CoBANK

OUTLOOK Economic Data and Commentary

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The Case For Free Markets

The debate in Washington over what to do next to revive the U.S. economy continues apace, with economists and political leaders sharply divided as to what policies offer the best way forward.

Some, like Nobel-prize winning economist Paul Krugman, argue that the federal government's stimulus programs are working as designed and that more Keynesian-style public spending is required to replace lost private-sector demand and fuel a self-sustaining recovery. In a recent column in the *New York Times*, for instance, Krugman argued that "running big deficits in the face of the worst economic slump since the 1930s is actually the right thing to do. If anything, deficits should be bigger than they are because the government should be doing more than it is to create jobs."

Others fear that the costs of stimulus are creating a giant burden that poses systemic, long-term risk for the economy. With the federal deficit exceeding $1.4 trillion in the 2009 fiscal year, there has been a backlash against government programs that add more to U.S. public debt.

George Melloan, who retired from *The Wall Street Journal* in 2006 after spending more than 33 years as a deputy editorial page editor, is one of the leading voices for those who believe that government is interfering too much. In his recent book, *The Great Money Binge*, Melloan proposes returning to Reagan-era policies of supply-side economics and limited government as a means for bringing the economy out of recession. Melloan recently talked with OUTLOOK about his take on the causes of the recession, how government has responded and what needs to happen next.

OUTLOOK: Many believe that the "Great Recession" was caused by a free market run amok without enough government oversight. You make the case that the opposite was true, that government intervention was part of the cause of the economic downturn. Why?

GM: The government has been intervening in the housing market for many years, dating all the way back to the New Deal. This intervention became especially intense in the 1990s, when the drive by the U.S. Department of Housing and Urban Development was for affordable housing. This brought about a liberalization of the terms that Fannie Mae and Freddie Mac could offer. The result was that a lot of very risky loans were written, mainly at the behest of the federal government. So those loans were bought up and guaranteed by Fannie Mae and Freddie Mac, folded into mortgage backed securities and sold around the world in huge numbers. It was those securities that began to go bad when the price of housing started to fall. The crisis in 2008 was basically engineered by the good intentions of the government to try to provide housing for a lot of people. That misfired.

It's never wise for the government to intervene too much. But this was a case where the government was actively promoting and demanding that the banks make what were basically risky loans. It is always a mistake for the government to intervene to that extent in the banking industry.

OUTLOOK: In hindsight, is there something that could have and should have been done differently from a public policy perspective?

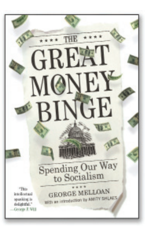
GM: Fannie and Freddie could have been brought under control a lot sooner. Their loan-to-capital ratios were expanded to the extent where they had ratios that were totally out of line with normal banking – which is something like 10-to-1 – and they were about 70-to-1. They could have been brought under stricter capital requirements. But that would have defeated the whole point of stimulating the housing market.

The other factor that came into play was the Federal Reserve. The Fed, in 2003, when recovery from the 2001 recession was well under way, decided to hold the interest rate target at where it had been during the recession. This resulted in a lot of money being created by the Fed, and a lot of that money flowed into housing, driving the price of housing up. Everybody remembers, I'm sure, that home prices were rising, and it wasn't because homes were becoming more valuable. It was because the Fed was inflating the currency, and so we had asset inflation. That contributed to the problem, because when that had run its course and home prices began to fall again, that's when sub-prime mortgage loans got into trouble.

OUTLOOK: Should the federal government, then, have bailed out the banks and the automakers?

GM: I argue in the book that Secretary of the Treasury Henry Paulson and the Fed over-reacted. I don't believe that anybody should have been bailed out. I think they should have been left to suffer the consequences. Of course, Paulson argues there was a terrible crisis and we had to do something. But they could have done some very simple things, such as

About this article



George Melloan worked for *The Wall Street Journal* for more than 50 years. He retired in 2006 as deputy editor of the paper's influential editorial page. His new book, *The Great Money Binge*, is based on the thesis that government intervention played a role in the creating recent recession and prevents the economy from recovering its natural balance.

