Capital Account Liberalization and the IMF: New Evidence from the Argentina Crisis

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Abstract
Since its inception in 1945, the goal of the International Monetary Fund (IMF) has been to "prevent crises in the [international] system by encouraging countries to adopt sound economic policies." In recent decades, the Fund's focal point has been on the liberalization, or opening, of financial markets to advance economic development. Previously known as the "A-plus student of the IMF", Argentina provides valuable insight into the IMF's policies and need for reorganization measures by raising the question of whether the IMF's liberalization policies are fostering or hindering economic prosperity. The IMP is pushing capital market liberalization forward even though there is no evidence that economic growth is significantly affected by it. Moreover, since capital market liberalization has contributed to instability, such as in Argentina, the IMF needs to refocus its efforts by assisting countries through Keynesian expansionary economic measures, a proven method for lessening the severity and duration of financial crises.

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Capital Account Liberalization and the IMF: New Evidence from the Argentina Crisis

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Abstract

Since its inception in 1945, the goal of the International Monetary Fund (IMF) has been to “prevent crises in the [international] system by encouraging countries to adopt sound economic policies.” In recent decades, the Fund’s focal point has been on the liberalization, or opening, of financial markets to advance economic development. Previously known as the “A-plus student of the IMF”, Argentina provides valuable insight into the IMF’s policies and need for reorganization measures by raising the question of whether the IMF’s liberalization policies are fostering or hindering economic prosperity. The IMF is pushing capital market liberalization forward even though there is no evidence that economic growth is significantly affected by it. Moreover, since capital market liberalization has contributed to instability, such as in Argentina, the IMF needs to refocus its efforts by assisting countries through Keynesian expansionary economic measures, a proven method for lessening the severity and duration of financial crises.
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INTRODUCTION

Over the last twenty years, the International Monetary Fund (IMF) had advocated the liberalization of capital markets throughout the world. Increasingly, it has used its power to force developing countries to open their capital markets to international capital flows. Many observers have argued that this IMF strategy has done more harm than good. Recent IMF policies in Argentina provide the basis for re-examining of IMF policies. In this thesis, I will argue that IMF policies have made Argentina’s problems worse than they might have been. I will then argue that a fundamental re-examination of IMF policies is necessary in order to improve its performance in the future. This thesis will be demonstrated by first analyzing the IMF from its inception and evolving status as a proponent of capital account liberalization throughout the last 59 years. Secondly, I will examine the IMF’s Market Fundamentalism Theory and explain how the Structural Adjustment Program targeted at developing countries is conducted. I will also critique the effectiveness of the program. Beginning in 1999, this paper will critique the effectiveness of the IMF response in handling the crisis in Argentina and analyze the future of international financial cooperation.

THE INTERNATIONAL MONETARY FUND

Bretton Woods Beginnings - 1960

In an effort not to repeat the disastrous economic policies that culminated in the Great Depression of the 1930’s, forty-five world governments signed the landmark agreement forming the IMF in 1944 with the goal of “preventing crises in the [global] system by encouraging countries to adopt sound economic policies.” The IMF’s
responsibilities included promoting international monetary cooperation, maintaining stable exchange rates and expanding international trade.\(^1\) To achieve these ends, it was agreed that governments needed to protect themselves from destabilizing capital flows by maintaining controls on capital account transactions.\(^2\) Chief British negotiator John Maynard Keynes promoted such measures by declaring: “not merely as a feature of the transition, but as a permanent arrangement, the plan accords to every member government the explicit right to control all capital movements.”\(^3\)

In line with mainstream economic philosophy, Keynes believed capital controls were the best course of action to prevent speculative international flows from hampering autonomy in policymaking. Such capital movements during the interwar period had disrupted exchange rates and all countries, with the exception of the US, believed the return to such a system after World War II would be incompatible with international economic stability.\(^4\) Although the United States did not impose capital controls in its economy in the 1940’s or the 1950’s, the U.S. government was sympathetic to other countries, primarily those in Western Europe as well as Japan, which had done so. The economist Eric Helleiner asserts this was partly due to the emergence of the Cold War and the reluctance of the U.S. government to alienate allies by pushing for liberalization.\(^5\) For all these reasons, the IMF was a strong advocate for

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the implementation and maintenance of controls during its first two decades of existence.

From 1947 to 1976 the functioning of the IMF as a central international monetary policy maker was limited because domestic policy was the dominant concern for member states.\(^6\) While the 1950s see a rise in international monetary cooperation, the limited power of the Fund was made evident by the fact that countries were not willing to work together in the international financial arena. By the end of the 1950s, the existence of the Fund was not what the founding fathers had in mind – a leader in international economic cooperation.

*Monetary Disorder of 1960’s – 1970’s*

A very different issue became of concern to the IMF during the late 1960s – 1970s in relation, – that of monetary disorder. The rapid freedom of international capital movements called into question domestic policy autonomy and the reliance on fixed exchange rates. A crucial turning point was reached when the US abandoned its fixed exchange rate in 1973, allowing the market to dictate the dollar’s performance.\(^7\) Further upsetting the international financial structure established by the IMF was the growth of multinational corporations and international trade in the 1970s. These factors increased the opportunity for countries to evade capital controls and create market pressures forcing Japan and Western European countries to allow their currencies to

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float. In the end, both regions tightened controls to stem speculative flows, but were forced to float when pressures became too high.⁸

Despite the chaos during the 1970’s, members still realized the importance of an international system to oversee financial markets. Accordingly, the second amendment of the IMF’s articles of agreement was agreed upon by members as a way to resurrect the Fund. Purposely vague, the new amendment declared that the new “purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services and capital among countries.”⁹ This opened up new avenues by which the Fund could become a viable force in the new international structure with the IMF now focusing on advocating liberalization.¹⁰ As such, member countries were urged to liberalize and deregulate domestic economies to fit into the IMF framework.¹¹

Despite the push for capital account liberalization in the 1970’s, developing countries preferred strong governmental roles and the safety features of capital controls in planning and policymaking. The general feeling was that unsupervised markets would put governments at a disadvantage and were not viable. The advent of Thatcherism and Reaganomics in the 1980’s, favoring free trade, investment, deregulation and privatization, changed the economies of emerging countries permanently. Due to high foreign debts that incurred and became due during this time period, countries, such as Argentina, were helpless to resist the IMF. As a condition for

⁸ See Helleiner, States and the Reemergence of Global Finance: From Bretton Woods to the 1990’s, p. 103.
⁹ See Helleiner, States and the Reemergence of Global Finance: From Bretton Woods to the 1990’s, p. 110.
¹⁰ See Helleiner, States and the Reemergence of Global Finance: From Bretton Woods to the 1990’s, p. 110.
¹¹ James Crotty, The Case For Capital Controls, (Massachusetts: University of Massachusetts, 2000), p. 6
loans, the United States and other developed nations required capital liberalization as a condition for new loans, putting the IMF in the forefront to enforce such policies.  

