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OVER-OPTIMISM AND THE IMF

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1. INTRODUCTION

An important part of the literature on the International Monetary Fund (IMF) involves evaluative studies which set out to assess the impact of the stabilisation and adjustment programmes that have been negotiated by governments with the Fund. How successful have these programmes been? Unsurprisingly perhaps, answering this question raises fundamental methodological issues. Before and after comparisons implicitly assume that other things have remained as they were, so that observed changes can be attributed to Fund-backed programmes. Comparisons between what was targeted and what was achieved implicitly assume that the targets were reasonable. Attempts to compare what happened with what would have happened in the absence of a Fund programme encounter the problem of the counterfactual, and there appears to be no scientifically satisfactory way of dealing with this problem even though researchers have made valiant attempts to overcome it as best they can.¹

While the results that emerge from these studies have been nuanced, some influential observers and analysts of the Fund have claimed that IMF programmes, and the conditionality they embody, do not work. They sometimes go on to suggest that, in its conventional *ex post* form, IMF conditionality should be abandoned and should be replaced by *ex ante* conditionality (IFIAC, 2000). The Fund has responded by claiming that, where programmes fail, it is often because of a lack of commitment by the government concerned. Failure reflects poor implementation. To try and remedy this, recent reform has focused on 'streamlining' conditionality to reduce the number and range of conditions stipulated in agreements and on increasing the degree of national ownership of programmes by encouraging broader participation in the discussions that culminate in an agreement (IMF, 2001).

An interesting, but generally overlooked, dimension of the discussion of IMF programmes is the negative bias involved in interpreting their impact. Where targets are not achieved, programmes are presented as 'failing'. But if performance falls short of the targets set, might this be because the targets are in fact set unrealistically high? In this context, programmes could simultaneously achieve a great deal and yet still be perceived as having failed. The problem might be one of over-optimism on the part of those negotiating the programme rather than a lack of achievement.

¹ For a review of this literature, see Haque and Khan (1998). Some of the more influential contributions include Killick et al. (1994), Goldstein and Montiel (1986), Edwards (1989), Khan (1990), Conway (1994), and Killick, Malik and Manuel (1995). Recent papers include Przeworski and Vreeland (2000), Barro and Lee (2001), Evrensel (2002), and Hutchison and Noy (2003). A theme of this recent research has been the effect of IMF programs on economic growth. While the consensus seems to be that the short run effect will be negative, this result depends on the precise specification of the estimating models, on the time frame chosen and on the countries studied.

This paper offers an examination of IMF programmes adopting this alternative approach. The organisation of the paper is as follows. Section 2 explores the factors that may lead to over-optimism. Clearly, from time to time, forecasts may go wrong, but random errors should imply that under-prediction will be as frequent as over-prediction. Here we focus on why there may be a systematic bias towards over-optimism. We do not do this by presenting a critical analysis of IMF forecasting techniques, but rather by exploring whether political economy factors will encourage an optimistic slant to be placed on predictions. Furthermore, we consider whether these factors will lead to universal over-optimism or whether they are more likely to induce it in some areas of economic performance than in others. Indeed, are there reasons to anticipate that over-optimism may occur in terms of some elements of programmes, alongside under-optimism (pessimism) in other elements?

Without presenting a formal model or test, Section 3 goes on to collate some of the available empirical evidence relating to over-optimism. This draws heavily on research undertaken by the Independent Evaluation Office of the IMF (IEO) in the context of its reports on other issues, but it also makes use of current research within the Fund's own Research Department and elsewhere. The evidence is found to be consistent with the claim that the Fund exhibits over-optimism in some areas.

Section 4 then examines the consequences of this for the design and effectiveness of IMF programmes. What is the impact of over-optimism on implementation and the longer term effects on reputation and credibility both from the point of view of the IMF and the governments concerned? Suggesting that realism is preferable to optimism, Section 5 suggests a number of reforms that could bring about such a shift in institutional aspirations and operations. Section 6 offers a few concluding remarks that reposition the discussion in this paper into the broader debate about IMF programmes and reform.

2. MOTIVATIONS FOR OVER-OPTIMISM

IMF programmes emerge from negotiations between staff from the IMF and representatives of the governments seeking financial assistance. An agreement incorporates predictions about the performance of key economic variables and lays down conditions in terms of specific policy variables. The former will influence the latter (and vice versa), and the Fund takes these inter-relationships into account within the context of a financial programming framework. For example, assumptions about the rate of economic growth carry with them implications for the amount of tax revenue generated, and this will in turn influence the extent to which discretionary fiscal policy needs to be adjusted. It will also have implications for the growth of money demand and this will affect targets relating to credit creation.

Once a programme has been agreed between Fund staff and the government, it then has to be approved by the Fund's Executive Board. In addition to this, it has to be approved implicitly by the country upon whose behalf the government has negotiated it. Otherwise, compliance will be adversely affected².

