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TABLE OF CONTENTS

ABSTRACT.....	3
INTRODUCTION	4
CHAPTER 1: JUSTIFYING CENTRAL BANK INDEPENDENCE.....	6
I-Sectoral Interest Groups	10
II- Political Structure	13
III- Financial Needs of the Government	16
IV- Ideology	17
V- Economic Openness	17
VI- Criticism	18
CHAPTER 2: HISTORICAL CONTEXT OF THE CENTRAL BANK	
INDEPENDENCE AND TURKEY	19
I- History of Central Bank Independence	19
II- Turkey	20
Before the 1990s	20
The 1990s: The impact of the IMF and the EU on Turkey’s economy	22
The 2001 Crisis and its Aftermath.....	27
CONCLUSION.....	34
LIST OF REFERENCES.....	36

ABSTRACT

It is not an unusual practice for governments to put pressure on central banks to make them follow certain monetary policies. However, recently that pressure reached to peak levels in Turkey as the high rank officials in the government accused the central bank of carrying out a monetary policy which is detrimental to the economic development of the country. In contrast, policymakers had not raised any objection when the central bank gained autonomy in April 2001. So, given the current widespread unpopularity of the central bank independence in Turkey, it is important to ask which circumstances made it possible in 2001 and the following years.

The major argument of the dissertation is that although granting independence to the Turkish central bank in 2001 can be explained by the interplay of national and international factors, the external actors, specifically IMF and European Union played the most significant role. It is also argued that the extraordinary economic environment created by the 2001 financial crisis provided a suitable environment so that these international actors gained more power to affect the Turkey's post crisis structural transformation. Lastly, it is stated that the current efforts of the government to limit the authority of the central bank can be explained by the relative decline of the influence of the IMF and the European Union over the Turkey's economic and political system.

The first chapter of the study will show how CB independence has been conceptualised in the relevant literature so far. This chapter will also present the views in the literature on why and under what conditions do policymakers grant independence to the central bank. In the second part, the historical development of the CB independence in the world and in Turkey will be discussed, and the conditions in 2001 that shaped the CB independence will be analysed.

INTRODUCTION

It is not an unusual practice for governments to put pressure on central banks to make them follow certain monetary policies. However, recently that pressure reached to peak levels in Turkey as the high rank officials in the government accused the central bank of carrying out a monetary policy which is detrimental to the economic development of the country. In contrast, policymakers did not raise any objection when the central bank gained autonomy in April 2001. So, given the current widespread unpopularity of the central bank independence (CB independence) in Turkey, it is important to ask which circumstances made it possible in 2001 and the following years. It becomes particularly interesting when it is considered that Turkey had a long history of state intervention, and policymakers used to employ monetary policy as a means of both long term development goals and short term election strategies. What conditions led to a more independent central bank in Turkey in 2001? Were the internal dynamics of Turkey's economical, social and political system or the international factors more decisive in the central bank being granted formal independence in 2001?

The major argument of the dissertation is that although granting independence to the Turkish central bank in 2001 can be explained by the interplay of national and international factors, the external actors, specifically IMF and European Union played the most significant role. It is also argued that the extraordinary economic environment created by the 2001 financial crisis provided a suitable environment so that these international actors gained more power to affect the Turkey's post crisis structural transformation. It is also stated that the current efforts of the government to limit the authority of the central bank can be explained by the relative decline of the influence of the IMF and the European Union over the Turkey's economic and political system.

The first chapter of the study will show how CB independence has been conceptualised in the relevant literature so far. This chapter will also present the views in the literature on why and under what conditions do policymakers grant independence to the central bank. The counterarguments to these views and whether the Turkish case supports these views are also presented. In the second part, the historical development of the CB independence in the world and in Turkey will be discussed, and the conditions in 2001 that shaped the CB independence will be analysed.

The academic sources being referred in the essay can be divided into two groups; first group consists of theoretical and empirical studies on CB independence while the second group mainly deals with the independence of the central bank in Turkey in relation with the historical development of the Turkish economy and the role of the IMF and EU in this development. In addition to the academic sources, news articles are also referred. The priority is given to the articles written in English; however Turkish sources are also referred if they are considered as more accurate or if a particular news is reported only in Turkish.

CHAPTER 1: JUSTIFYING CENTRAL BANK INDEPENDENCE

The main proposition in modern theoretical literature supporting the CB independence is that independent central banks reduce inflation. There are three arguments explaining the mechanism CB independence results in lower inflation rate (Eijffinger & Haan 1996, p.4): public choice arguments, relative dominance of monetary and fiscal authorities advocated by Sargent and Wallace (1981) and time inconsistency problem.

Public choice view highlights that policymakers tend to exert high pressure on monetary authorities. It is because the monetary policy has impact on budgetary performance; a tight monetary policy may worsen the budget deficit. The government may choose 'easy money' to solve the budget deficit problem which may be the result of a reduction in tax income due to a temporary recession in economic activity or of a rise in interest rate paid for financing the budget. Monetary authorities whose staff and management posts are directly determined by the politicians cannot resist the demands of the policymakers, especially if it also means a stance against public opinion and media pressure (Buchanan & Wagner 1977, p.117).

Another argument explaining the relation between CB independence and inflation is the one put forward by the Sargent and Wallace (1981) (Eijffinger & Haan 1996, p.5). According to this view, the inflation rate depends on whether monetary policy or fiscal policy is the dominant in a given country. If fiscal policy is dominant, monetary authorities have no power on the size of the budget deficit which leads to compensate budget deficit by increasing money supply. On the other hand, if the monetary policy is the dominant side, the fiscal authorities are forced to reduce fiscal deficit by either reducing the government expenditures or increasing the tax income.

However the best known and convincing explanation in the literature regarding the inflation inducing character of the politicized monetary policy is the time inconsistency problem. According to the time inconsistency theory advocated by Kydland and Prescott (1977, p.473)

and Barro and Gordon (1983), a discretionary policy for which policymakers select the best action considering the current situation, will not necessarily lead to maximization of the social objective function even if there is an agreed-upon, fixed social objective function. It is because current decisions made by various economic agents in a dynamic economic system depend partly upon their expectations of future policy actions. The time inconsistency problem in inflation-employment relation works as follows:

If workers believe that there will be no deviation from the inflation target, they negotiate a contract with firms accordingly. But in case of dependent central bank, instead of following the announced policy, the policymakers might carry out an inflationary policy and create an inflation surprise in order to reduce the unemployment at the expense of the workers' real wages. Thus, with the cost of higher inflation, the policymakers benefit from lower unemployment. However, workers will in the long run realize that the central bank's announcements are not credible, and they will expect higher inflation than the target rate. When workers expect higher inflation, it becomes increasingly costly for the central bank to create an inflation surprise anymore. The inflation will rise to the balance point where the benefits of any further inflation surprises are less than their costs. But because there are no inflation surprises, unemployment rate will be high. The final outcome is an economy with inefficiently high inflation, but no reduction in the unemployment rate (Dennis 2003, p.1).

