

## DAILY GLOBAL COMMENTARY

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### **There Should Be a *Quid Pro Quo* between the Fed and Financial Institutions** *March 17, 2008*

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The Fed's creation of various facilities in recent months – the Term Auction Facility (TAF) for depository institutions, the Term Securities Lending Facility (TSLF) for primary government securities dealers and the Primary Dealers Credit Facility (PDCF) – would be expected to alleviate some institutional liquidity issues that otherwise could metastasize into institutional solvency issues. Commercial and investment banks now can borrow against *seemingly* credit-worthy collateral with a much smaller “haircut” than otherwise. The Fed has created these new liquidity facilities in order to forestall a systemic failure of the financial system, not to enhance financial institution shareholder value.

A byproduct of the new Fed liquidity facilities, however, undoubtedly has been to enhance financial institutions' shareholder value – perhaps save for one. By the Fed taking onto its balance sheet less creditworthy collateral as result of these new facilities, U.S. taxpayers have increased contingent liabilities. (The Fed turns over to the Treasury each year the bulk of its profits. If the Fed were to sustain losses on its collateral, the amount of profits it turned over to the Treasury would be reduced.) Why should the current shareholders of financial institutions benefit at the expense of U.S. taxpayers in general?

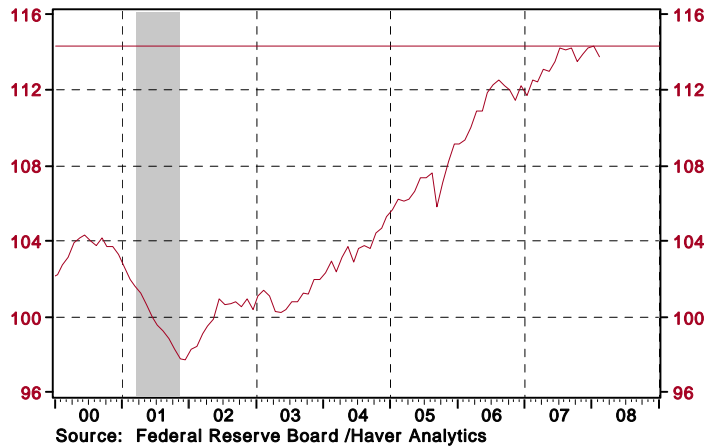
In a case where man bites dog, it appears as though the Fed and the Treasury may be looking out for the interests of the U.S. taxpayer. Publicly, both Fed and Treasury officials have urged financial institutions to raise additional capital *post haste*. I am not privy to private conversations, but I would hope Fed and Treasury officials are directly communicating to the CEOs of large financial institutions with “skinny” capital positions that they *will* raise more capital. By raising more capital, the contingent liabilities of U.S. taxpayers will be reduced and the existing shareholders of these large financial institutions will bear some of the social costs of these new Fed facilities through a dilution of their ownership in the financial institutions.

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### **Industrial Production Appears to Have Established a Cycle Peak**

Industrial production fell 0.5% in February, after a 0.1% gain in each of the last two months. The January reading appears to be the peak in the current cycle for industrial production, while factory production peaked in July 2007. The National Bureau of Economic Research (NBER) dates a business cycle based on four variables: (1) inflation adjusted personal income less transfer payments, (2) industrial production, (3) non-farm payrolls, and (4) inflation adjusted factory, wholesale, and retail sales. Nonfarm payrolls (December, 2007), inflation adjusted personal income less transfer payments (September, 2007), and inflation adjusted factory, wholesale, and retail sales (October, 2007) have established their respective peaks in 2007. The NBER will probably announce the onset of recession much later in the year.

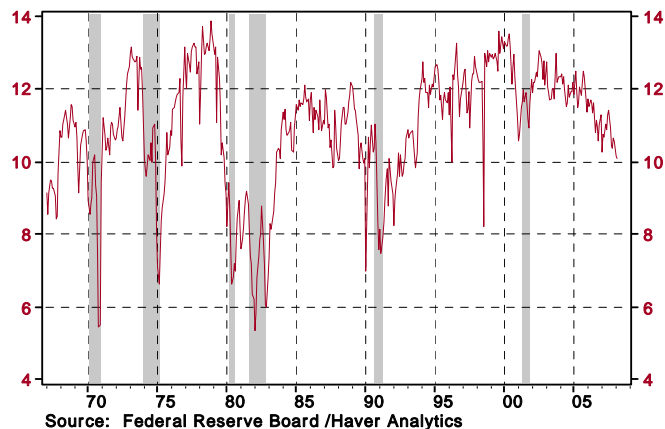
Chart 1  
**Industrial Production Index**  
 SA, 2002=100



The 3.7% drop in production at the nation’s utilities came after a 2.2% jump in January. Factory production fell 0.2% in February, after a steady reading in the January. Production of durables fell 0.3% in January, reflecting declines in all the major categories in this category, with the exception of machinery metals (+0.3%) and computers and electronic products (+1.2%). Production of autos (-1.0%), furniture (-3.0%), wood products (-2.9%), and primary metal (-1.4%) fell in February, in addition to other components.

