provide governments with useful restructuring options for addressing financial distress in the real economy in a timely and effective manner.

Appendix 1. A Restructuring Concept for Central and Eastern Europe

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The Region

Although Central and Eastern Europe (CEE) is still viewed as a single region, substantial differences exist among its subregions, including European Union (EU) members, Central European non-EU members and the CIS countries.

Ten Central European countries have achieved EU membership status, with four of them (Poland, Czech Republic, Slovakia, and Slovenia) characterized as having established broad-based economies and more highly evolved legal systems. While the financial crisis has affected these countries as well, its impact is expected to be less. The Baltic States (Lithuania, Latvia, and Estonia) and Hungary, however, are countries with smaller production base, significant over-leverage and/or lack of reform implementation (e.g. tax, pension, legal etc.) Finally, the most recent EU members (Romania and Bulgaria) are considerably less developed economically, politically and legally. Second subregion consists of the former Yugoslavia (excluding Slovenia) and Albania. While there are differences within this group as well, these are all still structurally weak economies at a fairly low stage of development.

The sub-region with the largest geography and population, the CIS countries, include commodity-based economies like Russia and Kazakhstan, undeveloped and/or dysfunctional countries like Ukraine or Moldova, and politically unacceptable countries like Belarus or Turkmenistan.

The one common theme throughout the CEE region is that restructuring (operational and financial) is typically avoided. Given the relatively recent emergence of most of the countries in the region from socialism, the region has not matured to the point where governmental actions have been effective in dealing with enterprise level distress. Political purposes, cronyism, and outright corruption have typically prevented meaningful restructuring and will hinder the recovery from the current crisis.

Specifics of the Crisis in the Region

The global financial and economic crisis has affected the region severely as the countries saw huge declines in external demand. For many Central European countries, export represents over 70% of GDP, while in CIS, the decline in commodity prices has had an additional negative impact on several countries' GDPs and finances. Moreover, credit in the region, especially Central and Southeast Europe, has been dominated by Western European banks (Austrian, German, Italian, and Scandinavian), and a large percentage of both corporate and consumer debt is denominated in Euros or other foreign currencies. The collapse of local currencies combined with a decline in asset values, especially regional stock markets and real estate, has resulted in lower earnings to service foreign debt, further exacerbating the crisis. As foreign banks moved to protect domestic balance sheets and repatriate capital, a liquidity freeze has resulted in the region. Virtually all foreign direct investment (FDI) has come to a halt. This has left enterprises throughout the CEE region stranded with a mountain of debt, no liquidity, and unfunded operating losses.

Governmental Reaction to Date

Most regional governments have had few monetary or fiscal tools to try to reinvigorate their economies, and there have been more urgent issues that they have had to confront. Several local currencies were on the verge of a meltdown, including those in Russia, Hungary, and the Baltic states. The Russian Central Bank spent a third of its foreign currency reserves stabilizing the ruble. The Hungarian Central Bank was forced initially to increase interest rates to prevent massive outflow. Second, as lending ceased and rumors spread that Western banks could be pulling out of the region, preventing a run on the banks also became a priority. All regional governments at least doubled the amounts guaranteed by the state. Several countries, including the Baltic States, Hungary, Ukraine, Serbia, and Romania have received funds from IMF, EU, and/or the European Investment Bank. Funding to-date has been primarily focused on easing the liquidity crisis

What Is Needed

As a result, the corporate sector is clearly struggling, and enterprise level governmental assistance has taken a back seat to the resolution of the monetary and banking crisis. There is ample evidence that even many good companies in the region are experiencing difficulties in extending financing and rolling over lines of credit and are becoming illiquid. The most pressing need is for additional capital and the restructuring expertise to deploy it productively. Excluding fairly short-term problems in the late 1990s, the region has not experienced an economic crisis since the collapse of socialism, and the region has been growing annually at 5% to 10% for the past decade. As a consequence, the restructuring expertise is still quite underdeveloped. There are few local turnaround firms, and bank workout departments are substantially understaffed, inexperienced, or nonexistent.

While most countries in the region have passed fairly good bankruptcy legislation, often modeled on the U.S. Bankruptcy Code, its application has been very limited. Substantial effort is needed to develop the infrastructure to implement existing bankruptcy, collateral, creditors' rights, and other related laws that currently exist but are rarely used.

Proposal for the CEE Region

The issues above are interlinked and thus should be dealt with in a comprehensive manner. We propose that a pool of restructuring capital be created, with the funds initially coming from multinationals such as EBRD, IFC, IMF, the World Bank, and the European Investment Bank. To the degree possible, the funds could be matched by local governments. As the program becomes established, commercial investors could participate through the sale of credit-enhanced offerings. This capital would be deployed through a newly created Regional Restructuring Finance Agency. The Restructuring Agency would have the dual role of providing credit and deploying restructuring expertise. Local capacity building and ROI strategy and criteria development are also important objectives to create a successful and lasting impact. Given subregional differences (discussed above), the strategies should be adapted to at least three subregions: the EU members, non-EU CE countries, and the CIS.

The capital would be invested in three types of situations. First, working capital for otherwise good companies would function as a bridge until the liquidity environment is normalized. Second, it would be invested as restructuring capital contingent on fund-approved turnaround plans. Finally, the capital could be used to rationalize "bubble" debt and equity investments primarily made between 2005 and 2007. New capital would be invested as debt, possibly ahead of existing senior positions. Investment would be based on meaningful operational and financial restructuring strategies, and returns would be enhanced with PIK interest or warrants to compensate for risk. The program would be voluntary and focused on small-and medium-sized enterprises (SMEs). Large corporations would be eligible as well, provided that they are independent from political interests and can be competitive if properly restructured. Key criteria would be that the companies have a viable core business, modern management, and an ability to increase internal demand in local markets.

An alternative "entry" mode could be through nonperforming loans (NPL). By purchasing NPLs, the Restructuring Agency would provide liquidity to local and foreign banks and bring restructuring discipline and expertise to deal more effectively with debtor companies. With the Restructuring Agency in control of the debt, it can restructure for its own account.