4. Supply and Demand Developments

Third-quarter national accounts data are consistent with the outlook presented in the October Inflation Report. With the worsening European sovereign debt problems since May, the economy grew at a slower pace compared to the first half of the year. Domestic demand continued to recover steadily, while the increased demand for imported goods and the decline in exports caused net external demand to weaken. Thus, the divergence between domestic and external demand growth has become more pronounced during the exit phase.

Recent data releases indicate that the third-quarter slowdown in economic activity is temporary. While exports remained weak in the last quarter, domestic demand, particularly for imported goods, picked up strongly. The widening divergence in aggregate demand components widens the foreign trade deficit.

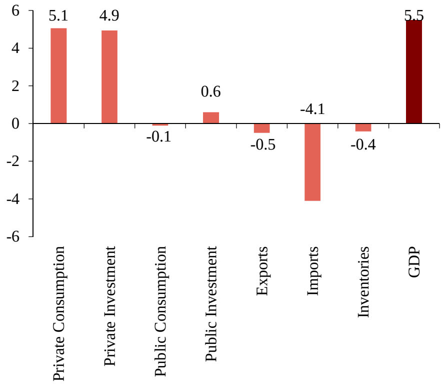
Although the weak global growth continues to restrain economic activity, the current stance of fiscal and monetary policies bolsters domestic demand growth. Accordingly, aggregate demand conditions provide increasingly less support for disinflation. Therefore, domestic demand should be kept under control in the upcoming period to limit the pass-through of rising unit costs into domestic prices.

4.1. Gross Domestic Product Developments and Domestic Demand

According to the national accounts data released by TurkStat, GDP grew by 5.5 percent year-on-year during the third quarter of 2010 (Graph 4.1.1). The third quarter annual growth has largely been driven by both private consumption and investment demand. However, amid falling exports and increased demand for imported goods, net external demand made a negative contribution to annual growth.

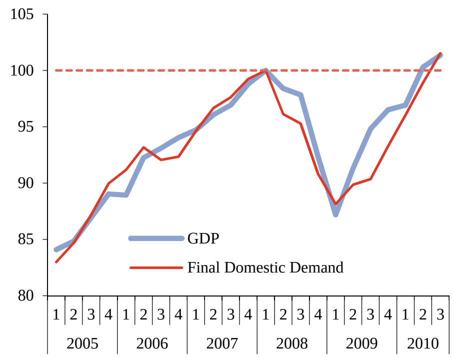
After accelerating in the second quarter, the seasonally adjusted GDP expanded by a slower 1.1 percent quarter-on-quarter. Exports declined rapidly, making a negative contribution to GDP growth, while domestic demand continued to grow steadily (Graph 4.1.2).

Graph 4.1.1. Contribution of Demand Factors to Annual GDP Growth
(Percent)



Source: TurkStat.

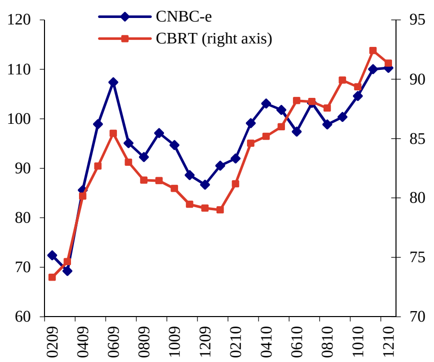
Graph 4.1.2. GDP and Final Domestic Demand
(Seasonally Adjusted, 2008Q1=100)



Source: TurkStat, CBRT.

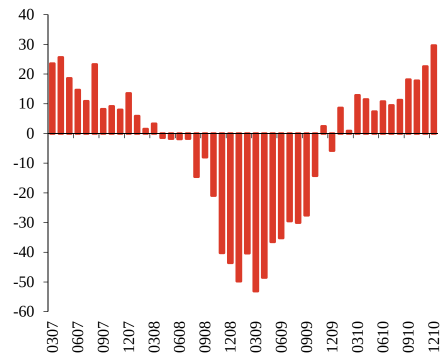
The fiscal and monetary policies in the last quarter as well as the waning political uncertainty after the September referendum helped both consumer confidence and the investment sentiment to improve substantially (Graphs 4.1.3 and 4.1.4). Indeed, the recent figures on production and imports indicate that the steady growth in domestic demand has accelerated over the fourth quarter.