Auto assemblies dropped to a 10.08 million pace in February, the lowest since October of 1992, excluding the auto industry strike-related drop in July 1998. In the 1990-91 recession, auto assemblies fell from 10.6 million in October 1990 to 7.6 million in December 1990 which was accompanied by severe job losses in the industry.

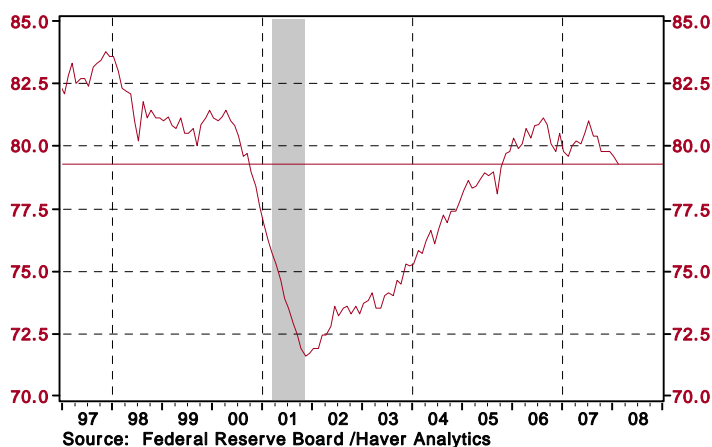
Chart 2  
**IP: Motor Vehicle Assemblies**  
 SAAR, Mil. Units



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Total capacity utilization fell to 80.9 in February from 81.5 in the prior month. The operating rate of the factory sector declined to 79.3, the lowest since October 2005. The peak operating rate was 81.1 in August 2006, followed by a nearly close reading of 81.0 in July 2007. There is enough unused capacity in the factory sector such that does not represent

Chart 3  
Capacity Utilization: Manufacturing [SIC]  
SA, Percent of Capacity



#### Industrial Production – February 2008

	<u>Sep-07</u>	<u>Oct-07</u>	<u>Nov-07</u>	<u>Dec-07</u>	<u>Jan-08</u>	<u>Feb-08</u>
<b>Industrial Production*</b>	0.1	-0.6	0.4	0.2	0.1	-0.5
<b>Total Capacity Utilization</b>	81.9	81.4	81.5	81.6	81.5	<b>80.9</b>
<b>Manufacturing output*</b>	0.2	-0.8	0.2	0.2	0.0	-0.2
<b>Man. Capacity Utilization</b>	80.4	79.8	79.8	79.8	79.6	<b>79.3</b>
<b>Capacity Utilization ex. High-tech industries</b>	80.8	80.1	80.2	80.2	80.1	<b>79.8</b>
<b>High-tech industries - output*</b>	0.8	2.2	1.1	0.6	0.3	<b>1.1</b>
<b>Manufact. Ex high-tech output*</b>	0.2	-0.8	0.2	0.1	0.0	-0.4