In addition to the theoretical considerations on CB independence, most of the empirical studies also report a negative relationship between independence and inflation (Haan & Kooi 2000, p.644). As an example, an empirical study conducted by Alesina and Summers (1993 p.154) which covers the economic performance of several countries during the 1955-1988 period suggests a strong negative relationship between the level and variability of inflation and CB independence. Some of other empirical studies who found an inverse relation between CB independence and inflation are Bade and Parkin (1988); Cukierman (1992); Grilli,

Masciandaro, and Tabellini (1991); Cukierman, Webb and Neyaptı (1992); Eijffinger and Schaling (1993); Frattianni and Huang (1994); Bleaney (1996). Although there are also a few studies which claim no relation between CB independence and inflation, the overwhelming majority of the literature suggests a strong correlation. One issue that empirical studies must take into account is that the effect of CB independence on inflation depends on the exchange rate regime. Countries had exchange rate targets rather than inflation targets under Bretton Woods system which left little room for central banks to pursue their own monetary policies. Some of the studies that produced no relation are among those which failed to take into account this point (Eijffinger & Haan 1996, p.29). Measuring how independent a central bank is can also change the results and conclusions.

The central bank independence can be studied in relation with its direct effect on inflation as stated above or its relation with other macroeconomic indicators like growth and income inequality. For example, if we take growth and CB independence, Grilli, Masciandaro and Tabellini (1991), De Haan, Knot and Sturm (1993), and Frattianni and Huang (1994) conclude that there is no significant impact of CB independence on growth, whereas DeLong and Summers (1992), Cukierman et al. (1993), and Cukierman and Webb (1995) find positive correlation between CB independence and the growth rate. Another way of examining CB independence - growth relation is studying inflation - growth relation in order to understand indirect effect of CB independence on growth. Empirical studies conducted by Grimes (1991), Fischer (1993) and Barro (1995) suggest a negative correlation between inflation and growth. Fischer (1993, p.488) claims that the main factor resulting in a low growth rate is uncertainty and lack of a stable macroeconomic framework. Therefore, the variance of inflation through years may serve as a more direct measure of the lack of stable macroeconomic framework. However, 'the inflation rate and the variance of the inflation rate are highly correlated in the cross-section, making it difficult to disentangle the effects on growth of the level of inflation

from the effects of uncertainty about inflation' (Fischer 1993, p.488). In the study, cross-sectional regressions method for large number of countries yields a high level of correlation between low inflation and growth. Fischer also indicates that inflation in Asian countries is significantly below the inflation rates in slower-growing Africa and Latin America, all of which can be considered as developing countries. In addition to cross country evidence, inflation has acted inversely with growth across the three different periods of time.

Income inequality is considered as another macroeconomic indicator which is strongly associated with inflation rate. Thalassinos et al. (2012), Beetsma and Van Der Ploeg (1996), Al-Mahrubi (1997), Romer and Romer (1998), Bulir (2001), Albanesi (2007), Dolmas et al. (2000) are some of the studies that have found correlation between these two indicators. In Dolmas et al. (2000) and Al-Mahrubi (1997) studies, the dependent variable is inflation, so the direction of the causality is from inequality to inflation. However, the majority of the studies find inflation as a cause and inequality as a result. An extensive research conducted by Bulir (2001) analysed the data from 80 developed and developing countries between the years 1970 and 1991 and found that there is a positive correlation between inflation and income inequality and the impact is stronger in countries with the inflation rate higher than 40% (Bulir 2001, p.154). Similarly, Thalassinos et al. (2012, p.137) examine the relation between inflation and inequality in 13 EU countries over the period 2000-2009 and again find that inflation gives rise to income inequality.

Although theoretical and empirical evidence suggest that CB independence reduce inflation, variance of inflation, macroeconomic instability and income inequality, it does not mean that the policymakers would automatically adopt CB independence. While serving the interests of certain groups, CB independence might on the other hand undermine the interests of other groups and specifically interests of policymakers who seek re-election. Therefore, it is important to understand in what circumstances policymakers choose CB independence.

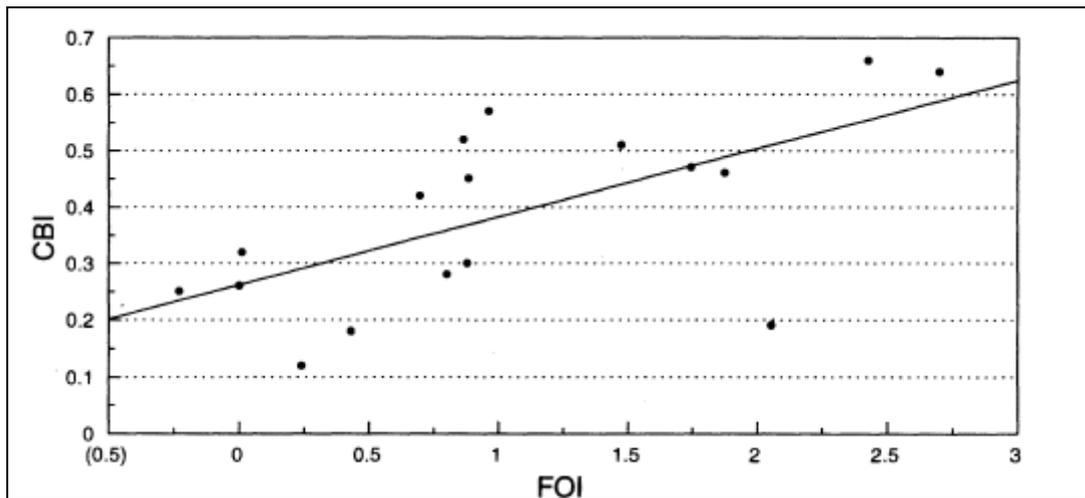
The following factors in the literature are said to determine whether central bank independence is feasible in a country or not (Maxfield 1997, p.19) (Bernhard & Leblang 1999, p.84).

