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Solving the Debt Crisis

Prior to the early August agreement by Congress to raise the federal government’s debt ceiling, Democrats and Republicans alike accused the other side of grandstanding, theatrics and willfully pushing America to the brink of financial disaster.

Theatrics aside, though, the debt ceiling fracas, along with Standard & Poor’s downgrade of U.S. debt from triple-A to double A-plus just days later, accomplished something quite important, says distinguished economist Douglas Holtz-Eakin: They got the whole country talking about the looming national debt.

Our days of kicking this can down the road and telling ourselves debts and deficits don’t really matter are over, says Holtz-Eakin, who served as director of the Congressional Budget Office from 2003 until 2005. Without serious, meaningful (and painful) cuts in spending, he adds, the United States faces, at best, stagnation, and, at worst, a return to the darkest days of the 2008 crisis.

Holtz-Eakin comes at the debt issue from a fiscally conservative perspective. Since 2010 he has served as founder and president of the American Action Forum, a 14-person, nonprofit Washington think tank whose mission he describes as introducing “center-right, conservative economic ideas into the national debate in a time-sensitive manner.” Nevertheless, a vigorous, bipartisan debate including all perspectives and potential solutions is vital to our democracy, he says. More than just a matter of getting our financial books in order, the decisions we make in the weeks and months ahead will go a long way toward determining what sort of nation we want to be, he contends.

OUTLOOK: Just how large is our debt?

Doug Holtz-Eakin: Net debt, that is, debt actually on the hands of the public right now, is about \$12 trillion, or around 70 percent of annual U.S. GDP. Gross debt, including debt held within the government (for example, money owed by the Treasury to the Social Security Trust Fund) brings that figure up to more than \$14 trillion and 90 percent of GDP. Gross debt is the better figure to use, since in the end it all comes back to the U.S. taxpayer anyway.

If we had addressed entitlements years ago, we might have had some cushion during these crises, but instead we frittered away time, and here we are.

About this article



Doug Holtz-Eakin is president of the American Action Forum and is a commissioner on the congressionally-chartered Financial Crisis Inquiry Commission. The FCIC is a bipartisan commission charged with examining the causes of the recent financial crisis and reporting its findings to Congress, the president and the American people. Mr. Holtz-Eakin was director of the non-partisan Congressional Budget Office and during his tenure the CBO analyzed the 2003 tax cuts, the Medicare prescription bill and Social Security reform. He also served as an economic policy adviser to Senator John McCain's presidential campaign in 2008. From 2001-2002 he was the chief economist of the President's Council of Economic Advisers and helped formulate policies addressing the 2000-2001 recession and the aftermath of the September 11, 2001, terrorist attacks.

Mr. Holtz-Eakin also was a senior fellow at the Peter G. Peterson Institute for International Economics and has been a visiting fellow at the American Enterprise Institute, Heritage Foundation and the American Family Business Foundation.

OUTLOOK: Why are those numbers significant?

DHE: Research by economists Carmen Reinhart and Kenneth Rogoff has shown that when nations' gross debt gets above 90 percent of GDP, economic growth slows significantly and they have a much higher probability of a sovereign debt crisis of the sort we've seen in Greece, Ireland and Portugal.

OUTLOOK: What's the difference between the deficit and the debt?

DHE: The deficit is how much your current year's spending exceeds current income. The total balance of what you owe is the debt. The deficit is this year's problem. The debt is the accumulation of every year's problem.

OUTLOOK: What percentage of our annual federal government spending is currently covered by tax revenues, and how much is borrowed? How does that compare with traditional levels of borrowing in this country?

DHE: Traditionally, business as usual has been to spend 20 percent of GDP, raise 18 percent in taxes, and borrow the other 2 percent. Another way to say that is that for every dollar you spend, you're paying 90 cents from taxes and borrowing a dime. Right now, we are spending 24 percent of GDP, raising 15 percent in taxes, and borrowing 9 percent. That means we're paying for 63 cents of every dollar we spend and borrowing 37. We are dramatically out of whack.

OUTLOOK: How did we get ourselves into this mess?

DHE: The answer, of course, is laced with controversy and there's lots of finger pointing. But there are really two key components. First, spending on entitlements such as Social Security, Medicare and Medicaid have been growing—predictably, I might add. It was clear that entitlement spending was going to grow dramatically when the Baby Boomers started retiring, and we should have done something about that a decade ago, or longer. Second, in recent years we've fought two wars (three, if you count Libya) and undertaken massive spending in the wake of the 2008 financial crisis. If we had addressed entitlements years ago, we might have had some cushion during these crises, but instead we frittered away time, and here we are.

