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P R O C E E D I N G S

MR. KIRCHER: All right, good afternoon everyone. I think we're going to get started, so those in the overflow room, please come on in. My name's Andy Kircher. I'm the communications manager for the Europe and Central Asia region. Before we get started, I just wanted to mention that we have Russian translation on channel 6. I'd also like to say that we are web streaming this event live, and we are entertaining questions from reporters from the field, from other -- from ECA countries who are sending in their emails to Paul Clare and then he'll relay them to me up here so I can take some of those from the online audience. So before I start, could I just ask everybody to silence your cell phones?

We'll have two speakers today, and then followed by a Q&A session. The first speaker is Laura Tuck, the Vice President for the ECA region. And then we'll have Hans Timmer, who is the Chief Economist for the Europe and Central Asia region. So with this, let me turn it over to you Laura and then we'll follow this by Hans, and then a Q&A session.

MS. TUCK: Thanks Andy, and thanks to all of you for coming to our semi-annual update for the Emerging Europe and Central Asia region. Right now the region is facing some daunting challenges and faces what we're calling a cloudy outlook for growth. There's a slowdown in Western Europe. There's the Ukraine crisis, and our geo-political concerns in other parts of the world. And of course there are structural problems in many of the countries, and these existed before the Ukraine crisis, but they still exist in many countries and they still need to be urgently addressed. So we hope today that we'll be able to shed some light on these issues and share some perspectives with you. I'm going to briefly summarize the main messages and give our growth forecast, and then I'm going to turn it over to our Chief Economist for Europe and Central Asia region, Hans Timmer, who will go into more details for you.

So let me just give you the three key trends that we see for this year. First, the recovery in the

EU new member states remains tepid. Growth in Western Europe is disappointing and the progress in addressing structural issues as I just mentioned has been very slow. In some countries, like the Baltics, there are some signs of improvement. They've been addressing some of the structural issues, and unemployment is coming down. And in several countries we're seeing some improved prospects for growth. But the geopolitical situation in Ukraine has developed into a deep crisis for the Ukrainian economy, and that's obviously having a big impact there. But except for in a few key industries, this has not yet had an observable impact on growth on the region as a whole.

In Russia, and some of the neighboring countries there, we're seeing growth slow down as many of the past drivers of growth have largely run their course. And in Russia, the geopolitical concerns and the uncertainty are casting what we think is the longest shadow on the country's medium term growth prospects.

So if we bring all these trends together, we're seeing our baseline forecast for emerging Europe and Central Asia at only 1.8 percent. As you can see from this graph, this is slightly faster than the 1.2 percent growth that the Bank is forecasting for the Latin America and Caribbean region, but it's much further behind the 6.9 percent growth we're seeing in the East Asia and the Pacific region. And in 2015, we expect only a slight improvement of growth for the the ECA region. We're seeing 2.1 percent, because we see that the global recovery will remain modest. Uncertainty and structural challenges in the region will continue to be a drag on a number of the countries.

Now these aggregate trends reflect really quite different circumstances in individual countries. If you look at this graph, you can see how we saw the region in April compared to how we're seeing things now. The gray bars are the forecast we made in April and the blue bars are the forecast we're making now. And you can see while the overall forecast has not changed dramatically, we've done some upward revisions for some of the countries and some downward adjustments for others. The most dramatic downward adjustment has been in Ukraine, which went into a much deeper crisis that we expected. But by contrast, we saw improvements in some of the new E.U. member states like Hungary and Romania, and we also upgraded Turkey's growth, because of the reduction in the political uncertainty, although some of that continues. So except for Ukraine and a few of the countries in, mostly in southeastern Europe where we expect a contraction on balance, we do forecast growth for the region as a whole but we expect it to be what we're calling tepid.

Now as Hans is going to explain, domestic factors will have an important role in each of these countries in shaping the effect of the international factors in the geopolitical tensions, and how those impact those countries' economic growth. So while we're monitoring the impact of the crisis on Ukraine, it's really important not to lose sight of the longer term issues that the countries really need to tackle to boost growth and create the jobs that we badly need.

In a number of countries of Central and Eastern Europe, the challenge is really to try to get the crisis put behind them, to revitalize the financial sector and improve the business climate. In Southeast Europe, really focusing on deepening the institutional reforms and improving governance is going to be critical, and in Russia and the neighboring countries, to enhance competitiveness and create the sources of growth that go beyond just oil and gas.

So let me turn now to Hans, and we'll look in detail. Thank you very much.

