that expansionary policies could not have any effect on real variables like unemployment, it is preferable not to confuse agents' expectations with *discretionary* interventions (Goldfeld, 1982, p. 362-363).

The *time inconsistency problem,* developed by Kydland and Prescott (1977), is a fundamental case for the application of *rules* rather than *discretion* in monetary policymaking and a precursor for the justification of independent central banks. In technical terms, the choice of an optimal policy for a certain time in the future becomes suboptimal when that time actually arrives. In other words, there may be incentives for the authorities to depart *ex post* from the optimal policy, which is declared *ex ante* (Lippi, 1999, p. 8).[28] It is argued that the "reason for this apparent paradox is that economic planning is not a game against nature, but, rather, a game against rational economic agents" (Kydland & Prescott, 1977, p. 473).

To demonstrate the implications of this problem in monetary policy, it can be remarked there is an incentive for authorities to deceive the public by inflating the economy to reduce unemployment. Agents with rational expectations will foresee that authorities have such incentives to depart from their previously announced inflation targets and will act accordingly. Thus, the output could not be systematically reduced and there will be a suboptimally high inflation rate (Kibmer & Wagner, 1998, p. 6-7). To overcome this problem, a commitment to original monetary targets could be enforced by adopting *rules* rather than *discretion* (Kydland & Prescott, 1977, p. 487). Furthermore, the *credibility* of monetary authorities becomes a mounting concern with this analysis. Since monetary policy is not a one-time game but rather a continuing interaction, loss of their reputation will not be preferred by the authorities. Indeed, the very nature of commitment to a target implies that deceiving the public would not be costless; there are some penalizing mechanisms (Telatar, 2002, 136-137). As Barro and Gordon (1983)

[28] This rather complicated problem can be demonstrated by a familiar example: "Given student foibles, a planned final exam is undoubtedly optimal, but [in] the morning of the exam the optimal policy is to cancel the exam, saving both student and faculty effort. The sequence is, however, a questionable equilibrium even the first time the game is played, since students might anticipate cancellation of the exam and change their behavior" (Goldfeld, 1982, p. 362).

demonstrate, “Given the repeated interaction between the policymaker and the private agents, it is possible that reputational forces can substitute for formal rules... the potential loss of reputation –or *credibility*– motives the policymaker to abide by the rule” (p. 101-102, emphasis mine).[29] The rationale of central bank independence becomes manifest here, as Friedman (2002) skilfully remarks:

> The literature of central bank independence is developed in the wake of the literature of time inconsistency, according to which the explanation for the high and chronic inflation that then plagued so many industrialized economies around the world was a systematic attempt by central bankers to ‘trick’ private-sector decision makers into producing more by bringing about a higher inflation rate than they were expecting. But why would central bankers do such a foolish (and according to the literature, ultimately unsuccessful) thing? Surely, left to their own devices they would not. Only the pressure of higher political authority to which they were subject could explain such a blatant folly (p. 13-14).

Ever since the incentive to inflate the economy was first regarded as coming from politicians, the isolation of political pressures has turned out to be the key solution. However, there are a variety of views about the way in which this aim can be achieved. While the analysis suggests that avoiding *discretionary* interventions and following *rules* is a possible solution, the lack of a superior authority to assure the implementation of rules is a problem (Eijffinger & De Haan, 1996, p. 7). Even if there was a firm experimentation of a monetary rule, inflation could be eliminated but the inflexibility of the rule could still lead to excessive output fluctuations and become quite costly in the circumstances of exogenous shocks. Thus, the complications arising from monetary rules and rigidities in labour and product markets led to discussions of *second-best* solutions to enforce the commitment to price stability by creating credible institutional arrangements like central bank independence (Telatar, 2002, p. 154-157). Rogoff’s (1985) *conservative central banker* and Walsh’s (1995) *contracting* approach can be identified as two key solutions in this regard (Kibmer & Wagner, 1998, p. 9; Hayo & Hefeker, 2001, p. 4).

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[29] The inflation bias that is supposed to arise from the time inconsistency problem is contested by Albanesi, Chari, and Christiano (2001). Opposing Kydland and Prescott (1977) and Barro and Gordon (1983) with the same technical tools, they found almost no inflation bias in authorities who do not commit to a predetermined target.

Rogoff (1985) argued that the monetary authority should be given to an independent and *conservative* central banker. This very decisive argument is presented as follows: "Society can sometimes make itself better off by appointing a central banker who does not share the social objective function, but instead places 'too large' a weight on inflation-rate stabilization relative to employment stabilization" (1985, p. 1169). Remembering the Taylor Rule that was presented above, it is clear that a central bank may place weight on either employment stabilisation or price stability. Rogoff argued that the inflation arising from the time inconsistency problem can be solved by appointing a conservative central banker who will not be tempted to reduce unemployment. Yet, it is also recognised that the weight should be "too large" but still not "infinite" (p. 1171), because the higher the weight, the more the employment cost will be apparent in the cases of supply shocks. To conclude, Rogoff pointed out that his model may be helpful in illuminating "why many countries set up an independent central bank and choose its governors from *conservative elements of the financial community*" (p. 1187, emphasis mine).[30]

Walsh (1995) constructs his case by using the *Principal-Agent* approach to eliminate inflationary bias in monetary policy. He argues that the government (the principal) should prepare the contract for the central bank governor (the agent) in such a way that there will be a material incentive for reaching the predetermined target, or a punishment for not reaching the target (1995, p. 150-151). In other words, the central bank is given independence to conduct its policy to reach an inflation target and the realisation of this goal determines the bank governor's income or potential dismissal. This *contracting* approach has been implemented by the *Reserve Bank of New Zealand,* where the governor's job is at stake if the

[30] Several authors remind us of the frequent confusion arising from the interchangeable usage of the terms *conservativeness* and *independence*. The term "conservative central banker" is ambiguous, because it is hard to define such character. These two can be distinguished since an independent central bank may not necessarily be conservative. (Berger & De Haan & Eijffinger, 2001, p. 4-7; Hayo & Hefeker, 2001, p. 4-5). Yet, all of this confusion can be seen as a demonstration of the fact that independent central banks have been mostly concerned with price stability, which is a conservative political choice.

determined rate of inflation is not maintained, as is determined in agreement with government (Fischer, 1995, p. 202).[31]

3.2 Central Bank Independence Definitions

There is a vast literature on CBI that aims to define various aspects of independence, quantify the existing central banks' independence, and assess the relationship between economic variables and CBI. A selective review of these efforts is the present concern. A government can influence and exert pressure on central banks in many ways. When explaining the independence of central banks, it is useful to distinguish between *personnel*, *financial,* and *policy* independence (Eijffinger, 1997, p. xi).

Personnel independence refers to the weight of governmental decisions in personnel appointments to the central bank. Since central banks are generally public institutions, it is quite impossible to eliminate all of the government influence in the appointment procedures. Yet, issues like composition of the central bank board or the selection, service duration, and dismissal of the governor can be arranged in different ways. *Financial independence* reflects the government's ability to finance its deficits from the central bank. Central banks' capability of creating money is the source of the tension here. While governments may want to enjoy *seignorage* revenue, bank independence in this regard implies the restriction

[31] Walsh assumes that the government and the central bank's governor share the same choices regarding inflation and output stabilisation. Additionally, both of the agents would have a motivation to diverge from their commitment and to exploit the possibility of reducing unemployment (Walsh, 1995, p. 152). Performance contracts are proposed to provide material incentives or punishments to the central bank's governor to eliminate the bias of exploiting such possibilities. With respect to this contracting approach, there is an objection that points out the *fallacy* inherent in the argument. McCallum argues that the motivation for dynamic inconsistency is not solved, but is only "relocated" by providing performance contracts to central banks. While the government is the one to prepare and impose the contract for the central bank, "government has exactly the same incentive not to do so as identified by Kydland-Prescott" (1995, p. 210). It is argued that: "[W]hen unemployment is higher than desired by the government, it will try to induce the central bank to be more expansionary...by devising extra types of financial (or nonpecuniary) rewards for the central bank if it accomodates" (p. 210). Likewise, Alesina, Roubini, and Cohen remind us of the possibility that a *partisan* or *opportunistic* government could have the chance to modify the performance contract (1997, p. 224).

of governmental borrowing from the central bank. *Policy independence* denotes central banks' freedom to conduct monetary policy without any political intervention. This is considered to be a restriction of politicians' temptation to exploit possibilities of reducing unemployment (Eijffinger, 1996, p. 2).

With respect to policy independence, an important distinction between instruments and goals should be put forward. As reviewed earlier, key instruments of a central bank include the determination of short-term interest rates, open market operations, rediscount window, reserve requirements, and moral suasion. Meanwhile, the major goals of monetary policy are price stability, full employment, balance of payments, and stability in financial markets (Telatar, 2002, p. 7). A central bank which has freedom to choose and use its monetary policy instruments without political pressure is argued to have *instrument independence*. However, such a bank is only free to use whichever instrument it wants to reach a predetermined goal; it cannot choose its own goals. If a central bank has the autonomy to chose not only the instruments, but also to determine the goals of monetary policy, then it has *goal independence* (Fischer, 1995, p. 202). Regarding the two significant theoretical models, it can be remarked that while Rogoff's (1985) conservative central banker has the ability to determine both the goals and instruments of monetary policy, in Walsh's (1985) contracting approach, the governor has only instrument independence to reach a prearranged goal.

A fairly similar distinction is made by Grilli, Masciandaro, and Tabellini (1991) (GMT) between *political independence* and *economic independence*. The division is described as follows: "Political independence is the capacity to choose the *final goal* of monetary policy, such as inflation or level of economic activity. Economic independence is the capacity to choose *the instruments* with which to pursue these goals" (p. 366, emphases original). It goes without saying that these two definitions coincide with goal and instrument independence, respectively.

This distinction between economic and political independence should not give the misleading impression that a central bank that is given economic independence is merely conducting a technical job. An instance where this confusion becomes apparent is worth quoting and scrutinising:

> Democratic accountability is appropriate in cases where institutions make political decisions, i.e. face a trade off with respect to conflicting objectives. But the independent central bank would be committed to only one objective, price stability. Hence *the bank will not make political decisions but technical decisions* with respect to policy implementation (Neumann, 1991, p. 78, emphases mine).

This statement seems to overlook the definition of political independence, which implies the possibility of the pursuit of various objectives. It is equally possible that a central bank with goal independence may also pursue full employment, at least in principal. But when the *raison d'etre* of CBI is recalled, the close association of the pursuit of low inflation with independence becomes apparent, as the conventional wisdom of this literature points: "In practice, however, the main virtue of having an independent central bank is that it can provide credibility. This is why we *identify independence with autonomy to pursue the goal of low inflation*" (Grilli et al., 1991, p. 367, emphasis mine). Thus, in practice, it can be safely stated that almost all independent central banks are primarily concerned with price stability.

Additionally, this quote illustrates the undemocratic nature of CBI. It is true that, with the independence reforms, goals like full employment are eliminated from the agenda of most central banks. However, the elimination of these concerns and the exclusive focus on price stability itself is a highly *political* choice that diminishes the democratic scrutiny of central bank's decisions. What is more, the conduct of monetary policy with the special aim of low inflation is not a technical matter. On the contrary, it is a political conduct which has serious consequences in the distribution of income through classes. As interchangeable usage of the terms *independence* and *conservativeness* demonstrates well enough (for details, please review footnote 30), the triumph of CBI brings the implementation of politically conservative monetary policy.

Another important distinction about CBI is made with respect to the legal framework that is drawn and the banks' actual situations. This concern arises from the fact that while many central banks are independent in legal terms, the exercise of this independence turns out to be highly divergent from case to case, and especially in developing countries where the respect for rule of law is quite different than in developed ones. Consequently, in complement to *legal independence*, *actual independence* became an important consideration in the construction of indices. The difference between these two types of status can occur because laws could not include every aspect of the limits of authority; even if this were possible, the actual implementation can still deviate from the law (Cukierman & Webb & Neyapti, 1992, p. 355). A similar point is made by referring to actual independence as *behavioural independence* (Marcussen, 2007, p. 147). As mentioned before, the *Reichsbank*'s legal independence could not prevent the hyperinflation of the 1920's. Granting independence to a central bank by laws, even at a *constitutional* level so as to safeguard independence from governments' threats to change the law with simple majorities (Neumann, 1991, p. 105), does not necessarily bring independence in actual terms. To be sure, as some point, "[t]he view that Federal Reserve decision making is dominated by technical expertise operating independently of political pressures is a myth" (Dillon & Willet, 1988, p. 30). Thus, it can be concluded that granting independence to a central bank by law cannot be seen as a guarantee for isolating political pressures.

3.3 Indices Developed for Measuring Independence

There are numerous indices that have been developed to measure and compare the independence of central banks in different countries. Since all of these technical efforts aim to deal with very much the same issue, two of the most prominent indices will be reviewed here and the objectivity/subjectivity in the building of indices will be evaluated.

Grilli, Masciandaro, and Tabellini (1991) provided political and economic independence indices and compared 18 developed countries' central banks (for the results, please see *Appendix B* and *Appendix C*). With respect to political independence, it is argued that three aspects are crucial. The first area of focus is the appointment procedures for the governor and boards of central banks.

Independence increases if the governor and board are not appointed by the government, and if they are appointed for a duration of longer than five years. Second, the relationship of the bank's governing body with the government is scrutinised. A central bank will be more independent if government participation in the board is not compulsory and if there is no need for governmental approval in policy formulation. Finally, official statement of central banks' responsibilities is important. This provides the legal terms to support a central bank in case of conflict with the government, and the statutory requirements that point to price stability as the key goal.

The economic independence of central banks is related to the monetary financing of the budget deficit and to the instruments of monetary policy. The former implies the limits on both governmental borrowing from a central bank and involvement of the central bank in the management of public debt. The latter entails the freedom to use monetary policy instruments and less financial regulation responsibility for more independent central banks (p. 369).

Cukierman, Webb, and Neyapti (1992) categorised legal independence issues of central banks into four groups (for a detailed list of variables, please see *Appendix D*). First, if the appointment decision of the bank's governor is made by the board of the bank rather than by the prime minister, the bank's independence increases. Second, independence again increases if the governor's time in office is sufficiently long and the bank is free of political interference while pursuing its policies. Another important criterion for independence is that the government should not be allowed to borrow from the central bank to finance state deficits. Finally, a central bank's independence increases when price stability is its sole organisational aim.

