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"CENTRAL BANK INDEPENDENCE AND TRNC CENTRAL BANK CASE"

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ABSTRACT

In today's world states are combined to together. And economy became the main problem for them. Many wars and conflicts occur just for the new markets. If the economy became the main problem than stabilization of the markets is the main objective of the states. To understand stabilization we have to know the inflation concept. Inflation is a very complex subject that to control easily by the states and it can be a disaster for the states. Also for the modern economics, inflation is the main research area because it is related to the other important subjects such as employment.

According to the economists, to keep the inflation at low levels, independent bodies in the economy are very important. Independent central banks rather than government bodies keep inflation low, because independent central banks main objective is price stability, in other words it means inflation and under these circumstances I try to define the central bank independence.

KEY WORDS: Central Bank Independence, Legal Independence Index, TRNC Central Bank

CONTEXT TABLE

SECTION 1

Aim

The of aim of this study is to define the concepts of central bank independence and understand the situation of the Turkish Republic of North Cyprus and measure the legal independence of the TRNC Central Bank.

Broad Problem Area

TRNC Central Bank is a small central bank that controls the banking system. After 2001 financial crises the law for central bank changes in a way to be more independent. Actually, this concept is known in the world after the eighties which is the beginning of the globalization concept.

Problem Definition

Turkish Republic of North Cyprus is partially dependent economically to Turkey, for the currency reasons. North Cyprus is using Turkish Lira instead of its own currency, actually from the beginning there is no national currency in circulation. So TRNC Central Bank has problems to use basic functions of the monetary policy.

What are the conditions of independence? Or under what circumstances a central bank can be independence? With using these general questions the concept of independence will be defined.

Methodology

For to measure the independence of the central bank, the legal independence index will be used. The model is occurring from three parts. First part is the legal independence index, second part is the turnover rate of the governor and third part is the questionnaire to central bank executives. In this study only the legal independence index will be calculated. The others will not be considered because of the lack of time and also the whole study must be done by more than by person because there are lots of variables to be defined.

SECTION 2

BRIEF LITERATURE REVIEW

Central Bank Independence

For different political systems or for different states the nature of financial systems are depends on the habits of the politicians. If there is a strong law with together of the strong politicians that are responsible to the public than the system will be strong to the internal and external shocks. With together of the constitution, central bank has the main role in the system; it controls the money supply, the banks and the whole other things for the system. Actually these are important topics to express the situation of a financial system of a country. To clarify the statement, it will be right to explain some the central banks of the developed countries.

Bank of Canada was founded in 1934. Its directors are appointed by the government to three-year terms, and they appoint the governor, who has a seven-year term. A governing council, consisting of the four deputy governors and the governor, is the policymaking body comparable to the FOMC that makes decisions about monetary policy.

Bank of England founded in 1694 which is one of the oldest central bank. The Court of the central bank is made up of the governor and two deputy governors, who are appointed for three year-terms.

Bank of Japan was founded in 1882 during the Meiji Restoration. Monetary policy is determined by the Policy Board, which is composed of the governor; two vice governors; and six outside members appointed by the cabinet and approved by the parliament, all of whom serve for five-year terms.

The Maastricht Treaty established the European Central Bank and the European system of Central Banks which began operation in January 1999. The executive board of the ECB is made up of the president, a vice president, and four other members, who are appointed for eight-year terms. The monetary policymaking body of the bank includes the executive board and the central bank governors from each of the euro countries, all of whom must have five-year terms at a minimum.

All the central banks above, except ECB, were rooted banks that have also strong economies with. But according to the modern world competitiveness, these strong states give their central banks authority to fight with the inflation and control the system. Even for the Bank of England, has given authority for to set the interest rates. It shows that, to improve the stability against volatile fluctuation in the economy, independence of central banks become the corner stone of the markets.

"Twenty years ago and earlier most central banks in the world functioned as departments of ministries of finance. They were expected, by law custom or both, to utilize their policy instruments to achieve a myriad of objectives like high levels of growth and employment, provision of funds to government for the financing of public expenditures and to address balance of payments problems."(Cukierman, 2005) This is an issue of a settled central government which controls every thing in the country. It is an understandable process that countries thirty years ago or more than that, countries are controlled by central governments; actually everything is controlled by the central, so the word of independence is sound a bit weird for that period but after the eighties, the period of globalization, things for the central government has changed. As a process of globalization and the effects on the economy, shows the way of the future and the independence called as a simple matter for the central bank.

Talk of 'independence' occurs mainly in the context of the freedom which central banks have to conduct monetary policy without political interference. It is not the only form of independence which is relevant to central banks, but it is the best place to start. "The usual argument for an independent central bank is that governments and politicians cannot be trusted to do the right thing with interest rates. They are assumed to be driven by the electoral cycle and prone to manipulate monetary policy for short-term political gains." (B.W. Fraser, 1996, p.14)

"It is understandable that policy makers and politicians (in part in response to public pressure) should wish to squeeze as much growth as possible out of the economy – to run it a bit faster and a bit further than its capacity limits allow. In the jargon, there is a tendency to exploit the short-run trade-off between output and inflation. Even economies which have few spare resources can grow at rates above their long-term capacity limits for a time. Although it may take some time to show up, higher inflation will be the inevitable result." (B.W. Fraser, 1994, p.2) Politicians, mostly act as a way of egocentric. They are the utility maximizers that always want to be on the top or in the center of the administration. This can be interpret as, taking the power of setting the policy rules of the monetary policy usually, results with low inflation rates for the economy. But also there are some thoughts, against for these issues that are about the accountability and transparency of the central bank.

