4. Supply and Demand Developments

The fourth-quarter economic activity recovered in tandem with the January Inflation Report projections. Excepting the compensation of the workday losses, the rebound proved mild in this period. Private consumption expenditures displayed a more robust increase compared to investment expenditures amid the measures and incentives in effect. In the last quarter, due to the decline in the share of tourism revenues in exports as well as the strong course of exports of goods, net exports contributed positively to the quarterly growth. Meanwhile, amid the decline in tourism revenues, the increase in perceived uncertainty and tightness in financial conditions, growth remained below past year's averages in 2016.

Despite a quarter-on-quarter slowdown, current indicators show that economic activity remained mild in the first quarter of 2017. In this period, domestic demand has been supported by sectors such as furniture and white goods, which have been stimulated by public incentives. On the other hand, the mounting uncertainty in the first quarter, the sluggish course of the labor market and the poor outlook in the services sectors, primarily in the retail sector, signal that domestic demand may lose momentum in this period. In the first quarter, exports increased both across regions and sectors. Accordingly, exports to the EU surged in this period. It is estimated that imports will register a milder increase than exports owing to the prospects for domestic demand and the exchange rate developments in the first quarter, and so net exports will continue to boost growth.

Prospects for the tourism sector still lack a noticeable sign of improvement. On the other hand, depending on the course of the real exchange rate, the improvement in the global growth outlook and the market diversification elasticity, exports of goods are expected to remain strong in 2017. Besides exports, supportive measures and incentives in effect are believed to bolster the moderate rebound in economic activity throughout the year. Accordingly, growth is expected to exhibit a more optimistic pattern in 2017 than the previous year. However, uncertainties over the monetary policies of advanced economies as well as the course of capital flows and geopolitical developments continue to pose downside risks to growth in 2017. Lastly, the favorable impact of commodity prices on the current account balance is projected to decline gradually in the period ahead.

4.1. Supply Developments

The GDP increased by 3.5 percent in annual terms and by 3.8 percent on a seasonal and calendar adjusted basis in the last quarter of 2016, while the GDP grew by 2.9 percent across 2016. The annual and quarterly upturn in the last quarter was driven by the services and industrial sectors, and the net tax item contributed positively to growth as well (Charts 4.1.1 and 4.1.2). On the other hand, the contribution of agriculture and construction sectors to growth in this period proved to be limited.

Chart 4.1.1.
Annual GDP Growth and Contributions from the Production Side (Percentage Point)

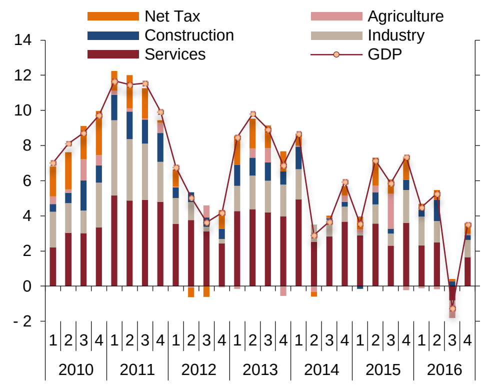
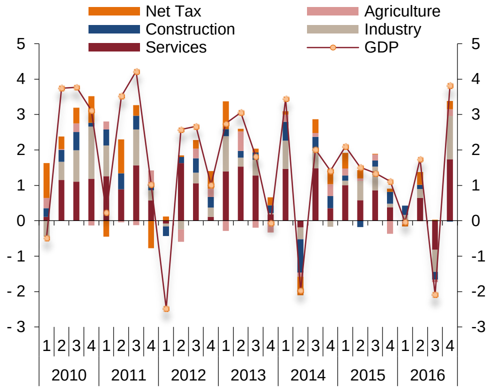


Chart 4.1.2.
Quarterly GDP Growth and Contributions from the Production Side (Seasonally Adjusted, Percentage Point)



Source: TURKSTAT, CBRT.

Industrial production realizations in the January-February period of 2017 hint at a mild increase in economic activity in the first quarter of the year (Charts 4.1.3 and 4.1.4). In this period, export-oriented sectors, particularly vehicles display a favorable performance. Sectors like furniture and white goods that are subject to tax incentives also support the increase in industrial production. In addition, the regulation that stipulates domestic production of pharmaceuticals without any patent protection is projected to bolster pharmaceuticals manufacturing across 2017. On the other hand, other sectors may confine the rise in industrial production in the first quarter.

Chart 4.1.3.
Industrial Production Index
(Annual Percent Change)

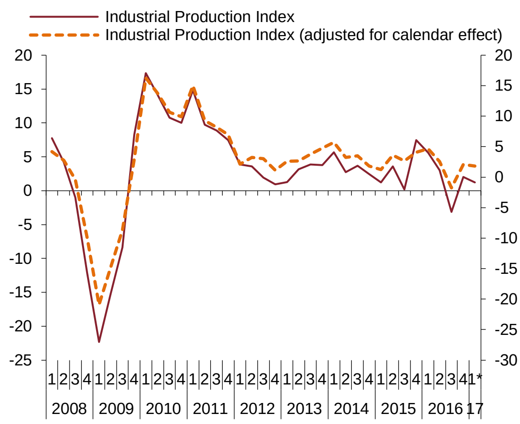
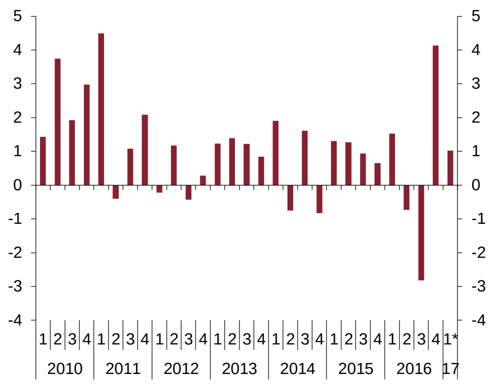