What motivations lie behind the staff of the IMF who are involved in this process, once the Fund has been approached by a government for a loan? It may be assumed that they will want to 'get to yes'. They want to reach an agreement with the government that is then endorsed by the Executive Board. After all, its Articles of Agreement delineate a role where the IMF assists countries in balance of payments need, and this will not be achieved if programmes are not agreed. Moreover, the staff involved will not further their careers by failing to negotiate agreements. There will be both a personal and an institutional desire to get an agreement.

In order to do so, the Fund staff have to ensure that the negotiated program is acceptable both to the government concerned and to the IMF Executive Board. The government, it may be assumed, will want the loan to be as large as possible. It will also want to minimise the domestic political costs of accepting and implementing the related conditionality. In short, the government will want to maximise the benefits and minimise the costs of the programme. This will give it the best chance of 'selling' it nationally and retaining its own political integrity. Having taken the decision to turn to the IMF, governments will not want to be rejected.

But from the viewpoint of both the IMF's staff and the government, there will be constraints on their desire to reach agreement. The IMF will be anxious not to undermine its financial reputation. It will therefore not be prepared to say yes at any cost. An approved programme

² For an analysis of compliance in the context of IMF programs, see Bird (2001, 2003).

must be internally consistent and coherent. However, the effects of individual programmes on institutional reputation may be somewhat intangible and difficult to take into account. There may also be an inconsistency between personal and institutional ambitions with staff adopting a short term view. Furthermore, the Fund will also be constrained in terms of the amount it can lend, and this will influence the details of programmes.

Governments will not endorse programmes that they believe will merely secure their political demise. If they believe that, with the best deal they can reach, the costs still outweigh the benefits, they will not sign the agreement.

While both the IMF and the government will enter into negotiations with the objective of reaching an agreement – although not at any cost – they will tend to be looking for different things from it. The IMF is a financial institution. Its primary concern will be to strengthen a country's balance of payments in the relatively near term. It will, however, want to achieve this while minimising adverse effects on other aspects of economic performance, in particular economic growth, in order to be consistent with its Articles of Agreement³. Governments will have a rather different agenda. Their primary long term aim, it may be assumed, is to raise national living standards. To achieve this, they will be keen to maximise the rate of economic growth. The balance of payments will be perceived by them as a short term constraint on achieving this long run objective. In circumstances where the IMF has become involved, the balance of payments constraint has become binding and governments are seeking to relax it. What is an objective for the Fund is a constraint for governments. Governments will therefore enter into negotiations with the Fund to overcome balance of payments problems and re-establish economic growth as soon as possible.

What about the Fund's Executive Board? Where does this fit into the story? For the Board, defending the Fund's reputation will be a significant factor. But the Board will also have a bias towards saying 'yes'. After all, it is making decisions about whether to assist members of the institution. Even members of the Board opposed to a particular programme are more likely to abstain rather than vote against it. And yet the Board will need to satisfy itself that

³ The Articles of Agreement spell out the purposes of the IMF. Article 1 (ii) explains that the Fund's role is "to facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy". Article 1 (v) says that it is "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity". Article 1 (vi) stresses that the Fund should try "to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members".

programmes make economic sense and have a good chance of being implemented. The staff of the Fund who are helping to design them will be aware of this⁴.

With the motivations discussed above, it may be anticipated that there will be a tendency towards optimism built into the design of IMF programmes. A key element relates to economic growth. Why is this central? By being optimistic about the prospects for economic growth, there will be related optimism about tax revenue. Programmes will then require less adjustment in terms of discretionary tax policy and government expenditure in order to achieve specific fiscal targets and, therefore, related monetary targets as well. Tax rates will not need to be increased so much, nor government expenditure cut so much.

Indeed, assuming a relatively high rate of economic growth, it may also be assumed that the demand for money will grow relatively strongly, implying greater latitude for money supply growth. By requiring smaller changes in fiscal policy, and by making optimistic assumptions about economic growth, programmes may be presented as involving relatively modest political costs. This then increases the perceived probability that they will be implemented. It also, of course, raises the probability that governments will agree to them and that the Executive Board will endorse them. If the anticipated economic growth is unforthcoming, the implication is that the improvement in the current account of the balance of payments will probably be greater than expected, and, as noted above, securing an improvement in the balance of payments is the Fund's top priority. In short, it seems to serve the interests of all parties to be optimistic about economic growth.

Over-optimism may not be limited to economic growth. There may be similar over-optimism with respect to export growth and capital inflows from abroad. What lies behind this? Starting off from a given balance of payments situation, programmes involve a combination of adjustment and financing. Adjustment with growth will be more attractive politically since it involves smaller sacrifices in terms of current living standards. Essentially, export capacity is created by increasing domestic production rather than by reducing domestic consumption. At the same time, increased export demand and supply may be associated with exchange rate depreciation. Indeed, over-optimism with respect to economic growth is likely to go hand in hand with over-optimism about export growth, since this implies that the economic growth will avoid a balance of payments constraint and be sustainable.

