Press Briefing: Europe and Central Asia Economic Update

October 11, 2013

MR. KIRCHER: Good morning, everybody. If you could please take your seats.

Thanks for coming to this press briefing for the World Bank's Europe and Central Asia Region.

I believe we have Russian translation on Channel 2.

Before I introduce our speakers today, if I could just ask that you silence your Smartphones, your cellphones, your iPads, your iPods, whatever you have.

You will also see on your desks--or you will soon see, as they pass it around--a press packet with the press release and a Regional Brief, to help for your stories.

Let me turn to the speakers today, and we have two.

To my right is Laura Tuck. She is the new World Bank Vice President for Europe and Central Asia. And to her right is Hans Timmer, the new Chief Economist for the World Bank's Europe and Central Asia Region.

After Laura and Hans deliver the presentation, we will then turn to the audience for questions and answers.

So, over to you, Laura.

MS. TUCK: Thanks very much, Andy, and thanks to everyone for coming to our briefing.

As we gather here for the World Bank/IMF Meetings, we are happy to report that emerging Europe and Central Asia is on the rebound, and that is our main message. But we consider this a little bit of a "good news and bad news" story.

The good news is that we believe that the risk of a crisis in the euro area has receded and that Europe is slowly coming out of the recession, and of course, this is having a ripple effect to the periphery of Europe, where the clients in emerging Europe and Central Asia are located.

Growth is returning slowly but continuously to the ECA Region, and we are predicting growth rates of 2.2 percent in 2013 and increasing to 3.1 percent in 2014.

But we observe that this recovery is what we call multi-speed. There is increasing differentiation between Central and Southeastern Europe and the CIS.

We see that the greater the proximity to the euro area, the greater the drag on growth.

Countries in Central and Southeastern Europe are expected to grow by just 0.9 percent on average in 2013, and growth in Turkey and the CIS will be slightly higher at 2.7 percent.

But despite this variation, we still believe that this is a remarkable turnaround. Compared to last year when we all sat here at the Annual Meetings, we were telling you that this Region was the hardest hit by the crisis, and we have seen that it was experiencing the slowest growth of all the Regions in the world. In 2011, we had 4.9 percent growth, and in 2012, that had fallen to 2.4 percent.

In particular, the recovery has been the weakest in those countries that are the most connected to the euro zone--the Western Balkans, Croatia and Slovenia.

So the good news, as I said, is that it is on the rebound. The bad news is that the financial risks, including from here in the United States, are emerging.

After Ben Bernanke's suggestion back in May that there could be a tapering off, capital flows into Eastern Europe and Central Asia dried up, yields moved up, stocks fell sharply, and currencies weakened. This affected those ECA countries with the largest current account deficits that were vulnerable to inflows, including countries in the Western Balkans, Armenia and Belarus.

So the reality, the tough challenge, is that the problems of the economies are structural, and they will require domestic and structural solutions--and that is the hard part. Unemployment stays high, persistently high--more than 10 percent--in Central Europe, and it keeps rising in the Balkans, where more than one in five workers is now looking for a job.

The key structural challenges where we see that ECA needs to take action are creating more jobs, clearly; addressing the issue of the aging population; and addressing issues associated with natural resources.

So we in the Bank are trying to help our ECA clients address these and other challenges through our policy advice, our analysis, our project financing, Reimbursable Advisory Services. In fact, next month, we will be launching two major reports which aim to help people deal with the creation of jobs and how to diversify their economies. We are also planning to launch a report on the growing challenges to pension systems that are related to aging and also a broader look at how to address the multifaceted challenges of an aging population.

Let me stop here and turn to Hans, who will give you more detail about the regional growth prospects.

Thank you.

MR. TIMMER: Thank you very much, Laura, and thank you all for coming.

For me, it is exciting to have joined the Region a month ago. What I would like to do is to show you some graphs to illustrate the messages that Laura just summarized.

If you can see the first one, that is a graph to illustrate more or less the overriding message that it is important for European countries to shift now from short-term fire-fighting to the more structural policy agenda to generate growth and jobs, as Laura said.

What we have done here is we have split GDP growth in Central Europe into two components--an underlying trend growth and a cyclical component. If you add the two up, you have GDP growth.

