CENTRE FOR MACROECONOMICS

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A Crash Course on the Euro Crisis

CFM-DP2019-15

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The financial crises of the last twenty years brought new economic concepts into classroom discussions. This article introduces undergraduate students and teachers to seven of these models: (i) misallocation of capital inflows, (ii) modern and shadow banks, (iii) strategic complementarities and amplification, (iv) debt contracts and the distinction between solvency and liquidity, (v) the diabolic loop, (vi) regional flights to safety, and (vii) unconventional monetary policy. We apply each of them to provide a full account of the euro crisis of 2010-12.

The macroeconomic crises of the past twenty years have been predominantly macro-financial crises. Both the 2001-02 and the 2007-09 U.S. recessions started with shocks to domestic financial markets, while crises in emerging markets, from Argentina to Turkey, typically had sudden stops of capital flows and changes in sovereign yields. Unsurprisingly, new economic concepts have been developed to understand these crises. These ideas are familiar to researchers, but they have not yet seeped through to textbooks. As a result, policymakers and students often have some vague familiarity with several of these models but lack an understanding of how they precisely work, how they can be applied, and how they fit together. The goal of this paper is to introduce these ideas at the intersection of macroeconomics and finance. Together they provide a richer, and more accurate, account of past and future macro-financial crises.

We apply the concepts to the euro crisis of 2010-12. It serves this role well for a few reasons. First, because it features both a deep banking sector and large capital flows, two defining features of crises in developed and developing countries, respectively. Second, analyses of the euro crisis using traditional concepts, like optimal currency areas, down- ward rigid wages, or fiscal multipliers are already well-covered in textbooks. Applying the modern concepts to the euro crisis makes clear what traditional accounts are missing. Third, avoiding a new crisis in the euro area is a priority, but institutional reforms have been slow and remain incomplete. Building a good understanding of what was behind the crisis in the first place can help guide the efforts to prevent another crisis.

With these goals in mind, this paper neither covers traditional ideas that are already well-covered in the textbooks, nor provides a full historical account of the sequence of events of the euro crisis. Instead, each section introduces one important concept in macro-finance aided by one novel diagram, and then applies this concept to a stage in the euro crisis illustrated with one new figure with data. Each section is mostly self-contained, and assumes familiarity only with economics at the intermediate level. It pedagogically illustrates economic concepts rather than present them in their generality. Alternative ways to present the material are to either skip the euro crisis applications, for a more theoretical primer on the ingredients of macro-financial crises, or instead to put the euro crisis application together for a full and uninterrupted account of those events.