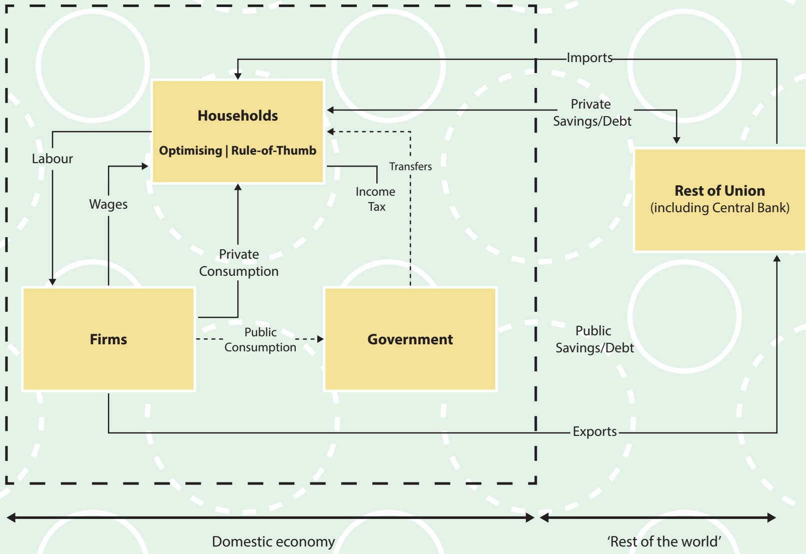
# Government to the rescue

**THE ECONOMIES** of small states are vulnerable. Their size and open nature leaves them exposed to economic shocks. William Gatt (supervised by Dr Gordon Cordina) from the University of Malta and Central Bank of Malta modeled an economy to study the effects of government policies in limiting economic turmoil.

The researcher used a Dynamic Stochastic General Equilibrium (DSGE) model of a small, open economy to simulate an economy similar to Malta. The model could study an economy over time, determine its reaction to random shocks, and the effect of changes in policy. Mr Gatt compared a government policy which directly shored up 'at risk' households to another policy with which government boosted economic activity by directly buying goods from the market. Direct transfers to households accelerated a faster economic recovery after drops in foreign demand.




Further studies showed that government intervention is more beneficial when more 'at risk' households exist. The downside to this policy is a requirement of a large economic surplus. Government would need to save when the economy is strong to buffer in times of distress. In this light, the role of government is as a saver, meaning that it should ensure precautionary savings adjusting policy targets for a budget surplus.

*This research was undertaken as part of a Master of Arts in Economics from the Faculty of Economics, Management and Accountancy. Opinions expressed are those of the author and not necessarily those of the Central Bank of Malta.*

# Europe, inflation, interest rates, and a financial crisis

**THE WORLD IS** currently going through the greatest financial crisis since the 1930s. To reverse the economic crunch, central banks lowered the rate of interest to reverse the slowdown in credit availability, a popular economic policy. Such approaches are based on solid economic theories. However, the unique crisis could have really changed how economies react.

Stephen Piccinino (supervised by Professor Josef Bonnici) analysed the relationship between inflation and interest rates in the euro area between 1999 and 2011. The economic theory called the Fisher effect defines this relationship, and assumes that if a central bank injects money too quickly into an economy it would simply raise the rate of inflation.

From January 1999 to August 2008, the Fisher effect held true and the rate of inflation increased with the rate of interest in a one-to-one fashion. While between September 2008 and March 2011, this relationship fell apart due to intervention by the European Central Bank (ECB). The ECB lent retail banks large sums of money at favourable rates. It also removed limits on how much banks could borrow and reduced interest rates. These changes influenced the relationship between interest rates and inflation.

During this period, inflation rose faster than interest rates, which meant that money held in bank accounts had a lower return than in previous years. These findings mirrored the Federal Reserve's policy interventions in the US between 1979 and 1982.

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