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The fragility of two monetary regimes: The European Monetary System and the Eurozone
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The European Monetary System (EMS) and the Eurozone are monetary regimes that exhibit some similarities. The most important one stems from their fragility.

The EMS that existed between 1979 and 1999 was a pegged exchange rate arrangement in which national central banks promised to convert their liabilities into a foreign currency, *de facto* the German mark, at a fixed price. The problem with this promise was that the central banks did not have unlimited supplies of Deutschemarks. As a result, when investors had doubts that the central bank would be able to make this conversion because of a lack of marks, there would be a run on it that would spiral into a crisis.

The designers of the Eurozone thought they could solve this credibility problem by abolishing the national currencies, thereby eliminating a commitment to convert national currencies into marks. In doing so, however, they shifted this credibility problem from the foreign exchange markets to the government bond markets.

In the Eurozone, the national governments have faced the same problem as the national central banks in the EMS, i.e. they made a commitment to convert their liabilities (government bonds) into a “foreign” currency (the euro), over which they have no control. In the absence of a liquidity backstop in the government bond markets, this actually created a similar problem of fragility to that seen in the EMS: when investors feared that the government would lack the euros to pay out at maturity, there would be a run on the government (De Grauwe - 2011).

In this paper, we compare the fragility of these two monetary regimes. We do this mainly by analysing the behaviour of the interest rate spreads (both in the interbank money market and government bond markets), using existing theories to explain these spreads. During crisis periods in both monetary regimes, the movements of some spreads tend to be dominated by time-dependent market sentiments that lead to deviations of the spreads from their underlying fundamentals.

An additional objective of this paper is to test the hypothesis that these self-perpetuating crises, as shown by diverging spreads, are focused on the part of the financial system where there is no credible lender of last resort. In the EMS, this was in the foreign exchange market, while in the Eurozone it was in the government bond markets.

We conclude that, in the EMS, the national central banks were weak and fragile, and the national governments were insulated from this weakness by the fact that they kept their own national currencies. In the Eurozone, the roles were reversed. The national central banks that became part of the Eurosystem and supported each other unconditionally were in fact strengthened.

In 2012, the ECB decided to step in as the lender of last resort in the government bond markets itself, under its Outright Monetary Transactions (OMT) programme. This had an immediate stabilising effect and led to rapid declines in the government bond spreads in the Eurozone (see De Grauwe and Ji - 2013). Thus, the power of the ECB to counter market sentiments of fear and panic is great. This is good news for the future of the Eurozone. Up to now, however, the ECB's power has been exerted only by announcement. It is clear that if market sentiments were to turn around again, the ECB would be forced to intervene.