How can a seemingly weak state in the financial services industry act strong? The role of organizational policy capacity in monetary and macroprudential policy

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Abstract

It is widely held in the public policy and political economy literatures that the Turkish state is weak and cannot adopt a proactive approach in the financial services industry by steering and coordinating the financial policy network. However, it is puzzling that this seemingly “weak” Turkish state, which is often marked by fragmentation, conflict, and a lack of policy coordination within the state apparatus, acted strongly between 2010 and 2016 by taking pre-emptive measures to contain the macrofinancial risks arising from hot money inflows and bank credit expansion. Examining the organizational policy capacity of the Central Bank of the Republic of Turkey, this article argues that proactive policy design and implementation are more likely to complement state capacity when the principal bureaucratic actors have strong organizational policy capacities.

Keywords: Policy capacity; state; Turkey; Central Bank; financial stability

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Introduction

Research suggests that evidence-based policymaking at the bureaucratic level can face challenges arising from various sources, such as a disconnection between researchers and policymakers; sociopolitical constraints; and/or deficiencies in the “problem-solving capacity” of the state, bureaucracies, and/or individual policymakers.

Given the prominence of policy design and implementation in the post-Global Financial Crisis (GFC) era, this article aims to investigate when and how organizational policy capacity is more likely, and whether it can, contribute to state capacity to respond proactively to the complex policy challenges posed by the financial globalization process. In this regard, the article examines the organizational policy capacity of the Central Bank of the Republic of Turkey (Türkiye Cumhuriyeti Merkez Bankası, hereafter the Central Bank), which informed monetary policy and macroprudential policy design and implementation in Turkey between 2010 and 2016. It finds that the Central Bank’s organizational policy capacity played a critical role in the Turkish state’s capacity to proactively manage the adverse effects of speculative, short-term, and unproductive capital (i.e., hot money) inflows in the post-GFC period. We argue that the design and implementation of proactive policy measures are more likely when the principal bureaucratic actors have a strong organizational policy capacity, including analytical, operational, and political capacities. In such cases, these actors complement the state capacity to respond to policy challenges such as macrofinancial risks, including excess credit growth, household debt, the appreciation of domestic currency, and a widening current account deficit.

Our findings and argument challenge the conventional wisdom in the literature, where it is widely held that the Turkish state is weak and cannot

adopt a proactive approach in the financial services industry.\(^6\) This is said to be due to “fragmentation,” “a lack of coordination and institutionalized consensus building” among the key actors, and lack of “shared vision” and “policy coherence” in the state apparatus.\(^7\) However, the Turkish experience in monetary and macroprudential policy design and implementation in the post-GFC period actually shows otherwise.\(^8\)

Specifically, in the post-GFC structural material context, quantitative easing by central banks in developed countries led to a surge in hot money flows to developing countries between 2009 and 2016.\(^9\) This exogenous shock resulted in a real appreciation of national currency and in excessive bank credit growth, which contributed to a widening current account deficit. These macrofinancial risks have been the main sources of macrofinancial instability and financial crises in developing countries, including Turkey.\(^10\) Indeed, in Turkey such capital flows led to the build-up of macrofinancial risks in the form of excess credit growth and leverage, low levels of domestic savings, a deterioration in the current account and the quality of external funding, and an increasing dependency on hot money flows.\(^11\) Unsurprisingly, the Turkish economy thereby became


\(^{7}\) Bakır, “Governance by Supranational Interdependence”; Bakır, “Bargaining with Multinationals.”


vulnerable to sudden stop and capital outflows. However, in contrast to Turkey’s previous experiences in the 1994 and 2001 financial crises, such hot money inflows did not result in currency, banking, or balance of payments crises. Indeed, the International Monetary Fund (IMF) noted that Turkey “successfully curbed credit growth.” As Central Bank senior officials emphasized the decline in the annual growth rate of consumer loans, the initial rising trend in the household indebtedness ratio became a declining trend, as well as improvement in the current account deficit and the quality of its funding.13 Perhaps more strikingly, research by the Central Bank showed that, by 2013, “the Turkish lira [had] become one of the least volatile currencies among emerging market economies” in the post-GFC era.14 But why was it different this time?

The Central Bank designed and implemented a “new policy mix” in November 2010, when policy rate and reserve requirements were used, along with an asymmetric interest rate corridor and a reserve options mechanism, in order to manage capital flows.15 More significantly, the bank was the key actor in the formation of the Financial Stability Committee (Finansal İstikrar Komitesi, FİK) in June 2011.16 The establishment of the FİK was pivotal in strengthening state capacity to proactively respond to the macrofinancial challenges posed by hot money flows. This was because various state actors in the financial services industry now began coordinating, cooperating, and collaborating in monetary and macroprudential policy design and implementation.17

