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RESEARCH NOTE

The Macroeconomics of Financial Crises for Undergraduates

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The current financial crisis is also a challenge for undergraduate macroeconomics instruction (*The Economist*, March 2010). We show that workhorse models of undergraduate macroeconomics, creatively applied and properly enriched with elements introduced back in Keynes' time, teach us a great deal about the current crisis and help prepare for future financial crises.

The tools needed for this endeavour are crisis versions of the *IS-LM* and Mundell-Fleming models that distinguish between money and capital markets, introduce risk premiums, and show how these interact with a dormant liquidity trap. *IS-LM* and Mundell-Fleming models have well-known limitations. They do not explain what started the crisis in the first place, how to prevent bubbles, or what regulations the financial industry needs. But they offer a useful bird's-eye perspective of the macroeconomic consequences of financial crises, and help to sort out the main policy issues.

We emphasize that high calibre financial crises often come in conjunction with a liquidity trap that cannot be easily identified when banks are part of the problem. Such traps lack the characteristic feature of zero interest rates. In addition, conventional policy recommendations may be misleading. Expansionary fiscal policy may be the sole remedy, given that there is no more crowding out in small open economies via exchange rate appreciation. But this is only true up to a certain point because liquidity traps may morph into perfect traps. There, neither monetary nor fiscal policy works when used alone, and a coordinated expansionary effort by the central bank and the government is needed. Finally, when the domestic banking sector is hit harder by a confidence crisis than the rest of the world, this may trigger a full scale depression.

Beyond these specific results, the paper has general implications and uses:

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It is a defense of macroeconomics, showing that even apprentices of macroeconomics possess tools that enable them to be active and constructive participants in discussions of the current crisis.

It helps and encourages undergraduate instructors to use the subprime crisis as a case study, emphasizing that macroeconomics is an applied science.

It may be used for guidance as to where macroeconomics should go, pointing to building blocks and properties that a renewed paradigm in macroeconomics should include. In this vein, it is also a warning against dropping the money market from macroeconomic models, a trend that has arrived in the undergraduate curriculum.