"Independent central bank can impose necessary financial discipline on policy makers and restrict them from short-sighted monetary expansion. Economic theory and empirical evidence give strong support for delegating monetary policy to the independent central banker. Although newly established central banks were generally provided with a considerable degree of statutory independence, the legal framework varies considerably from country to country and over time. In particular, weak constraints on the amount of credit granted to the government significantly reduce central banks' ability to conduct independent monetary policy. Moreover, the protection of law does not always shield central banks from political pressure. The legal provisions may be ineffective because observance of the law" (S. Maliszewski, 2000, p.2)

"The trend towards CBI is due to a combination of global as well as regional factors. Two main global factors underlie the trend towards higher CBI. One is an increased world wide quest for price stability triggered by the stagflation of the seventies and the dismal economic performance of some high inflation countries, in Latin America and elsewhere. The second factor is globalization, the gradual dismantling of controls on capital flows and the associated widening of international capital markets. Those processes reinforced the quest for price stability and raised the importance of CBI as a signal of macroeconomic nominal responsibility to domestic and international investors." (Cukierman, 2005) In today's world, everything is combined to together. One change in the domestic economy or one small decision of a government can ruin the other economies on the world. Such in a combined world, taking decisions on financial system needs qualified people. So setting the rules of the monetary policies by central bank is much better than instead of the central government or treasury ministry.

As to improve independence of the central banks Robert Sparve (2005), mentioned some of the important points of the independence the points also defined in the International Monetary Founds convergence report. To enlighten the issues, some of them are:

– Price stability is the primary objective. A specific target (e.g. a direct inflation target, the maintenance of a fixed exchange rate, or monetary aggregate targets) should be established and published.

– The central bank should determine and implement monetary policy to achieve its target without interference from the government.

– There should be a statutory prohibition for central bank board members against seeking advice, and for anyone else against giving them instructions.

– The term of office of the governor should be longer than the election cycle of the body which has the main responsibility for selecting the governor.

– A governor should only be dismissed for breaches of qualification requirements or misconduct.

– Direct government representatives should be eliminated from the policy board and probably also from the monitoring board, if either of these exists. If a government representative is a member of a policy board, this should at a minimum exclude the right to vote.

– The law should ensure that the central bank has sufficient financial autonomy to support policy autonomy, but within matching financial accountability.

– Policy and financial accountability should be clearly published. The central bank should prepare formal statements on monetary policy performance without the prior approval of the government. The statements should be forwarded to both the executive and the legislature and also published. Annual financial statements audited by external auditors should also be disclosed.

Due to the ECB, these issues are also defined in the Maastricht Treaty but there are some slight differences occur of course. Some of these important issues according to the independence of the central bank are:

– A conflict resolution process should be in place to resolve any policy conflicts between the central bank and the government by, for example, allowing the government to overrule the central bank. It should be absolutely clear to the executive, the legislature and the general public that responsibility for the results lies with the government, not the central bank, if the latter is overruled, its advice ignored or its effectiveness significantly limited by government policies.

– Lack of performance could constitute grounds for dismissal of the governor if required performance is clearly defined in terms of the primary objective and specific targets.

– If credits to the government are not strictly prohibited, they should be carefully limited to what is consistent with monetary policy objectives and targets.

– The statutory requirement for the central bank to obtain approval from the government should be in place in case the central bank needs to act as lender of last resort to insolvent institutions, if sufficient collateral is not available, in order to prevent a financial crisis affecting the financial sector as a whole.

– The central bank law should contain a procedure to be followed to provide, if necessary, additional funds to the central bank out of the government's budget. Quasi-fiscal activities should be explicitly prohibited, although temporary and clearly limited central bank credit to the government is permissible, but with the sole aim of addressing seasonality of revenues and expenditures.

Independence is defined in many ways in various studies and none of them has one meaning for it. In all studies the term defined as the freedom to act without of the government authority but this is a small part of the definition. To describe the whole term, authors divided into parts, like legal independence, financial independence, or goal independence and I will define each of the type of the central bank independence.

Types of Central Bank Independence

- Legal independence: In recent years many countries have adopted or made progress toward adopting legislative proposals removing their central banks from government control, which is, making them independent. This is the simplest way to define the legal independence. It is determine by the laws that how much independent of a central bank.

  "There is mounting evidence that the legal independence of most central banks in the world has increased during the nineties to an extent that appears to be a veritable revolution in central bank legislation. This is particularly remarkable in view of the fact that during the fourty years ending in 1989 there hardly had been reforms in CB legislation."(Cukierman, 2005)

Legal independence simply means as the independence of the central bank that is stated in the constitution or in law. Actually government has the authority on the on the treasury and by the law the treasury and central bank separated from each other and the level of independence depends on the law of central bank which is done by the politicians. There is also a funny way to express, “legal independence is still an important indicator of the policy makers' willingness to "tie their hands" and construct institutional framework capable to provide price stability” (S. Maliszewski, 2000, p.4). Do the politicians tie their hands by giving independence to their central banks? The answer is yes, but the point is how much they are tying their hands.

Legal independence exist with actual independence, because by it is alone it does not worth too much. Actual independence expresses the existing habits of the government that is related with the bank. Mostly in the developing countries the codes and the habits are different from each other. The laws can be stated clearly but the politicians treated as the codes are never existed. “Legal independence is an essential component of actual independence, but it is also of interest for several other reasons. First, it indicates what is the degree of independence that legislators meat to confer on the central bank. Second, practically all existing attempts at systematically characterizing central bank independence rely solely on legal aspects of independence” (Bade and Parkin 1984-Grilli, Masciandro, and Tabellini 1991) is defined by the authors.

- Financial independence: Financial independence means is to done the objectives of the monetary policy by the central bank. It is mostly known as the power to decide what to do with is own budget. Government or administrators can use the budget of the central bank as the source of income of the government and by knowing the income it is easy to transfer the funds to the government under the name of credits or loans.

