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Sovereign Debt and Default – A History

The ongoing sovereign debt crisis in Europe continues to weigh heavily on credit markets and political systems throughout the developed world. Greece, after racking up years of unsustainable fiscal deficits, recently defaulted on Euro-denominated bonds held by banks and other investors, and many experts continue to worry about the sovereign debt of much larger European governments like Portugal, Italy and Spain.

For Americans, the idea of sovereign default is more closely associated with Third World emerging economies, not Europe. But finance expert Alex Pollock notes otherwise. In a recent paper published by the American Enterprise Institute, Pollock points out that history is littered with sovereign debt defaults by developed nations – including European countries and even the United States.

OUTLOOK asked Pollock for his perspective on the current sovereign debt crisis – and the lessons history offers about what’s happening in Europe today.

OUTLOOK: Anyone who came of age in the decades after World War II is accustomed to a relatively high degree of economic stability in the developed world, so the sovereign debt crisis playing out in Europe feels like foreign territory. You note in a recent paper that it really isn’t anything new.

Alex Pollock: Anybody who borrows more than they can repay is going to end up defaulting – either explicitly or implicitly. And that includes governments. From ancient history up until the present moment, we’ve experienced governments defaulting on their debt.

OUTLOOK: Give us some historical examples.

AP: It’s a frequent occurrence. In the fourth century B.C., the Greek tyrant Dionysius of Syracuse borrowed from his subjects in gold and then found he was unable to pay. He was the government, the sovereign, so according to the story, he simply took every gold coin that said one drachma on it and re-stamped it “two drachmas” and then paid his people back with the re-stamped coins.

About this article

Alex J. Pollock is a resident fellow at the American Enterprise Institute, a public policy think tank based in Washington, D.C. Pollock joined AEI in 2004 after 35 years in banking, including more than a decade as president and chief executive officer of the Federal Home Loan Bank of Chicago. At AEI, he focuses on financial policy issues, including housing finance, government-sponsored enterprises, retirement finance, corporate governance, accounting standards, and the banking system. He is also the author of the book *Boom and Bust: Financial Cycles and Human Prosperity*. His research and commentary, including a recent paper on the history of sovereign debt defaults, are available at <http://www.aei.org/scholar/alex-j-pollock/>.

A recent book by the economists Carmen Reinhart and Kenneth Rogoff actually counts up all the sovereign defaults from 1800 until the early 2000s. They count 250 instances of sovereign defaults in 200 years – an average of more than one a year.

So isn't it odd that we get this idea that governments are completely safe loans, when there's this vast history of defaults? I guess it shows that group memory is pretty poor.

OUTLOOK: What about more recently?

AP: There is no shortage of examples. In the 1980s many governments of less developed countries, or "LDCs," defaulted on their debt, starting with Mexico in 1982. Paul Volcker, then the chairman of the Federal Reserve, thought that the entire American banking system was in danger from these government defaults. Ironically, it was preceded by a period in which everybody cheered these loans as a wonderful thing. They called it "petrodollar recycling," because the oil-producing countries had a lot of cash, they deposited that cash in U.S. banks, and the banks lent to governments who were short of funds. And everybody said, "Isn't that wonderful?" When asked about the risk, the chairman of Citibank infamously said, "Countries don't go bankrupt." Of course, very shortly afterward Mexico and then a whole lot of other countries around the world started defaulting.

We are talking loosely when we talk about making loans to "a country." You're not really making loans to a country – that is, to the country's productive land and people and resources. You're making loans to the government. And governments are entities that can run out of money.

OUTLOOK: Why do countries tend to get into trouble with debt?

AP: If you borrow money to consume, you're liable to get into trouble. If you borrow money to finance destruction, as in a war, then there's no source of repayment. And if you borrow money to buy things at very high prices and then prices collapse, the money is equally gone and of course there is no payoff.

OUTLOOK: Has the United States of America ever defaulted on debt?

AP: Do you remember silver certificate dollar bills? For a long time before the 1960s we had circulating dollar bills that were called silver certificates. If you looked at them it said this: "This certifies that there is on deposit in the Treasury of the United States of America one silver dollar payable to the bearer on demand." When I was a boy, you could take that silver certificate into a bank or to the Fed and get a silver dollar. In the 1960s the government of the United States simply said, "We're not giving you a silver dollar for the

If you borrow money to consume, you're liable to get into trouble. If you borrow money to finance destruction, as in a war, then there's no source of repayment. And if you borrow money to buy things at very high prices and then prices collapse, the money is gone and there is no payoff.

silver certificate anymore." So if you would like to experience a default, find one of these certificates, which are surely still around, and take it to the Fed and say, "It says on this 'one silver dollar payable to the bearer on demand.'" And they will say, "Sorry, sport, we'll be glad to give you another paper dollar."