Sacrifices in current consumption may also be avoided by borrowing from abroad. As this increases, so the immediate need for adjustment via reducing domestic aggregate demand

⁴ By saying 'no', the Board may feel that governments will be forced to adopt measures that more strongly compress domestic aggregate demand. These may have overspill effects on other member countries. Thus a bias towards saying 'yes' may reflect the desire to contain crises. Over-optimism about economic performance under a program may be a way of justifying this underlying desire.

falls, as does the need for financing from the IMF. There will therefore be an incentive for the IMF to be optimistic about capital inflows since this justifies a more limited level of IMF financing, and makes viable programmes that embody relatively modest amounts of domestic adjustment. Moreover, capital inflows may be endogenous to IMF programmes. Those that are optimistic about future economic growth and export performance are likely to prove more attractive to foreign investors. There will be an important element of self-fulfilling prophecy here since, to the extent that it exists, the external financing constraint on economic growth may be relaxed by the enhanced prospects for economic growth. It will again be in the interests of IMF staff, governments and the Fund's Executive Board to be positive and optimistic about the future inflow of foreign capital. Optimism with respect to economic growth, export growth and capital inflows is therefore positively correlated.⁵

But what allows the IMF and governments to exhibit optimism? Why is it not corrected over time? There is only limited scientific consensus over the causes of economic growth, and forecasting it is notoriously imprecise. Much the same could be said about the behavioural response to changes in exchange rates, the determinants of private sector saving and investment, and the reactions of capital markets to IMF programmes. To be optimistic about economic growth and these other variables does not require forecasters to be unprofessional. With a slower than projected rate of economic growth, the costs of implementing programs will rise above the level that was anticipated by governments at the outset, and this will reduce the rate of implementation. But will a poor record of implementation not then sensitise governments and the Fund to over-optimism? Will they not learn from past mistakes and scale down future growth projections?

There are reasons to expect that over-optimism will not be corrected through time. From a government's perspective, reducing the projected growth rate almost certainly implies increasing the targeted degree of fiscal adjustment. Moreover, there may be little domestic political cost associated with failing to implement programmes as originally agreed – there may even be a domestic political benefit to be had.⁶ And, in any case, programmes may be modified or waivers may be granted.⁷ Ultimately the government could effectively cancel the

⁵ The whole set of relationships will involve significant endogeneity. Projected economic growth will help attract capital. Capital inflows may facilitate economic growth and export expansion which then attract further capital inflows.

⁶ Governments may present themselves domestically as standing up to the IMF and defending national sovereignty over the design of economic policy. They may indeed never have been committed to the original program and have agreed to it merely to secure the initial level of financial assistance.

⁷ The IEO (2002) reports that waivers are granted relating to 25 per cent or more of structural performance criteria. The percentage for quantitative performance criteria is very much lower at about 2 per cent for countries drawing GRA resources from the Fund.

arrangement and negotiate a new one. If growth over-optimism enables governments to get what they perceive as a better deal from the IMF, why would they want to be anything other than as optimistic about growth as they are allowed to be, especially when this does not prejudice subsequent arrangements?

Apart from the incentives to perpetuate over-optimism, there will be somewhat limited institutional learning on the side of governments. For many countries, borrowing from the IMF is a reasonably infrequent occurrence and it is unlikely that there will be great continuity in terms of the government personnel negotiating programmes. The mobility of personnel may also be a factor that reduces 'learning' on the part of the IMF staff involved in designing country specific programs. The composition of 'missions' may vary from one to the next. But, in any event, the on-going incentive will again be to reach an agreement rather than to ensure that it is fully implemented. The poor implementation of past or current agreements will not therefore effectively police over-optimism with respect to future ones. Furthermore, institutionally, IMF arrangements under current consideration are more likely to be judged against their contemporary counterparts than against their historical ancestors. In this way, growth over-optimism is more likely to perpetuate itself rather than constrain itself.

One might imagine that it would be the Executive Board, mindful of the Fund's reputation that would eventually be the constraining force on over-optimism. The problem here is one of time inconsistency. Erosion of reputation is likely to be gradual and intangible. There will therefore be an incentive to apply a high discount rate to it. The reputational costs of over-optimism will therefore seem low in present value terms. Juxtaposed against these, there may be strong short term political pressures to agree to loans. Powerful advanced countries may attempt to reward 'friends' and influence 'foes' by endorsing IMF loans. Institutional arrangements that encourage a consensual approach by the Board may facilitate and perpetuate this. It is not difficult to imagine a model where one powerful advanced country 'buys off' opposition on the Board to a programme in a country that it wants to support for largely political reasons by making future commitments not to oppose programmes in countries that other advanced countries may favour. Growth over-optimism may provide apparent economic justification. If this is the case, it cannot be assumed that over-Optimism will be self-correcting. Indeed, it is more likely to be self-perpetuating.

