U.S. bailout mirrors Tajikistan

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Tajik women carry water in canisters outside the village of Gargara, about 110 km south of Dushanbe. The government is paying a heavy price for bankrupting its central bank.

What does the richest nation in the world have in common with the poorest country in Central Asia?

Both countries have faced a banking crisis and have drained the cash reserves of their central banks to try to subvert an economic crisis.

But while the U.S. Federal Reserve hopes its intervention will stave off an economic meltdown, the Tajik government is paying a heavy price for bankrupting its central bank: a flat-lined economy that is only propped up by remittances from Tajik workers in Russia.

Over the years, the world has seen plenty of bailouts.

The first style of rescue packages were government-to government bailouts, dubbed the Paris Club, like those used to prop up Argentina's economy during its 1980s debt crisis. Over the years, the private-sector flows began to swamp the government-to-government loans, says Win Thin, senior currency strategist at New York-based Brown Brothers Harriman & Co. Bailouts that involve sovereign defaults on commercial bank loans are dubbed the London Club. This style of renegotiation of loans was at the heart of the 1998 meltdown of the Russian economy.

Some bailouts have been solved within weeks. Mexico's external debt crisis in 1994 was quickly resolved after the country issued oil-backed bonds that were absorbed by various governments and the private sector. Others take years. The 1997 Korean economic crisis created after the collapse of several large Chaebols took years to work out.

But the bailout that best mirrors the one the United States is undergoing occurred in Tajikistan, a landlocked country bordered by Afghanistan to the south and Kyrgyzstan to the north.

"Tajikistan is a microcosm of what's happening in the U.S. now," says Alex Jurshevski of Recovery Partners, a Toronto-based debt and turnaround advisory firm. "Both [countries] have abandoned monetary control orthodoxy by intervening in private-sector financing decisions," he says. Now the central bank in Tajikistan is bankrupt.

The trouble with Tajikistan began in 1991, when the former Soviet Union republic broke from Russia. The IMF and World Bank poured resources into the country after it became clear the local banks were struggling with unprofitable agricultural loans to boost crop production.

The IMF supported the creation of an asset-management company, Kredit Invest, that could relieve banks such as Agro Invest by taking the loans off their books. But then the IMF took its eye off the ball. Although Kredit Invest was supposed to be in the business of winding down these assets, it started borrowing fresh money to lend anew to struggling local farmers.

The international lenders OK'd loans on a promise of a government guarantee. Unfortunately, the central bank — the National Bank of Tajikistan — did not disclose those guarantees to the Ministry of Finance in Takijistan, the IMF or other donors, says Mr. Jurshevski, whose firm Recovery Partners, was called in as an advisor to one of the multinational lenders in 2007. Kredit Invest suddenly had a $500-million liability and the central bank was on the hook.

"They decided, in a well meaning fashion, to take on private-sector risk and support unprofitable activities, with the end result that it exhausted its balance sheet and is now unable to perform some of its functions as a central bank," Mr. Jurshevski. says.

The IMF has insisted on a repayment of its Poverty Reduction and Growth Facility grants and is forcing the country to comply with a strict set of conditions related to its "Staff Monitored Program." Until the IMF grants the country a certificate of macro stability that proves it has met its requirements, no other donor can lend money. Because of the central bank's error, the country is suffering from a 20% rate of inflation and the only outside trade flows it enjoys is from expatriate workers sending money home to support their families. It will take years before the country rebuilds its foreign exchange reserves, he adds.

So what's the parallel with the United States?

The Federal Reserve has effectively monetized on its balance sheet all the assets and liabilities of the banking system, says Mr. Jurshevski. They started the year with $900+ billion and now its gone. The Fed is at the end of its rope in terms of the magnitude of conventional balance sheet resources available to it.

But while Tajikistan has been trying to lean on the IMF and World Bank for support, "there is no Fed for the Fed," Mr. Jurshevski says.

The expert on Corporate and Sovereign debt restructuring is worried about the U.S. situation: "Banks in the U.S. have not typically been net borrowers of cash. The Federal Reserve has never had to apply this much monetary stimulus ever, and once you start polluting your balance sheet with non-performing paper, that's the road to perdition. It will be hard for them to find an exit."