Graph 4.1.3. Consumer Confidence
(Seasonally Adjusted)



Source: TurkStat, CNBC-e, CBRT.

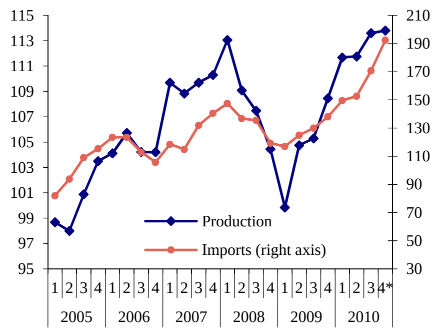
Graph 4.1.4. 12-Month Ahead BTS Expectations for Investment
(Seasonally Adjusted, Up-Down)



Source: CBRT.

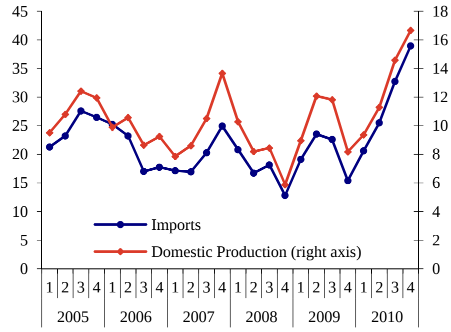
Production and imports of consumption goods were higher than the third-quarter average during October-November (Graph 4.1.5). Automobile loans have recently grown more robustly than consumer loans in general, with both domestic and imported automobile sales climbing (Graphs 4.1.6 and 4.1.7). The recently introduced policy measures, which are expected to contribute to a net tightening of loan standards, are likely to restrain borrowing and domestic demand growth in the upcoming period. December's fall in new order expectations of domestic consumption goods producing industries confirms this anticipation (Graph 4.1.8).

Graph 4.1.5. Production and Import Quantity Indices of Consumption Goods
(Seasonally Adjusted, 2005=100)



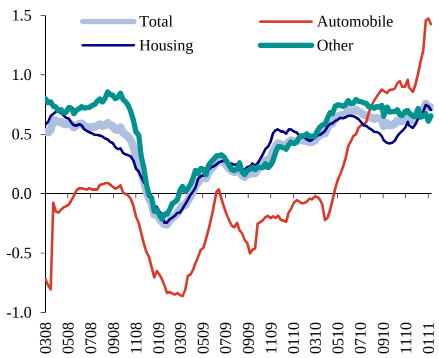
* October-November figures.
Source: TurkStat, CBRT.

Graph 4.1.6. Automobile Sales
(Seasonally Adjusted, Thousand)



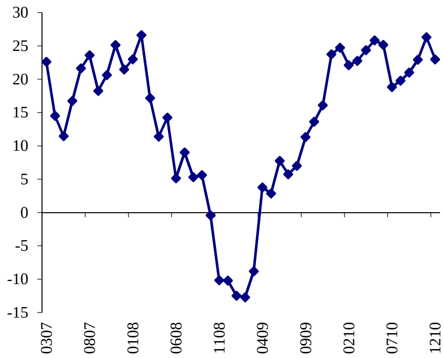
Source: Automotive Distributors' Association, CBRT.

Graph 4.1.7. Consumer Loans
(13-Week Average, Weekly Percentage Change)



Source: CBRT.

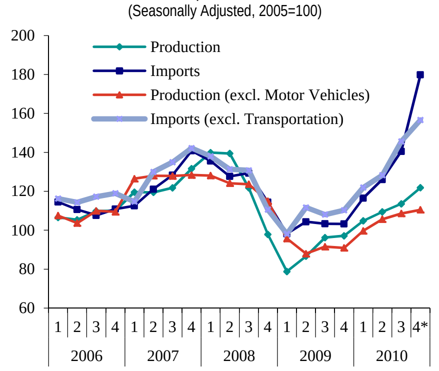
Graph 4.1.8. 3-Month Ahead BTS Expectations for Orders of Consumption Goods in the Domestic Market
(Seasonally Adjusted, Up-Down)



Source: CBRT.