MR. TIMMER: Thank you very much Laura. Welcome everybody. Good afternoon. So I will give a little bit more detail illustrating these three trends or these three key challenges that Laura just described. So it is the long prolonged difficult slow recovery in the E.U. member states, it's the economic crisis in the Ukraine, and then it's stagnation of growth in Russia that has an impact on the surrounding countries. And perhaps this is a nice graph to illustrate in one graph those three story lines. This is the level of industrial production in the E.U. member states, the light blue line. It is industrial production in Russia that is the black dotted line and then we have the Ukraine. So what you're seeing is stagnation in Russia. Which is you want to time it precisely; it's probably started in the summer of 2012, so way before the tensions in Ukraine, and for very different reasons than just the tensions in Ukraine. And in the blue line you see that there is a recovery in the E.U. member states, but it's not a strong recovery. It has lots of problems. And then the red line especially recently, you see that Ukraine is almost falling off the chart -- a deep crisis because of the tensions in the eastern part, where a lot of the industrial production is located.

So let's start with the long and difficult recovery in the new E.U. member state. It's not a surprise that this is difficult recovery, because we know from previous cases that every time after financial crisis, it takes many years before you can recover.

But on top of that, the imbalances that were created during the boom period before the crisis, the loss in competitiveness, the large current account deficits and the imbalances created by the crisis, large fiscal deficits, high levels of non-performing loans -- those imbalances were especially large in this part of the world, so that is very difficult to work your way out of it.

And thirdly, this was a global crisis, so the external environment is not really helping you to come out of the crisis.

The external environment is still not helping. If anything, we downgraded the growth for Western Europe. Also the global economy is not growing as fast as recently we wanted. What you are seeing here is the fiscal imbalances starting in 2010 and we focus again on the red line. Those are the new E.U. member states. Imbalances were very large because of the crisis, much larger than other parts of the region, much larger than in other parts of the world. On average, a seven percent fiscal deficit. And what you are seeing is that, especially in those countries, you see an improvement. So in that sense, it is a slow, it is a difficult recovery, but it is a recovery. And countries are trying to unwind those imbalances.

That is true also for another very important imbalance, and that is an imbalance that was created by the boom period before the crisis. I will have to explain this chart a little bit. What you are seeing in here is starting in 2000 up to 2008, the crisis cumulative growth of labor productivity per hour for individual countries. What you're seeing on the vertical axis is cumulative growth of wage cost per hour. If you are on this green line, then you are not losing competitiveness over that period with Germany.

Now what you see for most of those countries, they have been very successful because productivity growth was very high during that period, but wage growth was even faster. And all those countries had lost competitiveness, and that makes the recovery so difficult. But then, if we go to the next graph and we see what happened after the crisis, the same axis, and you see that all those countries are now under the green line, so they are regaining some of that competitiveness against Germany. Another example that it is a slow, it is a difficult process, but it is not a stand still. And ultimately these countries will leave the crisis behind them.

And that has consequences for one of the biggest concerns in those countries, the very high unemployment rates. Unemployment went up very fast after the crisis, remained high for many years, translating in long term unemployment rates. But we see improvements. And that's what you see on the left hand side, especially in those new member states of the European Union, especially in the Baltic countries. And those are the countries that had the boldest policy reaction after the crisis -- the sharpest adjustments in the rebalances, but also you see in Hungary, in Poland, the Czech Republic, you see a start of the declining unemployment.

So that's the story. It is a long, difficult process. The focus has been on correcting those imbalances. But something is happening there, and that is important because the indicator that we are focusing now so much on – income growth of the bottom 40 as an indicator of shared prosperity – is very much dependent on the success of this process, because it's very much linked to changes in unemployment in the market.

What you're seeing here is that in the boom period, unemployment rates came down every year to change annual change in unemployment. So it was not only high income growth, but it was also the improvement in the labor market. As a result of that, in that group of countries, income growth of the bottom 40 was at very high levels. And then the global crisis hit. Unemployment shot up and you see that income growth became negative for that group of people and now, when we extrapolate, this is all based on micro data. We don't have the evidence yet. But if we extrapolate, then the improvements that we are observing and further expecting will bring again positive growth for incomes of the bottom 40.

