**Friday, October 17th, 2008**

**Economic Update:** Last week, I went to our local Ace Hardware store in Irvine to buy an extension cord. I was wearing a suit and tie. As I stood at the cash register to pay for my 15' indoor/ outdoor cord, the cashier, a man probably in his 60s, glances at my "uniform." Presuming that I am a businessman of some sort, he says "how's business.” Knowing full well the impact this crisis must be exacting on every kind of business, my thoughts turned to my former work as a car dealer and I replied "not good". I talk to enough car dealers these days to know that that was an understatement.

"How's business here?" I asked.

"It's not good anywhere," he said as he handed me my 46 cents change.
"Everybody's just hunkering down," he went on to say. "If people don't come out and start to do things again, we're all going to be in trouble. Have a nice day."

When the meltdown of the financial crisis starts to become a part of daily conversation at the checkout counter at Ace Hardware, it is clear that the problems are deep and wide. I want to give you an update today on what I know at this point and what I see happening next.

- **Purchasing Bank Stock:** The recent move by Treasury to purchase preferred stock in banks has been described as a "nationalization" of these banks. It is not. First of all, we gave the Treasury very broad authority in the Rescue bill to react to rapidly changing economic conditions. When we passed the bill 2 weeks ago, it was not anticipated that capital injections into banks would be necessary. It was thought that the liquidity provided by the asset purchases would be enough. But in that intervening 2 weeks, further deterioration of the credit markets worldwide necessitated this coordinated move with nearly every industrialized country on earth. The US government will buy newly issued preferred stock in these banks. The characteristics of this newly issued preferred stock will be identical in every bank. It will be non-voting preferred with a 5% dividend that increases to 9% over time. The government will also receive warrants of common stock in the amount of 15% of the preferred issue with a strike price equal to the common stock price on the day the preferred is bought. OK so I know that is complex but here's what it means:
- The stock is non-voting because we really don't want the Treasury department sitting on the board of every bank. That could move us towards nationalization. **This avoids nationalization.**
- The dividend rises so that the cost of keeping the preferred stock outstanding becomes prohibitive over time so the banks are encouraged to buy out the Federal government as soon as they can afford to. So, there are incentives in place to insure that this is not a permanent investment.
- The warrants give the taxpayer upside potential so that if the stock price of a bank goes up, the taxpayer gets to participate in that gain and make a profit.
- The program is optional so banks are not forced to participate. But many will because it will enable them to loan again and will secure their capital base in these troubled times. Only regulated banks or bank holding companies may utilize this program.

- **So when will we know if this works?** As you know, the credit markets are "frozen". To be more specific, banks worldwide stopped lending to each other in late September. That is simply because no bank trusts any other to pay them back right now. The first sign that we are starting to reverse the "freezing" will be when interbank lending starts again.  The other major problem has been in the commercial paper market where major corporations go to borrow money to meet short term needs like inventory and payroll. Virtually no commercial paper from any corporation (no matter how strong or profitable) has traded since September 10th. That is why the Fed will begin buying new issues of commercial paper October 27th.  When Money Market Funds (major purchasers of commercial paper) begin buying and trading this stuff again, that will be the second major sign that markets are heading back to normal. Although it appears that the fear that caused this "freezing" is not getting any worse, there has been no "thawing" as of the date of this missive. Home loans, car loans and business loans will continue to be hard to get until these two "freezes" reverse.
- **But even if the "thawing" occurs and occurs fairly quickly,** the shocks to the economy will be long and deep and broad. That's why I believe that we are looking at an extended period of reduced economic activity even if all of these actions work. The stock market (as measured by the Dow Jones and other indices) is a symptom of the problem but it is not the problem. It is reacting to the uncertainties of the credit markets and their impact on corporate earnings. Many corporations even in sectors which are not directly affected by the credit freeze are seeing reduced earnings as their borrowing costs increase. Others have more direct impacts from the lack of credit and a cautious consumer attitude.

- **So what will Congress do next?** We return to DC on November 17th. I will not be surprised if there is a request to increase the Treasury's financial authority above the amount previously authorized. When that amount was set, it was not anticipated that the government would be buying preferred stock in banks or purchasing commercial paper. But deteriorating conditions have necessitated both of those moves. If the actions taken by Treasury to that point have not begun the "thawing" that we discussed above, there might be more actions or more authority that gets debated. Furthermore, Speaker Pelosi and Senator Obama are now talking about an additional "Stimulus II" package of $300 billion in spending. This proposal is all pure spending which the taxpayer will never get back, unlike the Rescue Package. Furthermore, this is not a "garden variety" recession in which we find ourselves. If the credit markets stay frozen, all the government spending in the world will not get the economy moving. If they unfreeze, then a jump start of some sort might make some sense to try to accelerate recovery. But that time is clearly not now.
- **The Rescue Bill expanded FDIC Insurance limits** to $250,000 until 12/31/09. But the bill also changed the limitations on accounts. For example, a business account (except a sole proprietorship) now gets its own $250,000 limit even if the owners have money in the same bank.
- Here is a link to the new rules for how many $250,000 limits might be available. **Click here.**

We are a long way from being through this. But at least conditions seem to have stopped getting worse for now.

Until next time I remain respectfully,

Congressman John Campbell