In addition to their legal independence index, Cukierman, Webb, and Neyapti (1992) also provide two indicators regarding the actual independence, the turnover rate of a central bank's governor and a questionnaire of independence. The former focuses on the frequency of the change in central bank governors. A high frequency of replacement could be evidence of political intervention against the head of the bank. Yet, it should be considered that the contrary could also be true in a case of low independence; a governor who is manipulated by a government may be in office for a long time (p. 363-367). The questionnaire that is sent to specialists in central banking aims to reveal the practical exercise of the law. While acknowledging the subjectivity of this method, it is argued that the discrepancy between actual and legal independence can be traced (p. 367).

At this point, it is crucial to evaluate the complications that may arise from the subjectivity of these indices. Developing indices requires providing criteria for independence, interpreting the laws of central banks regarding these criteria, and aggregating these criteria (Berger & De Haan & Eijffinger, 2001, p. 16). There is apparently an arbitrariness and subjectivity in each of these stages, an important fact that is also admitted by the creators of well-known indices (Grilli et al., 1991, p. 367; Eijffinger & Schaling, 1993, p. 51). These indices are severely criticized for the following reason:

> [W]hat are the criteria for a good measure? It cannot be 'one which gives a relation with inflation' since that makes the hypothesis unfalsifiable…What we are lacking is an objective reason to prefer one [measure] over the other. Without this, there can be no test of the independence hypothesis (Forder cited by Berger et al., 2001, p. 22).

A comparison of the most frequently used indices, by Cukierman (1992) and by Grilli, Masciandaro, and Tabellini (1991), reveals that they diverge significantly not only about the assessments of the laws, but also in their choice of criteria (Mangano, 1998, p. 490). What is more, the questionnaires on actual independence are based on the how central bankers *perceive* their independence (Itoh & Lapavitsas, 1999, p. 172). Once the subjectivity is accepted, numerous empirical studies on CBI that are based on such indices become doubtful. In other words, "the conclusions reached in the empirical literature about the supposed effect of CBI on various other economic variables (notably inflation) are on shakier foundations than is usually realized" (p. 470).

3.4 Empirical Evidence about Central Bank Independence

There is an immense literature devoted to measuring the empirical relationships between CBI and inflation, variability of inflation, growth, variability of growth, interest rates, budget deficits, and central bank credit. To be sure, there are 21 studies published between 1988 and 1996 that investigate the relationship between CBI and inflation (Eijffinger & De Haan, 1996, p. 64-69). Yet, as pointed out earlier, a significant number of these studies utilise indices that were arbitrarily developed. A review the main conclusions arising from these important, albeit problematic, studies will be conducted in this part of the thesis.

Numerous studies have concluded that, for developed countries, inflation is negatively related to CBI (Alesina & Summers, 1993; Grilli & Masciandaro & Tabellini, 1991; Eijffinger & Schaling, 1993; De Haan & Sturm, 1992). In other words, greater legal independence of central banks is associated with lower inflation. However, for less developed countries, there is no relation between inflation and legal independence of central banks (Cukierman & Webb & Neyapti, 1992). The doubts concerning the success of CBI are put forward as follows in the *World Development Report 2002*: "The empirical evidence on the effectiveness of central bank independence has been mixed. Especially among developing countries, there is little evidence that the statutory independence of the central bank makes a big difference for inflation outcomes" (p. 104). To complement this point, it is suggested that the turnover rate of central bank governors and inflation are positively associated in developing countries. In other words, because of the *lack* of independence, governors are frequently changed and this leads to higher inflation (Cukierman, 1993).

The frequently reached conclusion that connects legal independence and low inflation should be scrutinised critically. The negative correlation linking these two factors does not necessarily mean that there is causation (Hayo & Hefeker, 2001, p. 2; Eijffinger & De Haan, 1997, p. 30). There can be a reverse or two-way causality between legal independence and low inflation (Cukierman, 2005, p. 11-12). In fact, the commonly accepted causality from CBI to low inflation is not found in a study of Latin American and Caribbean countries (Jacome & Vazquez, 2005). The relationship can be considered a vicious circle when high inflation diminishes independence of central banks. In turn, this may lead to more inflation (Cukierman & Webb & Neyapti, 1992, p. 377).

A third variable may also be significant for explaining the co-existence of legal independence and low inflation. In fact, *inflation culture* or the traditions of countries concretely influence their monetary policy preference. In the case of Germany, for example, it can be argued that the apparent post-World War II success of the *Bundesbank* in fighting inflation arose from the public support for anti-inflationary policies due to the unpleasant experience of hyperinflation in the 1920s (Eijffinger, 1996, p. 30; Hayo & Hefeker, 2001, p. 2). Furthermore, a comparison of the inflation records of a formally dependent *Bank of Japan* with the independent *Federal Reserve* reveals the fact that the former achieved lower inflation rates than the latter (Cargill, 1995, p. 169). Thus, it seems that granting independence to central banks is not the key factor in explaining the low inflation, not only for developing countries, but also for the developed ones.

Another argument reminds us of the greater significance of interest groups in the pursuit of low inflation, instead of legal independence. As already reviewed above, Posen (1993) describes the well-articulated and influential interests of the financial sector with the term *financial opposition to inflation* and argues that, for politicians, granting independence to central banks means renouncing significant power to control the economy. Why would a politician voluntarily do this? The reason for such a surrender of control is considered as a correspondence of certain groups' and politicians' interests (Miller, 1998, p. 447-450).

Concerning the relationship between CBI and growth in developed countries, Grilli, Masciandaro, and Tabellini's expression '*free lunch*' stands out among the various studies suggesting no connection between growth and CBI (1991, p. 375). It is concluded that CBI has no relation to either output growth or the variability of growth. However, this conclusion seems to be incompatible with Rogoff's (1985) conservative central banker. In the model mentioned above, 'conservativeness' implied that the governor would be reluctant to stabilise fluctuations in output in comparison to an aim to fight inflation (Fischer, 1995, p. 205). Interestingly enough, this inconsistent finding "is normally treated as an unexpected bonus rather than as a problem for theory" (Itoh & Lapavitsas, 1999, p. 172).

There are some benefits attributed to CBI for enhancing growth because a predictable monetary policy may improve economic stability and, consequently, growth. However, CBI may also have some negative effects on growth since the pursuit of low inflation implies holding real interest rates high. This can be harmful for non-financial investments and subsequently for economic growth (De Haan & Sturm, 1992, p. 317). There are higher output losses in recessions when the central bank is more independent as it focuses more on inflation. Furthermore, CBI can be associated with high disinflation costs. Interestingly enough, this is also the case for developed European Union countries (Eijffinger & De Haan, 1996, p. 38).

3.5 Central Bank Transparency

The promotion of transparency in central banks is a relatively recent trend. In fact, central banks were usually characterised by secrecy before the 1990s. Central banks traditionally withheld their objectives, economic data, and views about the future path of the economy. One potential rationale for this closedness was avoidance of the time inconsistency problem. By obscuring their actions, central banks aimed to avoid political pressures (Mishkin, 2004a, p. 1). However, the transparency drive, coupled with inflation targeting, changed central banks' perception with respect to communication and came to be seen as an alternative solution to the time inconsistency problem.

With the implementation of inflation targeting, monetary policymaking became a quantifiable and open process in the eyes of the public. Explicit targets are stated from the beginning and the actual success of the implementation can be clearly observed. It can even be stated that inflation targeting "is a way of manipulating private-sector decision makers' expectations about future inflation" (Friedman, 2002, p. 16). To succeed at this targeting, central banks began to emphasise communication with the public. Thus, central banks began to hold regular press meetings, inform the government of their plans in an orderly fashion, and publish reports about their expectations of the future course of inflation; in short, they now utilise every opportunity for communication (Muchlinski, 2005, p. 131).

Efforts to define different aspects, develop indices, or make country comparisons are rather premature for the recent notion of transparency. Nevertheless, a review of Dincer & Eichengreen's (2007) transparency index, which is actually an extension of Eijffinger & Geraats' (2006), can be demonstrative. Here, the issue of transparency is examined within five different categories. *Political transparency* denotes openness about policy objectives and their rankings. *Economic transparency* refers to the availability of the economic data that is used by a central bank. *Procedural transparency* is related to the way in which policy decisions are made and implemented. *Policy transparency* implies the public explanation of policy decisions and possible future courses of actions by the central bank. Finally, *operational transparency* signifies the implementation of policy actions, including evaluation of implementations vis-à-vis targets (Dincer & Eichengreen, 2007, p. 26-28). Some of the listed key determinants of transparency are the inflation history, openness, financial depth, political stability, rule of law, government efficiency, voice, and accountability (p. 19).

Despite the virtues associated with transparency, such as provision of public support or conformation to democratic principles, there are some limits on its implementation. Transparency of central banks' objective functions or of the expectations regarding the future path of the interest rate can raise problems in communication or impact the public's support. Mishkin humourously argues that violation of the KISS (Keep It Simple, Stupid) principle may lead to difficulties in central banks' ability to focus on long-run objectives (Mishkin, 2004a, p. 2-5). Additionally, the privileged position of central banks with respect to their special knowledge may require confidentiality. A *creative ambiguity* can be necessary in instances like foreign exchange market interventions or protection of proprietary information (Muchlinski, 2005, p. 134).

It can be argued that the emphasis on *good governance* notion transparency is closely related to the *credibility* of central banks. The need for central banks to persuade economic agents of their commitment to a certain inflation target can be enhanced by transparent experimentations. Certainly, a central bank with open and clear targets and operation will be more convincing and credible than a secretive bank (Friedman, 2002, p. 15-17). However, it should be pointed out that transparency, and likewise credibility, are not value-free notions. On the contrary, "transparency's fundamental purpose is that of rendering greater discipline and accountability of policy makers and actors to the market" (Rodan, 2006, p. 198). It is clear that the diffusion of information arises from the need to convince market actors about central banks' devotion to their targets. Central bank transparency can be seen as a modification of first generation Neoliberal reforms in central banking. Thus, independence reforms are consolidated with a fine-tuning element (Marcussen, 2007, p. 152).

3.6 Central Bank Accountability

Isolating central banks from political scrutiny by granting them independence raises doubts about their democratic accountability. Delegating the ultimate control of such a fundamental financial issue to technocrats who are supposed to be above any political interest is essentially problematic. Despite the fact that these technocrats are not elected, they become vested with considerable authority to make ultimately political decisions (Coen & Thatcher, 2005, p. 339). It can be argued that Neoliberal ideas favour elite and technocratic institutions instead of democratic conduct (Harvey, 2005, p. 66). In fact, the insulation of central banks from political scrutiny is said to create a *democratic deficit* (Bakır, 2007, p. 146). The defence of *constitutional* mandates to strengthen and safeguard central banks' independence is instructive about the manner in which CBI is defended. As Milton

Friedman's following words make clear, even among liberal thinkers there is an anxiety about the essentially undemocratic nature of CBI:

> Is it really tolerable in a democracy to have so much power concentrated in a body free from any kind of direct, effective political control? What I have called the 'new liberal' often characterizes his position as involving belief in the rule of law rather than of men. It is hard to reconcile such a view with the approval of an independent central bank in any meaningful way (1962, p. 227).

Against the anxiety that CBI brings undemocratic implementation of monetary policy, there are some arguments that claim the contrary. It is suggested that, at the end of the day, democratically elected politicians have the ability to change the law associated with CBI. Just as independence is granted by law, it can be repealed. To make an analogy, while the rules of the game are ultimately under democratic control, it is only the game itself which is handed over to independent central banks (Eijffinger & De Haan, 1996, p. 15). It can be argued that there is a paradox here. If there is a widespread acceptance of the importance of price stability; "then you do not need an independent Central Bank, since the politicians would deliver much the same result, unaided. While if there is no such general support for counter-inflationary policies, granting a Central Bank independence will not work either" (Goodhart, 1995, p. 67). Likewise, Itoh & Lapavitsas (1999) points the "profoundly undemocratic view" inherent in the CBI arguments:

> Control over money, and influence over the generation and allocation of credit, affords considerable power to promote capitalist accumulation in certain areas and restrict it in others. It also affords power to influence the distribution of income through consumption and housing credit…[W]hat should be the processes of appointment and accountability for such a powerful institution?...It is pure ideology to claim that society cannot employ monetary policy consciously and in its own interests, instead entrusting it to an elite of high priests (p. 174).

The distrust in democratic processes, a characteristic of Public Choice stance towards politics, should be recalled in this discussion. By granting independence to central banks and securing it on *constitutional* level, this stance is trying to limit democratic scrutiny of masses on monetary policy. Additionally, it should be kept in mind that the preferred policy of price stability is itself a highly political choice which has distributional consequences. With independence, function of central banks, which have significant weight in accumulation and distribution of income is reduced and locked to a conservative policy choice; low inflation.

The growing emphasis on the accountability of central banks can be seen as an attempt to counterweigh the concerns about democracy that arise from the banks' independence (Bakır, 2007, p. 146). A simple definition of accountability is: "(1) people are given certain objectives; (2) there is a reliable way of assessing whether they have met those objectives; and (3) consequences exist for both the case in which they have done what they were supposed to do and the case in which they have not done so" (Stiglitz, 2006, p. 313). It can be thus inferred that central bank accountability requires clear objectives, certain targets for these objectives, and a penalty for failure to reach the objectives.

Accountability here is regarded mostly as a problem of successfully implementing inflation targeting regime. Because of the lack of a well-established principle for such penalties, cases differ with respect to accountability. For instance, the *Reserve Bank of New Zealand* has only instrument independence and the governor can be dismissed for failure to reach inflation targets. On the other hand, the *Deutsche Bundesbank* does not proclaim inflation targets and is entirely independent from the instructions of the government. Thus, it can be concluded that accountability is more extensive in New Zealand than in Germany (Goodhart, 1995, p. 69; Eijffinger & De Haan, 1996, p. 15-18).