- (1) Sectoral Interests,
- (2) The nature of political institutions and party systems,
- (3) The financial needs of government,
- (4) Ideology,
- (5) Economic Openness.

I-Sectoral Interest Groups

The first argument is that the relative powers of different sectoral interest groups in a country shape the policy of the government on the CB independence. If the groups who back price stability are more influential than other groups in society, policymakers tend to support CB independence. On the other hand, if the groups who support full employment and growth have more power, CB independence tends to be less popular. It is known that the financial sector is the primary supporter of the price stability and hence of the CB independence. The unity of financial sector's stance on price stability, and openness of the political system to sectoral groups' pressure have impact on the outcome. Posen (1995, pp.262-271)'s study quantifies the power of the financial sector and its influence on the policy making as FOI (Financial Opposition to Inflation) and finds out that there is a close relationship between high FOI index and CB independence in the OECD countries (Figure 1).

Figure 1: Financial Opposition Index and CB independence



Source: Posen (1995, p.265)

The calculation of the FOI, and its rate for Turkey in 2001 are as follows:

Univbk= it is equal to 1 if banks are entitled to operate in at least two of securities, insurance, and commercial lending sectors; 0 otherwise. It is 1 in Turkey since the universal banking is practiced in Turkey.

Regpow = it is equal to 1 if the central bank is not responsible for the banking supervision; 0.5 if the supervision authority is divided between the central bank and another agency; 0 if it is only the central bank's responsibility (It is 1 in Turkey since the supervision is under the authority of Banking Regulation and Supervision Agency)

Federal = it is equal to 1 if a country has a federal political structure; 0 otherwise (It is 0 in Turkey)

Fractn = the probability that two legislators chosen at random from a national legislature belong to different parties. (It is 0.80 in Turkey*)

$$\text{FOI} = \text{Univbk} + \text{Regpow} + \text{Federal} - \text{Fractn} = 1 + 1 + 0 - 0.80 = 1.20$$

The FOI index of Turkey in 2001 does not support the claim that the main determinant was the sectoral support as the Turkey's score places the country in the middle of the FOI index. It

* The number of MPs of the political parties were 136, 129, 111, 86, 85 and 3 (550 in total). The calculation of the possibility is $1 - \left(\frac{136}{550} \cdot \frac{135}{549}\right) - \left(\frac{129}{550} \cdot \frac{128}{549}\right) - \left(\frac{111}{550} \cdot \frac{110}{549}\right) - \left(\frac{86}{550} \cdot \frac{85}{549}\right) - \left(\frac{85}{550} \cdot \frac{84}{549}\right) - \left(\frac{3}{550} \cdot \frac{2}{549}\right) = 0.80$

also fails to explain the current deterioration in the central bank independence as the current FOI index is higher than the 2001 index. The difference comes from the slight decrease in 'Fractn' value as the ruling AK Party has 313 MPs out of 550 in the parliament. A decrease in 'Fractn' value means an increase in the FOI index and an increase in the popularity of the CB independence which is not the case in Turkey.

On the other hand, Maxfield (1997, p.23) reports that the CB independence will be less likely if working class and heavy industry sectors are powerful. She also conveys that the sectoral argument of CB independence is more relevant in the developing countries in comparison with the developed OECD members. When it comes to Turkey, this view gives us an ambiguous picture. Contrary to Maxfield's expectation, both the large conglomerates who have close relations with the transnational corporations and the small and medium-sized businesses were mostly in favour of the structural reforms in line with the requirements of the IMF and the EU in the post crisis context (Öniş 2009, p.419). Therefore, the relative power of the industrial sector compared to financial sector did not have negative impact on CB independence. Unlike business sector, labour unions were opposed to the post crisis structural reforms. However, unions became a 'marginalized element in Turkish society throughout the neo-liberal era' (Öniş 2009, p.426).

To sum up, the approach that looks the CB independence from the sectoral interests point of view gives us mixed results. The support of the business actors and absence of strong trade unions might have contributed to the CB independence; however the moderate level of Financial Opposition Index is insufficient to prove the validity of the view in the Turkish case. It also fails to explain the current unpopularity of the CB independence given the fact that the power of the financial sector, its opposition to inflation, the power of the labour unions and the support of the business sector has remained almost unchanged since 2001.

II- Political Structure

The second approach highlights the role of political institutions in order to understand the adoption of the CB independence. Bernhard, Broz and Clarke (2002, p.711) list five elements of political environment that have impact on the decisions of policymakers on CB independence: welfare gains, constraining future governments, policymaking capabilities, electoral opportunism, and government partisanship.

According to this ‘welfare gains’ argument, if the government cannot resist the pressures of various kinds and follows a loose monetary policy, society should pay for it as inferior economic outcome and loss of welfare benefits. In situations where the pressure on the government is severe, the possible benefit of conveying the monetary authority to an independent agency is higher. However, when we look at the Turkish governments in the 1990s, the ‘welfare gains’ approach is not validated. The common characteristics of the governments before the 2001 crisis were their vulnerability to the pressures coming from different interest groups. For instance, the minimum retirement age was repealed by the Prime Minister Suleyman Demirel in 1991 as a consequence of the public calling the old retirement system as ‘retirement in the grave’ and putting pressure on the government (Şahan 1996). Therefore we can easily say that the weak governments of the 1990s were prone to all kinds of pressures, however they did not choose to adopt CB independence in order to get rid of those pressures. It was only possible after the 2001 crisis.

‘Constraining the future governments’ is also claimed to be a motivation for the ruling governments especially if the current government has an expectation of a shorter term, if the current government is made up of autocrats and the future governments might be democratically elected or if there are opposition parties supporting inflationary policies (Goodman 1991, p.333). In contrary, if the policy changes are more incremental, CB independence is not considered vital since the current policymakers trust their successors. So

this line of thinking suggests that weak governments with expectation of shorter tenures tend to support CB independence since otherwise they could not stand against expansionary monetary policy demands. However, empirical studies attempting to prove these prepositions have mixed results (Bernhard, Broz & Clarke 2002, p.712). In contradiction with this hypothesis, Bernhard (1998, p.318) in his empirical study suggests that moderate leftist parties and low levels of polarization are associated with high levels of central bank independence. The Turkish case did not support the hypothesis either as the leading party of the coalition was leftist and there was no serious threat of populist opposition parties in 2001.