What about countries that fall into arrears in terms of their obligations to the Fund? Both the Fund's staff and the Executive Board may be expected to be concerned about arrears since not only will they weaken the Fund's financial position but they will also mean that those countries in arrears will be excluded from access to further IMF resources. Such concern may to some extent police over-optimism in terms of loans to countries that do not have outstanding obligations, but it may encourage it in the case of countries with such obligations.

There may be an element of defensive lending with new loans being used as a way of allowing indebted countries to fulfil their existing commitments. The desire to prevent countries from falling into arrears may motivate over-optimism in terms of new programmes in countries with existing obligations. The desire to maintain comparability between programmes may then mean that over-optimism spreads to programmes with countries that do not have outstanding obligations to the Fund.

What emerges from the above discussion? We see that governments as well as the IMF's staff and Executive Board will be predisposed towards excessive optimism in IMF programmes, particularly with respect to economic growth, export growth and capital inflows. The reasons for over-optimism are largely 'political' and institutional. The economic uncertainties surrounding the causes of economic growth, behavioural responses to policy changes and the modalities through which the catalytic effect of IMF programs may work, permit these factors to exert an influence. By being optimistic about economic growth, export growth and capital inflows, programs may be presented in a way that makes them appear more viable. The adjustment costs seem lower and the probability that the programs will be implemented therefore seems higher. Of course, should neither economic growth nor capital inflows be forthcoming at the rate projected, actual costs will turn out to be higher than anticipated, and therefore the chances of the programmes actually being implemented will be lower. However, a low *ex post* rate of implementation is unlikely to correct future over-optimism since the implied loss of institutional reputation associated with it is likely to be less significant than the contemporary reasons for its continuance. Moreover, governments may encounter low political costs from poor implementation. Political economy factors therefore point to serial over-optimism in IMF programs with respect to economic growth, export growth and capital flows.⁸ Is this what we find when we examine the empirical evidence?

3. EVIDENCE ON OVER-OPTIMISM

Traditionally, studies that have attempted to evaluate the effects of IMF programmes have focused on final macroeconomic outcomes or policy variables. They have generally avoided examining the accuracy of projections and whether targets have been hit, since this methodology raises the question of whether the targets themselves are attainable. Failure to hit targets could after all indicate either poor performance or poor target selection. However, in this paper, our focus is precisely on the accuracy of projecting and the selection of targets, so the wisdom surrounding their specification is of central importance. Insights into this

⁸ There may also be a tendency for bureaucracies (as agents) to be over-ambitious about what they can achieve in order to try and show themselves in a positive light (to their principals), and therefore secure their future. Easterly (2002), for example, stresses this argument when discussing the ambitions of aid agencies as compared to their actual achievements – as he sees them.

could no doubt be provided by a retrospective examination of IMF forecasts and the underlying models upon which they are based. Is there some in-built bias? We do not follow this route, although we allude to work that does. Instead, a moment's reflection suggests that a good target will be one that is both challenging and feasible. If targets are always hit, this provides *prima facie* evidence that they are insufficiently challenging. There is under-ambition or a pessimism bias. If, on the other hand, targets are never hit, and indeed missed by a significant amount, this provides equivalent evidence of over-optimism. Between these two extremes – where targets are sometimes hit and sometimes missed – there has to be some degree of subjective judgement. But evidence of a reasonably systematic and significant failure to achieve targets would provide support for a bias towards over-optimism. It would suggest that targets have become excessively challenging to the extent of becoming generally unfeasible.⁹

There are a number of recent studies upon which we can draw to provide evidence on this issue. These comprise both econometric and case study research. To begin with, the first three reports published by the Independent Evaluation Office (IEO) of the IMF are a very useful source of material (IEO, 2002, 2003a, 2003b). Table 1, taken from the IEO's report on the prolonged use of IMF resources, provides a comparison between programme projections and outcomes in ESAF (Enhanced Structural Adjustment Facility) programmes. It suggests that projections for exports were 'greatly over-optimistic' for prolonged users, but not for temporary users – although in neither case was the bias statistically significant, given the large variability in both projections and out-turns. Projections for real GDP growth were generally over-optimistic for both groups of users, with the errors tending to rise in the later years of multi-year programmes.

In the case of arrangements using general resources (GRA), which typically involve a shorter time frame, an analysis undertaken by the IEO, based on a database assembled by Musso and Phillips (2001), is summarised in Table 2. This suggests that growth projections were over-optimistic for both temporary and prolonged users, with the discrepancy between projected and actual out-turns being greater in the former group.