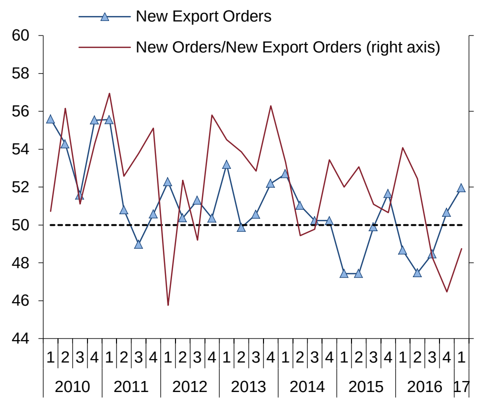
Chart 4.1.4.
Industrial Production Index
(Seasonally Adjusted, Quarterly Percent Change)



* As of February.
Source: TURKSTAT.

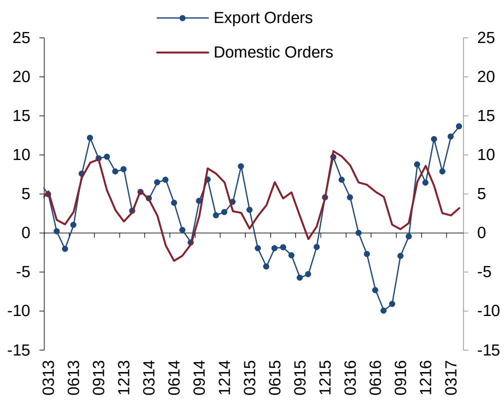
Survey indicators confirm the moderate first-quarter course of economic activity, and indicate that export sectors remain relatively better off (Charts 4.1.5 and 4.1.6). The expansion in export markets, the market diversification flexibility and the depreciation of the Turkish lira are considered to be influential in the rising export orders. On the other hand, the elevated uncertainty in the first quarter, the sluggish course in the labor market and the weak outlook in services, especially in the retail sector stand out as downside risks to domestic demand. April readings for BTS point to an improvement in manufacturing industry orders compared to the first-quarter average (Chart 4.1.6).

Chart 4.1.5.
PMI Orders Indicators
(Seasonally Adjusted)



Source: Markit.

Chart 4.1.6.
BTS Overall Orders over the Past 3 Months*
(Up-Down, Seasonally Adjusted, 3-Month Moving Average)

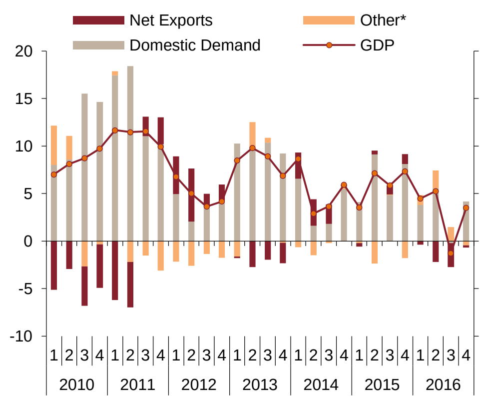


Source: CBRT.

4.2. Demand Developments

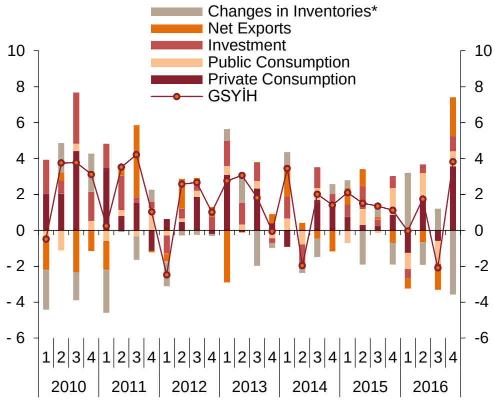
The data on GDP from the expenditures side indicate that final domestic demand added more to annual growth compared to the previous quarter, while net exports provided a limited negative contribution to growth in the final quarter of 2016 (Chart 4.2.1). Seasonally adjusted data reveal that the last-quarter rebound in economic activity was spurred by both final domestic demand and net exports. The annual and quarterly increase in final domestic demand was mainly led by private consumption, while the hike in investments also supported growth (Chart 4.2.2).

Chart 4.2.1.
Annual GDP Growth and Contributions from the Production Side (Percentage Point)



* Other includes statistical error due to inventories and chain index.
Source: TURKSTAT, CBRT.

Chart 4.2.2.
Quarterly GDP Growth and Contributions from the Expenditures Side (Seasonally Adjusted, Percentage Point)



* CBRT's estimate.
Source: TURKSTAT, CBRT.

