IMF admits: We failed to realise the damage austerity would do to Greece

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The International Monetary Fund admitted it had failed to realise the damage austerity would do to Greece as the Washington-based organisation catalogued mistakes made during the bailout of the stricken eurozone country.

In an assessment of the rescue conducted jointly with the European Central Bank (ECB) and the European commission, the IMF said it had been forced to override its normal rules for providing financial assistance in order to put money into Greece.

Fund officials had severe doubts about whether Greece's debt would be sustainable even after the first bailout was provided in May 2010 and only agreed to the plan because of fears of contagion.

While it succeeded in keeping Greece in the eurozone, the report admitted the bailout included notable failures.

"Market confidence was not restored, the banking system lost 30% of its deposits and the economy encountered a much deeper than expected recession with exceptionally high unemployment."

In Athens, officials reacted with barely disguised glee to the report, saying it confirmed that the price exacted for the €110bn (£93bn) emergency package was too high for a country beset by massive debts, tax evasion and a large black economy."

Under the weight of such measures – applied across the board and hitting the poorest hardest – the economy, they said, was always bound to dive into an economic death spiral.

"For too long they [troika officials] refused to accept that the programme was simply off-target by hiding behind our failure to implement structural reforms," said one insider. "Now that reforms are being applied they've had to accept the bitter truth."

The IMF said: "The Fund approved an exceptionally large loan to Greece under a stand-by agreement in May 2010 despite having considerable misgivings about Greece's debt sustainability. The decision required the Fund to depart from its established rules on exceptional access. However, Greece came late to the Fund and the time available to negotiate the programme was short."

But having agreed that there were exceptional circumstances that warranted the biggest bailout in the Fund's history, officials were taken aback by the much bigger than expected slump in the Greek economy. The country is now in its fifth year of recession and the economy has contracted by 17%. The IMF thought it would contract by just 5.5%.

In the evaluation of the package provided in 2010, the IMF said: "Given the danger of contagion, the report judges the programme to have been a necessity, even though the Fund had misgivings about debt sustainability.

"There was, however, a tension between the need to support Greece and the concern that debt was not sustainable with high probability (a condition for exceptional access).

"In response, the exceptional access criterion was amended to lower the bar for debt sustainability in systemic cases. The baseline still showed debt to be sustainable, as is required for all Fund programmes."

In the event, the report added, the Fund was open to criticism for making economic projections that were too optimistic."

While the report says a deep recession was unavoidable, it is critical of senior officials in Brussels and European capitals who said Greece would fare better outside the euro. Concerns that Greece could be ejected from the euro and return to the drachma intensified an already febrile situation.

“Confidence was also badly affected by domestic social and political turmoil and talk of a Greek exit from the euro by European policymakers,” it said.

Brussels also struggled to co-ordinate its policies with the ECB in Frankfurt, according to the report.

“The Fund made decisions in a structured fashion, while decision-making in the eurozone spanned heads of state and multiple agencies and was more fragmented.”

The Greek media recently quoted IMF managing director Christine Lagarde describing 2011 as a “lost year” partly because of miscalculations by the EU and IMF.

The authoritative Kathimerini newspaper said the report identified a number of “mistakes” including the failure of creditors to agree to a restructuring of Greece’s debt burden earlier – a failure that had had a disastrous effect on its macroeconomic assumptions.

“From what we understand the IMF singles out the EU for criticism in its handling of the problem more than anything else,” said one well-placed official at the Greek finance ministry.

He added: “But acknowledgement of these mistakes will help us. It has already helped cut some slack and it will help us get what we really need which is a haircut on our debt next year.”