Further information presented by the IEO based on case studies provides additional evidence in support of over-optimism. This is summarised in Table 3. Although the data do not allow a fine distinction to be made between over-optimism and weak implementation, the IEO claims that "the more extensive discussion in the country studies suggests that...both the authorities and staff recognised that programs were often built on very optimistic projections" (IEO,

⁹ It may be underlined here that, within the financial programming framework used by the Fund, targets which relate to intermediate policy variables such as the fiscal balance, monetary growth and the exchange rate will be linked to projections relating to economic growth, exogenous export growth, investment and savings rates

2002, p.53). Later in their report, the IEO points out that its survey of mission chiefs suggests that “internal incentives create a tendency to over-promise”. Thus:

About 45 per cent of mission chiefs surveyed by the IEO reported that the need to show balance of payments viability by the end of the medium term projection period had led to *ex ante* over-optimistic projections or over-ambitious program objectives ‘frequently’ or ‘always’, with another 28 per cent reporting the same phenomenon ‘sometimes’. In contrast, only about one quarter reported this practice occurring ‘never’ or only ‘occasionally’. (IEO, 2002,p.65)

In its third report, dealing with fiscal adjustment in IMF programmes, the IEO (2003b) again claims that its analysis of actual and projected economic growth across a large sample of programmes suggests that, apart from in transition countries, programmes exhibited over-Optimism; with this being particularly significant in programmes that started from a more adverse situation. The IEO points out that:

Growth slowdowns between the first and second year of the program occurred twice as often as they were projected, with programs tending to under-predict significantly more situations of adverse output developments than under-predict situations of favourable output developments. Negative growth for the second year of the program was projected in only 1.3 per cent of cases, but in reality happened ten times more frequently. (IEO, 2003b,p.6)

The IEO also presents evidence of over-optimism in terms of investment rates in 60 per cent of 83 stand-by and extended arrangements examined. In about one quarter of these cases, investment rates were 5 percentage points of GDP or more below projections. Furthermore, in terms of fiscal targets, the IEO finds that only about one half of the programmed improvement in overall and primary fiscal balances was achieved, with almost all the fiscal adjustment occurring in the first year of programmes. Over-optimism about fiscal adjustment is clearly linked to over-optimism with respect to economic growth, with the IEO finding that, whereas slower than anticipated economic growth seems to be associated with revenue shortfalls, it is not associated with lower levels of expenditure. Fiscal over-optimism with respect to revenue was particularly pronounced in the programmes that targeted ‘large’ fiscal adjustment of more than 3 percentage points of GDP over two years. A brief summary of fiscal performance running from one year before to one year after IMF programs is presented in Table 4.

In its second report dealing with the Fund’s involvement in capital account crises in Indonesia, Korea and Brazil, the IEO (2003a) points out that “contrary to the expectation that IMF support would certify the effectiveness of an adjustment program and help achieve smooth adjustment, many of the IMF supported programs initially failed to achieve a turnaround in market sentiment” (IEO, 2003). In a similar vein, Ghosh et al. (2002) examine

the effects of eight IMF programmes in crisis-hit countries during the 1990s, covering Mexico, Thailand, Korea, Indonesia, Brazil, Turkey and Argentina. The authors point out that:

“It is striking that in every instance in our sample, the outcome (for private capital flows) was worse than projected. Even in cases where the magnitude of the error was small, such as Argentina (1995), the program does not appear to have had a strong catalytic effect.” (Ghosh et al., p.14)

If, in general, actual economic growth is slower than projected, private sector investment is lower than projected and capital inflows are smaller than projected, it might be expected to follow that the current account of the balance of payments would be found to improve by more than is projected, although in theory this could be offset by shortfalls in fiscal adjustment. There is some empirical support for the excess performance of the actual current account as compared with projections. Based on a sample of 115 programs during the 1990s, the IEO finds that, whereas a deficit of 0.3 per cent of GDP is envisaged in the year following a programme, a surplus of 0.3 per cent is actually achieved. This finding is, to some extent, confirmed by other research; but only to *some* extent.

In a study related to the IEO's investigations, Atoian et al., (2003) examine the accuracy of IMF projections relating to the ratio of fiscal surplus to GDP and the current account of the balance of payments surplus to GDP across 175 programmes during 1993-2001, and over a number of time horizons. In summary, they conclude that “projections differ substantially from those actually achieved” (p.3). Fiscal adjustment seems to fall further short of projections over longer time horizons, whereas in terms of the current account, the improvement is more marked than was projected in the short term but less marked than projected over a longer time horizon. Interestingly, the authors explore various potential reasons for the divergence of actual from projected values and find that it may be explained by incomplete information concerning initial conditions, differences in the ‘model’ underlying IMF projections as compared with that suggested by the data on out-turns, differences between the reforms assumed within the projections and those actually implemented, and random errors in the actual data.

In other research conducted within the Fund, Baqir et al., (2004) also discover evidence of over optimism. They examine 94 programmes over the period 1989 to 2002 comparing the objectives in terms of both economic performance and policy variables over the three years prior to the programme with the actual outturns. Their findings are summarised in Table 5. Typically, outturns fell short of targets in the areas of economic growth and inflation, but were broadly in line with current account balance of payments objectives. As far as policy variables are concerned they also find evidence of over-ambition. The study offers an additional degree of disaggregation by exploring differences between programme types.

