CoBANK

OUTLOOK Economic Data and Commentary

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# Currency Futures: What Next for the Eurozone?



The agreement reached in the middle of August by Greece and the European Commission on a $95 billion bailout was supposed to help settle the global economy, but it was almost immediately followed by reports of a slowdown in China, which triggered turmoil in stock markets around the world. Any expectation that a Greek resolution was the only thing necessary to calm the global economy was quickly dispatched.

Still, European leaders seemed to think the agreement was a step forward, both for Greece and for the future of the euro. "If implemented with determination, the deal will allow the Greek economy to return to growth," said Jeroen Dijsselbloen, head of the Eurogroup, the collective of finance ministers from the Eurozone countries. Perhaps more importantly, the deal ensures the survival of the euro, the single currency shared by those 19 Eurozone nations – at least for the time being.

A lot is riding on that survival, and not just for Europe, says Menzie Chinn, Professor of Public Affairs and Economics at the University of Wisconsin's Robert M. La Follette School of Public Affairs and the co-editor of the *Journal of International Money and Finance.* In an ever more intertwined global economy, what happens in Europe over the next several years will directly impact the United States in everything from exports of U.S. goods to the interest rates we pay for borrowing money. Dr. Chinn talked to *OUTLOOK* about what the euro can and can't do for the nations of Europe, and what it might do to our economy here at home.

***OUTLOOK: The euro's official rollout in early 2002 was greeted as a miracle of European cooperation. In retrospect, was that excitement unwarranted?***

**Menzie Chinn:** The excitement was warranted, given the economic and political hurdles that European leaders overcame. But the key thing to understand is that the euro was essentially a political achievement aimed at uniting Europe, rather than a financial one. From a political standpoint, it was remarkable. From an economic standpoint, there were serious structural flaws at the euro's inception that have proven tremendously difficult to overcome.

**This Month's Expert**

Menzie Chinn is Professor of Public Affairs and Economics at the Robert M. La Follette School of Public Affairs at The University of Wisconsin-Madison and the coeditor of the *Journal of International Money and Finance.* He is the coauthor, with Jeffrey Frieden, of a paper, "The Eurozone in Crisis: Origins and Prospects," and of the book, *Lost Decades: The Making of America's Debt Crisis and the Long Recovery.*

Dr. Chinn is a research associate in the International Finance and Macroeconomics Program of the National Bureau of Economic Research and served as senior economist for international finance on the White House Council of Economic Advisers in 2000–01. He has been visiting scholar at the International Monetary Fund, the Congressional Budget Office, the Federal Reserve Board, the European Central Bank and the Banque de France.

The biggest flaw was that the set of member countries, from the outset, didn't represent what's known among economists as an "optimal currency area." That refers to countries that tend to be hit by the same economic shocks in the same way, enabling a common monetary policy to respond appropriately. You might have Germany, France, Belgium, Luxembourg, and Austria all experiencing a boom in exports, for example. From an economic perspective, it might make sense to tighten monetary policy to prevent those economies from overheating. But when you throw Greece, Ireland, Italy, Portugal, and Spain into the mix, if those countries haven't been experiencing the same boom, tightening might throw them into recession. So what's good for some member nations may be bad for others. It's very difficult to set an appropriate common monetary policy under those circumstances.

To be sure, the common currency does have real economic benefits for member countries. Having multiple currencies is both bothersome and costly, injecting currency transactions into every cross-border sale or investment, and forcing people to consider currency fluctuations minute by minute. This is expensive and impedes the flow of capital and goods across borders.

At the same time, having separate currencies enables individual countries to raise or lower currency value in response to economic conditions – say, weakening your currency to stimulate exports, as we've seen in China. For individual countries, joining the euro meant giving up this valuable economic shock absorber. That's the problem that hasn't been addressed by the Eurozone yet.