It is pretty crude, it is pretty simple, but it illustrates the central point that the story is not only about the cyclical developments, the shocks that are coming from outside, but increasingly the story is about the trend growth, which is significantly lower now than the Region was accustomed to, and there is enormous need for continuing the reform agenda. Otherwise, there is a possibility that not only Western Europe but also the ECA Region gets stuck in much lower growth rates.

Now, that is true for Central Europe, but in the next graph, you see it is also true for the CIS countries, where you also see that the recent trend growth is much lower than it used to be, illustrated by the stagnation in Russia at the moment. It is much easier to generate growth when commodity prices are increasing year after year, but when commodity prices are stable, even at a high level, it is much more difficult to generate growth.

The final chart, where we decompose the growth rates, is about Turkey. That story is slightly different. There, it is still much more a cyclical story. Turkey has been incredibly successful after the crisis to stimulate their own economy, largely with monetary stimulus, a lot of domestic credit creation, but to some extent, they are paying the price for it now. You see increasing current account deficits, and that creates vulnerability. So the dynamism is still there; the cyclical situation still needs attention.

So, after these three general slides, let me very quickly illustrate the good news, the bad news, and then the tough challenges.

First the good news.

There is a turnaround. It is not strong, it is not enough, but there is a turnaround. We see in Western Europe that in the first half of 2013, most economies achieved positive growth, and we see that also in Central Europe, here illustrated by monthly numbers of industrial production, where we see that especially in the second quarter of this year, industrial production is rising in Central Europe and in Turkey. But not yet in the CIS countries, which are very much dominated by the performance of Russia at the moment.

That leads to the growth rates that Laura already summarized but are here described for the different subregions, where you see that the results of that rebound will not be shown yet in the 2013 numbers. The 2013 numbers are depressed, mainly because of the very bad performance in the second half of 2012, but it is illustrated in the 2014 numbers, where the rebound is strongest in the central part of Europe, and that forecast is not really wishful thinking; it is very much based on the rebound that we are already seeing in the high-frequency numbers there.

Then, if you go to the potentially bad news, that is, tensions in financial markets, we are all talking about probably a very small probability of a default in the U.S. and what the consequences are on the financial markets, but there is also, of course, the future tapering off, the future change in monetary policy. And we had a preview after May of this year of what the consequences could be for the ECA Region--not to the scale of what we expect in the future, but it is a good indication to see where their vulnerabilities are. So, after the announcement of Bernanke in May that he might be thinking of tapering off, the consequence was immediate for the ECA Region, here illustrated with capital flows to the Region. They immediately dried up. And then, in September, when the Fed reversed the policies, it was back to normal again.

In the next slide, you see another consequence, and that is the sovereign bond yields--an immediate increase in the price that governments have to pay. And there you can see the vulnerable countries already, where

Turkey but also the Ukraine, countries that either have large current account deficits or don't have growth at the moment, are most vulnerable, but the impact is across-the-board, also illustrated in the next one, where we see sharp declines in stock markets in Russia, in Turkey and in other countries. Then the next graph emphasizes the point again, because when you looked at the currency markets, you also saw immediate turbulence.

So those are developments that countries should be aware of and especially should look at their domestic banking system, financial system, and whether they can absorb these kinds of shocks.

Then, finally, a few illustrates on the point that Laura ended with, the structural reforms that are needed to bring the Region to a higher growth level. And as Laura said, we just finalized a Jobs Report, we finalized a Report on Diversified Development, and we will soon also show more on aging societies. Ultimately, it is all about the job markets, and why is that important? It is because we have currently very high unemployment--not a surprise--but also, if you look at the next graph, when you look at demographics, where almost all of the countries will see shrinking populations, in that environment, to have dynamics, you need an increase in labor participation. That is also on the jobs agenda.

And just to already give you a preview of some of the messages that are coming out, for example, from the Jobs Reports, one of the issues is the incentive to move into the formal sector. If you look at the tax system and the loss of benefits, and the total tax is actually very high--it doesn't pay off a lot to go into the formal sector--that is not so much because the benefits are very high, it is not so much because taxes are high, but the social security system is not targeted enough. And you probably don't have enough progression in the tax system so that, at least at the bottom, there is not enough incentive to move into the formal sector.