George Melloan worked for *The Wall Street Journal* for more than 50 years and is author of *The Great Money Binge*

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suspending the mark-to-market rules, which requires banks to constantly try to set the value of their assets at the market level. The banks just had a liquidity crisis, it wasn't much beyond that. If they had suspended the mark-to-market rule, then most of them could have ridden out the crisis.

I just don't agree with the too-big-to-fail idea. If a bank is too big to fail, it is too big to exist, and it should suffer the consequences of whatever it does wrong.

OUTLOOK: Many predicted that without the bank bailout, the global economy would have spiraled into complete collapse. Do you think that was a real risk?

GM: I don't believe it was. They decided not to rescue Lehman Brothers, and Lehman went through bankruptcy and a work-out [Lehman's global assets were broken up and sold off to a variety of companies, including Barclays and Nomura Holdings]. The others would have done the same thing, worked out their own problems. They would have made deals with their counter-parties and straightened it all out. I just don't believe this idea that if the government doesn't intervene, then there is going to be some global systemic crisis. After all, bankers know how to get themselves out of trouble if you just let them.

OUTLOOK: Some experts believe the stimulus package helped save the economy and created jobs. You have said it did not work, in fact, and are critical of new government spending associated with the stimulus. Why?

GM: Our government has become big. It has become interventionist in a lot of things, and it's not improving the situation. Unemployment is still around 10 percent, which is far above the target [of approximately 8 percent] that was set in the stimulus package. I will admit that I've never had any confidence in Keynesian-type stimulus – it is basically a question of the government robbing Peter to pay Paul, Peter being the anonymous taxpayer and Paul being the person who is politically connected in some way and gets the money. It has no net effect of stimulating anything, really. It is just taking money from some people and giving it to others. Keynes would have argued that it creates velocity, brings money out of the mattresses or something, but I've never believed that. Keynes was a brilliant man and he said a lot of things, sometimes contradicting himself, but that particular thing was latched on to by politicians because it fit their particular needs to spend money for their constituencies. Keynes maybe is maligned a little bit too much when actually it was something that politicians adopted and embraced and they called it "Keynesianism."

OUTLOOK: What would have been a better government response to the recession?

GM: One response is that you can always achieve some stimulus by cutting tax rates. That does, in fact, work, and it also can cost the government revenues in the short-run. But in some cases – as Arthur Laffer has demonstrated from time to time – if you cut the rates, it actually increases revenue long-term. You can't use a static analysis, but cutting tax rates does stimulate the economy, so you recover some of the potential losses in new revenues. But governments really don't like to do that. It is much more convenient to take the money and spend it in ways that are more politically attractive. In the case of the stimulus, a lot of the money went to the states, which were in financial trouble, so in a way the stimulus package was just kind of a bailout for some states. It hasn't succeeded very well, because places like California and New York are still in very serious trouble.

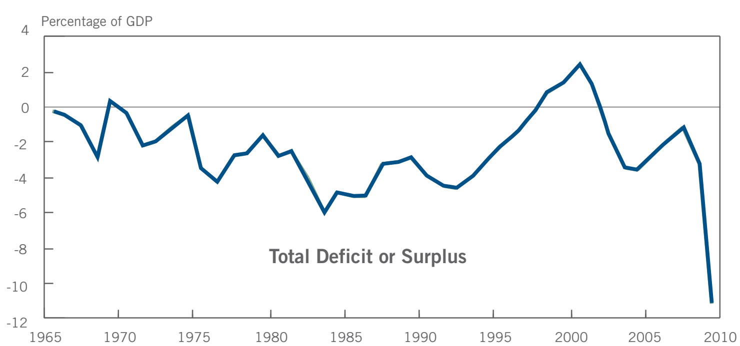
OUTLOOK: Laffer's basic theory is that tax rates have to be at the right level to maximize revenues – they can't be too high or too low. So, depending on where you fall on the Laffer Curve, you may need a tax cut – or a tax increase – to see an increase in revenue. How do we know a tax cut would have a stimulative effect and increase revenue?

