

Preventing the Next Financial Crisis

In early November, the federal government announced that U.S. gross domestic product grew 3.5 percent in the third quarter, following over a year of severe contraction, job losses and turmoil in world's credit markets. That news, coupled with the sustained rally the nation's major stock indices have experienced since the spring, gave optimists reason to hope that the worst of the economic crisis may be behind us.

Others aren't so sure. Some argue that the outlook for the U.S. economy remains as perilous as ever given escalating federal deficits, a weakening dollar and other systemic problems that have yet to be confronted. Among those who share that more sober view is Allan H. Meltzer, the legendary political economist at the Tepper School of Business at Pittsburgh's Carnegie Mellon University.

Outlook recently asked Meltzer to discuss the dangers that face the nation's economy as it emerges from the worst economic downturn since the Great Depression. Over a career spanning 50-plus years, Meltzer has advised several presidents and is widely regarded as one of the foremost authorities on the Federal Reserve and monetary policy in general. Meltzer is frequently credited with originating the phrase: "Capitalism without failure is like religion without sin." In January, he will publish the second volume of his seminal *History of the Federal Reserve*.

OUTLOOK: Where does the greatest danger of a second crisis lie?

AM: We have budget deficits as far as the eye can see and beyond. The administration chooses to underestimate them. One way it does that is by expecting or predicting a high growth rate in the economy and in tax revenue. We're not going to see that kind of growth, especially with policies that aim to tax all of us, and especially small businesses, the way they are planning to. They point to all kinds of new jobs that will be created by subsidizing nontraditional sources of energy. But we're not going to get rich doing that.

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The other way they underestimate deficits is through overoptimistic predictions of cost savings. For example, in this health care bill we hear about hundreds of billions of dollars in reduced Medicare spending. Anybody who believes that is a candidate to buy the Brooklyn Bridge. This is not a partisan phenomenon, by the way. The Bush Administration was very, very much a spending administration.

OUTLOOK: Given your concerns over a potential second crisis, what do you make of the market recovery that's been going on for months now?

AM: The recovery is for real. That is, financial markets are going up instead of down. The road from here will be bumpy. The third quarter of 2009 was quite good because we had the housing stimulus of \$8,000 per house and the automobile clunkers program, which borrowed sales from the future. We'll have good quarters and not so good quarters, but the general direction will be a slow growth path, until the crisis comes. Crises don't usually come slowly. They come all at once.

OUTLOOK: What form do you expect another next crisis might take?

AM: A new book by economists Carmen Reinhart and Kenneth Rogoff [*This Time is Different: Eight Centuries of Financial Folly*] examines financial crises going back hundreds of years. There's a certain regularity to them: a debt crisis, followed by an exchange rate collapse, and inflation. And that's what we're going to have, unless we make some fundamental changes soon.

OUTLOOK: What changes do you suggest?

AM: For one thing, we need a bipartisan commission that would agree on ways to cut government spending and raise taxes appropriately. And Congress would have to simply vote 'yes' or 'no' on the commission's decisions, without changing them. That was how we got through the contentious period of military base closings years ago, and it worked. That's the way we used to do trade agreements. When it's bipartisan, you can't criticize the opposition for having forced this or that.

Once we get the budget down to some modest deficit, we need to have some rules about fiscal responsibility. We have to ask ourselves this question: Why is it that for the first 170 years of this republic we generally ran surpluses, except in wartime, and since 1965 we've run bigger and bigger deficits? The answer is that we believed in two things in the first 170 years which we no longer believe in. One was the gold standard, which put natural limits on what you could spend. The other was a balanced budget. Now, the only time politicians talk about the balanced budget is when they're out of office.

About this interview

Allan H. Meltzer is an economist and professor at Carnegie Mellon University's Tepper School of Business. He is considered one of the foremost experts on the development and applications of monetary policy. His book, *A History of the Federal Reserve*, is considered the most comprehensive history of the central bank.



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OUTLOOK: Assuming a return to the gold standard can't happen, what could take its place?

AM: Strong monetary policy and a commitment to reduced spending. It's not impossible. The period from 1985 to 2003 is known in economics as The Great Moderation. We had strong growth, small recessions that didn't last very long and weren't very deep, good recoveries, and low inflation. And then we just threw that all to the wind.

