

ON THE INDEPENDENCY OF THE CENTRAL BANK OF THE TURKISH REPUBLIC OF NORTHERN CYPRUS

KUZEY KIBRIS TÜRK CUMHURİYETİ'NDE (KKTC) MERKEZ BANKASI'NIN BAĞIMSIZLIĞI

Okan Veli ŞAFAKLI

*Near East University
Department of Banking and Finance
osafakli@kibris.net*

Hüseyin ÖZDEŞER

*Near East University
Department of Economics
huseyinozdeser@yahoo.com*

ABSTRACT: Within the frame of discussions focusing on the provision of price stability, the central banks that attempt to enhance their independence have increased recently. Scientific studies in this field tend to support this discussion. The Central Bank of Turkish Republic of Northern Cyprus (TRNC) has been exceptional case due to the fact that Turkish Lira has been in circulation as a legal tender during the period of dollarization; and there is no relation between its inflation target and monetary policy.

JEL Classifications: E31 ; E52; E58; K20

Keywords: Central Bank independence; Legal aspect ; TRNC

ÖZET: Genel eğilim olarak fiyat istikrarını artırma yönünde odaklaşan tartışmalar çerçevesinde, Merkez Bankaları son zamanlarda bağımsızlıklarını artırma yönünde girişimde bulunmaktadırlar. Bu alanda gerçekleştirilen bilimsel çalışmalar ise bu tartışmaları destekler nitelik taşımaktadır. KKTC'de dolarizasyon kapsamında kanuni para olarak Türk Lirası'nın (TL) kullanılması ve dolayısıyla enflasyon hedefi ile para politikası ilişkisinin ortadan kalkması gerçeğinden hareketle Merkez Bankası bağımsızlığında KKTC istisnai bir vaka olarak ele alınmıştır.

Anahtar Kelimeler: Merkez Bankası bağımsızlığı ; Yasal yön ; KKTC

JEL Sınıflaması: E31 ; E52; E58; K20

1. Introduction

Most countries have implemented reforms designed to grant their monetary authorities greater independence from direct influence. These reforms were justified by studies showing independent central banks of industrial countries are associated with lower levels of inflation although this link is not previously evidenced for developing countries (Alesina and Summers, 1993; Cukierman, 1992). However, subsequent research by Cukierman et al. (2002) shows that legal CBI and inflation are negatively related in both developed and developing countries. Both theory and experience suggest that more independent banks develop superior monetary policy, thus providing an incentive for this trend. Consequent to the latter, a remarkable trend has been observed toward magnifying independence (Mishkin, 2007: 326). This has been accompanied by a wave of legislations to confer independence on certain central banks (the Reserve Bank of New Zealand in 1990, the Bank of France 1994, the Bank of England in 1997, the Bank of Japan in 1998, the European Central Bank from its creation in 1998) (Coleman, 2001: 729; Mishkin, 2007: 325-326). While the Federal Reserve is considerably independent central bank, the Maastricht Treaty, which established the Euro system, has made the latter

the most independent central bank in the world. The Maastricht Treaty specifies that the paramount, long-term goal of the ECB is price stability. The Euro system's concession cannot be changed by legislation; it can be changed only by revision of the Maastricht Treaty- a difficult process because *all* signatories to the treaty must agree to accept any proposed change (Mishkin, 2007: 324).

Parallel to developments taking place across the world, and particularly after the banking crises which have occurred in 2001 the TRNC Central Bank's legislation has been revised, which targets to increase the autonomous independency and the effect of the central bank of TRNC (Şafaklı, 2003).

In this study, central bank independence of TRNC will be measured and compared to other countries by using the broadest employed index focusing on laws (Cukierman et al., 1992).

2. Brief Literature Review and Research Methodology

Central bank independence can be defined as the independence from political influence and pressures in the conduct of its functions, in particular monetary policy (Casu et. al., 2006: 127). Central-bank independence relates to three areas in which the influence of government must be either excluded or drastically curtailed (Hasse, 1990): independence in personnel matters, financial independence, and independence with respect to policy. Not all scholars categorize the concept of central bank independence the same way, with different ones distinguishing different types of independence. Sylla distinguishes two meanings of independence: 1) political and 2) legal independence (Sylla, 1998: 25). Likewise, Fischer has defined two different types of independence of central banks: instrument independence, the ability of central bank to set monetary policy instruments, and goal independence, the ability of central bank to set the goals of monetary policy (Mishkin, 2007: 321; Debelle and Fischer, 1994). Differently, central bank independence can be divided into "political independence" and "economic independence" (Loungani and Sheets, 1997: 382; Grilli et. al., 1991; Elgie, 1998: 70). According to Issing (1993) personal elements of independence can be cited. In addition to these, Baka (1994-95) states that central bank independence is analyzed by taking into account three aspects: a) institutional independence, b) functional independence and c) financial independence.

