CoBANK

OUTLOOK Economic Data and Commentary

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Outlook for the Eurozone

About this article

Judy Shelton is a senior fellow at the Atlas Economic Research Foundation and author of *Money Meltdown: Restoring Order to the Global Currency System*.

Business headlines in recent weeks have been dominated by news of the Greek debt crisis and its impact on the broader European economy. Mounting government deficits in Greece – along with sagging investor confidence that the country can get its financial house in order – have caused the nation's borrowing costs to skyrocket and forced its European neighbors to come to the rescue in order to avoid significant damage to the euro, the region's common currency.

However, other European nations – particularly Portugal, Spain and Italy – are seen as having similar fiscal problems. Experts have called Greece's economic woes a "contagion" that must be quarantined and prevented from spreading further. As of this week, the 16 countries that use the euro and the International Monetary Fund have agreed to create a nearly $1 trillion rescue fund to support European nations burdened by heavy debt. Even so, the near-term outlook for economic recovery in Europe is uncertain.

OUTLOOK recently spoke with economist Judy Shelton, a frequent contributor to the Wall Street Journal, about the situation in Greece and its potential impacts on global economics. Shelton, a senior fellow at the Atlas Economic Research Foundation, specializes in international monetary and finance issues and is the author of *Money Meltdown: Restoring Order to the Global Currency System*.

OUTLOOK: The euro officially became a currency in 1999, and today it is the second most traded currency in the world after the U.S. dollar. How was it developed and conceived?

JUDY SHELTON: It goes back a long way. During World War II, General Dwight D. Eisenhower, commander of allied forces in Europe, said his dream after the war was that there would be a United States of Europe. He felt it was tragic that the European continent had experienced two horrible world wars within the same century, with such devastation wrought in both economic and human terms.

Following World War II, starting in the 1950s and with more structure in the 1960s, Europe's leaders decided they should think in terms of a common economic union. They reasoned that if they had a common economic area, it would also make sense to have a common currency. If everyone were to use the same monetary unit of account to measure value across borders,

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then individual nations would not try to increase exports by reducing the value of their currency to gain a price advantage. You can imagine, in our country, if each state had its own currency and the values of those 50 different currencies were constantly changing; people would find it difficult to make decisions about where to invest, where to buy or where to sell. That's what was happening in Europe, and each individual European country was paying a premium to get investment from outside its borders because potential investors not only wanted to get a return on their investment – they also wanted to make sure they wouldn't lose money if the exchange rate unexpectedly changed on them.

The intellectual godfather behind the introduction of the euro is economist Robert Mundell, a Nobel laureate who wrote extensively on the idea of "optimum currency areas." In short, a common currency for Europe would help to lower the cost of doing business, and it would encourage countries to conduct transactions with each other. It would potentially reduce interest costs for all the participating countries because it would eliminate the foreign exchange risk. So they started slowly moving in that direction. It seemed like quite a dream at the time, but they kept making steady progress.

There was another hoped-for benefit as well. If Europe were to become economically integrated to the point where countries even shared the same currency, perhaps it would ensure they never went to war against each other again. So the whole experiment was not merely for economic gains, there was a lot of political capital invested in the idea of a single currency as well.

OUTLOOK: In the 11 years since the euro was introduced, 16 of the 27 E.U. countries have adopted it as their official currency. How is the euro managed differently from the U.S. dollar?

JS: It used to be that each individual country's central bank managed its own national currency in the same way that our Federal Reserve manages the U.S. currency. Now the European Central Bank, headed by Jean-Claude Trichet, is entirely in charge of monetary policy for the euro – which means he oversees monetary policy for all the countries using the euro. Trichet is effectively equivalent to Ben Bernanke [chairman of the U.S. Federal Reserve], only the ECB is supposed to be independent from the governments of member countries. On an operating basis, European banks have borrowing and lending arrangements with the ECB that are comparable to the

GREECE - BY THE NUMBERS*

Population: 10,727,428

Median age: 41.8 years

Life expectancy: 79.66 years

President: Karolos Papoulias

Prime Minister: Yeoryios (George) Papandreou

GDP: $341 billion

GDP growth: -2%

GDP per capita: $32,100

Economic overview: Public sector spending accounts for 40% of GDP, with tourism providing about 15% of GDP. Overall, services account for 76% of GDP, industry 21% of GDP and agriculture 3% of GDP.