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17 The FİK was chaired by the Minister of the Treasury, who would brief the Council of Ministers regarding the results of FİK meetings and decisions. The remaining principle decision makers at the FİK who were involved in the analysis, development, and implementation of macrofinancial stability measures included the governor of the Central Bank, the chairman of the BDDK, and the undersecretary of the treasury. The remaining members of the FİK were the head of the Savings Deposit Insurance...
As a result, the Banking Regulation and Supervision Agency (Bankacılık Düzenleme ve Denetleme Kurumu, BDDK), which had previously been preoccupied with microprudential measures, now introduced macroprudential regulatory measures and started working closely with the Central Bank. It is puzzling that the supposedly weak state acted strongly by adopting such a proactive monetary policy and complementary macroprudential policy measures in order to effectively address macrofinancial risks.\(^{18}\) In the words of one deputy governor, “Turkey has adopted a policy mix of tight monetary policy along with accommodative macroprudential and fiscal policies [that has] helped to strengthen price, financial, and macroeconomic stability.”\(^{19}\) This episode deserves investigation, because it shows that the weak state capacity in the financial services industry in Turkey can be complemented by a strong policy capacity at the bureaucratic level. Furthermore, recent research shows that the Central Bank has a strong organizational policy capacity.\(^{20}\) However, our knowledge of the sources of organizational policy capacity and how they enable the Central Bank to play a leading role in the state’s attempt to contain macrofinancial risks (i.e., organizational policy capacity in action) is limited. This article aims to fill these gaps in the literature. Our findings show that the Central Bank’s organizational policy capacity is one of the key factors that enabled the Turkish state to take preemptive measures to contain the macrofinancial risks arising from hot money flows.

The theoretical perspective adopted in this article builds upon recent theoretical advances in the policy capacity scholarship.\(^{21}\) While the article sheds light upon the enabling conditions for organizational policy capacity and its role in improving state capacity, it also contributes to various strands in the broader public policy literature. First, this article is the first step forward toward linking

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the organizational policy capacity with the state capacity. Second, it responds to calls that there is “little empirical evidence or systematic research” in policy analytical capacity.\(^{22}\) Third, the article is, to the best of our knowledge, the first in the public policy literature to link the sources of organizational policy capacity with policy actions in central banking, whether in a developing or a developed country. Specifically, it links the policy analysis and capacity literatures, which have been grossly neglected so far, with central banking.\(^{23}\)

The remainder of this article is divided into four sections. The first section introduces the key relevant concepts and approaches via a review of the public policy literature, with a particular emphasis on organizational policy capacity and state capacity. The second section introduces the research design. This is followed by a discussion of how the Central Bank’s organizational policy capacity strengthens state capacity in Turkey. Finally, the concluding section summarizes the main findings and discusses the implications for future research.

**Literature review**

**Policy capacity and state capacity**

Policy capacity is “the set of skills and resources—or competences and capabilities—necessary to perform policy functions.”\(^{24}\) As such, it is defined here as an organization’s resources and skills for making and implementing sound policy decisions.\(^{25}\) The lack of such a capacity can impede informed policy design and implementation.\(^{26}\)

There are three dimensions of policy capacity at the bureaucratic level: organizational analytical capacity, organizational operational capacity, and organizational political capacity.\(^{27}\) The first of these, analytical policy capacity, requires “a recognized requirement or demand for research (a market), a supply of qualified researchers, [and] ready availability of quality data, policies, and procedures to facilitate productive interactions with other researchers,

\(^{22}\) Oliphant and Howlett, “Assessing Policy Analytical Capacity.”

\(^{23}\) For an exception, see Kranit Flug, “Policy Analysis in the Bank of Israel,” in Policy Analysis in Israel, ed. Gila Menahem and Amos Zehavi (Bristol: Policy Press, 2016): 141–152. Nonetheless, there the author only discusses the organizational structure and the process of policy analysis.


and a culture in which openness is encouraged and risk taking is acceptable.”

28 It “help[s] to ensure [that] policy actions are technically sound in the sense [that] they can contribute to [the] attainment of policy goals.”

29 In the context of central banking, we consider analytical capacity to be the capacity to gather, process, and analyze relevant information and data for policy design and experimentation.

30 Organizational operational capacity “allows [for] the alignment of resources with policy actions so that they can be implemented in practice.”

31 In this regard, for an organization to implement policies, it needs strong intellectual leadership and a quality human resource base, as well as intra- and interorganizational coordination of processes, a commitment to achieving goals, professional and departmental autonomy, and fiscal and personnel resource availability.

32 Finally, there is also organizational political capacity, which “helps to obtain and sustain political support for policy actions.”

33 This is because “policy capacity is also shaped by the political resources [e.g., the political legitimacy of an organization, the level of access to key policymakers, and communication with stakeholders and the general public] that an agency enjoys for performing its functions.”