Recessionary Period of the 1980’s

By the 1980’s, the groundwork was in place for a remarkable eradication of capital controls that had been intact for over 50 years. As liberalization occurred, developing countries incurred further foreign debts by continued borrowing. Developing countries unwillingly found themselves at the mercy of the IMF during the 1970’s after commercial banks had made large loans that were misused by military regimes and dictators. Subsequently, when oil prices rose in 1979 and the U.S. interest rate increased sharply, developing countries heavily in debt found themselves unable to make interest payments. Defaulted loans could only be avoided with continual refinancing, and hence a renewed position for the IMF. An international financial crisis began in 1982 when the Mexican government declared default on its debt. Mexico’s problems stemmed from Western loans incurred in an attempt to avoid the conditionality of the IMF. Further, the Mexican problem was compounded by a shift to austerity measures in the US which caused rates on loans in Mexico (stated in

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12 John Cavanagh and Robin Broad, “The Death of the Washington Consensus?” World Policy Journal 16, no. 3 (Fall 1999): 79-80
13 See Helleiner, States and the Reemergence of Global Finance: From Bretton Woods to the 1990’s, p. 146
15 See Helleiner, States and the Reemergence of Global Finance: From Bretton Woods to the 1990’s, p. 175.
dollars) to skyrocket while the US recession caused commodity prices to crash and limited Mexican export markets. The result was capital flight.\textsuperscript{16}

Culminating Crises of the 1990’s

The 1990’s saw financial trouble in Asia and Latin America where the Fund stepped in to rescue struggling economies. An influx of capital propelled short-term and temporary growth in the 1990’s by encouraging bad lending and bad investing. From 1990 to 1996, financial flows to developing countries went from $44 billion to $244 billion per year, one-half of which was short-term investment. By mid-1997 the “hot money” was leaving much more quickly than it came, with local economies having no backup plan to gain other sources of funds.\textsuperscript{17} Many countries, particularly developing ones such as those in Asia and Latin America, had not adjusted to the financial liberalization of the 1980’s and were unable to withstand external financial shocks.\textsuperscript{18} The 1994-1995 Mexican crisis began when substantial bank losses were evidenced after another devaluation. The culminating Asian crisis in 1997 in Thailand, Malaysia, Indonesia, the Philippines and South Korea resulted in the Fund extending $71 billion dollars in loans and imposing strict economic programs.\textsuperscript{19} Many economists maintain the Asian crash was the result of capital account liberalization during the late 1980’s and early 1990’s. Short-term capital flows went into long-term investments such as speculative real estate, adding to the crisis.\textsuperscript{20} However, the IMF, operating under its market fundamentalist approach, believed Asia’s problem was related to the

\textsuperscript{17} See Cavanagh and Broad, \textit{“The Death of the Washington Consensus?”}, p. 82.
\textsuperscript{18} Ibid., p. 83.
failure to completely deregulate markets and curtail the government’s role in the economy.\textsuperscript{21} The Russian crisis also arose during 1998, when the ruble depreciated and the country defaulted on part of its international debt.\textsuperscript{22} Against this backdrop of the recessionary 1990’s, many economists maintain the IMF has failed at its basic mission as crises around the world occur more frequently and more deeply and capital market liberalization has contributed to this instability.

\textit{Capital Account Liberalization}

Increasingly, the IMF has advocated capital account liberalization. Essentially, capital account liberalization promotes the free movement of capital in and out of countries without controls, or restrictions. Proponents, operating under what has been labeled the Washington Consensus, argued that once government interference ended, growth and productivity gains would follow around the world, based on high global investment.\textsuperscript{23} Once capital controls were removed, it was maintained that credit and technology would find their ways to poor countries.\textsuperscript{24} However, critics have argued that unregulated capital flows can be highly unstable, particularly when occurring in a less transparent environment, as an emerging economy. In the end, these flows can very quickly reverse themselves, creating turmoil for a country. Under the IMF’s revised 1970’s model, labor markets always work perfectly and efficiently, if quantity demanded always equals quantity supplied. When this occurs there should be no

\textsuperscript{21} See Eichengreen, \textit{Capital Flows and Crises} p. 3.
\textsuperscript{22} See Coyle, \textit{Governing the World Economy}, p. 21.
\textsuperscript{23} See Cavanagh and Broad, “The Death of the Washington Consensus?” : 87.
unemployment. If a problem exists, the problem is not with the market, but elsewhere. The term “market fundamentalism” has often been used to characterize the IMF stance on liberalization.\textsuperscript{25} Requiring little consideration of a country’s particular problems or circumstances, “market fundamentalism” enjoins liberalization and maintains that in the long run the economy will benefit despite short term problems.\textsuperscript{26}

\textit{Structural Adjustment Program}

Theoretically, the market fundamentalist approach is entrenched in the IMF's program for economic recovery – the structural adjustment program. The basic goals of the structural adjustment program are to open markets, reduce the size and role of the government and rely on markets to distribute resources according to where they are needed. Structural adjustment policies include privatization of government enterprises, cutting government spending, promoting exports, eliminating trade restrictions, and raising interest rates to induce investors to hold domestic financial assets.\textsuperscript{27} The IMF discourages restrictions on current account transactions, provides short term financing, and oversees orderly changes in exchange rates when required.\textsuperscript{28} The Fund has defended the structural adjustment program by claiming that forceful decisions need to be made in order to stabilize systems and restore confidence in developing countries.\textsuperscript{29}