Our relationship with China is very complicated because they need us as much as we need them. But their discontent with us is real, and I don't think anyone in the United States likes the idea of having our economic policy dictated from Beijing.

OUTLOOK: *We've been running a debt for so long, why is it coming to a head now?*

DHE: The key feature is not what's happening right now or what's happened in the past. What really matters is what you're expected to do in the future and what your lenders think you are capable of doing. Capital markets and ratings agencies around the world are no longer as confident that the United States will surely be able to handle its debt as they were in the past. That's what has changed.

OUTLOOK: *Yet during the wild market volatility in early August, investors flocked to Treasuries. In other words, they bought U.S. debt.*

DHE: At that point we were the best-looking horse in the glue factory. But that's not too comforting.

OUTLOOK: *What are the debt's implications for the dollar?*

DHE: None of this is good for the dollar, which, incidentally, means it's not good for the world economy. The fact that we've been the reserve currency, and that the international economy could coordinate around dollar transactions, has been very efficient. Having to hedge against the dollar, which you've seen China and others do recently, adds inefficiencies. The Chinese have twice floated the idea of developing a new international currency.

OUTLOOK: *Who holds the biggest share of our debt?*

DHE: Actually, U.S. individuals and institutions own the largest share, a little over 42 percent. The Chinese are the largest single foreign country, at 7.5 percent, followed by the Japanese at 6.4 percent. Our relationship with China is very complicated because they need us as much as we need them. But their discontent with us is real, and I don't think anyone in the United States likes the idea of having our economic policy dictated from Beijing.

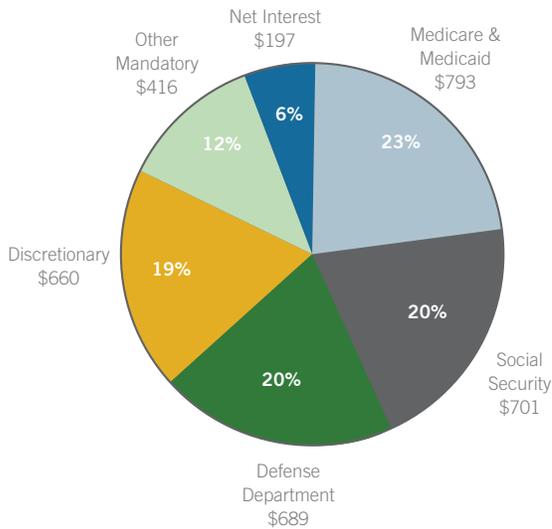
OUTLOOK: *What did you make of the brinkmanship surrounding Congress and the debt ceiling?*

DHE: Raising the debt ceiling is always an ugly affair. It has traditionally required Treasury secretaries to use their extraordinary powers and it always comes down to the last minute. This time, of course, was especially

U.S. FEDERAL SPENDING

Fiscal Year 2010 (\$ in billions)

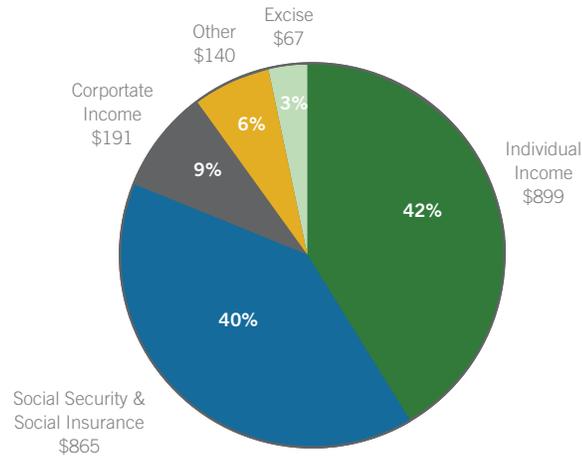
Total \$3,456



U.S. FEDERAL TAX RECEIPTS

Fiscal Year 2010 (\$ in billions)

Total \$2,162



Source: CBO Historical Tables

complicated, in part because the House of Representatives actually had to vote on it. In the past, they used a parliamentary procedure called the Gephardt Rule where, if they passed a budget, they were “deemed” to have increased the debt limit. So they never had their fingerprints on a vote. Then, it would go over to the Senate and there would be a quiet conspiracy that those who were up for reelection could vote “no” and those who weren’t could vote “yes” and it got done. The process has changed. The House has insisted that they vote up or down on every budgetary matter, and they didn’t know how to deal with it. And, of course, the stakes are higher. This time we were dealing with a terrible debt problem at the same time we needed to raise the ceiling.