Another argument of the 'Political Structure' approach is called 'policy making capacity' which is again related with constraining the future governments. This argument highlights the importance of the capacity of maintaining the independence of the central bank. In case of existence of so many veto players in the political system, it is harder to change the established institutional arrangement of the central bank which means CB independence would be permanent once established. So, central bank independence will prove more effective as a commitment mechanism in countries with multiple veto players in government (Keefer & Stasavage 2002, pp.29-30). However, the Turkish case again did not confirm the 'policy making capacity' argument. Turkey is a parliamentary democracy where the laws are enacted by the majority of the MPs. Since the government always has the majority in the parliament, bills proposed by the government are almost every time passed the parliament. President has right to turn the bill to the parliament for reconsideration, but if the parliament does not change its decision, president has to accept the bill. It means that a future government bill would almost never face a veto in the parliament or in the presidency.

The extent of 'electoral opportunism' is considered as another factor affecting the independence of central banks. Political business cycle literature claims that politicians want

to win elections and remain in the office, so it would be better for them to exploit macroeconomic tools for achieving that target (Bernhard & Leblang 1999, p.82). Therefore CB independence is more likely when (1) small changes in voters' choice do not lead to a government change; (2) the cost of not being in the ruling position is less (Bernhard, Broz & Clarke 2002, p.714). This approach also fails to describe the Turkish case. The results of the elections before and after the financial crisis and adoption of CB independence were as follows (Grand National Assembly of Turkey 1999) (Ntvmsnbc 2002):

Table 1: 1999 and 2002 general elections

Political Party	% of votes- 1999	% of votes- 2002
Democratic Left Party – leading coalition partner	22.2	1.2
Nationalist Movement Party- coalition partner	18.0	8.4
Virtue Party- Islamist (AK Party in 2002)	15.4	34.3
Motherland Party- coalition partner, centre right	13.2	5.1
True Path Party, centre right	12.0	9.5
Republican People's Party – centre left	8.7	19.4

As the table shows, the difference among the percentage of the votes of the political parties was narrow in the 1999 election. In contrast to the claim that the electoral opportunism would be higher, the coalition government acted otherwise in 2001. In the meantime, the consequences of the 2001 crisis on the coalition parties can easily be seen in the 2002 election results. All the three ruling parties fell outside the parliament because of the deepest economic crisis in Turkey's history (according to the election system, political parties should win at least 10% to have seat in the parliament). Because it is not possible to measure the perceived cost of being outside the government, the claim that the cost of not being in the ruling position matters can be considered irrelevant.

The last argument under the title of 'Political Structure' is called 'Government Partisanship'. This approach relates the CB independence with the ideological tendencies of the ruling

parties. According to this approach, leftist parties tend to oppose CB independence and prioritize employment as they represent the working class. On the other hand, right wing parties give priority to price stability as representative of the business and middle classes. However, the empirical studies did not support the government partisanship proposition (Bernhard, Broz & Clark 2002, p.715). It is not supported by the Turkish case either given the fact that the coalition government in 2001 was led by the Democratic Left Party which was inspired by the leftist political parties of the Western Europe (Ecevit 1999).

III- Financial Needs of the Government

Another set of scholars correlate the CB independence with the financial needs of governments. For instance, North and Weingast (1989, p.821) point out that the aim of the English government to establish the Bank of England, which can be considered as one of the first central banks, was mainly to finance its war with France. According to Cukierman (1994, p.56)'s more a-historical explanation, when a government needs to borrow large amount of funds from the capital market, it needs CB independence for gaining credibility and consequently lowering the cost of borrowing.

Among the five arguments explained, financial needs argument is the one which is more or less convenient for the explanation of the Turkish case. The average Treasury borrowing rate was rapidly increased from 65% in January 2001 to 193.8% percent in March 2001 as a consequence of the financial crash occurred in 21 February 2001 where the inflation rate was about 37% (Özatay et al. 2002, p.30). Therefore, it can be argued that Turkey's financial needs increased in a very rapid fashion just before the adoption of the central bank independence in April 2001. However, financial needs could also work in the opposite direction as the government might avoid CB independence in order to be able to finance its budget deficit by printing money. Therefore, it can be argued that the choice of the politicians depends not on the financial need but on their attitude towards inflation.

IV- Ideology

Another argument explaining the CB independence is about the ideology of the policymakers. Politicians who support a Keynesian approach to economic management or who have an interventionist approach might avoid an independent central bank. Again this claim cannot be supported by the Turkish case. The coalition partners had different orientations in terms of their economic understanding. As stated before, the biggest partner of the coalition was the Democratic Left Party which adopts the social democratic values. The other partners of the coalition were the centre right Motherland Party and Nationalist Movement Party. Given the existence of very different ideological stances within the government, the explanation of ideology is far from being helpful to understand the Turkish case.

V- Economic Openness

As opposed to the previous approaches, economic openness view take into account the international forces along with domestic circumstances. According to Maxfield (1997, p.33), the openness of the economy in the developing countries determines the extent of CB independence. She claims that in an open economy, governments have no power on the international capital in contrary to the closed economies. Therefore, they seek to raise their credibility in the eyes of international capital in order to receive international funds and to lower the cost of borrowing. The likelihood of an independent central bank depends on (1) existence of balance of payments difficulties (2) the expected effectiveness of the CB independence on the creditors (3) whether politicians expect longer terms in office (4) extent of financial regulation in the country.

The economic openness view on the CB independence does not provide a strong argument in Turkish case since like other approaches analysed so far, it cannot explain the timing of the

central bank reform. Turkey has been an open economy since 1980 and complete liberalization of the capital account occurred in 1989 (Öniş 2003, p.3).

VI- Criticism

Apart from the counterarguments supported by the empirical studies and the Turkish case, these five approaches have some common problems. While all the five approaches that listed above might explain the CB independence to some extent, they have two basic weaknesses in giving full explanation of the concept of CB independence. The first problem is that almost all of them tackle the autonomy of the central bank in a country as an isolated issue and they do not take into account the international context. The role of the international public institutions is not included in these five approaches. The differentiation between developed and developing countries is also missing. The second criticism that can be raised against these approaches is that they lack historical context. These mainstream a-historical approaches highlight the importance of the factors such as politicians seeking re-election, various interest groups affected by the monetary policy, financial needs of the government etc. which were present also before the 1980s. However, the widespread adoption of the CB independence first among the developed countries and then its diffusion into the developing world did not happen until the late 1980s. Likewise, the CB independence in Turkey cannot be understood without understanding the historical context of the CB independence in general and its diffusion into the developing world by the help of the IMF, and in case of the East Europe and Turkey by the help of the EU.