Baqir et al., discover that over-ambition is least marked in the case of high profile stand by arrangements. How can this be explained? The authors of the study suggest that the closer scrutiny that high profile programmes receive may encourage greater realism. They also suggest that a greater awareness of the domestic political constraints on adjustment may be factored into these programmes. In terms of our earlier analysis other explanations may also be available. In the case of high profile programmes, perceived failure in achieving targets may be assessed as having a larger negative impact on both the IMF's and the government's reputation. Moreover, the crisis conditions under which governments turn to the Fund may make it less necessary to talk up the growth prospects of programmes, first because the government can demonstrate the need for IMF involvement, and second because the Executive Board of the Fund needs less persuasion to participate given the systemic economic and political importance of high profile countries. Finally, it may also be that since high profile countries are defined by Baqir et al. to include those that receive relatively large amounts of IMF finance, this allows the related programmes to call for less adjustment. The degree of adjustment contained in programmes will be dictated by the amount of finance supplied. With more finance, less optimism is required in terms of economic growth, export growth and other capital flows in order to make programmes appear viable. Less short term emphasis will need to be placed on reducing fiscal deficits.

While the research reported above is in some respects limited, it all seems to point in a similar direction. Moreover, the findings reported by the IEO are based on both large sample econometric investigation and a wide range of case studies. Overall, therefore, there is strong empirical evidence of a tendency for IMF programmes to fall short of both the policy targets established and the envisaged macroeconomic outcomes. Although disaggregation shows a measure of diversity, there remains a systematic tendency to fall short of projections and targets. According to our definition, IMF programmes exhibit serial over-optimism. Does this matter? Is it a problem?

4. IS OVER-OPTIMISM A PROBLEM?

As discussed in Section 2, and up until recently, over-optimism in IMF programmes has not been widely perceived to be a problem. Indeed, it has fulfilled certain positive political economy functions and, to a point, has enabled the 'system' to work. The question is exactly 'to what point'? In the world of *realpolitik*, over-optimism may have kept IMF money moving. It has enabled the IMF to justify making loans and has enabled governments to survive the domestic political consequences of involving the Fund in the design of macroeconomic policy. It may spur countries on to make greater efforts to reform. But it remains of concern that targets are systematically missed. Ultimately, what is the point in having them if they are merely something of a cosmetic exercise?

Serial over-optimism involves five associated problems. First, there are the transactions costs associated with negotiating detailed conditionality that is then not implemented or does not deliver what is intended. Secondly, it means that when performance in terms of policy reform and macroeconomic outcomes is not forthcoming, this will have to be dealt with in other ways such as by modifying programmes, granting waivers or negotiating replacement programmes. These are likely to be inferior alternatives to delineating a realistic programme at the outset. The process of granting modifications and waivers lacks transparency and carries with it significant uncertainties which make macroeconomic management that much more difficult. Thirdly, serial over-optimism will gradually undermine the Fund's reputation, at a time when the institution is keen to strengthen its signalling role. Over-optimism is indeed inconsistent with an effective signalling function – unless the degree of over-optimism is predictable, which it is not. If the Fund wishes to improve its catalytic effect on private capital flows, it is hardly likely to achieve this if the policies and outcomes it predicts do not materialise. What value then for the Fund's good housekeeping seal of approval? Fourthly, if economic growth, current account improvement and capital inflows are over-predicted, it follows that the amount of adjustment and the amount of IMF lending needed will be under-predicted. This will have important consequences for the politics of adjustment and for policies relating to the financing capacity of the Fund. Thus, quota increases may be rejected as an indirect consequence of over-optimism relating to IMF programmes. Fifth and finally, over-optimism will create a psychology of institutional failure. Psychologically, it may be better to set realistic targets and achieve them than to set overly optimistic targets and miss them.

Two questions lead on from this. What can be done to overcome the bias towards over-optimism? And, given that over-optimism is there for a reason, how likely is it that the bias will be addressed? We turn to the first of these questions in the next section, and examine the second in the concluding remarks that follow.

5. POLICIES FOR DEALING WITH OVER-OPTIMISM

There are a number of potential policy responses to IMF over-optimism. First, having identified areas where there is a systematic bias, such as in predicting economic growth and fiscal adjustment, predictions and targets could be scaled back. The trick here would be to find the appropriate degree of scaling back. If taken too far, the discipline and signalling roles of IMF programmes could be weakened. In this regard, a reasonably full retrospective evaluation of why targets have been missed would be needed in order to feed into future programme design. Such an evaluation would have country-specific elements, but could also help to identify more general areas of over-optimism. Thus it is increasingly recognised that ‘institutions’ have an important bearing on growth, but that it takes a long time to change them. Historically, programmes may have been over-optimistic with regards to the speed at which such changes may be brought about, and this expectation could be modified downwards.¹⁰

Secondly, a greater understanding of the political economy of policy implementation would enable the Fund to form a more realistic view about the chances of programme success. Research is beginning to identify the factors that influence implementation and more formal analysis of these in the context of IMF programmes should constrain over-optimism.¹¹ This could pan out in various ways. If targets were not to be changed, there would at least be a reduction in the perceived probability that they would be met. But, more helpfully, greater recognition of the problems associated with implementation could lead to targets being adjusted to more realistic levels. The perceived success of IMF programmes could then be increased without there necessarily being any improvement in actual performance. However, it is not impossible that actual performance could improve if governments believed that the adjustment targets were more realistic and attainable. There could a positive impact on ownership and therefore on outcomes.