***OUTLOOK: And yet, for the first several years, the euro looked like an unqualified success.***

**MC:** As it turned out, that perception became part of the problem. Across the Eurozone there was a sense of the disappearance of risk. Once Europe was united in this common currency, banks in Germany and France went wild, lending to countries in the South, without considering the likelihood of being paid back. I think the assumption was that the powers that be would never let the euro project fail. If you look at interest rate spreads between German government bonds and Spanish or Italian government bonds around 2005, you would essentially see no difference, which is the same thing as saying they carried equal risk. Would anybody really think that German bonds and Italian bonds carry equal risk? No. So why were the spreads so small? I don't think anybody could answer that question.

> I think there's a realization among policymakers that austerity alone – telling countries they have to tough it out, cut spending, and raise taxes, then everything will be solved – doesn't work.

***OUTLOOK: Didn't European leaders foresee these problems?***

**MC:** I believe European officials pushing forward with the euro project thought that by binding the countries tighter and tighter over time with common regulations on labor and private markets and eliminating trade and financial barriers, eventually the countries integrate into an optimal currency area, and governments would warm to the idea of binding themselves tighter and tighter in terms of fiscal policy. And then you'd get to the end goal of a united Europe. I've never been particularly optimistic that it could happen in short order. Even before this summer's blowup with Greece, it seemed clear that this process would take a long, long time. But I didn't anticipate the blowup would be this big.

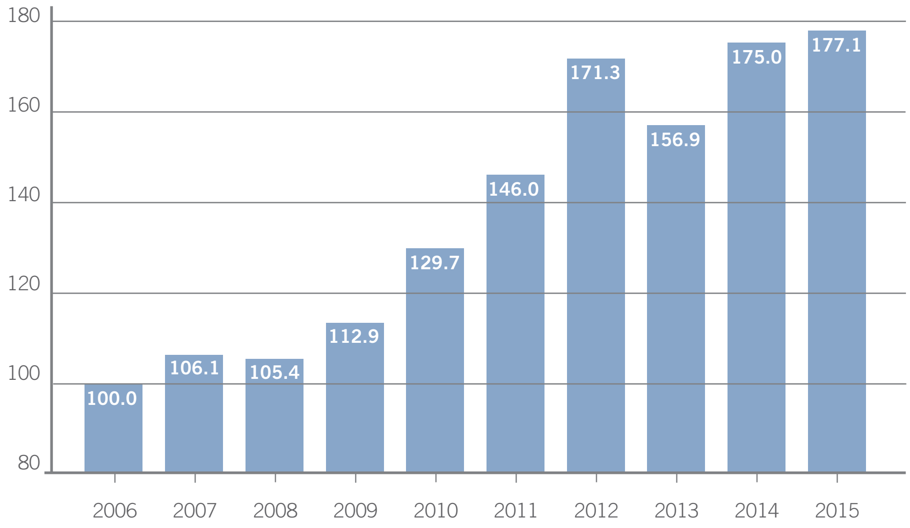
***OUTLOOK: How do you assess the recent bailout of Greece? Does this represent a long-term solution?***

**MC:** This latest bailout isn't solving the problem. It's just kicking the can down the road, deferring the problem for a year or, at most, two. You've got a government debt-to-GDP ratio in Greece of about 170%, which will continue to rise, or at the very least won't decrease. And with the debt ratio so high, who's going to lend to anyone in that country? And if nobody's lending to anyone, where will they get the investment to build new companies? What will happen to unemployment? And on it goes.

Barring some kind of miracle, it's hard to see how they're on a sustainable path. Eventually, there's going to have to be some kind of European resolution involving a write-down of Greece's debt. Actually, the bailout is a form of write-down, since stretching out the time over which they can pay lowers the present value of the debt. But there's got to be something more.