In the next part, as an alternative to the above approaches, the CB independence will be explained in an historical context and Turkey's story will be located within this context.

CHAPTER 2: HISTORICAL CONTEXT OF THE CENTRAL BANK INDEPENDENCE AND TURKEY

I- History of Central Bank Independence

Central banks have a long history as the establishment of the first central banks goes back to the 17th century. However, their relations with the governments, their functions, objectives, institutional structures and their level of independence have showed great diversity since the beginning. In case of a completely dependent central bank, monetary policy is directly set by the government. At the other end of the scale, in case of a completely independent central bank, the government confers monetary policy to the management of the central bank and 'is restricted by statute from interfering with the agent's freedom of action in the monetary domain' (Bernhard, Broz & Clark 2002, p.695). Until recently, most of the central banks in the world used to serve according to the policies of the governments and their objectives included pursuing high growth rate, reducing unemployment, financing government budget deficit, solving balance of payment problems and other policies in parallel with governments' economic programmes. The CB independence issue did not get special attention until the second half of the 20th century (Turkish Central Bank 2012, p.6).

Bibow (2013, p.3) explains the rise of CB independence since the late 1980s by 'the role of peculiar German traditions in spreading CB independence across continental Europe, while its global spread may be largely attributable to the rise of neo-liberalism' Maxfield (1997, p.3) lists the possible reasons as 'the end of the fixed exchange rate system devised at Bretton Woods, the seeming ineffectiveness of monetary policy in regulating the trade-off between inflation and unemployment, the globalization of financial markets, and European economic transformation, including integration and post-Communist transition'. The CB independence has been one of the main features of the economic reform programmes in both developed and developing countries over the past two decades (Maman & Rosenhek 2007, p.2). In parallel

with the trend, the presence of a fully independent central bank is also one of the conditions that every EU candidate country should meet before membership.

II- Turkey

Before the 1990s

As a matter of fact, the institutional structure and the level of autonomy of the Central Bank of Republic of Turkey used to change in parallel with the global economic developments from the very beginning. This relation can be seen as a reflection of the connection between the broader global economic order and Turkey's economic policies. After the foundation of the Republic in 1923, Turkey's economic structure has always been deeply influenced especially by the changes in the Western economic order.

The first central bank law entered into force in 1930 (Turkish Central Bank 2012, p.13). Rather than being an ordinary governmental institution, the central bank was established as a semi-private entity formally labelled as 'corporation' in order to create a central bank independent from political influence. As another measure for independence, the law enabled governmental institutions getting at most 15% of the equities of the bank. Also, the central bank was prohibited from public financing by the same law.

Nevertheless, the tendency to grant independence to the CB has changed in Turkey in parallel with the developments in the world after the Second World War. The exchange rate system planned in Bretton Woods at a global economic summit provided an exchange rate anchor for price stability which made CB independence less favourable as a tool for the stability. In parallel with the global unpopularity of the CB independence and the rise of interventionist policies in the world, Turkey's central banking law was revised 22 times in total most of which were done in the 1950s and 1960s (Turkish Central Bank 2012, p.14). These revisions worked mostly against independence as the shareholder composition was changed for the

benefit of the government and the ban on public financing was removed. Turkey has also adopted a centrally planned economy approach in the 1960s and started to issue five-year development plans with the first one covering the period 1963-1967. In line with the more interventionist understanding, a totally new central bank law was enacted in 1970 which made the bank an ordinary public institution supporting the government's development plans (Turkish Central Bank 2012, p.14). According to the law, it became mandatory for the bank to make its monetary policy in harmony with the development plans and annual plans of the government. Hence, it can be said that the law in 1970 made the central bank far more dependent in comparison with the former law as a consequence of more centrally planned and more interventionist economic policy. After the adoption of the new law, the central bank functioned under almost total control of the government without major changes in its status until the mid 1990s.

In the meantime, the understanding of the academics and policymakers in the world evolved into a point which is more favourable to the CB independence. The devaluation of the dollar relative to the gold in 1971 made the global fixed exchange rate regime collapsed. Since the dollar lost its status as the price anchor, countries which had been in the Bretton Woods system looked for a new anchor. Therefore, CB independence started to be considered as an alternative anchor for price stability. In the same years, CB independence gained popularity not only in the practice, but also in the theoretical field. Until the 1970s, it was thought that there was a consistent negative relation between unemployment and inflation based on the study of the William Phillips who found out the relation in 1958 by examining the United Kingdom's past unemployment and inflation figures. The evidence of this connection made policymakers believe unemployment levels can be arranged by the help of monetary policy. However, it was realized in the 1970s that monetary policy does not have impact on unemployment in the long run. Also, by the introduction of the rational expectations theory,

economists started to claim that the impact of inflation on employment is valid only if it is unexpected (Maxfield 1997, p.8).

Once the ineffectiveness of monetary policy in the long run was hypothesized, policymakers started to believe that monetary policy could not be used to reach a desired level of unemployment. But, CB independence was adopted neither by the most of the countries in the world nor by Turkey in the 1970s. It was the 1990s when the rise of the CB independence occurred.

In parallel with the global trend, Turkey has experienced a substantial transformation starting with the liberalization programme in January 1980 which moved Turkey from a centrally planned, inward oriented economy based on import substitution to an export-led open economy. This rapid transformation brought macroeconomic instability which continued until the financial collapse in February 2001. Three major crises happened during this period: in the years 1994, 2000 and 2001. The main reason behind these three crises is described as ‘transition from the import-substitution model to neo-liberal reforms without a parallel transition and institutional adaptation from an inward-oriented developmentalist state to an outward-oriented competition state’ (Öniş 2009, p.411). Especially after the full capital account openness in 1989 without adopting necessary regulatory institutions and legislation and with lack of fiscal and monetary discipline, the Turkish economy became heavily dependent on speculative short-term foreign capital flows.

The 1990s: The impact of the IMF and the EU on Turkey’s economy

As stated before, Turkey left the state led developmental approach and adopted the export oriented free market economy in 1980; however since this transformation lacked the necessary institutional infrastructure, the first 20 years of the market economy was associated with highly volatile growth pattern, chronic high inflation and populist policies funded by unpredictable short-term capital flows.