“European Monetary Institution interprets the term financial independence with covering two aspects: first, budgetary independence and, second, the prohibition of monetary financing. EMI refers as to the budgetary independence of the central bank itself, i.e. the question whether it has the appropriate means to fulfill its tasks properly. Budgetary independence comprises such issues as rules on the management of the central banks budget, ownership issues, and the allocation of central bank profits and the coverage of potential losses. One of the crucial aspects of budgetary independence is the question whether the central bank is entitled to determine its expenses and revenues autonomously or whether the approval of a government body is needed. It is widely acknowledged that financial dependence of the central bank on government institutions may be detrimental to CBI. One of the cornerstones of CBI is the prohibition of monetary financing. There is general consensus that directs central bank lending to the government, be it in securitized or non-securitized form (i.e. advances or purchases of government papers on the primary market, overdraft facilities) has to be prohibited by law" (Dvorsky, 2004). This is the general idea of financial independence and why the governmental bodies should be separated from the bank itself. Once both parts work with together the tools and functions of the monetary policy used by the government, which has many objectives such as full employment rather than price stability. Central banks main objective is price stability and by considering price stability also deals with the inflation which is a superb matter for the public. Essentially these both objectives are conflicting with each other. Inflation or employment can not be handled with together. The policies that must be used for them are different and the outcomes of the policies are also different. While considering employment level government can use fiscal policies that can create short-term booms but it brings inflation in the long-term and this is a conflict which can create confusion about the central government.

And also the term referred as; procedures for accumulating and distributing the bank's resources that excludes any possibility of financial pressure being exerted (Baka 1994-95). Central banks are the lender of last resorts for the financial markets. For any shocks or crises occurs in the system bank, itself must intervene to prevent any big loses from the system. Political decisions of administrators also make financial markets fragile. Once politicians interfere to the policies of the central bank than it will turned into a permanent problem for the economy. Politicians are not bureaucrats, in other words they are not permanent for the government. The decisions that they make could be for short-term, and in the long-term the facts can be changed for the economy, and decisions that politicians make turned into an opposite way. Executives of central bank are not permanent also but they stay longer than the politicians and they can assign again for the same position, and different from the politicians the decisions they make are not related with the short-term speculative growth policies.

The degree of financial influence on the central bank was determined by the government's ability to set salary levels for members of the governing board of the central bank, to control the central bank's budget and to allocate its profits (Pollard, 1993). This is a power of the government that can control the members or executives indirectly by setting the salary levels. Independent central banks have its own budget to decide whether the salary levels or simple expenses but to interfere, these simple actions, indicates the desire of the politicians to control every thing that is related with authority.

- Institutional independence: Institutional independence first of all, refers to the central banks power to formulate monetary policy independently from political institutions. Moreover, it may also refer to a central bank's freedom to set the final goals of monetary policy. This is also sometimes referred to as political or goal independence (Amtenbrink, F., 2004). The essence of the institutional independence is the saying last word when conflicting with the government. Stable prices are very important for the economy. It will generates economic expansion in the long-term if the right policies applied by the government, but politicians can use the monetary policy by their own purposes. Therefore institutionally independent central bank keep the prices stable, actually by keeping prices stable central banks keep inflation stable. Substantially, right to say the last word for the monetary policy makes the central bank economically independent.

Also institutional independence defined by which is primarily defined in terms of the bank's position within the system of governmental institutions and the procedures applied in appointing and recalling the bank's authorities (Baka, 1995).

And another definition is; "independence occurs when it has full discretion and power to deploy monetary policy to attain its goals."(Fisher, 1994). Institutional arrangements that provide the central bank with a substantial degree of freedom to formulate and implement monetary policy in pursuit of its policy target.

For the ESCB the institutional independence is gathered at the ECB but the states national central banks still on duty and the principle of institutional independence of each NCB is embodied in the five basic prohibitions that apply to the state institutions of legislative and/or executive power, preventing them from influencing in any way the activities of the central bank:

1. Prohibition on giving instructions – the state institutions of legislative and/or executive power is prohibited from giving instructions to the central bank;
2. Prohibition on approving, suspending, annulling or deferring decisions – any rights of state institutions of legislative and/or executive power to approve, suspend, annul or defer decision of the central bank are prohibited;
3. Prohibition on censoring decisions on legal grounds – state institutions of legislative and/or executive power are prohibited from censoring, on legal grounds established by the law or any other legal act, the decision of the central bank, presuming, as a consequence, coordination of this decision with the institutions of political or state power;
4. Prohibition on participating in the decision-making bodies of an NCB with a right to vote – participation of representatives of state legislative and/or executive power in the decision-making bodies of the central bank with the right to vote is prohibited;
5. Prohibition on ex ante consulting on an NCB's decision – explicit statutory provisions obligating the central bank to coordinate its decisions with state institutions of legislative and/or executive power are prohibited.

- Personal independence: Personal independence is the legal status of the central bank governor and other members of the highest decision-making body. This includes appointment procedures, rules for dismissal, the length of the term of office and the possibility of a renewal of mandate, requirements for professional competence and incompatibility clauses. While the governments typically have a primary role in the appointment of the members of the central banks' highest decision-making bodies, it is widely agreed that certain limitations on the governments' appointment power increase the degree of CBI. Such limitations may include, for example, a proportion of non-government appointments or the right to nominate candidates, e.g. by the state president or by the parliament (Swinburne et al., 1991, p. 31). Executives of the central bank give the final decisions of the monetary policy. Quality of the decisions determined by the degree of the personal independence. Government can interfere indirectly the members of the central bank by setting the salary levels of them. Also ministers set the appointment procedures and appoint the governor of the central bank and set the length of term of the executives. This creates a gap in the personal independence because ministers can set a governor which can control by them or else they can interfere for the policy issues from outside. Personally dependent central banks act as a department of the government. So there will be no considerable actions for the price stability which is the main objective of a central bank. These kinds of examples are seen in the developing countries where the constitution or law is not understood and apply by the politicians. Mostly the power of the central bank used for the financing of the government debts by printing money and this creates inflation if it becomes permanent, and there are lots of examples for such issue.