OUTLOOK: Do you think the \$780 billion stimulus has helped?

AM: What they did was primarily redistributive. A lot of the expenditures went to state and local governments. That certainly reduced state and local government deficits, but it just transferred the deficits to the federal government. It didn't change anything as far as reality is concerned.

A big selling point was temporary tax cuts for people with less than \$250,000 income. Any number of scholarly studies have shown conclusively that temporary tax cuts don't have any effect. Social Security holders, including my wife and me, got checks for \$250. That's not going to change my spending habits. It's a temporary gift from the government that will be offset by higher taxes. It's just pandering to the public.

OUTLOOK: Some economists are downplaying the dangers of inflation right now. What's your take?

AM: I don't think we'll have inflation this year or next. But the time to start doing something about that is now. The Federal Reserve has a dual mandate. It's supposed to be concerned about unemployment and inflation. Right now, they're focusing on unemployment and completely ignoring the prospect of future inflation. The Fed has a trillion dollars of excess reserves that were created chiefly to help the banks, commercial paper market and the money market funds. When those special programs ran down, the excess reserves were supposed to run down. Well, the special programs have run down, and the excess reserves have gone up. The banks are making large profits by borrowing from the Federal Reserve at zero interest rate and then buying government bonds at 3 or 3 1/2 percent. And the Fed gives them all sorts of comfort by saying they're not going to change that zero interest rate, in hopes that this will stimulate hiring.

During the 1970s, the Fed used a similar approach to try to stimulate employment, with the result of rampant inflation. We're on the same path now, except with much bigger deficits that need to be financed. I believe the Fed should raise the federal funds rate from zero to half a percent as a first step in a longer term program to get the rate back to where it needs to be for a non-inflationary policy.

OUTLOOK: How long will foreign countries and particularly the Chinese be willing to finance our debts?

AM: That's the big mystery. The Chinese are very aware of what's going on here. I recently spoke to a group of Chinese journalists visiting in Pittsburgh. Our debts were by far the most pressing question on their minds. They wanted to see if there was any hope for reduced deficits, since they are such large holders of our debt, and since that debt is only going to increase. When are the Chinese going to change their policy? I don't know. I don't think they know. But it's certainly something that they worry about a great deal.

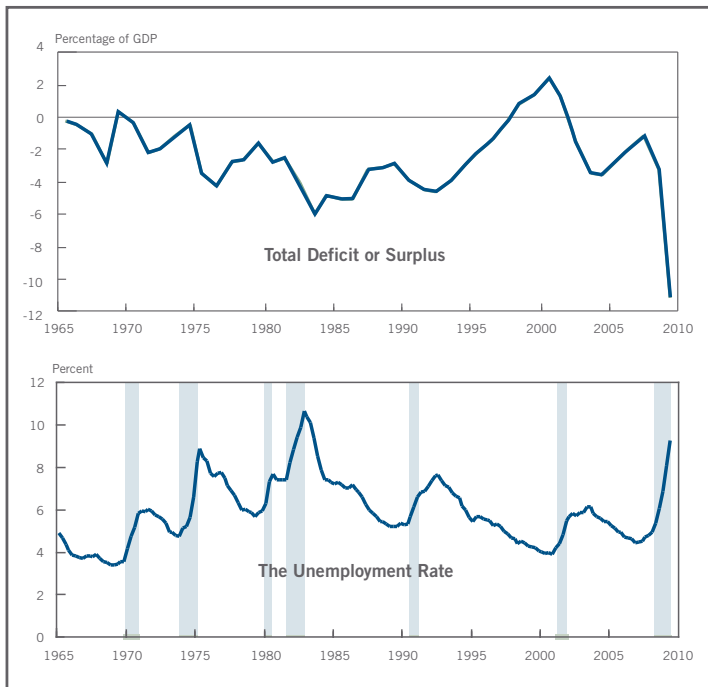
OUTLOOK: Do you see the dollar losing its status as the world's reserve currency?