34 Although there is no consensus on the definition of state capacity in the public policy and political economy literatures, it generally refers to “the government’s ability to formulate, pursue, and implement its policies.” Bakır notes that “administrative and institutional capacity [are the] key interrelated

dimensions” of state capacity.37 In this respect, state capacity also relates to “governance capacity”; i.e., “the resources and skills a government requires to steer a governance mode so as to make sound policy choices and implement them effectively.”38 State capacity constrains or enables policymakers’ decision to choose whether to follow an anticipatory or reactive approach to policymaking in the financial services industry.39 Weak states are assumed to adopt reactive policies in response to pressures originating from markets. Coleman offers a state capacity framework in the financial services industry, outlining how a state’s strengths and weaknesses in financial market governance are based on (1) the degree to which ultimate decision-making power is concentrated in the hands of a relatively small number of officials, and (2) the balance between the perspectives of central banks and finance ministries.40 Drawing on this framework, the conventional wisdom in connection with Turkey holds as follows:

Turkey has been characterized by fragmentation and a lack of coordination and institutionalized consensus building among supervisors [in the financial services sector] [. . .] Apart from this fragmented state apparatus in [the] financial services industry, there were also conflict of interest problems and [a] lack of adequate cooperation among financial supervisors [. . .] [A] proactive approach in the financial services industry by steering and coordinating policy community does not exist [. . .] [A] degree of centralization of the state apparatus (or regulatory/supervisor consolidation), and the existence of institutional arrangements, which ensure a balance between the perspectives of the [BDDK], [the] Treasury, and the Central Bank, are needed. As such, the Turkish state is weak and cannot adopt a proactive approach in the financial services industry by steering and coordinating [the] policy community.41

In contrast, this article argues that the seemingly weak Turkish state acted strongly in the financial services industry due to the Central Bank’s strong organizational policy capacity.

The administrative dimension of state capacity is closely related to organizational policy capacity at the bureaucratic level. This dimension refers to the efficient management of the human and physical resources necessary for the

38 Howlett and Ramesh, “The Two Orders of Governance Failure,” 322.
41 Caner Bakır, “Governance by Supranational Interdependence,” 192, 193, 204.
delivery of government outputs. This requires the identification of policy problems and effective policy design and implementation. Organizational policy capacity at the bureaucratic level enables the alignment of resources, the development of analytically sound policies, and a build-up of political support. As such, a greater organizational policy capacity enhances the administrative dimension of state capacity and is in fact essential for effective policy design and implementation. Furthermore, it is also critical for state capacity to manage the impact of globalization on administrative capabilities in regards to effective policy design and implementation. Thus, here we conceptualize state capacity as the state’s capability to respond proactively to the complex policy challenges posed by financial globalization through a portfolio of policy instruments.

**Method**

This article adopts an explanatory case study method. This is because we are focusing on an analysis of a contemporary phenomenon in its real-life context, where we have no control over the dependent and independent variables; we pose questions of why and how; we use multiple sources of evidence; and we aim to explain the causal relationship between organizational policy capacity and state capacity.

Interviews and written data have been used in the data collection process. A series of 60-minute semi-structured elite interviews with open-ended questions were conducted between 2013 and 2019. The interviewees included eight senior public officials: four senior people associated with the Central Bank (a former governor, two deputy governors, and a former director general of the Research and Monetary Policy Department [Araştırma ve Para Politikası Genel Müdürlüğü]), two senior banking regulators (a former senior banking specialist and a deputy chairman), and two senior treasury officials (the head of the Directorate General of Financial Sector Relations and Exchange [Mali Sektöre İlişkiler ve Kambiyo Genel Müdürlüğü] and a former acting deputy undersecretary).

Our data collection and analyses processes were iterative. Thus, there were several rounds of interviews continuing until additional interviews yielded no new information. The views endorsed by most of this cross-section of elite

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45 This institution has recently had its name changed to the Directorate General of Financial Markets and Exchange (Finansal Piyasalar ve Kambiyo Genel Müdürlüğü).
decision makers are anonymized, and they informed the analysis in this article. Furthermore, in terms of written sources, in-depth analysis of primary and secondary written sources were used to support the dataset obtained from the interviews. These sources included newspapers, academic publications, and the official reports of public bureaucracies and international intergovernmental organizations. These served as triangulation and supplementary sources for the interview data.

The temporal context began in November 2010, when the surge in hot money flows resulted in macrofinancial risks that required a new monetary policy mix and macroprudential tightening in order to contain bank balance sheet growth. It ended following the failed coup attempt of July 15, 2016, which necessitated a reversal of tight policy measures so as to stimulate bank credit expansion in response to the subsequent decline in hot money and credit flows that resulted in economic contraction.

Organizational policy capacity in action

Organizational structure relates to factors that facilitate or impede evidence-based policymaking and policy experimentation through the utilization of policy analysis and research. In this regard, it is useful to note that the Central Bank has gradually moved from a hierarchical organizational structure to a horizontal one, which facilitates greater interdepartmental interaction, communication, and collaboration. The formal organization of the Central Bank relates to its analytical and operational organizational capacity. In this respect, three departments play a crucial role: the Research and Monetary Policy Department, the Statistics Department (İstatistik Genel Müdürlüğü), and the Banking and Financial Institutions Department (Bankacılık ve Finansal Kuruluşlar Genel Müdürlüğü). These departments contribute to the organizational analytical capacity in support of price stability and financial stability. They also play significant interrelated and complementary roles in policy analysis.