A deep crisis in the Ukraine and not a surprise -- just a couple of examples. This is FDI going into Ukraine, starting in 2005, and all the way up to this year, 2014. We only have data until August, so we annualized this number here. But it is striking, as low as this number is. Everywhere in the world, FDI is a very stable variable, much more stable than other capital flows. You see here also that during the global financial crisis, FDI didn't change a lot. FDI dried up now in Ukraine. It's one example of how deep the crisis is. Another example is the depreciation of the exchange rate, the problems on the balance of payments reflected here, and so we have a deep crisis. And then the question is what is the impact of that crisis on the rest of ECA, on the rest of Europe, on surrounding countries? So we are looking at different kinds of transmission challenges.

What I will show you is the one for agricultural crisis, because the conflict comes with restrictions on agricultural trade. And I will secondly focus on the financial markets. Ultimately, the conclusion will be that the tensions in Ukraine are very, very hard for Ukraine itself. They don't explain that very tepid growth that we are seeing in the regions. You need other variables for there.

So this is a chart. We call that a spaghetti diagram. What we do here is look at food prices relative to average consumer prices in different parts of ECA. Here you have Ukraine. Here, the black one is Russia, and then we have Western Europe and the new member states. What you expect as a result of the trade restrictions on food, is that prices in Russia go up, food prices. And prices of the exporters, because they can't export anymore, come down. To some extent you see that, but it actually preceded the Ukraine crisis, so it's more a reflection of trade restrictions on meat, that started earlier. But if anything, it's not a very strong picture. So this is a difficult story for some farmers that export to Russia. It is not explaining the broad story of concern in ECA.

Then on the financial markets, another very important transmission mechanism, you see with spreads, that countries have to pay more on top of the U.S. benchmark on their bonds. They react to specific crisis periods. That's true for Ukraine on a very different scale on the right hand side. It was true also for Russia. And the impact on Russia is much bigger than on other countries in the region. Russia started off with 150 basis points below the average of all emerging economies, and it moved up to more or less being the same as the average in the emerging countries. It's an important development. It doesn't help Russia, but again, it's now so pervasive that we can explain the very low growth in Russia and in other countries.

Then that third story, stagnation in Russia. We discussed it half a year ago also. If you want to time it, it is probably the second half of 2012.

That's where quarterly GDP growth came down sharply. The Russian economy was growing very fast after the crisis, more than four and a half percent. It's hardly growing anymore. And that is illustrated here. Growth has come down, and with that, investments have come down also. In our view, that is very much related to a drying up of the sources that created growth in the boom period and in the longer boom period, and in the first years after the crisis. Those first forces were very much related to the oil price, and we are seeing here the oil price movement relevant for Russia after the crisis starts in the beginning of 2009. So after the crisis, oil prices rebounded very quickly. That was an environment where it was easy to grow domestic demand in Russia, because the revenues were not only high, but they were increasing. Then at some point, somewhere at the end of 2011, oil prices stopped increasing. They are more or less stable. If anything, there is a downward pressure on the oil prices. And it's not that easy to continue to increase domestic demand. On top of that, all the domestic demand had created capacity constraints in Russia, reflected in high inflation rates, and Russia really needed a different source of growth. That is very much a supply side story that is a story of the business climate. How can you create dynamism outside of the oil sector? So it's a real structural story. And that reflects also to surrounding countries -- Belarus, Moldova -- there are lots of countries that export a lot to Russia. So they are affected. It is in our view that it is not just a story of the conflict in Ukraine, it is a story that's much more related to the stagnation in Russia that started earlier. But as a result of that, we see in more countries very low growth.

So the bottom line is, again, the main observations again, the whole region is not growing fast because there are different stories. You cannot explain it by one story that explains why growth is so low. The Ukraine tensions, they have developed into a deep crisis but at least so far as we can analyze, the impact on other countries, at least on their GDP is not that big. That doesn't mean that for parts of economies and for certain sectors there is no impact. And there is still the story on the structural side for Russia and several other countries, it is, to some extent, captured by the unfinished transition that we have discussed so often.

Thank you so much.

MR. KIRCHER: Thank you very much, Hans and Laura.

So let's open it up now to the journalists in the audience. And when you ask your question, please identify yourself and your news organization. Thank you.

Andre, if you could take the first one.

ANDRE: Thank you for doing the briefing.

What is your projection for 2015 for Russia, and then figures, please -- I can't seem to find it here -- for the next year? And also, you mentioned that for Russia it's like -- it's not just the Ukrainian crisis; it's a bigger story of a conducive environment for economic growth. So how well are they doing in creating that environment? What are they doing? Are they doing enough in your point of view? And what are you doing with them? What are you continuing to do with Russia on that score, and generally with your projects? Thank you.