AM: We're a long way from that, mainly because people don't know where else to go. They talk about it, and they worry about it, but countries worldwide still hold about 60% of their foreign reserves in U.S. dollars, which is pretty close to where we've been historically.

OUTLOOK: Could the euro, or an Asian bloc currency, as some have suggested, one day supplant the dollar?

AM: The euro is a strong currency mainly because it has German monetary policy behind it. The Europeans, especially the French, came to realize that they could not have a separate monetary policy from the Germans. The deal was that they would adhere to the German noninflationary model, which has helped create price stability. But Europe has problems of its own. Their growth rates have been low. They have a bunch of countries with weak economies, such as Greece, Ireland, Italy, and to some extent Spain. Some of these could split off. And

BUDGET DEFICITS AND UNEMPLOYMENT



Source: Congressional Budget Office

then you have smaller countries, such as Latvia and Lithuania, who want in. And there's been some pressure to admit them, but they would bring their own serious economic problems. So that puts a lot of question marks on the future of the euro.

As for Asia, I think they'll get there eventually. But they have a lack of open capital markets and other problems they'll need to solve. But they're going to move in that direction, away from the dollar. Whether they challenge the dollar's position remains to be seen.

OUTLOOK: You've written about the implications of the end of "The American Century." What will the world look like if American economic power wanes?

AM: I have German friends who say, discreetly, "Thank goodness we're rid of the American hegemony and arrogance." And, of course, all people who are in a leadership role appear at times to be arrogant. And those in a position of following don't like that.

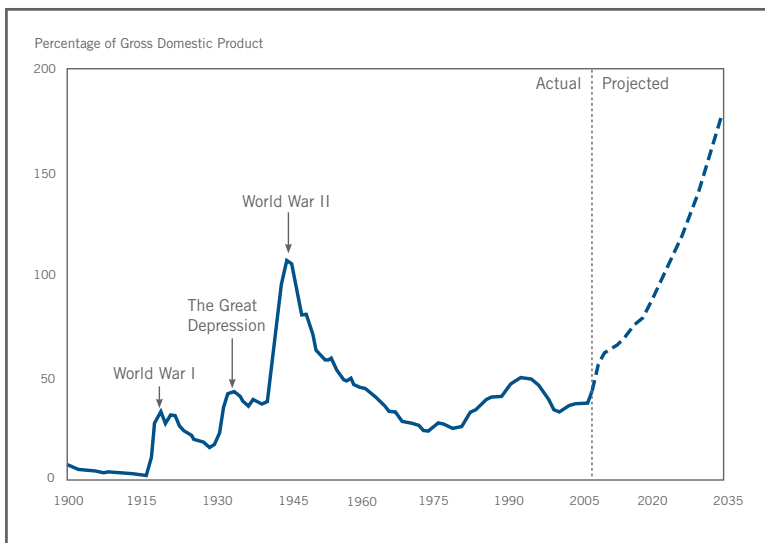
But people ask me what's going to take America's place? I don't think anything's going to take its place. Will the United States and China get together and run the world? I'm skeptical. You can't exactly point to great success in solving or agreeing on mutual problems we have, like Korea and Iran.

I think the world is going to be full of differences of opinions. Agreements are going to be much, much harder to reach. The United States since World War II has a lot to be proud of. We rebuilt our enemies. We established an order that produced the greatest increase in living standards that the world has ever seen. It's not a bad record.

OUTLOOK: What is the future of free market capitalism in the United States?

AM: I believe that the bulk of the population, the majority, likes the system. They may not admire everything about it, but they know it works, for themselves and for their children.

FEDERAL BUDGET DEFICITS – A LONG VIEW



Source: Congressional Budget Office

I believe that the bulk of the population, the majority, likes the free market system. They may not admire everything about it, but they know it works, for themselves and for their children.

Unfortunately, they have learned that they can modify the system by getting things from government. Whatever it is you need, if you can get some congressman to support it, he'll put it in his bill and it will become law. We built a subway here in Pittsburgh, which used to have a population of more than 600,000. Today, there are a little over 300,000 people living in the city. Why do we need a subway? We don't. They sold it to us by saying the federal and state governments would pay just about everything, so it wouldn't cost us very much. But that's just nonsense, because every other city in the country is doing the same thing.