OUTLOOK: What will the deal they reached actually do to address the debt?

DHE: In the end, not very much. The deal set a target for fiscal 2012, cutting spending by \$7 billion — a tiny amount. It also includes promises to cut spending in the future. Until that actually happens, anyone has the right to be skeptical based on history. And then there’s this super committee set up to address entitlements and other spending. The track record of these types of committees is less than stellar. What will matter is what happens after this deal. It’s a start, but there’s an enormous amount of work to be done.

OUTLOOK: Were you surprised by the Standard & Poor’s downgrade and the extraordinary week of volatility that followed?

DHE: The criticism of S&P had the flavor of shooting the messenger, and questioning the messenger’s timing. But neither the messenger nor the timing changes the message, which is correct. The debt is something the U.S. needs to come to terms with and fix, not complain about. The volatility, though, did surprise me. I thought the downgrade would affect markets by about 200 points in a relatively predictable fashion. A whole week

When the economy was falling, the stimulus helped break the fall. Any president faced with those circumstances would have done something. Doing nothing would have been viewed as malfeasance.

of sustained volatility probably reflected concerns about the underlying economy of the United States and Europe more than the downgrade. But since they happened at the same time, we'll never know.

OUTLOOK: President Obama argues that the stimulus spending after the 2008 market collapse saved us from greater financial disaster. Opponents say it only deepened the debt hole. What's your take?

DHE: The truth lies somewhere in between. The stimulus was extraordinarily poorly designed, and very ineffective considering the trillion dollars we spent. And a lot of it went to supporting pet projects on the president's and Congress' domestic policy agendas. The notion of shovel-ready projects is always rolled out in these moments, and it's always wrong. The only "shovel-ready" projects the United States has sitting on the shelf are ones that have gone through the environmental screening, have gone through the planning process, and then been deemed not interesting enough to finance. If we had stripped out all the pet projects and focused on a big payroll tax cut, which we finally got two years later, we would have had a program that was quicker, smaller in scale, and less costly. On the other hand, it's wrong to say the stimulus did no good. You can't throw a trillion dollars at the economy and get zero impact. When the economy was falling, the stimulus helped break the fall. Any president faced with those circumstances would have done something. Doing nothing would have been viewed as malfeasance.

OUTLOOK: Nobody wants to address that third rail – entitlement spending. Can the debt be reduced without cuts in entitlement spending?

DHE: No. It's very simple. Spending on Social Security, Medicare and Medicaid right now represent about 10 percent of annual GDP. If the costs escalate at their current rate, entitlement spending will soon rise to 20 percent of the GDP—or, the same amount that we currently spend on the entire U.S. government. That's clearly unsustainable. So we have to take these things on. Nothing can be sacrosanct. There have been discussions about changing the military retirement system from a defined benefits program to a cheaper defined contribution program, or changing the age of military retirement from 40 to 65. These things have happened elsewhere in the public and private sectors, but the military has so far been immune. Well, the budget problems are such that the military can't be immune—and neither can entitlements.

OUTLOOK: What happens if we do nothing and just keep borrowing?

