The Eurozone Crisis

After more than 60 years of unprecedented postwar peace and prosperity, Europe finds itself on the edge of an economic cliff. The question has shifted from whether Europe can pull itself out of its economic doldrums to one much more stark and ominous: Can the continent’s common currency, the euro, and its common sense of financial destiny and purpose, survive?

Of course, the journey to this precipice was not so sudden. Back in 2009, the debt-laden Greek economy imploded. After other Europeans came to the rescue with more than $150 billion in aid, and the Greeks pledged new austerity measures to get spending under control, the problems have only intensified. Portugal, Italy, Ireland and Spain have joined the ranks of at-risk nations.

Each week it seems some new remedy announced by European officials results in a brief spike of market confidence, followed by an even deeper slide as investors and pundits alike fear that as Europe’s problems mount, its options on how to respond have only narrowed.

Economist Judy Shelton, co-director of the Sound Money Project at the Atlas Economic Research Foundation in Washington, believes, like many observers, that 2012 likely will be a make or break year for the euro.


**OUTLOOK: What are the best- and worst-case Europe scenarios for the next year and what are the odds of each?**

**Judy Shelton:** The best case is each country signs, as a condition for staying in the Eurozone, a strict commitment to balance their budgets within two years. I mean cutting huge amounts, not “moving toward” fiscal discipline, not “austerity,” which is another way of saying tinkering around the edges. Deep, painful cuts. The key point is that the choices would be made within each country, so the citizens can’t blame Eurozone bureaucrats or other countries for the pain. That’s the best, if not only, way they can save the Eurozone in my opinion. Yet this would require a level of courage and decisiveness that we haven’t seen from most individual European leaders, so I don’t think there’s more than a 20 percent chance they’ll take this step.
The best case for the Eurozone is if each country signs, as a condition for staying in, a strict commitment to balance their budgets within two years. I mean cutting huge amounts. Deep, painful cuts.

Another possibility, which I’d also put at 20 percent, would be a similar agreement, but instead of each country and its own parliament agreeing democratically to lay out a balanced budget plan, they assign the enforcer role over to the International Monetary Fund or let a European court decide. Now you’ve got a recipe for political disaster, calling up all the ancient European national animosities, as citizens blame outsiders for telling them what to do.

Then, there’s the worst-case scenario, a 60 percent chance we’ll just see more in the months ahead of what we’ve already seen: wrangling, talk of austerity, riots and frantic meetings between finance ministers and central bankers as the underlying problem steadily deteriorates.

OUTLOOK: under your 60 percent scenario, does the euro fall apart?

JS: Ultimately, yes. I can’t say just when. It could be two weeks, or 18 months. What we’re watching is a slow motion train wreck. Frankly, I’m surprised it has played out this long. I recently heard someone say that if interest on Italian 10-year bonds rose above 7 percent, that would signal the collapse. Well, we passed that benchmark in mid-December and everyone is still muddling along. But as long as Europe sticks with this process of patchwork deals and meetings, at some point, vulnerable countries such as Greece, Spain, and Ireland will begin to fall away. France and Germany will do everything they can to keep Italy afloat, because of its size. But, ultimately, you could get down to just France and Germany as the only ones left. Now you’re into a bilateral situation rather than a Europe-wide currency. Do you even call it a “euro” any more?

OUTLOOK: would the demise of the euro precipitate a global banking crisis?

JS: In theory, no, because it should mean reverting back to national currencies as before the euro came into existence. After all, Britain never even signed on. But there is a difference between a managed “demise” versus a sudden collapse. If depositors became nervous about retaining the euro value of savings now kept in national banks, fearing that governments could redefine the value in terms of former currencies immediately subject to floating values, you could see a run on banks. The psychological impact can easily exceed the rational economic effect. Indeed, financial crashes are largely triggered by emotions such as fear about the future. Then, if people dump the euro in a panic as it appears headed toward collapse,
If the euro collapses you’d have a period of significant disruption as European nations try to figure out how to revert to their national currencies. Everybody becomes sort of paralyzed and Europe goes into a recession. That would be very disruptive to the United States.

there could be a climb in the dollar that goes beyond the Fed’s ability to endlessly supply dollars. Global banks would likely feel compelled to limit their portfolios to domestic borrowers to protect against unknown currency gyrations affecting foreign loans. Or perhaps worse, they could join the speculative game of betting on currencies, exacerbating the exchange rate movements.