Unemployment rate: 9%

Tax revenues: $108.7 billion

Government expenditures: $145.2 billion

**All economic data estimated for 2009.*
Source: CIA World Factbook

procedures used by U.S. banks in their relations with the Fed.

One difference is that the ECB has only one goal as its official mandate – price stability. In the U.S., our Fed has two goals – price stability and maximizing employment. Those goals can come into conflict for monetary policymakers. You might want tight money to keep prices stable, but you might opt for easy money to stimulate the economy and increase employment. For our Fed, it can sometimes pose a real dilemma. So in that sense, the European Central Bank's single mandate offers a more straightforward objective.

We've seen in times of crisis, however, that governments can influence the decisions ostensibly made independently by the ECB. The turmoil in Greece has proved to be a serious challenge for the presumed separation of stable monetary policy, immune to government concerns over national economies, and employment issues.

OUTLOOK: Just a few years ago, Greece was growing rapidly and widely viewed as lucrative emerging market. What happened and how did Greece get in trouble?

JS: Greece, Spain and a few other countries were not considered first-tier borrowers before the creation of the euro. They had the most to gain from adopting the euro, because it provided them the opportunity to borrow money at interest rates lower than they would otherwise be granted. After the transition to the euro, Greece became a much more attractive option for outside investors – an emerging-market country with lots of growth potential at a lower risk than would have otherwise accrued if you had to deal in drachmas. Plenty of investment capital flowed in for construction projects. It seemed reasonable to expect other Europeans to travel to Greece or build a second home in that neighboring country. The euro is a boon to travel and cross-border transactions, because it makes goods and services much more accessible. So countries that qualified as emerging markets – Spain, Portugal, Greece – had the most to benefit from adopting the euro. Inflation had earlier been a major issue with their national currencies, but they no longer had to worry about inflation now that the price stability-minded ECB was in charge. With the euro, it was much easier to attract capital from outside investors – maybe too easy for Greece.

While the Greeks were thinking it was terrific to be able to borrow and to have a growing economy with increasing revenues to the government, it wasn't necessarily a permanent situation. Also, Greece has very strong public sector unions, reflecting a somewhat socialist orientation. The Greek government was extravagant in promising large pensions to public sector employees and letting people have early retirement benefits. They began to run huge budget deficits that only seemed to worsen, with government spending increasing to levels that posed a burden on the private sector. Corruption was also a factor; the level of corruption in Greece, according to an organization called Transparency International, is rather high. Some of the government's expenditures meant to provide public services might well have been siphoned off.

In any case, the Greek government was finally overwhelmed by its overspending and chronic deficits in the aftermath of the global economic downturn. Revenues significantly declined while the big liabilities remained. The situation has been exacerbated by the fact that people are not necessarily paying all their taxes – another corruption issue on the private sector side. In short, the Greek government found itself facing a huge budget shortfall, forcing them to borrow even more euros to cover it. People started to question whether the government would be good for it, and then the ratings agencies reduced the credit rating for Greek sovereign debt. This instantly meant a significant increase in the government's cost of borrowing, making the deficit situation even worse. At that point, it was evident that a real crisis had erupted and initiated a downward spiral for a eurozone country.

OUTLOOK: How does this isolated debt problem in Greece spread into Europe and threaten the euro?

JS: Other European Union nations have similar debt problems to Greece, such as Portugal, Spain, Italy, and perhaps Ireland. Here's an analogy: Let's say California went bankrupt in the U.S. Would that threaten the dollar? Well, not directly. But let's say that 12 states went bankrupt. Suddenly that might well hurt the dollar, not only because it would mean reduced revenues to the federal budget but also because there would be less outside demand to invest in those dollar-using states. Europe is facing such a crisis – particularly if the financial problems continue to spread beyond Greece.

