PRESS BRIEFING:

EMERGING EUROPE AND CENTRAL ASIA ECONOMIC UPDATE

(WORLD BANK)

APRIL 9, 2014

LOCATION: FUND/IMF HQ2/3-768

[Start at 2:00 p.m.]

MR. KIRCHER: Good afternoon, everybody, and welcome to this briefing on the Emerging Europe and Central Asia Region.

My name is Andrew Kircher. I am the Communications Manager for the Region in the World Bank.

Just before we start, if I could ask everyone to silence their cellphones, including the speakers.

In terms of materials, we will have a Press Release, and we will also have a transcript of this later on that we can put out in the Press Room.

Before I introduce the two speakers today, I also want to add that we have Russian translation--I think it is on Channel 2. We will have two speakers, and then we will have questions and answers.

The first speaker today is Laura Tuck, Vice President for Emerging Europe and Central Asia Region at the World Bank. So, why don't we start with you, Laura, and then we'll go to Hans.

MS. TUCK: Thanks, Andy.

Welcome, everyone, and thanks very much for joining us today for our Economic Update for the Europe and Central Asia Region.

We have three main messages today.

First, the growth outlook for 2014 in the Region is much lower than we had expected at the end of last year, particularly in the eastern part of the Region. Growth in ECA is projected to be the lowest among all developing regions. That is the first point.

The second message is that many of the countries in our Region need to pursue pretty tough reforms to set the stage for boosting shared prosperity and creating jobs. If they do this, it will help them build up resilience to future shocks and help to really build the foundation they need for future growth.

The third message is that geo-political tensions and political instability in the Region may not only affect the economies of Russia and Ukraine but also could have impacts more broadly to the other economies in the Region.

So, first, let me turn to the subject of the economy. While most other developing regions are expected to see a modest acceleration of growth in 2014, ECA growth is retrenching, from 2.1 percent in 2013 to 1.9 percent in

2014. Growth this year, as I just said, is expected to be the lowest among all developing regions.

The ECA Region was also the hardest-hit Region by the global crisis in 2008 and 2009. Overall, it contracted by over 4 percent, and it has been the slowest Region to recover. Uncertainty has risen. You will see in our high and low case scenarios for the Region that in the high case, growth is expected to increase, to accelerate, to 2.7 percent, but under the low case scenario, economic output could contract by 0.2 percent.

This wide range of potential growth outcomes reflects two factors. First, in the short term, there are political risks, and in the longer term, there are structural rigidities which are still a big constraint on growth in many of the economies.

So, in this context, we have been saying that the Europe and Central Asia Region finds itself at a crossroads, with the potential that a number of countries could actually fall behind if they don't change their track quickly. If they are going to build the kind of resilience they need and set the stage for the robust, shared growth they want, they will need to really reinvigorate reforms going forward.

Overall, our growth outlook for the Region has been revised downward compared to the 2014 forecast that we gave you a year ago. This is especially true for Russia and for Ukraine, with knock-on effects for neighboring countries, particularly those that have strong economic links to those two.

Our projection for Turkey has also been revised downward, basically because of the specific economic vulnerabilities there and also because those have been exacerbated by the recent political instability in recent months.

In Ukraine, even before the crisis, GDP growth had been flat for the past couple of years. The country's challenging economic situation, which was due to long delays in economic reforms, is now being accentuated by the current tensions. Last year, we were forecasting a 3 percent growth rate for 2014, and now we are projecting a 3 percent contraction.

In Russia, falling investment and weak demand have dampened growth over the past year, and now the geo-political tensions are exacerbating this downward trend. Growth projections for this year have been revised downward from 3.6 percent in 2014 to around 1.0 percent, although obviously, there is a very high degree of uncertainty.

For Turkey, because of its large external financing needs combined with rising domestic political uncertainty, and also, Turkey has a pretty large exposure to the tighter global financial conditions, so as a result, we have revised our projections down there from 4.5 to 2.4 percent for 2014.

As you can see from this slide, there is a wide gap between the high case and low case scenarios. This reflects, as I have been saying, the increased uncertainty in the Region, particularly for Ukraine, Russia and Turkey. So, with the ongoing tensions between Russia and Ukraine, we have a concern for those, and we have a concern for the rest of the Region if tensions should escalate. Of course, we are hoping the situation is resolved peacefully so that the poor and the vulnerable do not lose ground on the path to improve their livelihoods.