Upon a decline in the third quarter of 2016 due to heightened domestic uncertainties and tightened financial conditions, private consumption increased at a quarterly basis in the last quarter amid the partial easing in macroprudential measures, the demand that was brought forward in automobiles, and the favorable course in certain housing-related sectors (Chart 4.2.3). In this period, the recovery in the machinery and equipment remained limited, while the year-long optimistic figures of construction investments were maintained across the last quarter (Chart 4.2.4).

Chart 4.2.3.
Private and Public Consumption
(Seasonally Adjusted, 2009=100)

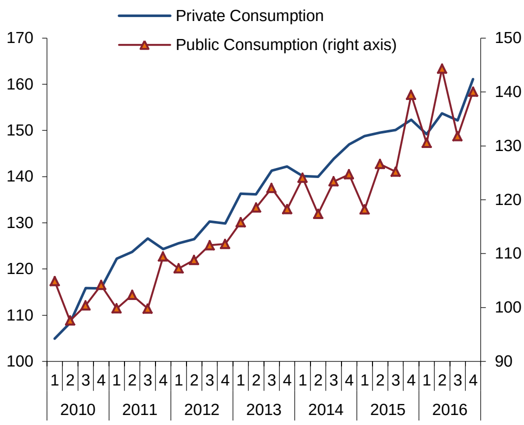
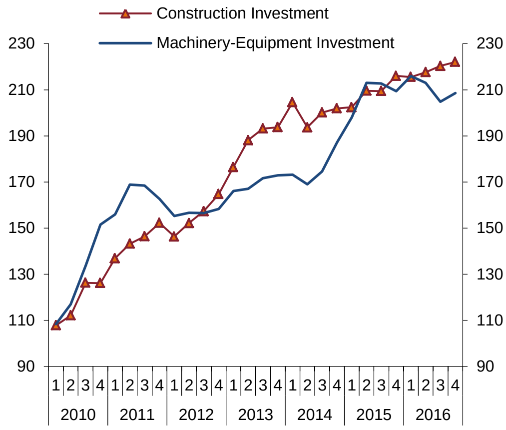


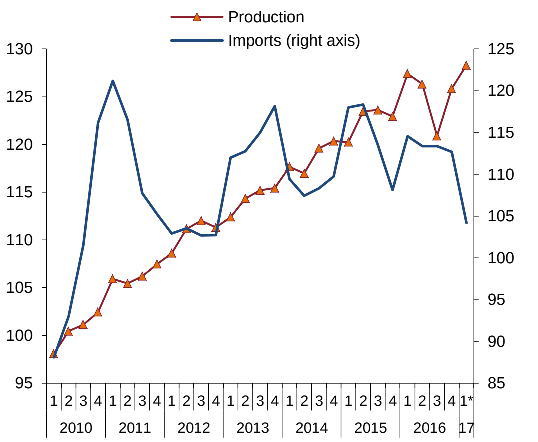
Chart 4.2.4.
Construction and Machinery-Equipment Investment
(Seasonally Adjusted, 2009=100)



Source: TURKSTAT.

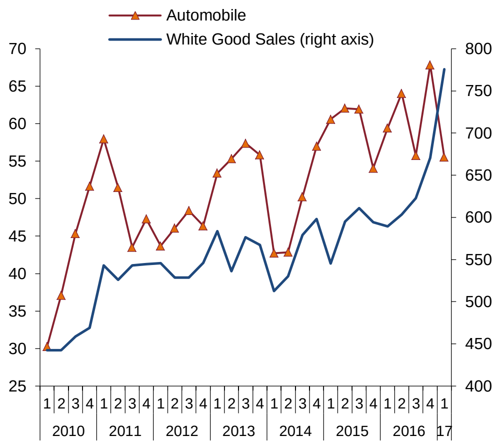
Private consumption expenditures are likely to remain moderate in the first quarter of 2017. Production of consumption goods stood above the previous quarter in the January-February period. On the other hand, the downtrend in the imports of consumption goods persisted into the first quarter of 2017 (Chart 4.2.5). Current data hint at stronger sales of white goods. The tax reduction effected in early February to last until the end of September is expected to sustain the favorable figures in the sales of white goods and furniture. However, sales of automobiles took a plunge in the first quarter (Chart 4.2.6). This is attributed to the fact that a part of sales, which are expected to occur in this quarter, were brought forward and took place in the last quarter due to the SCT rise and the depreciated Turkish lira. Additionally, services and the retail sector lacked an evident improvement compared to the last quarter, pointing out that the sectoral spillover of private consumption demand may remain limited in the first quarter. However, the improvement in these sectors in April depicts a more positive outlook for private consumption in the second quarter (Chart 4.2.7).

Chart 4.2.5.
Production and Imports of Consumption Goods
(Seasonally Adjusted, 2010=100)



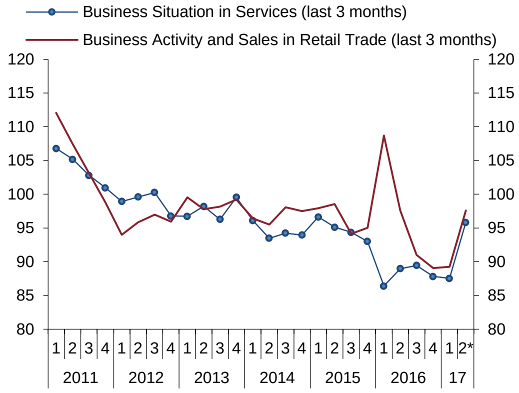
* As of February.
Source: TURKSTAT, CBRT.