In short, it’s an opportune time for genuine leadership toward meaningful international monetary reform.

OUTLOOK: We’ve known about European debt problems for quite some time. Why has it all come to a head just now?

JS: There’s no magic about a specific date. You just sort of reach a threshold when debt is no longer sustainable. I used to specialize in the Soviet Union. Throughout the 1980s they were considered a very powerful cold war rival, almost an economic equal to the United States. And then around 1989 they suddenly reached their threshold, and within a year or two they were literally bankrupt. You can borrow for a while and keep putting reality off, but at some point people simply rebel. Investors are very savvy about when you’re reaching that point, and they’re quick to head for the exit. We in the United States got a foreshadowing of investor rebellion last summer when our credit rating diminished. We’re seeing that happen all over Europe.

OUTLOOK: What are the implications for the U.S. and global economies if the worst-case scenario plays out in Europe?

JS: If the euro collapses you’d have a period of significant disruption as European nations try to figure out how to revert to their national currencies. Everybody becomes sort of paralyzed and Europe goes into a recession. That would be very disruptive to the United States. Currently, about 20 percent of the revenue of our S&P 500 companies comes from Europe.

The Chinese are very concerned as well. I was doing an interview with a Chinese television station just today, and Europe was their top concern. Although we in the U.S. assume everything the Chinese make goes to Wal-Mart, the fact is that Europe is a larger customer for Chinese goods than the United States is, so China is very concerned. China will likely shift its
focus to trade with other emerging markets because their business is going up in Brazil and Malaysia. But there’s no question that this is all potentially disruptive to the global economy.

**OUTLOOK: It’s amazing to think back to 1999 and the ebullience and sense of accomplishment that attended the launch of the euro.**

**JS:** The ebullience, at the time, was warranted. It was a tremendous achievement, after decades of planning. It made great sense for Europe to have a common currency. The idea still makes sense, which is what makes the current state of affairs so tragic. In fact, it would make sense to have a single monetary unit of account worldwide, if we really believe in a global economy and global marketplace where everyone has a chance to offer goods and services. The euro almost immediately after its launch became the world’s second most important currency after the dollar, and for the first 10 years looked like a terrific success. What has happened, unfortunately, is that fiscal irresponsibility has triumphed over monetary logic, and now this grand experiment appears to be in great danger of falling apart.

**OUTLOOK: Were the problems foreseeable?**

**JS:** Not only were the problems foreseeable, Eurozone leaders foresaw them. They knew fiscal discipline of member countries was crucial, which is why they started out by mandating that individual governments couldn’t have a current budget deficit in excess of 3 percent of their GDP, or sovereign debt greater than 60 percent of their GDP. Those were the criteria you had to live by if you were going to be accepted into the Eurozone.

The problem was enforcement. The initial plan was to fine countries that spent their way to dangerous debt levels. But when a government is piling up debt, it’s because they don’t have sufficient revenue. A fine means making them pay more money that they don’t have, and running their debts even higher. So the whole idea of fines became meaningless. In the wake of the 2008 crisis, of course, that 60 percent debt number seems like a distant memory, since virtually the entire developed world has blown way past it.
The euro became the world’s second most important currency after the dollar, and for the first 10 years looked like a terrific success. What has happened, unfortunately, is that fiscal irresponsibility has triumphed over monetary logic, and now this grand experiment appears to be in great danger of falling apart.

Another problem was no exit plan for countries that failed to live up to fiscal discipline. Eurozone policymakers who were there at the start have told me this was intentional. They were worried that if they included a clear exit strategy, countries would be even less willing to abide by rules because they knew they could just leave. So they set things up such that once you were in, leaving would be very painful.

OUTLOOK: How could they have imposed better discipline?

