

FED-CBT Political Power Relationship: Mind Games On “Independence”

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Abstract—Economic policy is a mechanism that actualizes countries’ development targets. Monetary policy is the most effectual instrument of economic policy. Central banks are of prime importance in monetary policy implementations.

Central banks must necessarily be independent in performing essential tasks such as price stability. There are some various criteria for FED’s independency. The criterion that the members of the Board of Governors are co-opted for 14 years of service is an important issue for both the independency and stability of monetary policy. There are various global power groups affecting all central banks around the world. Among the groups are local powers, political powers, pressures from the state system and economic bodies, and international political and economic pressures.

FED appears as an independent institution at first glance. However, its relationships with the Government and Congress point to the exact opposite. The Congress makes FED’s legal regulations and suppresses FED indirectly via financial issues if dissatisfied with FED’s monetary policy. Legal regulations handicap the execution of monetary policy directly and threaten FED’s independency.

Index Terms—Fed, CBT, Independence, Monetary Policy

I. INTRODUCTION

State bodies aim to enhance social welfare via economic policies. The establishment of a prosperous social structure depends basically on sustainable growth. Central banks assure price stability for enhancing growth and welfare (CBT, 2012:8). Central banks are supposed to be independent of the government or any other authorities in policy determination.

Central bank independence is the capability to make decisions over monetary policy and put the decisions into

action independently (Coskun, 2010:76). This study assesses ‘independence’ for the Federal Reserve System (Fed) and the Central Bank of Turkey (CBT) over their relationships with the governments. First, we will explain the definition and importance of central bank independence. Second, we will discuss two supplementary elements of independence: Transparency and accountability. Last, we will describe the Fed’s structure and functions and make a comparative analysis of the Fed’s and CBT’s relationships with political powers/governments.

II. IMPORTANCE OF CENTRAL BANK INDEPENDENCE

Independence refers to the situation where central banks perform duties without taking any order from the political authority and are free to determine the monetary policy criteria (Oktar et al., 2013:69-70). Independent central banks adjust the instruments for implementing monetary policy single-handedly (Dogru, 2012:13). To another definition, central bank independence is the freedom to determine the basic monetary policy parameters. This definition focuses on the cooperative authority-sharing between political power and central bank. Thus, central bank is autonomous to make decisions single-handedly on economic and political grounds (Barisik, 2004:2).

Central bank independence comprises 3 concepts: Personnel independence, financial independence and functional independence. Personnel independence implies if political power is authorized to appoint and/or discharge the bank governors. Financial independence discusses if the state capitalizes the bank. Functional independence emphasizes that the central bank be free from the control of political authority in monetary policy determination (Gerdesmeier &

Mongelli, 2007: 14). Central banks are of prime importance for actualizing countries' monetary policies. There is a significant relationship between central bank independence and economic stability. Empirical studies have showed that inflation rate will decrease as the level of central bank independence increases (Alkinoglu, 2000:75). Furthermore, central banks' monetary policy strategies are closely associated with independence. Central bank independence, developed financial structure and capital markets are highly important for a successful implementation of inflation target strategies (Tigli, 2007:95). Central banks must be absolutely independent in inflation target implementations (Mishkin, 2004:11).

- There are various parameters for determining central bank independence. The parameters discuss if the chair and Board of Governors are appointed by the government,
- periods of appointments,
- if government officials are the members of the Board of Governors,
- if the governmental approval is necessary for implementing monetary policy decisions and
- if central bank advances money to public sector.

III. APPROACHES FOR EXPLAINING CENTRAL BANK INDEPENDENCE

There are two approaches for explaining central bank independence: de jure-actual independence and political-economic independence.

A. De Jure–Actual Independence

Central banks are organized in a legal way that they can make decisions freely from political authorities (Eroglu & Abdullayev, 2005:80). De jure independence is the most important part of actual independence. De jure independence indicates to what extent the political power furnishes the central bank with authorities. However, there are informal relationships between political powers and central banks in many countries. The separation of political power and central bank is still unclear (Afsar, 2006/a:3).Units

B. Economic–Political Independence

Political independence means central banks determine policy targets freely from the influence of political power whereas economic independence is a central bank's authority to use monetary policy instruments single-handedly (Tigli, 2007:5). Economic independence enables to measure how easily the government finances budgets via central bank credits. A central bank's freedom to use monetary policy instruments must be equal to its economic independence (Kaykusuz, 2013:10).