One illustration on the next slide of the report that we will also publish soon on diversified development, as I said in the beginning, it is easy when commodity prices continue to increase to maintain high growth, but it is not that easy when commodity prices are stable. One of the conclusions in the report is that the determining factor whether you have success or not in all kinds of situations of commodity prices is the quality of your institutions, and very clearly, the countries that are performing well have much better institutions than the other countries.

That was my last slide, and I think there is a conclusion at the end, which means that in the short run, we have a bit of a mixed picture--there is good news, there is bad news--but the short-run developments will not solve the problems of the ECA Region. Those problems can only be solved through a continuation of the reform agenda. There is a huge potential there if countries are willing to pursue that agenda. There is also the possibility that the whole continent will end up for a longer time with lower growth.

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

Let's turn now to the questions in the audience, and when you ask the question, please identify yourself and your outlet, and also speak into the microphone so we can have the translation.

Andrei, why don't we start with you, in the front row.

QUESTION: Thank you, Andrew.

My name is Andrei Sitov [phonetic], with the Russian News Agency Tass, here in Washington, D.C.

I have a bunch of questions about Russia--basically, a big, systemic question, if you will. You are talking about drying up of the capital flows because of the tapering expectations, right, on the logic that the tapering may have to be delayed because of the current difficulties in Washington.

Can we expect a reversal of that trend? Can we expect capital to start coming back to the Region? That is number one.

Number two, given the importance of oil for Russia, for instance, do you calculate the level of prices where the decline in prices starts to become dangerous for a big producer such as Russia?

And lastly, the Russian President was famously following the Doing Business Report, using it for his policy-setting, but he quite recently made an unexpected--at least for me--announcement that he is sort of having second thoughts about the usefulness of that indicator.

Can you comment on that, please?

Thank you.

MR. KIRCHER: Well, Andre, I was going to take a few questions at a time, but you have already provided three--but I think I will still maybe ask a few more, and then we'll take them in bunches.

The gentleman in the front row.

QUESTION: Yes, Michael Hernandez with Anadolu Agency.

My question is for Mr. Timmer, and I was hoping to see if he could elaborate upon the structural reforms that Turkey needs to take going forward.

MR. KIRCHER: Okay. Let's take one more.

The gentleman right there.

QUESTION: Christopher Srimcam [phonetic] from Polish Press Agency.

A question about Poland. What is the biggest challenge for Poland that you see now, because according to the IMF World Economic Outlook, this will be the worst year with the lowest GDP; next year will be better, but still, unemployment is rising.

Thank you.

MS. TUCK: Maybe I'll start and then turn it to Hans and perhaps Michal and Mamta on Russia and Poland.

On the drying up of the capital flows, I think you saw from Hans'--one of the first tables he showed, which was when the announcement of the tapering off was made in May, you saw an immediate drop in capital flows, and then you saw steady improvement. So I think we have seen a lot of the reduction in the problem. It has eased, and now everybody is watching. And I think what is going on down the street is causing some jitters, but for the moment, I think we expect the situation to stay more or less the same on that.

As far as the Doing Business, I think we see that Russia well--the most important challenge for Russia now is to address the noncompetitive structural issues in the economy and to shift from a model that was very much focused on stimulating domestic demand to one that will address the non-competitive sectors in particular and try to develop more investment in the economy, because right now, it is pretty much growing at capacity, and to lift that capacity constraint--that will be required.

Maybe Hans will want to say a few things.

MR. TIMMER: Yes, on the oil price and what is the level where it becomes dangerous, my impression is that there is not one specific level. It all has to do with the relation between the expected prices and the actual prices, so that is an important factor. And still, many of the oil producers are pretty prudent in the sense that they reckon with lower prices than the current one.

But the issue is not so much to try to benefit as much as possible from high prices as long as it lasts; the real issue is to start preparing now for a situation where you are less dependent on just the oil prices and just your natural resources.

The prices have been high for a very long period, so that is very good. That time has to be used to build up other assets in your economy, whether that is human capital or whether that is improved institutions. And once you do that--including also infrastructure for future growth--once you do that, you are in a good position to absorb whatever prices there are.

Structural reforms needed in Turkey--I would argue that Turkey is really an example of a country that has been very successful with structural reforms. After their crisis in 2001, the banking sector is in a much better place, still very competitive. So, in that sense, it is not a country where you are looking for an acceleration of the reform agenda.

