4. Supply and Demand Developments

The GDP data of the second quarter of 2014 suggest that economic activity displayed a weaker outlook than that presented in the July Inflation Report with an annual growth of 2.1 percent. In the second quarter, the improvement in perceptions of uncertainty remained limited resulting in a persisting sluggish private sector demand and final domestic demand receded owing also to the slowdown in public demand. The deceleration in global growth led the exports to follow a weaker-than-projected course, yet net exports continued to contribute positively to annual growth in the second quarter.

Data pertaining to the third quarter of 2014 point to a mild increase in economic activity compared to the second quarter. On the production side, the industrial production index rose by 1.1 percent in July and August compared to the second quarter average. However, the supply-driven fall in agricultural production and the slowdown in the construction sector are estimated to restrict growth. On the expenditures side, domestic private demand recovered especially on the consumption side due to relatively eased financial conditions. Nevertheless, consumer and investor confidences are yet to recover with a steady and robust pace, putting a cap on the recovery of domestic demand.

External demand indicators show that the protracted trend of steady increase in exports halted amid weakening global demand and geopolitical developments, which are expected to restrict external demand for a while. Meanwhile, imports display a mild increase in line with the improvement in domestic demand. Against this background, the contribution of net exports to growth may be weaker in the upcoming period compared to the first half of the year.

In sum, consumption demand is expected to recover moderately, relative to the second quarter. On the other hand, external demand is slow due to the structural problems in the European economies and geopolitical developments. Accordingly, the modest recovery expected in the upcoming period is believed to exert no pressure on inflation, and the course of inflation is estimated to be mostly determined by supply-side factors.

4.1. Gross Domestic Product Developments and Domestic Demand

According to the national accounts data released by TurkStat, the GDP posted a year-on-year increase by 2.1 percent and remained slightly weaker than the outlook presented in the July Inflation Report. This was led by the weaker-than-envisaged domestic and external demand, the former being driven by exogenous uncertainties and slowing public spending, and the latter by the geopolitical developments and the downtrend in global growth. The seasonally adjusted GDP edged down by 0.5 percent quarter-on-quarter (Chart 4.1.1), which was caused by the decline in both final domestic demand and the external demand. Components of the final domestic demand suggest that private and public sector demand posted a decline due to investment and consumption expenditures (Chart 4.1.2).

Chart 4.1.1.
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, 1998 Prices)

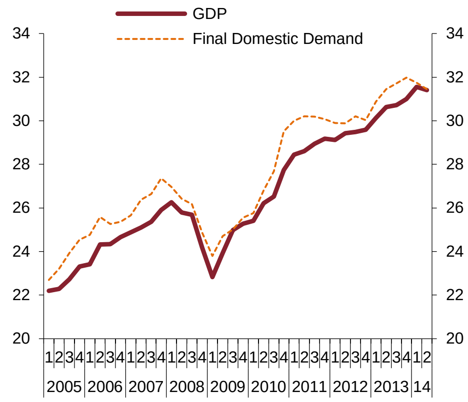
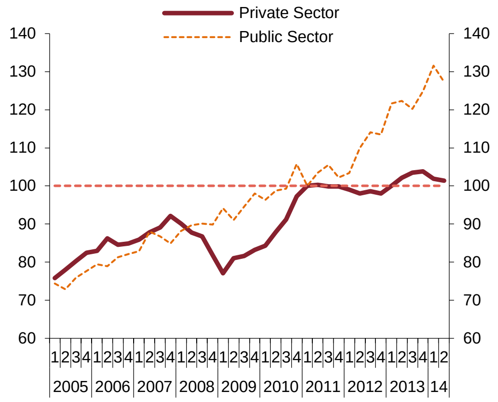


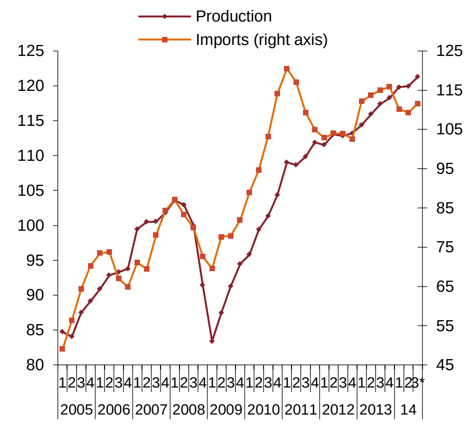
Chart 4.1.2.
Public and Private Sector Demand
(Seasonally Adjusted, 2011Q1=100)



Source: TurkStat, CBRT.