The difficult situation for the European Central Bank stems from the fact that it has oversight of the euro but does not officially have any say over the fiscal policies of member countries. So when those member countries decide they want to maximize employment, for example, and they decide to do it through fiscal stimulus – it increases the budget deficit. On top of prior fiscal excesses, it just requires additional borrowing which the Greek government hopes to finance by issuing country debt – in euros, of course.

The ECB had originally operated on the premise that sovereign nations would meet certain fiscal targets that were quite strict. For example, they were not supposed to run budget deficits greater than 3 percent of GDP. Another rule was that they were not supposed to accumulate government debt greater than 60 percent of their GDP. But when countries started violating those rules left and right as they dealt with the effects of the global economic crisis, the ECB was in no position to enforce those strictures. All of them – not just Greece, Spain and Portugal – violated those criteria, but the

European Central Bank continued to accept sovereign debt as collateral in its banking relations with member countries.

What started out to be a highly reputable central bank – leery of doing anything that might cause its currency to inflate – has become an institution prone to compromising with political leaders. The credibility of the euro has been damaged, and over the long run, it will likely have a negative impact on its value. That's the big crisis.

OUTLOOK: Greece has adopted a host of measures aimed at reducing their debt – a cut in public-sector wages, reduced pensions, a tax increase and improved tax collection. Won't that fix the problem?

JS: The Greek parliament is wrestling with new austerity measures which the government has promised to impose as a tenet for receiving new funding from its fellow members of the European Union, the ECB and the International Monetary Fund. Essentially, the Greek government must bring its budget much closer to being balanced – to reduce it from 13 percent of GDP to under 3 percent of GDP by 2014. But there is already some question as to whether there will be civil tolerance for the necessary fiscal measures. Riots in Greece protesting the austerity measures have made global headlines recently, with people being killed.

What's frightening is that, even if Greece is prepared to shore up its budget situation, it is going to take time. Meanwhile, they need cash to keep the country going – which is why they have requested massive financial assistance from other EU members. What the Greeks have said is that they can't afford to pay current market rates to borrow money; they are simply too high. Instead, they prefer to borrow at lower rates they can afford as part of a work-out situation. They see it as a way to avoid national bankruptcy and get back on track.

OUTLOOK: What role has currency speculation played in the crisis?

JS: Speculation has become a more lucrative investment activity, unfortunately, than evaluating the real prospects for a country. We've seen this type of frenzied scenario before, when speculators smell blood in the water, and we know how it can turn out. After the Soviet Union fell, the new Russia was anxious to assert itself as a market-based economy. Russia wanted to be seen as a promising emerging market country, a place offering new opportunities for high investment returns under the transformational leadership of President Boris Yeltsin. It wasn't long before Russia became quite dependent on the increasing capital flows. The government was spending more and more, trying to improve life for its citizens, and borrowing more and more to pay for it. The next thing you know, they were overloaded with government debt. The ruble began to lose value in 1998 as people became disenchanted with the Russian fiscal and economic situation. There was a stampede toward the exits, a rush to dump the currency. Desperate to bribe investors to keep purchasing Russian government debt, at one point the interest rate reached 200 percent. Every time money came in, it was immediately needed to pay off other liabilities that were coming due. It is that kind of a pattern that people remember. The speculators know that money and investments can move very quickly under such circumstances. They are geared up to benefit as much as possible by rapidly adjusting their positions as they detect a similar pattern developing for Greece.