\textbf{ARGENTINA}

\textit{Currency Board System 1991}

\textsuperscript{27} Robert Weissman., The IMF on the Run: The International Monetary Fund Tries to Outrun Its Critics. \textit{Multinational Monitor} 21, no. 4 (April 2000):10.
\textsuperscript{28} See Pauly \textit{Who Elected the Bankers: Surveillance and Control in the World Economy}, p. 81.
Throughout the 1990’s, Argentina worked under the close surveillance of a Fund supported program. This contrasted with countries that faced crises in the 1990’s including Mexico, Indonesia, South Korea, Thailand and Brazil, who only followed a Fund supported program when a domestic crisis began.\textsuperscript{30} During this time, the basis of the financial system in Argentina was the currency board system, implemented in 1991 after a decade of hyperinflation. The currency board system required a one-to-one peg between the US dollar and the peso with 100% backing of international reserves.\textsuperscript{31} Theoretically, a currency board system requires that the currency be covered by foreign currency reserves and the two currencies must trade at a fixed exchange rate with one another. First appearing on the international scene in 1849, currency boards were abandoned in the 1960’s with the rise of central banks in developing countries. However, the currency crises in the 1980’s and 1990’s moved countries to turn once again to currency boards for security.\textsuperscript{32}

Argentina kept the currency board in place due to the possible return of excessive inflation of the 1980’s, when consumer prices increased at a rate of over 200% per month. After the adoption of the currency board, Argentina saw a growth rate of over 7% per year during 1991-1994.\textsuperscript{33} The international community and the IMF, who used Argentina as a model for other countries to follow, applauded Argentina’s economic policies during the 1990’s.\textsuperscript{34} Today, however, the Fund

\textsuperscript{30} See Mussa, \textit{Argentina and the Fund: From Triumph to Tragedy}, p. 3.
\textsuperscript{32} Steve Hanke, How to Establish Monetary Stability in Asia, \textit{Cato Journal} 17, no. 3 (Winter 1998): p. 298
\textsuperscript{33} Martin Feldstein, Argentina’s Fall, \textit{Foreign Affairs} 81, no. 2 (Mar/Apr 2002): 8.
\textsuperscript{34} See Mussa, \textit{Argentina and the Fund: From Triumph to Tragedy} p. 1.
maintains that despite IMF support for the economic policies of Argentina during the
early 1990’s, it did not force the government to maintain them.\textsuperscript{35}

The actual test for the convertibility plan came during the slow economic growth
of 1993-1998.\textsuperscript{36} The peg survived the Tequila (Mexico) crisis of 1994 and the Asian
collapse of 1997-98, however, the Brazilian crisis of 1998 led to its downfall.\textsuperscript{37} When
Brazil, Argentina’s largest trading partner, devalued its currency (the reale), against the
dollar, Argentina’s peso appreciated against the reale, thus severely damaged
Argentina’s export market and forcing a recession. While the Argentinean economy
attracted capital flows in the short term, long run exports were less competitive as a
result of the devaluation.\textsuperscript{38} The IMF supported the currency board even though
Argentina was not in the same currency area as the US and was subject to different
shocks, making the currency board unsustainable when Brazil devalued.\textsuperscript{39} As early as
January 14, 1999 the \textit{New York Times} foresaw significant trouble in the Argentinean
economy from the Brazilian devaluation, but supported by the IMF, the Argentinean
government stood behind the peg, calling it “a requirement and demand of the
people.”\textsuperscript{40} As a result, Argentina was vulnerable to plummeting exports and staggering
unemployment because of the Brazilian devaluation, but was unable to change their
economic course due to the currency board system.\textsuperscript{41} Argentina, like other Latin
American countries, was forced to rely on the IMF for funding since the Russian default

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\textsuperscript{33} See Mussa, \textit{Argentina and the Fund: From Triumph to Tragedy} p. 5.
\textsuperscript{34} See Mussa, \textit{Argentina and the Fund: From Triumph to Tragedy} p. 12.
\textsuperscript{35} See Mussa, \textit{Argentina and the Fund: From Triumph to Tragedy} p. 1.
\textsuperscript{36} See Deseci, \textit{Financial Crisis, Contagion, and Containment}, p. 108.
\textsuperscript{37} See Mussa, \textit{Argentina and the Fund: From Triumph to Tragedy}, p. 22.
\textsuperscript{38} Ibid. See Mussa, \textit{Argentina and the Fund: From Triumph to Tragedy} p. 5
\textsuperscript{40} Sam Dillon, “Argentina May Suffer Most From Neighbor’s Ills.” \textit{New York Times} January 14, 1999,
Late Edition: 5
\end{flushright}
of 1998 had scared speculators away from emerging economies, thus limiting the amount of financing resources available. In a quarterly fiscal review conducted with the IMF in April 1999, Argentina promised to cut one billion dollars in governmental spending. The IMF’s structural adjustment program called for tighter austerity measures in an attempt to force the economy out of the recession but it was ignoring the deteriorating export market caused by the appreciating peso. Further damaging the Argentinean economy was an increase in interest rates by the Federal Reserve in April of that year. This proved devastating to this economy in that 90% of its foreign debt was stated in dollars.

*Crisis Culminates in 1999*

As is typical during the Argentine and other currency crises, external shocks prompt fears of currency devaluation. Fears of ending the peg, coupled with uncertain presidential elections caused the stock market to drop 18% in May of 1999 and it continued to fluctuate due to speculation as money flowed in and out of the country.

This was further exacerbated by the failure to meet IMF targets for monthly budget deficits of $2.95 billion – by June 1999 the deficit was ballooning to $5.1 billion.

Governor Eduardo Duhalde of Buenos Aires, Argentina’s most powerful province, publicly declared that the Pope should be asked to support a debt moratorium for

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42 Ibid., p. 5.
Argentina and other struggling countries.\textsuperscript{47} This was not a good move for this market as Argentina would remain a target of instability for some time to come.