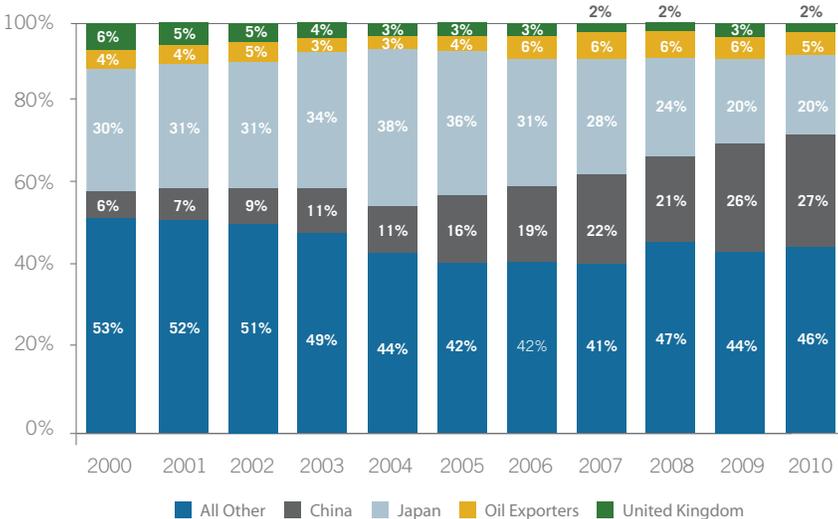
DHE: That could lead to two possible outcomes. One scenario would be a modest global recovery with the United States as a diminished borrower, forced to pay higher rates as lenders become more and more skeptical about our ability to repay. As a country, we'd face significant stagnation, standards of living wouldn't rise, and we would condemn the next generation to a broken economy and enormous debt payments that diminish their ability to lead their lives as they want to — defaulting on the promise to leave behind a standard of living that's better than the one we inherited. That's the good scenario. The bad scenario is you get something that looks like Greece, or like the United States in 2008, a deeper and deeper spiral, and in the aftermath you still haven't fixed the problem.

OUTLOOK: The U.S. funds a lot of its deficit spending with shorter-term debt, which leaves the government exposed to a future increase in interest rates. How great a risk do we face in that regard?

DHE: One of the characteristics of countries that get in trouble is they start relying heavily on short-term borrowing. If you look at the U.S. Treasury portfolio, it's heavily weighted toward money coming in overnight. The very real danger is you get into a spiral where you have to keep borrowing, even if interest rates rise.

MAJOR FOREIGN HOLDERS OF U.S. TREASURY SECURITIES, 2000-2010

Holdings at end of June (% of total)

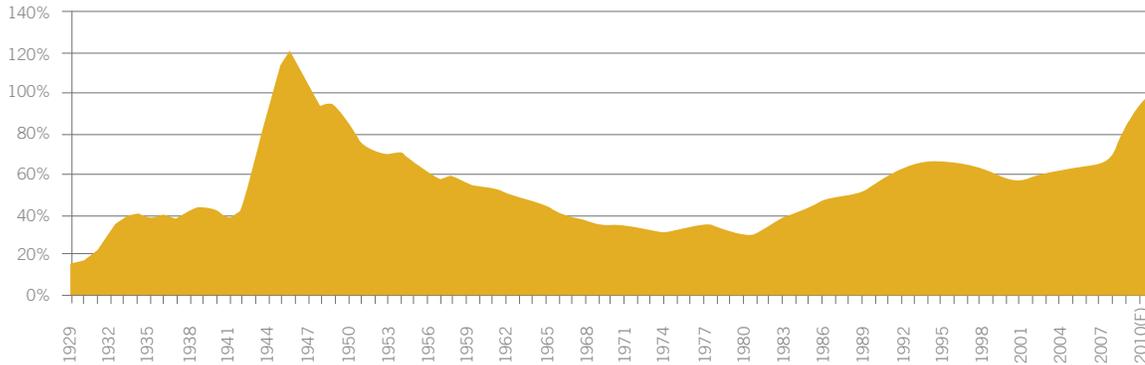


Source: U.S. Department of the Treasury/Federal Reserve Board

OUTLOOK: How do you compare the debt problems we're facing with what Europe is going through?

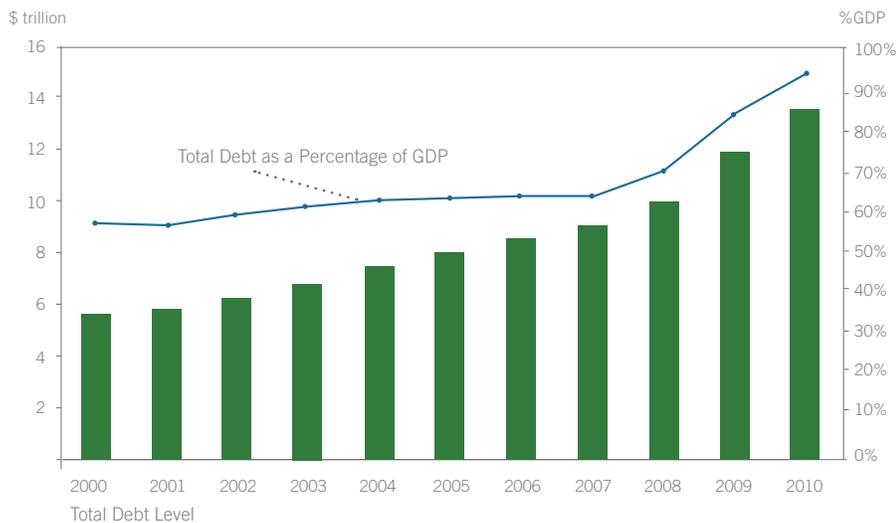
DHE: They're not dissimilar. Apples to apples comparisons are hard, because European governments tend to be more centralized, as opposed to all of the state, local and federal government we have. But if you consolidate and look at debt levels in the U.S. and debt levels in Greece, Spain, and Ireland, they're more similar than they are different. We as a country are not immune to the laws of arithmetic, or the laws of economics. The notion that we are immune is a mistake. But there are differences. The biggest is that underneath our debt we don't have a broken economy. The economy of Greece is fundamentally broken. Given their wage and productivity structures, they cannot compete. We can.

