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OUTLOOK Economic Data and Commentary

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China's Economic Slowdown

Through years of global economic volatility, one of the few constants has been China's remarkable GDP growth, chugging along at 10 percent per year since the early 1980s. Then, this past summer, all that changed. The Shanghai Index dropped 8 percent in August, erasing more than $1 trillion in value from Chinese stocks and capping a 38 percent decrease from highs earlier in the summer. The same month, the Chinese devalued their currency, the yuan, by 1.9 percent against the dollar. China's official GDP growth figure now sits at around 7 percent.

The ramifications of this are troubling, since countries around the world have come to rely upon China's seemingly boundless appetite for everything from raw materials to designer shoes. Could China's economic miracle be coming to an end? And what would that mean for the global economy?

It's time for a deep breath, says David Dollar, senior fellow in Foreign Policy and Global Economy and Development for the Brookings Institution. While the Chinese slowdown is real, Dr. Dollar – who served as the U.S. Treasury's economic and financial emissary to China from 2009 to 2013 – believes fears of economic collapse are just as unrealistic as the idea that China could maintain rampant growth forever. He spoke with *OUTLOOK* about steps China must take to avoid a worst-case scenario, why he believes China's middle class will keep growing, and what U.S. agriculture and other industries that do business with China can expect in the months ahead.

OUTLOOK: Just a few years ago, China's economic progress seemed unstoppable. Are the recent troubles growing pains, or something more?

David Dollar: It was inevitable that China's growth rate would slow from the 10 percent average we had seen for years. The big question now is, how much? Visiting Seattle in September, Chinese President Xi Jinping targeted 7 percent as a good GDP growth goal for the middle-income country that China has become. And he emphasized that it's natural to have some bumps.

On the other hand, the worldwide market sell-off we saw over the summer betrays fears that China might be slowing down much more aggressively. So we're looking at two possible scenarios – 7 percent versus something much lower. I don't take the most dire predictions of slowdown very seriously, because there's still plenty of room for growth in the Chinese middle class. But it's possible that China could slow to 4 or 5 percent for the foreseeable future. That would have quite a large impact on the global economy – especially countries that rely on commodities exports to China.

OUTLOOK: Why was 10 percent growth unsustainable?

DD: It's easier to grow at 10 percent when you're poor and you're overcoming problems related to poverty. When your GDP is $1,000 per capita, 10 percent growth means you're adding $100 per year. Well, now China is at $10,000. So to grow at 10 percent, they'd have to add $1,000 per capita. Nobody's ever done that. Think about a start-up company. When you're a small player, your market growth can be off the charts. Once you're one of the big players, that's much harder. If China can maintain 7 percent growth, that means $700 per capita. Not only is that very good by historical standards, in real terms it's adding more real value than when you're a poor country growing at 10 percent. That's simple mathematics.

OUTLOOK: Until this summer, China's shift from an export-driven economy to a more balanced, consumer-driven economy seemed orderly and well-planned. What hurdles did Chinese leaders not foresee?

DD: They knew they'd relied too heavily on exports, and they've built up a lot of excess capacity in a number of areas. So in the first half of the year, industrial growth was slowing while consumption, based primarily on services, was growing. The Chinese would like to control this and see a very gradual transformation. What they didn't foresee was the potential for industry to slow down much more aggressively than they planned. In some ways, I don't think they realized what a true market economy they've built, and what happens when you have excess capacity and declining profits. You get less investment.

OUTLOOK: Did we see the worst of China's economic troubles over the summer, or do you foresee more disruptions?

DD: I think we've probably seen the worst in terms of the Chinese stock market. They had a big bubble that has now corrected by about 40 percent. It's still a little high in terms of valuations, but it's in the ballpark of where it should be. Still, markets globally remain very worried that we're going to see more disruptions.