By the end of 1999, President-elect Fernando de la Rua successfully pushed a measure through congress cutting $1.4 billion in governmental spending and an increasing taxes by over $2 billion in an effort to send the message to investors abroad that the country was willing to take a firm stance in correcting the economy.\textsuperscript{48} The IMF favored such measures by approving $7.4 billion loan agreement in a swap of maturing bonds for new debt. This went against the IMF’s revised mandate in that the institution was not solving balance of payments insolvency issues, but rather bailing out creditors and stalling the repayment of debt. Many economists at the time felt De la Rua’s actions were intended to gain the support of the IMF, not to alleviate the concerns of the citizens of Argentina.\textsuperscript{49}

By June 2000, six months after progressive austerity measures were implemented, the Argentinean economy remained in decline. Domestic unrest heightened on June 10 when the first of several national strikes was initiated, a sign of the effects of tax increases and spending cuts.\textsuperscript{50} Now at 14%, the unemployment rate was increasing, much to the consternation of the citizenry.\textsuperscript{51} In the wake of this, negotiations with the Fund led to $938 million in further spending cuts in order to

\textsuperscript{50} Clifford Krauss, "One-Day National Strike Freezes Much of Argentina" \textit{New York Times} June 10, 2000: A.3
sustain the loan agreement promised in the beginning of the year.\textsuperscript{52} Although controversial, it is not uncommon for Fund-supported programs to fail in meeting conditionalities i.e., in this case the Fund member was allowed to put forward corrective policies to reinstate the program with new objectives.\textsuperscript{53} The Fund maintained that at any time it would have supported any other plan to reduce the deficit.\textsuperscript{54} Many economists maintain that if the Argentinean government had chosen a more flexible system economically, unemployment would have been lower and growth would have been stronger, and creditors would have had more confidence in the government.\textsuperscript{55} By August 2000, unemployment had risen to a three-year high of 15.4%. At the same time the \textit{New York Times} reported “More tax revenue and a decline in public spending this year have pleased the International Monetary Fund.”\textsuperscript{56} Post-devaluation figures for Mexico and Brazil during this time showed growth rates of 7.6% and 4%, while the projected growth rate for Argentina was at best 2\%.\textsuperscript{57}

By year-end in 2000, the IMF was demanding a zero budget deficit by 2005 and elimination of the country’s state pension fund system.\textsuperscript{58} There is a basic dichotomy that stifled growth in Argentina. Investors are hesitant to put money in an economy that is retarded, but there is no hope for future growth without such investment.\textsuperscript{59} In

\textsuperscript{53} See Mussa \textit{Argentina and the Fund: From Triumph to Tragedy}, p. 38
\textsuperscript{54} See Mussa \textit{Argentina and the Fund: From Triumph to Tragedy}, p. 6.
\textsuperscript{55} See Mussa \textit{Argentina and the Fund: From Triumph to Tragedy}, p. 9.
\textsuperscript{58} Floyd Norris, “Argentina’s Woes: with Peso Overvalued, it Can’t Compete”, \textit{New York Times} December 8, 2000, Late Edition: C.1
December, the IMF increased its lending package to $39.7 billion in an effort to “...improve the investor climate, and together with enhanced domestic and external confidence, lay the ground for sustained economic growth in Argentina.”

For its part, Argentina promised to freeze spending for five years and to reduce the government deficit to zero within five years. At this point, the country had $123.5 billion in outstanding debt, with a ratio of debt to gross domestic product totaling 51%. Why is the high debt to GDP significant? (1) Prior failures in raising taxes had little success in Argentina as an avenue to increase revenue. (2) Argentina not only had to convince creditors they could raise money through taxes, but also that the tax monies could be converted into foreign exchange while being pegged to the dollar. (3) Even during liberalization, the ratio of external debt to exports was over 400%, leading one to believe that a substantial financing risk existed and debt restructuring was in order. (4) Like other emerging market countries, Argentina was vulnerable to external shocks, such as Brazil’s recession. The financial package provided by the IMF was to ensure no devaluation would occur in the near future.

_Austerity Measures Throughout 2001_

Despite a short-term rally in Argentina in the first quarter of 2001 as a result of a cut in the Federal reserve interest rates and during the IMF announcement of funds, by March reality had struck once again in the form of another rash of austerity measure. In the face of spending cuts and reduction of federal subsidies to provinces, the new

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62 See Kahn, “I.M.F. Plans Billions in Aid to Argentina”, p. A.16.
63 See Mussa, _Argentina and the Fund: From Triumph to Tragedy_, p. 16-17.
austerity plan aimed to cut $1.9 billion in 2001 and $2.5 billion in 2002.\textsuperscript{64} The mounting social outcry prompted the Argentine president to call upon Domingo Cavello, a hero during the early 1990’s and founder of the currency board system, to return to Argentina as economic minister.\textsuperscript{65} Cavello was spurred to reverse the austerity measures advocated by the IMF. In a statement, Mr. Cavello stated “all of the attention of my ministry will be directed at rapid reactivation and vigorous economic growth, to increase employment and increase family income, so people will consume more, and we will exit this recession that has gone on for three years.”\textsuperscript{66} However, in the first days of his tenure in office, he was quoted as saying “convertibility is here to stay and never will be abandoned.”\textsuperscript{67}

Despite Cavello’s supply-side initiatives, central bank reserves fell 8% during the first quarter of 2001.\textsuperscript{68} Compounding this problem was the decrease in private banking deposits, which reflected evasion measures against the financial transaction tax.\textsuperscript{69} Cavello’s main problem, however, was that time was running out. Debt payments totaling $1.3 billion were due in May and Cavello’s program could not work quickly enough to stimulate the economy.\textsuperscript{70} Speculation was furthered by the announcement of the abandonment of a plan to deregulate the health insurance system, a conditionality of the IMF program.