OUTLOOK: What do you say to those who suggest that capitalism is finished?

AM: *The New York Times* ran a series of articles on that very topic. Shortly thereafter I got calls from a bunch of reporters asking what I thought about the end of capitalism. I was polite for the first five calls, and then I lost my patience. I told the sixth reporter that it was the most stupid question I've been asked in 40 years. Open your eyes. Capitalism used to be limited to Western Europe and the former British colonies, such as the United States, Canada and Australia. Today, it's in China, India, in Japan, Vietnam. It's all over Asia. They've all gone toward capitalism. They all do it in their own unique ways, but it's still capitalism. Why? Because it's the only system that works. ■ **OL**

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 10/31/09. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC & Blue Chip Economic Indicators **US Treasury Securities**

2009	GDP	CPI	Fed Funds	2-year	10-year
Q2	-0.70%	1.30%	0.18%	1.00%	3.30%
Q3	3.20%	3.00%	0.16%	1.00%	3.50%
Q4	2.40%	1.70%	0.14%	0.90%	3.40%
2010	GDP	CPI	Funds	2-year	10-year
Q1	2.60%	1.60%	0.17%	1.00%	3.40%
Q2	2.70%	1.60%	0.19%	1.00%	3.50%
Q3	2.80%	1.90%	0.23%	1.10%	3.60%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.28%	1.20%	1.85%	2.67%	3.17%	3.57%
0.25	0.81%	1.43%	2.09%	2.86%	3.32%	3.68%
0.50	1.56%	1.55%	2.33%	3.04%	3.45%	3.79%
0.75	2.03%	1.48%	2.52%	3.19%	3.57%	3.87%
1.00	1.30%	1.30%	2.67%	3.32%	3.67%	3.94%
1.50	1.29%	2.01%	3.14%	3.65%	3.92%	4.15%
2.00	2.54%	3.03%	3.67%	4.01%	4.19%	4.37%
2.50	3.14%	3.43%	3.95%	4.21%	4.34%	4.49%
3.00	3.39%	3.74%	4.16%	4.36%	4.46%	4.58%
4.00	3.94%	4.24%	4.47%	4.55%	4.60%	4.71%
5.00	4.26%	4.50%	4.62%	4.67%	4.74%	4.80%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

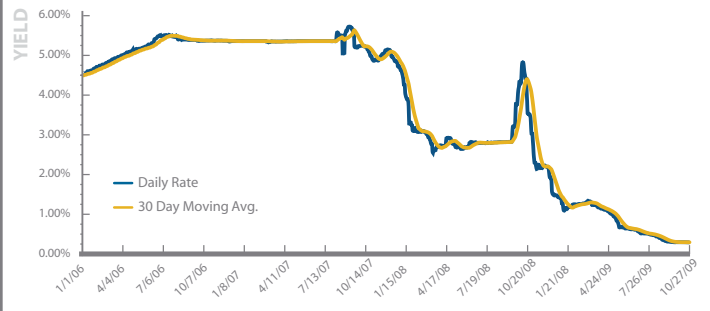
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	12	12	11	7
90	31	30	29	17
180	52	54	53	31
365	95	88	94	54

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

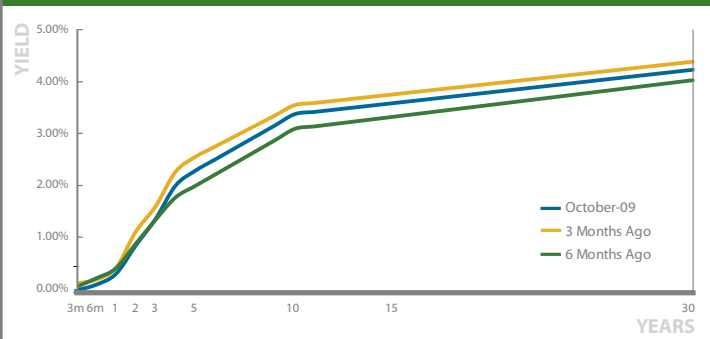
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE





CoBank Reports Third Quarter Financial Results

Bank Records 3Q09 Net Earnings of \$116.8 Million; Maintains Strong Levels of Capital and Liquidity

CoBank has announced financial results for the third quarter and for the first nine months of 2009.