- Political independence: Political independence means insulate the central bank from political influence in defining its policy objectives (Grilli, Masciandaro, and Tabellini, 1991), or it relates to its ability to choose autonomously objectives and make decisions on monetary policy. Without policy autonomy, central bank has the authority to formulate the monetary policy. Money has the greatest power in the economy and the institution that controls the money supply will have the power. For this reason classic governments wants to hold the right of printing money. In modern world the borders are diminishing by globalization and for to control financial markets become more complex for the governments. Financial markets interacts with each other, one sudden rise in the currency rates can creates big cracks in the economies. This is a fact of huge amounts of government debt which could be done by the politicians. A state face with so many different problems that has to be solved and the financial problems are the most complex ones to solve. Only of the stability for the financial markets, an independent body in the economy must decide on the monetary policy, and that is the reason why central banks must be economically independent.

"(i) the procedure for appointing members of central bank governing bodies; (ii) the relationship between these bodies and government; and (iii) the formal responsibilities of the central bank.
... This is why we identify independence with autonomy to pursue the goal of low inflation." Political independence refers to the autonomy of the central bank to set its own objectives, as well as the independent appointment of governor and board." (Grilli 1991, p.368)

- Goal independence: Goal independence is also called as the institutional or economic independence of the central bank, but whether the meanings are almost the same there are slight differences of the essence of the term with other definitions.

Goal independence means the freedom that the central bank has to select the objectives of monetary policy, whether it is low inflation, the target rate of employment, the level of GDP, and also refers that the central bank's ability to determine the goals of policy without the direct influence of the fiscal authority (Debelle and Fischer 1994). Here is the difference is the institutional independence is cover the goal independence and economic independence. As defined before for the goal independence it is the power to make decision for the monetary policy and the central bank is the final authority for the financial markets. Actually for dependent central banks, auditing on financial markets is the only objective but goal independence gives right to central banks to control financial markets with monetary policy.

Goal independence is the freedom that the central bank has to select the objectives of monetary policy, whether it is low inflation, the target rate of unemployment, the level of GDP (Debelle and Fischer 1994). It is the basic objective of the central bank to select the tools of the monetary policy; as a matter of fact this can be happen with the goal independent systems.

"The degree of policy influence was determined by the government's ability to appoint the members of the central bank governing board, government representation on this board, and whether the government or the central bank was the final policy authority." (S. Pollard, 1993) Policy independence is also goal independence in a way. In most studies, they define one meaning but the both meanings have the same contents.

- Economic independence: Economic independence encompasses those aspects that allow the central bank to freely implement policy in pursuit of monetary policy goals (Grilli, Masciandaro, and Tabellini, 1991). Again the term is very similar to those above, goal and institutional independence, but it is also a kind of definition that is defined and used by different authors.

Economic independence (sometimes referred to as operational independence) refers to the central bank's freedom to choose the policy instruments to achieve its objectives. Economic independence encompasses those aspects that allow the central bank to freely implement policy in pursuit of monetary policy goals or can be called as the ability of the central bank to choose the monetary instruments in pursuing its goals without government interference (Grilli, Masciandaro, and Tabellini, 1991).

Economic independence, on the other hand, is defined (Grilli 1991, p.368) as the freedom of a central bank to choose the instruments of monetary policy with regard to:'(i) the influence of the government in determining how much to borrow from the central bank; and (ii) the nature of the monetary instruments under the control of the central bank'. These are the simple indicators that can be seen by quick researches on the market.

Actually economic independence is referred as the freedom to choose policy tools of monetary policy to control a countries economy and financial markets of the system without of the influence of the central government. Economic independence is defined by how much influence does government has on the central bank about of the policy issues? Or can government sell its' debt securities to the central bank without any limitations. If these questions answers are yes than there is no economic independence of central bank. And for the welfare of the financial markets economic independence is a very important issue to set stabilization.

- Instrument independence: means control over the instruments that affect the inflation process, including in particular the prevention of any direct financing of government deficits (Mboweni, 2000). Direct government funding without controlling will create problem for the system and the problem is called as inflation. This occurs by, if government sold securities to the central bank and transfer huge amounts of cash flow to the fix the budget deficit, or to pay the public debt than there will be excess amount of money supply that effects the nominal prices rise at the short-term, and this will cause the inflation rise and if this happens as usual action of the government than the inflation will be a systematic problem. To prevent this kind of action from the economy, central bank must be free to use the policy tools.

Central banks are able to interfere, the markets when necessary if there is something going wrong in the market or the numbers that showed that there is going to be something bad for the system. In such cases central banks use some policy tools like discount rate ratio, open market operations and instrument independence means the freedom to use these tools according to the situation that it depends.

And therefore instrument independence is the freedom that the central bank has to pick the appropriate policies that produce a certain outcome in the economy (Debelle and Fischer 1994). And also central banks are responsible for the outcomes that occur from their actions in the economy. For that reason central banks are liable to the public and taking legal actions against them is possible but off course under the perspectives of the law.

Central bank's ability to create money is the primary source of tension between the monetary and fiscal authorities because the creation of fiat money is one source of government revenues through imposing an implicit tax on money balances. Government's fiscal operations could be viable in the long run only on condition that its current debt burden plus the present value of its expenditures equal the present value of revenues. Fiscal viability requires that the discrepancy between the debt plus expenditures and tax revenues should be financed by seigniorage. The availability of central bank credit is one of the alternatives for the government to finance its deficit. Government's fiscal decisions may limit the independence of central banks by affecting their monetary policy decisions and their financial positions. Therefore, appropriately defined limits would allow central banks to pursue monetary policies independent of government fiscal decisions and protect their financial positions, especially in conditions where access to central bank credit by governments is cheap relative to market conditions.

