DAILY GLOBAL COMMENTARY

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Gross Financial Investment vs. Net Financial Investment

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When economists discuss investment in real capital expenditures they make a distinction between gross and net. If investment expenditures just match the depreciation of capital equipment, then *gross* investment rises, but *net* investment is unchanged. Increases in *net* investment, not gross investment, are what matters with regard to the future productivity of the economy.

Financial institutions have been experiencing a good bit of "depreciation" of their financial capital of late due to losses on some of their investments. So-called sovereign funds have been advancing these financial institutions funds in order to shore up their diminished capital. But this is akin to the gross investment expenditures discussed above. These fund injections just replace some of the financial capital that has evaporated due to losses. These capital injections do not enable financial institutions that have experienced recent accelerated depreciation of their capital to *increase* their lending – just allow them to cut back *less* on their lending than otherwise. In the absence of this depreciation of financial capital, these sovereign funds could have been advancing funds that would have resulted in net new lending.

U.S. commercial banks have been adding to their loans and investments at a faster pace in the past four months as commercial paper issuance has contracted (see Chart 1). The reason for the contraction in commercial paper outstanding is the increased risk aversion to commercial paper directly or indirectly related to the residential mortgage market. With the difficulties in rolling over commercial paper, borrowers have tapped back-up lines of credit at commercial banks. In addition, some of the entities formerly funding themselves in the commercial paper market were "sponsored" by commercial banks. These sponsoring banks have taken onto their balance sheets the assets of these sponsored entities. When we examine the behavior of the combined aggregate of commercial bank credit and commercial paper, we see that there has been a sharp slowing in the growth of this aggregate in the past four months (see Chart 2). Again, this is akin to the distinction between gross and net investment. Although bank credit growth has picked up, it has been largely to refund old debt rather than to create net new debt.

Chart 1

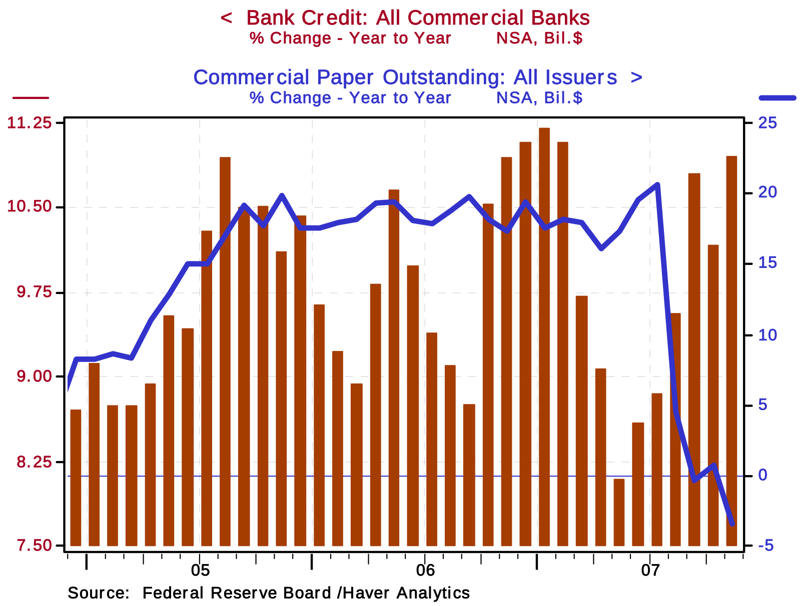
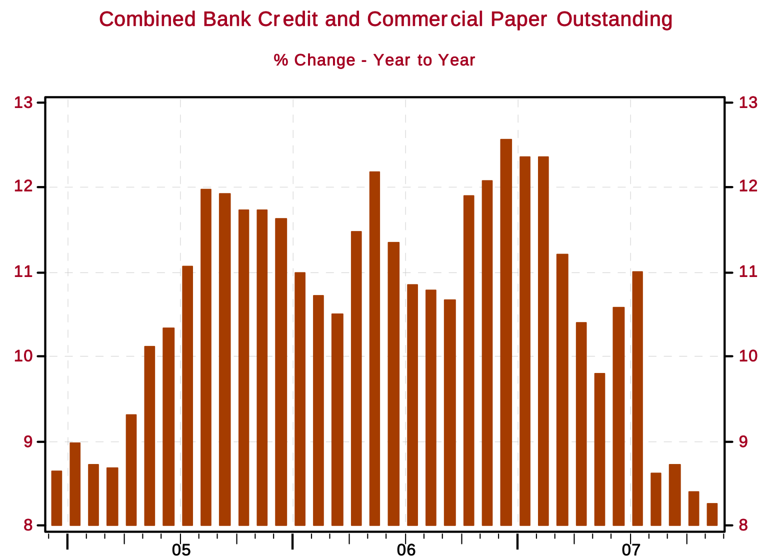


Chart 2



The upshot of all this is that the U.S. economy is experiencing a sharp increase in the depreciation of its financial capital. It will need large increases in its *gross* financial investment just to keep its *net* financial investment from contracting.