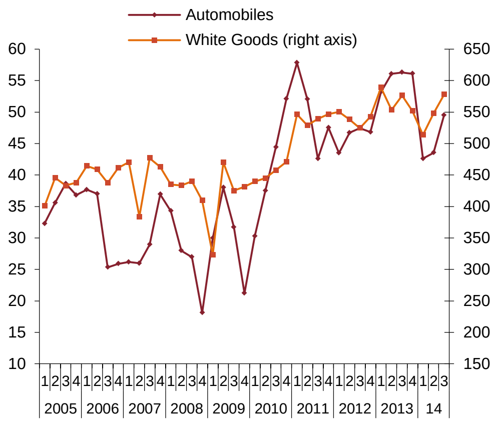
The third-quarter data indicate that private final demand was moderate in the third quarter. In the July-August period, the production and imports of consumption goods increased (Chart 4.1.3). Across subcategories of consumption goods, production increased in both durable goods and non-durable goods. Among other indicators of the demand for durable goods, imports of durable goods increased, and sales of automobiles and home appliances registered a recovery amid improved financial conditions as well (Chart 4.1.4). Moreover, in the July-August period, the data on machinery-equipment investments indicate that the production of investment goods excluding transport vehicles increased, but the imports thereof decreased (Chart 4.1.5). On the construction front, data on investments indicate that the production of mineral products dropped, whereas imports thereof continued to rise (Chart 4.1.6). Given the decline in the construction sector employment, private construction investments are estimated to have decelerated in the third quarter. Accordingly, the third quarter is expected to witness a recovery in the private sector consumption expenditures in contrast to a weak course in the private investment demand on a quarterly basis.

Chart 4.1.3.
Production and Import Quantity Indices of Consumption Goods
(Seasonally Adjusted, 2010=100)



* As of August.
Source: TurkStat, CBRT.

Chart 4.1.4.
Sales of Automobiles and White Goods
(Seasonally Adjusted, 1000)



Source: TURKBESD, AMA, CBRT.

Chart 4.1.5.
Production and Import Quantity Indices of Capital Goods Excluding Transport Vehicles
(Seasonally Adjusted, 2010=100)

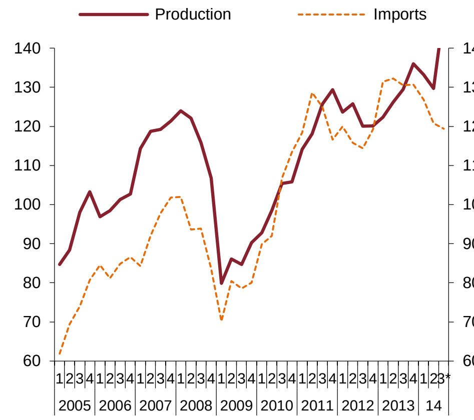
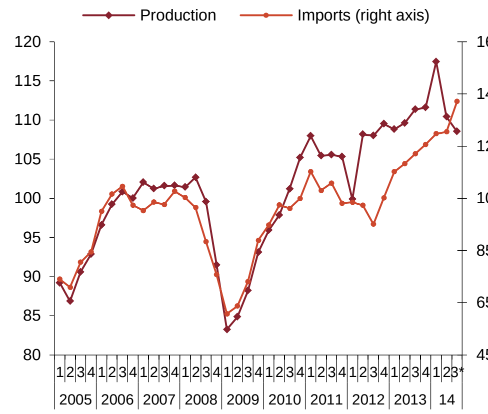


Chart 4.1.6.
Production and Import Quantity Indices of Non-Metallic Mineral Goods
(Seasonally Adjusted, 2010=100)



* As of August.
Source: TurkStat, CBRT.

BTS indicators suggest that the mild recovery in domestic demand may continue in the last quarter of 2014. In fact, registered domestic market orders in the manufacturing sector of consumption and investment goods remained relatively flat, yet 3-month-ahead order expectations of these sectors increased notably (Charts 4.1.7 and 4.1.8). Meanwhile, firms' long-term investment expectations improved, whereas employment expectations remained below the average of the post-crisis period (Chart 4.1.9). On the other hand, due to the volatile course of financial conditions and geopolitical developments, consumer confidence follows a weak path (Chart 4.1.10). Registered domestic orders of consumption and investment goods still hover below the 2013 readings, which shows that the domestic demand expectations of firms still lack a robust rebound. Accordingly, consumer and investor confidence indicators point to a downside risk to the growth outlook.

Chart 4.1.7.
Registered Domestic Market Orders and Expectation of New Domestic Market Orders in the Manufacturing Sector of Consumption Goods*
(Seasonally Adjusted)

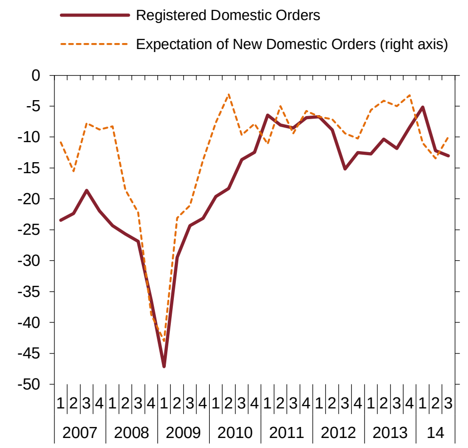
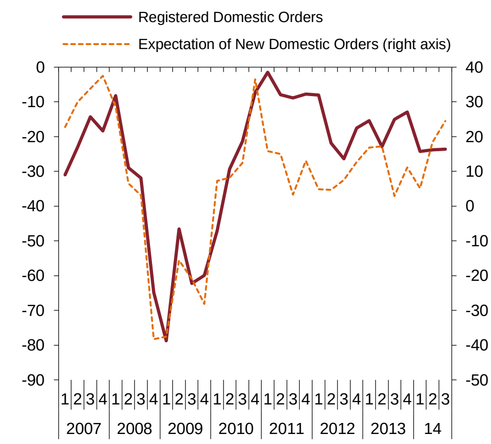
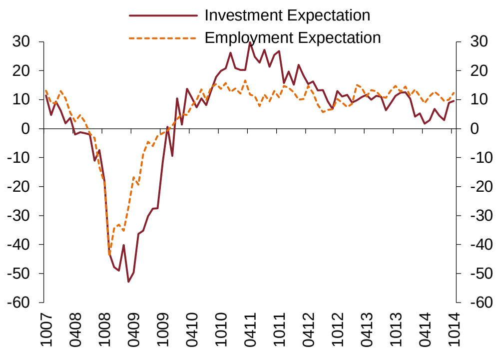