The most widely employed index of central bank independence is due to Cukierman et. al., (1992), although alternative measures were developed by Bade and Parkin (1984), Grilli et. al., (1991), de Haan and Van 'T Hag (1994) among others.

In order to measure the degree of independence of Northern Cyprus Central Bank, the index of Cukierman, et al (1992) also called as the legal central bank independence has been used. According to this index, the legal characteristics of the central bank as stated in its charter are grouped into four clusters of issues: 1) The appointment, dismissal, and term of office of the chief executive officer of the bank; 2) 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; 3) The objectives of the central bank; and 4) 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. This four clusters were built up from 16 different legal variables as shown in Table 1, 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. This 16 variables weighted accordingly are aggregated to reach an index value for the respective country.

Table 1. Variables for Legal Central Bank Independence

Variable Number	Description of Variable	Weight
1	Chief executive officer(CEO)	
	a. Term of office	0.05
	b. Who appoints CEO?	0.05
	c. Dismissal	0.05
	d. May CEO hold other offices in government?	0.05
2	Policy formulation	
	a. Who formulates the monetary policy?	0.05
	b. Who has the final word in resolution of conflict?	0.05
	c. Role in the government's budgetary process	0.05
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
	Total weight	1.00

(Source: Cukierman et. al., 1992)

According to Cukierman's (1992) index values among the 22 industrial countries the most independent central banks were Switzerland (0.68), Germany (0.66) and Austria (0.58) while the least ones were Norway (0.14), Japan (0.16) and Belgium (0.19) (Eijffinger and De Haan, 1996: 23). Even though this was the case in 1990's most of these countries have taken remarkable steps to improve their central bank independence. Specially, the model of European Central Bank became the leader of legal independence protected by Maastricht Treaty after its introduction.

3. Case of TRNC

The independency of TRNC Central Bank is different from any other banks analyzed across the world. As understood above the fundamental argument for the independency of central banks' is to achieve price stability by pursuing independent monetary policy. However, there is no relation between the inflation target of TRNC and its monetary policy due to the fact that Turkish Lira has been in circulation as a legal tender during the period of dollarization. This makes the inflation occurring within Turkey as the basis originator of inflation for TRNC. Figure 1 illustrates the inflation for TRNC and Turkey in parallel with respect to each others.

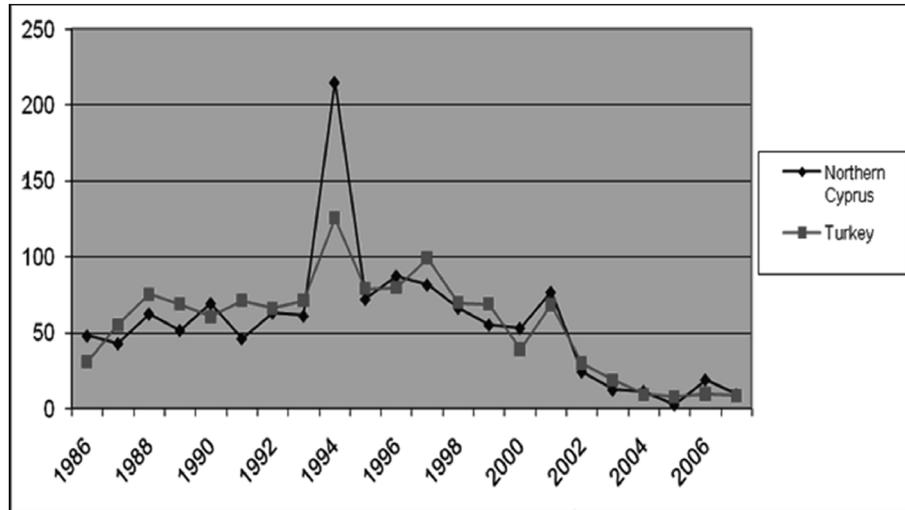


Figure 1. Inflation Rate in Turkey and Northern Cyprus (1986-2007)

Source: Northern Cyprus State Planning Organization- State Statistical Institute of Turkey

Time-series analysis as detailed below can be conducted to examine the interaction between the inflation rates of two countries.