We have recently published reports, country-level economic reports, on both Russia and Ukraine, and we have copies here, I believe, outside, if you are interested in further details.

So, just let me repeat the three messages – first, that the growth outlook for Emerging Europe and Central Asia is much lower than we expected, and it is the lowest of all of the developing regions.

Second is that these countries do need to continue their pursuit of structural reforms – and some of them are very tough – if they are going to boost shared prosperity and create jobs and build resistance to further shocks.

And third, the rising geo-political tensions will affect Russia and Ukraine but also the economies in the region more broadly.

So, for our part, we in the World Bank are helping these countries address these challenges and others to reduce poverty and boost shared prosperity through policy dialogue, analytical work, investment project funding, budget support, and Reimbursable Advisory Services. And we hope that through these tools, we can help these countries reach higher growth in the future.

Let me thank you again for attending, and let me turn the microphone over to Hans, who will provide a lot more detail on those points.

Hans?

MR. TIMMER: Thank you very much, Laura, and good afternoon.

Let me give just a little bit more background to the three messages that Laura just presented.

The first message is that we have downgraded our forecast, especially for the eastern part of Europe and

Central Asia Region, and that should not come as a surprise, because recent economic news in that part of the world has not been good. Let me give a couple of illustrations.

What you are seeing here is the level of industrial production, and the red line is CIS countries. You can see that there was a sudden drop in industrial production starting in September last year, and that is while the rest of the Region was actually, as expected, recovering very much in the wake of the recovery in Western Europe. If you look at Germany over the last 12 months, industrial production grew 5 percent. In countries like Hungary, Poland and Romania, you saw growth in industrial production of 6 to 8 percent.

So, while that recovery was going on, suddenly, a turn for the worse in Russia and other countries. Now, that might have been partly the Sochi impact, that suddenly the investment for Sochi stopped, but it is much more complicated than that. How complicated, that is, you see when you look at financial market indicators. What you are seeing here are the spreads, the yields on government bonds relative to the yield on U.S. Treasuries. And what you see is that very recently, suddenly, there was this jump in yields for Russia very clearly related to the geo-political risks; but since the summer, you saw already a sharp rise in the spreads in Turkey also related to rising tensions and Turkey's rising vulnerabilities.

And if you look at Ukraine – and then, you have to take the other axis, because that is really at much higher levels – then you see already, for a much longer time, an upward trend in those spreads, very much a reflection of the increasing macroeconomic imbalances in Ukraine.

And then, just another indicator – if you look at exchange rates here vis-à-vis the dollar, you see a huge difference between the Eastern part of the Region and the Western part of the Region; sharp depreciations in Russia, Kazakhstan, but also Turkey, around 20 percent. In the long run, that might be part of the solution, the real depreciation in those countries, because you can export more, but in the short run, it is really a reflection of the increased problems. So the news was not good in the short run.

The second observation is that countries really have to pursue tough reforms to boost long-term growth. That is always easy to say, it is always true, and that is why we always say it. But there is a reason why we emphasize that at this moment especially, and that reason is that increasingly in the Region, it is structural impediments that are limiting growth. These impediments have a different character in Central and Eastern Europe than in the CIS countries, but in all cases, what you see is that governments have only been focusing since a limited extent since 2008 on needed adjustments and structural reforms.

So let's take a step back and take a longer-term view at the Region.

What you are seeing here is GDP growth, a little bit of a spaghetti diagram, but the dashed line is GDP growth in the ECA Region. What you see is that, as Laura already said, they were hit hardest by the crisis, they did not rebound strongly, and they seem to be converging at very low growth paths. That is not good.

When you look at current account deficits in the Region, you also see that they were very dependent compared to other developing regions on capital inflows, and they have not adjusted enough after the crisis.

Now, that is reflected especially in Central and Eastern Europe in lots of vulnerabilities in financial markets, here shown by the bars, with NPLs as a percentage of GDP, very large NPLs in the Western Balkans, but actually also in the euro 11 countries, lots of vulnerabilities still in the financial sector, not enough reforms, and not enough adjustments. So, in these countries, you now have a situation where you do not have a return to high profitability and competitiveness; you have stubbornly high unemployment; you still have problems in the financial markets, and at the same time, you have fiscal systems that are really stretched to the limit. So the problem in the West is lack of reform in financial markets, lack of adjustments in a macroeconomic sense.