Thirdly, since the current policy of using modifications, waivers and replacement programmes to deal with situations where targets are not met lacks transparency and, as a consequence, creates uncertainty which disrupts signalling, a clearer policy that delineates the circumstances in which they would be permitted, alongside more realistic targets, might help overcome these shortcomings.

Fourthly, existing methods of introducing flexibility into IMF programmes, could be taken one stage further, by contemplating alternative scenarios at the outset of programmes rather

¹⁰ The IEO reports referred to earlier again provide compelling evidence that the time taken to implement institutional changes has been underestimated in the past.

¹¹ For a discussion of how this might be achieved, see Bird (2003), and Bird and Willett (2004).

than by modifying them as time goes by. Essentially, the sensitivity of programmes to various factors would be considered *ex ante*. What are the things that threaten the success of programmes and to which are they vulnerable? Rather than having one central prediction for economic growth or export growth, there could be a ‘fan’ of possible outcomes with approximate probabilities attached to them. Targets would be set according to the most probable outcomes, but there would be contingent conditionality which would be dependent on alternative events. For example, where economic growth turned out to be less strong than anticipated, there would already be contingent plans with respect to fiscal policy. In effect, the design of programmes and their targets would attempt to endogenise external shocks. A disadvantage of this approach might be that it would appear to increase the time and effort needed when programmes are being initially negotiated. However, this would not necessarily be the case. If governments (and indeed the Fund) believed that they had alternative plans for dealing with different states of the world, they might be less concerned about the ‘central forecast’ embedded in the IMF programme. There would be an ‘insurance policy’ to deal with the vulnerabilities surrounding the initial programme. The advantage of this approach would be to reduce uncertainty about future economic policy and about IMF support. This would in turn strengthen the Fund’s signalling role and would remove (or at least reduce) the stigma of failure. Rather than failing to implement ‘Plan A’, countries would instead be switching to and then successfully implementing ‘Plan B’.¹²

6. CONCLUDING REMARKS

There is a large and long-standing literature on IMF conditionality and the effects of IMF programmes. Concern that they do not work well in terms of influencing policy variables and macroeconomic outcomes has led to suggestions that *ex ante* conditionality should be abandoned (IFIAC, 2000). It has also led the IMF to pursue a policy of ‘streamlining’ conditionality in such a way as to focus on a narrower range of variables and to encourage greater ‘ownership’ of programmes. Indeed, ownership is prescribed as a key to improving the extent to which programmes negotiated with the IMF are then implemented by governments.

It is against this background that this paper examines whether IMF programmes are perceived to fail because the targets and predictions they embody are over-optimistic. There are reasons to believe that the Fund’s staff involved in designing programmes, the governments that commit to implementing them, and the Fund’s Executive Board that

¹² Time would, of course, also be saved later in the ‘life’ of a program as modifications and waivers would be less likely to be needed. Program reviews might also become somewhat more straightforward. On top of this, the ‘mortality rate’ of programs might be expected to fall as a consequence, making replacement programs less necessary.

approves them, will be inclined to exploit the scope for over-optimism that the lack of scientific consensus about the underlying economics allows them. There are strong political economy motivations for over-optimism. Empirical evidence, limited as it is, endorses the *a priori* presumption that over-optimism will exist. Moreover, up until now, political and institutional factors have resulted in the bias towards optimism being perpetuated rather than corrected.

Yet, over-optimism, or a lack of realism, has its downside. Target setting becomes discredited if targets are systematically missed, and this will gradually adversely affect the reputation of those engaged in setting the targets. Not least, setting targets will fail to transmit the signals that they are intended to transmit if they lack credibility. Increasing attention is therefore being paid to the way in which targets are set within the context of IMF programmes. The degree of underachievement has reached a threshold where it has become an important policy issue. Moreover, the Fund's Independent Evaluation Office has begun to highlight the issue and to correct the information asymmetries that previously allowed it to occur.

This paper examines various ways in which realism could replace over-optimism. The basic policy shift advocated is to move away from dealing with over-optimism in IMF programmes by means of *ex post* modifications, waivers and programme replacement, and towards a contingent approach to conditionality. An important benefit from such a shift would be to alter the psychology of failure. At present, the Fund suffers from the paradox of over-optimism. By assuming things will turn out better than they actually do, the Fund creates the impression that it is failing when, in fact, its achievements may be significantly positive. Frustration is the difference between aspirations and achievement, and much of the current frustration with IMF programmes and conditionality may be associated with unrealistically optimistic aspirations rather than serious underachievement.