The Chinese didn't do themselves any favors in August when they devalued the yuan by 1.9 percent against the dollar. The goal, ostensibly, was to

This Month's Expert

David Dollar is a senior fellow in Foreign Policy and Global Economy and Development for the Brookings Institution. An acknowledged authority on the Chinese economy and U.S.-China economic relations, he served from 2009 to 2013 as the U.S. Treasury's economic and financial emissary to China. In that role, he oversaw economic and financial policy discussions between the two countries, and kept Washington informed on economic and policy developments in China.

From 2004 to 2009, Dollar served as country director for China and Mongolia for the World Bank. His other World Bank assignments primarily focused on Asian economies, including South Korea, Vietnam, Cambodia, Thailand, Bangladesh, and India.

DOLLAR VS. YUAN

Source: XE.com

jumpstart the economy by making their exports cheaper – but 1.9 percent was too small to have any tangible impact in that area. On the other hand, symbolically, the move added a lot of uncertainty to global markets. The gradual appreciation of the yuan against the dollar has been a source of stability for the world economy for years. All of a sudden people are wondering, could there be a larger Chinese devaluation ahead?

OUTLOOK: How likely do you think that is?

DD: For practical reasons, I think it's unlikely. A lot of the developing world is in trouble because commodity prices and volumes have dropped. So if China tries to devalue in any significant way, other developing countries will get out ahead of that, devaluing their own currencies in order to make their exports more attractive. That means China, in real terms, wouldn't get that much out of devaluation. All of which simply makes the 1.9 percent drop in August more perplexing. It's hard to know what they were thinking. I was happy to see Xi Jinping say in September that he sees no basis for further devaluation.

OUTLOOK: You've written that China's troubles are a sign of "real reform lagging financial reform." Could you elaborate?

DD: China has moved fairly quickly on financial reforms such as deregulating interest rates almost completely, and introducing deposit protection to make sure households understand the difference between a protected, insured bank deposit versus nonbanking activity that's inherently risky. But they've also pledged to reform other sectors of the economy, and this is taking much, much longer. For example, they said they would reform state-run enterprises, open up service sectors of the economy and allow greater labor mobility.

There's a tremendous need for better health care in China, as well as assisted living for the rapidly aging population, which is a more serious problem in China than in the United States. There are entire sectors where foreign capital could come in and do innovative things. These reforms would spur productivity growth and efficient investment, and make Chinese companies more innovative and efficient. Unfortunately, the leadership is not moving ahead on any of these reforms in any significant way.

OUTLOOK: What's stopping them?

DD: It made sense for China as a resource-poor country to develop

> At the highest levels, the Chinese are worried that foreigners will come in and outcompete their domestic firms.

manufacturing exports and bring in foreign capital and technology to support that. But services such as telecommunications, logistics, health care and airlines are dominated by a small number of state enterprises that are often connected with individual families. They don't want to open up. They've got a nice, protected environment. At the highest levels, they're worried that foreigners will come in and outcompete their domestic firms.

OUTLOOK: Why is labor mobility important?

DD: To develop its manufacturing, China has allowed workers to move, but with restrictions. Those coming from the countryside are legally classified as migrant workers and cannot become citizens of a city. Usually they live in dormitories, and if there's a downturn, they're expected to go back to their villages.

While that system helped keep labor costs and the price of exports low, shifting toward a more service-oriented economy means China has to build domestic demand. But they've got a majority of the population with rural registration, meaning that these workers can't bring their families to cities and participate in the growing consumer economy. At the more skilled end of the labor market, such as Internet or telecommunications, you need talented people who are mobile. But it's hard for skilled workers to move around in the Chinese system as well. Breaking down some of those barriers would be a natural way to increase productivity.

OUTLOOK: Mobility implies greater individual freedom. To what extent must financial reforms in China be accompanied by other freedoms, such as the press?

DD: That's a great question. Historically, countries have been able to develop capitalism under an authoritarian political system in the early phases of their economic growth. But as incomes rise, they usually transition to greater civil liberties, freedom of the press, and democracy. And when people have more economic freedom, they naturally want more political freedom.