The first significant attempt of the IMF to make structural reforms in Turkey was after the 1994 financial crisis which was triggered by an abrupt outflow of short term international capital. The standby agreement signed between IMF and Turkey was a commitment to apply structural reforms which were considered to be the real reason of the economic turmoil. It was because the financial crisis showed that monetary discipline is one of the mandatory principles that should be deployed in order to get rid of unstable economic performance. The reform policy was also in line with the new understanding of the Bretton Woods institutions in the 1990s. The priorities of the Bretton Woods institutions in the 1990s regarding the developing world were different than their priorities in the 1980s. In the first decade, ensuring fiscal discipline and leaving the state led model of development which involved protectionism and import substitution were the main objectives. Conversely in the 1990s, these international organizations focused on the governance issues of the developing countries (World Bank, 1992). This approach highlighted the importance of the state in preventing from the market failures and in case of a failure, fixing it. The key elements of the new framework contained the establishment of new institutions to regulate various markets. This new approach did not conflict with the essence of the liberal market economy principles, but it aimed better implementation of the liberal system (Sönmez 2011, p.114). Independent central banks and regulatory agencies constituted an important part in this transformation to the regulatory state. In parallel with this new paradigm, after the crisis, three critical reforms as a part of IMF-led programme enabled the Turkish Central Bank to pursue relatively more independent monetary programme. First, short-term advances provided to the Treasury by the Central Bank were decided to be gradually restricted. According to this restriction, the total amount of advance payment provided by the bank to the Treasury would not exceed 3% of the state budget (Turkish Central Bank 2012, p.17). After the macroeconomic indicators got better by the

implementation of the short term measures such as the devaluation of the Turkish lira in order to reduce current account deficit, the support of the government to the programme declined. After one year of implementation, the standby agreement was suspended by the IMF in September 1995 since the ruling coalition government collapsed and immediate election was announced (Arpac & Bird 2009, p.140). This particular example showed that the success of IMF led regulation reform in a developing country depends much on the economic and political circumstances in that country.

During the following two years, there was no clear attempt to make further reforms on the central bank in order to reduce the inflation rate or to stabilize the Turkish economy (Ertuğrul & Selçuk 2001, p.7). In 1998, a new programme under the IMF guidance which aimed to reduce inflation rate and to make necessary structural reforms was launched. In the context of this programme, further reforms were implemented: as the first measure, the Treasury and the Bank agreed on the total abandonment from the financing of the Treasury. The second reform was that the monetary programmes of the Central Bank started to be publicly announced and became binding for the Bank and the Treasury. Lastly, the Bank was authorized to set the short term interest rates which have great importance in achieving the targets of the declared programmes (Turkish Central Bank 2012, p.17)

In contrast to the intensive involvement of the IMF, the EU was at the backstage in the 1990s because of lack of any incentive it can provide to Turkey. The Turkey - EU relations can be traced back to 1959 when Turkey applied for being a member of European Economic Community just after the application of Greece. After the formal application, it became an associate member initiated by the Ankara Agreement in 1963. In 1987, Turkey applied again for full membership to the European Community outside the context of the Ankara Agreement, but it was rejected in 1989 based on the argument that Turkey did not meet the basic economic and political criteria for full membership. The timing of the application was

not particularly good as the Community had recently expanded by the accession of Spain and Portugal and next step for the EU was to deepen the integration process. The recommendation of the Community to Turkey was to give priority to Customs Union negotiations. In parallel with the Ankara Agreement, a Customs Union Agreement was signed by Turkey and the EU in February 1995 and put into effect in 1 January 1996 which abolished 'tariffs and quantitative barriers to trade between the parties and applied a Common External Tariff to imports from third countries' (Çarkoğlu & Rubin, 2004).

In spite of the Customs Union, the relationship between Turkey and the EU did not go well in the following years. In December 1997, Turkey was not given a pre-accession strategy as the other eleven candidate countries. Rather, Turkey was only included in the enlargement process (Eralp 2000, p.2). Turkish political elite was not satisfied with the fact that they could not receive candidacy status, and in return, Turkey suspended policy dialogue with the EU (Kuniholm 2001, p.3).

In 1998, the first progress report of the European Commission on Turkey stated that the members of the EU 'will be required to respect the stability and growth pact and to renounce any direct central bank financing of the public sector deficit and privileged access of public authorities to financial institutions and to have completed liberalisation of capital movements' (European Commission 1998, p.47). It was pointed out in the report that The Central Bank of Turkey was not independent from the government. The report indicated that according to the legislation, most of the monetary policy decisions were taken by the government or by mutual decision of government and bank management. It was also stated that Turkey did not comply with the Treaty on the issue of central bank financing of the budget deficit. However, the report did not have any effect in practice, since Turkey had no incentive to listen to the EU's policy advices without any membership vision.

The situation changed radically in 1999 when the European Council decided to welcome Turkey as a candidate country in the Helsinki Summit. This time the EU strengthened its role as ‘anchor’ on Turkish economy for structural reforms, including the central bank independence (Öniş & Bakır 2007, p.5).

When we looked at the 1990s as a whole, it is safe to argue that the reform efforts led by the IMF can be still seen valuable as the Central Bank was under total control of the government before the two reform programmes of the 1990s. However, these reforms remained partial as by the end of the decade the Bank had other objectives like pursuing economic growth along with providing price stability. Also, appointment, terms of office and resignation of the central bank governors and their deputies remained to be dependent on the policymakers’ discretion. In spite of the reform attempts mentioned above, this period was ‘characterized by high and chronic inflation, volatile real output growth performance due to dependence on short-term financial flows as a major source of external financing, weakly regulated banking sector, soft budget constraints and fragmented party system as well as populist cycles’ (Alper & Hatipoğlu 2009, p.1). The macroeconomic indicators of Turkey further deteriorated towards the end of the decade; budget deficit, public debt, current account deficit, inflation, and the ratio of liabilities of financial sector to official reserves were all high were all in alarming levels (Özatay et al. 2002, p.32).

Two factors can explain this failure:

- (1) Absence of the European Union as an external anchor made the substantial reforms infeasible.
- (2) The crisis in 1994 was milder than the 2000 and 2001 crises so that policymakers in Turkey were reluctant to make radical changes.

The 2001 Crisis and its Aftermath

Turkey had been implementing an IMF led fixed exchange-rate stabilization program aiming to reduce inflation and to reduce the public debt accumulation since 1999. However, the programme started to face problems in November 2000 and IMF had to provide extra funds in order for the programme to survive. However, within a few months, it became clear that the fixed exchange rate regime cannot be sustained because of huge amounts of capital outflow. As a result, the fixed exchange rate mechanism was replaced by the free floating exchange regime in coordination with the IMF in February 2001 (Akyüz & Boratav 2002 p.1).