Speculators see a country get into trouble and they begin figuring out what sorts of side bets can be made to profit from it. There is nothing illegal about such activities, but they can prove extremely destabilizing for financial markets as things move quickly. Derivatives permit traders to effectively bet whether a government will go into bankruptcy, whether the nearly $1 trillion bailout package cobbled together under duress will actually prevent the euro from further declining. As people trade euros for dollars or gold, the value of the euro declines. It recently hit a 14-month low in its exchange rate with the dollar and the price of gold is climbing to new highs. For central banks around the world that hold euros as a global reserve currency, alongside their dollars and gold, it's a bit of a shock. Now they must deal with a situation where the euro's value as an asset in their foreign currency reserve position is declining. It's a very dicey situation and the jury is still out on whether the euro can surmount these travails. But unless the situation is somehow resolved, the euro's very status as a global reserve currency is imperiled.

OUTLOOK: What is the global economic impact of a devalued euro?

JS: As the euro decreases against the dollar, you can expect to see many of the typical effects as described in economic textbooks. That is, Europeans are going to find it more expensive to buy imported goods. Oil is priced in dollars, so that is the first place they are going to feel it – very expensive oil.

For companies in the U.S., what they will likely encounter is greater difficulty in selling products to Europe, because goods produced outside the eurozone will be expensive for Europeans to buy. When the dollar was extremely strong in the mid-1980s, companies such as Caterpillar pressured the U.S. government to bring down the value of the dollar because they couldn't export. We could see that kind of a situation again. For European farmers, say, buying farm equipment from the U.S. will become more expensive if the dollar gains relative to the euro; it would take the European farmers many more euros to purchase the necessary dollars to buy what they wanted from America. To the extent that McDonald's runs operations in Europe but imports certain machinery from the U.S. to maintain consistent quality, it could become more expensive for them. To protect themselves from the currency risk, they will want to buy products locally as much as possible.

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Indeed, European businesses in general will seek to buy from other European producers to avoid the high cost of dollar-priced goods and services.

On the other side, American farmers will have to contend with their European counterparts being able to offer lower prices on their own exported goods. Presumably, it is an advantage now for the Europeans in the sense that they can be more "competitive" in export markets. But it is due to currency gyrations, rather than genuine competition based on the same monetary unit of account for measuring quality.

OUTLOOK: One solution that's been suggested would be to simply take Greece off the euro and remove it as a member of the European Central Bank. Is that a viable option?

JS: Even if Greece were kicked out tomorrow, it's not clear what would happen. For instance, I think of the human effects: What would it mean to a Greek fisherman in a small village to be told that his country no longer uses the euro? Of course they are going to continue to use euros; they have them in their hands. The ECB may say you're off the euro, but they'll continue to use that currency for as long as others are willing to accept it. It's like telling someone they are not allowed to speak a certain language any more. The matter takes on greater seriousness if the government suddenly decrees that savings accounts in Greek banks have been automatically converted to newly-issued drachmas – which could be seen as expropriation. And if, at the same time, Greece is prohibited from selling its government debt to other European countries or directly to the ECB, it could quickly become catastrophic. It would not take much to bring about the same sort of debacle experienced by Russia, with sky-high interest rates offered by a desperate government on the verge of collapse.

There is no reason that Greece, Portugal or Spain should be kicked out of the euro unless they are deemed utterly insolvent rather than merely illiquid. They are now being punished to a degree that merely exacerbates the problem. Yes, they definitely need to tighten up fiscally – their governments have been reckless. But they could perhaps slowly work their way out of the danger zone if allowed the time to do so. When things are unraveling so quickly, with Germans justifiably feeling victimized by the lax behavior of fellow EU countries, it's easy to lose the political will to preserve what is basically a good idea – a common currency. And if the speculators drive the process at a hyper-pace, the whole dream could be lost in a hurry. Bailouts are never popular and always risk hurting incentives to act with integrity. Recall what happened in the U.S. when the Federal Reserve acted to bail out Goldman Sachs and AIG, but then decided not to save Lehman Brothers. Clearly, you reach a point when the criticism over bailouts has become so severe that you finally say: “That’s it, what ever happens, happens.” The wisdom lies in figuring out whether there is more to lose than to gain by succumbing to market-driven events – and whether a salvaged system can prove viable going into the future with the proper changes and a new commitment to discipline. It would be a shame to lose the benefits of the euro. Let’s hope we are not witnessing the beginning of the end, although it seems clear that a new common currency would require more automatic adjustments and be less subject to fiscal irresponsibility on the part of participating countries.