With respect to the democratic control of monetary policy, an important anxiety concerns its connection to fiscal policy. What can be said about the possible conflicts arising from independent monetary policy and government-controlled fiscal policy?[32] At the least, it can be inferred that coordination problems can occur

[32] In this regard, Sargent & Wallace (1981b) provided a leading analysis entitled *Some Unpleasant Monetarist Arithmetic*. The underlying argument here counteracts the central tenet of *Monetarism,* which is limiting the supply of money in order to avoid inflation. The analysis starts with a choice: assuming that fiscal policy is dominant in the economy, budget deficits may be financed by debts rather than by monetising. However, there are limits and complications to this preference. When the rising real interest rate due to indebtedness is larger than the growth rate of the economy, a government faces the problem of debt sustainability. Government may then force monetary

(Eijffinger & De Haan, 1996, p. 18-19). Precommitment of monetary policy to price stability may cause problems for a democratically decided expansionary fiscal policy. Yet, there are arguments that CBI may be beneficial even in cases of conflict. Central banks' straightforward focus on controlling inflation in a transparent way can reveal expansionary fiscal policies. Thus, "independent monetary policy may have the advantage of providing a *disciplinary* check on other policies" (Swinburne & Castello-Branco, 1991, p. 421, emphasis mine). This point is quite interesting because it supports the dispersion of a particular contractionary policy to other fields. As stated earlier, the set of policies that constitute the WC should be evaluated as interconnected, since they share a particular belief about the role given to the state. Thus, together with the promotion of tight fiscal policies, CBI constitutes a part of Neoliberal reforms that aim to safeguard conservative economic policies.

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authorities to monetise the deficit. In such a case, the consequent inflation is higher than if the budget deficits had been monetised from the beginning. From this argument, CBI can be defended because it can limit the pressures coming from political authorities for the monetising of deficits (Telatar, 2002, p. 183-184; Parasız, 2003, p. 312; Eijffinger et al., 1996, p. 5). Yet, coordination problems that arise concerning monetary and fiscal policy can be put forward as an argument against CBI (Alesina, 1989, p. 83).

CHAPTER IV

THE CASE OF THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

In the second chapter, the historical context and special interests surrounding the rise and defence of CBI were evaluated. In the third chapter, academic efforts to theorise and analyse CBI were explored. The CBRT will now be examined in this fourth chapter. In light of the critical analysis previously developed, various aspects of the CBRT's independence will be assessed. *Materialisation* of some theoretical insights and the divergence of the empirical exercise from the academic literature will both be addressed. In this effort, the chapter is organised chronologically so as to encompass all the important events in the historical evolution of the CBRT. Starting from its foundation, the CBRT's history throughout the 20th century will be evaluated with reference to the underlying global and Turkish economic contexts. Divisions are made chiefly by paying attention to the convergence of certain economic trends. The inflation rates throughout these years can be followed in *Appendix E*. The CBRT in the 2000s will be scrutinised in a detailed manner, encompassing the reform process of 2001, the CBRT's actual independence after 2001 and the perceptions of the key actors.

4.1 Foundation of the CBRT

The *Ottoman Empire* had a peculiar central bank, established as the *Ottoman Bank* on 24 May 1856 and almost entirely owned by the British and the French. On 4 February 1863, the bank was awarded the privilege to issue notes and took the name of *Imperial Ottoman Bank*. The bank had the duties to be treasurer of the state, to collect the state revenues, and to handle the domestic and foreign debt. However, the Ottoman Empire could not enjoy the *seignorage revenue* that the bank extracted from its operations. In the First World War, the Empire's escalating need to borrow was not welcomed by a central bank that was owned by foreign capital (Kazgan & Öztürk & Koraltürk, 2000, p. 43-44; Tekeli & İlkin, 1997, p. 59).[33]

Support for the establishment of a national central bank in the early years of the Turkish Republic came mainly as a result of this inadequacy of existing monetary authority. Because of the discomfort arising from the Ottoman Bank, the Turkish Republic conditionally renewed the bank's privilege to issue notes in 1925 for another ten years. It was explicitly stated that government had the right to establish a central bank besides the Ottoman Bank and that the latter was prohibited from objecting or challenging (TCMB, 2001, p. 4). Additionally, it should be pointed that the government was longing to establish a central bank which is considered as a symbol of *sovereignty* and *economic independence*, the notions highlighted by the young Turkish Republic regarding the unfortunate situations experienced by the Ottoman Empire.

The Ottoman Bank did not step aside while the government was making attempts to seize the privilege of issuing notes. The bank tried to convince the government that such an attempt was mistaken due to the insufficient conditions of the economy. The government's insistence led the Ottoman Bank to offer help in the establishment of a central bank. Indeed, it is interesting to find an expert view from the Ottoman Bank that supported the existence of foreign capital in the bank's shares to ensure its *trustworthiness* (Tekeli & İlkin, 1997, p. 279). However, Prime Minister İsmet İnönü clearly stated his hesitation to rely on the Ottoman Bank and rejected the bank's efforts (p. 267).

Another attempt at the establishment of a central bank was made by the very first national bank of Turkey, Isbank. Head of the Board of the Central Bank of the Netherlands Dr. G. Vissering was invited to Turkey in March of 1928 to provide

[33] The bank's capital was divided into 135,000 shares. While 80,000 of them were owned by the British and 50,000 by the French, only 5,000 were given to the Ottomans (Tekeli & İlkin, 1997, p. 57).

his views. Vissering prepared a comprehensive report including an analysis of the Turkish economy, the status and structure of the envisioned central bank, economic obstacles to the establishment of a central bank, and finally, the issue of the transformation of a commercial bank into a central bank. He advised that the bank should be a private joint stock company and not dependent on the government (p. 261-263). It should be noted that Vissering's advice in this report is analysed and quoted widely in a speech made by CBRT governor Süreyya Serdengeçti, entitled *Central Bank Independence*. Serdengeçti argues that the consciousness of an independent central banking was existent even before the establishment of the CBRT (2005, 11-13). In regard to the transformation of a commercial bank into a central bank, Vissering presented a favourable view of the process by noting that the experience, personnel, and material needs already existing in such a bank could save significant effort and time when compared to the costs of the establishment of an entirely new bank. The Director General of Isbank, Celal Bayar, conveyed this report to Prime Minister İsmet İnönü by adding his own view that it would be easier for Isbank to assume the responsibilities of a central bank than for an entirely new central bank to be created. However, these suggestions were refused by İnönü, who regarded Isbank as a newly established and weak bank (p. 266).

The reasons behind the failed attempts of the Ottoman Bank and Isbank to convince the government are assessed by Bakır (2007) as the lack of a strong finance lobby and the existence of a strong public bureaucracy, particularly the treasury. Additionally, the attempts of the Ottoman Bank represented the continuation of the interests of international capital and lenders, which were in conflict with the desire of the young republic to acquire its economic independence. Finally, the nonexistence of aligned interests between the Ottoman Bank and Isbank resulted in a weak opposition to the government's decisions (p. 17-18).

The government made several attempts to utilise expert views on the issue of establishing a central bank. The president of the *Bundesbank*, Hjalmar Schacht, was invited to present his views. However, due to his heavy workload, he was not able to come and instead offered the help of a colleague, Karl Müller. In April of 1929, Müller came to Turkey and provided a report concluding that the economic conditions were insufficient for the establishment of a central bank. Accordingly, he advised several measures to increase savings of foreign currency and to limit the budget burdens be implemented prior to the establishment of a central bank in order to enhance the stability of money. This report did not satisfy the expectations of the government because it suggested that, if the above mentioned measures were taken, the establishment of the bank would only be possible after five years (TCMB, 2001, p. 4-5; Tekeli & İlkin, 1997, p. 270-273). Another expert, Count Volpi, a former minister of the Italian Treasury, came to Turkey in November 1929 to provide his views on the subject. Contrary to Müller's report, Volpi suggested that national money and a national bank should be established immediately (p. 274).

The government entrusted the preparation of the draft of the law to establish the central bank to the director of Ziraat Bank, Şükrü Ataman, and Minister of Education Cemal Hüsnü Taray. The draft was prepared by making use of other central banks' foundational laws, specifically the Chilean law (p. 284). The assessment of this proposal was conducted by a commission headed by the Minister of Treasury, Şükrü Saraçoğlu, and composed of bankers and members of the parliament. The excessive regulation of banking raised discontent on the side of the banking sector. Consequently, the draft was rejected by the commission (TCMB, 2001, p. 5). In order to further advance the draft, Leon Morf of the University of Lausanne was invited to participate. Morf suggested changes to 60 of 113 articles of the draft. He proposed a two-fold structure for money: While paper money would be controlled by the government, the responsibility of issuing banknotes backed by gold would be given to the emission bank. With Morf's suggestions included, the draft was presented to the Grand National Assembly of Turkey (*Türkiye Büyük Millet Meclisi*) on 28 May 1930. Coincidentally, at the last stage of its acceptance, the draft underwent yet another important change. A French economist, Charles Rist, was in Turkey at that time for an unrelated reason, but a conversation between him and Şükrü Saraçoğlu turned out to have an important influence on the draft. Rist warned Saraçoğlu about the possible complications of the proposed two-fold structure of money. Accordingly, a last minute change was made, giving the exclusive right to issue money to the central bank and lowering the intended capital from 25 million to 15 million liras. This law, numbered 1715, was passed by the GNAT on 11 June 1930, officially establishing the Central Bank of the Republic of Turkey (*Türkiye Cumhuriyet Merkez Bankası*). The bank began to function on 3 October 1931 (Tekeli & İlkin, 1997, p. 290-291; TCMB, 2001, p. 5-6).

The law that established the CBRT stated that the fundamental aim of the bank was to "support the *economic development* of the country" (Law 1715, 3rd Article, emphasis mine). To this end, the bank was given the following functions: setting rediscount ratios, organising money markets and money circulation, executing treasury operations, and, finally, taking measures to protect the value of Turkish currency, in partnership with the government (Law 1715, 3rd Article). At this point, it should be emphasised that the original purpose of the bank was to enhance economic development, while protecting the value of currency was merely one among the four duties given to the bank. Consistent with the world trends in central banking that was mentioned before; the CBRT was shaped to enhance domestic stability with its establishment law.

The CBRT was established as a joint stock company with four types of stocks. A-class stocks were owned by government institutions and this total share could not surpass 15 percent of the bank's capital. B-class stocks were sold to national banks operating in Turkey, C-class stocks were given to the non-national banks and to the privileged companies, and D-class stocks were sold to Turkish business companies and Turkish corporate and private individuals (Law 1715, Articles 25-29). The structure of the joint stock company and the limitations on the government's shares in the bank's capital are usually interpreted as signs of the emphasis given to the notion of independence in the establishment of the CBRT (Bakır, 2007, p. 20; Serdengeçti, 2005, p. 13).

4.2 The CBRT in the 1930s, 1940s, and 1950s

The establishment of the CBRT coincided with the Great Depression, a devastating crisis in the capitalist market economy which brought the definite end of the *laissez-faire* era. The triumph of protectionism and recognition of the state's critical role in the economy characterised the 1930s. Similarly, the general stance of the Turkish economy up until the time of the Second World War is considered as *statist* (Kepenek & Yentürk, 2005, p. 62) or *protectionist–statist industrialisation* (Boratav, 2007, p. 13). The macroeconomic principles of balanced budgets and sound money are noticeable in this era (Türel, 2001, p. 72). The young republic's avoidance of indebtedness and the heavy emphasis given to monetary stability can be traced back to past experiences. The Turkish Republic tried to avoid the Ottoman legacy of huge debts and economic dependence on international financial capital (Bakır, 2007, p. 41).

With the help of consistent surpluses in the budget, the CBRT's pursuit of contractionary monetary policies avoided inflation. Throughout the 1930s, the general level of prices steadily declined due to the deflation in agricultural prices and the increased state involvement and determination of prices (Doğruel & Doğruel, 2005, p. 104). With the onset of the Second World War, increasing military spending, diminishing chances of international trade, and contracting production resulted in significant supply deficiencies and inflation. More dramatic was the existence of severe scarcity, stockpiling, and profiteering, even in basic consumption goods (p. 113).

The end of the Second World War marked the beginning of the *Embedded Liberalism Compromise* throughout the world, which can be summarised as "a form of multilateralism that is compatible with the requirements of domestic stability" (Ruggie, 1982, p. 399). Similarly, the closed, protectionist Turkish economy moved in an open and integrated direction in which foreign capital and aid was welcomed (Kepenek & Yentürk, 2005, p. 91). This trend of liberalisation was accompanied by the first *devaluation* of the currency in 1946.[34] The devaluation was designed to adapt the economy to the post-war world and to limit the possible increase in newly liberalised imports. Interestingly, the devaluation was made at a time when the country did not lack foreign currency, because of Turkey's attendance to the policies of the IMF, in which devaluations exceeding 10 percent were made under the monitoring of the latter (p. 121).

Unlike the earlier developments influenced by international conjuncture (the Great Depression of 1929 and deflation, the Second World War and inflation), this time inflation in Turkey was mostly the result of domestic economic policies. While inflation was mild up to 1954, it increased significantly from then onwards (Doğruel & Doğruel, 2005, p. 159). Keynesian expansionary policies marked this era as the CBRT gave generous credits to the private sector and specifically to agriculture in the public sector. Turkey implemented its second devaluation in 1958.[35] Measures that were taken included devaluation and an IMF-style stability package designed to overcome high inflation and problems of balance of payments. But before the outcomes could arrive, the *coup d'etat* of 27 May 1960 marked the beginning of a new, state-involved era (Parasız, 2003, p. 398-400; Kepenek & Yentürk, 2005, p. 125-126).

4.3 The CBRT in the 1960s and 1970s

The 1961 constitution brought *planning* to the agenda. The aim was to surpass a mounting balance of payment deficits, growing inflation, and increased dependency to the world with planned development. In-country manufacturing of formerly imported goods was encouraged so as to overcome the chronic need for foreign currency and the dependency on the world (Kazgan et al., 2000. p. 155).

[34] With the devaluation of 7 September 1946, the exchange rate between the Turkish lira and the US dollar rose from 1.28 to 2.80 (Boratav, 2003, p. 98).

[35] On 4 August 1958, Turkey made a *de facto* devaluation in the currency by changing the exchange rate between the Turkish lira and the US dollar from 2.80 to 9.02, yet this devaluation did not became official until 22 August 1960. The reason for this reluctance to declare the devaluation is argued to have come from the stress on the stability of the Turkish lira in the early years of the republic (Doğruel & Doğruel, 2005, p. 159; Parasız, 2003, p. 399-400).

This statist-interventionist and closed model was implemented throughout the 1960s and 1970s (Boratav, 2007, p. 209).