The following table reports unit root test for inflation rates in Turkey between 1986 and 2007. To test whether the series are stationary or non-stationary, we use the Augmented Dickey-Fuller (ADF) test. The null hypothesis is that "There exists unit root". If the ADF test statistic is greater than the critical values, then we cannot reject the null hypothesis and we conclude that there is a unit root and the series is non-stationary. Non stationary series, in turn, need to be made stationary in order to complete the rest of the time-series analysis. Table 2 provides the unit-root test output. First off, we test for the existence of a unit-root in level with no trend and no intercept, with a lag specification of 1.

Table 2. Unit –Root Test Output with No Trend and No Intercept

ADF Test Statistic	-0.760759	1% Critical Value*	-2.6889	
		5% Critical Value	-1.9592	
		10% Critical Value	-1.6246	
*MacKinnon critical values for rejection of hypothesis of a unit root.				
Augmented Dickey-Fuller Test Equation				
Dependent Variable: D(TR)				
Method: Least Squares				
Date: 04/26/09 Time: 13:44				
Sample(adjusted): 1988 2007				
Included observations: 20 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
TR(-1)	-0.057827	0.076012	-0.760759	0.4567
D(TR(-1))	-0.335048	0.212467	-1.576940	0.1322
R-squared	0.156352	Mean dependent var	-2.335500	
Adjusted R-squared	0.109482	S.D. dependent var	23.42764	
S.E. of regression	22.10802	Akaike info criterion	9.124397	
Sum squared resid	8797.760	Schwarz criterion	9.223970	
Log likelihood	-89.24397	Durbin-Watson stat	2.148290	

The test-statistic of -0.76 is greater than the critical values at 1, 5 and 10% significance levels. Therefore, we are not able to reject the null hypothesis. This means the series are non-stationary. We then test for unit root with trend and trend + intercept (Table 3), but the results turn out to be similar. Next, we test for unit root at the series' first difference. The ADF test statistic is smaller than the critical t-values, therefore we reject the null hypothesis and we conclude that the inflation series becomes stationary at its first difference.

Table 3. Unit –Root Test Output with Trend and Trend + Intercept

ADF Test Statistic	-4.388371	1% Critical Value*	-2.6968	
		5% Critical Value	-1.9602	
		10% Critical Value	-1.6251	
*MacKinnon critical values for rejection of hypothesis of a unit root.				
Augmented Dickey-Fuller Test Equation				
Dependent Variable: D(TR,2)				
Method: Least Squares				
Date: 04/26/09 Time: 13:19				
Sample(adjusted): 1989 2007				
Included observations: 19 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(TR(-1))	-1.631458	0.371768	-4.388371	0.0004
D(TR(-1),2)	0.146683	0.221381	0.662580	0.5165
R-squared	0.730781	Mean dependent var		-1.124211
Adjusted R-squared	0.714945	S.D. dependent var		40.60609
S.E. of regression	21.67982	Akaike info criterion		9.089941
Sum squared resid	7990.247	Schwarz criterion		9.189356
Log likelihood	-84.35444	Durbin-Watson stat		1.993263

Now we repeat the same process for the inflation rates in TRNC. The table 4 provides the unit-root output for TRNC inflation rates at the level, no intercept and no trend.

Table 4. Unit-Root Output for TRNC Inflation Rates at the Level, No Intercept and No Trend.

ADF Test Statistic	-0.982688	1% Critical Value*	-2.6889	
		5% Critical Value	-1.9592	
		10% Critical Value	-1.6246	
*MacKinnon critical values for rejection of hypothesis of a unit root.				
Augmented Dickey-Fuller Test Equation				
Dependent Variable: D(TRNC)				
Method: Least Squares				
Date: 04/26/09 Time: 13:56				
Sample(adjusted): 1988 2007				
Included observations: 20 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
TRNC(-1)	-0.139217	0.141669	-0.982688	0.3388
D(TRNC(-1))	-0.463384	0.206419	-2.244866	0.0376
R-squared	0.316667	Mean dependent var		-1.680000
Adjusted R-squared	0.278704	S.D. dependent var		51.37183
S.E. of regression	43.62966	Akaike info criterion		10.48399
Sum squared resid	34263.85	Schwarz criterion		10.58356
Log likelihood	-102.8399	Durbin-Watson stat		2.144018

As the t-statistic reveals, we are not able to reject null, therefore the series are non-stationary. Repeating the unit-root testing with trend and intercept reveals similar results (Table 5). We, in turn, look for a unit-root in the series' first difference.