The situation, as you see here in the graph, in Turkey is very different. Turkey entered the crisis – we discussed that last time, also – with very strong financial institutions, very healthy macroeconomic policies. They used that situation to stimulate the economy – you see that there – with very strong credit growth, but you can argue that they have overdone it. It led to large current account deficits and the vulnerabilities they are facing now.

The next graph shows the stubbornly high unemployment, and then, for the Western part of the Region, you see low inflation and declining inflation. It is all part of the picture that the Western part of the Region seems to be converging to a very low growth path, very different from the still high inflation in Turkey.

If we then move to the East, we see very different structural impediments, and that is basically a lack of reforms, here illustrated with the EBRD transition index – the higher the bar, the more reforms you have. You see for the CIS countries that these reforms have stalled, but they are also at a much lower level than in the Western part, which are just focused on competition policy. Very big improvements still to be made in the Eastern part. The impediment in the Eastern part, in addition to the problem of competition policies in general, are governance problems.

Still, those countries had grown quite robustly after the crisis, and that is because they benefit a lot from not only the high, but the rising commodity prices. They used that very well to increase consumption, to share that consumption, but they are now reaching the limits of growth.

The final observation is that the situation is very uncertain, and that is why we develop different scenarios, and we are not coming out just with a point forecast. We especially put a lot of emphasis on downward scenarios. One way we do that is by looking at the impact of Russia to neighboring countries through the trade channel. That is one of the channels we explore to see what the impact on other countries could be, but it is only one of the channels, and it is probably not the most important one. Another channel is reversal of capital flows and capital flight in the countries. And probably the most important channel is the impact of uncertainty directly on the investment climate and the incentive to invest. And that is very worrisome, because if we analyze what has happened over the last five years with investment in the Region, it has done worse than any other developing region in the world. And it could be much worse when the situation deteriorates in a geo-political sense. So, it is that mechanism that we used to then develop the lower case scenario.

So the bottom line, as Laura has already said, is that ECA is at a crossroads. Of course, you can say that a country like Ukraine is at a crossroads, or that Turkey is at a crossroads in terms of what policy direction to take, but we mean, actually, that almost every country is at a crossroads in an economic sense.

The real choice now is whether to continue to navigate the cyclical developments and start adjusting to a much lower growth path, or whether to take a much more aggressive and ambitious approach and reinvigorate growth in different parts of the world. And when you look at the numbers, there seems to be a sense of urgency. It is very important what policymakers are doing now and the kinds of choices they are making. So, in that sense, this is a really important time for the Region.

Thank you very much.

MR. KIRCHER: Thank you, Laura, and thank you, Hans.

Let's open it up now to questions. When you ask a question, please identify yourself and your news organization.

Andrei, why don't we start with you.

QUESTION: Thank you, Andrew, and thank you for doing the briefing.

I have questions on Ukraine and Russia. On Russia, very simply about the plans of the World Bank itself, has anything changed in those plans and working with Russia in light of the recent developments?

And on Ukraine, frankly, I was a little confused by the figures. The Bank announced $3 billion additional financing for this year on top of the 3.7, and I have tried to ask people at the Bank how this works, and I can never get a clear answer, whether it is new money or old money. If it is new money, how soon will it be approved and disbursed, all of that?

Thank you.

MR. KIRCHER: Okay, why don't we take a few before we get to the answers.

Does anybody else in the audience have a question?

Did you have one? No. Okay. Let's start with Andrei's questions.

MS. TUCK: Thanks, Andrei.

With regard to our program in Russia, the World Bank has mostly a knowledge-based program in Russia. We do a lot of Reimbursable Advisory Services and analytical work. We also have a lending program, and we have been preparing projects in the area of social inclusion, early childhood education, and energy efficiency, and we are continuing to move forward with those projects.