Chart 4.2.6.
Automobile and White Good Sales



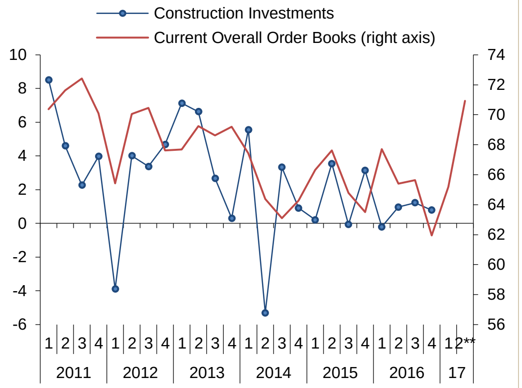
Source: AMA, WGMA, CBRT.

Chart 4.2.7.
Business Situation in Services and Business Activity and Sales in Retail Trade
(Seasonally Adjusted)



* As of April.
Source: TURKSTAT

Chart 4.2.8.
Construction Investments and Current Overall Order Books*
(Seasonally Adjusted)



* Construction investments are quarterly percent change. Current overall order books are a sub-index of the construction confidence index.
** As of April.
Source: TURKSTAT

Current indicators do not signal a strong recovery in investments in the first quarter. In the January-February period, production of machinery and equipment inched up, while imports thereof lagged behind the last quarter readings (Chart 4.2.9). As for construction indicators, the production of non-metallic minerals remained unchanged quarter-on-quarter, while the imports thereof receded. On the other hand, a joint analysis of the recovery in the current level of construction orders and the incentives for the housing sector implies a possible momentum in construction investments in the first quarter (Charts 4.2.8 and 4.2.10).

Chart 4.2.9.
Production and Imports of Machinery and Equipment
(Seasonally Adjusted, 2010=100)

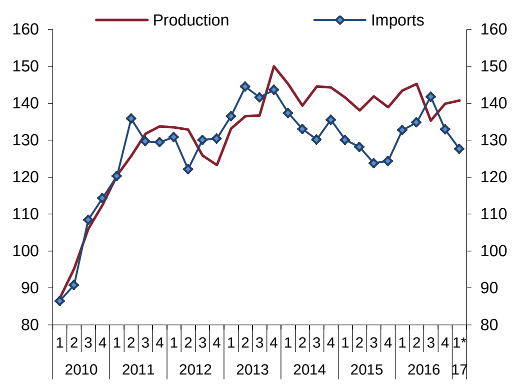
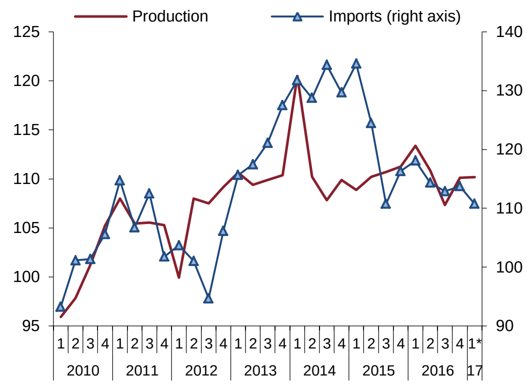


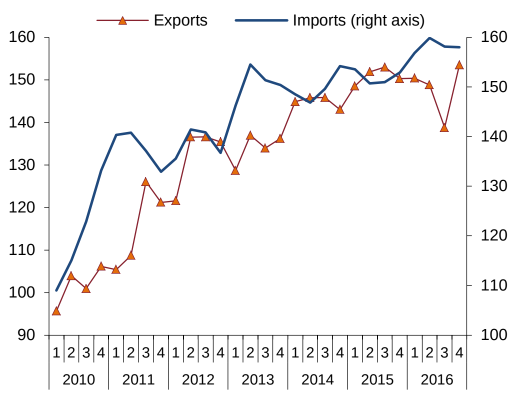
Chart 4.2.10.
Production and Imports of Non-Metallic Minerals
(Seasonally Adjusted, 2010=100)



* As of February.
Source: TURKSTAT, CBRT.

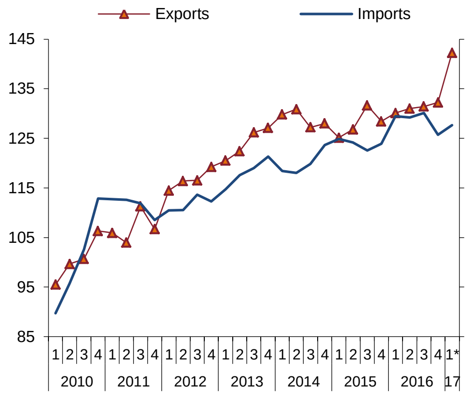
In the last quarter of 2016, the share of tourism within exports dwindled and exports of goods surged, which led to a rise in total exports of goods and services and a flat course in the imports of goods and services (Chart 4.2.11). Thus, net exports added substantially to quarterly growth in the last quarter. Recently released data show that the strong upswing in exports spread across sectors and regions (Chart 4.2.12). However, current data indicate a slight rise in imports resulting from the mild course of domestic demand. Accordingly, net exports are likely to spur growth further in the first quarter.