Table 2: Indicators of the early 2001 attack on the Turkish lira

	Feb-19	Feb-20	Feb-26
Exchange Rate (Thousands of Turkish Lira/Dollar)	688	686	1080
Overnight Borrowing Rate	44%	2056%	102%
Central Bank Reserves (Billion Dollars)	27.9		22.6

Source: Derviş (2005, p.63)

As a result of the following devaluation of the Turkish Lira by more than 50%, and skyrocketing interest rates, numerous companies went bankrupt or had to downsize, unemployment increased sharply, inflation rose again and the government started to have struggle to pay its debts.

The IMF emerged as a more influential actor in the Turkish economy in this context despite the fact that the former exchange rate stabilization programme was also sponsored by the institution. It was possible because the power of the national policy makers and various interests groups weakened and IMF was able to overcome their resistance to the reform process. (Öniş 2011, p.417) describes this development as ‘the deep political impact of the 2001 crisis was not only to disempower the existing political parties in the national political arena but also to empower the IMF vis-à-vis domestic political actors, a development which had major ramifications for the subsequent phase of the neo-liberal restructuring process’.

Another factor enhancing the power of the IMF was the amount of the credit it provided to Turkey. The credit amount benefited by Turkey was 12 billion SDR which was about two times more than the credit released under the previous programme (Dikbaş 2013). As Öniş (2011, p.417) points out, ‘the amount of financial assistance not only rendered the IMF far more powerful in the policy space, but also allowed Turkey to ride over the crisis much more smoothly than would otherwise have been the case’.

The influence of the Bretton Woods institutions was also apparent as Prime Minister Bülent Ecevit appointed Kemal Derviş as economy minister just after the outbreak of the crisis (Hürriyet Newspaper 25 April 2001). Before the appointment, Kemal Derviş was a senior official at the World Bank, where he had worked since 1978 (BBC News 12 August 2002). He was appointed as an above-politics technocrat to coordinate the adjustment process and carry out negotiations with the IMF and other international actors.

Another proof of the great role of the IMF in the post crisis context and specifically in the independence of the Turkish Central Bank is the legislation process in which the Bank gained autonomy. After Kemal Derviş took office, he announced the ‘Transition to the Strong Economy Programme’ which is also known as ‘Derviş Rules’ which was consisted of the 15 legislation proposals imposed by the IMF as the precondition for signing a standby agreement (Hürriyet Newspaper 25 April 2001). In contrast to the conditions of the standbys in the previous decade, this time the IMF forced Turkey to make institutional reforms in a radical manner rather than aiming incremental improvements. The package envisaged new independent regulatory bodies and substantial reforms in various areas such as banking, public procurement, telecommunication, tobacco, sugar etc.

Although the IMF was the leading actor in the central bank reform in 2001, the role of the EU cannot be ignored. As stated before, Turkey followed the IMF led programmes also in the 1990s but no radical reforms could be possible without the EU. More precisely, one of the three conditions, namely the guidance of the IMF was present in the 1990s, however the absence of the EU as a strong external anchor and economic crises being milder than the 2001 crisis prevent Turkey from undergoing institutional reforms in the 1990s.

Öniş (2011, p.417) describes the synergy created by the EU and IMF as follows: ‘the economic conditionalities put by the Copenhagen Criteria of the EU and IMF conditionality became interlocked in the sense that the incentives provided by the EU in the direction of eventual membership rendered the task of implementing IMF disciplines easier’. The presence of the EU as an intervening variable was important in the sense that significant components of the Turkish public saw orthodox, IMF style reforms as an instrument for attaining EU membership and its associated material benefits.

The role of the EU in the reform process can easily be seen in the main policy documents. For instance ‘Transition to the Strong Economy Programme’ the role of the EU was underlined by stating that ‘from the perspective of the full membership in the EU, it is absolutely essential that Turkey finds a lasting solution to the problem of high inflation as quickly as possible, that it restores healthy public balances, and achieves stable growth’ (Turkish Central Bank 2001, p.33)

Also the Accession Partnership Document published one month before the adoption of the Central Bank Law clearly identifies the central bank autonomy as one of the ‘priorities and intermediate objectives identified for Turkey’. Under the title of ‘Economic and Monetary Union’, it is underlined that ‘modifying the law on the Central Bank in order to allow participation in the European system of central banks and completing the independence of the Central Bank from the Government’ are needed.

The role of the EU can also be seen in the annual progress reports. In all progress reports since 1998, European Commission had been criticizing the Central Bank law of Turkey, but after the reform, the Central Bank Law was welcomed in the 2001 report. It is stated in the report that ‘the independence of the Central Bank has been increased with the adoption of the amendments to the Law on the Central Bank of the Republic of Turkey in April 2001.’ The report was also positive with regard to ban on the direct public financing by the Central Bank. It is pointed out that ‘the provisions preventing the Bank from granting, advancing or extending credit to the Treasury, public establishments and institutions have been reinforced.’ (European Commission 2001, p.65)

The strong influence of the IMF and the EU continued after the Justice and Development Party (JDP) government took office in November 2002. In spite of the suspicious attitude of the international and national actors toward the Party at the beginning, the Party adopted a pro-western position. As a reflection of this position, the European Union and IMF were given an important place in the Government Programme. It is assured in the Programme that the full membership to the EU was one of the key targets of the government. It was pointed out in the Programme that the initiation of the negotiation process would be one of the priorities of the government in order to make the accession process irreversible. The determination of the government in fulfilling the Copenhagen Criteria was also underlined. The relations with the IMF was also said to be maintained in the new government (Grand National Assembly of Turkey 2002).

The reason why the newly elected JDP government strictly followed the reform programme in its first and second terms can be explained by economic and political considerations. From the economic point of view, Turkey was still in the post-crisis period with a heavy public debt and high inflation rate which was around 30%. So it was not possible for the new government

to upset IMF and international capital or to follow a heterodox economic course (Öniş 2009) (Turkish Central Bank 2014a).

In the following years, although the macroeconomic indicators showed a recovery and expansion of international liquidity strengthen the government's hand, Turkey signed a new standby agreement in 2005 with the IMF as a demonstration of the its commitment to economic reforms. Turkey-IMF standby relationship continued until the last instalment of the debt was paid by Turkey in May 2013 (Dikbaş 2013).