JS: Well, I’ve always been an advocate of the gold standard. Politically, that would have been a long shot, but attaching your currency to a physical property rather than the whims of policymakers automatically imposes discipline on governments, including harsh penalties for violating sound fiscal policy.

Short of a gold standard, they could have imposed some kind of rule forbidding European banks from buying debt from any member country that exceeded the 60 percent sovereign debt criteria. Countries in violation still could have sold their bonds to private investors. But any country on that “watch list” would have strong incentives to get off, not just for access to bank capital but to preserve their reputations. And since banks are the ones interacting directly with the European Central Bank, preventing banks from lending money to irresponsible countries might have helped stop the debt contagion from spreading throughout the Eurozone.

Unfortunately, leaders took the exact opposite approach, with policies that actually encouraged banks to load up on risky sovereign debt.

OUTLOOK: How so?

JS: Consider the 2004 international banking agreement known as the Basel II Accord, which was intended to ensure financial stability by imposing capital requirements on banks. European banks were supposed to carefully assess the risk of their assets and set aside a certain percentage of capital to cover those risks. For example, loans to other banks required 20 percent against risk, home mortgages 50 percent and consumer loans 100 percent. But the accord put zero risk requirements on sovereign debt. Instead of preventing banks from overexposing themselves to bonds from debt-ridden
The Eurozone ushered in a very real sense of European shared destiny after centuries of destructive nationalism and warfare. That shared destiny is extremely vulnerable if the euro collapses.

countries, these policies essentially lured them into piling on as much as possible. And since all the debt was counted in euros, they didn’t think too hard about whether the bonds were German, French or Greek. It was all acceptable and all carried a zero risk weighting. And since the banks are tied directly to the European Central Bank, when they got into trouble they were quickly deemed too big to fail.

**OUTLOOK:** Change a few of the particulars and you might be describing the U.S. subprime mortgage meltdown and its aftermath.

**JS:** That’s true. Europe has no corner on fiscal irresponsibility.

**OUTLOOK:** How is the U.S. situation different from what Europe faces?

**JS:** We have a strong federal government and a currency that’s not going to break apart, so Europe faces a lot more immediate complexities. But the inherent dangers of using monetary policy to accommodate irresponsible spending are the same. If anything, the centralized nature of the U.S. government and the Federal Reserve makes it too easy for the Fed to say, “we’re going to launch quantitative easing and buy up U.S. Treasury debt and mortgage-backed securities and hold them as assets.” We shouldn’t kid ourselves that we are immune to economic realities.

**OUTLOOK:** How would the continent change without the Eurozone and the euro.

**JS:** The Eurozone ushered in a very real sense of European shared destiny after centuries of destructive nationalism and warfare. That shared destiny is extremely vulnerable if the euro collapses. One main feature of a common currency has been open borders and unlimited mobility. The idea was that labor could move from one country to another, just like in the United States. If California is struggling and there are jobs in Wyoming, people can move to Wyoming and it doesn’t threaten the stability of the dollar. The whole idea of being a United States of Europe, in a social sense, would be shattered. So would the idea of a shared market. Under a single currency, countries can’t compete for advantages by depreciating their currency. All of that would be lost and they would now become, I won’t say enemies, but no longer a cooperative economic union.
**OUTLOOK:** Some observers have suggested it would be a smart strategic move for a country such as Greece to revert to the drachma and devalue their way back to the point that their labor and products become attractive.

JS: I hate that idea in every way. How do you make individual citizens revert? Money is a very psychological, intimate asset. What does Greece do if its citizens still prefer euros? You wind up with a two-tiered currency situation, where drachmas become the trash currency for trivial purchases and euros for major purchases. The only way to prevent that would be for the Greek government to forcefully redenominate individual bank accounts, with no warning. Yesterday, you had X number of euros in your account, and now you have X number of drachmas. That’s a recipe for rebellion, panic and a black market—not prosperity.

**OUTLOOK:** Given their strong economy and productivity, and the fact that the deutschmark was a leading global currency prior to the euro, what do the Germans have to lose if the Eurozone folds?