GM: Yes, that's right. The Laffer Curve is just a restatement of the old law of diminishing returns. Every merchant knows if you get your price too high, you lose revenues rather than gain them. That's the way with taxes. At any level, a tax cut would provide some stimulative affect. It doesn't mean you get back more than you cut, but it does mean there is some economic stimulus. There's a lot to be said for that. It might be worth losing some government revenues if you can get the economy rolling again.

OUTLOOK: We've begun to see growth again from many sectors in the economy and some experts believe the worst is behind us. What's your assessment of the future?

GM: I think the future is still rather scary looking. Sure, the American economy is very powerful and has been trying to recover for about six months. But there is a big problem. The Federal Reserve has been buying enormous amounts of government paper, the Treasury securities and mortgage backed securities of Fannie Mae and Freddie Mac. When the Fed buys all that paper – and we're talking about trillions

TOTAL GOVERNMENT DEFICIT/SURPLUS AS A PERCENT OF GDP



Source: Congressional Budget Office

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of dollars – it creates money. The whole history of public finance is that when the Fed creates a lot of money to buy government debt, you ultimately get inflation, or you get stagnation caused by the enormous claims that government deficits make on the capital markets. Today, those claims are enormous. In the fiscal year 2009, the Treasury had to borrow net about $1.7 trillion, which doesn't even include state and local borrowing. That's a huge chunk out of even the global capital markets. When this kind of thing is happening – government running these huge, huge deficits – you face the prospect of inflation, stagnation or possibly both, as we had in the 1970s with stagflation.

I don't think this can continue, because the Fed is creating too much money. It is being held in reserve in the banks now, but it has the potential for generating inflation.

OUTLOOK: What should government do next to get that under control and head off inflationary pressure?

GM: Don't pass any more spending bills. Back away from health care reform, back away from cap and trade. The government can't go on this way. You can't keep building up huge deficits, because there is disaster at the end of that road.

OUTLOOK: Given some of the political reshuffling we've seen in recent months, the future of both health care reform and cap and trade legislation have been called into question. If lawmakers do end up passing legislation on those topics, what in your view would be the impact?

GM: More federal debt and larger federal deficits. Cap and trade is, in my view, ridiculous. The claim by congressional leaders that they can alter the climate by passing a law is a sign of megalomania. The bill passed by the House should be thrown in the wastebasket. It would be an enormous tax on energy, and we can't afford a huge tax on something as basic as energy.

Health care, even by conservative estimates, would add about $1 trillion over time to the federal deficit. When we are running deficits well over a $1 trillion now, why do we need another trillion? As I just pointed out, the Fed can't continue to directly finance deficits for the federal government. It can't go on doing that without creating inflation.

OUTLOOK: In your book, you equate such policies to socialism. Not everyone would agree with that assertion, but what is the danger there?

GM: Socialism is economically inefficient. You get poorer as a people. We saw that in dramatic fashion in the old Soviet Union, which I covered at one point as a journalist. It was an industrial nation, but a very poor industrial nation. People who would have been middle class in any other society were living in slum-like conditions in Moscow and St. Petersburg in state-owned apartment buildings.

Government is not good at running things, because there is no competition. Competition creates efficiency, and to have competition you have to have private players out there competing against each other. Government has no competition. Anybody who thinks they want socialism had better be prepared also for a less wealthy economy and lower standards of living.