In line with the new constitution and the state's extensive role in the economy, the law governing the CBRT was changed. Accepted on 14 January 1970 with the number of 1211, this new law can be considered as a reflection of the planned economic understanding, albeit with some *delay* (Türel, 2001, p. 73). In the reasoning of the law, it is clearly stated that the law aimed to restructure the function of the CBRT according to the planned development, in order to support the credit policies of the government (Reason of Law 1211, p. 171). Additionally, it is mentioned by the bank that the law was prepared in consideration of international central banking experience (Kazgan et al., 2000, p. 187). In this law, the CBRT's functions are listed as follows:

> a) *Implementing the money and credit policy within the framework of development plans and yearly programmes*,
> b) Taking measures to protect internal and external value of the currency together with the government,
> c) Regulating size and circulation of national money according to this law,
> d) *Assuming lending missions to the banks* within the limits drawn by this law (Law 1211, 4th Article, emphases mine).

With this law, the CBRT was subordinated development plans regarding monetary and credit policies. Quite contrary to what the literature on CBI promotes, the CBRT was envisaged as an *instrument* employed by the development plans, as an integral and inseparable part of the political project of development. Accordingly, the CBRT conducted expansionist monetary and credit policy so as to finance the economic development of the country (Kazgan et al., 2000, p. 168-173). To be sure, the total amount of CBRT credits increased by 38 percent in the 1st Development Plan period (1963-67), by 92 percent in the 2nd Development Plan period (1968-1972), and by 528.9 percent in the 3rd Development Plan period (1973-1977). These credits can be grouped into three categories. First, they were given to the treasury to finance short-term deficits of the budget. Second, they were given to tobacco purchases. Third, they financed the state-owned economic enterprises (Kepenek & Yentürk, 2005, p. 158-160).

Inflation rates were relatively mild throughout the 1960s since the plans foresaw an increase in the money supply proportionate to the increase in national product. Nevertheless, the Turkish government ordered a third devaluation in 1970.[36] Inflation throughout the 1970s was more acute, because of both domestic and international incidents. The rapid expansion of CBRT credits is regarded as a significant cause of this inflation (Doğruel & Doğruel, 2005, p. 177). As the import substitution proceeded through its hard phases, contrary to the original aim, the economy became more dependent on international markets and foreign currency. Collapse of the Bretton Woods exchange rate arrangement and the devastating increase in oil prices resulted in instability and stagflation around the world. Turkey suffered severely from balance of payments crises and growing inflation, and consequently made three further devaluations in 1977, 1978, and 1979 (Parasız, 2003, p. 403).[37]

The dismissal of the CBRT's governor in 1978 was an interesting incident that will be helpful in demonstrating the variation of actual and legal independence of central banks together with the coordination problems between the central bank, the government and the treasury. Cafer Tayyar Sadıklar was appointed governor on 26 July 1976, at a time when a centre-right coalition government led by Süleyman Demirel of the Justice Party (*Adalet Partisi*) was in power. In January of 1978, a centre-left leader, Bülent Ecevit of the Republican People's Party (*Cumhuriyet Halk Partisi*), became prime minister. Sadıklar was not working harmoniously with the Minister of the Treasury, Ziya Müezzinoğlu. Sadıklar was accused of making alterations to the balance sheet of the CBRT, being responsible for unpaid checks, favouring people close to the Justice Party in the allocation of foreign currency in the controlled exchange regime, and supporting economic ideas close to those of the Justice Party (TCMB, 1978, p. 110; Bakır, 2007, p. 132). He was asked to resign by Bülent Ecevit. However, Sadıklar resisted and the CBRT released a book

[36] On 10 August 1970, the exchange rate between the Turkish lira and the US dollar rose from 9.02 to 15 (Parasız, 2003, p. 401).

[37] The exchange rate between the Turkish lira and the US dollar rose from 15 to 19.25 on 22 September 1977, to 25 on 1 March 1978, and finally to 47.10 on 12 June 1979 (Parasız, 2003, p. 403).

in August of 1978 including his speeches and various newspaper columns written about the issue, entitled *Independence, Impartiality of Central Bank of the Republic of Turkey and the Press*. Sadıklar claimed that: "Governments want a dependent central bank, working as a branch of the treasury" (TCMB, 1978, p. 59, translation mine). Additionally, he argued, "the lack of coordination and polemics should not be beared by this country anymore. The government should show the necessary sensitivity to this issue" (p. 139, translation mine).

The government decided to overcome the coordination problem by dismissing Sadıklar, and to this end made a series of attempts to remove him from office. According to the 25th Article of Law 1211, appointment of the bank governor was made for five years with the proposal of the bank board and by decision of the Council of Ministers. The governor was protected by the 28th Article, which states that dismissal of the governor can only be made if he is permanently unable to conduct his duties. Sadıklar was initially offered another assignment. Then a hostile report was prepared to change him by the decision of the bank board. The bank board rejected the report and was therefore renewed, and on 18 September 1978, Sadıklar was dismissed. After the dismissal, he wrote a book entitled *Central Bank Incident* in 1979, arguing that moral and legal codes were violated by his dismissal. Additionally, he tried to support his case by quoting the international press, including *The Economist*: "This incident raised discomfort in the *international banking circles* in which Sadıklar has a significant reputation" (1979, p. 54, emphasis and translation mine).

In assessing this incident, it should be pointed out that although the CBRT was officially dependent on the government, the governor's long term of office had provided him with a relatively independent status. Despite the fact that Sadıklar regards himself as an *impartial technician*, a collection of his speeches about the 'right' economic policies demonstrates the fact that he is conservative. Sadıklar regards state-owned economic enterprises as the biggest weakness of the Turkish economy. Furthermore, he is decisive in the fight against inflation and in this quest, for Sadıklar, collective agreement should not be untouchable (Sadıklar, 1979, p.

55-57). This conservativeness of the governor was not appreciated by the center-left government and consequently, in order to solve the problem of coordination, Ecevit unkindly dismissed the governor. This case illustrates serious problems that arise from even the relative independence of the CBRT's governor. Firstly, it is clear that inflation adverse policies are not favourable to all, especially to the left oriented governments. In spite of the presentation of their stance as *technicians*, it is clear from this incident that central bankers take essentially *political* decisions. The locking of particular inflation adverse policies in central banks caused severe coordination problems between monetary and fiscal policy. Aligning with the monetary policy by preferring contractionary fiscal policies may be a solution. But it is inherently undemocratic to force an elected government to pursue a particular political choice that has distributional consequences. In this incident, Ecevit government rejected to align the fiscal policy and preferred to hamper independence of the governor and succeeded at the expense of a considerable dispute and tension. In a nutshell, it can be argued that the pursuit of inflation adverse policies, when they are in conflict with the government's choices, undermines the right of democratically elected governments' to administer the economy.

4.4 The CBRT in the 1980s and 1990s

The Turkish economy was in crisis in the late 1970s. Its problems included depressed exports, high inflation, and severe troubles in the financing of oil and import inputs. Some commentators even argue that, without the postponement of debts and finding of new credit, the Turkish economy would possibly have become unmanageable (Kazgan, 2005, p. 198). The weakened condition of the Turkish economy gave international institutions a considerable degree of bargaining power and influence. A programme of structural adjustment and stability was jointly provided by the IMF and the WB and declared on 24 January 1980 with the label of *24 January Decisions*.[38] The implementation of these decisions, all of which

[38] Kemal Derviş, an influential figure who had orchestrated the CBRT's independence reform in 2001, also made remarkable contributions to the preparation of the 24 January Decisions. Together

systematically favoured capital vis-à-vis labour, was accomplished with *military discipline*, after the *coup d'etat* of 12 September 1980 (Boratav, 2007, p. 148-149). To be sure, the Neoliberal transformation implemented by Turgut Özal was not merely limited to the exercise of a set of 'right policies'. Additionally, this can be considered as a *passive revolution* that secured, in an authoritarian way, the reestablishment of the hegemony of the bourgeoisie (Yalman, 2004, p. 69).

This liberalisation programme can be considered as an instance *par excellence* of the Neoliberalism that rose throughout the world from the late 1970s onwards.[39] Indeed, in a perfect coincidence, the restructuring of the Turkish economy and its integration to international markets with the guidance of free market ideology was initiated. Integration with the world economy became an end in itself (Yalman, 2004, p. 67). Consistent with the international trend towards the rejection of what is termed as Keynesian Welfare National State's aims like full employment and the Neoliberal promotion of low inflation, Turkish state abandoned it's albeit underdeveloped welfarist aims. The measures taken in the 24 January Decisions reform package were parallel to the Neoliberal policies that were later labelled as Washington Consensus: reducing state involvement in the economy, including the privatisation of state-owned economic enterprises; emphasising fiscal discipline; repressing the increase of wages; abolishing price controls and subsidies for various goods; repealing the state's control in determination of banks' interest rates; promoting exports by cheap credit and tax reductions; and, finally, simplifying bureaucratic procedures to attract foreign capital (Kepenek & Yentürk, 2005, p. 199-207).

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with some colleagues, Derviş prepared the rationale, background, and model of the structural adjustment programme that was accepted by Turkey (Ekzen, 2001, p. 119-120).

[39] However, liberalisation programmes are not unfamiliar to Turkey. Albeit with some differences, commentators point out that the liberalisation after 1980 had similarities to the liberalisation of 1950-1954 (Kazgan, 2005, p. 195) and 1923-1929 (Boratav, 2003, p. 149).

With respect to monetary policy, a significant devaluation was a part of these decisions.[40] More importantly, the fight against inflation became a top priority in the economic policy agenda. In order to slow inflation, which was believed to be the result of excessive monetary expansion, contractionary monetary policy was conducted with high interest rates and with the reduction of domestic demand. Overall, the CBRT conducted monetary policy on the premises of *Monetarism*. While in the first two years after the 24 January Decisions there was a rapid decrease in inflation, inflation increased again soon enough and followed a wavy route from then onwards (Kazgan, 2005, p. 197; Parasız, 2003, p. 405; Doğruel & Doğruel, 2005, p. 189).

A decision declared on 7 August 1989, which enabled the free movement of capital and made the Turkish lira convertible, was a significant step in the liberalisation of the Turkish economy. Consistent with the aim of attracting foreign capital, this free entry decision completed the liberalisation process that had begun earlier in the decade. Furthermore, Turkish citizens became able to make transactions with foreign currency by the abolition of former prohibitions (Kepenek & Yentürk, 2005, p. 213). However, the timing of this decision is very much contested. It is argued that liberalising foreign exchange transactions in a country that lacks fiscal discipline causes the *institutionalising of inflation* (Doğruel & Doğruel, 2005, p. 199). Another significant consequence of this decision is the confrontation with the choice of the *impossible trinity*. As explained earlier, a central bank faces a decision to control either the foreign exchange rate or the interest rate under the conditions of unrestricted capital mobility, but cannot do both simultaneously. The CBRT aimed to control nominal exchange rates in the 1990s and therefore mostly pacified monetary policy (Boratav, 2007, p. 180-181). Additionally, after 1989, the CBRT did not *sterilise* the money resulting from the inflows of foreign exchange. Instead, this money was utilised as a source for public expenditures, by way of short-term domestic borrowing (Kazgan, 2005, p. 141).

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[40] The exchange rate between the Turkish lira and the US dollar was raised from 47.1 to 71.40 on 24 January 1980. After 1 July 1981, the exchange rate began to be adjusted on a daily basis (Kepenek & Yentürk, 2005, p. 204).

The consequences of these speculative capital movements, which are usually given the label of *hot money*, should be scrutinised further. The entrance of hot money introduces important changes in the economy. First and foremost, it appreciates the domestic currency and undermines the competitiveness of the country. The abundance of foreign currency also encourages giving a balance of payments deficits, which become easily financed. Additionally, there is an incentive to make transactions with the more reliable foreign *hard currency*, a trend called *dollarisation*. Furthermore, the entrance of hot money increases consumption and diminishes savings, resulting in initial increases of national income (Yentürk, 2005, p. 131-134; Yeldan, 2002, p. 14).

However, when the foreign capital becomes distressed by uncertainties, rising balance of payments deficits, the political risks, and starts to outflow; the result is devastating shocks in foreign exchange markets and banks and a huge economic crisis. Commentators argue that in an economic system that is *bound to the flows of hot money*, regarding the political tensions as the *reason* of the crises is highly misleading. In the 1994 Turkish crisis, a main cause was Prime Minister Tansu Çiller's aim to artificially lower the interest rates in a domestic borrowing procedure. However, other factors could also be reasons for the crisis (Boratav, 2007, p. 183).[41]

In the 1994 crisis, there was a huge outflow of capital, which resulted in a 4 billion dollar decrease in the CBRT's international reserves. A significant devaluation was implemented together with IMF-style stabilisation policies, an important one being nominal exchange rate targeting.[42] With regard to the independence of the CBRT, an important step was taken on 21 April 1994 with the limitation of credits given to

[41] By the same token, the 2001 crisis can not be regarded as the *result* of the tension between President Ahmet Necdet Sezer and Prime Minister Bülent Ecevit (Boratav, 2007, p. 183). Similarly, Yeldan argues that in the 2000 disinflation programme, "the underlying cause of the meltdown was ultimately the external fragility generated by unregulated in- and out-flows of financial capital which were excessively mobile, excessively volatile, and subject to herd psychology" (Yeldan, 2002, p. 11).

[42] The exchange rate between the Turkish lira and the US dollar was 19,000 TL/$1 in January. With the devaluation, the rate increased to 38,000 TL/$1 (Yentürk, 2005, p. 144).

the Treasury. The advances, once declared as 15 percent of the aggregate general budget funds, were decreased to 12 percent for 1995, 10 percent for 1996, 6 percent for 1997, and 3 percent for 1998 and the following years (Parasız, 2003, p. 410-411). However, the limitation of credits to the government does not seem to have been influential in inflation. Inflation rates floated around 65 to 70 percent in the first half of the 1990s and around 80 and 90 percent in the latter part of the decade. Nominal interest rates were over 100 percent throughout the decade and an effort was made to overcome inflation by contractionary monetary policy by exchange rate anchors (Yeldan, 2002, p. 1).