Chart 4.1.8.
Registered Domestic Market Orders and Expectation of New Domestic Market Orders in the Manufacturing Sector of Investment Goods*
(Seasonally Adjusted)



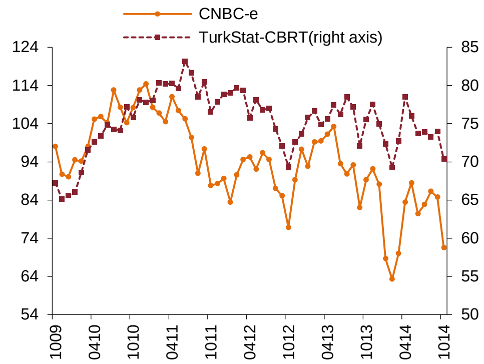
* Question 19 in BTS asks the survey respondents whether registered domestic market orders are above or below normal. Question 21in BTS asks the survey respondents the expectation of new domestic market orders to increase or decrease in the upcoming 3-month.
Source: CBRT.

Chart 4.1.9.
BTS Expectation for Investment and Employment*
(Seasonally Adjusted)



* Question 23 in BTS asks the survey respondents the expectation of fixed investment to increase or decrease in the upcoming 12-month relative to past 12-month. Question 7 in BTS asks the survey respondents the expectation of total employment to increase or decrease in the upcoming 3-month.
Source: CBRT.

Chart 4.1.10.
Consumer Confidence*



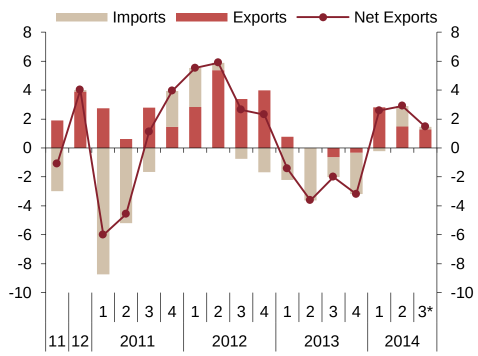
* Preliminary data for CNBC-e.
Source: CNBC-e, TurkStat, CBRT.

In summary, economic activity decelerated in the second quarter due to the decline in both private and the public sector demand. The third-quarter data indicate that final private domestic demand registered a mild rebound on account of consumption expenditures. The data on survey indicators reveal that the mild recovery in domestic demand may continue in the last quarter of the year. On the other hand, weakening in external demand, uncertainty over global monetary policies, geopolitical developments, the recent heightening in financial volatility and the languishing course of consumer and investor confidence may hamper growth. Under these circumstances, demand conditions are not expected to exert upward pressure on inflation and domestic demand developments will contain the deterioration of the current account deficit.

4.2. External Demand

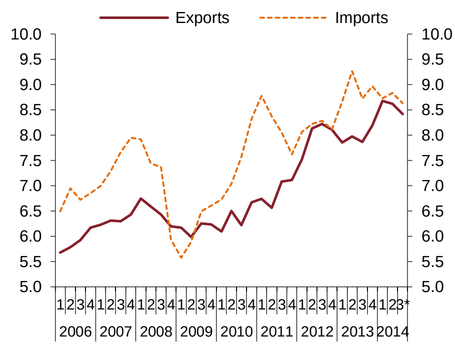
Second quarter GDP data of 2014 indicate that exports of goods and services grew by 5.5 percent, while imports thereof fell by 4.6 on annual basis. Thus, net exports contributed 2.9 percentage points to annual growth, and the balancing among external demand components continued in this quarter (Chart 4.2.1). In seasonally adjusted terms, exports recorded a decline due to the fall in gold exports, whereas imports posted a quarter-on-quarter increase in the second quarter on account of the rise in gold imports (Chart 4.2.2).

Chart 4.2.1.
Contribution of Net Exports to Annual GDP Growth
(Percentage Point)



* Estimate.
Source: TurkStat, CBRT.

Chart 4.2.2.
Exports and Imports of Goods and Services
(Seasonally Adjusted, 1998 Prices, Billion TL)



Data regarding the third quarter of 2014 reveal that the export quantity index trended slightly upwards in the July-August period. Having increased steadily since the last quarter of 2012, the core index excluding gold exports followed a flat course in this quarter (Chart 4.2.3). On the external demand front, the manufacturing industry PMI for the Euro Area implies a weak economic growth in the third quarter (Chart 2.1.4), and the persisting geopolitical risks limited the rise in exports. The export-weighted global growth, a medium-term indicator, posted a slight decline in the inter-reporting period (Chart 2.1.1). Therefore, the positive contribution of exports to growth is envisaged to be lower in the upcoming period (Chart 4.2.1).