\textsuperscript{66} Ibid., W.1.
\textsuperscript{67} Ibid., W.1.
\textsuperscript{69} Ibid., A.5.
\textsuperscript{70} Ibid., A.5.
The IMF again loosened requirements in April for Argentina’s debt quota in an
effort to keep the country so touted as the miracle economy afloat, despite the failure of
Argentina to meet the target for the first quarter by over $1 billion.\(^\text{71}\) To bide time,
Cavello announced a series of debt swaps that created a short-term solution to a long
term problem.\(^\text{72}\) Finance secretary Daniel Marx was quoted as saying “... it does not
replace fundamental questions in the management of the economy.”\(^\text{73}\) This statement
was borne out by a decline in tax revenue by over 9%. Further, bank deposits declined
over $5 billion by April 2001 as citizens began moving savings abroad.\(^\text{74}\)

Temporary measures such as bond swaps did little to strengthen a fledgling
economy. On July 12, Domingo Cavello announced further deficit cutting by both the
provinces and the federal government totaling $3 billion.\(^\text{75}\) An IMF statement heralded
this measure in saying “... keeping spending by the provinces under control is
essential.”\(^\text{76}\) Meanwhile, the consensus among economists was that a default or debt
restructuring was likely for the future.\(^\text{77}\) The demise of Argentina occurred at the same
time as a change of the U.S. administration from the Clinton to Bush presidency. The
US plays a vital role in the IMF as the largest shareholder and the holder of the sole
veto vote. The new Bush administration was against any international bailout to

\(^{71}\) Clifford Krauss, “Argentines Sell Short-Term Debt at A High Cost”, *New York Times* May 9, 2001,
Late Edition: C.11.
\(^{72}\) Jonathan Fuerbringer, “Argentina Plans Debt Swap in Billions, Delaying Payments”, *New York Times*
\(^{73}\) Unknown, “Argentina, With Bond Swap, Seeks to Revive Its Economy”, *New York Times* June 5,
2001, Late Edition: W.1
\(^{74}\) Clifford Krauss, “In Argentina, More Room to Breathe”, *New York Times* May 5, 2001, Late Edition:
C.1.
13, 2001, Late Edition: A.1
developing nations because of the moral hazard problem: investors become careless lenders because they believe that governments will rescue them with a bailout.\textsuperscript{78} 

Therefore, Bush believed the best course of action for Argentina and other developing countries was to work out their own solutions. September 11 only suspended any possible change in this policy and Argentina would increasingly find that they were on their own in the world with a public debt totaling 45\% of GNP.\textsuperscript{79} 

A unique governmental structure also created more problems for Argentina in July 2001 when Buenos Aires, the most populated province in Argentina, opted to print its own currency. Buenos Aires had to reduce its spending (in pesos) because of Cavello’s demands, but it did not want to layoff workers or cut their wages.\textsuperscript{80} Also, the new notes promised vendors 7\% interest after a year when redeemed. Despite this, two days later another austerity bill was passed by Argentina’s Congress cutting government salaries and pensions by 1\% and increasing business taxes. The IMF issued a press release stating “we welcome the passage today by Argentina’s Congress of the package of measures designed to achieve a zero fiscal deficit. This demonstrates the political unity behind Argentina’s commitment to fiscal discipline, and decisive implementation of these measures should help to stabilize the macroeconomic situation and to strengthen confidence.”\textsuperscript{81} As a result the IMF approved an accelerated disbursement of $1.2 billion to Argentina, which was announced in a news briefing on August 3, 2001.\textsuperscript{82} 

By November, despite IMF loans and austerity measures meant to boost the economy, the administration found itself in negotiations to restructure the country’s foreign debt and avoid default.\textsuperscript{83} With popularity down to single digits, Cavello announced “a new social contract” to fight tax evasion and to provide cash subsidies to impoverished children and senior citizens most damaged by the social program cuts.\textsuperscript{84} However, in what became a pattern for Argentine leaders, short term last-minute measures were of no value. The citizenry withdrew over $500 million from banks and interest rates rose as high as 200\% as financial insolvency was seen as inevitable.\textsuperscript{85} Fund spokespersons were still behind the country at this point of no return, stating for the record that they welcomed the country’s efforts to achieve sustainable growth. The IMF believed that one of the government’s largest problems related to the provinces, where 14 out of 23 deputies were from the opposition party. The population in the provinces is 80\% of Argentina’s total population.\textsuperscript{86} More than 40+ months into the crisis the IMF took the stance that all governors had to agree to a revenue-sharing arrangement. However, with unemployment looming over 20\%, the provinces were not willing to concede budgetary cuts.\textsuperscript{87} In another desperate move, bank withdrawals were limited for all citizens in an effort to save the banking industry from collapse.\textsuperscript{88}

Ironically, it was at this point that the IMF announced that it would not recommend the dispersal of $1.3 billion dollars previously promised to the country.\footnote{Unknown, “I.M.F. Won’t Support New Loan for Argentina”, \textit{New York Times} December 6, 2001, Late Edition: A.18.} Openly stating that the loan was necessary if the country was to service its debt, this announcement was a devastating blow. Cavello responded by instituting more controls on the currency, but it was too late to make an impact.\footnote{Clifford Krauss, “Argentine Economy Minister Tries to Maintain Optimism”, \textit{New York Times} December 6, 2001, Late Edition: A.18.} The IMF had abandoned its poster child during its most dire time of need, making default inevitable.

Despite the dire circumstances forced upon Argentina, the IMF refused to change its path and demanded another $4 billion out of the public budget.\footnote{Unknown, “I.M.F. Gives Budget-Cut Order to Argentina”, \textit{New York Times} December 10, 2001, Late Edition: A.6.} Speaking of the measures that Argentina needed to complete, US Treasury Secretary Paul O’Neill stated “It’s not something that can be imposed from outside.”\footnote{Joseph Kahn, “U.S. Says It Favors Deferring Argentine Aid” \textit{New York Times} December 21, 2001, Late Edition: A.6.} This was an ironic statement in that the IMF had been forcing upon Argentina for more than forty months austerity measures such as conditions for receiving loans. Cavello and de la Rua resigned within hours of one another on December 20\textsuperscript{th}, leaving the country in complete ruins. On December 23 governor-turned-president Adolfo Rodriguez Saam announced what had been coming for months – the largest debt default in history which totaled $132 billion dollars. Treasury Secretary O’Neill was quoted as stating “They [Argentina] don’t have any export industry to speak of at all. And they like it that way. Nobody forced them to be what they are.”\footnote{Larry Rohter, “A Fiscal Crisis, Paid in Credibility” \textit{New York Times} December 25, 2001, Late Edition: A.16.} This was misleading in that the only reason
the Argentine export market had declined was due to the devaluation of the Brazilian real and the limits of Argentina’s currency peg. The latter, in fact, was advocated by the US and the IMF, and hindered any ongoing monetary policy initiative from being introduced. Austerity measures forced upon the country by the IMF cut jobs and bankrupted export-producing companies. Given these circumstances, it was impossible for Argentina to build an effective export economy. The Argentine fiasco proves the general ineffectiveness of the IMF as its policy focused on fiscal constraints, which only damaged the situation further in the midst of a recession. The country that Fidel Castro accused of “licking the Yankee boot” by mimicking U.S. policies of liberalization and embracing free competitive global markets had suffered the largest default in world history.