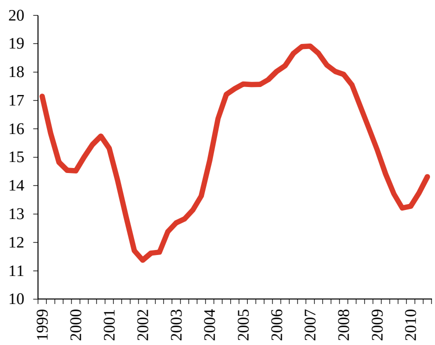
The production and imports of investment goods increased significantly during October-November compared to the third-quarter average, particularly on the back of motor vehicles (Graph 4.1.9). Indicators for the last quarter suggest that private investment would accelerate quarter-on-quarter and continue to rise sharply year-on-year.

Graph 4.1.9. Production and Import Quantity Indices of Capital Goods
(Seasonally Adjusted, 2005=100)



* October-November figures.
Source: TurkStat, CBRT.

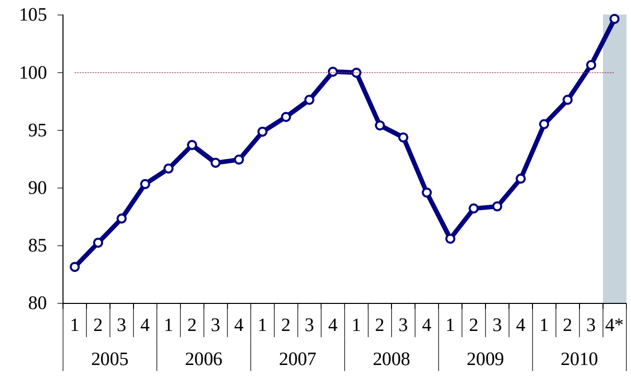
Graph 4.1.10. Private Investment to GDP
(Current Prices, Annual Moving Average, Percent)



Source: TurkStat.

Accounting for a smaller share of national income than in the pre-crisis period, investment spending is expected to recover further in coming months amid waning demand uncertainty and supportive monetary conditions (Graph 4.1.10). In fact, both the gradual rise in capacity utilization rates and the recent surge of manufacturing industry investments, hitting the four-year high, support this observation (Graph 4.1.4). However, global uncertainties continue to dampen external demand, slowing the pace of recovery in investments, particularly in the manufacturing industry.

Graph 4.1.11. Private Demand
(Seasonally Adjusted, 2008Q1=100)



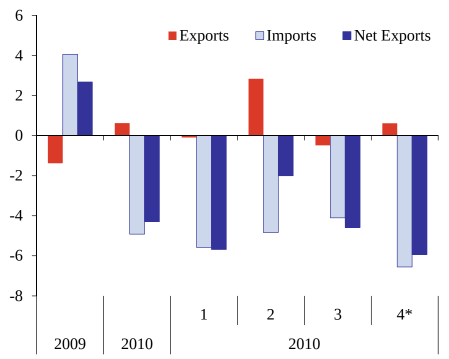
* Estimate.
Source: TurkStat,CBRT.

In summary, fiscal and monetary policies had a more significant expansionary impact on domestic demand over the final quarter of 2010. Consumption and investment increased gradually, and hence, private demand grew at a faster pace (Graph 4.1.11). Given the recent uptrend in import prices it is essential to keep domestic demand under control for the inflation outlook. The relevant policy measures are expected to put domestic demand on a relatively more moderate growth path, and thus, aggregate demand conditions are unlikely to exert significant pressure on inflation over 2011.