Pros and Cons of Central Bank Independence

In today's world there are many aspects of central bank independence. Of course there are many studies or researches that are against or support the independence of the bank. This is well run society, but public accountability can help to preserve the independence of central banks. Provided the decisions of central banks are competent to begin with, and are transparent and understood by the public, there will be less opportunity for political interference (B.W. Fraser, 1994, p.8).

Central bank accountability, as defined by the ECB, is the legal and political obligation of an independent central bank to justify and explain its decisions to the citizens and their elected representatives (ECB, 2002b, p. 45) Transparency is a related feature that has also been highly acclaimed. The consensus view is that it is desirable, not only because it enhances the accountability of the CB, but also because it affords better control of the public's expectations by the bank. This generally raises the efficacy of monetary policy and in many cases welfare as well (Cukierman, 2005, p28).

Measurement of Central Bank Independence

Measurement of the central bank independence is important for to define whether the bank is independent or not. It would be true to say that every study follows the main points of the previous study and put new information or change in away that is suitable for the research area. There are lots of studies that are declare the ways to measure independence of the bank but I would indicate about the most important ones which are also the starting point of the other measurement techniques

Grilli, Masciandaro and Tabellini are measured the independence by creating two indexes of central bank independence, one is based on economic measures of independence (with a scale ranging from zero to eight), and the other is based on political measures of independence (with a scale ranging from zero to seven). It is a simple method that can be done by looking at the general aspects of the central bank laws.

Cukierman, B. Webb, and Neyapti (1992) are measured independence by their own technique. They created indices for the legal aspect of independence. It is formed by three parts that are firstly, index of legal independence, secondly the questionnaire for the executives of the bank and thirdly the central bank turn over rate. These all parts come together and define the actual independence of the banks.

SECTION 3

BASIC STATUE of TRNC CENTRAL BANK

Turkish republic of Northern Cyprus Central Bank was established by a special law in July, 1983, with the decision of the council. Bank officially started operation at the beginning of the year 1984. By small changes of the mission, bank is still keep on its duty until now which is controlling the banking sector.

After the period of war, the Turkish bank, Ziraat Bankası operates as the Central Bank of Northern Cyprus until to the establishment of the republic.

RESEARCH on TRNC CENTRAL BANK INDEPENDENCE

Methodology

For to measure the independence of the Turkish Republic of Northern Cyprus Central Bank, I use the Cukierman, B. Webb, and Neyapti's model which is also called as the legal central bank independence.

The model followed two principles. Firstly, it has to be coded only a few narrow but relatively precise legal characteristics. Secondly, the written information is used from the charters. Additional information on how the law is applied was deliberately left out. "These principles make it possible to rank central banks by degree of independence in various legal dimensions with relatively few subjective judgments and to focus on concrete details of the law rather than on a broader but more impressionistic view of it." (Cukierman, B. Webb, and Neyapti, 1992, p.356)

The legal characteristics of the central bank as stated in its charter are grouped into four clusters of issues:

- The appointment, dismissal, and term of office of the chief executive officer of the bank.

- The policy formulation cluster, which concerns the resolution of conflicts between the executive branch and the central bank over monetary policy and the participation of the central bank in the budget process.
- The objectives of the central bank.
- Limitations on the ability of the central bank to lend to the public sector; such restrictions limit the volume, maturity, interest rates, and conditions for direct advances and securitized lending from the central bank to the public sector.

The clusters were built up from 16 different legal variables, each coded on a scale of 0 (lowest level of independence) to 1 (highest level of independence. The codes are set to a stronger mandate and greater autonomy for the central bank to pursue price stability.

Table 1

Variable Number	Variables for Legal Central Bank Independence	Weight
1	**Chief executive officer**(CEO)	0.20
	a. Term of office	
	b. Who appoints CEO?	
	c. Dismissal	
	d. May CEO hold other offices in government?	
2	**Policy formulation**	0.15
	a. Who formulates the monetary policy?	
	b. Who has the final word in resolution of conflict?	
	c. Role in the government's budgetary process	
3	**Objectives**	0.15
4	**Limitations on lending to the government**	
	a. Advances (limitations on non-securitized lending?)	0.15
	b. Securitized lending	0.10
	c. Terms of lending (maturity, interest, amount)	0.10
	d. Potential borrowers from the bank	0.05
	e. Limits on central bank lending defined in	0.025
	f. Maturity of loans	0.025
	g. Interest rates on loans must be	0.025
	h. Central bank prohibited from buying or selling	0.025

(Source: Cukierman, B. Webb, and Neyapti, 1992)

As mentioned above, the index is constituted from four parts. First part is about chief executive officer of the bank. For the policy issues of the central bank, CEO is responsible at the first place and the effects on governor from the central government, determines simple independence of the bank. Term of office of the governor, assignment of the governor, dismissal, and working different positions in different bodies of the government or in private sector, are the simple determinants of the independence of the governor.

Second part is related with the policy formulation of the central bank. This part is trying to find the official formulator of the monetary policy and right to say the final word, when there is a conflict with the government and also the central banks role in the government's budgetary process.

Third part has one question which is about the objectives of the central bank. Actually this is one of the important points in the index.

And finally the fourth section that is the most important part in the index. It has also the biggest weight. This part deals with the limitations on lending to the government. Government lending is an important issue which has to be examining by in details. For this reason fourth part has eight questions to explain, which are all enlightens from one way. Starting from, advances to government, securitized lending, terms of lending for he securitized lending, potential borrowers from the bank, limits of the central bank lending than is defined in the law, maturity of loans, the interest rates on loans and finally the index questions, does the central bank prohibit from buying or selling government securities in the primary market? All the questions are about the lending to the government that is defined in the law.