I think there's a realization among policymakers that austerity alone – telling countries they have to tough it out, cut spending, and raise taxes, then everything will be solved – doesn't work. Certainly, countries in trouble will have to continue to make adjustments in wages and prices in order to become more competitive and some, such as Ireland, have already done a lot in that direction. But at some point there will have to be a write-down that gives debtor countries a fresh start. And, intellectually, leaders understand that.

## RATIO OF GREEK GOVERNMENT DEBT TO GDP




*Source: Trading Economics*

The problem is that after successive bailouts, most of the debt has transferred from private creditor banks to public institutions such as the ECB, the European Union, and the International Monetary Fund – which means that any write-down will have to be borne in part by the taxpayers. How popular will that be? Even if there's an intellectual understanding of what needs to be done, that doesn't mean you have the political wherewithal to do it.

***OUTLOOK: What would happen if a European country exited the Eurozone?***

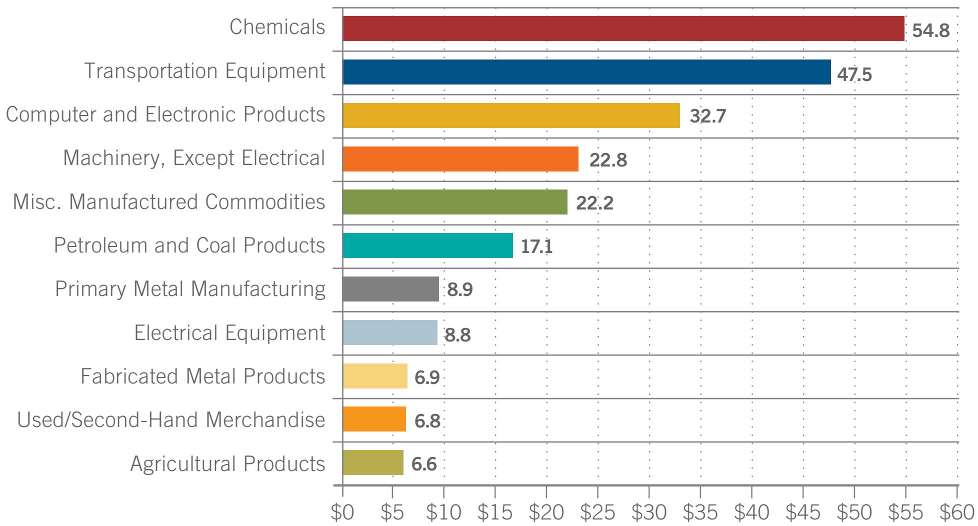
**MC:** There's no legal provision for a country to exit from the Eurozone. By design, membership was irrevocable. Once you enter, there's no way out. Because it's impossible to know what an exit looks like, it's hard to say what the implications would be. I think it might be possible for the Eurozone to survive one exit, assuming it's a smaller country. The danger is that after that first one, other countries would be watching closely and assessing the pluses and minuses of leaving. If two or three countries, or a single large country such as Italy, were to leave, all bets are off. It's hard to see how to sustain the whole framework of the euro, politically, economically and financially, if that happens.

***OUTLOOK: Does the American economy benefit from uncertainty about the euro?***

**MC:** If you're in Spain, and you're worried that your country might ultimately get kicked out of the Eurozone, it's likely you'll convert your euros to dollars and buy U.S. Treasuries, which are widely seen as the safest investments in the world. So a continuing crisis in the Eurozone would likely lead to increased European capital investments in the United States. That would push down U.S. interest rates, which might be seen as a good thing for American borrowers, since it reduces borrowing costs. And things made in Europe would be sold at cheaper prices in the United States, helping importers. But there's always the danger of supply disruptions if things get bad. The bottom line is that you'd really prefer to have more stability.