During the 1990s, there were devastating economic crises throughout the world, beginning in Asia and originating with the troubles of unregulated capital movements. As mentioned before, it was from these crises and rising poverty throughout the world that the IMF's well-known *WC* recipes began to be criticised and elements of a *PWC* began to be developed. In addition to 'right policies' of the WC, the PWC included the institutional setting through which liberalisation reforms could succeed. Specifically promoted by the WB, *good governance* notions such as transparency started to become crucial in this era. The CBRT was very much up to date in observing these developments. After the Asian Crisis, the Governor of the CBRT, Gazi Erçel, made a speech in 1998 entitled *Lessons From the East Asian Crisis for Turkish Policy Makers*. An essential lesson was the importance of the *transparency* of the banking system and central banks (Erçel, 1999, p. 355). It is clear that the CBRT was paying attention to the good governance notions which emphasised the institutional aspect of reforms.[43]

[43] In his Opening Speech in the 72nd Ordinary General Meeting of Shareholders, Süreyya Serdengeçti spared the whole concluding part to the organisations and institutions. There, by using the NIE style of analysis, Serdengeçti points out the importance of the organisational structure of the market economy, respect of law and property rights, elimination of uncertainty by institutions, and the World Bank's criteria regarding these institutions (2004, p. 42-43).

4.5 Independence Reform and the CBRT in the 2000s

4.5.1 Independence Reform in 2001

The Turkish economy, facing persistent crises and a severe earthquake in 1999, entered 2000 with another IMF-based disinflation programme. There were three main elements in the disinflation programme of 2000. First, public expenditures were limited and new targets of non-interest fiscal surplus rates were put forward. Second, the rates of devaluation were announced beforehand in line with the goals of inflation. Third, the CBRT implemented a monetary rule which automatised the generation of liquidity to net foreign assets. This last point can be made clear as follows: "Accordingly the CB[RT] committed itself to a policy of *no sterilization*, whereby changes in the monetary base would directly reflect changes in the net foreign assets of its balance sheet" (Yeldan, 2002, p. 2, emphasis original).

The problem with this kind of programme is its excessive reliance on foreign capital inflows in order to control the devaluation of currency. A nominal anchor is merely an instrument to repress inflation temporarily. Experience shows that after a period of increased consumption, investment, and national product, together with the appreciation of domestic currency, the speculative exit ends the programme with a significant devaluation (Yentürk, 2005, p. 84; Kepenek & Yentürk, 2005, p. 223-224). Additionally, the CBRT had been limited in regard to its stabilisation tools, especially by its promise to limit domestic liquidity according to foreign reserves and merely worked as an *accounting officer* (Yeldan, 2002, p. 14).

In November 2000, domestic banks began efforts to close the foreign currency deficits of their budgets. The CBRT's net foreign reserves decreased by 5.5 billion dollars in two months. The exchange rate did not increase due to the IMF's help in foreign exchange reserves. Still, there was a huge problem in the liquidity of the Turkish lira. Even though the CBRT initially provided liquidity by violating the limits set by the IMF, it stopped funding on 30 November. Due to the mounting interest rates in the overnight market, up to 873 percent, several banks could not pay their debts, which were passed on to the Savings Deposit Insurance Fund (Kazgan, 2005, p. 240-241). The CBRT was severely criticised for not functioning as the *lender of last resort* in the face of such liquidity problems and was held responsible for the paralysis of the payment system (Eğilmez & Kumcu, 2007, p. 184).

The crisis of February 2001 was the most catastrophic and deep economic crisis that Turkey has had to cope with. Triggered by a political dispute, there was a sudden rush to buy foreign currency. The exit of 4 billion dollars of foreign currency can be traced in the balance of payments records in February of 2001 alone. Due to the anxiety of the dissolving of all the foreign exchange reserves, in the night of 21 February nominal exchange rate targeting was abandoned and the Turkish lira started to float freely.[44] Interest rates in the overnight market rose to momentous levels like 4019 percent. The economy contracted by 4.5 and 11.8 percent in the first and second quarters, respectively. In the first five months of 2001, 15,000 firms were closed. The unemployment rate rose from 6.6 percent in 2000 to 8.4 in 2001 and 10.3 in 2002. Overall, the legacy of the crisis includes dependency on the IMF and the WB programmes, heavy indebtedness, worsening distribution of income, and rising unemployment and poverty (Kazgan, 2005, p. 244-255).

In the midst of these uneasy economic circumstances, an IMF letter of intent, dated 18 December 2000, included an important new commitment regarding the independence of the CBRT. It clearly stated that a new CBRT law would be passed by the end of April 2001 as a *precondition* of an 8th revision. The characteristics of this law were presented as follows: The law would make *price stability* the main goal of monetary policy. The bank would be given *instrument independence* to reach this goal together with improvements in *accountability* and *transparency*. Additionally, it was stated that this reform would enhance accordance with the central banking criteria of the *Maastricht Treaty*. Finally, the IMF was informed

[44] The exchange rate betwen the Turkish lira and the US dollar was 678,700 in January, 905,500 in February, and 1,100,000 in March 2001 (Kazgan, 2005, p. 245).

about the preparations to begin an *inflation targeting* regime (IMF Letter of Intent, 2001, December 18). This letter of intent, signed by CBRT Governor Gazi Erçel and Minister of Economy Recep Önal, flawlessly presents the key notions of the central bank reform which were actually being implemented. However, the figures that realised this reform were different, because the 2000 programme had collapsed with the crisis of February 2001 and a new one was established by Kemal Derviş, who was given Recep Önal's position as Minister of Economy on 2 March. Furthermore, with the resignation of Gazi Erçel on 25 February, Süreyya Serdengeçti was appointed CBRT governor on 14 March. Interestingly enough, the timing of the reform was consistent with what had been promised before.

Invited to the country by the request of Prime Minister Bülent Ecevit, Kemal Derviş resigned from the *Vice Presidency of the WB* and took lead of the Turkish economy with a wide range of responsibilities and an influential bargaining power. He brought 15.7 billion dollars of extra funding from the IMF and the WB and initiated a new economic program entitled *Strengthening the Turkish Economy: Turkey's Transition Program* (Parasız, 2003, p. 417). Derviş played a key role in the continuation of structural reforms in general and the CBRT's independence reform in particular. Bakır (2007, p. 88) regards Derviş' *political entrepreneurship* and *mediation* as significant aspects of this latter reform. The general stance of the programme is that of *PWC*:

> "Our targets include;
>
> - ensuring *transparency and accountability* in resource allocation in the public sector,
> - *preventing irrational interventions in the running of the economy*, and
> - strengthening *good governance* and the fight against corruption" (*Strengthening the Turkish Economy*, 2001, p. 13, emphases mine)

It is clear that good governance notions such as transparency and accountability are emphasised in the program. What is more, the program's aim of *depoliticisation* is obvious from the conceptualisation of interventions in the economy as 'irrational'. It is argued that the economy could work on rational grounds if political interventions were isolated. This program shares the argument of Public Choice, which points out that rent-seeking and corruption prevail within the state. The remedy is seen as the separation of the economic and the political by means of independent institutions and laws, sometimes at the constitutional level. Furthermore, by emphasising the institutional aspect of the state by utilising *NIE*, transparent and accountable public authorities are considered to be a solution for corruption. In addition, it should be noted that this program includes, albeit residually, “measures to strengthen social solidarity”, an aspect which is also typical in PWC (Strenghtening the Turkish Economy, 2001, p. 24-25).

The programme, in which there were 15 legal amendments, including the law that granted independence to the CBRT, was implemented in a noticeable rush.[45] The slogan ‘*15 laws in 15 days’* was used, meaning that these reforms would be passed in the GNAT in 15 days. According to Derviş, this was a “psychological motivation slogan”, designed to communicate resoluteness (Derviş et al., 2006, p. 73-74). Yet this resoluteness obviously can be regarded as a pressure, even an imposition, on the democratic processes of Turkey. Indeed, the parliament’s right to discuss and to reject these laws was undermined. International creditors’ demands had replaced the national will (Kazgan, 2005, p. 247-248). Derviş regards the reform of the central bank not as IMF conditionality, but rather as the result of the advice of Turkish experts and reformers (Derviş et al., 2006, p. 153). While it is true that the CBRT was ready for the reform, its implementation was obviously IMF *conditionality* (Chang & Grabel, 2005, p. 232). After the implementation of the independence reform, a letter dated 3 March 2001 informed the IMF that the law had passed (03.05.2001, IMF Letter of Intent, Paragraph 42).

Not only was the implementation of the reform package criticised, but the reforms themselves also raised displeasure. Ironically, Prime Minister Bülent Ecevit, who had invited Derviş to Turkey himself, expressed his discontent on 27 March 2002

[45] To quote the words of the program, these 15 law aimed at “restructuring the economy and achieving lasting stability” (*Strenghtening the Turkish Economy*, 2001, p. 13). These Neoliberal measures included the Sugar Law and Tobaco Law, which handed over authority to regulatory bodies. While the Natural Gas Law sought to liberalise that market, the Telecom Law implied the acceleration of privatisation. The Civil Aviation Law brought the free determination of prices in that sector. Furthermore, there were pretentious objectives in laws like the Public Borrowing Law, which “aims to bring *transparency* and *accountability* to the state” (p. 21, emphases mine).

about reforms of the independent boards, one of which was the CBRT. Ecevit pointed out that these boards assumed the responsibilities of governments in very vital issues. Furthermore, Ecevit ironically proposed that if these boards were to rule the country, and the government would have no authority, there would be no need for elections (Çulha-Zabcı, 2002, p. 159). Clearly, a certain degree of depoliticisation was achieved by delivering key economic decisions to independent boards with the *Strenghtening the Turkish Economy* programme. Consequently, these constraints on political action led to belated objections from politicians.

The CBRT's formulation of a new law required three stages of preparation and more than four years' time. Seeking a strategy and preparing a preliminary draft constituted the first step. Then comments about the draft were taken from the ECB, various European central banks, and the IMF. Finally, the practical implementations of central banks throughout the world were incorporated into the draft (Türel, 2001, p. 74). It should be noted that in the reasoning section of the law, convergence to the EU norms constituted a significant rationale. Additionally, the changing economic circumstances and the developments in central banking throughout the world were taken into consideration (Reason of Law 4651, p. 1). The final version of the law's draft came to the Planning and Budget Commission of the GNAT on 16 April 2001. In the commission, several changes were made to the law, resulting in the softening of some expressions of extreme independence. For instance, the second part of this clause was deleted: "The bank will conduct its duties and authority given to itself by the law independently, and without instructions from any office or agency" (Türel, 2001, p. 78). After these modifications, the CBRT Law, numbered 4651, was conveyed to the GNAT and accepted on 25 April 2001. The CBRT law that was finally accepted consists of almost the same characteristics envisaged in the IMF Letter of Intent, dated 18 December 2000.

In the 4th article of the law, the CBRT's duties and powers were redefined:

> *The primary objective of the Bank shall be to achieve and maintain price stability.* The Bank shall determine on its own discretion the monetary policy that it shall implement and the monetary policy instruments that it is going to use in order to achieve and maintain price stability.
> *The Bank shall, provided that it shall not be in confliction with the objective of achieving and maintaining price stability, support the growth and employment* policies of the Government.
> *The Bank shall determine the inflation target together with the Government* and shall in compliance with the said target adopt the monetary policy. The Bank shall be the ultimate body authorized and responsible to implement the monetary policy. The Bank shall enjoy absolute autonomy in exercising the powers and carrying out the duties granted by this Law under its own responsibility (emphases mine).

This article focuses on the key aspects of the *independence* granted to the CBRT. First, the foremost aim of the bank is achieving and maintaining *price stability*. Only if it is not in conflict with this aim can the bank assist with the growth and employment policies of the government. Regarding the CBI literature, the explicit statement of price stability as the main goal is crucial for independence. Additionally, the declaration that price stability should have primacy over growth and unemployment in possible conflicts is also significant. The determination of inflation targets, together with government and the implementation of monetary policy in an absolute autonomy, means that the CBRT has gained *instrument independence*. The bank does not have the right to determine the goals of monetary policy by itself, yet it enjoys independence in using monetary policy instruments freely to reach the goals.

Another article designed to provide independence to the bank officials is Article 29. Regarding appointments, office terms, and dismissal of the bank's Vice Governors, the same conditions are provided as those for the Governor. Thus, Vice Governors are appointed for five years by a decree of the Council of Ministers. They can only be removed if they are not able to perform their duties or if they perform any other duties outside the bank, like trading, with the exception of charitable activities.

With respect to the bank's independence, the cancellation of the 50th Article, which regulated short-term advances to the Treasury, and the following article, which determined the rules of credit to public institutions, are also significant developments. The foremost aim given to the CBRT in the 1970 law, "implementing the money and *credit policy* within the framework of development plans and yearly programmes" (Law 1211, 4th article, emphasis mine), is now completely eliminated. Not only can the bank not give credits to the Treasury or public institutions, but it also cannot buy the papers issued by these institutions for borrowing in the first-hand market. It is interesting that one of the original key functions of the bank provided by the former law is wholly prohibited by this new law.

The Monetary Policy Committee was established under Article 22/A. Members of this committee include the Governor, Vice Governors, a member elected from the bank board, and a member appointed by the recommendation of the Governor with a joint decree. The Undersecretary of the Treasury or the Deputy Undersecretary can participate in the meetings without the right to vote. This committee is responsible for determining the principles of monetary policy and the inflation target, informing the public regularly with reports analysing the monetary policy targets and implementations, and taking measures to protect the value of the currency.

When considering the theoretical literature of CBI, there are important implications in the CBRT's independence under the new law. A brief exercise can be made in regards to the study of Grilli, Masciandaro, and Tabellini (1991). Political independence of central banks is composed of 8 variables (to review, please see section 3.3 and *Appendix B*). The points that improve the CBRT's level of independence are statutory requirements that the central bank pursue monetary stability amongst its goals and legal provisions that strengthen the central bank's position in conflicts with the government. As such, the CBRT is independent in 2 of the 8 total categories. In a list of 18 developed countries, 10 countries' central banks are more independent than the CBRT. However, regarding the second criterion, which requires the governor to be appointed for more than five years, the CBRT stands just on the boundary of the limit. If this criterion were put forward as "five years *or more*," the CBRT would be regarded as more independent. Additionally, for the sixth criterion, requiring no government approval of monetary policy, the 4th Article of Law 4651 is similarly just at the limit and is open to interpretation. On one hand, it envisages joint determination of the inflation rate, but it also gives absolute independence to the CBRT in its conduction of policy.