On the question of Ukraine, we have a portfolio – the numbers are getting mixed between World Bank and World Bank Group, and some of it is fiscal year and some of it is calendar year, so I don't blame you for getting confused. The $3.7 billion is our ongoing portfolio which we are continuing to disburse that covers the different sectors. In terms of new lending, we are currently preparing three new investment projects in the areas of district heating energy efficiency, in the areas of urban investment, water supply, wastewater sanitation, and also a Social Safety Net Project. The latter is very important to underpin the kinds of reforms that will be necessary to stabilize, to work on the structural reforms in the macro economy.

So we are preparing to do some budget support. For now, we are talking about $1 billion, underpinned by a reform program. We have not yet decided exactly the timing or the structuring. We aim to support the government and help them nurture the reforms that need to be taken, so an initial financial support quickly, followed up with part of a series to cover reforms across the economy in governance, banking, governments being public procurement, and those kinds of reforms, and the safety net.

QUESTION: If I may, just to clarify, if I understand you correctly, the $3.7 billion is separate and ongoing - we don't touch this. The additional $3 billion is $1 billion up front for budget support, and the rest is for the three new projects, right?

MS. TUCK: That number covers the whole calendar year, and it also has investment projects that could come in the World Bank's next fiscal year in the areas of health and power. And the whole number also includes IFC, which is $400 million for this calendar year.

QUESTION: And could you then give me an overall figure – how much can Ukraine expect, for instance, this calendar year?

MS. TUCK: That is the $3 billion.

QUESTION: That is the $3 billion.

MS. TUCK: Yes.

MR. KIRCHER: Yes, in fact, we have the Press Release that we put out on March 10 that we can give you, which has all those figures and talking about 2014.

MS. TUCK: Yes.

So, if you want, we can separately – we have our Country Director here – we can break it down, because there is fiscal year and calendar year, and there is World Bank and IFC and MIGA, and we can give you the exact numbers, because depending on which source, it can be confusing.

MR. KIRCHER: Okay, thank you.

Are there any other questions from the audience?

Please, in the second row.

QUESTION: Just one very general question. My name is Nadia [phonetic], and I work for Ukraine Television here in Washington.

Financial assistance from the IMF and the World Bank is widely discussed in Ukraine these days, and some politicians say that the demands are too high for our country, that we must pay too big a price with all the reforms, and gas prices rising. How can you comment on this – that it is too high a price for Ukraine.

Thank you.

MS. TUCK: I think Ukraine is currently having a macroeconomic crisis. You saw already, before the recent events, the very slow growth and the need to undertake major reforms to keep the economy sustainable.

I think the IMF program is designed to put the macro economy on a sustainable footing, and those are the reforms that would be required to reduce the fiscal deficit, reduce the current account deficit, and make the currency competitive. Without those, I think you would not see a sustainable path.

What we hope to do, then, is to help with the structural reforms that will boost the economic growth that the economy needs and also protect the poorest, very importantly, through a broad social safety net program.

MR. KIRCHER: Hans, did you want to add anything on the – what was your question – I'm sorry.

QUESTION: The question was what can you answer to Ukraine and politicians who are saying that Ukraine has to pay too big a price for the IMF and World Bank loans, making reforms.

MR. TIMMER: I think the most important

observation was the one that Laura gave. They were on a completely unsustainable path. And if there is no support, that would create enormous hardship, and that would be a very high price to pay. So the support from the IMF and the World Bank is mitigating the disaster that was coming.

Qimiao Fan: I think it is very important to emphasize that the current crisis is actually a result of the delays in reforms. That is point number one.

Second, the reform program is not what the World Bank or the IMF is demanding. That is a government program. It is a program that I don't think at this moment, Ukraine has any choice because of the macroeconomic imbalances.

Point number three – the World Bank support and the IMF program are actually going to help Ukraine to mitigate some of the negative impacts of these reforms, which are really needed to restore macroeconomic stability and restart growth in the country.

MR. KIRCHER: Just to clarify, that is Qimiao Fan, the Country Director for Ukraine, Belarus and Moldova; and perhaps afterward, we can talk a little more in depth.

Are there any other questions before we leave today?

Please, in the second row.

QUESTION: Hi. Lydia Kelly [phonetic], Reuters.

Yesterday, the Russian Economy Minister came out with a new economic growth forecast for this year which is more optimistic than your forecast when it comes to the bad case scenarios. They envisage the economy shrinking by 0.5 percent. You said it could shrink by as much as 1.8 percent.