U.S. NATIONAL DEBT AS A PERCENTAGE OF GDP



Source: BEA, CBO, Treasury Direct

TOTAL FEDERAL DEBT 2000-2010



Source: BEA, CBO, Treasury Direct

OUTLOOK: Do you think the Eurozone will survive as an institution?

DHE: I thought their best chance was to cut Greece loose at the beginning of all this. I don't know why they felt they could fix the problem by throwing money at it. The thing to remember about the Eurozone is that it gives individual countries such as Denmark a voice in world affairs that they would never have on their own, so they will work very hard to keep together. But I'm less and less optimistic.

OUTLOOK: You've spent a lot of time working with members of Congress. These are smart, ambitious people. Why is it so hard for them to find solutions?

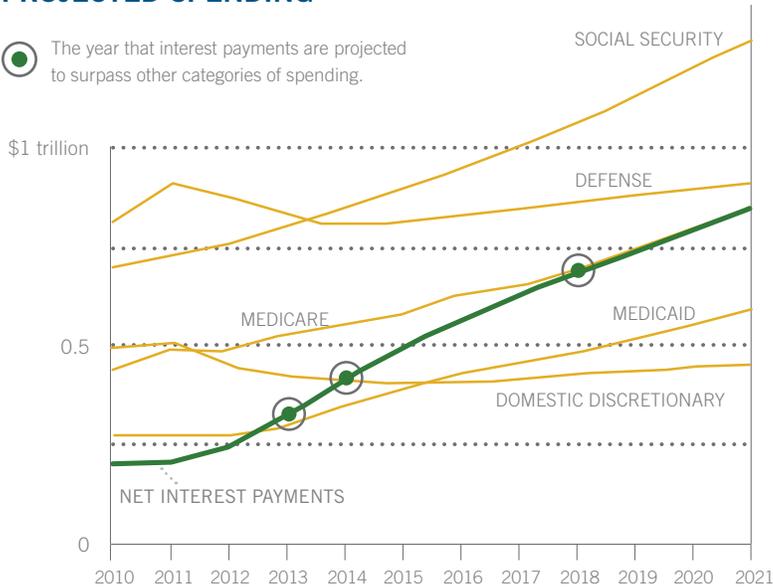
DHE: Smart, ambitious people still have different values. How you budget the federal government is an expression of values. How big do you think the social safety net should be? How much should taxes be raised and who should pay them? All of this is really a discussion about how large our government will be, and what role it will play in our lives. By the way, that's a good debate. It might be ugly to watch, but it's the right debate. Some people might see all this public disagreement as a weakness, but it's really a great strength. In a democracy, this is what we do.

OUTLOOK: So, what's the recipe for a turnaround in the debt, and the economy?

DHE: If you go around the world and look at countries that have faced both a bad economy and bad debt problems at the same time, the menu for success seems to be to keep taxes low and reform the tax system to make it more efficient. Then, you cut government spending, starting with the number

PROJECTED SPENDING

 The year that interest payments are projected to surpass other categories of spending.



Source: White House Office of Management and Budget
The Washington Post, Feb. 17, 2011

of people employed by government. In the United States, we don't have nearly as many government employees as other countries, so there's not as much to cut. And there are government programs that you really shouldn't cut too deeply, such as infrastructure, defense, basic research, and education. That leaves wealth transfer programs: entitlements, Pell grants, farm subsidies and the like. All the stuff politicians love! You have to walk that line. Politically, that's hard.