OUTLOOK: You're saying that, technically, would constitute a default.

AP: It's certainly a default in my mind.

Earlier there was a specific default by the United States government, in 1933. In the 1930s a lot of terrible things were happening in the world economy. Of all the government bonds of various countries sold in New York in the 1920s, 35 percent were in default. Thirty-five percent! In order to finance the First World War, the United States issued bonds to its citizens that explicitly provided that the holder of the bond had the right to be paid in gold. In 1933 the United States decided to go off gold, and when the holders of the bonds said, "Well, I'll take my payment in gold, the United States said, "Tough luck, we're not paying in gold." The case ended up in the Supreme Court and was decided 5-4 in favor of the government. And the argument of the justice who cast the deciding fifth vote was, "Well of course this is default. But if you're the sovereign, you can default if you want to."

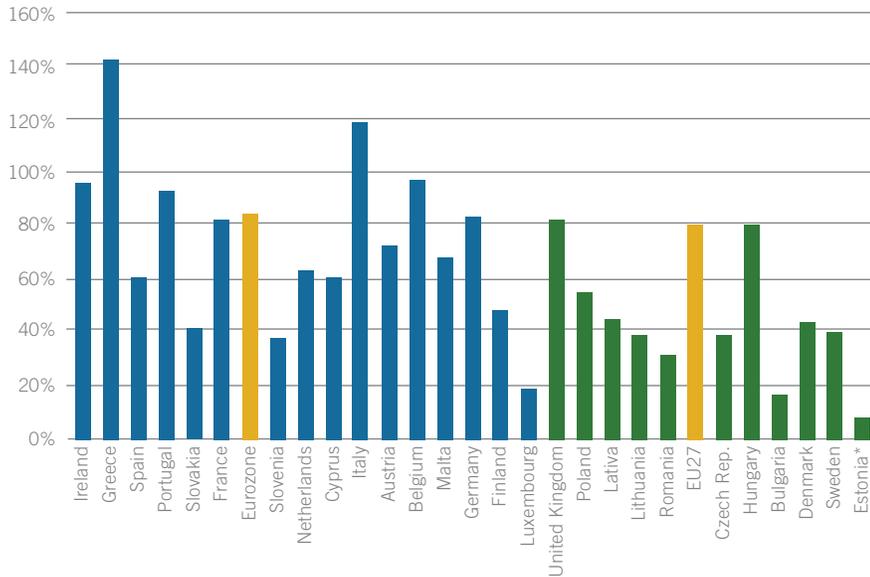
That's the key point about sovereign debt. The very meaning of sovereignty is that you can default if you want to.

OUTLOOK: That almost makes it sound like government bonds are more risky, not less risky, than the debt of other borrowers.

AP: David Hume, in addition to being one of the greatest philosophers of all time, was also a great economist. He once said: "It would scarcely be more imprudent to give a prodigal son a credit in every banker's shop in London, than to empower a statesman to draw bills on posterity." That's very true. Once you issue paper that is an obligation of future generations, where is the limit?

Nonetheless there does get to be a limit where governments can't pay, and that's when what I call "Pollock's Law of Finance" comes in. And Pollock's Law of Finance is: "Debt which cannot be paid will not be paid." Good to remember for all bankers.

TOTAL GOVERNMENT DEBT IN EUROPE AS PERCENTAGE OF GDP



*Estonia joined the Eurozone on Jan. 1, 2011

Source: EUROSTAT

OUTLOOK: In your recent paper you spend a lot of time on the European debt crisis of the 1920s and 1930s, which you argue has parallels to today. What is instructive about that episode?

AP: Most of the sovereign debt defaults of more recent times – Mexico in 1982, Russia in 1998, Argentina in the early 2000s – have occurred in the emerging or developing world. In the 1920s and 1930s, European societies were, as they are now, among the leading and most advanced economies of the world. Yet we had a European government debt crisis then, as we do today. That’s the parallel.

OUTLOOK: What precipitated that crisis?

AP: During World War I, England, France and other allied governments borrowed

gigantic amounts money for armaments supplied by the U.S., and their principal creditor became the United States. They had run through their assets, the investments they had, their stocks and gold, but they wanted to keep on fighting the war, so America sold them all kinds of munitions on credit. (By the way, this should make you think of China manufacturing things and taking back American debt.) As it came about, the European countries could not pay their receivables. They had borrowed far beyond the capacity of their economies to generate the cash to pay off the debt. So they came up with a great plan: “We’ll make Germany pay.” War reparations paid by Germany after World War I were simply a form of debt: The Germans would pay to France and Britain so that France and Britain could pay the United States.

