Chapter 16
The Content of IMF Staff Reports for Euro Area Countries

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ABSTRACT
This chapter analyzes the tone and information content of the two external policy reports of the Internal Monetary Fund (IMF), the IMF Article IV Staff Reports, and Executive Board Assessments for Euro area countries. In particular, the researchers create a tone measure denoted WARNING based on the existing DICTION 5.0 Hardship dictionary. This study finds that in the run-up to the current credit crises, average WARNING tone levels of Staff Reports for Slovenia, Luxembourg, Greece, and Malta are one standard deviation above the EMU sample mean; and for Spain and Belgium, they are one standard deviation below the mean value. Furthermore, on average for Staff Reports over the period 2005-2007, there are insignificant differences between the EMU sample mean and Staff Reports’ yearly averages. Researchers find the presence of a significantly increased level of WARNING tone in 2006 (compared to the previous year) for the IMF Article IV Staff Reports. There is also a systematic bias of WARNING scores for Executive Board Assessments versus WARNING scores for the Staff Reports.

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, 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.

The primary purpose of this article 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? At the empirical level, researchers address these issues by analysing the tone of the IMF Article IV Staff Reports and Executive Board Assessment for the euro area countries using computerized textual analysis algorithm DICTION 5.0. 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 views of the Executive Board are summarized in a Public Information Notice (PIN) that is attached to the Article IV report.

The main contribution of this study is an evaluation of the effectiveness of the IMF’s external surveillance in the run-up to the current crisis. In addition, in contrast to previous studies, this study is the first to apply content-analysis methodology to analysing the IMF Reports. According to Li (2006), very few studies examine the texts of publicly available documents; instead, the majority of the analysis has been on the quantitative variables contained in the reports.

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