I don't think we are still heading that way. I think there is a huge public reaction taking place out there, as we've seen with the elections in Virginia, New Jersey and Massachusetts. I think there is sort of a turning point here that is very interesting politically. But if either of these two programs make it into law – cap and trade or health care overhaul – they will be rather hard to reverse. There is the question of whether the public reaction has happened soon enough.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 1/31/10. 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**
Q3	2.20%	3.60%	0.16%	1.00%	3.50%
Q4	4.00%	3.10%	0.12%	0.90%	3.50%
2010	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.90%	1.70%	0.12%	1.00%	3.70%
Q2	2.80%	1.50%	0.14%	1.10%	3.90%
Q3	2.90%	1.90%	0.19%	1.10%	3.80%
Q4	3.00%	1.90%	0.19%	1.00%	3.70%

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	0.25%	0.85%	1.75%	2.67%	3.26%	3.75%
0.25	0.50%	1.07%	2.00%	2.88%	3.41%	3.87%
0.50	1.04%	1.27%	2.27%	3.09%	3.58%	4.00%
0.75	1.51%	1.37%	2.51%	3.28%	3.73%	4.12%
1.00	1.19%	1.39%	2.74%	3.45%	3.87%	4.22%
1.50	1.44%	2.09%	3.24%	3.83%	4.16%	4.45%
2.00	2.48%	2.97%	3.77%	4.20%	4.44%	4.68%
2.50	3.09%	3.45%	4.10%	4.45%	4.64%	4.83%
3.00	3.47%	3.88%	4.38%	4.64%	4.79%	4.95%
4.00	4.13%	4.47%	4.77%	4.91%	5.02%	5.12%
5.00	4.54%	4.82%	4.99%	5.08%	5.17%	5.23%

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

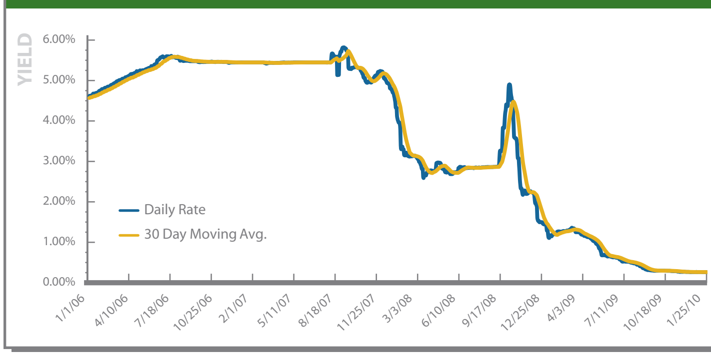
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	12	12	11	7
90	32	31	28	18
180	60	58	52	33
365	118	101	95	62

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.

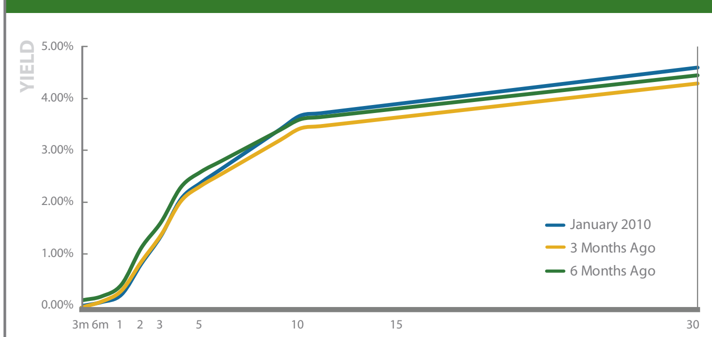
3-MONTH LIBOR



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 Full-Year Financial Results for 2009

On February 23, 2010, CoBank announced fourth-quarter and full-year financial results for 2009. Net interest income and net earnings reached all-time highs despite lower average loan volume during the year. Although loan quality declined as a result of impacts from the global recession on the bank's customer base, CoBank's overall levels of capital and liquidity remained strong.

"We're extremely pleased with the financial performance CoBank delivered in 2009 on behalf of customer-owners across rural America," said Robert B. Engel, president and chief executive officer. "Despite a very difficult market environment, the bank continued to fulfill its mission as a highly dependable source of credit for all the industries we serve. We remain focused on meeting our customers' borrowing needs, while protecting the bank's foundation of strength and stability for the long term."