The post-GFC period of 2009 and 2010 proved a challenging environment for developing countries, as loose monetary policies (i.e., quantitative easing) in developed countries led to a surge in destabilizing hot money inflows to

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47 For a detailed discussion, see Bakır and Çoban, “Policy Analysis and Capacity in the Central Bank of Turkey.”
developing countries, including Turkey. These hot money inflows resulted in the appreciation of the Turkish lira, excess bank credit growth, and increased household leverage, which led to a widening current account deficit. To manage these macrofinancial risks, the Central Bank acted proactively and introduced a “new policy mix” by experimenting with an “unconventional monetary policy” in November 2010.

The Central Bank’s new policy mix involved an asymmetric interest rate corridor and a reserve option mechanism. The former aimed to establish a flexible monetary policy to encourage or deter hot money flows without changing the policy rate, while the latter directed banks to accumulate foreign reserves at the Central Bank by depositing foreign currency and/or gold in lieu of Turkish lira reserve requirements. The aim was to sterilize capital inflows and stabilize the foreign exchange rate in times of surge or decline in capital inflows.

While these two policy instruments demonstrate the proactive stance taken by the Central Bank against the adverse effects of capital inflows, it soon became clear that the new policy mix was not effective in containing bank credit growth, and so it had to be complemented by macroprudential policy measures such as risk weights, provisioning, and maturity restrictions targeting the rapid growth of consumer loans and increased household leverage. In this respect, the Central Bank played a principal role in the establishment of the FIK in June 2011, which resulted in macroprudential tightening by the BDDK in order to contain the macrofinancial risks.

Recent research has identified six key analytical and operational sources of the policy capacity of the Central Bank during this period: (1) the ready availability of quality data; (2) human capital with high technical knowledge and expertise in evidence-based policy analysis and advice; (3) recruitment and career development practices enhancing policy analysis; (4) horizontal organizational arrangements facilitating more interdepartmental interaction, communication, and collaboration; (5) an organizational culture based on open discussions and risk-taking, thereby promoting policy innovation; and

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48 IMF, “Recent Experiences in Managing Capital Flows.”
49 Kara, “Turkey’s Experience with Macroprudential Policy.”
(6) the policy learning and transfer capabilities arising from interactions with the transnational epistemic community of central bankers.\textsuperscript{54} In addition to these resources and capabilities, the Central Bank also had the political capacity to generate the much-needed political support that would help to translate its policy preferences into government policies. Indeed, the “political support given to the Central Bank’s policy design and implementation is the most critical type of [organizational policy] capacity” allowing it to address the macro-financial risks.\textsuperscript{55}

Given all this, the overriding question is as follows: how does the organizational capacity of the Central Bank affect monetary and macroprudential policy design and implementation, with special reference to the containment of macrofinancial risks through the new monetary policy mix and macroprudential regulation?

Our interviews revealed that the design and implementation of the new policy mix and the introduction of macroprudential measures following the establishment of the FİK were informed by these various forms of policy capacity. In regard to the principal sources of analytical, operational, and political capacity at the Central Bank, all of the senior interviewees at the Central Bank noted that the governor of the Central Bank at the time, Erdem Başçi, was the principal agent. Başçi took a leadership role in the introduction of the asymmetric interest rate corridor and the establishment of the FİK, whilst also empowering and encouraging other senior central bankers to engage in the reserve option mechanism. In the words of a former deputy governor of the Central Bank: “Erdem [Başçi] can quickly translate an idea into a policy […] Deputy governors are also important, but it is the governor who is a leader. He was very active, with high potential and strong credentials. Thus his mindset translates an abstract idea into a policy.”\textsuperscript{56}

Başçi was an economist at a research university before being appointed to the Central Bank. When the Justice and Development Party (Adalet ve Kalkınma Partisi, AKP) came to power in November 2002, Başçi initially served as an advisor to Minister of Economy and Deputy Prime Minister Ali Babacan, after which he served as a deputy governor of the Central Bank for eight years before being appointed as governor, a capacity in which he served between April 2011 and April 2016. As this career path indicates, Başçi had multiple professional identities as a respected academic, policy advisor, and decision maker in his role at the Central Bank, and this enabled him to operate at the intersection of policy design and implementation. For

\textsuperscript{54} Bakır and Çoban, “Policy Analysis and Capacity in the Central Bank of Turkey,” 228.
\textsuperscript{55} Ibid.
\textsuperscript{56} Interview, CB3, İstanbul, February 22, 2019.
example, he championed using an asymmetrical corridor as a policy instrument for a new objective: capital flow management. As noted by a senior central banker:

> It was the governor who was most influential in the adoption of the policy [i.e., the asymmetric interest rate corridor]. I also believed that we needed to implement something new [. . .] The Turkish lira was overvalued and capital inflows were fast. When these issues [large capital inflows and their associated risks] came to our agenda, there was a need for a new [policy] tool.57

In the words of the governor himself, “During the Euro zone crisis we seriously [took] this [tool] into account. A very wide and asymmetric interest rate corridor served its function [. . .] when we tightened liquidity policy. In a short period of time we achieved the desired objective.”58

It is widely recognized that “[i]n the new policy design orientation understanding the origins and implications of the ideas held by decision-makers and advisors is a major subject of analysis.”59 Yet there is no simple answer to the question posed above, as it is difficult to track the origins of policy ideas due to the “infinite regress” problem.60 Nevertheless, an asymmetrical corridor as a new liquidity management tool in central banking clearly represents an elaboration of an idea put forward by Charles Goodhart, a former member of the Bank of England’s Monetary Policy Committee and a professor at the London School of Economics. In a November 2009 speech entitled “Liquidity Management” and presented at the Jackson Hole Economic Policy Symposium organized by the Federal Reserve Bank of Kansas,61 Goodhart became the first academic to advocate an asymmetrical corridor as a policy tool for central banks to manage liquidity.62

57 Interview, CB4, Ankara, January 6, 2013.
58 Interview, CB1, Ankara, December 7, 2013.
62 Goodhart’s abstract policy idea, which was proposed for developed country central banks for liquidity management in the post-GFC period, was translated into a policy instrument for capital flow management by the Central Bank. Specifically, Goodhart’s idea to use the upper and lower limits of the corridor in a way that was more dynamic than constant, more asymmetric than symmetric, and more innovative than traditional influenced the monetary policy design and implementation targeting capital flows at the Central Bank.
Baçı noted that Goodhart’s policy idea informed his own design thinking and legitimized the Central Bank’s implementation of an asymmetric interest rate corridor:

There was a talk by Professor Charles Goodhart in Jackson Hole [. . .] where he notes that the asymmetrical interest rate corridor is a highly useful policy tool, but it has been neglected and not used by the central banks [. . .] Although I did not attend the [symposium] I did read the article. We also referred to [Goodhart’s] article when we described our policy implementation in [national and international] meetings.63

Besides the governor, deputy governors serving as members of the Monetary Policy Committee (Para Politikası Kurulu) are also recognized as key individual actors in forming the backbone of the Central Bank’s analytical and operational policy capacity. These individuals were referred to by our interviewees as “innovative,” “open to new ideas and dialogue,” “like-minded,” and “competent.” One such individual noted as follows:

Our advantage [in the policy design and implementation] was that there was a group of managers from academia. They like to think outside the box. Thus, there was not much bureaucratic inertia. [In regard to calibrating the monetary policy mix] we did some brainstorming [. . .] we discussed what would work and not work [. . .] We had the presence of well-rounded academics who could make quick decisions, think outside the box, [and] implement [. . .] They did not hesitate to consider new policy ideas. Academics are like that. They are interested in fresh ideas and approaches on [capital flow management]. They look [at policy issues] from a different angle.64

In this respect, these individuals constituted a “dream team” closely cooperating and collaborating with each other in monetary policy design and implementation. These senior officers of the Central Bank perform the role of both policy analysts and decision makers. All the senior central bankers we interviewed referred to the significance of having academics with training in economics at the top of the bank’s decision-making hierarchy:

We follow developments in the world closely [. . .] When one of us sees or identifies something, we can communicate that with one another in five to ten sentences during a five-minute face-to-face talk. Such an understanding of each other is of the utmost importance [in initiating discussions on new ideas and policies]. In its absence you get nowhere [. . .] We speak the same

63 Interview, CB1, Ankara, December 7, 2013.
64 Interview, CB4, Ankara, January 25, 2019, and December 6, 2013.
language. More significantly, the governor internalizes new policy ideas [such as the reserve option mechanism] and supports them immediately. This is not an easy thing in central banking when you introduce a new policy.\(^\text{65}\)

In addition to their academic background, the senior decision makers were also socialized so as to share common programmatic policy ideas through attendance at various international meetings, which complemented their agentic role in policy design and implementation at the Central Bank. In the words of one deputy governor, “the policy formulation is done by the top management because they attend the major meetings at the BIS (Bank for International Settlements), the Financial Stability Board, the G20, and the IMF, where they understand markets [and] get feedback.”\(^\text{66}\)

The interviewees also highlighted the relationship between these individual agency-level complementarities among senior central bankers on the one hand and, on the other, the organizational culture at the Central Bank, which informed its analytical policy capacity: “The staff know their job well. They do not have feelings of inferiority. They are open to dialogue and new ideas. They can be convinced. They do not drag their feet when you need interdepartmental cooperation [. . .] You cannot impose things from the top down.”\(^\text{67}\) On the same note, another interviewee said:

Bureaucrats, at the end of the day, consider their superiors’ response to new ideas. I mean, “Will he understand me?” And, “If I bring a new idea to his attention would he be interested in it or not? Or would he [just] say, ‘Why are you meddling in my affairs’? These are very important. That’s why top management is of the utmost importance. It is about their openness to subordinates [in policy design and implementation].\(^\text{68}\)

These horizontal organizational and institutional arrangements facilitate more interdepartmental interaction, interpersonal trust, communication, and collaboration, which in turn strengthens staff morale and interpersonal relations: “A new university graduate, an assistant economist, can make a presentation to the Monetary Policy Committee with confidence and without a fear of expressing his ideas.”\(^\text{69}\)

In regard to the implementation of new policy ideas, the Central Bank’s communication strategy is recognized as an important part of its operational capacity. This is because it increases the legitimacy and predictability of the

\(^{65}\) Interview, CB3, Istanbul, February 22, 2019.

\(^{66}\) Interview, CB2, Istanbul, February 22, 2019.

\(^{67}\) Interview, CB3, Istanbul, February 22, 2019.

\(^{68}\) Interview, CB2, Istanbul, February 22, 2019.

\(^{69}\) Interview, CB2, Istanbul, February 22, 2019.
Central Bank’s actions, as well as the effective management of its policy instruments in managing capital flows. In the words of one deputy governor:

After developing a new policy, you need to communicate it. You need to share your ideas with stakeholders who might be citizens, politicians, bankers […] and convince them. Thus, their expectations will change […] I remember the “new policy mix” era. Those who were critical [of the policy] at the outset were convinced over time through the communication [that facilitated its effective implementation].70

In addition to the top managers actively involved in ideational entrepreneurship and policy implementation at the Central Bank, their subordinates in the Research and Monetary Policy Department and the Banking and Financial Institutions Department were also integral to the policy design process in “explor[ing] the details” of new policy ideas and instruments.71 As one senior central banker notes:

When I was heading the Research and Monetary Policy Department, our role was to put policy ideas and actions into coherent and consistent theoretical context. This is because we need to communicate what we do. For example, we formed the Financial Stability Analysis group [within the FİK]. We had meetings two to three times a week. We examined relevant policies that might inform our policies in historical perspective. We discuss how we can do it differently […] The participants of this group included the deputy governor, as well as managers, economists, and specialists from the Research and Monetary Policy Department and the Banking and Financial Institutions Department. Each week one of them volunteered to make a presentation on a specific topic. We were reading and discussing several relevant articles or research findings. In doing so, we were able to form the [cognitive] background of our policies. [Policy design] is triggered by the senior staff, but in these [ad hoc interdepartmental groups] we put flesh on the bones of policy ideas. It is about thinking how to strengthen policy ideas and improve their instruments. This is how upper- and lower-level administration interact [in policy design and implementation].72

The Central Bank wanted the implementation of macroprudential measures by the BDDK to complement its new policy mix in its effort to contain macrofinancial risks. The main reason behind the initial establishment of the FİK was, in the words of one deputy governor, to “support the Central Bank’s financial stability measures [i.e., the new policy mix] with the BDDK’s

70 Interview, CB2, İstanbul, September 17, 2016.
macroprudential regulatory policy.” In a similar vein, the deputy chairman of the BDDK mentioned that, “since the capital inflows were not [influenced as expected] by the Central Bank, the Central Bank requested the BDDK to implement regulatory measures [in the FİK meetings].”

In linking its policy preferences with the governmental agenda, the Central Bank relied on its political capacity. For example, interviewees noted that the FİK served as a formal setting for the introduction of macroprudential policy measures as a result of Başçi’s entrepreneurship. In this respect, strong interpersonal ties and mutual trust between then-governor Başçi and then-minister Babacan were critical. The strength and content of these interpersonal ties included a shared neighborhood, childhood, and schooling. These ties were one of the key temporal sources of the Central Bank’s political capacity to link its policy preferences with the governmental agenda setting via Babacan. Indeed, most of the interviewees from the Central Bank and the BDDK noted the importance of Başçi’s access to Babacan, who was a strong “supporter” of the Central Bank in politics and markets and who “sheltered” the governor from senior politicians’ fierce partisan campaigns.