The arbitrariness and subjectivity of the indices that have been developed to measure CBI and to compare countries becomes apparent with this simple demonstration. Despite the availability of more sophisticated and comprehensive indices, this does not change the fact that the issue is necessarily imprecise. Notwithstanding these problems, there have been very few attempts to analyse the independence of the CBRT with these indices. The index of Cukierman, Webb, and Neyaptı (1992) is utilised (to review, please see section 3.3 and *Appendix D*) by Eroğlu and Abdullayev (2005) and the CBRT's legal independence is measured at 86 percent. In another study by Bakır (2007), the legal independence of the CBRT is measured at 0.62 points. Compared to 9 other central banks in terms of independence, the CBRT enjoys the 4th position, after the European Union (ECB), Sweden, Switzerland, and New Zealand, ranking ahead of the central banks of the United States, Canada, Australia, England, and Japan (p. 219).[46]

With Law 4651, significant changes were made regarding the *accountability* of the CBRT. In the 42nd Article, it is stated that:

> The Prime Minister may have the operations and accounts of the Bank audited. The Governor shall submit a report to the Council of Ministers on the operations of the Bank and the monetary policy followed and to be followed, each year in April and October. The Bank shall furnish information regarding its operations to the

[46] There are different stances in the assessment of the CBRT's independence among Turkish scholars. Aktan & Dileyici (2001) regard the reform as a *positive* attempt, albeit incomplete, to provide monetary discipline. Taking a *Constitutional Political Economy* approach, they propose to secure an optimal monetary rule in the constitution in order to enhance predictability (p. 33-34). On the other side of the scale, scholars likeYeldan (2005) point out that independence is an essentially undemocratic notion which seeks to manage national economies according to the interests of *international financial capital* by independent agencies. Yet Yeldan further points out that his criticisms should not imply the abolition of independence or implementation of inflationary policies. His criticism is towards the CBRT's indifference to goals other than price stability (2005, p. 3).

> Planning and Budget Commission of the Grand National Assembly of Turkey twice a year.

The conduct of monetary policy and accounts of the bank are open to periodic assessment by the Council of Ministers and the GNAT. Thus, the CBRT is held accountable to the executive and the legislative branches. Additionally, it is stated that the Prime Minister can ask for any kind of information and that the bank may have its accounts checked by independent auditing institutions. The CBRT's attention to the notion of accountability can also be found in Governor Süreyya Serdengeçti's speech, entitled *Central Bank Independence*. There, Serdengeçti remarks that: "Central bank independence brings an obligation to that institution to explain itself to public…This notion is the *other side of the coin* and is called accountability" (2005, p. 7, emphasis mine). A central bank's accountability to the public implies that the latter is well-informed about the targets of monetary policy and thus can evaluate the success or failure of the bank. Accountability as such is much more a problem of reaching inflation targets rather than of choosing different policies democratically. To be sure, the CBRT's accountability is only about the bank's accomplishment of a pre-determined inflation target.[47]

Transparency is a closely related notion, crucial for the implementation of accountability. In order for the public to assess the targets for which the central bank will be held accountable, various channels of communication are utilised. In the 42nd Article of Law 4651, it is stated that:

> The Bank shall prepare periodical reports concerning monetary policy targets and implementations and disclose this information to public…The Bank shall submit information to the Government in writing and inform the public, disclosing the reasons of incapability to achieve the determined targets in due time published or the occurrence of the possibility of not achieving and the measures to be taken thereof.

Thus, the CBRT is required to provide information concerning its targets and to make explanations if the exercise actually deviated or could possibly deviate from the target. Accordingly, the bank started to share its views with regard to the

[47] Bakır's comparison of the accountability of central banks concludes that the CBRT takes 4th place among the banks of 8 developed countries and the European Union (2007, p. 160).

economic circumstances in general and monetary policies in particular by various channels, such as press releases, announcements, reports, press meetings, presentations, and speeches (Yılmaz, 2007, p. 9). This emphasis on transparency is beneficial to the bank since it reduces uncertainty about the future course of policies and helps manage expectations accordingly. The more agents form their expectations in harmony with the central bank, the easier it is for the bank to achieve its predetermined targets (Serdengeçti, 2005, p. 8).[48]

4.5.2 The CBRT after 2001

The CBRT continued to incorporate contemporary notions of central banking even after its 2001 independence reform. An important effort of the CBRT in clarifying its targets is the implementation of *inflation targeting*. Between 2002 and 2005, the CBRT practised *implicit* inflation targeting. This can be regarded as a preliminary strategy to gain experience and foster convergence to the main goal, *explicit* inflation targeting. In due course, certain progress has been made in the following areas: technical infrastructure, low fiscal preponderance, well-developed financial markets, an independent accountable and transparent central bank, and adherence to the price stability target (TCMB, 2006, p. 17-19). As of 2006, the CBRT began to implement an *explicit* inflation targeting regime. Thus, a certain point of consumer's rate of inflation is selected as a target and the projected path for three years is declared with an uncertainty interval of two points upwards and downwards. The implementations are assessed in *inflation reports,* which are released in three month periods. If deviations exceed the limit of 2 points, then the CBRT is required to explain the reasons for this and the measures to be taken in response, to both the government and the public (p. 20-23).

In evaluating the monetary policy implementation of the independent CBRT, at first glance, the disinflation process after 2001 looks like a confirmation of the most widely celebrated result in the CBI literature: independence is negatively

[48] With respect to transparency, Bakır's findings reckon that the CBRT took 3rd place among the banks of 8 developed countries and the European Union (2007, p. 153).

associated with inflation. That is to say, the more independent a central bank is, the lower inflation will be. In *Table 2.*, it is obvious that inflation has been considerably reduced and has reached single digit numbers, which is unseen among generations under the age of 35. Some commentators argue that this success is the result of the emphasis of stability programmes on breaking inflationary expectations and the independent CBRT's ability to direct these expectations (Doğruel & Doğruel, 2005, p. 212).

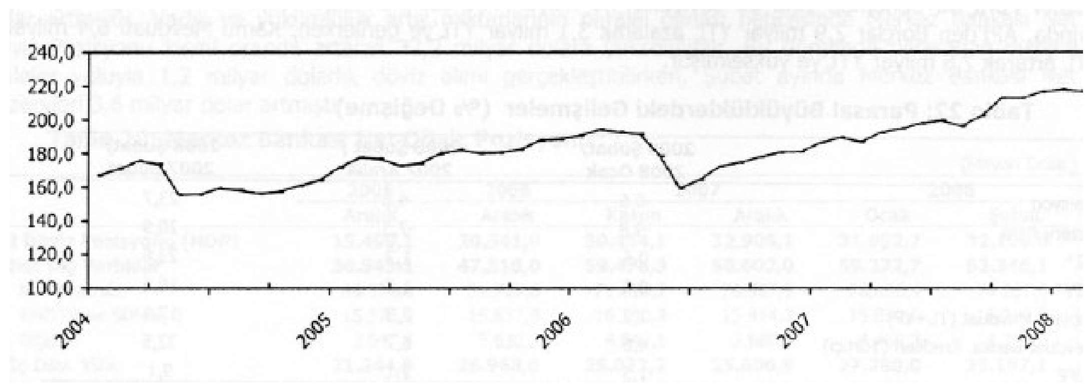
Table 2. Inflation Targets and Realisations in the 2000s

YEAR	2002	2003	2004	2005	2006	2007	2008	2009	2010
Target	35	20	12	8	5	4	4	7.5	6.5
Realization	29.7	18.4	9.3	7.7	9.6	8.4	-	-	-

Source: CBRT Web Site

However, the relative success or failure of the CBRT in achieving the targets of inflation should be evaluated with regard to variables other than monetary policy. It is true that contractionary monetary policy, which is safeguarded as *the goal* of the CBRT, contributed to the apparent fall in inflation. In addition, the coordination of tight fiscal policies throughout the early years of the programme should be noted.[49] Moreover, real appreciation of the Turkish lira (please see *Figure 2.*) and the significant entrance of foreign capital should be taken into consideration (Bağımsız Sosyal Bilimciler, 2007, p. 37).

[49] Kumcu (8 June 2008) points out that the reason for inflation in Turkey throughout the 1980s and 1990s was not the lack of CBI. Instead, it was because of the uncooperative fiscal policies designed to fight inflation. He argues that without the support of suitable fiscal policies, an independent Central Bank could not have ensured price stability alone. This latter theoretical conclusion is also supported by Eijffinger (1997).



Real Exchange Rate (1 dollar + 1.5 euro) (1987 = 100)

Figure 2. Real Exchange Rate Index

Source: State Planning Organization, March 2008, p. 20

The ability of the CBRT to actually control inflation should be scrutinised further. A second look at *Table 2*. reveals that while the CBRT had missed the inflation targets from *below* in the years 2002, 2003, 2004, and 2005, it missed targets from *above* in the years 2006, 2007, and 2008. The global fluctuation in May 2006 was a significant factor in the missing of these targets. Indeed, the shrinking of global liquidity resulted in capital exits from Turkey, which devaluated the Turkish lira to a certain degree. As mentioned in the inflation report of the CBRT, the rise in foreign currency's value was the foremost reason for the high realisation of inflation (Bağımsız Sosyal Bilimciler, 2008, p. 109).

The sizeable deviations from inflation targets in 2006 and 2007, where realisations were almost twice the target, raised discussions about the credibility of the CBRT (Bağımsız Sosyal Bilimciler, 2008, p. 109-110). Consequently, as it became clear that the 2008 target would also be missed, the CBRT made revisions to its goals. The new targets of inflation are 7.5 for 2009, 6.5 for 2010, and 5.5 for 2011. According to the 42nd Article in the CBRT's law envisaging *accountability* when the targets are not reached, the revisions were relayed to the government via a letter and declared to the public on 28 July 2008. In that letter, exogenous events like the worldwide increase in food and energy prices and domestic uncertainties were emphasised in the explanation of the missed targets. Additionally, noting that the tight fiscal policies had a remarkable contribution in reaching single digits in inflation, the provision of fiscal discipline and continuation of structural reforms were highlighted as crucial in future successes (TCMB, 2008, p. 10-11). These points illustrate the fact that central banks' effectiveness in reaching a predetermined inflation target is very much related to the movements of global capital (Bakır, 2007, p. 54-55).

At this point, the demonstration made by Cansen (2008) about the structure of the Turkish economy in the 2000s can be helpful in understanding the events described above. In the quest for low inflation, high interest rates were used by the CBRT. Such high interest rates slow the economy by dissuading real investments and domestic consumption. The high interest rates attract foreign capital, which enters the economy by appreciating the domestic currency (please review *Figure 2*). The positive sides of this policy are an increase in national income and a decrease in inflation. Yet on the other hand, cheapening the foreign currency raises the balance of payments deficits and worsens international competitiveness, and the high interest rate results in higher interest payments in the budget. This whole system of high interest rates and low exchange rates is bound to the foreign capital for continuation. The high interest rates attract foreign capital, since it offers remarkable arbitrage profits. Especially between the years 2002 and 2006, international finance capital gained remarkable profit rates and higher than average returns in the international financial markets, mostly in the two digits (Bağımsız Sosyal Bilimciler, 2008, p. 119).

So far, different aspects of the CBRT's *legal independence* defined by the 2001 law and the implementation of monetary policy after 2001 have been evaluated. However, as explained in the CBI literature, *actual independence* of central banks may diverge from the legal framework drawn. In this regard, two interesting incidents that hampered the actual independence of the CBRT can be scrutinized: the appointment of the present governor and the moving of the CBRT from Ankara to İstanbul.

After the CBRT gained independence, much speculation and dispute emerged in the first appointment procedure of a new governor. Serdengeçti's time in the governor's office ended 14 March 2006. The government did not immediately announce its appointment of the new governor. Rumours pointed towards Vice Governor Erdem Başçı to be the name on the appointment decree sent to President Ahmet Necdet Sezer. However, the General Director of Albaraka Türk, Adnan Büyükdeniz, was the named appointee, and he was rejected by the President on 23 March. On 7 April, a new decree was sent to the President, offering Durmuş Yılmaz, a member of the bank board and the Monetary Policy Committee, as the appointee. Approved by the President, Yılmaz became the Governor of the CBRT on 18 April 2006, roughly a month after the appointment procedures began (Milliyet, 2006).[50]

Throughout this process, various speculations were made about the independence of the CBRT and the possible governor candidates, their relationships with the government, and even the lifestyle of these candidates, including their wives' clothing. Independence of the CBRT is harmed by such a lengthened appointment process, which was regarded as the government's attempt to appoint a politically close bank governor. These political disputes raised discontent amongst the previous CBRT governors. Erçel observed that the unfortunate political power contests in the governor's appointment procedure damaged the CBRT's credibility (Erçel, 2006). Likewise, in a private interview, Süreyya Serdengeçti emphasised the faults of government as follows:

> The government managed this appointment procedure so badly. We see that in America, in Europe, when a central bank governor's time in the office is going to end, months before, the incoming central bank governor is declared to the public. They appear on the television, giving pictures hand in hand or so… A pretty soft transition is provided. It is very important not to make people anxious. Whereas in Turkey, although I have said all this to government months before, things did not

[50] A couple of years after this appointment, Prime Minister Recep Tayyip Erdoğan stated that the government had actually wanted Mehmet Şimşek to be the Governor of the CBRT (Özkök, 2008). At that time, Mehmet Şimşek worked at Merrill Lynch, a famous international firm specialising in wealth management, capital markets, and advisory. In the 2007 elections, Şimşek was elected as a member of parliament and appointed as a Minister of State responsible for the economy. Interestingly enough, Mehmet Şimşek was given control of the Treasury as a tied institution and the CBRT as a relevant institution.

> happen this way. What is more, it did not happen after I left the office (Serdengeçti, 2008, translation mine).

In regards to the monetary policy, Serdengeçti argued that this mismanagement of the governor's appointment had a considerable role in the CBRT's missing of the 2006 inflation target. In addition, Serdengeçti considers the government's mismanagement of 2006 global fluctuation, rising fiscal expenditures, increases in food and energy prices, and the inadequately explained April 2006 inflation realisations to be other factors in the missing of the 2006 inflation targets. Consequently, *expectations* have changed and the CBRT's *credibility* is damaged (Serdengeçti, 2008). As is clear from these economic analyses, Serdengeçti emphasises and utilises the New Classical Macroeconomic's views regarding expectations and credibility of central banks. Forming a credible central bank and managing expectations is of crucial importance for him.