4.2. External Demand

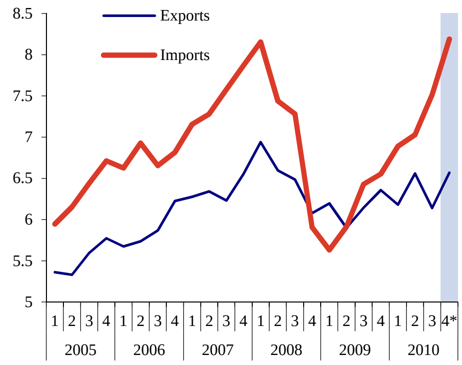
The outlook for net external demand was broadly consistent with the October Inflation Report forecasts in the third quarter. While exports of goods and services were down 2 percent year-on-year, imports of goods and services were up as high as 16.9 percent year-on-year. Thus, the negative contribution of net exports to GDP increased quarter-on-quarter (Graph 4.2.1). In seasonally adjusted terms, exports contracted rapidly quarter-on-quarter, whereas imports remained on a strong uptrend (Graph 4.2.2). Hence, the post-crisis divergence between domestic and external demand growth became more pronounced in the third quarter.

Graph 4.2.1. Contribution of Net External Demand to Annual GDP Growth
(Percent)



* Estimate.
Source: TurkStat, CBRT.

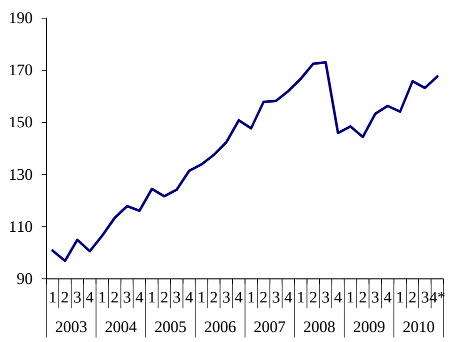
Graph 4.2.2. Exports and Imports of Goods and Services
(Seasonally Adjusted, 1998 Prices, Billion TL)



* Estimate.
Source: TurkStat, CBRT.

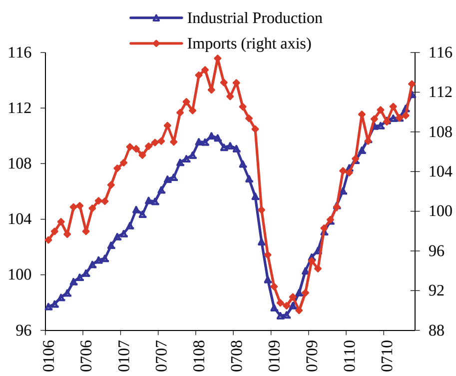
According to quantity indices, exports of goods remain volatile, after having accelerated in the fourth quarter following the third-quarter fall. In fact, the quantity index for exports excluding gold, a key indicator of underlying external demand, increased quarter-on-quarter in the fourth quarter (Graph 4.2.3). This observation is supported by the renewed momentum in global growth during the fourth quarter following the third-quarter slowdown (Graph 4.2.4). Therefore, exports of goods and services are expected to increase quarter-on-quarter in the final quarter.

Graph 4.2.3. Quantity Index for Exports Excluding Gold
(Seasonally Adjusted, 2003=100)



* Estimate.
Source: TurkStat, CBRT.

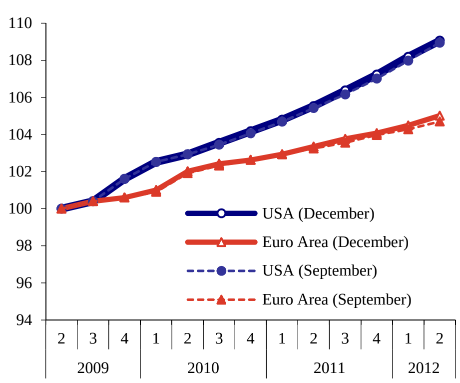
Graph 4.2.4. Imports and Industrial Production Index for the Global Economy
(Seasonally Adjusted, 2006=100)



Source: Netherlands Bureau for Economic Policy Analysis.