In the end, the Germans couldn’t and wouldn’t pay that much. By 1924, it was clear that these debts couldn’t be paid and something had to be done. It was not dissimilar from what’s happened over the last year in Europe. The Greeks can’t pay, so what do we do? We have big international meetings to try to somehow work it out. They did the same thing in those days. They worked out a big deal, called the Dawes Plan, which restructured the German reparations and included new loans to Germany. Germany was going to use the new loans to pay France and Britain, and France and Britain could then pay the United States. But somebody had to make new loans to Germany, and guess who that was? The United States!

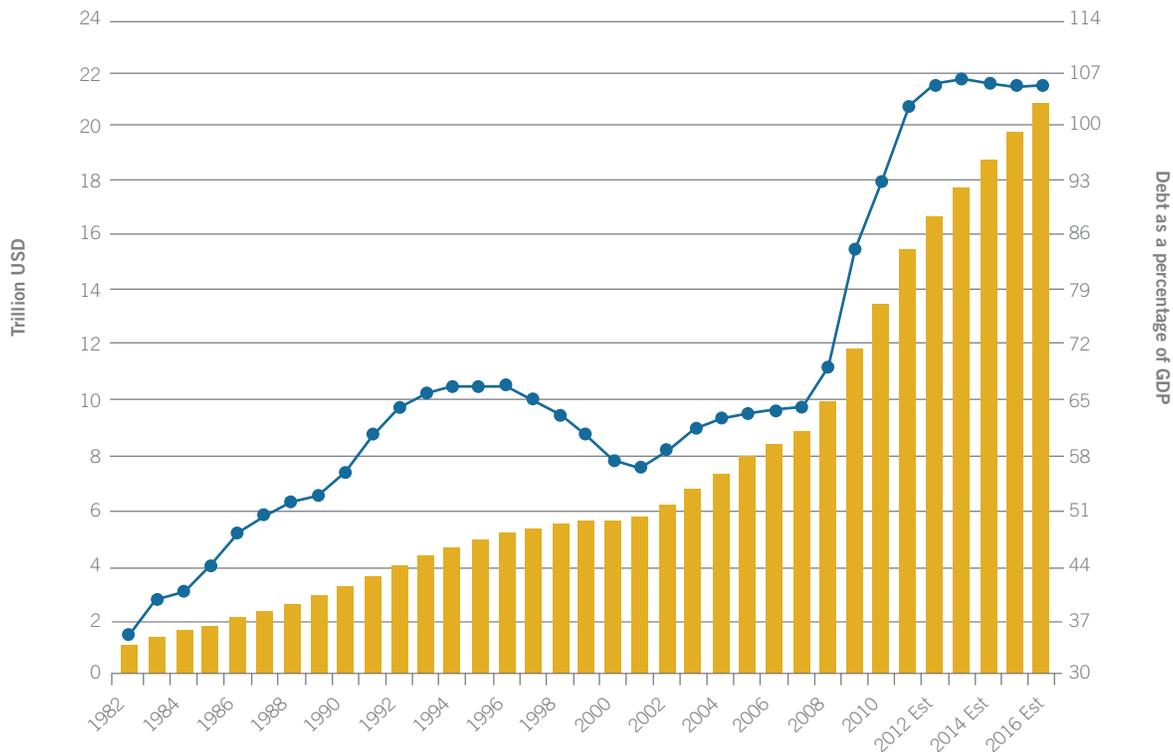
OUTLOOK: How did the plan work out?

AP: In the end the Dawes debt was not repaid. The Weimar Republic of the 1920s in Germany was overthrown. Both reparations and debt were repudiated by the new Nazi government.

People need to remember that governments can lose control of a country and be replaced. People kick the old government out, which happens often enough in history. The new government comes in and says, "Oh, that debt? I'm not paying." A famous historical example is Russia in 1917, during the communist revolution. The new communist government repudiated the previous government's debt.

John Maynard Keynes says somewhere that there's a limit on the extent to which any society will burden itself to pay off bondholders. At some point you basically have to make yourself slaves to pay off the holders of past debt. There's a limit to that, and it will eventually cause a political reaction. We're seeing that in Greece now, for example.