OUTLOOK: *Given the size of cuts required to bring the deficit under control, how impactful do you think such cuts will be on our quality of life? How "austere" does the future look?*

DHE: The question is, compared to what? Compared to promises that can't be kept? People use the term "austerity" as though it's one option among many. Cuts are coming. The real question is, do we reform Social Security now in a way that's painful, yes, but cuts future benefits chiefly for high wage earners who are still working and have time to make adjustments? Or do we wait until 2037 when seniors who are already retired see their benefits cut by 25 percent across the board? Those are the type of choices we face.

OUTLOOK: *Throughout history, countries with sovereign debt problems have often resorted to printing money and inflating their way out of the problem. Do you see a potential for the U.S. to go down that road?*

DHE: You hear some people float that as a possibility, but we worked very hard during the 1970s and 1980s to get inflation under control, and we succeeded. After interest rates spiked and we had the big recession of 1981-82, the Fed, under Chairman Paul Volcker, became unrelenting in its concern over how much money it printed. And over the next 20 years we saw inflation squeezed out of the system to the point that we've got 1 percent to 2 percent as the target. That idea spread worldwide. Hyperinflation has been largely gone because of this remarkable international consensus on sensible monetary policy. What a shame it would be to casually throw that all away because we refused to buckle down and do the right thing.

These are large and daunting problems. Yet all of our problems are self-inflicted, which means that they are our problems, and we can fix them.

OUTLOOK: *What are the long-term negative impacts to a country that pursues an inflationary approach? Do they offset the “benefit” it gets from repaying debts with a debased currency?*

DHE: It’s an artificial solution. Deliberate inflation may technically take debt off the books, but at terrific expense to your currency, your financial standing and your ability to borrow. In addition to the damage to our country, a return to hyperinflation would affect all of us in very personal ways. Think back to the 1970s, when “cost of living” adjustments were a major and necessary part of every employment contract. Spiraling inflation and interest rates become dominant factors in every decision about buying a home or a car, or anything else. It generally interferes with life and becomes insidious.

OUTLOOK: *Is there still time for us to turn things around?*

DHE: Sure, there’s still time to put the U.S. on a sensible fiscal course. There’s still time to return to more rapid growth. This is an important moment. These are large and daunting problems. Yet all of our problems are self-inflicted, which means that they are our problems, and we can fix them. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 7/31/11. 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

2011	GDP	CPI	Fed Funds	2-year	10-year
Q2	2.00%	4.20%	0.10%	0.60%	3.30%
Q3	3.20%	2.00%	0.13%	0.60%	3.30%
Q4	3.20%	2.00%	0.15%	0.80%	3.40%
2012	GDP	CPI	Fed Funds	2-year	10-year
Q1	2.80%	2.20%	0.18%	0.90%	3.50%
Q2	3.00%	2.10%	0.20%	1.10%	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 SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.26%	0.45%	0.88%	1.65%	2.32%	2.95%
0.25	0.47%	0.52%	1.03%	1.80%	2.44%	3.04%
0.50	0.52%	0.59%	1.17%	1.99%	2.59%	3.15%
0.75	0.57%	0.66%	1.35%	2.16%	2.75%	3.29%
1.00	0.61%	0.75%	1.51%	2.34%	2.88%	3.38%
1.50	0.77%	1.03%	1.94%	2.70%	3.19%	3.63%
2.00	1.14%	1.43%	2.36%	3.03%	3.45%	3.82%
2.50	1.62%	1.92%	2.79%	3.36%	3.71%	4.01%
3.00	2.09%	2.41%	3.22%	3.68%	3.96%	4.21%
4.00	2.96%	3.33%	3.87%	4.15%	4.34%	4.50%
5.00	3.60%	3.97%	4.28%	4.47%	4.59%	4.67%

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

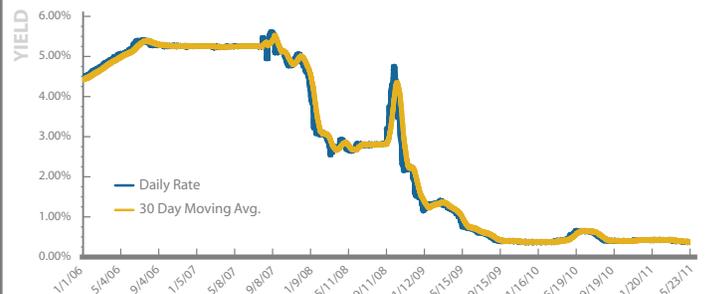
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	6	8	9	7
90	15	20	23	17
180	27	38	43	32
365	63	85	87	63

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.