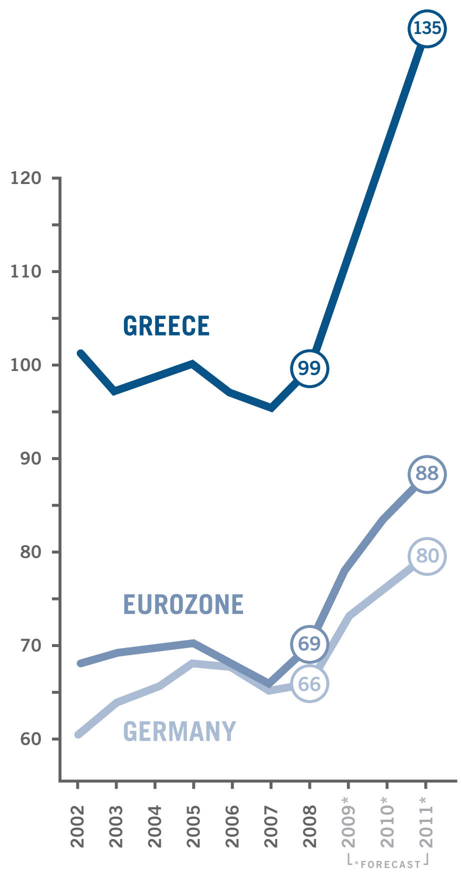
OUTLOOK: In recent years, the banking crisis in the U.S. and global economic downturn caused some experts to question the dollar as the world’s reserve currency, with some suggesting the euro as a viable alternative. How does the weakening of the euro affect this discussion?

JS: I find it most interesting that the president of France, Nicolas Sarkozy, is calling for a new Bretton Woods system, which was the global monetary system established in 1944 to create a level monetary playing field. Under the Bretton Woods system, rules were created so that countries could trade with each other without fearing that any one nation could devalue its own currency to gain an export advantage. The idea was to have a better economic foundation to support international trade and finance in the postwar years. Europe needed to recover from World War II and to make sure the economic policies that had arisen during the 1930s – competitive devaluations, high tariffs and other protectionist trade barriers – would not be repeated.

The Bretton Woods system was based on fixed exchange rates tied to the U.S. dollar, which was itself convertible into gold. The International Monetary Fund was originally created to oversee this system and to ensure that its participants conformed with the requirements. The Bretton Woods system was extremely useful, in my view, and provided the stable monetary platform that enabled more than two decades of global economic growth based on free market principles and comparative advantage among nations.

When Sarkozy says “Bretton Woods,” he no doubt means that we need a new a rules-based global system. But it’s not clear if he is willing to establish a universal reference point that would be seen as the new global unit of account. Given that the euro now seems under a cloud, we may see strengthened calls for a truly independent global reserve currency – or we might alternatively see new proposals for consolidating the fiscal budgets for eurozone countries in an effort to control euro monetary policy more rigidly.

EUROZONE DEBT AS A PERCENT OF GDP



Source: European Commission

OUTLOOK: In a recent Wall Street Journal article, you argued that government interference has distorted the global monetary system. What do you mean by that?

JS: Well, governments are obviously not doing a great job in balancing their budgets. If you are going to let governments continue to supply the money that people are required to use, it's imperative that the value of that money not be distorted as a result of chronic deficit spending, which leads to inflation. When is the last time the U.S. ran a surplus? It's been roughly a decade. Worse, if you look at the projected budget numbers to 2020, there are only deficits, never a surplus. It appears as though Europe, too, is going to be mired in deficits for the foreseeable future.