After defining all the questions, it has to be sum up together to obtain one result. The basic data on the 16 variables described in table 1 were aggregated into eight legal variables as follows. The four variables concerning the appointment and term of office of the governor of the central bank were aggregated into single variable labeled CEO, equal of the four components. The three variables under policy formulation were aggregated into a single variable by computing a weighted mean of the variables in that group, with weights of 0.5 for the resolution of conflict, 0.25 for who formulates monetary policy, and 0.25 for active role of the central bank in formulating the government budget. The objectives variable was treated separately. The first four variables for limits on lending were treated separately; the last four variables in the group were averaged with equal weights into a single variable. This aggregation produces one summary legal variable for each of the first three groups, and five legal variables for the limitations on lending group.

Findings

Under the line of the legal independence index, I researched the TRNC Central Bank law and define findings and after that I put them together to get a result. Firstly, I will interpret the findings of the central bank on table 2.

Table 2

TRNC Legal Central Bank Independence		
Variable Number		Results
1	**Chief executive officer(CEO)**	
	a. Term of office	0.50
	b. Who appoints CEO?	0.25
	c. Dismissal	0.83
	d. May CEO hold other offices in government?	0.50
2	**Policy formulation**	
	a. Who formulates the monetary policy?	0.67
	b. Who has the final word in resolution of conflict?	0.80
	c. Role in the government's budgetary process	1
3	**Objectives**	0
4	**Limitations on lending to the government**	
	a. Advances(limitations on non-securitized lending?)	0,67
	b. Securitized lending	0
	c. Terms of lending (maturity, interest, amount)	0,33
	d. Potential borrowers from the bank	1
	e. Limits on central bank lending defined in	0,33
	f. Maturity of loans	0,67
	g. Interest rates on loans must be	0,25
	h. Central bank prohibited from buying or selling government securities in the primary market	1
Aggregate legal central bank independence level		0.43

Starting from the first part of first question, the result is 0.5 which means governor has five year of term of office. Second question is about the appointment of CEO, and the result is

0.25 that means executives of the government appoints the CEO. The third question is about the dismissal of the governor which can be happen only for the reasons that are not related with the policy issues and the answer is 0.83. Fourth question is about the other duties of the governor in other offices in the government that can be happen only with permission of the executive branch and the answer is 0.5

Second part of the survey is about the policy formulation of the central bank. First question of the second part is about who is formulating the monetary policy and the answer of this question is bank participates, but has little influence and the code is 0.67. Second question is for the right of the final word when conflicting with the government; the answer is government, on policy issues clearly defined as the bank's goals or in case of conflict within the bank which has a code of 0.80. Third question is, role in the government's budgetary process and the answer is central bank active for it, and the code for this is 1.

Third part of the index is only deals with the policy issues of the central bank. The answer for this question is the stated objectives do not include price stability and the code for this question is 0.

Fourth part of the index is the most detailed section that deals with the limitations on lending to the government. First question is about the advances to the government which states advances are permitted, but with strict limits that corresponds to 0.67. Second is the securitized lending which is stated as no legal limits on lending that is 0. Third one is the terms of lending to the government that is defined as will agreed between parts central bank and the government and code is for this is 0.33. Fourth one is about the potential borrowers from the central bank which is defined as only the central government can borrow from the bank and the code is 1. Fifth question is about the limits on central bank lending, which is defined in as the shares of the government revenue that has a code of 0.33. Sixth question is about the maturity of loans, which is defined as within one year and the code for this question is 1. Seventh question is about the interest rates on loans that are lending to government must be? Answer for this question is the rates for lending are not mentioned and the code is the 0.25. Finally the last question is deals with the does central bank prohibited from buying or selling government securities in the primary market but the answer is yes and the code is 1.

Basic interpretation of the findings

The variable codes which are designed 1 to 0, shows the independence of central bank. Higher the code for a variable means higher the independence and results for the index is define the level of independence for the TRNC Central Bank under the legal frame.

I will interpret every answer briefly in order to indicate the situation of the central bank;
Variable 1-Chief Executive Officer

a. Term of office; the answer for this indicator is governors' duty in the central bank is for five years. This is defined in the 13. article of the law also in the article defines that governor can be appointed again by the ministries council at the end of term. In some of the developed countries, this period is between 6-8 years and in some of them it is more than 8 years. Basically length of the period shows, the stability of the decisions or if governor see the effects of their decisions than the following decisions on monetary policy will be more accurate.

b. Who appoints CEO; the answer for this variable is executive collectively. This is an important variable because the relationship between the government and governor is stated by law but if the governor and government decide some policies behind the closed doors than there will be no independence to consider. And if the executives or rime minister can affect the decision making process by making pressure on governor. The most independent central banks appoint the governors by board of the central bank but this process can create lack of transparency. In order to protect transparency and also the ability to control most governments appoints the governor by them selves. For the TRNC Central Bank it is stated in the 13. article.

c. Dismissal; this rule stated in the article 18 which can be interpret as dismissal can be applied only for reasons not related to policy. If governor has the freedom to give decisions for monetary policy than decisions that they make will be more efficient because governor knows that what ever happens in the market they are not directly responsible for that so when critical actions happens in the system, governor can take risky positions.

d. May CEO hold other offices in government; this is stated in the13. article in the law that only with the permission of the executive branch. Basically it means the governor cannot work in other bodies of government or in other places which is the first objective of earning money. The law states that only in such places of associations or cooperatives that is not related with money or the first objective is not earning money. Central banks are lender of last resorts, they are the boss of the markets and if executives of the central bank will have duties in other offices than the market will know the actions of the bank and they will be prepared for the situation. So this will start domino effect before the action of the central bank. For example, in a financial crisis if the actions of the bank are known before from the public to prevent the crises will be hard for them because some speculative attacks can occur and also there will be some opportunists that want to make some money. Also the executives try to use the situation of the market for their own benefit.