Table 5. Unit-Root testing wit Trend and Intercept

ADF Test Statistic	-7.860098	1% Critical Value*	-2.6889	
		5% Critical Value	-1.9592	
		10% Critical Value	-1.6246	
*MacKinnon critical values for rejection of hypothesis of a unit root.				
Augmented Dickey-Fuller Test Equation				
Dependent Variable: D(TRNC,2)				
Method: Least Squares				
Date: 04/26/09 Time: 13:56				
Sample(adjusted): 1988 2007				
Included observations: 20 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(TRNC(-1))	-1.530291	0.194691	-7.860098	0.0000
R-squared	0.764795	Mean dependent var		-0.235000
Adjusted R-squared	0.764795	S.D. dependent var		89.88057
S.E. of regression	43.59023	Akaike info criterion		10.43625
Sum squared resid	36102.06	Schwarz criterion		10.48604
Log likelihood	-103.3625	Durbin-Watson stat		2.199574

At first difference, we are able to reject null and the series have become stationary at their first difference. Now that both series have become stationary at their first differences, we can conclude that both series are integrated of order 1. We can now test for co-integration between the series. In order to do so, we need to examine the properties of the regression residuals. The first step is to estimate the least squares regression (Table 6).

Table 6. Least Squares Regression

Dependent Variable: TRNC				
Method: Least Squares				
Date: 04/26/09 Time: 14:42				
Sample: 1986 2007				
Included observations: 22				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-8.665612	9.716077	-0.891884	0.3831
TR	1.176565	0.153642	7.657817	0.0000
R-squared	0.745684	Mean dependent var		56.09091
Adjusted R-squared	0.732968	S.D. dependent var		43.42982
S.E. of regression	22.44243	Akaike info criterion		9.146292
Sum squared resid	10073.26	Schwarz criterion		9.245478
Log likelihood	-98.60921	F-statistic		58.64216
Durbin-Watson stat	2.260558	Prob(F-statistic)		0.000000

Next, we generate the residuals from the regression equation. Finally, we perform a Dickey-Fuller test by regressing the change of residuals (dres) on lagged residuals (lagres) and the lagged term (laggedterm) (Table 7).

Table 7. Dickey-Fuller Test

Dependent Variable: DRES				
Method: Least Squares				
Date: 04/26/09 Time: 14:38				
Sample(adjusted): 1988 2007				
Included observations: 20 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
LAGRES	-0.996696	0.357764	-2.785904	0.0122
LAGGEDTERM	-0.116985	0.232405	-0.503368	0.6208
R-squared	0.575490	Mean dependent var		1.067867
Adjusted R-squared	0.551907	S.D. dependent var		33.72129
S.E. of regression	22.57296	Akaike info criterion		9.166022
Sum squared resid	9171.693	Schwarz criterion		9.265595
Log likelihood	-89.66022	Durbin-Watson stat		1.886922

Since the calculated Dickey-Fuller test statistic -2.786 is less than the 5% critical value of -1.96, we reject the null of no co-integration. The variables, therefore, are co-integrated.

3.1 Monetary Targeting in TRNC

With the contribution of the State Planning Organization, alternative to the central bank at the technocrat level, government determines development plans and annual programs for the economic targets in TRNC. Especially the “Program for 2008” specifies %5 of real growth rate, and %5 of inflation has been targeted (SPO, 2007). Both the real and sectoral plans are based upon the growth rate. Despite of the fact that finance and budget policies are not included within the economical programs, monetary policies are not also included within the economical targets and this fact is reflected within the annual reports. Because the TRNC Central Bank acts as “Banking Regulation and Inspection Institute” rather than nourishing monetary policy with respect to the economical targets (TRNC Central Bank, 2006).