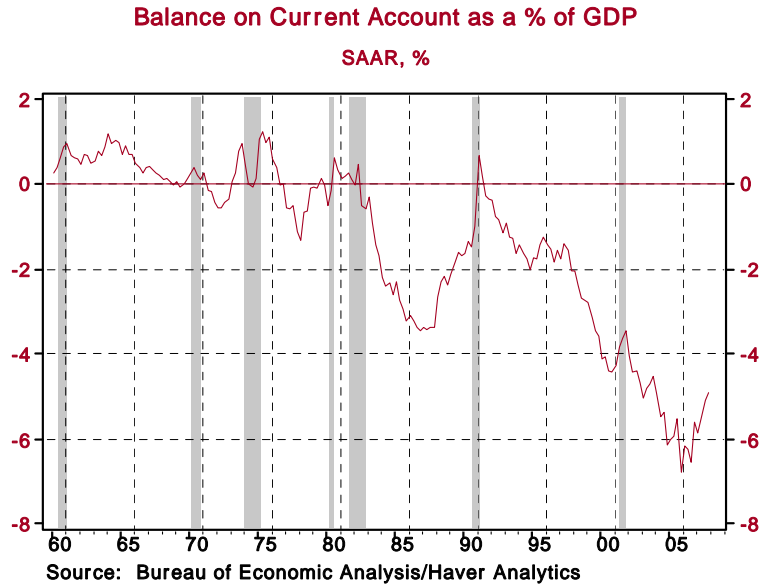
\* - percent change from prior month

#### 2007:4 Current Account Balance: Notable Improvement

The U.S. current-account narrowed to \$172.9 billion in the fourth quarter from \$177.4 in the third quarter. As a share of GDP, the deficit declined to 4.9% in the fourth quarter from 5.1% in the third quarter. The 6.55% reading of the current-account as a percentage of GDP in the third quarter of 2006 was the largest on record (see chart 4). The weak dollar has accounted partly for the improvement in the trade deficit. The trade weighted dollar declined 4.8% in the fourth quarter.

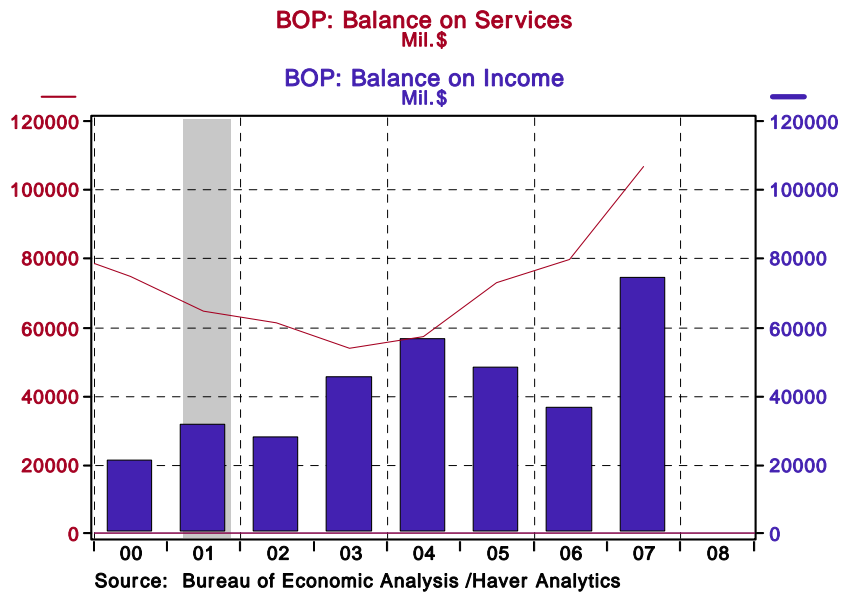
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Chart 4



In 2007, the current-account deficit decreased to \$738.6 billion from \$811.5 billion in 2006, reflecting increases in the surpluses on income and on services and a decrease in the trade deficit on goods.

Chart 5

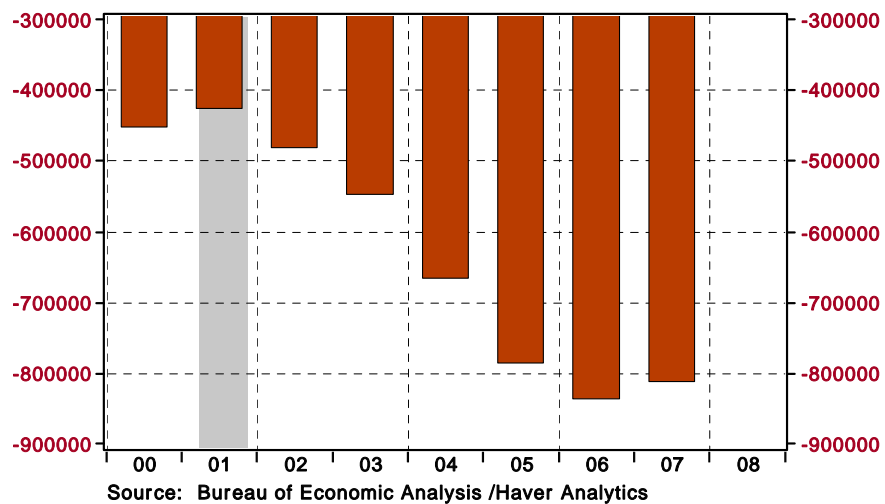


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Chart 6

**BOP: Balance on Merchandise Trade**

Mil.\$



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