JS: There are two answers, one financial and the other symbolic and emotional. On the financial side, think about a German company doing business in Spain. That’s good for Germany, and good for Spain. For the past decade they’ve been dealing strictly in euros, so they didn’t have to pay a premium for the currency risk of taking capital out of Spain and transferring it from pesetas to deutschmarks. Without the common currency, you’re back to the old, cumbersome, and highly expensive system of transaction costs every time you do business with another country, even your next door neighbor. On top of the inconvenience, you also need to pay for complex hedging investments to protect against inter-currency fluctuations. So they stand to lose real wealth to what are or should be unnecessary expenses under a unified currency.

On the emotional side, Germans, after all these years, still bear the enormous psychological burden of two World Wars. They have a tremendous investment in being a good neighbor and want very much to believe in the Eurozone. Former German Chancellor Helmut Kohl made it his lifelong dream that Germany
would be reunited en route to having a common currency across Europe. The deutschmark was Europe’s strongest currency and Frankfurt was the leading center of fiscal rectitude and monetary prudence. So they risked the most going in, and yet they were willing to commit. That says a lot about the destiny they hoped to embrace. That’s what Germany stands to lose.

Outlook: But isn’t there also a growing sense among average Germans that they’re bearing the burden of irresponsibility elsewhere in Europe?

JS: That’s always been a question, so current Chancellor Angela Merkel and other German leaders are in a particularly tough spot. When the euro was unveiled, two German economists actually sued, saying they were essentially being robbed by being forced to give up a good currency for a questionable one. The German Supreme Court ultimately decided Germany could join the euro, but in settling the case the court required the government to ensure that the value of the euro not be compromised.

Lately, that famous case has been resurrected in the German courts, reasserting the claim that individuals have had their rights violated. That’s why Merkel is being stretched back and forth, between this sense of common European destiny on the one hand and, on the other, German citizens saying, “Why am I paying for Greeks’ vacations and pensions?” We are getting dangerously close to the point where the Germans will say, “Forget it. We tried, but other Europeans are not willing to abide by the rules.” For now, though, they are still saying that muddling through is better than abandoning the dream.

Outlook: What did you make of Britain’s recent decision not to go along with the latest European debt crisis agreement, saying it lacked proper safeguards?

JS: Prime Minister David Cameron clearly felt it was not in the country’s interest to go along. Britain has always been a financial capital and they don’t want to be bound by rules established in Brussels. This probably makes Britain look smart from a financial point of view, but at the same time they’ve lost some of their standing when it comes to having a voice in the future of the European Union, which they’re a part of. Of course, they’ve been trying to have it both ways for years, by remaining part of the European Union without joining the Eurozone or

TOTAL GOVERNMENT DEBT AS A PERCENTAGE OF GDP

*Estonia joined the Eurozone on Jan. 1, 2011

Source: EUROSTAT
giving up their own currency. Even though Cameron accompanied the recent announcement by reaffirming Britain’s commitment to the European Union, there’s been some strong criticism from Europeans saying you can’t have it both ways any longer. So in that sense, their position as a part of Europe has been weakened.

OUTLOOK: What do you expect the European Central Bank to try next?

JS: I suspect the ECB will say they are satisfied with the steps the individual countries have promised and therefore they will start buying sovereign debt, very similar to what the Fed has done in the United States with its quantitative easing programs. Unfortunately, that’s not a long-term solution to the underlying problem of sovereign nations spending too much money and taking in too little revenue. It just extends the problem a little bit more.

CONTINENTAL DIVIDE

Europe’s sovereign-debt crisis is exposing economic fault lines within the euro currency zone.

A look at notable disparities among some of the Eurozone countries. Colors track yields on government bonds, which indicate investors’ perceived risk—with red as the riskiest. The charts show a snapshot of each nation’s economy relative to the entire 16-nation bloc.
In a global economy with global markets, the idea of common currency is just too attractive to ignore. If Europe reverts to a system of a lot of individual currencies, people will very quickly remember how good it was to have the euro, and others will try to come up with one that doesn’t fall victim to the same errors.