Consequently, TRNC Central Bank does not have a clear target in constituting price stability. Granted that the considerable part of inflation in TRNC is the result of the “Purchasing Power Parity” which ascends from Turkey, while the remaining part is the result of peculiar demand and cost factors of TRNC.

3.2 The Degree of Central Bank Independence in TRNC

By using the Cukierman et al. (1992), legal independence of Central Bank in TRNC has been measured by examining the TRNC Central Bank law (Law No 41/2001).

Table 8. Legal Central Bank Independence of TRNC

Variable Number	Description of Variable	Weight	Assigned Numerical Coding	Weighted Result
1	Chief executive officer(CEO)			
	a. Term of office	0.05	0.50	0.0250
	b. Who appoints CEO?	0.05	0.25	0.0125
	c. Dismissal	0.05	0.83	0.0415
	d. May CEO hold other offices in government?	0.05	0.50	0.0250

Table 8. Continue

2	Policy formulation			
	a. Who formulates the monetary policy?	0.05	0.67	0.0335
	b. Who has the final word in resolution of conflict?	0.05	0.33	0.0165
	c. Role in the government's budgetary process	0.05	0.80	0.0400
3	Objectives	0.15	0	0
4	Limitations on lending to the government			
	a. Advances (limitations on non-securitized lending?)	0.15	0.67	0.1005
	b. Securitized lending	0.10	0	0
	c. Terms of lending (maturity, interest, amount)	0.10	0.33	0.0330
	d. Potential borrowers from the bank	0.05	1	0.0500
	e. Limits on central bank lending defined in	0.025	0.33	0.0082
	f. Maturity of loans	0.025	0.67	0.0167
	g. Interest rates on loans must be	0.025	0.25	0.0062
	h. Central bank prohibited from buying or selling government securities in the primary market	0.025	1	0.0250
Aggregate legal central bank independence level				0.43

Interpretation of the results above (Table 8) according to variable basis can be given as follows:

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 Article 13 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 and decisions on monetary policies could be changed accurately according to their impact.
- 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 then there will be no independence to consider. And if the executives or prime minister can affect the decision making process by putting 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 themselves. For the TRNC Central Bank it is stated in the Article 13.
- c. Dismissal; this rule stated in the article 18 which can be interpreted as dismissal is requested only with conditions which are not related to policy. If governor has the freedom to give decisions upon monetary policy, then the corresponding decisions could either be safe or risky. Because in the state of unexpected consequences governors can take risky standpoint.

- d. May CEO hold other offices in government; this is stated in the Article 13 of the law that only with the permission of the executive branch. Basically it means that the governor cannot work in other bodies of government or in other places which is the first objective of earning money. The law prescribes 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 bosses of the markets and if executives of the central bank will have duties in other offices then 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 or the executives side. Also the vice versa is possible. From 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 it to have 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 required reserve ratio 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 being using instead of a national currency. So this process considerable impact on 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, then there will be no effective monetary policy. The only thing that central bank can do is to control the financial institutions, or to supply them credit for to be in liquid position. Or central bank can control with the credit value of the market but it is not a short-term policy and it's hard to get efficient results from policy. 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 so. 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 then there will be no independence for central bank. Actually governments by themselves give authority to central banks to achieve better results for inflation but hold the authority of to right to say the final word on 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 then the inflation problem becomes permanent too. According to article, central bank is not directly active but in case if 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 together with 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 through.

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 exceed 20 percent of the central bank liabilities. This can set some limitations on the government but the customs between the central bank and government should be known briefly to understand whether they excess these limits or not by different procedures.

In other countries 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 should be defined 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, then there will be excess money supply that will increase money demand too, and according to process inflation will rise, and if central bank does not intervene to rise than the inflation can cause some big crashes on the economy.

- b. Securitized lending; there are no legal limits on securitized lending which is stated in the law. Actually, there are no securities or bonds that government issue 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 be known from anyone, and what will happen to economy cannot exactly be explained by the economists.

For a central bank to be independent in this way, the variable should be known but not permitted. Generally this variable is not defined in the law. This concept is not often used regularly until there is problem in the financial system within the economy.