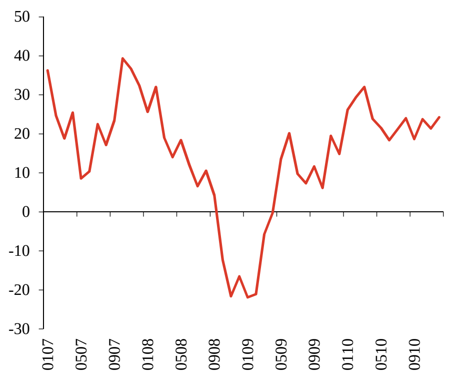
The global economic outlook over the medium term suggests that there downside risks to growth in external markets remain. Indeed, growth forecasts for the euro area, Turkey's largest export destination, remain broadly unchanged from October, while expectations for export orders do not point to a significant acceleration over the upcoming period (Graphs 4.2.5 and 4.2.6). Accordingly, exports are expected to recover slowly and gradually amid sluggish external demand.

Graph 4.2.5. GDP Forecasts for Advanced Economies
(Seasonally Adjusted, 2009Q2=100)



Source: Consensus Forecasts.

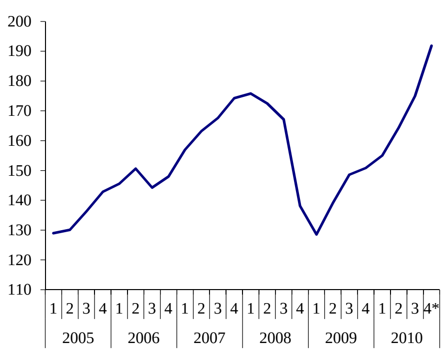
Graph 4.2.6. 3-Month Ahead BTS Expectations for Export Orders
(Seasonally Adjusted, Up-Down)



Source: CBRT.

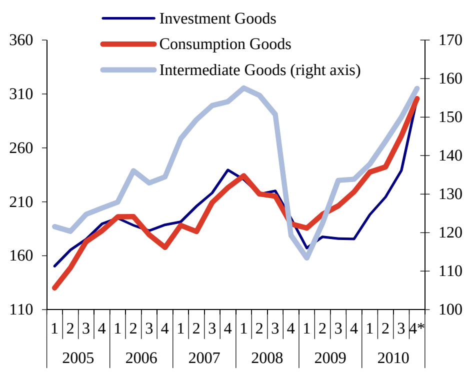
Imports continue to grow as domestic demand recovers steadily. Seasonally adjusted quantity index for imports indicates that imports continued to rise rapidly during October-November (Graph 4.2.7). Across subcategories, imports of consumption, investment and intermediate goods continued to surge (Graph 4.2.8)

Graph 4.2.7. Quantity Index for Imports
(Seasonally Adjusted, 2003=100)



* October-November figures.
Source: TurkStat, CBRT.

Graph 4.2.8. Quantity Index for Imports by Subcategories
(Seasonally Adjusted, 2003=100)

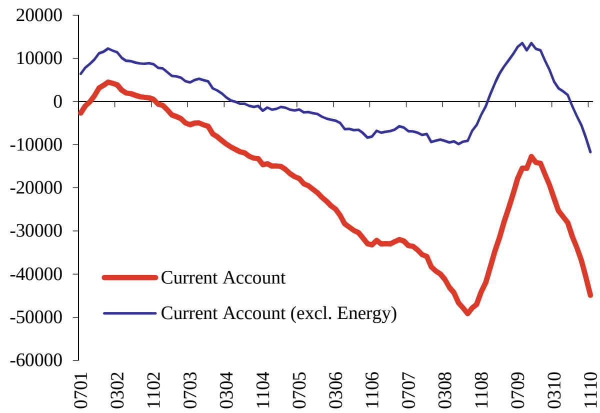


* October-November figures.
Source: TurkStat, CBRT.

Recent data releases suggest that the foreign trade balance continued to deteriorate in the last quarter. Despite the recovery in exports during the fourth quarter, net external demand is expected to make an increased negative contribution to annual growth amid the robust demand for imported goods

(Graph 4.2.1). This indicates that the divergence between domestic and external demand growth has become more pronounced during the exit. As a result, the current account continued to deteriorate (Graph 4.2.9). It is important to keep domestic demand under control amid weak external demand in order to stabilize the foreign trade deficit, and hence, the current account deficit.