What this Greek crisis and corresponding crisis for the euro indicates is that a disconnect exists between money and the real economy. That is, money supplied by national governments, or a super-national institution like the European Central Bank, is less a tool for making economic decisions in the private sector and more an instrument of government policy – a shock absorber of sorts for fiscal mismanagement. You have a real economy with hard-working entrepreneurs who are eager to improve their economic prospects. It's the very nature of capitalism to want to recover from an economic downturn. Indeed, it's a universal quality. People want to get back on the path to increased prosperity by operating more efficiently, cutting costs or tapping new ideas. Trichet, the head of the ECB, recently gave a speech at Stanford University acknowledging this idea that the world of money and finance has lost its "raison d'etre" – its reason for being – as it has become delinked from the real economy. He noted that finance has come to serve itself rather than serve the needs of helping people make productive investments. Think of it: Here is the individual who heads the central bank that issues the world's second most important reserve currency suggesting that there is a disconnect between finance and the real economy.

Capital is like financial seed corn, it represents the resources you refrain from consuming for the sake of being able to invest in the future. The idea is that you are willing to sacrifice today to achieve greater future productivity. Money is meant to provide a reliable means for evaluating those investment opportunities. But money has turned, instead, into a moving target that provides misleading signals of actual value and confounds the logic of free markets. Central banks may choose to stimulate through inflation, reducing the value of money, or they may choose to restrain, tightening with high interest rates. But what if they get it wrong? Of all the things we should have discovered after the fall of the Soviet Union and communism, it is that free markets and the aggregate assessments of all the people out there trying to buy and sell, save and invest, lead to better economic returns, better

Money has turned into a moving target that provides misleading signals of actual value and confounds the logic of free markets.

outcomes, than central planning.

How ironic that, in a presumably capitalist nation, we still rely on central planning to decide what should be the interest rate on loanable funds. We have a central bank, the Federal Reserve, where a small group of people go into a room – it's fairly secretive – and decide the price of capital, that is, at what rate loanable funds should be made available to those who wish to borrow. This is more a matter of government intervention than allowing the interaction of supply and demand to determine the interest rate. Under a gold standard, for comparison's sake, it would be up to individuals to evaluate whether an economy was overheating. If they thought financial standards were getting too loose, with too much credit being created, they could opt to convert their paper money into gold – automatically contracting the money supply – rather than risk a run on the fiat currency.

It certainly appears that the debilitating financial crisis the world has gone through can be traced to government intervention and monetary policy that enabled assets to become mispriced and facilitated unhealthy accumulations of credit. Money was too loose, too long, as evidenced by the substantial asset bubble that developed – a bubble that exploded with devastating economic impact. Naturally, there is continuing economic debate about causation. But it certainly seems obvious to me that the money supply was not properly calibrated to the real value of the economy.

OUTLOOK: In your view, what's the best path forward?

JS: I definitely think the world deserves a better monetary system than the current free-for-all that saddles economic progress with the failings of spendthrift governments. I would very much like to see a new Bretton Woods-style conference as a spur to rethinking the basic purposes of money. I would like to see the governments of all countries – major industrial nations as well as emerging-market countries – make it a priority. Just as we realized in 1944, the global monetary system should serve the needs of the productive people who work in the private sector – those who produce real goods that others wish to buy, goods that improve living standards throughout the world. We need a monetary foundation to serve their needs rather than the ambitions of governments operating without fiscal constraints.

The whole rationale for Bretton Woods was to provide a more hopeful future – a future worth fighting for. The idea of a level monetary playing field dedicated to free trade and an open marketplace gave people the incentive to prevail, to win the war and recover economically. No more going back to policies that permitted nations to devalue their currency to gain unfair advantage against legitimate competitors around the world. A system based on fixed exchange rate – anchored by a dollar convertible into gold – would provide the needed stable platform.

We went off the Bretton Woods system in 1971, leaving behind the gold standard for floating exchange rates. It may be that the long experiment with floating rates may be coming to an end. It's possible that, in the wake of the global currency turmoil unleashed by the Greek crisis, we will hear more discussion about the potential benefits of returning to a fixed-exchange-rate system. A huge percentage of derivatives are linked to changes in the relative value of major currencies or the differential interest rate policies of the Fed and the ECB. All those bets would effectively disappear if such opportunities to speculate did not exist.