These elite decision makers “shared a common worldview” on critical policy issues such as “the need to contain excess bank credit growth, which leads to financial instability,” and there was “mutual trust among them [that] was critical” in the translation of the Central Bank’s policy preferences into governmental policies. Unsurprisingly, they were on the same page in regard to the interbureaucratic design and implementation of the portfolio of the monetary policy mix and macroprudential measures. This was one of the key temporal sources of political capacity, in this instance enhancing both the Central Bank’s policy capacity and state capacity. One senior central banker explained the significance of the political capacity as follows:

It is of the utmost importance that the governor and the minister be on the same page [... ] Trust is the most significant factor in this respect. It makes a

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73 Interview, CB2, İstanbul, September 17, 2016.
74 Interview, R1, Ankara, January 11, 2016.
big difference for a minister if he trusts his bureaucrat. I remember [ . . . ] I made a presentation to the minister and we were together with Erdem Başçı when he was a deputy governor. Our proposals in my presentation were implemented within two to three days by the government [ . . . ] [As another example,] the establishment of the Financial Stability Committee was very fast. If you planned such a committee in Switzerland it would take three years. We had [the FİK] established within one month or so after thinking of it. The minister was pivotal in this outcome [ . . . ] The presence of a trusted minister was important for [top bureaucrats at the Central Bank] and for the governor, because central bankers moved forward with his support. Although the Central Bank had instrument independence, our decisions affect the economy directly. Thus there is a need for support from state managers. In the absence of this, things do not work.79

In light of this, the same interviewee noted the following:

The Central Bank’s autonomy is temporal. The Central Bank has a law. However, its operationalization of what has been written in this law depends on your relations with politicians. It changes across time and depends on personalities. We do not have a tradition on this issue in this country. It is so new. The Central Bank’s law [strengthening its legal independence from politicians] dates back to 2001. Some other central banks have 200 years of experience. We do learn these things over time by making mistakes, hitting the wall, and paying the price.80

Finally, it should be noted that the Central Bank’s organizational policy capacity was not the only factor contributing to the new policy ideas and their instruments. This was of course a necessary condition, but it alone was not sufficient to design and implement, for example, the new policy mix. The existence of structural, institutional, and agency-level complementarities reinforce effective policy design and implementation, which generates desired policy outcomes.81 One senior central banker made this point nicely:

It is a necessary condition. Because there are three pillars of [policy design and implementation] at the Central Bank. First, the trust of the politician of the Central Bank. Second, the Central Bank’s policy design and implementation capacity. Third, conducive global conjecture that reinforces the Central Bank’s actions. I say if any one of these is missing, it won’t work.82

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79 Interview, CB4, Ankara, January 25, 2019; emphasis ours.
80 Ibid.
81 For a detailed discussion of the effect of complementarities arising from interactions among structures, institutions, and agents, see Bakır, Bank Behaviour and Resilience.
82 Interview, CB4, Ankara, January 25, 2019.
Regarding the conducive global conjecture, the GFC as a structural context led to a shift in programmatic policy ideas, from microprudential regulation to macroprudential regulation. In addition to the Central Bank’s capacity at the organizational level and the political support that it received, this ideational shift also created institutional complementarity that reinforced the Central Bank’s experimentation with the new policy mix and its call for the establishment of the FİK. As a new consensus of the transnational epistemic community in finance, “the idea of macroprudential regulation (MPR) moved to the centre of the policy agenda and became the principal interpretative frame for financial technocrats and regulators seeking to navigate the [GFC] and respond to it, not only in terms of diagnosing and understanding it, but also in advancing institutional blueprints for regulatory reform.” As one interviewee stated:

> It is difficult to implement something new. Your global stakeholders [e.g., the international financial community, the BIS, and the IMF] do not let you do it since it runs [against] widely accepted conventional wisdom among central bankers. There are commonly accepted central banking principles. You cannot deviate from them easily. However, the GFC challenged some of these principles. This created a space for us to try new ideas and instruments.84

**Concluding remarks**

This article has examined Turkey’s proactive stance against the surge in capital inflows in the post-GFC period to contain macrofinancial risks, with special reference to the Central Bank’s organizational policy capacity. We have argued that the design and implementation of proactive policy measures are more likely to complement state capacity when the principal bureaucratic actors have a strong organizational policy capacity. Specifically, this article has shown that strong state capacity in maintaining financial stability in a proactive monetary and macroprudential policy design and implementation is most likely when the principal bureaucratic actors have strong analytical, operational, and political capacities. Despite this, when the Turkish lira plummeted to record lows against major currencies in August 2018, it became clear that, while


84 Interview, CB4, Ankara, January 25, 2019.
strong organizational policy capacity is certainly one of the necessary conditions in maintaining macrofinancial stability, it is not sufficient on its own. As Kara rightly notes, “it is also important to note that macroprudential policies cannot be a substitute for sound structural reforms. In many cases, macroprudential policies can rather be regarded as second-best solutions that save time until deeper structural adjustments [e.g., macroeconomic reforms] take place.”

In a world of complex monetary policymaking, central banks around the world need to have high analytical and operational capacities, which are internal sources of policy capacity. Yet they also need to have the political capacity to be able to translate their policy preferences to the governmental agenda. This article emphasizes how the much-neglected political support given to the Central Bank’s policy design and implementation is the most critical type of capacity. This is an external source of policy capacity.