As a result of the fact that they have been very successful, they could also be very successful after the crisis to stimulate their economy, and that is where the problem is now, because that has led to so much domestic credit supply, to so much domestic demand, that they have a widening of the current account and have become much more vulnerable to shocks in financial markets because they rely on portfolio capital inflows.

And I would argue the story is a bit similar for Poland, also a country that has been very successful over the last ten years in terms of structural reforms and has been less vulnerable than many other countries in Central Europe to the shocks that came from Western Europe. That does not mean that you automatically get a high growth path, and the lesson from all other countries is that it is not one-time reforms that will endlessly give you high growth, but you will have to continue your reforms. And those are the kinds of reforms that deal with aging societies and that deal with problems in the job markets.

MR. KIRCHER: Michal Rutkowski, Country Director for Russia, did you want to add something?

MR. RUTKOWSKI: Yes.

Andrei, a quick response to you. There is no more important time than now to pay attention to Doing Business Indicators, because what is happening in Russia is that you see a slowdown in growth, and then--basically, Russia is at full capacity, so you cannot grow unless you invest. You need private investment, so you need good business climate.

So, in this sense, I would say that, substantively, it is the most important time for Doing Business Indicators, and from what I see, there is a lot of work going on. There are technical discussions on some of the indicators, like construction permits, but otherwise, I see that full energy is there.

The second thing I just want to say is that I want to bring to your attention that since the announcement of the tapering of the quantitative easing, in Russia, there was a capital outflow, but Russia was less affected that other emerging [unclear] economies in the Region, and India and Brazil, so in this sense, I would be more optimistic about it.

Thanks.

MR. KIRCHER: Okay.

I think we have Mamta Murthi, the Country Director for Central Europe, who wants to follow up on Poland.

MS. MURTHI: Just on Poland, to elaborate on what Hans said, I think Poland is at an inflexion point. The growth that could have been achieved through catch-up, if you like, has been achieved. And now, to sustain high rates of growth, the Polish economy really needs to become more innovative. There is a range of structural measures that are needed. This is not just about innovation policy. This is about the business environment. This is about a labor market that remains somewhat segmented. This is about research, R & D. So that is where the future of Poland lies.

MR. KIRCHER: And lastly, we have Martin Raiser, Country Director for Turkey, in the back.

MR. RAISER: We complement each other.

I just wanted to add on Turkey--you asked which structural reforms--the Deputy Prime Minister just spoke at a conference early this morning, and he said that the key priorities for Turkey are more flexibility in the labor market, improvements in the business climate to increase the competitiveness particularly of exporters in Turkey, and measures to boost domestic savings.

It seems to me that if you add in addition to that an improvement in the skill level, reforms to the education system, you have a wonderful catalog.

So I can just support the Deputy Prime Minister in what he said.

Thank you.

MR. KIRCHER: Okay, thank you, Martin.

Let's go back now to the audience if there are any further questions.

Please, in the front row--could you please use the microphone?

QUESTION: Hello. I am [unclear] from Bosnia Herzegovina Daily Newspaper Dveuni Avas [phonetic].

Can you say something about Western Balkan countries--Bosnia, Croatia, Serbia and Montenegro--what are the prospects for those countries?

Thank you--and Macedonia.

MR. KIRCHER: Okay. And you are from Macedonia?

QUESTION: Of course--I'm sorry--of course, if possible, especially for Bosnia.

Thank you.

MR. KIRCHER: Okay. And your question is about the economic prospects?

QUESTION: Yes.

MR. KIRCHER: Okay.

For this, as you can see, we have our Country Directors here, who are able to speak specifically to your particular countries, and we have Ellen Goldstein, who is the Country Director for the Western Balkans.

Ellen, can I ask you to take up that question, please--those two questions, actually.

MS. GOLDSTEIN: One was specifically for Bosnia, and the other was general prospects.

Well, I think in general, the prospects tend to mirror the situation in Europe. I mean, we are experiencing in the Balkans some resumption in growth this year. It is quite fragile, but we do expect to see a modest recovery over the next two to three years.

And again, a lot is going to depend on the choices that are made in terms of structural reforms and pursuing the reforms in some of the areas that my colleagues were talking about on the public expenditure side.