Could you comment one more time on where the threats are coming from, chiefly, and what are actually the chances, considering what has happened within the last two weeks between Russia and the rest of the world? Where do we stand now?

MS. TUCK: Russia was already on a slow growth path before the recent events. As Hans said, I think a lot of the demand-side growth had already been abating, and the need for tough structural reforms was coming. And now you are starting to see all kinds of uncertainty, which they need for investment, both for domestic investment and private foreign investment, which is declining now.

As Hans said, uncertainty could be the biggest factor. That is what they need is the investment. It is hard to put a boundary on what uncertainty could do, so we put a best guess on it of 1.8. If the situation does not deteriorate further, growth could even be positive this year. However, if you start to see mounting tensions, and people get increasingly nervous, it could be even higher.

So it is just – when we put those estimates out, that was our best guess of the bounds for the likely outcomes.

Michal Rutkowski: Just one important clarification.

The minus 1.8 is entirely based on expectations related to capital flows, investor confidence, and bank deleveraging. It does not include anything related to possible or potential trade sanctions. So I want to be clear that it is only based on factors other than the trade sanctions. So it could be even worse than you said, Laura.

MS. TUCK: Okay.

This is Michal Rutkowski, our Country Director for Russia.

QUESTION: Has the Bank actually tried to assess the potential impact of sanctions as such?

MR. RUTKOWSKI: We have not started working on it in the Russia context.

MR. TIMMER: If I may, I think that numerically, the impact of the factors that Michal mentioned is that the impacts on investment and uncertainty on capital flows or capital flight are much more important than the trade impacts when you do those kinds of calculations. That is why it was so important to focus immediately on the biggest items.

And I think the growth forecast, the point estimate of the Russian Government, is actually lower than our point estimate, and how broad you make these uncertainty ranges is almost an issue of taste. But I think it is very important to realize that through the capital flows and through the investments, the impact can be very large.

MR. KIRCHER: Thank you, Hans.

I think that if that's it for the questions – sorry, Andrei – we'll go to the gentleman in the second row.

QUESTION: My question is about Turkey.

For Turkey, would you please just specify or detail the concerns that you have for Turkish growth?

MS. TUCK: One of the challenges that Turkey is facing is that with its large current account deficit, it is very dependent on capital flows to finance it, so if you see, for instance, potential reduction in quantitative easing in the U.S. and elsewhere, also as there are uncertainties in the capital markets, you start to see an impact on the potential for Turkey to obtain that financing at the kinds of prices that it has had in the past, and that can be threatening.

As you see political uncertainty, you can also see a reduction in foreign direct investment.

MR. KIRCHER: Okay. I think, if there are no other questions, Andrei, we'll let you have the last word.

QUESTION: Yes, I just wanted to ask about a different subject.

I understand you are launching, or you have launched, major regional projects for countries like Tajikistan, for instance - I am referring to CASA 1000 and the Rogun Project.

Just maybe a brief update about how it is going and how significant it is for the Region.

Thank you.

MS. TUCK: We took the CASA Project to the Board at the end of March. This is a transmission line that could connect Tajikistan and Kyrgyz Republic to Afghanistan and Pakistan, and the idea is that it would allow them to export already existing surplus hydro energy that is generated during the summer, when they just spill water because they don't need it, to countries that have an energy deficit during the summer. So the idea is to get a win-win by connecting them.

We took the project to the Board, and we have been supporting them. They are currently finalizing the negotiations on the prices, and we hope that it will proceed. We think it brings a lot of benefits, obviously, economic benefits, to four countries that have a lot of development needs but also a Region where there is the potential for geo-political mutual gains, and working together and stabilizing in the wake of the NATO pullout, and so forth.

So we think there is a lot of potential benefit to this project.

Rogun is not a project. The World Bank has been involved in helping to do high-quality assessments of the proposed investment to ensure that it is done to the highest standards – open, transparent, disclosed, riparian discussions. We have a high-level committee that review – a panel of experts – so we are proceeding through technical studies, economic, environmental and social assessments, and we are hoping to have the fifth riparian consultations soon. The report should be completed by the middle of this year sometime.

MR. KIRCHER: Okay. We thank everybody for coming. We will have the transcript out to the Press Room later, and please get the Press Release on the way out.

Thank you.

[Concluded at 2:33 p.m.]