IV. SUPPLEMENTARY INDEPENDENCE FACTORS: TRANSPARENCY AND ACCOUNTABILITY

Two supplementary factors have emerged in parallel with the development process of independence: Transparency and accountability (CBT, 2012:10).

A. Transparency

Transparency plays a key role in understanding central bank activities better and minimizes information asymmetry between central bank and private sector (Toptaş, 2005:7). Furthermore, transparency focuses on long-term targets and creates surplus value for a clearer public communication for providing support for the optimal monetary policy implementation (Mishkin S., 2004:25). Transparency is both an obligation for institutions and a benefit-providing instrument for their policies (Issing, 2005:66).

Transparency informs economic agents about central banks' policies and directs their expectations accordingly. Expectations are highly important for the success of central bank policies (Altuntas, 2012:76).

B. Accountability

Independence authorizes central banks to make decisions and policies single-handedly. Accountability is the other dimension of independence (Toptas, 2005:8).

The accountability principle is particularly important for independent central banks. The principle recommends that central banks be answerable to the society for their implementations (Yazgan, 2003:66).

V. HISTORY OF FEDERAL RESERVE SYSTEM

The idea of establishing a central bank emerged in the 18th century and was actualized in the 20th century after creating an extensive public opinion. Many people from farmers to US presidents opposed the idea. Farmers were the majority of the population. They argued the establishment of a central bank would make merchants richer. There were several unsuccessful attempts to establish a central bank. Financial crises showed the country's economy was actually weak (Akyazi, 2001:9). The Federal Reserve System (Fed) was established in 1913 after the 1907 crisis proved the establishment of a central bank was sine qua non for recovering the country's economy (Mehrling, 2002:207). Four great depressions that broke out between 1873 and 1907 resulted in the establishment of the Fed. The banks suffered from severe problems during the crisis periods and the problems forced bankers and governments to establish a central bank (Tigli, 2007:24). As a result, Congress established the Fed for providing the country with a more reliable, flexible and stable financial and monetary system (The Federal Reserve System, 2005:1).

Early operational steps aimed to guarantee the operation of the new system by August 1914 and provide more effective supervision in US banking sector. Further steps were for recognizing the Fed as an independent central bank in parallel with the banking system's gradual progress (Fase & Vanthoor, 2000:9).

The Fed was established for creating a wide perspective on economic activities in all segments of the country. Federal Reserve banks are available in 12 different regions countrywide (Board of Governors of Fed, 1994:3). The System performs various functions with 12 reserve banks and 25 branches. Each of the 12 reserve banks is an incorporated company. Different from other companies, the incorporated companies are non-profit institutions (<http://auhf.ankara.edu.tr/>).

TABLE I. FEDERAL RESERVE BANKS AND BRANCHES

Number	Letter	Bank	Branch
1	A	Boston	
2	B	New York	Buffalo, N.Y.
3	C	Philadelphia	
4	D	Cleveland	Cincinnati, Ohio Pittsburgh, Pa.
5	E	Richmond	Baltimore, Md. Charlotte, N.C.
6	F	Atlanta	Birmingham, Ala. Jacksonville, Fla. Miami, Fla. Nashville, Tenn. New Orleans, La.
7	G	Chicago	Detroit, Mich.
8	I	St. Louis	Little Rock, Ark. Louisville, Ky. Memphis, Tenn.
9	J	Minneapolis	Helena, Mont.
10	K	Kansas City	Denver, Colo. Oklahoma City, Okla. Omaha, Nebr.
11	L	Dallas	El Paso, Tex. Houston, Tex. San Antonio, Tex.
12	M	San Francisco	Los Angeles, Calif. Portland, Ore. Salt Lake City, Utah Seattle, Wash.

Source: (Board of Governors, 1994:10).

As is seen in Table 1, 12 banks and 25 branches are classified in numbers from 1 to 12 and in letters from A to M.

VI. STRUCTURE AND FUNCTIONS OF FEDERAL RESERVE SYSTEM

The structure of the Fed is quite different from other countries' central banks. The Fed is beyond a single-central-bank system. The Fed is a 12-regional bank system simply because there are numerous big commercial banks countywide and US is a federal state (Karadag, 2007:6). The Fed is unique in terms of capital structure. The Fed's capital belongs to the member banks. The member banks have to purchase the Fed shares at 6% of the capital. Thus, we can interpret that commercial banks may intervene in the

Fed's policies. The foundation structure of the Fed consists of 12 Federal Reserve banks, the Board of Governors and member commercial banks (Tigli, 2007:24). The Board of Governors ensures the coordination between the banks. Accountable to Congress, the Board observes and supervises the system. The members of the Board of Governors are co-opted for 14 years of service. The length of office is a critical factor for independence and stability of monetary policy. The determination and execution of monetary policy are the uppermost duties of the Board. Furthermore, the Board is in charge of determining legal reserve ratios, informing the President about the course of national economy, representing the country in foreign economic relations, auditing the banking system and reporting the banking system activities semiannually to Congress (Akyazi, 2001:10). The Board of Managers is another important constituent of the Fed. The Board is composed of 7 members that are appointed by the President and approved by Congress. Thus, Congress and the government are highly influential in the appointment process (Karadag, 2007:7).