Chart 4.2.3.
Export Quantity Indices
(Seasonally Adjusted, 2010=100)

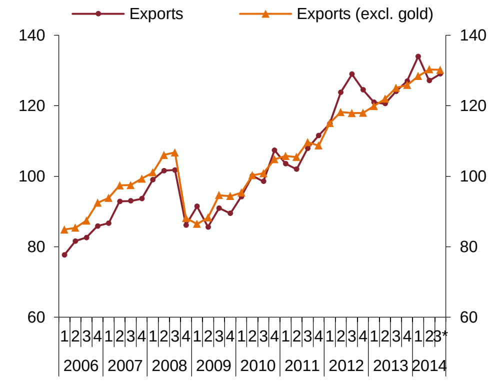
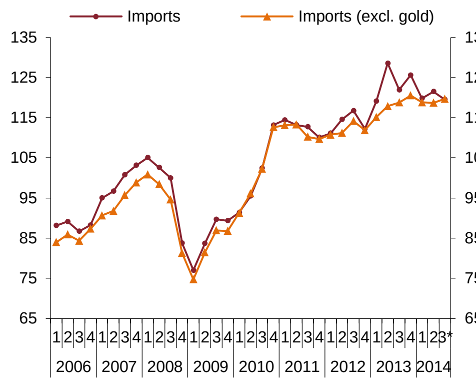


Chart 4.2.4.
Import Quantity Indices
(Seasonally Adjusted, 2010=100)



* Estimate for September.
Source: TurkStat, CBRT.

After the second-quarter rise, the import quantity index posted a decline in the July-August period due to gold imports. However, excluding gold, the index recorded an increase in the same period. Domestic demand indicators for the third quarter point to a modest rise in consumption demand. Accordingly, imports excluding gold are expected to increase amid the rebound in domestic demand (Chart 4.2.4). However, imports of goods and services are estimated to remain below the previous quarter's readings due to the fall in gold imports in this quarter (Chart 4.2.2).

Against this background, the positive contribution of net exports to growth is expected to diminish gradually in the third quarter (Chart 4.2.1). The current account balance is estimated to witness a sustained recovery in both seasonally adjusted terms and on a 12-month cumulative basis. Seasonally adjusted core indicators on the current account balance appear to have remained flat, while recovery continues in 12-month cumulative terms (Charts 4.2.5 and 4.2.6). However, the uncertainties fueled by the recently elevated geopolitical unrest and financial volatility may attenuate consumer confidence and impede the mild growth in final domestic demand for the rest of 2014. Additionally, the possible persistence of the negative outlook in external demand may restrict exports and the contribution of net exports to growth.

Chart 4.2.5.
Current Account Balance*
(Seasonally Adjusted, Billion USD)

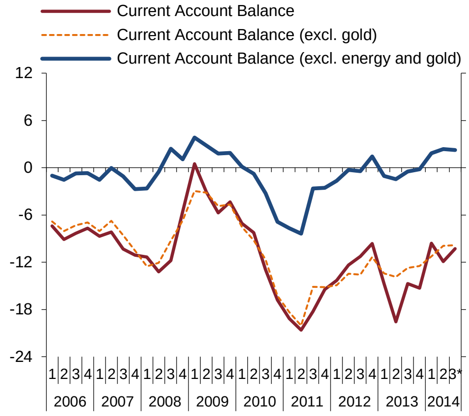
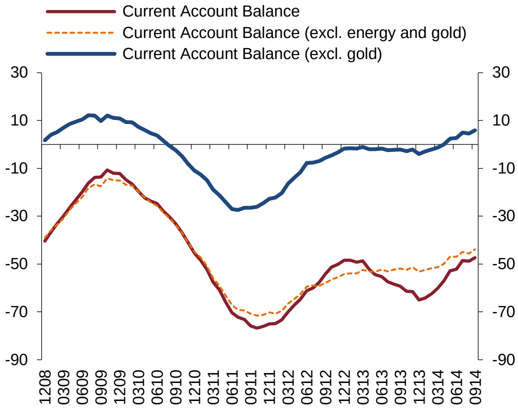


Chart 4.2.6.
Current Account Balance*
(12-Month Cumulative, Billion USD)

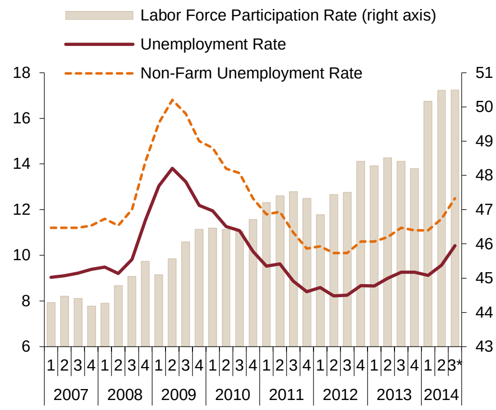


* Estimate for September.
Source: TurkStat, CBRT.