This is an important variable which has many different sides. We can consider from the government side, the market side and the executives side. Also the vice versa is possible. For the government side accountability has to be considered but governors must not have a position in the government because executives can interfere the policy. For the market side transparency is important for the stability of the financial system but knowing the key information before applied can collapse the market. And for the executives' side, to work in other offices may put some pressure on them and working in the public is not a preferable issue because executives can use the situation for their benefit.

Variable 2-Policy Formulation

a. Who formulates monetary policy; for this indicator answer is bank participates, but has little influence. As stated in the fifth article central bank formulates the monetary policy but together with many different objectives. For to have a control over monetary policy, using to tools of money is very important. When there is a need of liquidity money supply has to be increased by the amount or to prevent increase in the prices according to excess of cash money than money supply has to be gathered. To increase or decrease money supply, central bank uses some tools for it, discount rate ratio, open market operations and disponibility rate. Most effective one in the short-term is open market operations. It is done by selling or buying the government securities. For making the monetary policy by central bank it self, gives the best results for monetary policy and for this reason the grooving trend in the world is to make central banks more independent to achieve low inflation rates.

Northern Cyprus has no printed currency, the Turkish Lira is using instead of a national currency. So this process has lots of big effects for the monetary policy. If there is no power to print money, how the money supply can be set. The basic power of monetary policy is the money or currency. If there is no official currency, than there will be no effective monetary policy. The only thing that central bank can do is to control the financial institutions, whether to supply them credit for to be in liquid position. Or central bank can control by the credit value of the market but it is not a short-term policy and to get efficient results from policy is hard to achieve. Also central bank cannot control the foreign currency rates which have a great effect on the system. So, not having a printed currency effects monetary policy and lose control over all the financial system.

b. Who has the final word in resolution of conflict; this has no clear definition in the law that states. This is a tricky variable, because if there is a conflict for the policy issues between the government and central bank, central bank must have the right to say the final word but if government is the final authority than there will be no independence for central bank. Actually governments by themselves giving authority to central banks to achieve better results for inflation but holding the authority of to right to say the final word conflicts with the main objective. Also by saying the last word government can act as they wish so. This is dangerous, because politicians can over heat the economy before the election period and this can be seen as growing economy but in the long-term it can create financial crises and can increase the inflation. But in another way this can control the central bank. The effectiveness of this issue is directly related with the personalities of the both sides.

c. Role in the government's budgetary process; in article five, it states that if anything is asked by the government from central bank, they will give any support, they can. But if they are active in the budget, than government can take advances from central bank which is not a desirable situation. Because if this process becomes permanent than then the inflation problem becomes permanent also. According to article, central bank is not directly active but any thing is needed central bank can involve.

Variable 3-Objectives

Objectives of a central bank define the stability of that system. If a central banks main objective is price stability and including of increased independence then the financial system can be stable to the shocks that can be occur unexpectedly. Legally specified objectives indicate the level of independence of a central bank. Because specified objectives such as preventing the price stability against one of the government objectives of full employment, makes bank more independent.

For TRNC Central Bank, this is not clearly defined in the law. Central has many objectives such as supporting the government objectives of full employment, growth plans and financially stable economic system with together of their objectives of setting the credit volume and control over the banking system in Northern Cyprus. So objectives of the central bank are conflicting with the government objectives and according to this situation when a problem occurs suddenly, central bank cannot intervene directly to stabilize the system. Because there will be a huge bureaucracy to pass trough.

Variable 4-Limitations on lending to the government

a. Advances; advances to government which stated in the article 34, represents the privilege of the government to get numerous funds against debts. Advances to government defined in the law as 5 percent of governments' total budget and in any case advances cannot excess 20 percent of the central banks liabilities. This can set some limitations on the government but the customs between the central bank and government has to be known briefly to understand whether they excess these limits or not by different procedures.

In other counties the system defines the rules on this variable, like the countries that are developing and financial agreement with the IMF generally has coded 0.67, defined as the strict limits up to 15 percent of governments' revenue, because these countries has weak economies with selfish politicians that limits has to define strictly or else opportunities of bank can be used by them. Also in developed countries limits are strictly controlled by constitution that independence is a hallmark of their systems.

Amount and volume of advances are really important for an economy. If the volume is higher than the production, than there will be excess of money supply that will increase money demand also, and according to process inflation will rise, and if central bank does not intervene to rise than the inflation can cause some big crashes in the economy.

b. Securitized lending; there is no legal limits on securitized lending which is stated in the law. Actually, there are no securities or bonds that government issue for to close the debt in TRNC. But this must be stated clearly to define whether permitted or not. Because future actions of politicians will not known from anyone else, and what will happen to economy cannot definitely said by the economists.

   In the world, for a central bank to be independent in this way, the variable must be, not permitted but in the world, this variable generally is not defined in the law. This concept is not using actively until there is some problem in the financial system in economy

c. Terms of lending; is stated in the 34. article in the law. In the law it defined as, agreed between the central bank and executive. At first sight, this can be seen as a small issue but actually it is a big problem. Terms must be defined by the central bank alone, to control the interest rates that are very volatile. Also maturity must define by the central bank itself to keep the system stable. Amount is the most important one in the terms of lending variable. Because government can take what ever it is needed and if the amount is huge than taking all of them at once may cause problems. Lastly maturity is the same effects as other subjects. If government does not pay the amount at the time it matures than central bank has to supply this money from somewhere else with using tools that it has. This is an undesirable condition that costs too much for bank itself and also for the economy. This is showed that in TRNC Central Bank politicians and executives has authority act as they want in a way. Such cases occur in developing countries related with the weak political system.