Graph 4.2.9. Curent Account Balance
(12-Month Cumulative, Million USD)

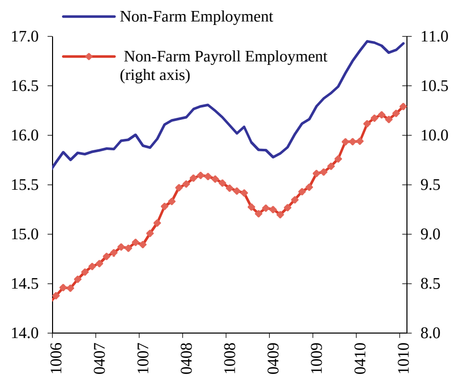


Source: TurkStat,CBRT.

4.3. Labor Market

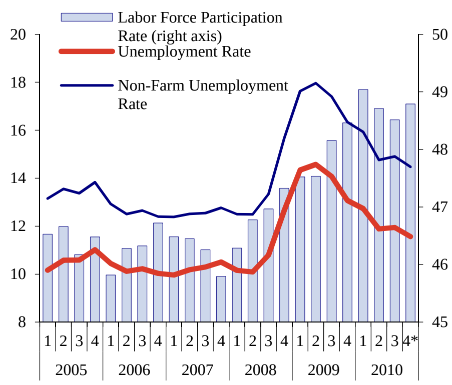
Having recovered quickly since the first quarter of 2009, non-farm employment fell slightly during the third quarter of 2010 amid slower economic growth. However, non-farm payroll employment, a key indicator of underlying employment, continued to increase, suggesting that the slowdown in non-farm employment is temporary.

Graph 4.3.1. Non-Farm Employment
(Seasonally Adjusted, Million)



Source: TurkStat, CBRT.

Graph 4.3.2. Unemployment
(Seasonally Adjusted, Percent)

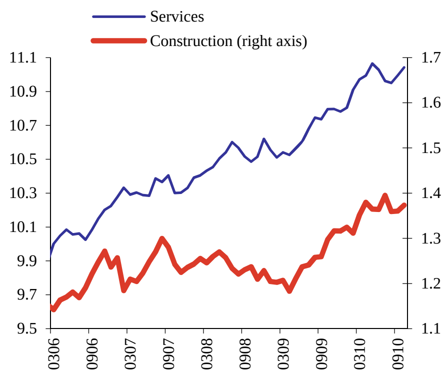


* As of October.
Source: TurkStat, CBRT.

Despite slowing non-farm employment, the unemployment rate remained flat in the third quarter due to falling labor force participation rate. The unemployment rate declined slightly following the increase in non-farm employment during September and October. Crisis-driven job losses have been compensated by the economic recovery, but employment growth has failed to meet the growing need for labor. Indeed, non-farm unemployment remains about 2 percentage points above its pre-crisis level even though the economy has returned to pre-crisis levels (Graph 4.3.2). The large number of unemployed and the new labor market entrants exceed the economy's capacity to create jobs, fueling concerns that the unemployment rate would decline slowly in the upcoming period, taking a long while to reach pre-crisis levels.

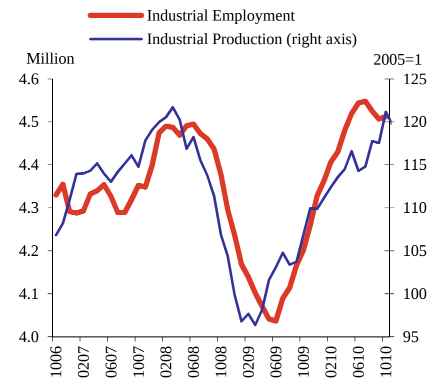
Although the services sector accounted for most of the third-quarter pause in non-farm employment growth, recent data releases indicate that services employment has increased (Graph 4.3.3). Meanwhile, September's decline in industrial employment was followed by a weak growth in October (Graph 4.3.4). The fall in manufacturing industry employment, a major component of industrial employment, was mainly driven by the fall in unregistered employment (Graph 4.3.5). This observation supports the view that the fall in non-farm employment is temporary.

Graph 4.3.3. Services and Construction Sector Employment
(Seasonally Adjusted, Million)



Source: TurkStat, CBRT.