4.3. Labor Market

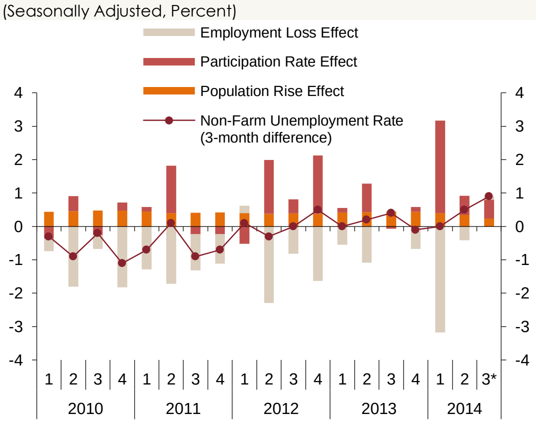
Total and non-farm unemployment rates were flat in the first quarter of 2014. However, similar to the second quarter, unemployment rates increased notably in the third quarter of the year (Chart 4.3.1). Total and non-farm unemployment rates hit 10.4 and 12.5 percent in July 2014. The rise in unemployment rates was driven by the continuing increase in the non-farm labor force to the working age population besides the pause in the rise in non-farm employment (Chart 4.3.2). Having surged in the first quarter, non-farm employment climbed slightly in the second quarter and remained weak in the third quarter of the year (Chart 4.3.2).

Chart 4.3.1.
Unemployment Rates
(Seasonally Adjusted, Percent)



* As of July.
Source: TurkStat.

Chart 4.3.2.
Contributions to Quarterly Changes in Non-Farm Unemployment
(Seasonally Adjusted, Percent)

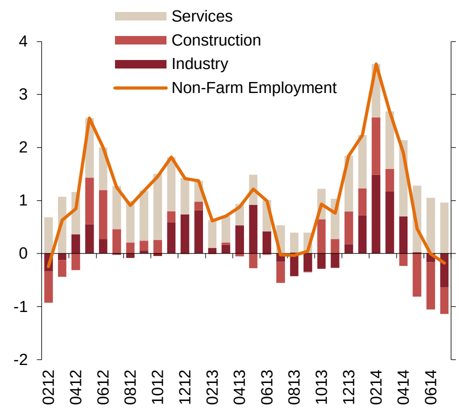


* 2-month difference as of July.
Source: TurkStat, CBRT.

Non-farm employment by sectors indicates that the services sector continued to contribute positively to the non-farm employment. However, employment in the construction sector declined in the second and third quarters of the year (Chart 4.3.3). Moreover, growth in industrial employment lost pace in the second quarter, and edged down in the third quarter compared to the previous quarter (Chart 4.3.4).

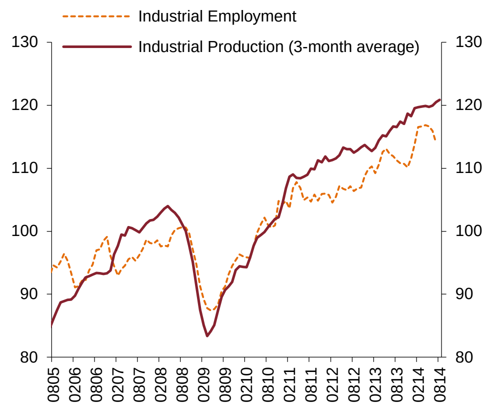
Indicators regarding the economic activity point to a modest recovery in the third quarter. Industrial production stayed unchanged in the third quarter on a quarterly basis. Meanwhile, the July-August data suggest a mild increase in production in the third quarter (Chart 4.3.4). On the other hand, mineral production, which provides information on construction activity, decreased further in the third quarter (Chart 4.1.6). This confirms the decline in the construction sector employment.

Chart 4.3.3.
Contributions to Quarterly Change in Non-Farm Employment
(Seasonally Adjusted, Percentage Point)



Source: TurkStat, CBRT.

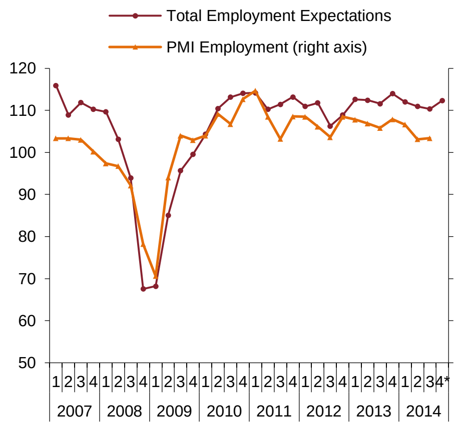
Chart 4.3.4.
Industrial Employment and Production
(Seasonally Adjusted, 200 =100)



Source: TurkStat.

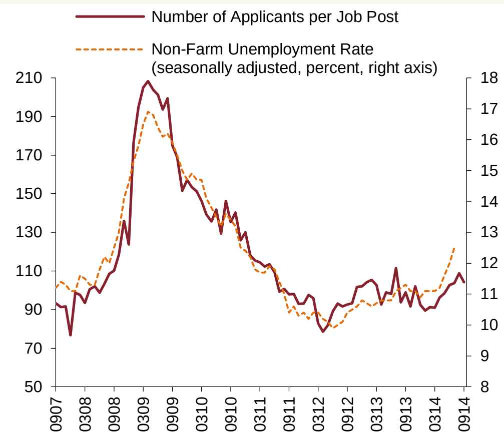
The total employment expectation, which is listed among the BTS indicators reflecting the views of firms operating in the manufacturing industry, posted less optimistic expectations in the third quarter. In addition, total employment expectation edged up in October compared to the previous month (Chart 4.3.5). Similarly, the PMI employment reading that includes the assessments of the firms operating in the manufacturing industry, remained optimistic in the third quarter. Meanwhile, the PMI employment plummeted in the second quarter on a quarterly basis, and remained unchanged in the third quarter. Although leading indicators continue to move towards optimistic expectations, the current reading of the PMI employment warns of downside risks to industrial employment (Chart 4.3.5).