The Federal Open Market Committee (FOMC) has an important place in the Fed's structure. The members of the Board of Governors comprise the chair of the Federal Reserve Bank of New York and 4 other rotatable chairs. The committee is responsible for open market operations for classifying the Fed's monetary market conditions and monetary and credit growth (Kamiloglu, 2003:60). The Fed develops monetary policy by controlling the federal funds rate. Various technical and advisory committees –such as Advisory Committee, Consumer Consultative Committee, Advisory Council, Federal Advisory Council, Thrift Institutions Advisory Council and FOMC– are available for supporting the Fed's operation (Karadag, 2007:7).

One of the principal functions of the Fed is to assure price stability as in other countries and help achieve economic targets by activating the financial system. Furthermore, the Fed is also in charge of executing regulatory, administrative and investigative functions (Kogar, 1994:394). The Fed regulates money supply, classifies loan volume, informs the government about financial matters, supervises and regulates financial institutions and renders payment services to the public via depository institutions (Akyazi, 2001:9).

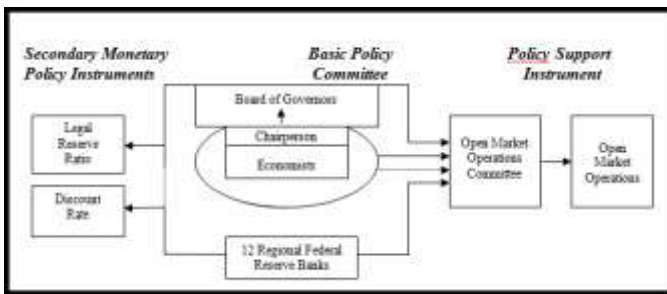
The Fed deals with some primary objectives of the economy such as employment, price stability, foreign trade and economic growth in performing the aforementioned functions. However, the Fed fails to perform all these functions alone but contributes positively to the process via future credit and monetary policies (Harvey & Huang, 2001:2).

VII. MONETARY POLICY INSTRUMENTS OF FEDERAL RESERVE SYSTEM

Among the Fed's monetary policy instruments are open market operations, discount rate, legal reserve ratio, route to persuasion, selective credit control and minimum payment rate. Open market operations are flexible and sometimes more prominent than any other instrument. The Fed

merchandises treasury bonds and bills for adjusting the economic liquidity (Akyazi, 2001:11).

TABLE II. FED'S MONETARY POLICY INSTRUMENTS AND OPERATION MECHANISM



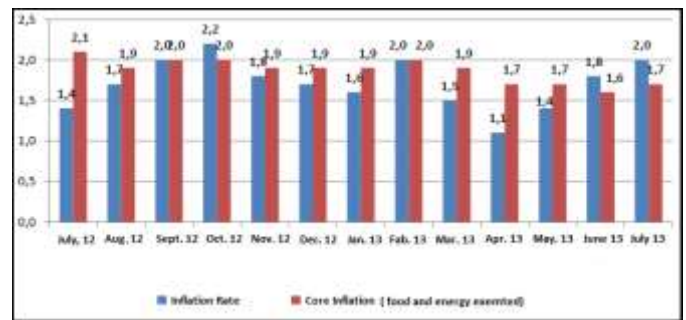
Source: (Akyazi, 2001: 12).

Discount rate is the rate of interest charged on the loans provided for commercial banks and other depository institutions via a regional American central bank. There are 3 kinds of discount: Primary loans, secondary loans and seasonal loans. Primary discount is the type of overnight loan provided for a short time for good depository institutions. The institutions unable to use of primary loan will steer for secondary loan. The interest rate of secondary loan is higher than that of primary loan. Small depository institutions in need of funding in the same year use this kind of loan (Kara, 2012:43). The role of discount rate has today declined in importance (Gordon, 2012:534).