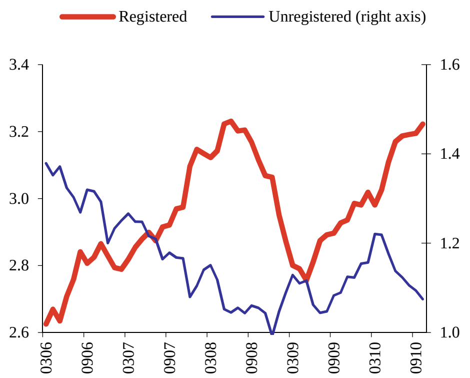
Graph 4.3.4. Industrial Employment and Production
(Seasonally Adjusted)



Source: TurkStat, CBRT.

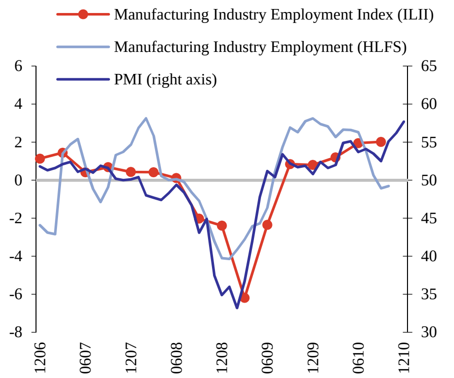
Output developments and the PMI employment index show that industrial employment continued to rise in the fourth quarter, albeit at a slower pace (Graph 4.3.6). However, uncertainties about the pace of recovery in external demand continue to dampen industrial employment. Moreover, it should be noted that the PMI employment index provides insight into large-scale and registered firms, and is therefore more consistent with the manufacturing employment index based on firm survey data. The household industrial employment is expected to increase at a slower pace than suggested by the PMI employment index in coming months.

Graph 4.3.5. Registered and Non-Registered Manufacturing Industry Employment
(Seasonally Adjusted, Million)



Source: TurkStat, CBRT.

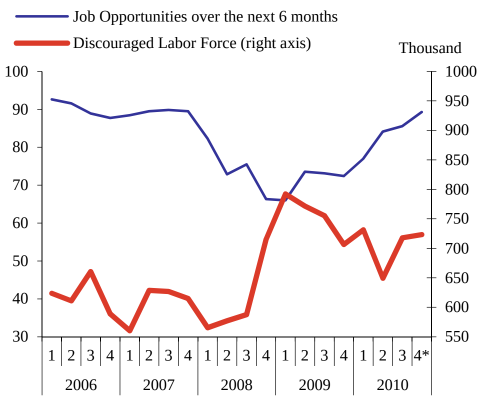
Graph 4.3.6. Manufacturing Industry and PMI Employment Index
(Seasonally Adjusted)



Source: TurkStat, Markit, CBRT.

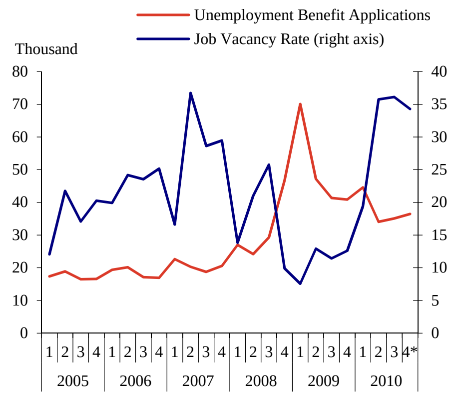
Fourth-quarter indicators show that labor market conditions showed no deterioration in the last quarter. The job opportunities index derived from the Consumer Confidence Index continued to improve, reaching pre-crisis levels, while the number of discouraged labor force remained flat (Graph 4.3.7). The Turkish Employment Agency's release of the fourth-quarter job vacancy rate, the ratio of private sector job vacancies to the number of job applications by unemployed, and applications for unemployment benefits showing employment losses do not point to a deterioration in employment conditions during the fourth quarter (Graph 4.3.8).

Graph 4.3.7. Job Opportunities Index and Discouraged Labor Force
(Seasonally Adjusted))



* October figures.
Source: TurkStat, CBRT.