MS. TUCK: Thanks, Andre.

So we recently published our RER for Russia, and in our baseline projections for this year, for 2014, we have a projected growth rate to end the year at 0.5 percent. But for next year, you were asking about 2015, we're projecting in the baseline 0.3 and then in 2016, 0.4. Correct? But we also have optimistic and pessimistic scenarios that go along with that. So the baseline assumes no further sanctions and no further unrest. So in an optimistic scenario, we would see an end of tensions and an end of sanctions, and then we could see it actually rising to 0.9 in 2015, and 1.3 in 2016. But we also have a downside if things got worse on either -- if tensions increased or if new sanctions were added, it could be -0.9 in 2015, and possibly -0.4 in 2016. But, of course, you know, that's a wide range, and it really depends on how the situation evolves.

As far as what they're doing, I think you heard from Hans that they owe a lot of the growth to the demand side - the oil prices - both domestic demand and external demand. And now the focus should be on increasing competitiveness and productivity on the supply side. A lot of it has to do with improving the business environment and skills to improve labor force productivity in the labor market. We're doing a lot with them as part of our reimbursable advisory services to work in the business environment to help identify areas where they can deregulate or change labor market regulations, et cetera, to help enhance the investment climate.

MR. KIRCHER: Okay, thanks.

Any other questions from the audience?

The gentleman in the first row. Just turn on your microphone there. Yeah, there you go.

MR. WEST: Oliver West from Emerging Markets.

I just wondered, are you seeing capital outflows in Russia, and do you think is that part of the economy? Do they need to be taking measures against that? Just a general inquiry on that.

MR. TIMMER: The observation is that there is more volatility in the financial markets in Russia. You see from time to time pressure on the exchange rate, of course, and that means the measures that should be taken are the measures that have been put in place already, a gradual movement to more flexible exchange rates. That is good for many reasons, but also to absorb the volatility that is created by the tension.

Another reason is that you should expect the exchange rate to depreciate, also related to the development of the oil prices. We have seen over a long period sharp appreciation as the oil prices moved up. As they are no longer moving up, you should see an opposite turn. And then what is complicating it also for Russia is that they were targeting against the basket of currencies, dollar and euro, but we are expecting quite a bit of movement between the dollar and the euro itself, because they are in a very different cyclical situation. So there is a strong case to be made for a very flexible exchange rate, and the Russian Central Bank is moving in that direction.

MR. KIRCHER: Thanks, Hans.

The lady in the first row, please. And then we'll go to you back there.

MS. YUKHANANOV: Hey, it's Anna Yukhananov from Reuters.

I was wondering if you could speak more about how Russia's kind of long-term or medium-term stagnation affects some of its neighbors and what advice you would give in the short term versus the medium term for them to deal with it. Is it more capital controls or is it more government spending? What would you recommend? I know it's lots of different countries, but broadly. Thank you.

MR. TIMMER: I think the story for many of the neighboring countries is not that different from the story of Russia itself. Also, there are impediments on the supply side. Also there you see that reforms are not complete yet. The transition is not complete yet, and when we observe that there are still improvements possible on the business climate in Russia, that is actually true for Belarus, that is true for many of the other countries also. So the main focus of policymakers in those countries should be in similar kinds of issues. That is, I think, more important than our trying to fine tune whatever cyclical developments are coming to those countries.

MS. YUKHANANOV: And just a quick follow-up on that. How likely do you think that's going to happen if it hasn't happened in the past few decades and it seems like it may not happen at all? Thank you.

MS. TUCK: Actually, I think that this is a big part of the World Bank agenda, and for each of these countries it is very much the focus on enhancing the competitiveness, productivity, the institutions, and I think in each of the countries of the CIS we have programs to do that. And of course, we're seeing the impact -- your first question was the transmission through trade and remittances, and we're definitely seeing, as you saw in the charts earlier, the downgrading of the growth prospects in the current situation. And so the way around it then is enhancing the competitiveness through the different steps.

MS. YUKHANANOV: Will it have more of an impetus?

MS. TUCK: Within those countries you're talking about?

MS. YUKHANANOV: Yes.

MS. TUCK: Yes, exactly.

MR. KIRCHER: The gentleman in the last row.

MR. DONOVAN: Hi, it's Sean Donovan from the Financial Times.

I was just wondering if you're seeing any signs in Ukraine of that incredible sort of sharp fall bottoming out in any way and whether you think the kind of current engagement you're getting from the Fund and others is going to be enough to turn things around, and how long the recovery is going to last there.