I think we should be prepared to consider some fairly radical proposals to get back to a sound money system. It may well turn out to be those real producers in the world make fundamental monetary reform a major policy issue. It is not enough to call for lower taxes or balanced budgets or limited government if the fundamental issue of monetary integrity is left off the table. I think people are starting to think in terms of what money should deliver in terms of its quality as a meaningful measure, a store of value. Can we count on the money supplied by government? What is a dollar, and how is it defined? Does it have any intrinsic value beyond the paper it is written on? Money provides the foundation for everything else, that is, the logic behind consumption and production decisions, savings and investment.

We may well see the issue of sound money raised to new heights in political terms. A proposal to return to a Bretton Woods-type system or even an updated international gold standard would garner serious attention, in my view. I am not saying this in a partisan way, but rather expressing the common view that we certainly don't want to go through what we just went through, ever again. The people who make up the global economy should be assertive in suggesting new rules. We should be proposing new approaches to the problem of currency chaos. We need money that we can count on. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 4/30/10. 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**
Q4	5.60%	2.60%	0.12%	0.90%	3.50%
2010	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.90%	1.70%	0.13%	0.90%	3.70%
Q2	3.00%	1.30%	0.23%	1.10%	3.90%
Q3	2.80%	1.80%	0.25%	1.10%	4.00%
Q4	3.00%	1.80%	0.25%	1.10%	3.90%

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	0.34%	1.01%	1.75%	2.66%	3.23%	3.72%
0.25	0.68%	1.22%	2.00%	2.85%	3.39%	3.84%
0.50	1.21%	1.37%	2.25%	3.06%	3.55%	3.96%
0.75	1.76%	1.41%	2.47%	3.24%	3.69%	4.07%
1.00	1.24%	1.33%	2.66%	3.39%	3.81%	4.16%
1.50	1.36%	2.01%	3.16%	3.77%	4.10%	4.38%
2.00	2.44%	2.90%	3.70%	4.14%	4.39%	4.60%
2.50	3.01%	3.37%	4.04%	4.39%	4.58%	4.75%
3.00	3.39%	3.78%	4.33%	4.59%	4.74%	4.87%
4.00	4.09%	4.43%	4.73%	4.87%	4.97%	5.04%
5.00	4.50%	4.77%	4.95%	5.03%	5.10%	5.14%

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

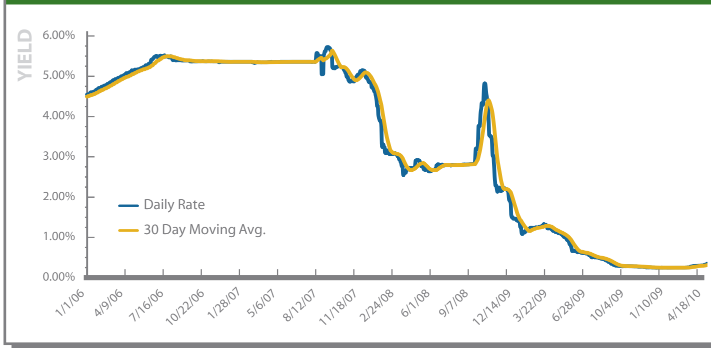
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	11	11	11	7
90	29	30	28	18
180	50	54	51	32
365	98	94	91	58

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.

