Analyze the article

Lecturer: The of the article " Financial Engine Failure" compares the concurrent failure of the twin engines of the BA flight from China to Heathrow to the failure of the banking and financial markets in the US. He places blame on LBO debt, complex mortgage-backed securities and consumer and commercial-property lending for America's decline into recession, and concludes by claiming that the recent cut in interest rates by the Feds, due to the concern of bank failures, may not be the solution.

According to asymmetric information analysis there are a number of factors that have lead to substantial worsening of adverse selection and moral hazards, resulting in the current financial crisis. (Mishkin) These factors are increases in interest rates, stock market declines, increases in uncertainty, bank panics and unanticipated declines in the aggregate price level.

Increased interest rates have resulted in adverse selection, which has lead to a decline in investment and collective fiscal activity because of a regression in lending.

A drop in the stock market has increased adverse selection and moral hazards because it has resulted in a weakening of the market value of firms' net worth, so lenders are less eager to lend, as deficits from loans are likely to be acute. This decline in lending has then triggered investment and aggregate yield to decline. Also, the waning corporate net worth has increased moral hazard inducements for companies to make risky investments because they now have less to lose. Again this increase in moral hazard makes lending less attractive.

The failure of financial institutions in the mortgage debacle, together with the drop in the stock market has led to uncertainty in financial markets. It is more difficult to determine good from bad credit, which again has resulted to a fall in lending, investment and cumulative activity.

The source of the current bank panic therefore, is asymmetric information. The result is that loan funds have been reduced and the price of intermediation has risen, which has caused a drop in investment and a decline in aggregate economic activity (Mishkin). The current bank panic could lead to further interest rate hikes, which would in turn increase adverse selection in financial markets, which is why the Feds have cut interest rates.

The current unforeseen fall in the price level has also resulted in decline in firms' real net worth and an increase in adverse selection and moral hazard problems facing lenders. This in turn has resulted in a decline in investment and economic activity.

The asymmetric information approach also favours an expanded lender-of-last-resort role and a discounting facility (Mishkin), which would provide liquidity to the financial sectors that most need it.

The Feds have tried to hold back 'the credit crunch' but now we need to see how far they will go. Will they lower interest rates further even though they do not have as much room as in the past to cut Will they provide the much needed liquidity to the financial sector In other words, are they able to bail America out of a recession

The Economist,(2008) " Finance engine failure", February 7

http://www. economist. com/finance/printerFriendly. cfmstory_id= 10655023

23 February, 2008

Mishkin F, (2006) Economics of Money, Banking & Financial Markets, Pearson Ed, 8th Ed.