The Chinese Communist Party leadership is trying to keep control of the Internet and the media. They're resisting overt moves toward political

> The outlook for agricultural exports is pretty positive. There's a big difference between commodities used in construction versus food. China's middle class will continue to grow and demand more meat, vegetables and fruits.

liberalization. It's going to be a bigger and bigger contradiction for them to deal with. One hundred million Chinese went abroad last year, and there are 250,000 Chinese students in the United States. That's small relative to China's overall population, but it's still a big number, and it's bound to have an effect on the way people look at freedom.

OUTLOOK: If the Chinese economy were to suffer a serious decline, might the leadership abandon market capitalism and return to more traditional communist economy?

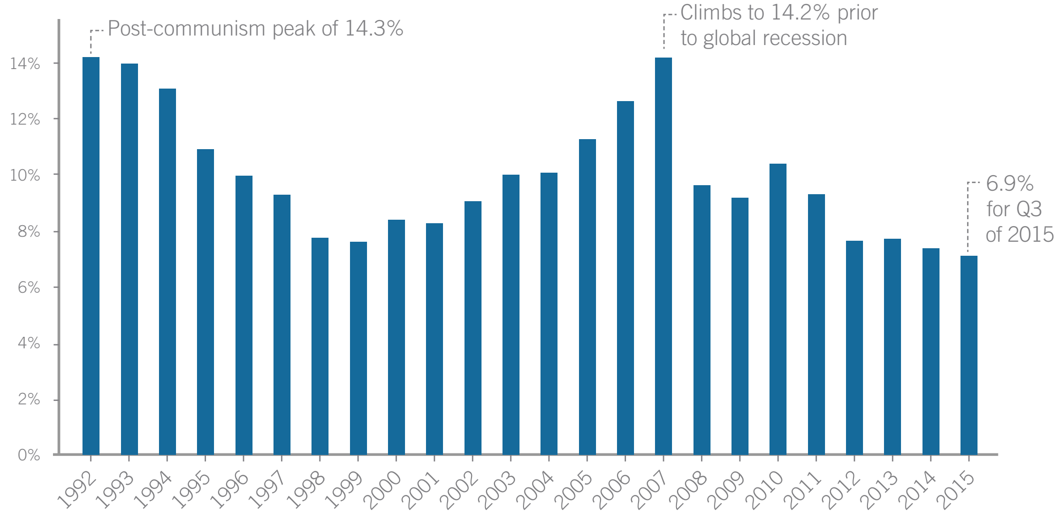
DD: That's very unlikely. The Communist Party's legitimacy with the Chinese people depends on delivering the economic goods, which is directly related to free markets. If they were to roll back market freedoms in any significant way, I think they would be risking their viability.

OUTLOOK: In August, the U.S. stock market dropped suddenly on bad news from China. What does this say about the interconnectedness of our nations' economies?

DD: Actually, the direct economic relationship between the U.S. and China is quite small. Less than 1 percent of U.S. exports go to China, and only about 1 percent of U.S. overseas investment is in China. But we do face significant indirect risks. China is the main trading partner for more than 100 countries around the world. As China slows down, the dropping demand for iron, copper, and minerals used in construction and manufacturing is creating problems for Asia, Australia, Africa, and much of Latin America. If things get much worse for Mexico and the rest of Latin America, where our direct economic ties are greater, we could certainly catch that cold. Federal Reserve chair Janet Yellen was pretty clear that China was the main reason the U.S. in September held off raising interest rates.

OUTLOOK: China does directly account for 20 percent of U.S. agricultural exports. What's the outlook there?

CHINA'S GDP GROWTH RATE



Source: Fortune.com

DD: Unlike, say, exporters of copper, the outlook for agriculture is pretty positive. There's a big difference between commodities used in construction versus food. China has overbuilt real estate and won't need new construction for a long time, even if the overall economy does well. But China's middle class will continue to grow and demand more meat, vegetables and fruits. The same holds true for China's appetite for U.S. and European luxury goods. Even if Chinese growth slows to 4 percent, that still represents growth in a huge market.