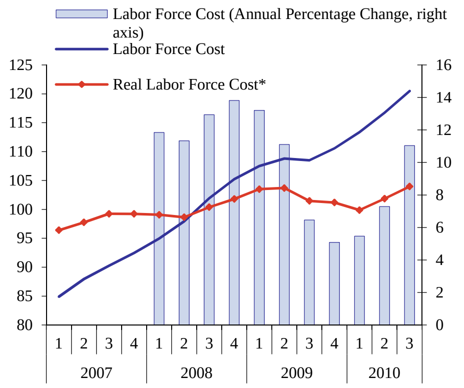
Graph 4.3.8. Private Sector Job Vacancy Rate and Unemployment Benefit Applications



* October-November figures.
Source: Turkish Employment Agency, CBRT.

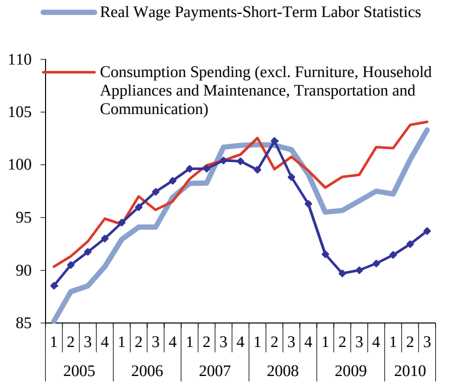
Recently, labor costs have been of greater importance due to rising import prices and strong domestic demand. Hourly labor costs dropped by 1 percent year-on-year in real terms during the first nine months of 2010, bringing inflation further down (Graph 4.3.9).[1] However, the minimum wage for 2011 is hiked by an average 9.7 percent year-on-year. Considering the inflation target for 2011, this wage hike raises employers' costs by 4 percent in real terms. Therefore, with other cost factors to consider, it is essential to keep domestic demand under control to keep inflation on a downward path.

Graph 4.3.9. Hourly Labor Cost
(Seasonally Adjusted, 2008=100)



* Deflated by CPI.
Source: TurkStat, CBRT.

Graph 4.3.10. Household Spending, Non-Farm Employment and Real Wages*
(Seasonally Adjusted, 2007=100)

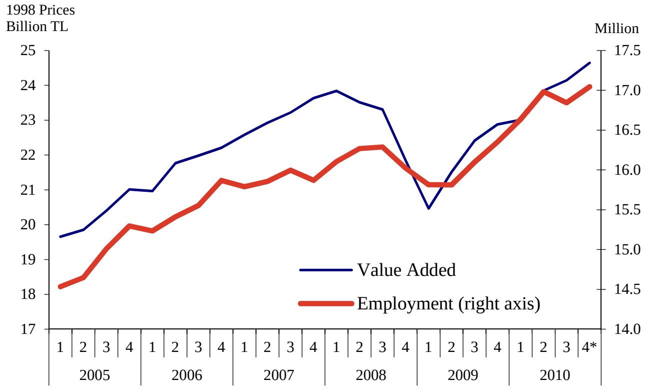


* Calculated by the weighted average of total wages paid in industrial, construction, trade, restaurants and hotels, transportation and communication sectors. Converted to a real index by using the household consumption deflator.
Source: TurkStat Short-Term Labor Statistics, CBRT.

In sum, although non-farm employment declined slightly in the third quarter, developments in subcategories and near-term indicators suggest that this decline is temporary and employment would continue to improve gradually. However, the large number of unemployed and the labor market dynamics indicate that it would take a long while before unemployment falls back to pre-crisis levels. Employment will continue to grow in the upcoming period, providing further support for the gradual recovery in aggregate demand, while high unemployment would put a cap on rising labor costs (Graphs 4.3.10 and 4.3.11).

[1] The Hourly Labor Cost Index with base year 2008 is published by TurkStat as earnings and non-earnings (social security, severance and termination payments, and other labor cost payments by the employer).

Graph 4.3.11. Non-Farm Value Added and Employment
(Seasonally Adjusted)



* Estimate.
Source: TurkStat, CBRT.