Chart 4.2.11.
Exports and Imports of Goods and Services
(Seasonally Adjusted, 2009=100)



Source: TURKSTAT.

Chart 4.2.12.
Quantity Indices for Exports and Imports
(Non-Gold, Seasonally Adjusted, 2010=100)



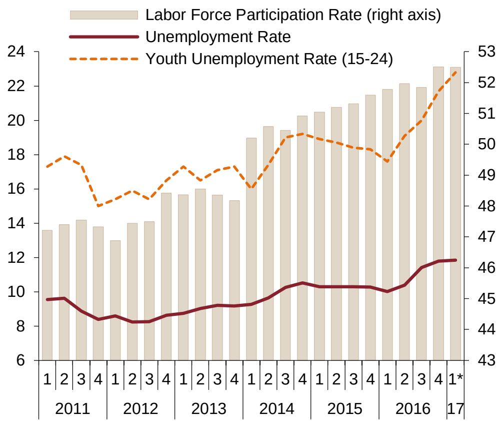
* Forecast for March.
Source: TURKSTAT, CBRT.

In sum, the last-quarter economic activity was buoyed both by domestic demand and net exports. Indicators for the first quarter of 2017 show that economic activity remained on a mild track, albeit slowing on a quarterly basis, while net exports bolstered quarterly growth against the loss of momentum in domestic demand. Meanwhile, high levels of uncertainty in the first quarter coupled with the sluggish course of the labor market and the services sector, particularly the retail sector are considered to pose downside risks to the domestic demand outlook.

4.3. Labor Market

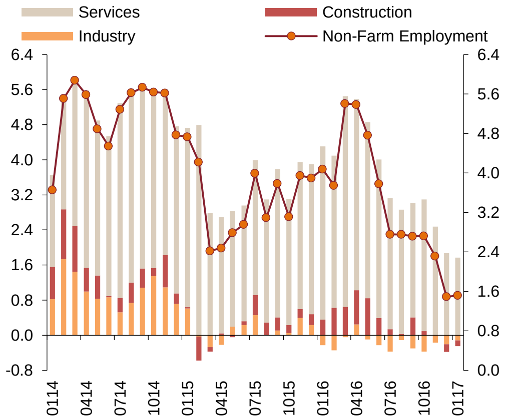
In 2016, the economic downturn led to a contraction in new job opportunities, a rise in job losses and an upsurge in unemployment. In the last quarter of the year, the rise in non-farm employment fell short of the rise in the labor participation rate and the total unemployment rate inched up by 0.4 points quarter-on-quarter to 11.8 percent (Chart 4.3.1). Parallel to the course of economic activity in the second half of the year, industrial and construction sectors witnessed a contraction in the third quarter as opposed to a partial recovery in the last quarter (Chart 4.3.2).

Chart 4.3.1.
Unemployment Rates
(Seasonally Adjusted, Percent)



* As of February.
Source: TURKSTAT.

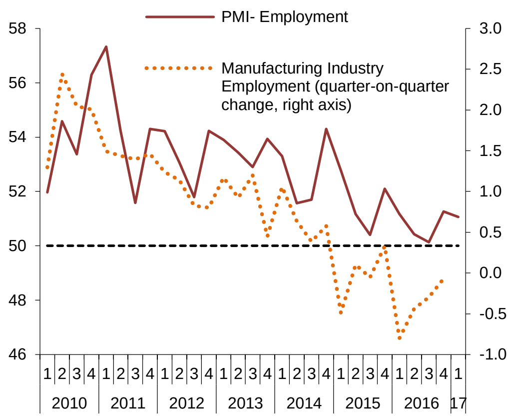
Chart 4.3.2.
Contributions to Changes in Non-Farm Unemployment
(Seasonally Adjusted, Percentage Point)



Source: TURKSTAT.

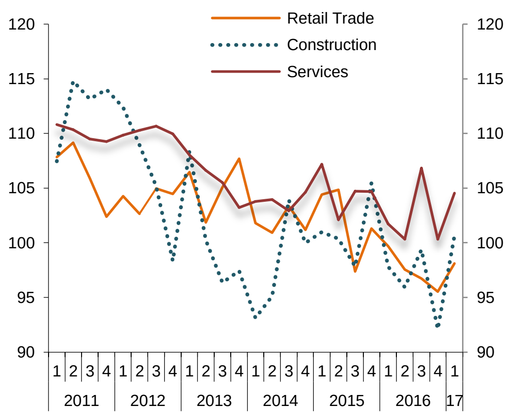
Data regarding the December 2016-February 2017 period show that the labor market stood weak in the first quarter of 2017. Employment grew at a crawl in this period and total unemployment has remained unchanged since the last quarter, while youth unemployment trended up again. However, leading indicators show that the outlook in March may prove more favorable compared to the first two months. The PMI employment, an indicator for the manufacturing industry employment, receded in January, but jumped in March, driving the quarterly average upwards (Chart 4.3.3). Similarly, upon muting in January and February, 3-month-ahead employment expectations in services, retail and construction sectors posted an evident rise in March (Chart 4.3.4). These indicators imply that the worsening in employment may have come to a halt at the end of the first quarter.