The second harmful incident regarding the CBRT's actual independence was the government's insistence on moving the bank headquarters to İstanbul.[51] This was actually part of the government's project to make İstanbul a *finance center*. By providing the necessary infrastructure and gathering all of the public and private financial institutions in İstanbul, the government hoped to establish an internationally significant finance center. Despite the CBRT's negative stance towards this issue, the government pushed forward with its plans. On 2 July 2008, a law draft was presented to the GNAT. It envisaged that the CBRT, together with Vakıfbank, the Banking Regulation and Supervision Agency, and the Capital Markets Board of Turkey, would be moved to İstanbul within two years. In the reason of the law, the notion of İstanbul as a finance center was emphasised (Reason of Law Draft 1/625, p. 2). About this movement and the government's close affiliation with the financial sector, the severe but humourous criticism raised by Nurettin Özdebir, Head of the Ankara Chamber of Industry, is worth quoting:

[51] Reflections of this insistence can be found in Prime Minister Recep Tayyip Erdoğan's following statement: "The Central Bank is independent in the decisions that it takes. As a government, we can decide the place where it will be situated. Since, in this country, the decision to make the Central Bank independent is taken by the parliament…If a law is needed, we will pass it. We have decided it" (Hürriyet, 2008, translation mine).

> In our opinion, instead of moving the Central Bank to İstanbul, there is a need to move the Minister responsible for economy, Mehmet Şimşek, from London to Ankara. Because he is still looking at Turkey through the glasses of the finance sector and he supposes that economy is composed of only the finance section (Radikal, 2007).

Özdebir's criticism of the government's stance and his request for the citizens of Ankara to challenge this relocation was not the only response to the proposed project. A platform labelled the Ankara Civil Initiative, composed of 378 organisations, including chambers and civil society organisations, made a declaration against the *financial migration*. Possible risks and costs of this movement were listed and it was noted that the independence of the CBRT was what was most important, and the location of the bank's headquarters is irrelevant in this regard (Ankara Chamber of Commerce, 2008).

4.5.3 Perceptions of Key Actors about Independence

Analysing the perceptions of the key actors can be illustrative of the way in which the reform was rationalised. Such an exercise can provide some insights about the divergence or convergence of theoretical arguments of CBI and its implementator's views. These speeches can be regarded more as reflections of relevant institutions' stances than as mere personal standpoints. In this quest, an analysis will be made of the speeches of the initiator of the independence reform, Kemal Derviş; previous Governor of the CBRT, Süreyya Serdengeçti; and the present Governor of the CBRT, Durmuş Yılmaz.

Kemal Derviş's diagnosis of the problems in Turkey in the preface of *Strenghtening the Turkish Economy* is worth quoting at length:

> The main reason for this unfavourable debt dynamic is *the relationship between state and society, politics and economics*. Despite various reform attempts, the rent contest continued in economy and social life throughout the 1990s. Politics, besides its beneficial and legitimate functions like providing legal frameworks, conducting the duty of supervision, determining foreign and security policies, and protecting the poor, maintained *the habit of intervening in the working of the market and the taking of the economic decisions*...This is also the main source of the inflation which we could not manage to overcome (Derviş & Asker & Işık, 2006, p. 104, emphases and translation mine).

It is clear that Derviş regards political intervention in "the working of the market and to the taking of the economic decisions" as illegitimate. Actually, this is a perfect manifestation of Derviş' aim to restructure the relationship between politics and economics in the guidance of *depoliticisation*. He seeks to limit *the political* to certain issues and to provide *the economic* an area of freedom from the intervention of the former. However, it should be remembered that this aim *itself* is highly political. The source of inflation is considered to be the interventions in the working of the market. This is a faultless replication of *Political Business Cycles*' arguments. As explained earlier, this stance regards politicians as self-interested individuals who inflate the economy during the election times in order to be re-elected. In order to solve this problem, an effort is made to restructure the relationship between politics and economics by limiting the political to 'legitimate' areas. Furthermore, the tone of this argument is close to the *PWC* in its emphasis on institutional aspects and poverty. To be sure, in the book in which he evaluates the 2001 crisis and modern social democracy, Derviş explicitly locates his stance as different from the early Neoliberals, who sought a minimal state. Instead, he envisages an effective state and further analyses what kind of mechanisms he proposes (p. 263-264). To be more specific, regarding the independent institutions, Derviş argues that:

> There is a need for regulatory *rules and institutions* with *impartial and independent* characteristics in the working of modern economies…Such decisions and implementations should be held far from the short-run criterions, arbitrary decisions, steps that could provide rent to a certain sections or individuals, populism of the political authorities and the executive. This choice is not against democracy (p. 264, emphases and translation mine).

Despite the lip-service paid to democracy, it is clear from these arguments that a limitation of democratic accountability is the goal. Brightly termed by Gill (2000) as the *new constitutionalism of disciplinary neoliberalism*, this is obviously the isolation of political decisions from democratic scrutiny. Politicians are regarded as short-termist, populist rent-seekers, arguments which are familiar from Public Choice. Arbitrary decisions of politicians are aimed to be eliminated by a particular organisation of the state, which is presented as being composed of impartial rules and independent institutions, the latter including independent central banks.

However, when the essentially conservative political choice of low inflation locked in independent central banks is recalled, the harm to democracy becomes clear. What Derviş envisages is not an impartial state with neutral institutions. Instead, he promotes the Neoliberal view of the state, which is detrimental to democracy by its limitation of political scrutiny in key issues such as monetary policy.

With respect to CBI, it should be illustrated that the CBRT rationalises independence in much the same way as the literature does. A quotation from the previous CBRT Governor Süreyya Serdengeçti's speech, entitled *Central Bank Independence,* can be illustrative:

> [P]rice stability can only be achieved through long-term, stable and decisive policy implementations. Yet, due to the *nature of politics*, political authorities can be more easily influenced by various *pressure groups* with short-term visions and they can be inclined to adopt a short-term way of thinking, especially in *times of elections*...Maintaining *credibility* is only possible with a central bank following a transparent, honest and *consistent* line of behavior in its communications policy and declarations to the public. In other words, it is only possible with *a central bank doing whatever it has promised to do* (2005, p. 3-4, emphases mine).

These statements can be considered a successful summary of the *Political Business Cycles* arguments. As mentioned earlier, this approach suggests that politicians manipulate the economy on behalf of their and certain group's interest, specifically in times of elections. The undemocratic isolation of monetary authority is rationalised with the supposed *nature of politics*, composed of self-interested politicians and interest groups. This is perfectly in line with Public Choice's way of thinking. For Serdengeçti, in order to overcome such short-termist interventions to the economy, the central bank should be isolated from political pressures. Another important theoretical source for CBI is also incorporated in this speech. The emphasis on credibility and consistency can be regarded as lessons drawn from Barro and Gordon's (1983) solution to the *time inconsistency problem.* As analysed in the theoretical background of CBI, *New Classical Macroeconomics* emphasises the role of expectations in monetary policy. The central bank's dishonest interventions, mostly the result of political interventions, that aim to reduce unemployment are foreseen by agents endowed with rational expectations. Consequently there will be a high inflation rate with no real output change. In order to eliminate this problem, monetary policy is argued to be conducted consistently and credibly by independent central banks. Serdengeçti's words, "doing whatever it has promised to do", can be regarded as an acceptance of the time inconsistency problem, solving it with stress on the credibility of central bank.

Taken as a whole, the reform process, which began with drafts in the late 1990s, was officially stated to the IMF in 2000, realised in 2001 by Derviş, and consolidated in 2006 with inflation targeting, has brought a significant change to the way the CBRT regards its mission. A speech made by the present Governor, Durmuş Yılmaz, on the 75th anniversary of the CBRT, is a perfect manifestation of this transformation:

> An independent central bank has constituted and will continue to constitute a cornerstone for *structural transformation towards good governance* and good institutions in Turkey. The Central Bank of Turkey aims to fulfill *expectations* by operating as a sound institution through its *independent*, *transparent* and *accountable* status, by policy implementations focused on its *sole mandate of price stability* and by practices to increase *efficiency in institutional design* (Yılmaz, 2007, p. 12, emphases mine).

It is perhaps hard to find a better organisation of the key terms and notions that were discussed in the political economy chapter of this thesis. Granting independence to central banks, which became a key aspect of the *Washington Consensus* from the 1990s onwards, was realised by the CBRT with the reform of 2001. This relatively late reform of the CBRT introduced the bank with the elements of both the WC and the PWC simultaneously. The CBRT Governor is proud of this Neoliberal transformation and regards it as an admirable reform for Turkey. The general Neoliberal aversion to inflation is seen in the limitation of the CBRT's sole duty to price stability. Additionally, the importance of expectations in conducting monetary policy, the major contribution of *New Classical Macroeconomics*, is acknowledged. It is interesting that the CBRT, which aimed to enhance the *economic development* of Turkey with its 1970 Law, now confines its aim to 'fulfilling expectations'. Thus, CBRT now emphasises investors' confidence and price stability at the expense of the aims like economic development and full employment. Consistent with the international move towards PWC, *good* *governance* notions such as transparency and accountability are also incorporated with this reform. The CBRT implements monetary policy open to public and is held accountable for reaching certain targets under the inflation targeting regime. Furthermore, the bank's stress on efficiency is an insight brought by *New Public Management*, an approach that significantly changed the perception towards public administration units in the Neoliberal era. By utilising the analysis of *New Institutional Economics*, Yılmaz stresses the efficiency in the institutional design of the bank.

Overall, the perceptions of the key figures in the CBRT's independence share the Neoliberal stance towards politics and economics. All of them regard politicians as rent-seekers that act in a populist manner. In order to overcome this 'problem', they both point out the necessity of independent institutions, which are supposed to work with the rationality of economics, instead of some narrow political agenda. Incorporation of the PWC jargon of good governance and presentation of it as objective and neutral are other key points in their arguments; the institutional qualities of such institutions are identified as transparency, accountability and efficiency. To conclude, it is striking to find such a widespread internalisation of Neoliberal practises and rhetoric in the speeches of the actors whose contributions were crucial in the construction and working of the independent CBRT.

CHAPTER V

CONCLUSION

In this thesis, the notion of central bank independence and its implementation in the case of the Central Bank of the Republic of Turkey have been analysed in a multidisciplinary manner. The aim was to illustrate the essentially *political* nature of CBI, which is usually discussed as merely a *technical* phenomenon in the economics literature. Numerous past efforts at definitions, indexations, and international comparisons have overlooked the relationship between CBI and a particular political view of the state and public administration. Analysing CBI as a part of the Neoliberal transformation of the state, this thesis addressed the rationale of CBI reforms, which had gained predominance from the 1990s onwards. Hereby, the main conclusions will be presented and topics for further research will be suggested.

Central banks hold a privileged position in the economy by virtue of their right to be the issuer of money, lender of last resort, bank of the state, and bank of the banks. Due to these key functions, central banks have been regarded as a symbol of *sovereignty*. The young Turkish Republic sought to establish a central bank immediately and rejected offers of assistance from the Imperial Ottoman Bank, the foreign capital-owned central bank of the Ottoman Empire. The relationship between this institution and national politics has long been under scrutiny. Especially during World War I, when the finance of war and reparations were mostly monetised, there were arguments to isolate central banks from politicians. Yet until the end of the *Embedded Liberalism Compromise*, there was no elaborate theoretical rationale for this and central bank reforms in this regard were exceptional.

The theoretical case for CBI primarily comes from two schools of thought. The older school is *Public Choice*, which assumes that a politician is a *homo-economicus* who exchanges votes for policies in the political marketplace. From this analysis, a neutral or benign conceptualisation of the state and bureaucracy is replaced with a view of a negative, rent-seeking, and inefficient state. Specifically, the arguments of *Political Business Cycles* regard the political manipulation of the economy as a central concern for politicians, who are considered to be either *opportunistic* or *partisan*. Thus, the isolation of political interventions from monetary policy becomes a key reform issue for politicians. However, the paradox here is that the politicians, who act according to self-interest, will not tie their own hands, except for some enlightened technocrats.

The theoretical arguments that stem from *New Classical Macroeconomics* are very sophisticated and impossible to assess without advanced knowledge of econometric modelling. It is argued that since agents with *rational expectations* cannot be systematically deceived, government interventions cannot have real effects on growth and unemployment. Thus, the central bank's sole aim is reduced to the maintenance of price stability. The *time inconsistency problem* provided the rationale for *rules* rather than *discretion* in monetary policy, and, in addition, attention is paid to the *credibility* of central banks. The rigidity and difficulty arising from implementing rules is potentially overcome by *second best* solutions, like conservative central bankers and performance contracts for governors, both of which represent the basic rationale of CBI. However, not only the inflation bias that has been argued to arise from the time inconsistency problem, but also the introduction of CBI as a solution to the time inconsistency problem is doubtful. Additionally, it is uncertain that the assumption of rational expectations is realistic enough to portray economic agents.

The CBI literature is dominated by recurrent attempts to define different aspects of independence, develop indices, and compare central banks. Nevertheless, these indices suffer from a significant degree of arbitrariness and subjectivity. As the brief exercise of applying a political independence index to the CBRT revealed, the assumption of ‘less’ or ‘more’ independence is to a large extent dependent on the construction of the particular index and its interpretation by the researcher. Thus, the huge literature of country comparisons and the favoured result of the inverse relationship between CBI and inflation seem to rest on unstable foundations. Be that as it may, research in developing countries shows that the introduction of CBI hardly delivered its promise to secure low inflation. In Turkey, after the CBRT was granted independence in 2001, inflation declined significantly to single digit rates. Yet in addition to contractionary monetary policies, tight fiscal policies, huge inflows of foreign capital, and appreciation of domestic currency were also all influential factors in this disinflation. Soon enough, the inability of the CBRT to control inflation was demonstrated with the global liquidity shortage, which raised exchange rates and resulted in inflation and a significant revision of the inflation targets.

Despite the technical tone of the CBI literature, giving independence to central banks and focusing exclusively on inflation is a political choice that has consequences in the distribution of income amongst classes. Indeed, the separation of *the economic* and *the political* within CBI reforms does not imply the removal of politics from monetary policy. On the contrary, it locks central banks into the specific political choice of pursuing low inflation. As Gill’s (2000) term *the new constitutionalism of disciplinary neo-liberalism* perfectly grasps, CBI is the institutionalised solution to the fight against inflation. This solution is essentially undemocratic because it eliminates the right of politicians to influence the monetary policy, a situation often termed as *democratic deficit*. Not only CBI itself, but also its implementation, which became a key part of the *Washington Consensus*, is undemocratic. To be sure, the independence reform in Turkey was initiated by Kemal Derviş with the slogan of ‘*15 law in 15 days’*. The CBRT gained its independence with imposition of this reform package as IMF *conditionality*.