**OUTLOOK: The Fed made headlines recently with its announcement to use “swap lines” to help European banks get dollars and improve their liquidity. Is that helping?**

**JS:** What we’ve done is muddy the water, saying, in essence, if you need dollars, we’ll supply them cheaply. Unfortunately, what that does is declares the whole idea of free market floating currency rates a farce. If European banks need dollars, they can already get them. All the Fed did was transfer arbitrage profits away from people in the foreign exchange markets who normally handle this. Steps such as this underscore the lack of any comprehensive international monetary system or currency order. The status quo is clearly not working.

**OUTLOOK: Given all the European struggles, how long will it be before someone else tries to enact a common currency among nations?**

**JS:** In a global economy with global markets, the idea of sharing a common currency is just too attractive to ignore. If Europe reverts to a system of a lot of individual currencies, people will very quickly remember how good it was to have the euro, and others will try to come up with one that doesn’t fall victim to the same errors. Common currencies are good, but not if they’re subject to fiscal abuse, followed by monetary accommodation of that abuse.

I think you could see, for example, a Eurasian monetary union. Certainly Russia is trying to make that happen with Kazakhstan and Belarus, and would like to bring in Asian countries. You could see bilateral agreements possibly between China and Russia. You could see Russia trying to get Europe to pay for energy using a new Eurasian currency. Whether those could succeed is an open question.

Meanwhile, I think in the wake of this global crisis, the good that could emerge would be a real demand for international monetary reform, with actual rules and discipline. The next big question is who will stand up and take the lead. The United States is the logical choice, but China is eager to influence this process as well.
Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 11/30/11. 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

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

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<tr>
<th>Years Forward</th>
<th>3-month LIBOR</th>
<th>1-year Swap</th>
<th>3-year Swap</th>
<th>5-year Swap</th>
<th>7-year Swap</th>
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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

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<tr>
<th>Cost of Forward Funds</th>
<th>Average Life of Loan</th>
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<td>Forward Period (Days)</td>
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<td>180</td>
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<td>365</td>
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</table>

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

Source: Insight Economics, LLC and Blue Chip Economic Indicators
About CoBank
CoBank is a $62 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.

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Registration is now open for CoBank’s 2012 customer meetings. Each meeting will feature presentations from leading experts on the economy, global trends, business management and politics. The programs are designed to give directors and managers valuable knowledge, insight and information they can use every day in both their business and personal lives.

To register for one of the 2012 Customer Meetings, please visit cobank.com/meetings. Here’s the list of upcoming meetings:

- **Midwest Customer Meeting**
  - **February 21-22**
  - Embassy Suites La Vista
  - Omaha, NE

- **Minnesota Customer Meeting**
  - **February 23-24**
  - DoubleTree Park Place
  - Minneapolis, MN

- **Pacific West Customer Meeting**
  - *In conjunction with the Agricultural Council of California*
  - **March 6-7**
  - Estancia La Jolla Hotel & Spa
  - La Jolla, CA

- **Central Customer Meeting**
  - **March 12-13**
  - Bloomington-Normal Marriott
  - Bloomington, IL

- **Northeast Customer Meeting**
  - *In conjunction with the Northeast Cooperative Council*
  - **March 27**
  - DoubleTree Hotel
  - Syracuse, NY

- **Western Plains Customer Meeting**
  - *In conjunction with the Kansas Farmers Service Association*
  - **March 29-30**
  - Hyatt Regency Wichita
  - Wichita, KS

- **North Dakota Customer Meeting**
  - **April 3-4**
  - Ramada Hotel Fargo
  - Fargo, ND

- **Texas Customer Meeting**
  - **May 21-22**
  - Hyatt Regency Hill Country
  - San Antonio, TX

- **Southeast Customer Meeting**
  - **June 14-15**
  - Ritz-Carlton Amelia Island
  - Amelia Island, FL

If you have questions about any CoBank meeting or can’t find what you’re looking for, please contact CoBank’s Corporate Communications department at 303-740-6456 or by email at corp.comm@cobank.com.

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