Chart 4.3.3.
PMI Employment Index and Manufacturing Industry Employment (Seasonally Adjusted)



Source: TURKSTAT, Markit.

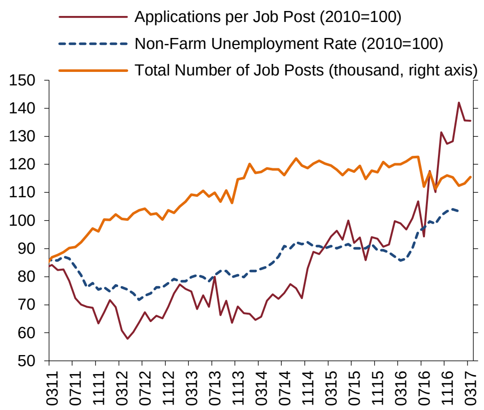
Chart 4.3.4.
Employment Expectation by Sectors over the next 3 Months
(Seasonally Adjusted)



Source: TURKSTAT.

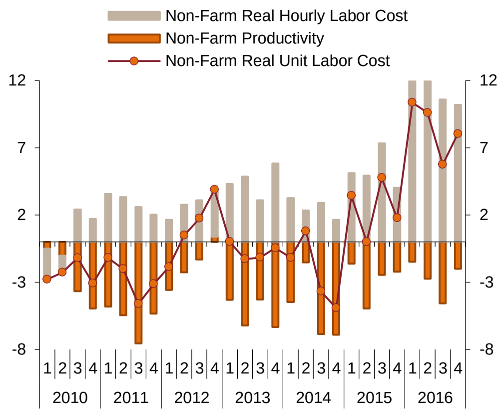
Data from Kariyer.net indicate that the total number of job posts still remains low at the second-half readings of 2016. However, this indicator also posted a limited rise in March (Chart 4.3.5). On the other hand, applications per job post, which are closely associated with unemployment rates, trended upwards. Thus, leading indicators signal sustained high levels of unemployment rates in the first quarter of the year.

Chart 4.3.5.
Applications per Job Post, Non-Farm Unemployment Rate and Total Number of Job Posts
(Seasonally Adjusted)



* As of February.
Source: Kariyer.net, CBRT.

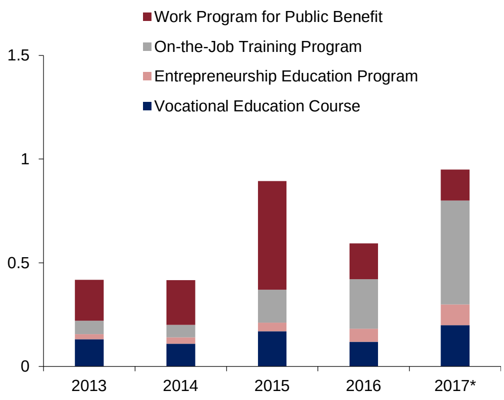
Chart 4.3.6.
Contributions to Non-Farm Unit Labor Cost
(Annual Percent Change, 2010=100)



Source: TURKSTAT, CBRT.

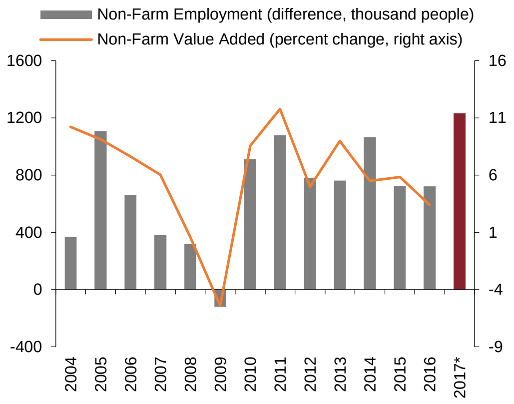
Supply-side effects of labor market developments reveal that rising unemployment confined the increase in wages particularly for those earning above the minimum wage. However, labor costs stood out as an additional burden on inflation due to the minimum wage adjustment of 2016. In this period, which is marked by low productivity gains, wage hikes were largely reflected on unit labor costs (Chart 4.3.6). On the other hand, the minimum wage support to employers provided by the government partly compensated for the adverse effects of wage hikes on both employment and costs. The minimum wage was raised by 8 percent in 2017. The sustained government support to employers in 2017, which was introduced in 2016 following the minimum wage increase, will continue to limit the cost increase incurred by the employer.

Chart 4.3.7.
Number of Beneficiaries in Employment Programs
(Million)



* Targeted. Compiled from news articles based on official statements.
Source: Turkish Employment Agency.

Chart 4.3.8.
Non-Farm Employment and Non-Farm Value Added



* Targeted.
Source: TURKSTAT.

In 2016, active labor programs continued to bolster employment. The focus of these practices shifted from working for the public interest, which are temporary in nature, to on-the-job training programs. In 2017, active labor programs are aimed to be amplified compared to 2016 (Chart 4.3.7). Across 2017, an employment mobilization campaign was launched aiming at a 2-million rise in employment including the beneficiaries of the on-the-job training program.[1] This targeted increase of employment by 2 million people under these programs throughout 2017 corresponds to a high increase in employment by around 1 million 200 thousand compared to the previous year's average (Chart 4.3.8).