- c. Terms of lending; is stated in the 34. Article in the law. It is agreed between the central bank and executive. At first glance, this can be seen as a small issue which is essentially significant. Terms and maturity must be defined 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 whatever is needed and if the amount is huge then taking all promptly may cause problems. Ultimately, maturity is the duplicate effect as the other subjects. If government does not pay the amount on time, it matures then 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 too. This shows us that in TRNC Central Bank politicians and executives has authority as they like. Such cases occur in developing countries related with the weak political system. In order to be an independent bank, the bank should be fully authorized to say the final word on lending procedures and also for the monetary issues. If the terms of lending defined explicitly and held strictly by the central bank, economy will survive from short-term attacks but governments may feel the need for privilege to keep things working on track accordingly to the law. Executives cannot get advances from the bank to fulfil the commitments that they have to. In order to fulfil the commitments, governments get foreign credit or loan that has heavy responsibilities with strict rules. It will be right to say that banks may sometimes give more harm when trying to protect the financial systems.
- d. Potential borrowers from the bank; this is stated in the 34. And 37. Articles in the law, which states 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. In case of increase in the number of potential borrowers, the volume of money will be high, leading to the occurrence of inflation. If also the number of borrowers increases, the terms of lending will change consequently affecting the financial systems. Reasons for this are that there will be several terms of credit given by the bank and setting the interest rate interval will be immense.

For this variable, the most independent but not full explanation will be to say that only central government could borrow from the bank. Note that government cannot borrow from the bank directly as in the circumstance where it is independent from the central bank. With this explanation, mentioned variable conflicts with the above variables noted.

- e. Limits on central bank lending defined in; the 34. Article of the law defines 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 in total. This is an important variable that defines the limitations to government lending. If central bank gives without any limit on credit than regime may take place whenever needed, and the above mentioned problems of high inflation, lack of administration, benefit to politicians and etc. may materialize.
- f. Maturity of loans; is not defined in the law. Only in the 34. Article; the loans must be paid in short-term. This is a general definition that could ensue within a month or a year. In practice, loans are paid back within a year back to the central bank. Governments generally adopt loans to balance the budget at the end of the financial year.

Maturities of loans are important for the shocks that could occur in the economy. If the maturity of the loans expires in a long period then economic shocks may occur. The ability to pay the loan back to the central bank will be very difficult and additionally during the succeeding budget period, central bank will be in a complex status to fund back the government. So maturities must be defined and controlled accurately.

- g. Interest rates on loans must be; in the law, interest rates are not acknowledged by exact numbers. It is hazardous to the funding capability of the central bank, because if government takes loans at very low rate with huge amounts then 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 the market rates but not too extreme 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 in equilibrium whenever it is needed, and funds back to prevent any possible crashes. So in order to be an independent central bank, interest rates must be defined solely by the bank.
- h. Central bank prohibits buying or selling of government securities in the primary market; TRNC government does not issue securities or treasury bonds to hold on to the funds. Reach the funds. So practically, central bank cannot buy or sell the securities from the primary market.

This is a significant issue for the central bank, because governments make use of this opportunity to fund back their budgets or for other expenses. Central bank is the governments' financial agent in proceeding the selling and buying for the government.

4. Conclusion

The importance of providing price stability for the purpose of achieving economic targets, have been widely discussed in the literature and has been supported by the empirical studies on industrial countries. Accordingly, enhancing central bank independency within the modern economies has been the general tendency. The ultimate point that has been achieved in empowering the central bank independency is the European Central Bank, with it independency strongly being protected by the Maastricht Treaty. European Central Bank officially gives priority to the objective of price stability requiring full monetary independence.

In this study, legal independence of TRNC Central Bank has been measured. Index value of 0.43 shows that TRNC Central Bank is legally more independent than most of the countries' as evidenced by Cukierman's (1992) index values. From the past to the present these countries expectedly have taken precautions on increasing their central bank independencies and have reduced political interferences.

Despite of the fact that TRNC Central Bank can be counted as legally independent, it is not possible for it to pursue price stability target because TRNC Central Bank acts as Regulation and Supervision Institute that tries to provide financial stability rather than acting as the institute of setting the monetary policy. TRNC Central Bank can not set monetary policy due to the dolarization as cited before. Consequently, since the proponents of central bank independency assert that there exists an inverse relationship between inflation and central bank independence, the case of TRNC Central Bank can not be discussed on this ground. It is the Turkey's inflation that largely determines inflation for TRNC rather than the monetary policy pursued by TRNC Central Bank.

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