For Bosnia in particular, we are in a situation where the political impasse tends to be holding Bosnia back from a higher level of growth and performance, and this has been the case for quite some time. But in this respect, we are hopeful--we are working with the government of the State and the various entities this year--in particular to try to reform the business environment because we believe that the potential that exists for Bosnia can best be exploited through encouraging the private sector to invest in Bosnia. So we are planning to go ahead with a very ambitious reform agenda on the business environment area.

MR. KIRCHER: And I think the second question, Ellen, was about Macedonia.

QUESTION: And Serbia.

MR. KIRCHER: Oh--now we have Serbia.

Ellen?

MS. GOLDSTEIN: Okay. Well, Macedonia has been performing quite well in terms of its commitment to reforms, and there has been some recovery in growth there. However, what we have seen in Macedonia--and it is not only in Macedonia, but it is prominent there--is that with the initial growth recovery, we have not necessarily seen the expansion in jobs and employment that we would like to see when we have that kind of growth recovery. So that is probably the major issue that we are working with the Macedonians on now, is how to transform this, or how to orient the recovery toward a type of inclusive growth that will actually stimulate more job creation.

On Serbia right now, I think we are very encouraged by the commitment that has been shown by the government in the past month or so to start tackling some reforms that are actually long overdue, particularly reforms related to the restructuring of the public enterprise sector, the so-called non-private enterprises, and we have seen a very strong commitment and we are hopeful that despite the fact that these are difficult measures to undertake that these are measures that Serbia needs to take. Many of the other countries in the neighborhood have gotten a little bit of a head start on that kind of reform, and Serbia being one of the larger economies in that area needs to play catch-up and needs to undertake these reforms in order to really start the growth recovery.

MR. KIRCHER: Okay, thank you, Ellen.

I think the gentleman in the last row had a question.

QUESTION: Yes. I am [unclear], Euro Press Croatia.

I would like to follow the line. What are your remarks for Croatia?

MS. GOLDSTEIN: That will be Mamta.

MR. KIRCHER: Yes. That would be back to Mamta Murthi.

MS. MURTHI: Croatia is now entering the fifth year of recession, and I think the primary focus at the moment needs to be on creating the fiscal space for growth-enhancing expenditures and then the outstanding agenda on the business environment and on labor markets.

I think Croatia is in a pretty tight bind at the moment because of the entry into the European Union, and the contributions that it has now to start paying, because it is a relatively rich new member country. It does have an enormous opportunity from new membership, and it can take advantage of the resources that are available and the large market that it has access to, but this is going to require some pretty strong measures, and in the short term, if it is to take full advantage.

So, at this moment, our message is really around ongoing fiscal consolidation to create the space for growth-enhancing expenditures and business environment issues that have been outstanding for some time.

MR. KIRCHER: Okay, thanks.

A question in the last row.

QUESTION: Yes, I want to ask a question about Turkey. I don't know if there is an expert.

My question is related to the conflict that

Turkey is having with its neighbor, Syria, because there are a lot of people that are coming from Syria to Turkey, and this is probably creating a lot of problems in the social arena. Especially, I want to know if this is going to affect employment, or what is going to happen, because my information is there are close to 500,000 people there now in Turkey from Syria.

MR. RAISER: This is correct. There about half a million registered Syrians in Turkey. So far, it has no macroeconomic implications, but the fiscal costs of accommodating these people in Turkey is significant. Turkey has shown itself to be very generous in bringing these people in and accommodating them well.

There are implications on the local labor markets, but it is not something that we have looked into in a sufficient amount of detail to really give you a full assessment, so maybe we can talk after the press conference a bit more in detail.

MR. KIRCHER: Okay, maybe we should go one last round. Are there any more questions from the journalists present?

[Pause.]

MR. KIRCHER: No. Okay.

Well, thank you again for coming, and just one last note. If you are interested, there is a press conference tomorrow morning at 9 o'clock with the presidents of the EBRD and the European Investment Bank, and we are going to be discussing the Joint IFI Action Plan and what progress has been made so far in delivering on that.

So, we hope to see you tomorrow at 9 o'clock. Thanks for coming.

[Whereupon, at 11:47 a.m., the meeting concluded.]