In short, in early 2017, employment continued to crawl and total unemployment stood unchanged from the last quarter of 2016. Leading indicators suggest some rebound in employment toward the end of the first quarter. Current trends in employment and unemployment rates may dampen the private consumption demand for the upcoming period. Loan support offered to firms and the rise in employment that may be included in the plus employment program is believed to bolster private consumption and the trend of recovery in economic activity.

[1] Under the employment mobilization campaign, employers that increase employment in sectors with high value added will be offered incentives. The employers hiring new college graduates are given priority in this program. Accordingly, 50 and 25 percent of the monthly net minimum wage payment of the new employees will be covered by the government in the first and second years, respectively. Moreover, as per the Decree No. 687 of 9 February 2017, insurance premium, income tax withholding and stamp duty support shall be offered over the minimum wage for the additional employment to be provided by private employers as of February 2017.

4.4. Outlook for 2017

In addition to incentives to boost domestic demand, economic activity is estimated to exhibit a mild and gradual recovery across 2017 owing to the projected improvement in exports. Waning domestic uncertainties in particular are likely to give a push to this trend in the second half of the year. Due to the partial easing in macroprudential measures, the consumer loan pattern as well as employment incentives are expected to spur private consumption expenditures in 2017. On the other hand, wages are estimated to contribute less to private consumption expenditures in 2017 than the previous year. Meanwhile, investments are likely to prove stronger than 2016 owing to the planned increases in public investments and the incentives in effect.

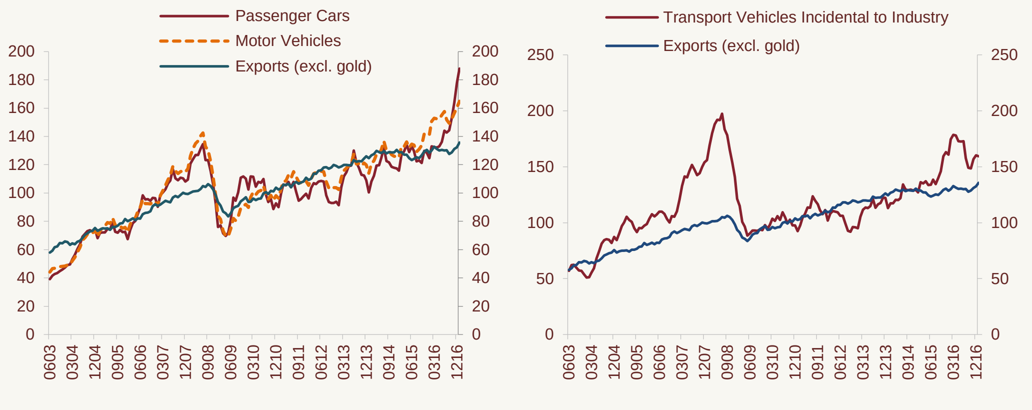
In 2017, exports of goods are expected to offer a larger contribution to growth. The improvement in the export-weighted global growth outlook, the possible positive income effect of the hike in oil prices on Turkey's oil-exporting trading partners, the course of the real exchange rate, export incentives and market diversification flexibility are primary factors to stimulate exports in 2017. However, the lack of a noticeable signal for improved tourism revenues may suppress the contribution of exports of services to growth.

To sum up, economic activity is likely to gain gradual strength on the back of domestic and external demand throughout 2017. Thus, growth is estimated to perform better in 2017 than the previous year. However, blurred monetary policies of advanced economies, the course of capital flows and geopolitical developments pose downside risks to growth. Finally, the positive effect of commodity prices on the current account deficit is projected to decline gradually in the months to come.

Box 4.1 The Recent Acceleration in Automotive Exports and the EU Export Demand

The automotive industry is an important sector in Turkey and also across the world. It creates high value added and employment, and also generates FX revenue through the exports channel, while driving growth through its strong backward and forward linkages with other sectors. In particular, the automotive manufacturing saw a rapid shift from advanced economies to emerging economies after the global crisis, which caused emerging economies to have an increased share in global production. In fact, annual production in 2015 by China, India and Turkey has increased by 12, 5 and 3 times, respectively since 2000 (Pişkin, 2017). Accordingly, automotive exports surged by 13.4 percent in Turkey in 2016, which produced a foreign trade surplus by around 2 billion USD on a sectoral basis.[2] Despite having displayed a parallel move with the growth of total exports since the global crisis, automotive exports diverged positively from total exports as of early 2016 (Chart 1). Even though this divergence is spread across all sub-sectors of the industry, it is more remarkable in passenger cars. Accordingly, this box gives an analysis of the recent increase in automotive exports in the context of the demand from the EU, which is Turkey's largest export market.

