IMF Fiscal Surveillance during the Eurozone Crisis

Lena Golubovskaja, Maynooth University, Maynooth, Ireland

ABSTRACT
This study analyses the tone and information content of the IMF Article IV Staff Reports during the Eurozone crisis. Researchers create a tone measure denoted WARNING, based on the existing DICTION 7.1 Hardship dictionary. Researchers find that in the run-up to the current credit crises the warnings by the IMF were issued to Luxembourg, Malta, Portugal, and Slovenia. In contrast, the more severely hit countries were not warned by the tone of the IMF Article IV Staff Reports. Researchers also conclude that the IMF interactions were more effective with low-income countries and with other emerging economies than they were with advanced and large emerging economies. Individual countries Article IV Staff assessments for Ireland and Spain indicated the warnings by the IMF were only in the years when the countries were deeply in recession and it was too late to provide any policy guidance.

KEYWORDS
Article IV Staff Reports, Content Analysis, DICTION, Eurozone Crisis, Fiscal Surveillance, Warning Indicators

INTRODUCTION
With a few notable exceptions, economists worldwide failed to predict the emergence and gravity of the financial crisis that originated in the United States in 2007. Because governments worldwide rely on the IMF to provide a warning system to anticipate critical events (see statement of the G20 Leaders), it is crucial to investigate how the IMF failed to detect early signs of the crisis. The IMF is a multilateral organization that is statutorily mandated to provide an early warning to the member countries so that national authorities can take measures to mitigate the impact of a crisis. Despite this mandate, some have claimed that the IMF did not sound any alarm in the run-up to the current crisis, or that when raising concerns it did so in a muted or hedged manner (IEO, 2010). To illustrate this, in the summer of 2007, the IMF staff indicated that in the United States “core commercial and investment banks are in a sound financial position, and systemic risks appear low” (IMF, 2007:14). In addition, as late as April 2007, the opening sentence of the Global Financial Stability Report (GFSR), the IMF flagship on financial issues, noted, “Favorable global economic prospects, particularly strong momentum in the Euro area and in emerging markets led by China and India, continue to serve as a strong foundation for global financial stability. However, some market developments warrant attention, as underlying financial risks and conditions have shifted since September 2006 GFSR”. In addition, Subramanian (2009) says that the failure of the IMF “was to preside over large capital flows to Eastern Europe despite the lessons that it should have learned from the experience of the Asian financial crisis in the late 1990s. These flows to Eastern Europe were, in some cases, so large that it did not require hindsight to see the problems that they would lead to. Warnings about the unsustainability of these flows should have been loud and insistent. And they were not.” Others have claimed that the IMF issued warnings but that they were not heeded.
Furthermore, during the global financial crisis, the IMF’s role in financial sector surveillance involved three interrelated aspects: drawing policy lessons from the crisis and recommending actions to restore financial stability; developing recommendations to strengthen supervisory, regulatory, and macroprudential frameworks, in collaboration with other agencies; and making the Financial Sector Assessment Program (FSAP) more effective and integrating it with Article IV surveillance. The IMF’s headline messages about the causes of the euro area’s financial crisis during the crisis period were generally consistent with the EU members’ authorities’ views. The IMF indicated high sovereign debts levels, weak governance and fiscal framework as the main causes of the crisis. With respect to addressing these factors, it was proposed to reinforce policy coordination in the euro area. Specifically, the EC recommended a strengthening of the SGP, a more intrusive surveillance of external imbalances in the euro area, stronger ex-ante coordination, and a permanent framework of crisis management. Unsurprisingly, the IMF provided an enthusiastic assessment of the overall European Economic and Monetary Union response to the crisis. To illustrate, the Staff Appraisal section, the IMF noted, “the immediate crisis response has been strong and far-reaching, demonstrating the euro-area’s capability to act together when pressured” (IMF, 2010).

The primary purpose of this paper is to evaluate these differing views and establish whether the IMF Reports foresaw the crisis and warned people about it. Moreover, if so, how explicit were those warnings? This paper is an extension of Golubovskaja (2014) and assesses the IMF’s role during the global financial crisis from 2008 through 2015. It evaluates the IMF’s diagnosis of the causes of financial weaknesses and its resultant financial sector policy recommendations. At the empirical level, researchers address these issues by analysing the tone of the IMF Article IV Staff Reports for the euro area countries using computerized textual analysis algorithm DICTION 7.1. Under Article IV of the IMF’s Articles of Association, the IMF holds bilateral discussions with members, usually every year. A staff team member visits the country, collects economic and financial information, and discusses with officials the country’s economic development and policies. The team returns to headquarters and the staff prepare a report. This Staff Report forms the basis for discussion by the Executive Board.

The main contribution of this study is an evaluation of the effectiveness of the IMF external surveillance in the run-up to the current credit crises and during the global financial crisis. This paper adopts a chronological approach since the IMF’s response and views changed over the period from 1999 through 2015. It traces the evolution of the IMF warnings and response and assesses the quality of these diagnoses, analysis, and policy recommendations.

BACKGROUND

Was the Miracle a ‘Mirage’? EMU Fiscal Policies

In 2007, the last year before the onset of the economic and financial crisis, the public finances in the euro area were in their strongest position for decades. This result owed more than was appreciated at the time to favourable economic conditions. With the onset of the crisis in 2008, GDP growth fell dramatically and turned negative by the end of the year, leading to a marked deterioration in the public finances. In 2009, a year of deep recession followed, with growth shrinking by 4.09% on average in EU16 (compared to an expansion of 2.77% in 2007) (Table 1). In detail, the highest negative real GDP growth rates in 2009 were in Finland (-7.76%), Slovenia (-7.33%), and Ireland (-7.10%). Furthermore, the greatest drop in the growth rate, by 15.24% from 2007 to 2009, was in the Slovak Republic. In 2007, general government deficits corresponded to less than 1% of GDP in EU16. Debt has also deteriorated strongly. In 2007, the euro area debt corresponded to 66% of GDP (European Commission, 2010).

However, until the outbreak of the financial crisis in August 2007, the mid-2000s was a period of strong economic performance throughout the euro area. Economic growth was generally robust;
Related Content

Application of DEMATEL and MMDE for Analyzing Key Influencing Factors Relevant to Selection of Supply Chain Coordination Schemes
[www.igi-global.com/chapter/application-of-dematel-and-mmde-for-analyzing-key-influencing-factors-relevant-to-selection-of-supply-chain-coordination-schemes/205853?camid=4v1a](www.igi-global.com/chapter/application-of-dematel-and-mmde-for-analyzing-key-influencing-factors-relevant-to-selection-of-supply-chain-coordination-schemes/205853?camid=4v1a)

[www.igi-global.com/chapter/a-review-of-security-mechanisms-for-multi-agent-systems/220546?camid=4v1a](www.igi-global.com/chapter/a-review-of-security-mechanisms-for-multi-agent-systems/220546?camid=4v1a)
Generalized Intuitionistic Fuzzy Entropy Measure of Order and Degree and Its Applications to Multi-Criteria Decision Making Problem
www.igi-global.com/article/generalized-intuitionistic-fuzzy-entropy-measure-of-order--and-degree--and-its-applications-to-multi-criteria-decision-making-problem/171654?camid=4v1a

Application of Soft Computing Techniques for Renewable Energy Network Design and Optimization
www.igi-global.com/chapter/application-of-soft-computing-techniques-for-renewable-energy-network-design-and-optimization/123081?camid=4v1a