Chart 4.3.5.
BTS Employment Expectations and PMI Employment Index
(Seasonally Adjusted)



* As of October.
Source: TurkStat, Markit, CBRT.

Chart 4.3.6.
Number of Applicants per Job Post and Non-Farm Unemployment Rate



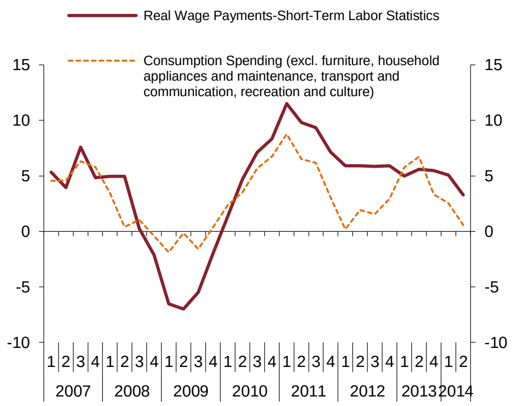
Source: TurkStat, Kariyer.net.

According to data obtained from Kariyer.net, a human resources firm, the growth in the total number of job posts decelerated slightly, whereas the total number of job applications continued to accelerate in the third quarter. Accordingly, the number of applications per job post, which is a closely linked indicator to non-farm unemployment, computed by dividing the total number of job applications by the total number of job posts, surged in the third quarter. Meanwhile, the number of applications per job post in Kariyer.net recorded a month-on-month decline in September, which is considered to be a positive development (Chart 4.3.6).

In the first half of 2014, wage developments proved to support domestic demand. In this period, total wage payments continued to rise on an annual basis in real terms (Chart 4.3.7). However, the annual growth of real wage payments decelerated in the second quarter of the year compared to the first quarter. Moreover, the higher-than-envisioned consumer price inflation compared to the projections in early 2014 may put a cap on real wage growth for the rest of the year.

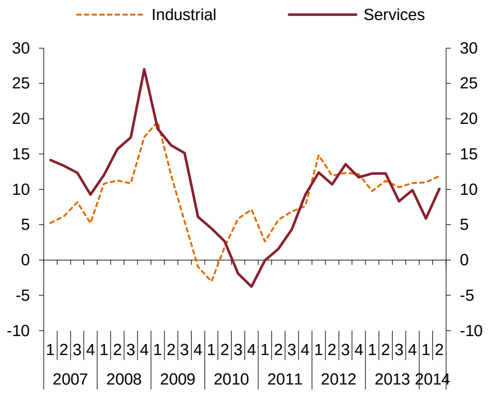
On the cost front, the impact of wage hikes on consumer prices is likely to increase in the first half of the year. As of the second half of 2014, the average rise in hourly wages proved higher than the minimum wage hike for 2014. Accordingly, unit wages in the industrial and services sectors posted a higher rate of increase than inflation, rising by 11.9 and 10.1 percent, respectively, on an annual basis in the second quarter of 2014 (Chart 4.3.8).

Chart 4.3.7.
Household Domestic Consumption and Real Wage Payments* (Annual Percent Change)



* Calculated as the weighted average of total wages paid in industrial, construction, trade and services activities. Deflated by CPI.
Source: TurkStat , CBRT.

Chart 4.3.8.
Unit Labor Cost*
(Annual Percent Change)



* In the services sector, unit labor cost is calculated by dividing total wage payments by turnover adjusted by services prices. In the industrial sector, total wage payments are divided by output.
Source: TurkStat Short-Term Labor Statistics, CBRT.

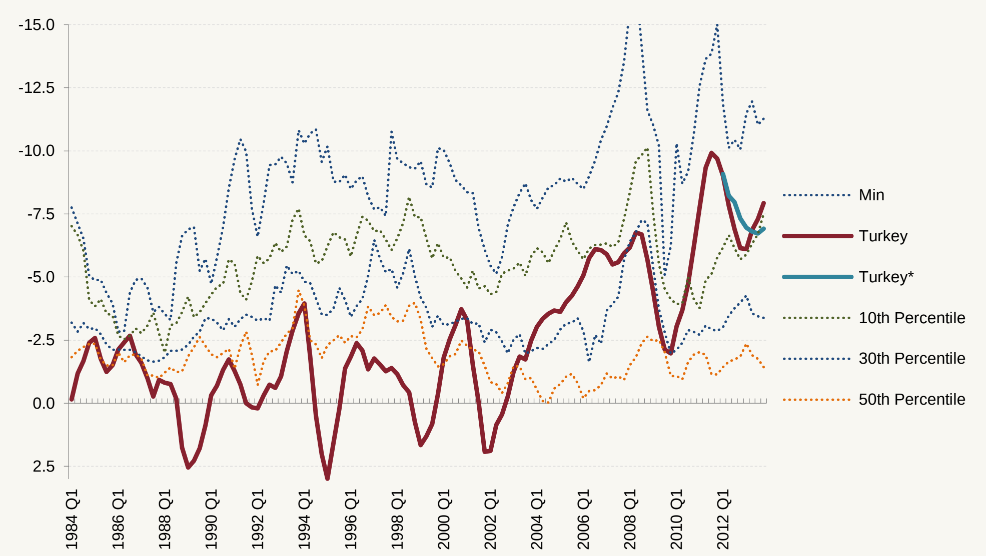
In sum, non-farm employment, which surged in the first quarter of 2014, decelerated gradually afterwards. This was mainly caused by the slumps in the construction sector employment in the second and third quarters besides the absence of support from the industrial employment to the rise in non-farm employment. Leading indicators do not show favorable signals for the labor market in the third quarter. Moreover, uncertainties over global growth are estimated to affect the course of non-farm employment negatively. Against this background, total and non-farm unemployment rates may be slightly higher in 2014 compared to the previous year.