Default of 2002

By January 6, 2002 the impossible happened as Argentina abandoned the one to one parity of the peso to the dollar.94 Overnight, the peso depreciated by over 30% and inflation rose dramatically.95 Capital controls were then initiated to limit the cash going out of the country.96 Meanwhile, forty percent of the country’s population was living below the poverty line and unemployment had reached over 22%.97 Therefore, country found itself in a conundrum as economic changes demanded by the IMF could not be accomplished without the necessary funds to boost the economy, but the IMF refused to

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provide these funds until the economy improved. The members of the South American Common Market pleaded with the IMF in defense of Argentina, asking the Fund to “understand Argentina’s complex situation and agree to aid the country while it pursues internal policies that will permit economic growth rather than more austerity.”

On its own now, the government hesitated to print more money now that the peg had been abandoned for fear of a return to hyperinflation. Instead, a tax was added to all exports in the hope of raising additional revenue to pay the salaries of public employees. However, with reserves falling by over $100 million a day and inflation exceeding 45%, the situation was dire.

The problems continued throughout 2002, with the IMF and Argentina at odds with one another. Specifically, the Argentine government was not willing to adopt further austerity measures and the IMF, led by the US, was not willing to disperse any additional funds. In September the economy minister, Roberto Lavagna, announced that no more international debt payments to the IMF or other entities would be made due to the lack of foreign reserves. With a renewed focus on social programs and the financing of provincial expenditures, the President was not willing to sign an agreement with the IMF that required abandoning this new course. By the first quarter of 2003, Argentina and the IMF had resolved issues enough to announce the postponement of Argentina’s debt payments in exchange for new commitments by Argentina to tax collection, the development of bankruptcy procedures, and renewed fiscal targets at the

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central and provincial level. \(^{101}\) Today, Argentina owes $14.3 billion to the IMF, more than 500% of their IMF quota which is 300%. There are signs of improvement after the three year ordeal as trade accounts are at a surplus and unemployment is slowly being reduced through the creation of new jobs. \(^{102}\)

**IMF lessons to be learned**

*Reaction of the IMF*

There are many lessons to be learned from the Argentinean default and the reaction of the International Monetary Fund. More than any Latin American country, Argentina bought into liberalization by cutting tariffs, privatizing enterprises and opening its doors for multi-national corporations to enter. \(^{103}\) A critique of the Market Fundamentalist approach is that particular circumstances of a country are not taken into account by the IMF when crisis management policies are implemented. Regardless of the factors that led to the crisis, the Structural Adjustment Program dictates a “cookie cutter” approach to financial crisis that is insufficient in dealing with the complexities in developing countries.

The structure of Argentina’s economy was certainly known to the IMF, which lifted the country up as a model of liberalization for the world in the 1990’s. The currency board system that pegged the peso to the US dollar was touted as a successful policy strategy. On one hand, it aided in eliminating hyperinflation the 1980’s and resulted in foreign exchange flowing into the country throughout the 1990’s. However,

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the currency board curtailed the use of monetary policy and therefore eliminated a crucial domestic policy that Argentina might have used to restore market confidence and minimize currency speculation.\textsuperscript{104} Economically, a currency board wishes to limit the use of monetary policy in the event a crisis strikes, such as in the case of the Brazilian devaluation.

A second factor contributing to the severity of the crisis was the ineffective response of the Argentinean government after the devaluation of the Brazilian real. As indicated above, the devaluation of the real increased the value of the peso against the real. This is significant in that Argentina and Brazil were close trading partners. Once the Brazilian real was devalued, Argentinean exports were too expensive and this served to adversely impact the economies of both countries. The possibility of borrowing funds to survive this tough period was severely limited as private lenders and other countries were unwilling to lend emerging countries money during the continuing crises in the 1990’s throughout the world. The International Monetary Fund is the lender of last resort for many countries, including Argentina that faced a liquidity crisis.

Third, the currency board system eliminated any flexibility the government had in getting through difficult situations. The peso could not be devalued and money could not be printed by the central bank to stimulate the economy. Keynes advocated such expansionary measures in situations like those faced by Argentina, but the peg hindered such actions from being taken. From the viewpoint of the IMF, Argentina had survived the Asian and the Russian crises of the 1990’s while the currency board system remained strong and kept inflation low. Admittedly, the economy grew throughout

\textsuperscript{104} Martin Khor, Confronting Chaos: The Imperative of Reining in the Global Financial System, Multinational Monitor 19, no. 10 (October 1998): p.10
1996-1998 at a rate of 6% per year. Following the Brazilian devaluation, however, the economy slowed to a 3.1% growth rate in 1999 and 0.2% in 2000. It should have been clear to the IMF that the currency peg was unsustainable and the peg needed to be abandoned. This would allow the peso to fall against the reale to boost exports with Brazil and other Latin American countries. However, the official response was quite different and was a damaging one. IMF conditionalities were based upon the goal of a zero deficit, and this required Argentina to pursue recessionary fiscal policies. With the peg, Argentina could not absorb the massive cuts to its social infrastructure and it collapsed under this pressure. A reduction in interest rates would have been well-advised to solve the liquidity problem, but the IMF instead demanded higher interest rates to maintain Argentina’s foreign reserves. This only compounded the problem by making debt issued in dollars more difficult to repay, causing further social unrest and unwarranted suffering.

The IMF also ignored a crucial aspect of the Argentinean economy occurring throughout the 1990’s, that is Argentina’s current account deficit. While it has been stated that a current account deficit in a emerging economy is beneficial in order to compensate for deficient domestic savings, the Argentinean deficit was beyond this threshold. While the savings rate was substantially above the investment rate immediately following the currency board installation, the resulting years were characterized by low savings rates and a large increase in foreign debt. This resulted in initial investor panic as the ratio of foreign debt to foreign exchange reserves reached

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105 See Desei, *Financial Crisis, Contagion, and Containment*, p. 175
over 300% in 2002 and foreign reserves could finance fewer than 30 days worth of Argentinean imports$^{106}$

Structural deficiencies in Argentina were ignored or, at best, downplayed by the IMF. Tax evasion was rampant throughout Argentina with over 60% of taxes going unpaid, and there was little governmental regulation to enforce tax collection. During a time of fiscal deficits, funds from taxes are crucial for maintaining the economy. Unfortunately, it was not until the final stages of the crisis that the IMF addressed these problems. While Cavello did make public the need for better taxing measures, the government had already been weakened and had lost creditability. Therefore, moves to force bills to be paid by credit card or check in the hope of obtaining additional tax revenue were unsuccessful.