TABLE 1
Optimism of Real GDP and Export Projections in ESAF Programs ¹

	Prolonged Users		'Temporary' Users	
	Mean	Median	Mean	Median
Merchandise export growth				
Outturn	7.4	5.8	17.2	13.6
Projected	10.5	9.9	12.5	12.5
Real GDP growth				
Outturn	3.5	3.7	4.2	5.4
Projected	4.1	4.0	5.0	4.7

Sources: IMF Policy Development and Review Department and IEO Calculations

1 Average annual growth in per cent for years T to $T+4$, where T is the year in which the program started.

TABLE 2
Accuracy of Short Term Projections for Users of General Resources¹

	Prolonged Users		'Temporary' Users	
	Mean	Median	Mean	Median
Real GDP growth				
Outturn	1.7	3.9	-0.9	0.2
Projected	2.4	3.4	0.2	-1.0
Difference ¹	-0.7	0.0	-1.1	-0.4

Sources: Database assembled by Musso and Phillips and IEO Calculations.

1 The median of the differences is not necessarily equal to the difference of the respective medians.

TABLE 3
Realism of Program Projections: Average Projections Less Outcomes¹ –
Case Studies

(all figures are percentage points a year)

	Pakistan	Philippines ²	Senegal	Morocco ³
Real GDP growth	1.4	2.1	1.7	1.2
Export growth (in US dollar terms)	5.7	2.5	2.8	0.9
Fiscal balance (in per cent of GDP)	1.9	1.6	1.9	1.8
Government revenue (in per cent of GDP)	1.3	1.1 ⁴	—	—
National saving (in per cent of GDP)	2.3	0.5 ⁵	2.8	-0.8

Sources: IMF staff reports.

- 1 Average of all initial projections for programs since 1983, for the year in which the program started and the two succeeding years.
- 2 Growth and ratios expressed in relation to GNP, rather than GDP.
- 3 For Morocco, except for export growth, projections are for the year in which the program started and the immediately succeeding year, due to the limited time horizon of projections in program documents.
- 4 National government tax revenue as a per cent of GDP.
- 5 The apparent rise in the saving rate in the late 1990s and early 2000s may be over-stated as a result of statistical weaknesses.

TABLE 4
Changes in Fiscal Balances from (T-1) to (T+1)¹

(all figures are in per cent of GDP)

	All Arrangements	ESAF/ PRGF	SBA/EFF	
			Transition Countries	Non-transition Countries
Envisaged				
Government balance	1.7	1.6	1.1	2.0
Primary balance ²	1.4	1.0	0.4	2.0
Government revenues	0.4	0.4	-1.7	1.3
Government expenditures	-1.2	-1.2	-2.8	-0.7
Actual				
Government balance	0.8	1.0	1.8	0.2
Primary balance ²	0.7	0.6	0.3	1.0
Government revenues	0.2	0.1	-1.4	0.9
Government expenditures	-0.7	-1.0	-3.2	0.6
Count	133	60	21	52

Sources: MONA and WEO databases.

- 1 Figures subject to rounding errors.
- 2 Based on a sample of 115 arrangements.

TABLE 5
Objectives in IMF Programmes: Programme vs. Actual

	Programme			Difference (programme/minus actual)			
	t - 3	t - 2	t - 1	Actual	t - 3	t - 2	t - 1
Real GDP growth (in percent)							
All programme-years	5.2	4.6	3.5	1.8	3.4	2.8	1.7
PRGFs	5.7	5.3	4.7	3.3	2.4	2.0	1.4
SBAAs	4.5	3.8	2.0	0.3	4.2	3.5	1.7
o/w large access	4.1	2.9	1.3	1.1	3.0	1.8	0.2
CPI Inflation (percent, end-of-period)							
All programme-years	5.0	6.0	8.0	10.3	-5.3	-4.3	-2.3
PRGFs	4.3	5.0	7.0	8.4	-4.1	-3.4	-1.4
SBAAs	6.0	7.0	9.1	13.2	-7.2	-6.2	-4.1
o/w large access	6.0	6.3	6.6	8.9	-2.9	-2.6	-2.3
Current account balance (percent of GDP)							
All programme-years	-8.6	-9.1	-9.4	-9.4	0.8	0.3	0.0
PRGFs	-11.4	-12.4	-13.2	-13.9	2.5	1.5	0.7
SBAAs	-4.1	-4.7	-4.6	-4.5	0.4	-0.2	-0.1
o/w large access	-2.1	-1.3	-1.3	-1.0	-1.1	-0.3	-0.3

Source: Baqir et al., (2004)

Notes: Table reports means by group except for inflation for which medians are reported due to outliers. All observations are used for each sample. The same general pattern is preserved if sample size is kept constant across columns. The last three columns report the difference between the programme columns and the actual columns.

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