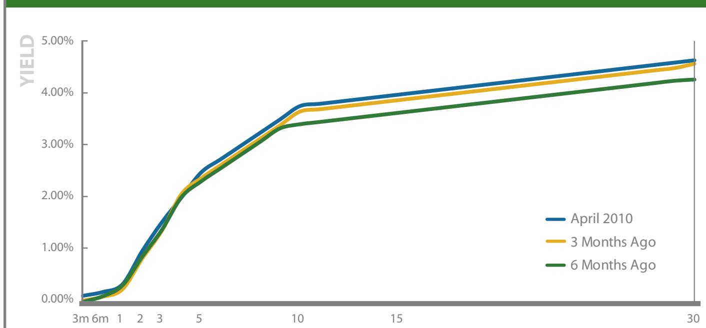
3-MONTH LIBOR



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 First Quarter Financial Results

Bank Records 1Q10 Net Earnings Of $168.7 Million; Maintains Strong Levels Of Capital And Liquidity

CoBank has announced financial results for the first quarter of 2010.

First-quarter net income was $168.7 million, compared with $159.9 million in the first quarter of 2009. Net interest income was $230.7 million, compared with $253.3 million in the same period last year. Average loans outstanding during the quarter declined 2.2 percent to $44.7 billion, as compared to the first quarter of 2009, primarily as a result of a decrease in seasonal lending to agribusiness customers and generally weak loan demand across many industries. Growth in loans to the bank's energy and affiliated Farm Credit association customers partially offset that decline.

The growth in net income during the quarter was driven primarily by a $36.4 million increase in noninterest income that included refunds of a portion of Farm Credit insurance fund premiums paid in prior years, partially offset by other factors, including the reduction in net interest income noted above.

"CoBank continues to deliver solid financial performance on behalf of its customer-owners across rural America," said Robert B. Engel, president and chief executive officer. "Lower prices for agricultural commodities and farm inputs, along with reduced inventory levels at cooperatives, moderately impacted overall loan volume for the bank in the first quarter. That said, CoBank continues to generate robust earnings and remains well positioned to meet the needs of our customers in market conditions that are both challenging and unpredictable."

At quarter end, 96.0 percent of the bank's loan portfolio was classified in the highest regulatory category used to grade creditworthiness, up modestly from the prior quarter. Nonaccrual loans improved slightly to $298.6 million, compared to $307.6 million as of December 31, 2009. During the quarter, the bank recorded a $12.5 million provision for loan losses, compared to a $20.0 million provision for loan losses in the first quarter of 2009 and a $25.0 million provision in the fourth quarter of 2009.

"We're pleased to see some stabilization in overall loan credit quality during the quarter," said Mary E. McBride, CoBank's chief operating officer. "However, loan quality remains an area of focus as weakness in parts of the global economy continues to affect customers in a number of industries we serve, including dairy and forest products."

About CoBank

CoBank is a $58 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.

The bank's reserve for credit exposure now totals $508.6 million, or 2.0 percent of non-guaranteed loans outstanding when loans to Farm Credit associations are excluded. "Our strong reserve functions as an important safeguard for the bank's capital foundation against loan losses resulting from the economic turmoil of the last several quarters and its impact on our customer base," McBride said. "The bank's shareholders continue to benefit from our prudent and disciplined approach with regard to loan loss reserves."

Capital levels at the bank remain strong and well in excess of regulatory minimums. As of March 31, 2010, shareholders' equity totaled $4.1 billion, and the bank's permanent capital ratio was 15.2 percent, compared to the 7.0 percent minimum established by the Farm Credit Administration, the bank's regulator.

At quarter end, the bank held approximately $12.7 billion in cash and investments. CoBank averaged 251 days of liquidity during the first three months of the year, compared with the FCA's 90-day regulatory minimum. "As global credit markets have continued to stabilize over the past several months, we expect to adjust our liquidity position closer to our management target of 180 days over the balance of the year," McBride said.

Engel noted that the cooperative model continues to provide significant advantages for CoBank in the face of prolonged uncertainty and volatility on the economic, political and regulatory landscapes. "We are fortunate that our board – and our base of customer-owners – understand the importance of managing for the long term and protecting our bank's foundation of strength and stability," he said. "CoBank's cooperative structure provides a strong alignment of interests in that regard. We're pleased that the bank's value proposition continues to resonate so strongly with our customers and that we have been successful meeting our customers' needs as their financial partner."