The actions of the IMF in Argentina provide further evidence that structural reforms are needed if the international organization is to play a positive role in the future. Currently, IMF policies only serve to sustain the losses of insolvent banks and borrowers in developing countries, rather than to fulfill their original mandate to provide liquidity assistance in resolving balance of payments problems.$^{107}$ Further, the Washington consensus did not clarify what a country should do when liberal financial policies undermined exchange rates objectives. In the case of Argentina, a pegged exchange rate was chosen. An adjustment in policies was necessary when Brazil devalued. However, pressure from the IMF to maintain the exchange rate peg

$^{106}$ See Desei, *Financial Crisis, Contagion, and Containment*, p. 180
undermined confidence and produced capital flight.\footnote{See Pauly, *Who Elected the Bankers: Surveillance and Control in the World Economy*, p. 123.} IMF critic Joseph Stiglitz, former Chief Economist for the World Bank, claims a country in danger of default should not be advised to adopt austerity measures in order to improve the balance on their current account by building up foreign-currency reserves. The only way to improve the balance on current account is to increase exports or decrease imports.\footnote{Joseph Stiglitz, *Failure of the Fund: Rethinking the IMF response*, *Harvard International Review* 23, no. 2 (Summer 2001): 14.} But, increasing exports was impossible in Argentina due to the appreciation of the peso, and decreasing imports only led to lower consumption and choices for consumers in a period of time where social unrest was rampant. In addition, the Fund does not act quickly enough to solve liquidity crisis.\footnote{William Niskanen, *Reshaping the Global Financial Architecture: Is here a role for the IMF?* *Cato Journal* 18, no. 3 (Winter 99): 332-333.} As further evidenced in the Argentine collapse, the culminating three-year crisis changed the country from dealing with liquidity issues to insolvency problems once the debt default was made public.

*A New Financial Order*

In 1999 Princeton economist Alan Blinder published an article entitled “Eight Steps to A New Financial Order.”\footnote{Alan S Blinder, *Eight Steps to a New Financial Order*, *Foreign Affairs* 78, no. 5 (Sept/Oct 1999).} Although written prior to the Argentine crisis, the approach can be applied to the latest IMF crisis. The first recommended principle is to avoid a fixed exchange rate.\footnote{Ibid. p. 54.} Not only was Argentina’s exchange rate fixed, but it was pegged to the dollar in a strict one-to-one parity that could not be relinquished without an act of congress. The story would be entirely different had the peg been between close trading partners such as Brazil and Argentina. However, the pressures to liberalize and the goal to look “western” to the IMF and the Washington consensus
prompted Argentina to introduce the currency board system in 1991 and link the peso with the much stronger dollar, making the economy very susceptible to external influences beyond its control. Throughout the crisis, IMF and Argentine officials touted the importance of the currency peg and neither was willing to publicly call for its demise.

Principle number two calls for countries to borrow less in foreign currency. This certainly has implications for the economy of Argentina, where over 90% of outstanding debt was in dollars rather than pesos. Citizens were encouraged to borrow in dollars due to the apparent stability of the currency board. The irony of this policy is clear when one remembers that the IMF called for an increase in interest rates to win investors back into the market. The debts stated in dollars, while seemingly more stable, increase because of the higher interest that must be paid on principle. While the IMF was calling for increasing exports to jump start the economy, the U.S. Federal Reserve Bank raised interest rates, even if only slightly, which further appreciated the peso and made the export market unsustainable. Fewer exports meant lower sales, lower tax payments and less money in the pockets of citizenry to repay the dollar denominated debt, stated in dollars, that was greater than ever. The fact that the IMF failed to fully recognize this problem is crucial in understanding the changes that need to occur within the IMF. Argentina had a very specific economy, which differed from that of Brazil, Thailand, South Korea, Malaysia or Russia. Nevertheless, the same austerity measures were implemented.

\textsuperscript{113} Ibid., 55.
Principle number three calls for not rushing to open capital markets.\textsuperscript{114} This is the crux of the argument between many economists and the IMF, i.e. rapid liberalization of capital markets have not given them enough time to properly handle a large influx of funds during a short period of time; hence the onset of the financial crises of the 1980’s and the 1990’s. Open markets are not best for all countries of the world, despite the preaching of the International Monetary Fund. Argentina is a clear example of a country where structural deficiencies were not taken into account prior to the liberalization of capital markets. First, tax evasion was rampant throughout the country prior and subsequent to the crisis. It had been common in Argentina as well as other Latin countries, to make the majority of purchases in cash, making it easier to avoid taxes. Economic minister Cavello recognized this and valiantly tried to call for its revamping, but insufficient authority and guidance within government led to an eventual policy failure. Opening up capital markets in the light of widespread tax evasion, and only focusing on fixing it post-crisis, was a serious blunder for both the government and the IMF.

The fourth principle for a sound international economic framework is to follow sound macroeconomic and financial policies.\textsuperscript{115} But who is the key decision-maker in the international economy regarding sound economic policy for developing countries? The Washington Consensus has been severely criticized for policies that were implemented throughout the 1980’s in the developed world, led by the United States. Certainly the Argentine authorities thought they were acting in the best interests of the popular during the currency board system, and the blessing of the IMF contributed to

\textsuperscript{114} Ibid. p. 57.
\textsuperscript{115} Ibid. p. 58
this belief. Today, however, the IMF is the sole arbiter of sound and valid financial practices. Each country’s internal structure and makeup is not taken into account by the IMF. In the initial framework of the IMF in the mid 1940’s, developing countries were not part of the process. The scene is quite different now as developed countries rarely, if ever, request advice from the Fund. Hence, a change of policy procedures adapted to fit the needs of developing countries is needed.