Net income for the third quarter was \$116.8 million, compared to \$140.9 million for the same period last year. Total earnings for the nine months ended September 30, 2009, were \$432.8 million, a 3.6 percent decrease compared to the same period in 2008. The decrease in third-quarter net income was attributable primarily to a \$25.0 million provision for credit losses, bringing the total provision for credit losses in the first nine months of the year to \$55.0 million. No such provisions were recorded during the first nine months of 2008; however, a \$55.0 million provision was recorded in the fourth quarter of last year. In the third quarter of 2009, the bank also recorded a \$15.0 million impairment on investment securities.

Partially offsetting those factors was continued growth in net interest income from improved net interest margins. Net interest income rose 0.3 percent in the quarter, to \$223.1 million. Net interest income in the first nine months of the year was \$716.0 million, up 6.6 percent from the same period last year.

“We remain pleased with CoBank’s financial performance in the midst of prolonged turmoil in the world’s economic, credit and financial markets,” said Robert B. Engel, president and chief executive officer. “The bank continues to generate robust net earnings, which enable us to fulfill our mission as a source of dependable credit for our customer-owners across rural America. At the same time, we are committed to maintaining our prudent approach to reserves for credit exposure, which has kept the bank and its shareholders well protected throughout the economic crisis.”

Total loans and leases for CoBank were \$42.4 billion as of September 30, 2009, compared to \$44.6 billion at year-end and \$43.1 billion at September 30, 2008. Lending to agribusiness customers has declined markedly in 2009 as compared to 2008 due to the substantial drop in prices and associated volatility for grains and farm inputs from 2008’s exceptionally high levels. At the same time, the bank has seen growth in U.S. government-guaranteed loans that support American agricultural exports, in loans to energy customers, and in loans to and participations with affiliated associations and other partners across the Farm Credit System.

At quarter end, 96.0 percent of the bank’s loan and lease portfolio was classified in the highest regulatory category used to grade creditworthiness, compared to 96.1 percent at June 30, 2009. Nonaccrual loans and leases increased to \$442.5 million, compared to \$336.8 million as of June 30, 2009, and \$217.8 million at year-end. Those changes were attributable to stresses

About CoBank

CoBank is a \$60 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. In addition to serving its direct borrowers, the bank also provides wholesale loans and other financial services to affiliated Farm Credit associations and other partners across the country.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore. For more information about CoBank, visit the bank's web site at www.cobank.com.

Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.

in a number of the industries CoBank serves, particularly livestock, communications, ethanol and dairy. The bank's reserve for credit exposure now totals \$486.3 million, or 2.1 percent of non-guaranteed loans and leases outstanding when loans to Farm Credit associations are excluded.

The bank's margins and net interest income have been enhanced by the steepened yield curve resulting from actions by the world's central banks to counter the global economic downturn. "We have deliberately positioned our balance sheet to benefit from a yield-curve environment like the one we are in today," Engel said. "That prudent approach has been an important contributor to our overall financial performance throughout 2009."

Capital and liquidity levels at the bank remain strong and well in excess of regulatory minimums. At quarter end, the bank held approximately \$16.2 billion in cash and investments. The bank averaged 287 days of liquidity during the first nine months of the year, compared with the 90-day minimum established by the Farm Credit Administration, the bank's regulator. "We have deliberately increased levels of liquidity over the past year as a result of the credit crisis and its impact on funding access and flexibility," Engel said. "However, overall debt issuance and market capacity have improved in recent months. If conditions continue to improve, we anticipate that we will manage our liquidity position closer to our target of 180 days."

Engel noted that actions CoBank has taken to preserve and enhance earnings capacity have helped to shield the bank over the past year from the negative impacts the recession has had on overall asset quality.

"Solid earnings serve not only as an important source of capital for the bank but as a valuable buffer against the higher levels of credit losses that can be expected in any economic downturn," Engel said. "We are fortunate to serve a diverse base of vital industries throughout rural America, and to derive real strength from that diversity. We look forward to continued service to our customers, and to maintaining the strength and stability of the bank for the long term."