

Lehman lessons weigh on Cyprus talks but 1920s slump must not be ignored

Failure to rescue the US bank will be borne in mind, but the European precedent to current woes is also worth consideration



One Sunday in September 2008, the world waited for the expected rescue of Lehman Brothers by the US Treasury. It didn't happen. When no buyer could be found, the plug was pulled on the investment bank. The assumption that Lehman was too small to matter proved wrong – disastrously wrong.

Unless Europe wishes to compound the follies of the past week, the Lehman precedent will surely be borne in mind at the talks on Sunday to piece together a bailout for Cyprus – the fifth in the eurozone in less than three years. Those who say the monetary union has been a success must have an interesting definition of failure.

The Cypriot storm came as a shock to Europe's policy elite. The assumption has been growing for the past few months that the crisis was over, which was true to the extent that the existential threat to the euro has greatly diminished. Financial markets were soothed by the pledge by Mario Draghi, the president of the European Central Bank (ECB), to do "whatever it takes" to safeguard the euro, but life was not really returning to normal.

The rest of the eurozone knew Cyprus was festering away, but considered the country too inconsequential to worry much about. Meanwhile, complacency set in and there was no longer the urgency to make rapid progress on the economic and political integration necessary to underpin monetary union. Europe lapsed back into its default mode: muddling through. That was a mistake, because the problems of a country that accounts for just 0.2% of eurozone GDP have highlighted two structural weaknesses of the monetary union.

Firstly, it contains far too many countries that should not really be in the club, and were allowed in only because politics was permitted to trump economics.

The fact that Cyprus was an offshore tax haven was ignored, just as a blind eye was turned to Greece's lack of competitiveness and Italy's high level of public debt. This lack of cohesion can no longer be overlooked, and making the euro work will require a far greater centralisation of power. In reality, that means countries such as Greece, Spain, Italy and indeed Cyprus taking orders from Germany, and accepting they have the status of regions rather than sovereign states.

This would be hard to stomach for these proud nations, even in good times. The fact that these are seriously bad times for Europe is the second big problem facing the single currency, because while finance ministers and central ministers have been preening themselves on "ending" the threat to the monetary union, the crisis was clearly not over for those eurozone citizens affected by slow growth, rising unemployment and painful austerity programmes. This meant most of them, since the weakness that started on the euro's fringes has since spread to the core nations. France is in a poor state, as is the Netherlands, and even Germany is starting to suffer.

Predictably, comparisons are being made between Europe today and Japan 20 years ago. Europe does indeed seem to share some of Japan's traits: an ageing population, a dysfunctional financial system and an inability to grow. The history of the past 150 years shows that most recessions are over within a year and few last longer than two.

Europe's downturn is five years old and shows no immediate sign of ending. Nor, unlike in the US and the UK, is there any sense of the ECB taking any policy initiatives that might boost growth. As David Owen, an economist at Jefferies investment bank, noted last week there have been few examples of recessionary conditions becoming ingrained, but Europe seems to be one of the special cases.

There is a European precedent for the current crisis, although it is not one the continent likes to be recall. A paper called *Till Debt Do Us Part*, by Bob Swarup and Dario Perkins of Lombard Street research, says there are direct parallels between Europe now and Europe in the 1920s, only with the roles reversed. Today it is Germany that is imposing austerity on the weak countries on the euro's periphery, at a time when they have no easy way out due to their membership of a fixed exchange-rate system.

Back in the 1920s, Germany was in a similar position to the Mediterranean countries today. It had financed the first world war through excessive borrowing and was then forced to pay reparations by the allies, with France in particular insisting on draconian conditions. Membership of the Gold Standard meant there was no escape.

When the Wall Street crash struck in October 1929, the dogged determination of Germany – fresh from the hyperinflation of 1923 – to stay on the Gold Standard meant it felt the full blast of the deflationary storm coming out of the US.

Swarup and Perkins note: "The German government, bowing to international pressure, haunted by fears of hyperinflation and facing reparations linked to gold, refused to either default on its debt or devalue its currency by suspending membership of the Gold Standard.

Instead it adopted brutal austerity policies, much like those it is now forcing on the Mediterranean countries.

"This compounded the country's economic misery and sent unemployment surging higher. It pushed the economy into what today we might call a Greek-style austerity/depression trap."

A straight read across from the interwar years to 2013 is too simplistic. Europe's population is older and welfare provision more extensive, even in the countries where austerity is biting hardest. Slow to act it may be, but the ECB is there to ensure financial stability across the eurozone.

Even so, the growing popularity of antiestablishment parties is a warning. The same toxic mix of economic hardship, political impotence and resentment at outside interference that was evident in Germany in the late 1920s and early 1930s is again present.

Swarup and Perkins rightly warn it is vital that the economic lessons of the 1930s are remembered. There will need to be debt relief rather than restructuring, a realisation that aggressive fiscal austerity is a mistake when exchange rates are fixed, and a much more activist approach by the ECB to provide a growth stimulus.

The longer the depression lasts the stronger extremist forces will become and the greater the risk that one or more countries will decide to leave the single currency because they cannot tolerate the economic distress, the social unrest and the political instability. Germany, of all nations, should understand this.