Principle five speaks volumes for all financial crises, especially the Argentinean one—austerity is not always the right medicine.\textsuperscript{116} In the forty-plus months of the crisis, the IMF continually destabilized the Argentine economy by calling for fiscal austerity and privatization measures. Cutting welfare spending during a financial recession only compounds the problem facing the common citizen, many of whom have lost their jobs due to a declining export market. The problem intensifies, however, as the IMF continues to demand zero deficits. Expansionary fiscal policies, such as those advocated by John Maynard Keynes, need to be included in the policies of the IMF in order to prevent future crises from occurring.

Principle six, devoting more resources to protect innocent bystanders, is also applicable to Argentina.\textsuperscript{117} In this case, the innocent bystanders are the citizens of Argentina and the suffering they had to withstand due to misguided IMF policies. Austerity budgetary cuts aimed at social programs hurt those who have no direct say in the policies themselves. This leaves the people of Argentina with only one option, that of social protests and national strikes. On several occasions, national papers reported such strikes occurring throughout the country that paralyzed businesses and the banking

\textsuperscript{116} Ibid., p. 58
\textsuperscript{117} Ibid., p. 59
industries. The IMF refused to take responsibility for these events, blaming the practices of the Argentine government while at the same time demanding further cuts that would hurt the people of the country even further. It was not until 2003 that Argentine authorities realized the severity of the detrimental effects that austerity measures have had on the people, but reform policies were implemented too late to make a difference. Cutting interest rates rather than raising them, as the IMF had demanded, would have given people more money to spend to boost the economy. In the end, the entire IMF package hurt the Argentine government but, most notably, the innocent Argentine citizens were the true fatalities in the deal.

Principle seven prescribes the procedures for an orderly debt settlement.\textsuperscript{118}

Throughout the crisis, the IMF changed conditionalities and added adding further criteria to the lending package as a hook to the receipt of funds. This creates problems in that confusion is usually rampant in a system that is continually changing, despite the best efforts of the debtor to attempt to accommodate the lender. Conditionalities should be settled at the beginning of a lending arrangement, not during the most chaotic periods of the country. Further calls to cut spending only served to alienate the citizenry from the government and further damaged the economy. Insolvency fears need to be dealt with promptly in order to repay debt while maintaining a positive cash flow. Expansionary economic policy is the best way to accomplish this through the activation of additional income into the economy to spur spending, not austerity measures that make matters worse.

\textsuperscript{118} Ibid., 60
Lastly, the final provision for a new financial order is for the IMF to focus on the prevention of financial crises rather than to search vainly for a cure after the initial occurrence.\textsuperscript{119} Beyond the obvious financial ones, the costs of the crisis are enormous in that countries such as Argentina rarely if ever fully recover from an economic standpoint to be whole again. The IMF needs to focus on preventative measures in developing countries, whether by abandoning their policy of financial liberalization or simply revamping it to recognize the need for capital controls or other restrictive measures. Capital controls would help safeguard countries that have structural problems, such as lack of transparency in the banking industry, or tax evasion issues such as in Argentina. While there is a place for an international institution such as the IMF, austerity measures implemented in emerging economies have throughout time proven costly and irreparable.

\textit{Conclusion}

In summary, the International Monetary Fund, while it is an organization that has the potential to serve an important purpose in the world today, has largely failed in their mission toward developing countries. Beginning with currency crises in 1982 and culminating in the largest sovereign default in history in Argentina in 2002, the Fund’s structural adjustment program, wrapped in liberalization, has been a failure. Latin American, Asia and Russia have all suffered from austerity programs that only deepened their crises. Austerity economics, aimed at curbing government spending on social programs and the further privatization of public organizations, interferes with the goal of fiscal independence and financial solvency. The IMF needs to return to the basic

\textsuperscript{119} Ibid., p 61.
tenets of the Bretton Woods system of capital controls and begin looking at countries in an case-by-case manner in order to best avert crises internationally.
CHRONOLOGY

1991: Currency board introduced pegging the peso to a one-to-one parity against the dollar; ends decade-long hyperinflation.

1997: Asian “Tigers” Crisis involving Thailand, South Korea, Malaysia, the Philippines and Indonesia; little effect on Argentina’s economy.

1998: Russian crisis; currency board remains strong.

Jan 1999: Brazilian devalues currency in an effort to salvage struggling economy: signs of trouble for their largest trading partner, Argentina.

April 1999: Argentine leaders travel to the US for financial assistance.

May 1999: US Federal Reserve raises interest rates, further appreciating the peso, still pegged to the dollar.

Oct 1999: Fernando de la Rua elected President of Argentina vowing recession will end soon.

Dec 1999: $2 billion increase in taxes passed as a result of IMF conditionalities.


Nov 2000: National strike begins at joint statement of de la Rua and the IMF demanding further economic reforms.

Dec 2000: $39.7 billion promised by the IMF to Argentina; outstanding debt totaling $123.5 billion.

Mar 2001: Domingo Cavello, father of the currency board system, re-appointed finance minister.

July 2001: Bush administration declares no further assistance available for Argentina in a policy shift from the Clinton administration.

National Strikes throughout country protesting worsening conditions.

Moody’s lowers credit rating of Argentina to Caal, 7 levels below investment grade.

Aug 2001: US treasury department agrees to speed up September’s loan installment (from Dec 2000 agreement).
Dec 2001: Bank accounts frozen throughout country.

IMF refuses further funds to Argentina.

President de la Rua and Economic Minister Cavello resign.

Dec 23, 2001: President Adolfo Rodriguez Saa declares $123 billion default, the largest in history.

Jan 7, 2002: President Eduardo Duhalde, the fifth president in 2 weeks, ended the currency board system by unlinking the peso from the dollar.

Growing resentment between the IMF and Argentina.

Mar 2002: Tax imposed on all exports.

June 2002: Talks between IMF and Argentina to resume.


Nov 2002: Argentina defaults on payment to World Bank.

Jan 2003: Agreement with IMF made to issue new loans.

Jan 2003: IMF defers loan payment.

May 2003: President Nestor Kirchner elected.

Sept 2003: President Kirchner announces no further payments will be made to IMF or other international lenders. Deal made days later to avoid further default and provides for more amicable relations with the IMF and president Kirchner, who vows not to impoverish his country any further.
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