OUTLOOK: What about other U.S. exports, such as heavy machinery?

DD: China's demand for heavy machinery is slowing down. I think you already see it reflected in the stock prices of U.S. machinery firms, and Caterpillar cited China as a factor in its plans to cut up to 10,000 jobs. On the other hand, Boeing just announced China will be buying 300 new planes. So there is some demand for U.S. machinery at the high end, but much less than we saw during the heyday.

OUTLOOK: Could China lead the United States into another recession?

DD: I'd describe that as unlikely but possible. Here's how it could happen: As opportunities in China's industrial and real estate sectors have slowed, the Chinese are looking for investments overseas for their enormous pool of savings. As long as it happens in an orderly way, that capital outflow from China benefits the rest of the world, including the United States. The bad scenario would be if the Chinese people really start losing confidence in their economy, and capital outflow gets out of control. That might depress China's currency, causing other countries to follow suit. That's something the United States would not be able to insulate itself from, since a sharp rise in the dollar would harm U.S. exports. I consider that a relatively low probability, but it's definitely something that markets are worried about.

OUTLOOK: What is happening to the wealth of individual Chinese citizens, who have made such incredible progress in recent years?

DD: It's true that Chinese stocks endured a 40 percent correction this past summer, and some people were clearly hurt. But keep in mind that before the correction we saw a sizable bubble, so even with the drop the Chinese stock market remains higher than it was a year ago. Another mitigating factor is that Chinese on average invest only about 5 percent of their household wealth in the stock market, so the exposure of individual families to the correction was not huge. Most of their wealth is in real estate, which has gone flat, but hasn't plummeted. So Chinese households still have a lot of wealth. Many are buying real estate in California and investing in the U.S. stock market.

OUTLOOK: Will the Chinese middle class continue to develop as consumers and, from a U.S. perspective, a market for U.S. products?

DD: That's going to happen under just about any scenario. The big question is, how fast? If China maintains the 7 percent growth they've targeted, they'll double their GDP in about a decade. If they slip down to 4 percent growth, it'll take 20 years. China's actions in the months ahead will be crucial.

Unless they open up markets, including services, to foreign investment, it's going to be hard to hit that 7 percent. But either way, you're talking about hundreds of millions of additional members of the middle class. Ultimately, that's good for China, and it's good for us.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 9/31/15. 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**
Q4	2.70%	1.30%	0.18%	1.04%	2.43%
2016	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.60%	1.90%	0.26%	1.29%	2.57%
Q2	2.80%	2.30%	0.34%	1.51%	2.72%
Q3	2.70%	2.30%	0.43%	1.73%	2.87%
Q4	2.60%	2.30%	0.56%	1.94%	2.99%

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	0.33%	0.46%	0.92%	1.31%	1.63%	1.92%
0.25	0.40%	0.54%	1.01%	1.39%	1.69%	1.93%
0.50	0.51%	0.65%	1.14%	1.49%	1.77%	1.99%
0.75	0.62%	0.80%	1.24%	1.60%	1.86%	2.12%
1.00	0.73%	0.89%	1.33%	1.67%	1.92%	2.11%
1.50	0.98%	1.16%	1.55%	1.86%	2.08%	2.29%
2.00	1.19%	1.36%	1.70%	1.98%	2.18%	2.31%
2.50	1.40%	1.55%	1.88%	2.12%	2.29%	2.42%
3.00	1.61%	1.74%	2.05%	2.26%	2.39%	2.53%
4.00	1.95%	2.07%	2.31%	2.46%	2.50%	2.65%
5.00	2.23%	2.34%	2.45%	2.62%	2.68%	2.73%