## LEADING INDUSTRY EXPORTS TO EUROPE IN 2014

IN BILLIONS




*Source: TradeStats Express*

***OUTLOOK: There large disparities among the U.S. states. Why does Europe's single currency struggle while the dollar remains stable?***

**MC:** A fiscal union means you've got to commit to making large transfers of money from one state or country to another, when one is going through a period of trouble. The taxpayers in European countries were unprepared at the launch of the euro to harmonize the taxation and spending system across Europe, and harmonize how they spend money on bridges and roads. In contrast, in the United States, there is a common Federal taxation and spending system, particularly after the New Deal.

Moreover, we have a monetary policy that better fits for all the states within the union. In Europe, when an individual country goes into recession, they have to tax their people or borrow to maintain government spending. When the banking system in Spain got into trouble, the government of Spain had to bail out the banks, and now the government of Spain is a bad credit risk. Nobody's going to help them. Brussels is not going to spend a lot on, say, Portugal. In the United States, individual states do raise taxes and borrow, but they're not going to build a comparable level of debt. That's because, when California goes into a downturn, the U.S. government sends more revenue to California to cushion the blow. And the process reverses when California booms, and other states enter a downturn. In other words, we share the risk throughout the whole country. The federal government builds up debt, which can be a problem, but it has a better means of taxing to sustain the debt it's incurring.

Finally, in the United States, we also have labor migration that acts as a natural pressure release valve. People can move to where the jobs are. Europe technically has open borders and labor migration as well, but in a practical sense, language and cultural barriers make it much more difficult to pick up and leave your country than your U.S. state.

Finally, the U.S. has a more rapidly growing economy. When you think of debt sustainability, the question is, what's the general path of your debt divided by GDP? If you have economic growth, the denominator – GDP – is growing faster, and that just makes things look better moving out into the future.

***OUTLOOK: Why should Americans care about what's going on internally in Europe?***

**MC:** The Eurozone is the world's largest economy in terms of GDP. We want financial stability within the Eurozone because global financial markets today are so tightly integrated. And the greater the uncertainties and turbulence of financial markets, the less likely people are going to be to consume, both in the United States and abroad, and the less likely companies are going to be to invest, building new plants and equipment. Investment has already been pretty lackluster since the financial crisis of 2008. The bottom line is, you don't want more turbulence in the world's largest economy.

***OUTLOOK: How long do we have until European troubles present a serious problem for the U.S. economy?***

**MC:** There's no way to tell for sure. But, say we go through the next five years with the same sort of grinding non-resolution in Europe we've got right now. Five years seems hard to imagine, but it's amazing how long this crisis has stretched out already. That means we'd be looking at five years missing a powerful engine of global economic growth.

Here's the real danger: Think of the U.S., Europe, and China as three legs of the global economy. China has a big question mark hanging over it right now. If Europe's out of the action, that leaves the United States as the sole leg sustaining growth. I'm quite confident that someday there's going to be another recession in the United States. I don't know when, and I don't think it's going to be soon. But if China and Europe are in the doldrums when that happens, that's a serious, serious situation. People and companies who've made plans based on even moderate economic growth will see prices falling, and it all feeds on itself like we saw in 2008. And you don't even need a 2008-type financial crisis for things to become quite painful. To me, that's why it's so important for Europe to get back on its feet. ■

# Interest Rates and Economic Indicators

*The interest rate and economic data on this page were updated as of 7/31/15. 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 and Blue Chip Economic Indicators*

| | | | | US Treasury Securities | |
|---|---|---|---|---|---|
| **2015** | **GDP** | **CPI** | **Funds** | **2-year** | **10-year** |
| Q3 | 3.20% | 2.20% | 0.17% | 0.92% | 2.42% |
| Q4 | 3.00% | 1.90% | 0.29% | 1.12% | 2.52% |
| **2016** | **GDP** | **CPI** | **Funds** | **2-year** | **10-year** |
| Q1 | 2.70% | 2.10% | 0.43% | 1.38% | 2.69% |
| Q2 | 2.80% | 2.30% | 0.59% | 1.65% | 2.85% |
| Q3 | 2.70% | 2.40% | 0.75% | 1.94% | 3.05% |