This finding offers valuable insight into the central bank independence literature, which has overemphasized central banks’ independence from politicians. This dominant paradigm in central banking ignores the fact that central bankers need the support of politicians if they wish to translate their policy preferences into actual government action. Furthermore, it must be noted that politicians are not homogenous entities sharing the same beliefs or policy prescriptions. For example, some politicians tend to intervene in monetary policy, whilst others share central bankers’ worldviews and advance their preferences in the bureaucratic and political arenas. In doing so, they strengthen state capacity by steering policy formulation and implementation.

Policy actions are contingent upon both temporal and non-temporal contexts. The caveat in our analysis is that the overall capacity of the Turkish state, and that of the Central Bank in particular, is contextually contingent. Thus, the state capacity and the organizational capacity are volatile. This has become more visible with the seismic political regime change taking place at the structural level in Turkey. Unsurprisingly, the Central Bank’s policy capacity has been eroding in the years following its introduction of the “new policy mix.” While organizational policy capacity enables evidence-based policymaking and policy experimentation that contribute to a lower inflation rate, output, and financial stability, the Central Bank’s autonomy

85 Kara, “Turkey’s Experience with Macroprudential Policy,” 137.
has not been internalized by the government. This is clearly evidenced by senior politicians’ recent fierce partisan campaigns for lower interest rates and their efforts to blame the Central Bank’s interest rate policy for causing inflation, lower economic growth, and investment rates. Following the departure of Başçı in April 2016, the analytical, operational, and political sources of organizational policy capacity were dismantled. Political intervention became most visible with the government’s dismissal of Başçı’s successor as the governor of the Central Bank, Murat Çetinkaya, following a presidential decree on July 6, 2019—nearly one year before the official end of his term in 2020. Thus, the organizational policy capacity of a central bank is by no means isolated from its formal or informal independence from populist politicians.

We have found that the Central Bank’s policy autonomy is temporal: it depends on interpersonal relations between senior central bankers and politicians, as well as on whether they have mutual trust and a shared understanding of policy challenges and their solutions. Specifically, it was significant that the governor of the Central Bank and the Minister of the Treasury shared the view that the macrofinancial policies had to slow down excessive bank credit growth. This finding offers insight into the existing research on the rise and decline of bureaucratic autonomy in Turkey. Our research confirms the view that Turkey has recently opted “for de-delegation, centralization of decision making, increasing political control over economic governance, and a retreat from the norms of good governance via independent agencies.”

In this context, however, it is also noted that the “independence of the Central Bank is preserved” because “the risk in endangering independence would be substantial, not only because of probable repercussion[s] in other sectors, but also the importance of signaling investors, rating agencies, and the like” or “the links between central bank independence and capital inflows as well as IMF loans.” In contrast, we have shown that the temporality of the

88 See “Erdogan Backs off in Battle with Turkish Central Bank,” Financial Times, March 12, 2015; Bakır, “Merkez Bankası Başkanları ve Siyasetçiler.”
Central Bank’s independence and autonomy are informed by the interpersonal relations between senior central bankers and politicians. In the absence of trust and a shared understanding of policy issues, monetary policy formulation and implementation become increasingly subject to partisan challenges, which in Turkey have been more severe than those of the pre-2001 period. More political intervention certainly undermines the Central Bank’s confidence, commitment, and interest in providing innovative policy advice and implementation. Moreover, politicians are increasingly intervening in senior appointments, staff recruitment, career development, and promotion, which have all become more influenced by political criteria. This adversely affects the bank’s ability to attract and retain analysts with the requisite skills, knowledge, and expertise, and it also has a negative effect on staff morale and interpersonal relations. These accelerating challenges will erode not only the policy capacity of the Central Bank, but also that of the Turkish state in the financial services industry. Given the current partisan interventions into various policy sectors, one should not be surprised if one observes policy design and implementation failures, poor policy outcomes, and increased socioeconomic costs in Turkey in future.

It is essential to note, though, that the politicization of central banking is not confined to the Turkish context, as it has gained pace around the world in the post-GFC period. There are several factors, which also apply to the Turkish context, driving this trend. For example, macroprudential policy can cause conflict between politicians and the central banks because measures imposed to cool down a booming economy might not be politically desirable. The major central banks, for example, have shied away from using countercyclical macroprudential measures due to the politicization of central banking, among other factors, such as a lack of adequate data and analysis. Finally, the distributional aspects of monetary policy and macroprudential policy pave the way for the politicization of central banking, as the rise of populism forces politicians to intervene in the conduct of monetary policy and macroprudential policy in order to meet societal demands. Considering the politicization of central banking under these circumstances, we may expect more government intervention into central banking around the world.

92 See Bakır, Merkezdeki Banka ve Uluslararası Bir Karşılaştırmá.
93 Andrew Baker, “The Political Economy and Paradoxes of Macroprudential Regulation,” SPERI Paper no. 40 (Sheffield: Sheffield Political Economy Research Institute, March 2017), 11. It should be noted that Babacan and Başç, both of whom agreed on limiting bank credit growth and jointly took policy measures, represented a novel exception to this tendency.
References