Full-year net income was a record $565.4 million, up 6 percent from $533.4 million in 2008. Net income for the fourth quarter of 2009 was $132.6 million, compared with $84.6 million in the fourth quarter of 2008. Fourth-quarter net income in 2009 included a $25.0 million provision for loan losses, compared to a $55.0 million loan loss provision in the fourth quarter of 2008. Total provisions for loan losses for 2009 and 2008 were $80.0 million and $55.0 million, respectively.

Net interest income for the bank rose 10 percent to $946.0 million, from $862.6 million in 2008. The increase was primarily driven by improved margins, including the positive impact of the bank's balance sheet positioning throughout 2009. During the year, CoBank benefited from the steepened yield curve environment that resulted from actions taken by the world's central banks to counter the global recession.

Average loan volume during 2009 was $44.5 billion, down 2 percent from the prior year primarily due to lower seasonal financing requirements from agribusiness customers. As previously disclosed, seasonal agribusiness lending was reduced during the year due to the substantial drop in prices for grains and farm inputs from 2008's exceptionally high levels. Offsetting that decline was growth in other areas of the business, including U.S. government-guaranteed loans that support American agricultural exports, loans to energy customers, and loans to and participations with affiliated associations and other partners across the Farm Credit System.

"CoBank and its shareholders benefit from the diversification of our loan portfolio and the degree of balance we have among our agribusiness, rural infrastructure and Farm Credit System customers," Engel said.

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.

In March, the bank will pay $268.9 million in total patronage, including $183.8 million in cash and $85.1 million in common stock. For most customers, that represents 100 basis points of average loan volume, lowering their overall net cost of debt capital from CoBank.

"Patronage is an important benefit for organizations that choose CoBank as their lender," Engel said. "The strong patronage payout authorized by our board for 2009 underscores the strength of the cooperative model and the compelling value proposition that CoBank offers its customer-owners."

At year-end, 95.8 percent of the bank's loan and lease portfolio was classified in the highest regulatory category used to grade creditworthiness, compared to 96.0 percent at September 30, 2009, and 97.2 percent at December 31, 2008. Nonaccrual loans and leases decreased in the fourth quarter to $307.6 million from $442.5 million at September 30, 2009. The quarter-over-quarter improvement in nonaccruals was largely attributable to the successful resolution of a loan to a customer in the poultry industry. At the end of 2008, total nonaccrual loans for CoBank totaled $217.8 million.

At year-end, the bank's reserve for credit exposure totaled $498.2 million, or 2.0 percent of non-guaranteed loans and leases outstanding when loans to Farm Credit associations are excluded.

"We believe we are well-reserved for the credit risk inherent in our loan portfolio," said Mary McBride, CoBank's chief operating officer. "The bank's shareholders continue to benefit from the prudent and disciplined approach we have adopted with regard to loan loss reserves, which has kept the bank well protected in a difficult environment."

Capital and liquidity levels at the bank remain strong and well in excess of regulatory minimums. At year end, the bank held approximately $12.7 billion in cash and investments. The bank averaged 287 days of liquidity during 2009, compared with the 90-day minimum established by the Farm Credit Administration, the bank's regulator. "Throughout the year, we maintained higher levels of liquidity as a result of the credit crisis and its impact on funding flexibility," McBride said. "Given recent improvements in overall debt issuance and market capacity, we expect to adjust our liquidity position closer to our management target of 180 days."

Engel noted that CoBank's ongoing capacity to generate strong earnings is an important strategic advantage for the bank and its customers. "During a year that proved enormously difficult for many of the nation's financial institutions, CoBank was successful in generating record levels of net income to fund patronage, build capital, and cushion the bank from the negative impacts of the recession and credit crisis," Engel said. "Most importantly, we were able to stand by our customers and meet their needs for debt capital as their financial partner. We look forward to continuing to deliver on our value proposition for our customer-owners throughout 2010."