### 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 SWAP RATES

| Years Forward | 3-month LIBOR | 1-year Swap | 3-year Swap | 5-year Swap | 7-year Swap | 10-year Swap |
|---|---|---|---|---|---|---|
| Today | 0.31% | 0.54% | 1.19% | 1.64% | 1.95% | 2.23% |
| 0.25 | 0.47% | 0.70% | 1.35% | 1.74% | 2.03% | 2.28% |
| 0.50 | 0.60% | 0.87% | 1.49% | 1.85% | 2.12% | 2.35% |
| 0.75 | 0.79% | 1.07% | 1.62% | 1.98% | 2.22% | 2.43% |
| 1.00 | 0.98% | 1.22% | 1.73% | 2.06% | 2.28% | 2.47% |
| 1.50 | 1.32% | 1.58% | 1.97% | 2.26% | 2.44% | 2.60% |
| 2.00 | 1.67% | 1.79% | 2.14% | 2.38% | 2.53% | 2.66% |
| 2.50 | 1.86% | 1.98% | 2.30% | 2.50% | 2.62% | 2.73% |
| 3.00 | 2.05% | 2.17% | 2.45% | 2.61% | 2.71% | 2.80% |
| 4.00 | 2.36% | 2.48% | 2.67% | 2.77% | 2.83% | 2.89% |
| 5.00 | 2.61% | 2.70% | 2.81% | 2.89% | 2.92% | 2.95% |

### 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**

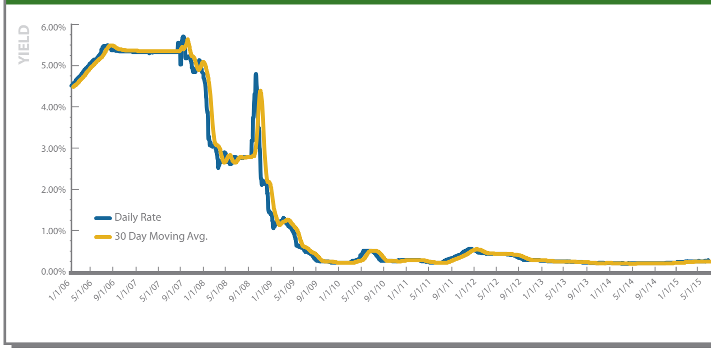
| Forward Period (Days) | Average Life of Loan | | | |
|---|---|---|---|---|
| | 2-yr | 3-yr | 5-yr | 10-yr |
| 30 | 8 | 8 | 7 | 5 |
| 90 | 17 | 20 | 16 | 12 |
| 180 | 30 | 36 | 28 | 22 |
| 365 | 66 | 75 | 59 | 43 |

*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.

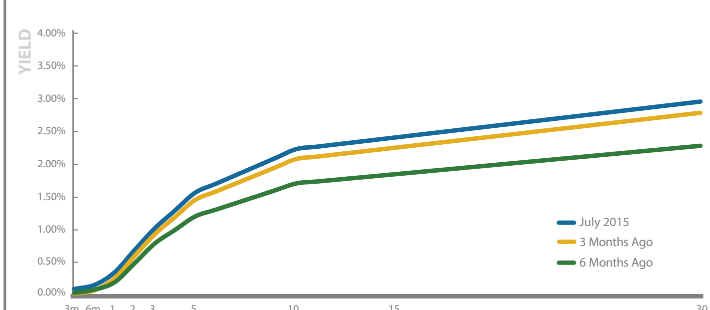
## 3-MONTH LIBOR




### 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 Second Quarter Financial Results

CoBank, a cooperative bank serving agribusinesses, rural infrastructure providers and Farm Credit associations throughout the United States, recently announced its financial results for the second quarter and first six months of 2015.