Box 4.1 Current Account Balance Fluctuations and Current Account Deficit Corrections

Using quarterly data, this box discusses some statistical features of current account balance fluctuations and current account deficit corrections for 45 advanced and emerging economies in the post-1984 period. The objective is to portray current account balance developments in Turkey from a long-run international perspective.[1] The analysis indicates that the current account balance cycles are shorter and the corrections in the current account deficit are faster in emerging economies. In addition, large corrections are found to be more likely as the current account deficit to the GDP ratio gets higher.

Chart 1 presents the current account balance to the GDP ratio for Turkey and other emerging economies. The dispersion of the current account balance is presented for emerging economies including Turkey, for the 10th, 20th, 30th, 40th and 50th percentiles, which correspond to percentiles of emerging economies posting current account deficits during 1984-2013. The chart indicates that the current account deficits of emerging economies move similarly. More specifically, between 1985 and 1986, which is the period after the debt crisis in the early 1980s, the current account deficit declined in all countries, whereas during the 1990s, which is marked by the implementation of financial liberalization reforms, the current account deficit rebounded. The current account deficit declined across all countries during the early 2000s, which was followed by a surge until 2009. The current account deficit narrowed sharply after the global crisis, yet widened again during the period of ample global liquidity.

Chart 1. Current Account Balance to GDP in Emerging Economies during 1984-2013 (Percent)



* In order to control for the high volatility in gold trade, gold trade is excluded between 2012 and 2013.

Source: IMF, Authors' calculations.

[1] Advanced economies include Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Israel, Italy, South Korea, New Zealand, Norway, Portugal, Slovak Republic, Slovenia, Spain, UK and USA. Emerging economies include Argentina, Bangladesh, Bolivia, Brazil, Chile, Colombia, Costa Rica, Croatia, Czech Republic, Ecuador, Hungary, India, Indonesia, Mexico, Pakistan, Panama, Peru, Philippines, Romania, South Africa, Thailand, Turkey, Ukraine, Uruguay, Venezuela and Vietnam.

Comparing Turkey's current account balance to that of other emerging economies shows that Turkey ranked below average during the 1980s and 1990s, whereas Turkey's current account deficit deteriorated relative to other countries during the 2000s. Before the 2009 crisis, Turkey hovered around the 30th and the 40th percentiles in terms of the current account deficit, while it ranked above the 10th percentile as of the last quarter of 2010. Thanks to the adopted policy measures, the current account deficit declined and Turkey ranked below the 10th percentile as of end-2013.

Table 1. Selected Statistics on the Duration of Current Account Cycles

	Duration (Quarter)	Number	Percentage Distribution	Peak (Percent)	Speed of Deterioration (Percent)	Speed of Correction (Percent)
ALL COUNTRIES	All	105	100	-5.90	0.69	0.83
	0-16	26	24.76	-5.59	0.97	1.29
	16-24	34	32.38	-5.69	0.80	0.89
	24-32	10	9.52	-6.41	0.76	0.70
	32-48	23	21.90	-6.55	0.40	0.57
	48-	12	11.43	-5.53	0.28	0.31
ADVANCED ECONOMIES	Duration (Quarter)	Number	Percentage Distribution	Peak (Percent)	Speed of Deterioration (Percent)	Speed of Correction (Percent)
	All	36	100	-5.64	0.57	0.53
	0-16	2	5.56	-4.74	0.94	1.05
	16-24	9	25.00	-4.34	0.97	0.62
	24-32	4	11.11	-6.12	0.96	0.67
	32-48	13	36.11	-7.30	0.31	0.50
	48-	8	22.22	-4.39	0.25	0.26
EMERGING ECONOMIES	Duration (Quarter)	Number	Percentage Distribution	Peak (Percent)	Speed of Deterioration (Percent)	Speed of Correction (Percent)
	All	69	100	-6.04	0.75	0.99
	0-16	24	34.78	-5.66	0.97	1.31
	16-24	25	36.23	-6.18	0.74	0.98
	24-32	6	8.70	-6.61	0.63	0.72
	32-48	10	14.49	-5.58	0.51	0.66
	48-	4	5.80	-7.80	0.34	0.40

Source: IMF, Authors' calculations.