Open market operations are the Fed's favorite policy instrument (Gordon, 2012:535). The Fed has implemented monetary policy traditionally via open market operations. The operations are related to the purchase and sale of the US treasury securities (Labonte, 2013:1). In open market operations, the Fed transfers reserve to or withdraws from the banking system by way of bill purchase and sale. The Fed applies for floatation for stocking small amount of money in the banking system.

Reserve requirement refers to the amount of money that commercial banks are supposed to stock at a Fed-determined rate in return for their deposits. The Fed steers the economy by increasing and decreasing the rate (Kogar, 1995:395). Legal reserves may escalate and/or diminish banks' funding costs. The oldest implementation in the US banking history, legal reserves are considerably important (Karadag, 2007:36). Legal reserve ratios affect the public trust in monetary policy and indicate to what way monetary policy will progress. Route to persuasion, selective credit control and minimum payment rate have today become out of date (Akyazi, 2001:12). We will explain the Fed's actual target as price stability and the inflation rates revolving around it.

TABLE III. INFLATION RATE



Source: (Turkish Ministry of Development, 2013:12).

As in seen, inflation rate has risen in the last four months including July simply because recent events in the Middle East have increased oil prices (Turkish Ministry of Development, 2013:12).

TABLE IV. INTEREST RATE (%)



Source: (Turkish Ministry of Development, 2013:13).

As is seen in Table 5, short-term interest rate and policy interest rate follow a similar trend. Long-term interest rate is 1.62 in June 2012 and 2.3 in June 2013.

VIII. FEDERAL RESERVE BANK-GOVERNMENT RELATIONSHIP

There are various power groups affecting all central banks around the world. Among the groups are local powers, political powers, pressures from the state system and economic bodies, and international political and economic pressures (Toptas, 2005:29). The relevant power groups disrupt independence somehow. There is a wide range of discussions over and various ideas for the explanation of central bank independence.

Independence refers to a central bank's autonomy to determine monetary policy single-handedly without the effect or pressure of any other institution (Egilmez & Kumcu, 2009:53). To another definition, independent central banks must be free from political pressure in performing their functions for making decisions about price stability (Aydin & Eren, 2013:95).

A central bank is never expected to be completely independent of government actions. For instance, the Fed works in cooperation with the political authority in economic issues. Thus, we can describe central bank independence as 'in-government independence' (Akyazi, 2001:13). The Fed's board of managers consults frequently with government officials and decision-makers (Crawford, 2010:132). The Board of Governors is the central authority in the Fed system

and the US President appoints 7 members of the Board by the approval of the Senate (Wynne, www.dallasfed.org:5).

The Fed's cooperation with the government is two-dimensional: It is 'treasurer' and 'consultant' of the government in domestic and foreign affairs. The Fed is one of the most critical sources of information for the government. The US government is able to follow economic developments and changes in all US states thanks to the Fed. The chair of the Fed shares his/her ideas with the public for the country's economic conditions and financial and other economic developments. Furthermore, the chair gives Congress reports on the aforementioned topics. The chair is a member of the Advisory Council in international monetary and financial affairs (Akyazi, 2001:13).

As is seen, "independence" suffers directly or indirectly from implicit intervention even when it is theoretically well-established. The Fed is under the influence of Congress since Congress is authorized to make regulations on the Fed and amend them if deemed necessary. Regulation-makers may threaten the Fed to take control of financing sources if dissatisfied with the Fed's monetary policy. The President is highly influential in the Fed structure due to his effect on Congress since the regulations by Congress may affect the Fed's capability of monetary policy implementation (Tigli, 2007:25). The regulatory power/government may threaten the Fed, budget and monetary policy authorities with Congress if economic indicators and performance are poor (Havrilesky & Chappell, 1993: 56).

Robert E. Weintraub, who worked part-time between 1962 and 1965 and full-time between 1972 and 1983 for the Democratic Party and Republican Party, has stated that the Fed is dependent on the US presidents' requests in monetary policy determination (Kaya, 2007:67). However, central banks are expected to be free from government and/or parliament control in monetary policy determination and implementations (Dilik, 2005:1). In a study conducted on central bank independence in 71 countries, the Fed has been ranked as the fifth in terms of statutory independence (Afsar, 2006:4).

IX. FED-CBT COMPARISON: MIND GAMES ON INDEPENDENCE

The Fed was less independent when established in 1993 and the secretary of the Treasury was a member of the Fed. However, its independence increased in 1936 when 2 member government officials were eliminated from the Board of Governors and all members' period of service was extended from 10 years to 14. Furthermore, the Secretariat of the Treasury was separated from the Fed for maximizing the investments in treasury securities in 1951. The separation was a definite plus for increasing the Fed's independence in monetary policy determination. Turkey has taken various institutional and structural steps in banking sector since the 1996 Turkey-EU Customs Union Agreement. The harmonization of central bank regulations with the EU legislation and independent execution of monetary policy are

two key factors for the effective operation of financial system (Ozturk & Essiz, 2012:78).