MS. TUCK: I think over the last few weeks we've seen the situation stabilize a little bit. We've seen a reduction in the -- you can correct me -- but a reduction in the capital outflows. And I think that it's been -- well, with the reduction this week and the hostilities, some hope for reduction in the expenditures. We think that we'll have to do a reassessment of the financial needs. Right now we have a run up to the elections at the end of this month, and so there's a hope that after the elections, when we get a new parliament in place, that they'll be able to regain the reform momentum and really pick up on the needed measures to stabilize the banking sector, the gas sector, and then continue with the other structural reforms that are in the program on the governance, on the service delivery, et cetera. So I think the government is very committed, but I think you'll see this slowdown in reforms over the next few weeks while they move through this political cycle.

MR. KIRCHER: Okay, thanks. The gentleman with the camera. Please identify yourself. Thanks.

QUESTIONER: Ivica Puljic, Al Jazeera, Balkans.

My question is, economic growth is expected to drop from 2.4 percent last year to 0.6 percent this year. Can you talk a little bit about causes, about reasons, about a solution? And can you elaborate, is there any possibility that Croatia and Serbia are heading into a recession? Thank you.

MR. KIRCHER: Why don't we call on Ellen Goldstein, the country director for the Western Balkans?

MS. GOLDSTEIN: Yes, thank you very much.

Yes, as you rightly point out, we're going to see a slowdown throughout the Western Balkans. Now, I do not cover Croatia. Mamta may want to speak to Croatia. But in those countries that are not members of the European Union, we expect to see a slowdown. That slowdown is actually driven very much by the severe flooding that occurred in mid-May, particularly hitting Serbia and Bosnia and Herzegovina. In both those countries, we are likely to see negative growth rates this year. Certainly, in Serbia; possibly also in Bosnia. As a result, we really have a bimodal distribution of growth in the Western Balkans where you have the flood-affected countries growing negatively, or declining, but the rest of the countries are actually continuing on what has been a fragile but quite steady recovery from the global crisis. So those countries are all growing above 2 percent; some even above 3 percent this year.

MS. TUCK: And Croatia remains in a protracted recession, and prospects for this year are very subdued with only modest recovery expected in 2015.

MR. TIMMER: May I?

MR. KIRCHER: Yes, please, Hans.

MR. TIMMER: Because we told the story of the EU member states, which doesn't cover the Western Balkans, and I would argue the story for the Western Balkans is similar but more difficult. There you have countries that had even larger imbalances caused by the crisis, where unemployment was at higher levels, where the fiscal tensions are even more difficult, and where you have high levels of nonperforming loans in the banking sector. So for those countries, the process is the same. You see some recovery but it's even a more difficult process than what you see in the EU-11.

QUESTIONER: What about the recession problem?

SPEAKER: Croatia has been in recession for five years, and it is in the sixth year of recession this year.

SPEAKER: I know, but --

MR. KIRCHER: Maybe we can follow up afterwards and we can do a stand up.

The lady in the first row over there. Please turn on your microphone.

QUESTIONER: I was wondering, how do you see the appreciation of the dollar in terms of its effects on emerging markets? Do you think it's posing a restriction on their growth? Or do you think it is going to help their exports? So what are the effects of appreciation of the dollar on emerging markets?

MR. TIMMER: I think you gave the answer already. It is positive. It creates new opportunities for exports. A big problem after 2008 has been that the euro remains very strong, vis-à-vis the dollar and other currencies, that either countries were part of the euro system or had their country targeted to the euro, so that was a very difficult situation. And now we are entering a period where monetary policy in the U.S. will tighten while it will, if anything, loosen in Europe, and that creates improvements in competitiveness, not only for the euro area in Western Europe but also for surrounding countries.

QUESTIONER: Just to follow up on that, what about the effects on their current deficit accounts -- current account deficits? Will it -- especially I am asking this from the stance of Turkey. Do you think the depreciation of the Turkish lira against the dollar is going to pose new challenges, new financial risks to Turkish, and maybe surrounding emerging markets?

MR. TIMMER: The impact of depreciation on your current account is always -- it worsens it in the short run; it can improve it in the longer run. The real solution for the large current account deficit in Turkey is improved savings domestically. It is a much more domestic story than a story linked to the currency.

MR. KIRCHER: Okay. I think -- any other questions before we go?

No? Okay, well, thank you again for coming, and please get the press release on the way out. And we'll send out the transcript to the press room as soon as we have it back.

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