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

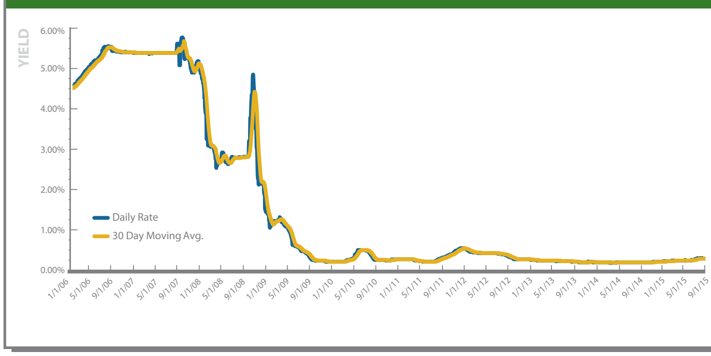
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	7	8	6	5
90	16	19	14	12
180	27	33	25	21
365	61	67	55	41

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.

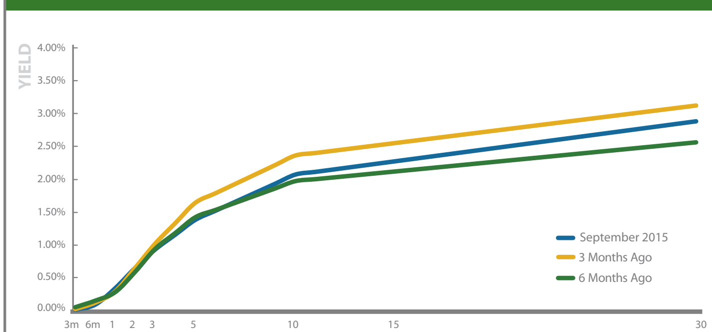
3-MONTH LIBOR



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, Colorado State University Open Doors to New Agricultural Center

The result of four years of planning and a year-long construction project, the new CoBank Center for Agricultural Education at Colorado State University opened its doors to students in September. The new complex is designed to help fill a void in agricultural education teachers for K-12 students and community colleges across Colorado and the United States.

The CoBank Center for Agricultural Education encompasses more than 14,000 square feet, with customized laboratory, technology, teaching and office space. The center includes a special exhibit space for the Farm Credit Colorado Agriculture Hall of Fame, a signature program of the Colorado Future Farmers of America Foundation. Not only will the center function as an academic space for faculty, staff and students, but it will also serve as a community meeting space, bringing together individuals from the agricultural industry, rural communities and local schools.

"It is essential that our students help educate the next generation about agriculture," said Ajay Menon, dean of the CSU College of Agricultural Sciences at the recent ribbon-cutting ceremony. "We know that we will have at least 9 billion people to feed globally by 2050, and many of those people are here in this country, in our state and throughout our counties. Our college will be at the forefront of innovations that will ensure that people are fed, clothed and healthy, and agricultural education is a key component of maintaining the longevity and viability of our industry."

CoBank president Mary McBride (in light blue jacket) at the opening of the CoBank Center for Agricultural Education.

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.

Fundraising for the center was led by the Colorado FFA Foundation, which helped raise $2.6 million of the $3.3 million needed for the new facility with significant private support. The lead gift was provided by CoBank and its Farm Credit Association partners American AgCredit, Farm Credit of Southern Colorado and Premier Farm Credit. The center sits just north of CSU's campus at the college's Agricultural Research, Development and Education Center.

"It did not take us long to see the value in this project." said Mary McBride, president of CoBank. "We know the future of agriculture, and the need that is out there for new teachers. I am delighted that CoBank and the Farm Credit System could play an important role in the construction of the home for the next generation of agricultural leaders."

The Agricultural Education program at CSU has seen significant expansion in recent years, growing from a single faculty member to two full-time faculty members and an instructor. The program is led by Assistant Professor Kellie Enns, who noted the impact the new center will have on young agriculturists.

"This building has been a dream for me, my colleagues, and my students for many years," said Enns. "So much time, thought, and planning went into creating a space that will position our students to go into classrooms across the state and around the country to teach agriculture to young people and inspire them to remain committed to the land and to the people that work on it."

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