Table 1 presents some statistical features of the current account balance cycles in all country groups. A total of 105 current account balance cycles are determined, 36 of which are in advanced economies, while 69 are in emerging economies.[2] Cycles are grouped according to durations and countries. The duration of cycles reveals that nearly 60 percent of the cycles in advanced economies are longer than 8 years, while 80 percent of those in the emerging economies are shorter than 8 years. This finding is compatible with the observation that business cycles in emerging economies are shorter than those in advanced economies. Turkey experienced 5 cycles during the 1984Q1-2013Q4 period. These cycles include the cycle around the 1994 crisis, the cycle that ends with the 1999 correction, the cycle around the 2001 crisis, the cycle around the 2009 crisis and the cycle that encompasses the 2012 current account correction. The average duration of these cycles is 18 quarters.

[2] For further details, see Bulut et al. (2014).

The table also exhibits the peak, the speed of deterioration (quarterly percentage change during periods of widening in current account deficit) and the speed of correction (quarterly percentage change during periods of correction/narrowing in the current account deficit). A major difference observed between country groups is that the speed of deterioration in advanced economies is higher than the speed of correction, whereas the exact opposite applies in emerging economies. In other words, the current account deficit corrects more rapidly in emerging economies and the same observation also holds for Turkey. For the five cycles that occurred in Turkey, the average speed of deterioration is 11 quarters, while the average speed of correction is 6 quarters.

Running a high current account deficit constitutes a critical risk factor for a country. High levels of current account deficit may display fast and sizeable corrections, which may be accompanied by large shocks in the exchange rate and the national income.[3] In this context, Charts 2 and 3 present the possibilities of corrections in a certain time period according to various current account deficit levels. These charts indicate that the possibility of a sizeable correction is higher for a higher current account deficit. For example, Chart 2 shows that the possibility of a country running a current account deficit above 6 percent to make a correction above 6 percent in 4 quarters is 8 percent, while the same possibility is 16 percent in 6 quarters. Correction probabilities in the current account deficit by country groups demonstrate that they are higher in emerging economies than advanced economies in all levels of current account deficits as shown in Chart 3. More specifically, the possibility of an emerging economy running a current account deficit above 6 percent to make a correction higher than 6 percent in 4 quarters is 10 percent, while this possibility is 5 percent for an advanced economy. This divergence is compatible with the prevalence of a crisis during current account deficit corrections in emerging economies.

Chart 2. Correction Probability Above 6 Percent

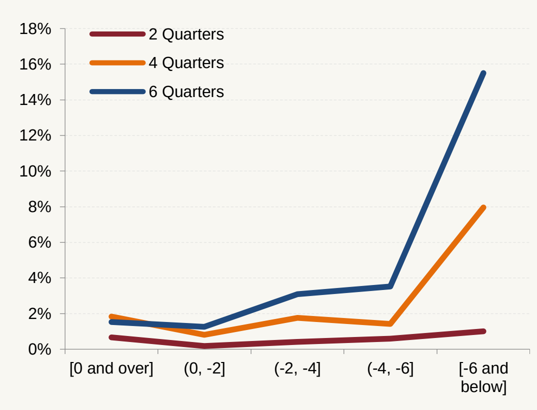
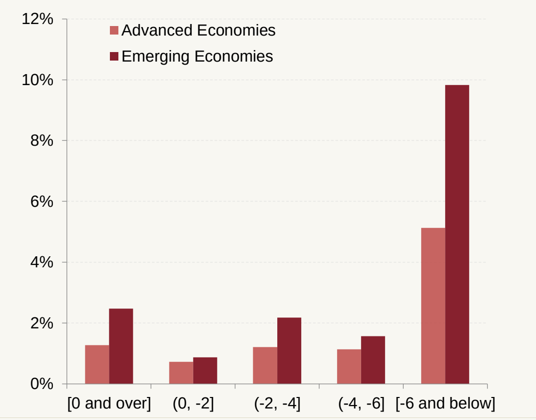


Chart 3. Correction Probability Above 6 Percent in 4 Quarters



[3] For the relationship of the current account deficit corrections with sudden stops, exchange rate and national income, see Edwards (2005).

The current account deficit surged in Turkey following the 2009 crisis and Turkey's rank deteriorated notably as illustrated in Chart 1. At end-2011, the current account deficit hit the historic high of 9.7 percent. Furthermore, the financing quality of the current account deficit also deteriorated due to the increase in short-term capital inflows. These high levels in the current account deficit bore the need for a sizeable correction and the risk of a sudden stop as depicted in Charts 2 and 3.

Macroprudential policies have recently been put into practice in Turkey in order to contain macrofinancial risks posed by high current account deficits. To this end, in the last quarter of 2010, the CBRT adopted a new policy mix that also takes financial stability into account in the face of surging credits, the excessive appreciation of the exchange rate and the high levels of the current account deficit. The excessive appreciation of the exchange rate was eliminated following 2011 and the credit growth rate fell to plausible levels also owing to the measures adopted by other regulatory institutions. In line with these developments, the current account deficit started to recover and fell to 6.5 percent in the second quarter of 2014. Excluding gold trade, this trend of recovery appears to be sustainable and the current account deficit excluding gold receded from 9.1 percent at end-2011 to 5.9 percent in the second quarter of 2014. According to the MTP covering the 2015-2017 period, the current account deficit is estimated to decline to 5.7 percent at end-2014 with the continued trend of recovery in the years to come. Contrary to the previous corrections that generally occurred during crisis periods, this recovery is experienced in an atmosphere of mild economic growth, which proves that implemented policy measures successfully provide a significant balancing in the economy.

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