There are sharp differences between the Fed and CBT in terms of capital. The Fed's capital is supplied by the Fed's member commercial banks whereas CBT is capitalized by national Turkish banks, foreign-financed banks, chartered companies and natural and legal persons. The US has a single central bank with 12 Federal Reserve Banks in 12 different regions and Turkey has established a single central bank with branches. However, there is no sharp functional difference between the Fed and CBT (Akyazi, 2001:24).

Political independence focuses on the parameters for chair and governor appointments, term of office and inclusion of government officials in the Board of Governors (Eroglu & Eroglu, 2010:132). The chair of CBT is appointed for 5 years of service for only once. The chair of the Fed is charged for 4 years on re-appointment condition. 13 chairs have served in the 83-year history of the Fed whereas CBT has charged 18 chairs in 70 years (Ozturk & Essiz, 2012:79).

Turkey's 2006 open inflation target has enabled Monetary Policy Committee (PPK) to determine monetary policy decisions independently and we can regard this development as an important step for independence. Furthermore, Turkey's policy preferences within the CBT law have created a positive atmosphere in the markets during the 2006 Global Financial Turbulence and 2008 Global Financial Crisis. These policy preferences are critical steps for actual independence. CBT has followed accurate monetary policy implementations for minimizing the potential adverse effects of international credit markets and sustaining the stability of financial system. These developments have raised CBT's independence standards. However, some post-2006 events have damaged the independence perception. Politically-driven chair and co-chair appointments have led to serious worries about independence particularly during the chairmanship of Durmus Yilmaz. Furthermore, CBT's post-2006 'low exchange rate-high interest' policies have received negative public criticism. The discussions over the purchase of government debt securities (GDS) have damaged CBT's actual independence (Eroglu & Eroglu, 2010:136).

CBT has recently revised policy preferences being implemented up to 2013 for controlling open market turbulence and converging with target inflation rate by using interest instrument together with exchange instrument. The recent revision has initiated debates over the concept of independence. Thus, PPK has decided in favor of interest rate hike on 28 December 2013. However, the government has suggested applying interest rate cut and thus compelled CBT to prove necessarily that it is an independent institution. Some officers of CBT have been discharged on the General Assembly members' 'government-driven' suggestion without the chair's consent. General Assembly members are appointed by Treasury (<http://www.radikal.com.tr/>). The Fed has also suffered from a similar case. Congress' authorization to make and amend the regulations on the Fed exercises power over the Fed. . Regulation-makers may threaten the Fed to take control of financing sources if dissatisfied with

the Fed's monetary policy. As is seen, the President is highly influential in the Fed structure due to his effect on Congress (Tigli, 2007:25).

Both the Fed and CBT independence is disturbed implicitly. Actual and functional independence undergo intervention indispensably. The intervention process is performed indirectly on relatively legal basis in US. However, CBT's independence suffers from direct intervention on de-facto basis.

X. CONCLUSION

Economic policy is a mechanism that actualizes countries' development targets. Monetary policy is the most effectual instrument of economic policy. Central banks are highly important in monetary policy implementations.

Central banks must necessarily be independent in performing essential tasks such as price stability. There are some various criteria for the Fed's independence. The criterion that the members of the Board of Governors are coopted for 14 years of service is an important issue for both independence and stability of monetary policy. There are various global power groups affecting all central banks around the world. Among the groups are local powers, political powers, pressures from the state system and economic bodies, and international political and economic pressures.

The Fed appears as an independent institution at first glance. However, its relationships with the government and Congress point to the opposite. Congress makes the Fed's legal regulations and suppresses it indirectly via financial issues if dissatisfied with its monetary policy. Legal regulations handicap the execution of monetary policy directly and threaten the Fed's independence.

Central bank independence means a central bank determines monetary policy and uses the authorities under no influence or pressure of any institution, unit and political body. However, CBT's independence undergoes indirect intervention that damages its actual and functional independence. The intervention process is performed indirectly on relatively legal basis in USA. However, CBT's independence is disrupted directly on de-facto basis. Thus, various interventions that can be described as "mind games" handicap a central bank's actual independence although the Fed and CBT appear legally independent.

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