In the political side, although the JDP won the elections in 2002, the military with a strict secular understanding was still very powerful in civil domain, and the memory of the last military intervention was very fresh. As Cizre (2008, p.224) conveys, in 1997 the military-dominated National Security Council (NSC) announced a couple of measures to eliminate the so called 'creeping Islamization' while the Welfare Party (of which Erdoğan was a member) was in the coalition government. The pressures exerted by the military finally led to the resignation of the government, closure of the Welfare Party by the Constitutional Court and the banning of its key policymakers from active politics. Therefore, the European Union and its political conditions for the membership set by Copenhagen Criteria were vital for the JDP to resist pressures from the military. In the EC's Progress Report in 2002, the military involvement in the civil politics was criticized as follows (European Commission 2002, pp.24-25):

Military members of the National Security Council expressed their opinions about political, social and foreign policy matters in public speeches, statements to the media and declarations. They also played an active role in the debate about reforms to comply with the EU political criteria. They have been particularly active on issues such as cultural rights, education and broadcasting in languages other than Turkish.

In 2005 Progress Report, the efforts of the government on the civil-military relations were appreciated and it was encouraged for further reforms (European Commission 2005, p.14):

Since 2002, Turkey has made good progress in reforming civil-military relations. It is essential that Turkey consolidates reforms adopted in previous years and remains committed to further reforms in this area... Statements by the military should only concern military, defence and security matters and should only be made under the authority of the government, while the civilian authorities should fully exercise their supervisory function

It can be said that the dominance of the military over civil politics continued until 2011. In the meantime, the JDP faced a closure case in 2008 because of the charge of being the centre of anti secular activities. 6 out of the 11 judges in the Constitutional Court voted for the closure, where at least seven votes in favour were needed for a dissolution ruling (Tait 2008).

Between 2002 and 2011, several reforms were carried out in order to decrease the influence of the military on the civil politics. Some of them were change in the balance of the National Security Council composition in favour of civil members, enhanced parliamentary oversight of defence expenditures, reform in the Turkish Armed Forces Internal Service Law, which used to define 'the role and duties of the Turkish military and which contains articles granting the military a wide margin of manoeuvre' (European Commission 2005, p.14) etc. However, the leverage of the EU as an external anchor on political and economic policies of the government lost its significance after 2011. One of the major reasons is the fact that the threat of the military was alleviated by the government by that year. The rise of right wing parties in the Europe, growing concerns of the European citizens in the crisis context over possible economic consequences of a Turkish accession can be seen other reasons of the diminishing power of the EU on Turkish politics.

The developments in the IMF-Turkey relations were very similar to that of the EU. After the 19th and last standby agreement covering the years between 2005 and 2008, the government

did not want to sign a new standby agreement thanks to the improved macroeconomic conditions (Radikal, 19 March 2008). Finally, the last instalment of the IMF debt was paid in 2013.

When the leverage of the IMF and the EU on national politics of Turkey declined, the independence of the central bank deteriorated. There are several metrics in the literature which is claimed to assess this deterioration in legal independence of central bank by looking at appointment procedures of the governor and board members, the length of governor's term, the existence of statutory requirement to pursue monetary stability and so on (Eijffinger & Haan 1996, p.23). Some of these studies are Alesina (1988), Grilli, Masciandaro and Tabellini (1991) and Cukierman (1992). However, since there is only a weak link between legal and actual independence in the developing countries because of poor levels of rule of law and transparency, Cukierman (1992) and Cukierman, Web and Neyapti (1992) suggest a measure of real CB independence based on the turnover rate of central bank governors. The logic behind this metric is the assumption that frequent replacement of the central bank governors reflects the removal of those who challenge the government. While this method is more appropriate to evaluate CB independence in a developing country, it also becomes useless in case of an obedient central bank governor (Vuletin & Zhu 2011, p.1185). If we assess the independence of the Turkish Central Bank by measuring the legal independence or real independence based on turnover rate, we will see that there is no change between 2001 and 2014 given the fact that there has been no amendment of the central bank law and no premature resignation of the governor. On the other hand there are widespread concerns that the central bank has been under heavy pressure of the government and that its monetary decisions have been affected by the government. Those concerns, which are shared by three major credit rating agencies Moody's, Fitch and Standard and Poor's (Ant & Finkel 2014) (Hürriyet Daily News 11 August 2014) (Afanasieva 2014) and by the IMF are mainly

stemmed from the speeches of the policymakers and failure of the central bank to tighten the monetary policy when needed.

There are strong signs that the pressures coming from the government influence the decisions of the Central Bank to a great extent. For example, the IMF accuses the bank of failing to follow tight monetary policy ‘where inflation is still relatively high or where policy credibility has come into question. The fact that the realized inflation rates have been higher than the Central Bank’s targets for the last three consecutive years (2011 to 2013) can also be attributed to the dependence of the bank (Balçı 2014). The inflation expectation survey conducted by the Bank itself in August 2014 shows that the expected inflation is 8.5% by the end of 2014 as against 5% official target (Turkish Central Bank 2014b, p.2).

CONCLUSION

There are several approaches in the literature that we can make reference in order to understand why Turkey adopted CB independence in 2001 and why the government’s attitude towards its practice became problematic recently. However, we saw that five major approaches in the literature (sectoral interests, the nature of political institutions and party systems, the financial needs of government, ideology and economic openness) do not fully explain the Turkish case. Beyond the specific limitations of each approach which are described in the related parts, those five approaches share common weaknesses. First of all, they fail to take international actors into account; rather they implicitly consider an isolated economy. Another weakness of the mainstream approaches is that they are to a great extent a-historical. Most of the conditions proposed by those approaches as necessary for the CB independence used to exist in the history, but CB independence became prevalent only after the 1980s.

It is shown in this essay that three factors played the most significant role in Turkey’s adoption of the autonomy of the central bank: the role of the IMF, the role of the European

Union membership vision and lastly historical context, especially the role of the 2001 financial crisis. The severity of the crisis was also important as only partial improvement in CB independence was observed after the 1994 crisis whereas the full autonomy of the bank was adopted after the severest financial crisis in Turkey occurred in 2001.

Similar to the rise of CB independence, its recent decline and critical stance of the government against independence can also be explained by the same factors as the leverage of the two international players on Turkey has declined significantly and Turkish economy is now more robust to financial crises compared to 2001.

However, since the Turkish economy is still heavily dependent on the foreign capital, credibility of the central bank has critical importance. While developed countries, especially the US, are following expansionary monetary policies, attracting international capital might be relatively easy because of abundant liquidity. The recent deterioration in the independence of the Turkish Central Bank coincided with that kind of expansionary period in global economy. However, in case of possible global monetary tightening, the credibility of the central bank will be more important for attracting the international capital.

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