Net income for the second quarter was $232.3 million, compared to $232.9 million in the second quarter of 2014. For the first six months of 2015, net income was $464.6 million, compared with $464.2 million in the same period last year. Those results reflected a $25 million loan-loss reversal taken in the second quarter of 2014 and a $10 million provision for loan losses recorded in the first quarter of 2015. The earnings impact of the difference in the provision for loan losses was generally offset by changes in noninterest income.

Net interest income for the second quarter was $309.4 million, compared with $311.4 million in the same period last year. For the first six months of 2015, net interest income was $624.6 million, compared with $620.3 million in the prior-year period. The impact of higher average loan volume on net interest income was offset by spread compression in the bank's loan and investment portfolios, as well as a reduction in the amount of income from net accretion of asset and liability fair value adjustments resulting from the application of business combination accounting standards in connection with the bank's 2012 merger with U.S. AgBank.

*Robert B. Engel*

"We're pleased with both the quarterly and year-to-date results of our business, including solid growth in our portfolio across all of our operating segments," said Robert B. Engel, CoBank's chief executive officer. "In addition to loan growth, CoBank's profitability, credit quality and liquidity all remain strong. Most importantly, the bank continues to fulfill its mission by providing dependable credit and financial services to vital rural industries."

Average loan volume rose 5.5 percent during the quarter to $81.1 billion, from $76.9 billion in the second quarter of 2014. For the first six months of 2015, average loan volume rose 5.4 percent to $80.9 billion. The increases resulted from higher levels of borrowing from customers in a number of industries, notably affiliated Farm Credit associations, rural electric cooperatives, rural communications service providers and food and agribusiness companies.

**About CoBank**

CoBank is a $107 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. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving more than 75,000 farmers, ranchers and other rural borrowers in 23 states around the country.

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. 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.

Noninterest income was an important driver of results for both the quarter and year-to-date periods. In the second quarter of 2015, noninterest income was $49.9 million, compared with $18.8 million in the same period last year. For the first six months of the year, noninterest income was $96.8 million, compared to $57.0 million in the first six months of 2014. The increases in noninterest income included higher gains on sales of investment securities, partially offset by impairment losses on other investment securities. The 2014 period included net losses on debt extinguishments in excess of prepayment income, whereas prepayment income exceeded debt extinguishment losses in the first six months of 2015.

At quarter-end, 1.69 percent of the bank's loans were classified as adverse assets, compared with 1.84 percent at December 31, 2014. Nonaccrual loans increased to $136.6 million at June 30, 2015, from $130.3 million at December 31, 2014. The bank's allowance for credit losses totaled $602.2 million at quarter-end or 1.50 percent of non-guaranteed loans when loans to Farm Credit associations are excluded.

*David P. Burlage*

"Overall, loan quality measures for CoBank remain very strong," said David P. Burlage, chief financial officer. "We continue to benefit from the credit profile of the industries we serve, all of which produce essential goods and services in rural communities."

Capital levels remain well in excess of regulatory minimums. As of June 30, 2015, shareholders' equity totaled $7.6 billion, and the bank's permanent capital ratio was 15.7 percent, compared with the 7.0 percent minimum established by the Farm Credit Administration (FCA), the bank's independent regulator. At quarter-end, the bank held approximately $24.0 billion in cash and investments and had 188 days of liquidity, which was in excess of FCA liquidity requirements.

Engel noted that, despite a solid second quarter, the bank continues to face challenging market conditions that have impacted and could continue to impact earnings and overall financial performance this year.

"CoBank's margins remain under pressure due to artificially low interest rates as well as intense competition in the banking industry for the business of our customers," Engel said. "The low rate environment also continues to pressure earnings on invested capital. Meanwhile, we continue to make significant investments in people, processes and systems in order to fulfill our promises to meet the financial needs of our customer-owners and provide continued support to the sustainability and vibrancy of rural America. As always, we are thankful for the leadership and support provided by our board, which enables us to focus on building the long-term strength and capacity of CoBank rather than on short-term financial results."