Almost all independent central banks aim to maintain price stability, including the CBRT. The political nature of CBI manifests itself in these inflation adverse policies. The quest for price stability is not politically neutral, especially when the abandoned route of growth and employment policies is considered. To be sure, consistent with its 1970 Law, the CBRT actually provided credit to finance the *development* of the country. Reduction of the central bank's role merely to the quest for price stability and prohibition of central bank credits to public institutions are two significant changes brought by the 2001 Law. Underlying this choice is financial capital's aversion to inflationist policies, which erode the net value of financial assets. This is not to say that inflation is a desirable phenomenon. It is clear that high inflation is harmful because it distorts relative price signals, increases uncertainty, and discourages economic agents from undertaking long-term contracts. Yet a relatively mild inflation is conducive to employment, economic growth, and to the surplus created by industrial capital.

Not only the policies that central banks pursue, but also the banks *themselves* have undergone a transformation recently. With the rise of Neoliberalism, the ways in which public administration units, including central banks, are conceptualised have changed significantly. *New Public Management*, a theoretical stance that gained prominence with Neoliberalism, explicitly endorsed market-based management techniques and prepared the rationale for public administration reforms. Thanks to utilisation of the *Principal-Agent Approach*, notions like performance contracts and the agencies held independent from politicians were introduced and became influential in central banking. Thus, central banks became independent institutions responsible for reaching predetermined performance targets regarding inflation.

It should be noted that the implementation of *inflation targeting* brings an understanding of *accountability* that lies very far from democracy. The accountability here only implies the assessment of the success or failure to reach an inflation target. Accordingly, in July 2008, the CBRT gave an account to the public and the government of its apparent failure to reach inflation targets. This so-called *accountability* was merely a short letter, concluding that targets had been revised and structural reforms would resume. Thus, this notion of accountability can hardly be regarded as a democratic concept.

With the introduction of *transparency*, another *good governance* notion that has been incorporated into central banking, publication of reports and frequent speeches made the implementation of monetary policy fairly open to public scrutiny. The frequent use of this notion is a result of the economic crisis in Asia. This promotion of transparency can be regarded as a measure taken to enhance the *credibility* of a bank and to provide international investors with confidence in the pursued policies. Furthermore, the crisis in Asia raised severe criticisms of IMF policies, even by its sister institution, the WB, and resulted in the formation of the *Post-Washington Consensus*. Thus, the emphasis has shifted from the 'right policies' to the institutional arrangements that can provide the most fruitful environment for these policies. Overall, the utilisation of *New Institutional Economics* in the support given to good governance notions such as transparency and accountability in central banking can be considered as a reflection of this new consensus. It is no coincidence that CBRT governor Durmuş Yılmaz regards the central bank reform process as a cornerstone for good governance in Turkey.

This thesis has attempted to reveal the underlying assumptions and interests in the defence of CBI in general and the case of the CBRT in particular. Nevertheless, this study is limited in some aspects. First, due to the extreme technical expertise required to analyse the mathematical models in CBI literature, the focus on the models themselves was limited. A critical evaluation of internal coherence of these models awaits further research. Second, due to limitations of time and scope, the review of the case of the CBRT did provide modest insights about the way in which bank is transformed with the independence reform. A series of interviews with other bank officials, financial sector employees, and politicians would be a further fruitful exploration about changes in the CBRT following the independence reform.

To conclude, it is hopefully demonstrated that the raising interest in CBI is related to Neoliberal reforms, which restructured state's economic administration units on the basis of a particular understanding of politics. Granting independence to central banks is not a neutral since a central bank takes essentially political decisions that are influential in the distribution of income. The case of the CBRT reflected the distinctive characteristics of central banking reforms, which became prominent in the Neoliberal era such as independence, focus on inflation, emphasis on good governance, and the implementation of inflation targeting regime.

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APPENDICES

Appendix A. Central Banking Institutions Before 1900

(Source: Capie et al., 1994, p. 6)

Bank	Founded	Monopoly note issue	Lender of last resort (decade)
Sverige Riksbank	1668	1897	1890
Bank of England	1694	1844	1870
Banque de France	1800	1848	1880
Bank of Finland	1811	1886	1890
Nederlandsche Bank	1814	1863	1870
Austrian National Bank	1816	1816	1870
Norges Bank	1816	1818	1890
Danmarks Nationalbank	1818	1818	1880
Banco de Portugal	1846	1888	1870
Belgian National Bank	1850	1850	1850
Banco de España	1874	1874	1910
Reichsbank	1876	1876	1880
Bank of Japan	1882	1883	1880
Banca D'Italia	1893	1926	1880

Appendix B. Political Independence of Central Banks

(Source: Grilli & Masciandaro & Tabellini, 1991, p. 368)

	Appointments				Relationship with government		Constitution		Index of political independence
Countries	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Australia		*					*	*	3
Austria						*	*	*	3
Belgium				*					1
Canada	*	*					*	*	4
Denmark		*				*	*		3
France		*		*					2
Germany		*		*	*	*	*	*	6
Greece			*					*	2
Ireland		*				*	*		3
Italy	*	*	*		*				4
Japan							*		1
Netherlands		*		*	*	*	*	*	6
New Zealand									0
Portugal					*				1
Spain				*	*				2
Switzerland		*			*	*	*	*	5
UK					*				1
US				*	*	*	*	*	5

Notes: (1) Governor *not* appointed by government; (2) Governor appointed for >5 years; (3) *All* the Board *not* appointed by government; (4) Board appointed for >5 years; (5) No mandatory participation of government representative in the Board; (6) No government approval of monetary policy formulation is required; (7) Statutory requirements that central bank pursues monetary stability amongst its goals; (8) Legal provisions that strengthen the central bank's position in conflicts with the government are present; (9) Overall index of political independence, constructed as the sum of the asterisks in each row.

Appendix C. Economic Independence of Central Banks

(Source: Grilli & Masciandaro & Tabellini, 1991, p. 369)

	Monetary financing of budget deficit					Monetary instruments		Index of economic independence
Countries	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Australia	*	*	*	*	*	*		6
Austria			*	*	*	*	**	6
Belgium		*		*	*	*	**	6
Canada	*	*	*	*		*	**	7
Denmark		*			*	*	**	5
France				*	*	*	**	5
Germany	*	*	*	*	*	*	*	7
Greece				*		*		2
Ireland		*	*	*		*		4
Italy				*				1
Japan	*		*		*	*	*	5
Netherlands			*	*	*	*		4
New Zealand			*	*		*		3
Portugal				*		*		2
Spain			*	*			*	3
Switzerland		*	*	*	*	*	**	7
UK	*	*	*	*		*		5
US	*	*	*	*	*	*	*	7

Notes: (1) Direct credit facility: not automatic; (2) Direct credit facility: market interest rate; (3) Direct credit facility: temporary; (4) Direct credit facility: limited amount; (5) Central bank does not participate in primary market for public debt; (6) Discount rate set by central bank; (7) Banking supervision *not* entrusted to the central bank (**) or not entrusted to the central bank alone (*); (8) Overall index of economic independence (being the sum of the asterisks in columns 1–7).

Appendix D. Variables for Legal Central Bank Independence

(Source: Cukierman & Webb & Neyapti, 1992, p.358-359)

Variable number	*Description of variable*	*Weight*	*Numerical coding*
1	**Chief executive officer (CEO)**	0.20	
	a. Term of office		
	Over 8 years		1.00
	6 to 8 years		0.75
	5 years		0.50
	4 years		0.25
	Under 4 years or at the discretion of appointer		0.00
	b. Who appoints CEO?		
	Board of central bank		1.00
	A council of the central bank board, executive branch, and legislative branch		0.75
	Legislature		0.50
	Executive collectively (e. g council of ministers)		0.25
	One or two members of the executive branch		0.00
	c. Dismissal		
	No provision for dismissal		1.00
	Only for reasons not related to policy		0.83
	At the discretion of central bank board		0.67
	At legislature's discretion		0.50
	Unconditional dismissal possible by legislature		0.33
	At executive's discretion		0.17
	Unconditional dismissal possible by executive		0.00
	d. May CEO hold other offices in government?		
	No		1.00
	Only with permission of the executive branch		0.50
	No rule against CEO holding another office		0.00
2	**Policy formulation**	0.15	
	a. Who formulates monetary policy?		
	Bank alone		1.00
	Bank participates, but has little influence		0.67
	Bank only advises government		0.33
	Bank has no say		0.00
	b. Who has final word in resolution of conflict?[a]		
	The bank, on issues clearly defined in the law as its objectives		1.00
	Government, on policy issues not clearly defined as the bank's goals or in case of conflict within the bank		0.80
	A council of the central bank, executive branch, and legislative branch		0.60
	The legislature, on policy issues		0.40
	The executive branch on policy issues, subject to due process and possible protest by the bank		0.20
	The executive branch has unconditional priority		0.00
	c. Role in the government's budgetary process.		
	Central bank active		1.00
	Central bank has no influence		0.00
3	**Objectives**	0.15	
	Price stability is the major or only objective in the charter, and the central bank has the final word in case of conflict with other government objectives		1.00
	Price stability is the only objective		0.80
	Price stability in one goal, with other compatible objectives, such as a stable banking system		0.60
	Price stability is one goal, with potentially conflicting objectives, such as full employment		0.40
	No objectives stated in the bank charter		0.20
	Stated objectives do not include price stability		0.00
Variable			*Numerical*

Appendix D. (Continued)

number		*Description of variable*	*Weight*	*coding*
4		**Limitations on lending to the government**		
	a.	Advances (limitation on nonsecuritized lending)	0.15	
		No advances permitted		1.00
		Advances permitted, but with strict limits (e. g., up to 15 percent of government revenue)		0.67
		Advances permitted, and the limits are loose (e. g., over 15 percent of government revenue)		0.33
		No legal limits on lending		0.00
	b.	Securitized lending	0.10	
		Not permitted		1.00
		Permitted, but with strict limits (e. g., up to 15 percent of government revenue)		0.67
		Permitted, and the limits are loose (e. g., over 15 percent of government revenue)		0.33
		No legal limits on lending		0.00
	c.	Terms of lending (maturity, interest, amount)	0.10	
		Controlled by the bank		1.00
		Specified by the bank charter		0.67
		Agreed between the central bank and executive		0.33
		Decided by the executive branch alone		0.00
	d.	Potential borrowers from the bank	0.05	
		Only the central government		1.00
		All levels of government (state as well as central)		0.67
		Those mentioned above and public enterprises		0.33
		Public and private sector		0.00
	e.	Limits on central bank lending defined in	0.025	
		Currency amounts		1.00
		Shares of central bank demand liabilities or capital		0.67
		Shares of government revenue		0.33
		Shares of government expenditures		0.00
	f.	Maturity of loans	0.025	
		Within 6 months		1.00
		Within 1 year		0.67
		More than 1 year		0.33
		No mention of maturity in the law		0.00
	g.	Interest rates on loans must be	0.025	
		Above minimum rates		1.00
		At market rates		0.75
		Below maximum rates		0.50
		Interest rate is not mentioned		0.25
		No interest on government borrowing from the central bank		0.00
	h.	Central bank prohibited from buying or selling government securities in the primary market?	0.025	
		Yes		1.00
		No		0.00

Appendix E. Inflation in Turkey

Yıl	1938=1)	1923=1)	1980=1)
1923	1.198	1.000	0.005
1924	1.394	1.164	0.006
1925	1.505	1.256	0.007
1926	1.529	1.277	0.007
1927	1.343	1.121	0.006
1928	1.338	1.117	0.006
1929	1.422	1.187	0.006
1930	1.310	1.094	0.006
1931	1.239	1.034	0.005
1932	1.207	1.008	0.005
1933	1.078	0.900	0.005
1934	1.062	0.886	0.005
1935	0.986	0.823	0.004
1936	0.989	0.826	0.004
1937	1.004	0.838	0.004
1938	1.000	0.835	0.004
1939	1.021	0.853	0.004
1940	1.108	0.925	0.005
1941	1.325	1.106	0.006
1942	2.209	1.845	0.010
1943	3.220	2.689	0.014
1944	3.301	2.756	0.014
1945	3.330	2.781	0.015
1946	3.204	2.675	0.014
1947	3.252	2.715	0.014
1948	3.297	2.753	0.014
1949	3.545	2.960	0.016
1950	3.392	2.832	0.015
1951	3.355	2.801	0.015
1952	3.526	2.944	0.015
1953	3.695	3.085	0.016
1954	4.028	3.363	0.018
1955	4.507	3.763	0.020
1956	5.026	4.197	0.022
1957	5.654	4.721	0.025
1958	6.541	5.462	0.029
1959	8.020	6.697	0.035
1960	8.613	7.192	0.038
1961	8.725	7.285	0.038
1962	9.057	7.563	0.040
1963	9.645	8.054	0.042
1964	9.723	8.119	0.043
1965	10.374	8.662	0.046
1966	10.945	9.139	0.048
1967	11.634	9.714	0.051
1968	12.111	10.113	0.053

Appendix E. (Continued)

Yıl	1938=1)	1923=1)	1980=1)
1969	12.801	10.689	0.056
1970	14.311	11.950	0.063
1971	17.431	14.555	0.076
1972	20.098	16.782	0.088
1973	23.273	19.434	0.102
1974	26.857	22.426	0.118
1975	31.960	26.687	0.140
1976	37.198	31.061	0.163
1977	45.568	38.050	0.200
1978	69.856	58.331	0.306
1979	113.166	94.495	0.497
1980	227.918	190.313	1.000
1981	305.409	255.019	1.340
1982	392.147	327.446	1.721
1983	515.241	430.231	2.261
1984	764.618	638.462	3.355
1985	1108.313	925.451	4.863
1986	1492.012	1245.842	6.546
1987	2071.659	1729.852	9.090
1988	3598.470	3004.753	15.788
1989	5875.223	4905.860	25.778
1990	9417.982	7864.094	41.322
1991	15624.061	13046.222	68.551
1992	26576.528	22191.623	116.606
1993	44143.010	36859.783	193.680
1994	91051.172	76028.491	399.492
1995	176300.704	147212.564	773.528
1996	316296.101	264109.894	1387.765
1997	585122.725	488582.376	2567.255
1998	1074337.138	897080.508	4713.707
1999	1781192.658	1487310.787	7815.071
2000	2759341.417	2304073.193	12106.747
2001	4260428.226	3557493.251	18692.839
2002	6177620.928	5158365.214	27104.617
2003	7740559.023	6463431.613	33962.085
2004	8559510.168	7147262.678	37555.273