Chart 1. Total Exports and Automotive Exports by Sub-Sectors (Quantity Index, 6-Month Moving Average)



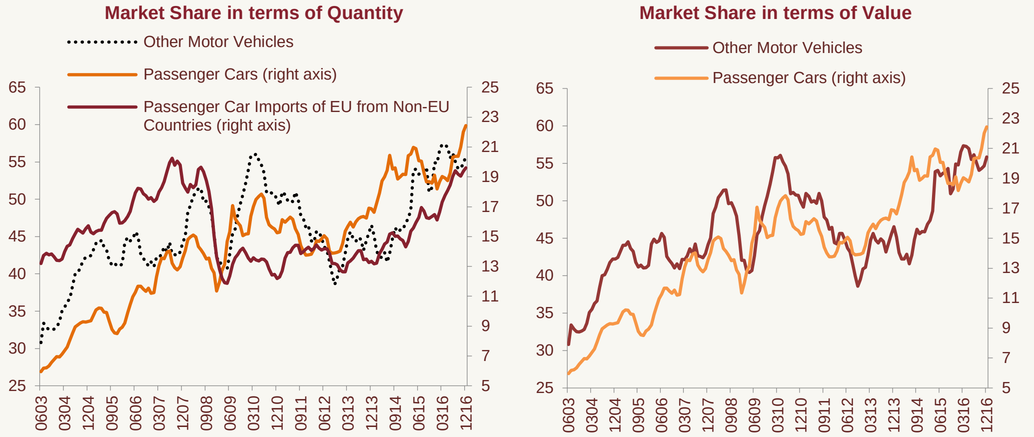
Source: TURKSTAT, CBRT.

Chart 2 shows the change in Turkey's market share in the EU's imports of motor vehicles from non-EU countries over time. In general, Turkey's market share in passenger cars and other motor vehicles[3] has been increasing. In terms of quantity (units of kg), Turkey's market share in passenger cars grew by around 3.8 times from 2003 to 2016, while it surged by 1.8 times in other motor vehicles.

Turkey's market share in passenger cars, which was 18 percent in January 2016, climbed by 4 points to 22 percent in December. This increase is crucial especially in a time when non-EU imports of passenger cars also surged rapidly in quantity. The increasing market share is believed to be driven especially by exports of new models by automotive producers. The market share in other motor vehicles, which was 55 percent in early 2016, rose by 1 point and reached 56 percent at the end of 2016.

[2] Based on foreign trade data No. 87 under the Turkish tariff nomenclature. Also includes automotive parts and accessories.
[3] Includes other motor vehicles, tractors, motor vehicles designed to carry 10 or more people (including the driver), motor vehicles designed to transport things and special-purpose motor vehicles (wrecker, crane, fire brigade, concrete mixer, street sweeper, asphalt vehicles, etc.).

Chart 2. Turkey's Market Share in EU's Imports of Motor Vehicles from Non-EU Countries (Percent, 6-Month Moving Average)

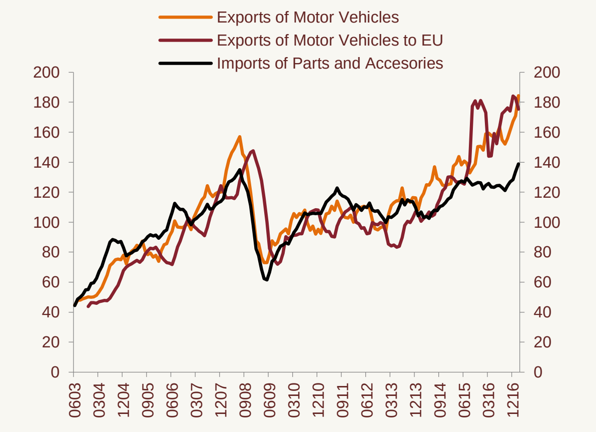


* Imports of EU from non-EU countries are 6-month cumulative and denominated in 100 thousand tons.
Source: Eurostat, CBRT.

On the other hand, in 2016, Turkey's market share in passenger cars in quantity was higher than that calculated by current prices. This indicates that average price per kg is lower in Turkey than other countries that export passenger cars to the EU. On the other hand, the opposite is true for other motor vehicles. In other words, Turkey's market share in other motor vehicles calculated by current prices is higher than that in quantity terms. Hence, the average price per kg is higher in Turkey than non-EU countries that export motor vehicles to the EU.

Given the high use of imported inputs in the production of motor vehicles (Saygılı et al., 2010), the recent surge in Turkey's exports of motor vehicles may cause an increase in imports of parts and accessories as well. However, imports of parts and accessories have remained stable since early 2015 even though exports of motor vehicles have increased (Chart 3). This indicates that the share of domestic inputs in the production of motor vehicles might have increased in the respective period. On the other hand, the increase in exports driven by new models stimulated an increase in imports of parts and accessories. Given sufficient accumulation of physical and human capital, some parts and accessories required by new models will be produced in Turkey over time, which will cause imports of parts and accessories to grow slower than the exports of motor vehicles.

Chart 3. Exports of Motor Vehicles and Imports of Parts and Accessories (Quantity, 2010=100, 6-Month Cumulative)



Source: Eurostat, TURKSTAT, CBRT.

In sum, the upsurge in automotive exports points to favorable external demand conditions in 2016. The strong market growth in the EU, which is the main exports market, as well as the introduction of new models drove automotive exports higher in this period. Meanwhile, Turkey's increasing market share in the expanding EU market is a positive development regarding growth and the current account balance. In this respect, automotive exports may continue to grow given the increasing market share of Turkey in the EU market and the more favorable outlook for EU growth in 2017.

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