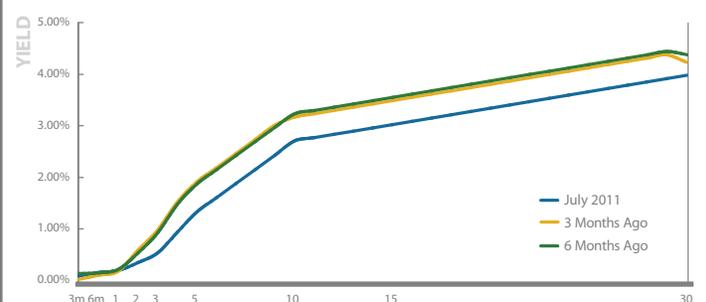
3-MONTH LIBOR



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





About CoBank

CoBank is a \$66 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 retail 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.

CoBank Reports Second Quarter Financial Results

Net Income Increases 20 Percent To \$180.7 Million

CoBank this month announced financial results for the second quarter of 2011. Quarterly net income rose 20 percent to \$180.7 million, compared with \$150.4 million in the second quarter of 2010. Net interest income for the quarter was \$276.5 million, compared with \$217.9 million a year ago. Average loan volume for the second quarter was \$52.1 billion, compared to \$43.2 billion for the same period in 2010.

For the first six months of 2011, net income increased 23 percent to \$392.8 million, from \$319.0 million a year ago. Net interest income increased 29 percent to \$577.7 million. Total loan volume for the bank at June 30, 2011 was \$48.8 billion.

As in recent quarters, sustained higher and continued volatile prices for grains and other agricultural commodities had a significant positive impact on the bank's financial results. Generally, rising commodity prices increase seasonal borrowing requirements for grain and farm supply cooperatives and other agribusiness customers. The bank also saw modest year-over-year growth in loan volume with rural electric cooperatives around the country and with Farm Credit association customers serving farmers, ranchers and other rural borrowers in the northeastern and northwestern United States.

"The increase in average loan volume we've experienced this year has been dramatic and has largely been the result of commodity price volatility and its impact on our borrowers in the grain and farm supply industries," said Robert B. Engel, CoBank's president and chief executive officer. "Demand for financing in many of the other sectors we serve has weakened, consistent with slow economic growth in the broader U.S. economy. As always, we remain focused on meeting the needs of our customers and on protecting the financial strength and stability of the bank for the long term."

At quarter end, 1.87 percent of the bank's loans were classified as adverse assets, compared with 1.61 percent at March 31, 2011, and 1.71 percent at December 31, 2010. Nonaccrual loans rose to \$191.3 million, from \$156.3 million at the end of the first quarter and \$167.0 million at the end of the



ENGEL



BURLAGE

year, reflecting credit challenges facing a small number of agribusiness customers. During the second quarter, the bank recorded a \$25.0 million provision for loan losses, increasing the provision to \$37.5 million for the first half of the year. The provision for loan losses in the first six months of last year was \$16.5 million. The bank's reserve for credit exposure totals \$531.9 million, or 1.74 percent of non-guaranteed loans outstanding when loans to Farm Credit associations are excluded.

"Overall credit quality remains well within the bank's risk-bearing capacity," said David P. Burlage, CoBank's chief financial officer. "In addition, we continue to maintain a strong reserve for credit exposure, which protects the bank's capital base in the event of future credit losses in our loan portfolio."

Capital levels at the bank remain strong and well in excess of regulatory minimums. As of June 30, 2011, shareholders' equity totaled \$4.7 billion, and the bank's permanent capital ratio was 14.0 percent, compared with the 7.0 percent minimum established by the Farm Credit Administration (FCA), the bank's regulator.

At quarter end, CoBank held approximately \$16.5 billion in cash and investments. The bank averaged 186 days of liquidity during the first six months of the year, compared with the 90-day regulatory minimum set by the FCA. The bank recorded \$4.0 million in impairment losses during the second quarter, primarily due to continued weakness in the U.S. housing market and its impact on certain mortgage-backed investment securities held by the bank. "The fact that approximately 97 percent of our investment securities carry an implied or explicit guarantee from the U.S. government provides us with a high degree of confidence about the overall credit risk in our investment portfolio," Burlage said. ■