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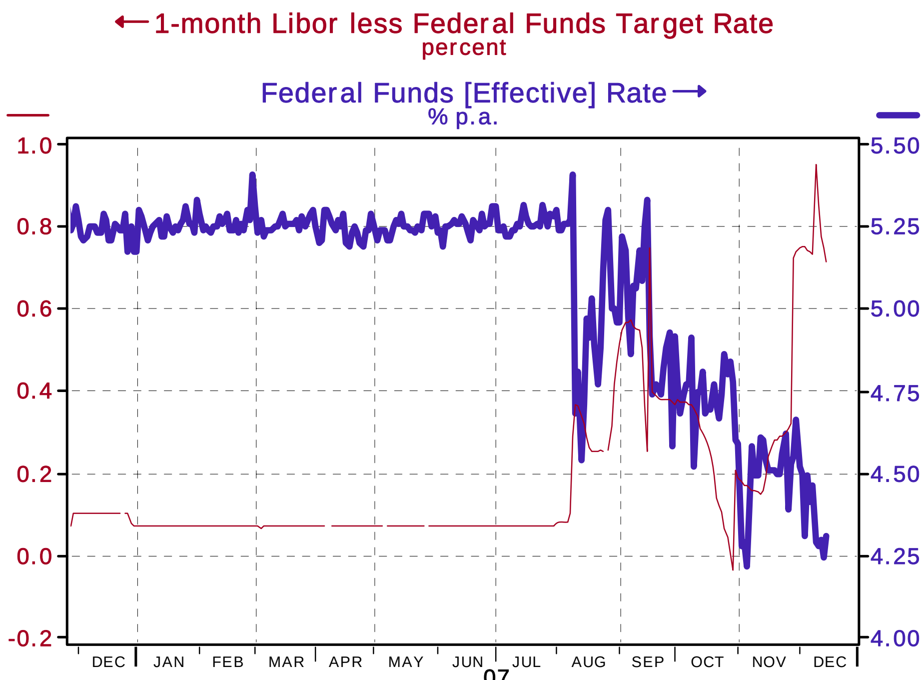
Central Banks Act, Are Money Market Spreads Narrowing?

The much awaited results of the Fed's December 17 auction of $20 billion under its Term Auction (TAF) are now available. The auction had 93 bidders asking for $61.3 billion, which is indicative of the interest in the auction. The stop-out rate was 4.65%, 10 basis points lower than the discount rate. The subscription and the stop-out rate are supportive of the Fed's new measure to the extent that there was no shortage of bids and the rate did not exceed the discount rate.

Chart 3

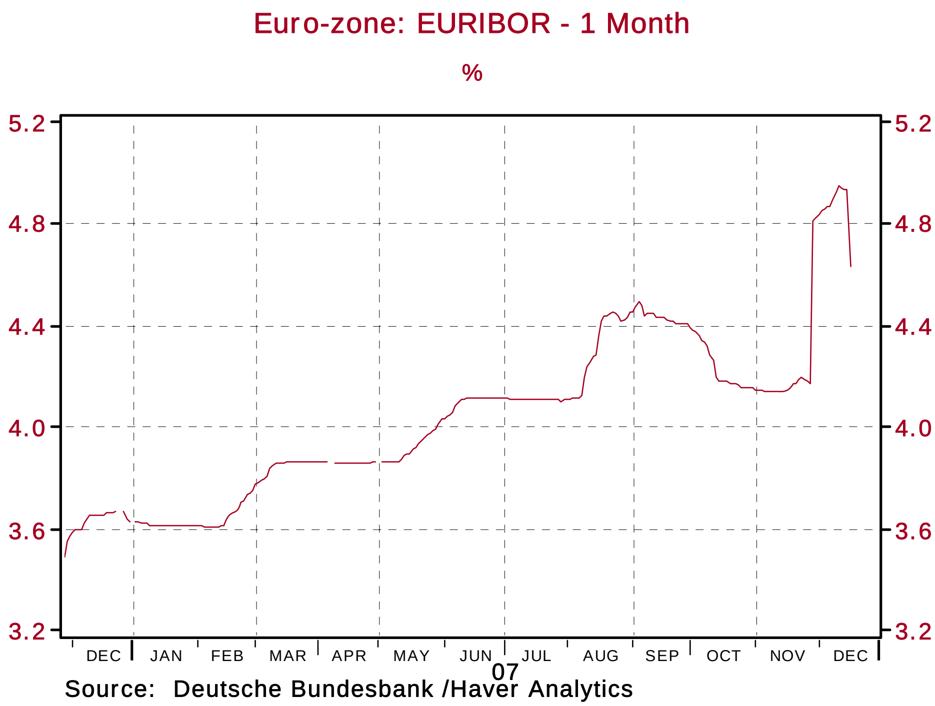


Source: Haver Analytics

The ultimate success of these auctions will be measured by the how much money market spreads will narrow, how rapidly, and if they will hold unlike the earlier success in August-October period that fizzled out. As shown in Chart 3, the spread between 1-month Libor and the target federal funds rate was 95 basis points on December 11, one-day prior to the announcement of the TAF. As of this writing this spread is 68 basis points.

The European Central Bank's (ECM) massive auction of $500 billion appears to be working in the right direction. The 1-month Euribor was fixed today at 4.56%, down from a high of 4.95% on December 12 (see chart 4, data ends on December 18 in chart 4).

Chart 4



The next auction is a 35-day term auction on December 20 for the period December 27 – January 31. Fed has indicated that the auction will be also around $20 billion.