For to be an independent bank, this variable must be answered by; controlled by the bank which gives the bank full authority to say last word on the lending procedures and also for the monetary issues. If the terms of lending defined strictly by the central bank, economy will survive from short-term attacks but in sometimes governments really needs that advances to keep on road and related with the law, executives cannot get advances from the bank to fulfill the commitments that they has to. So to fulfill the commitments, governments get foreign credit or loan that has heavy responsibilities with strict rules. It will be right to say that for to prevent the financial systems sometimes central banks give more damages.

d. Potential borrowers from the bank; this is stated in the 34. and 37. articles in the law that only central government can borrow from the central bank. This is not clearly defined in the law. The more institution borrows from the central bank, the more central bank has to give and control. And if there are more potential borrowers, than the volume of money will be high and than inflation occurs. Also if the number of borrowers increases the terms of lending changes and the financial system is affecting from it. Because there will be several terms of credits than is given by the bank and setting the interest rate interval will be huge.

   For this variable, the most independent explanation is only the central government borrows from the bank but this is not a full independent explanation. Because for to be the independence of central bank, government cannot borrow from the bank directly. Also by this explanation, this variable conflicts with the above variables.

e. Limits on central bank lending defined in; the 34. article of the law which is stated as the shares of the government revenue. Central bank can give advance to the government as 5 percent of the governments' budget or with not excess 20 percent of the central bank liabilities total. This is an important variable that defines the limitations to government lending. If central bank gives without any limit on credit than regime takes when ever need and it will create the problems that I mentioned above like high inflation, lack of administration, beneficial politicians and so on.

f. Maturity of loans; this is not mentioned briefly in the law. Only in the 34. article; the loans must be paid in short-term. This is a general definition that can be within one month or one year. In practice, loans are paid back within one to central bank. Mostly loans are taking by government to balance the budget at the end of financial year.

Maturities of loans are important for the shocks that can be occurred in the economy. If the maturities of the loans getting longer and an economic shock occur, the ability to pay back the loan to central bank will be very hard and also for the next budget period, central bank will be in a difficult situation to fund back the government. So maturities must be defined and control very carefully.

g. Interest rates on loans must be; in the law, interest rates are not mentioned by exact numbers. It is defined as the rates will be agreed by the parts together. It is dangerous for the funding capability of central bank because if government takes at very low rates by huge amounts than there will be less reserve to feed the market.

   In practice, the rates that central bank use are around the market rates, it will be always below from the market rates but not too much to become the only source of the government or to become an advantage of government because central banks first objective is to watch banking sector to keep market stable and whenever needed, they fund banks to prevent from any crashes. So for to be an independent central bank, interest rates must defined solely by the bank.

h. Central bank prohibited from buying or selling government securities in the primary market; TRNC government is not issuing securities or treasury bonds to reach the funds. So practically, central bank cannot buy or sell the securities from the primary market.

   Actually central bank is prohibited from this kind of operations. This is an important issue for the central bank, because governments use this opportunity to fund back their budgets or for other expenses. But central bank is the governments' financial agent to do the procedures for to sell or buy for the government.

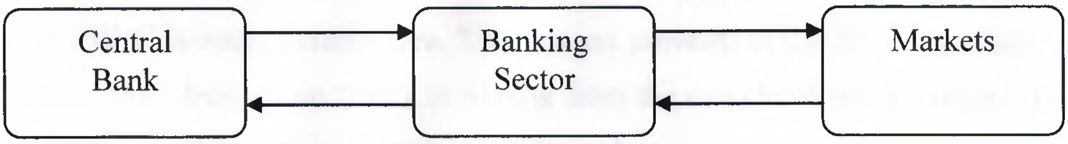
SECTION 4

Conclusion

In this section, I will interpret the overall findings and results, to have knowledge about the independence concept of TRNC Central Bank.

Independence is a very big concept which is very difficult to define every aspect of it. According to some empirical works, effects of independence on economy are not clearly defined, it may decrease the inflation also or do nothing on the economy, this happens mostly in developed countries.

TRNC Central Banks' main duty is to watch and control the banking sector. Banking sector is very important for TRNC, because the only way to control the financial sector happens with the banking sector. This is a partial control which has little influence on the whole system but it is the only way. Under these circumstances central bank is important for the welfare of the system, and being independent of the bank is defines the efficiency of the market. This could be explained in a small diagram.



This is a basic way to show the operating logic of the system. Central bank is the starting and the ending point of the system. Whenever banks need funds to be liquid for the short-term obligations, central bank supply funds for them to keep stable the system. But in here the independence concept is very important. Because for to do these actions, central bank must be instrumentally independent. Otherwise government can take funds for the deficits that occur in the budget or public organizations can take funds instead of the banks. So the systems main object will change in a way that banks cannot find funds to operate efficiently in the short-term and if this event continues for a long period banks will bankrupt one by one and the market will be in a very difficult situation. This is exactly happened for the TRNC banks. So independence is very important for the system.

Also by being independent from the government authority, central bank can operate efficiently, keep inflation at low levels and will stabilize the economy.

The effects of independence of central bank on the Northern Cyprus economy are seen after the changes in the central bank law. There are rooted changes in the law after the 2001 crises which effected whole of the economy. Of course it is not a full independent central bank but it makes lots of progress for the welfare of the economy. Firstly the term of office of the governor has changed to five years, than the right to hold offices of governor in other parts of the government has changed; now central bank only deals with the monetary policy issues. And the biggest change is in the lending procedures to the government, it is now decreased from 15 percent of the government budget to 5 percent of the government budget. And also funding to public sector is completely prohibited. This creates big changes in the economy. With together these variables the actual independence is very important. The legal procedures and its applications can be different, under this context the personality of the governor and the personalities of the executives are very important. The relationship between these parts defines the actual independence.

There is another difficulty that central bank has to cope with which is full dolarization concept. TRNC is using Turkish Lira. This process prevents to use the tools of the monetary policy. So every decision on policy is coming from the outside. With this issue central bank cannot be independent but can be partially independent.

Finally, Northern Cyprus Central Bank proceed lots of thing with together of the changes that occurs and also there are lots of things to achieve that are waiting. So, by more independence of the central bank the banking system will be more efficient.

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