U.S. NATIONAL DEBT VS. DEBT AS PERCENTAGE OF GDP



Source: U.S. Office of Management and Budget

LARGEST DEBT-TO-GDP RATIOS

COUNTRY	DEBT AS PERCENTAGE OF GDP
Japan	225.9
St. Kitts & Nevis	196.3
Lebanon	139.0
Jamaica	135.7
Greece	130.2
Eritrea	129.7
Grenada	119.1
Italy	118.4
Iceland	115.6
Barbados	111.6

Source: U.S. News and World Report

OUTLOOK: *In your paper, you argue that banks are especially susceptible to pressure from government to hold sovereign debt. Why is that?*

AP: Banks take instructions from the government all the time. The more regulated they are, the more susceptible they are to direction and pressure from the government. Governments always want to promote government debt, and banks are very susceptible to being the vehicles through which this is undertaken. In the current Greek crisis, government debt is very widely held by banks. The banks have agreed to a “voluntary” loan restructuring, which means writing off a lot of the debt. You can imagine the discussions between the big European banks and the governments and central banks: “You *will* ‘voluntarily’ do this deal.”

OUTLOOK: *What do you think the endgame in Europe will be today? How will the current crisis play out?*

AP: What happens when you have unpayable debt? There is default in one way or another. You can have an overt default, like we just had with Greece. Or it can be an implicit default. Once you get to a paper currency or a fiat currency system, the government can just create inflation in order to impose losses on the bondholders. You pay off in cheaper dollars later.

You can also do the same thing through exchange rates, by letting your currency depreciate. For instance, foreign investors who bought United States bonds have the experience of very large currency depreciation losses. We lose track of the fact of how much the U.S. dollar has depreciated against other currencies. In 1970 one dollar would buy four Swiss francs. A dollar today buys less than one Swiss franc.

Of course Greece’s problem is that it can’t depreciate the euro because it doesn’t control its own paper currency. That’s the same problem California has. California very well might want to have its currency depreciate versus the currency of the rest of the United States, but it can’t.

“In the end the losses are taken, one way or another. And life goes on. Things are written off, some people fail, some people survive. But life goes on.”

OUTLOOK: *Whether explicit or implicit, wouldn't a series of defaults on sovereign debt in Europe be catastrophic for the world economy?*

AP: Here's the happy ending to any kind of debt crisis: In the end the losses are taken, one way or another, and life goes on. Things are written off, some people fail, some people survive. But life goes on. And it won't be that long before we're in the midst of another boom.

OUTLOOK: *You sound almost casual about that.*

AP: Financial cycles, including cycles of sovereign debt, are inevitable. But we're cycling around a rising trend. So as long as you have an enterprising, free-market economy with a basic rule of law and the freedom to innovate, which enables entrepreneurs to start things and allows that which succeeds to grow, on average the trend of economic and intellectual well-being is up. We have a very long-term upward trend line, and we cycle around this trend.

Part of recovering from the down cycle is writing off old mistakes and old debt, so that life can go on and we can continue. This is what Adam Smith, in his marvelous phrase called, the “natural progress of opulence.”

Maybe we can end on that optimistic note. What I always say to people is, five years or so from now when we're back in a boom, try to remember all these painful lessons, which seem so vivid now but which will not seem vivid then. ■

Business and Health Care Reform, Part II

Earlier this week, the U.S. Supreme Court heard oral arguments on the legal challenge to the landmark health care reform law. Officially known as the Patient Protection and Affordable Care Act, and unofficially as “Obamacare,” the law imposes dramatic changes on the American health care payment system. Supporters say the legislation will help improve access to health care for many people, especially the poor, and trigger badly needed changes in the delivery system. Opponents argue its costs and complexity will prove to be a crushing burden for an already weak economy.

In the February edition of Outlook, we interviewed a strident critic of the law – Robert Graboyes, senior fellow at the National Federation of Independent Business. Graboyes contended in the interview (available [here](#)) that the law will do nothing to quell rising health care costs while discouraging job growth among small businesses.

This month, in order to provide a balance of perspectives, we interview economist Henry J. Aaron, a senior fellow at the Brookings Institution and a supporter of the law. We asked Aaron to respond to the criticisms leveled by Graboyes. While conceding that the law is complex and difficult to implement, he believes its benefits greatly outweigh the costs.

OUTLOOK: Talk about the most significant benefits of health care reform.

Henry Aaron: One is a dramatic expansion of Medicaid. Roughly 15 million to 16 million more people will be added to Medicaid rolls, so millions more Americans will have health insurance when that change takes effect in 2014. The federal government will pick up virtually all of the cost the states would otherwise incur, so at least for the first several years there’s negligible incremental fiscal obligation on the states.

The second major provision requires insurers to cover all who come, and it limits the degree to which they can vary premiums based on personal characteristics. There’s also a prohibition on canceling insurance regardless of the individual customer’s claim history. The insurance companies were in contact with the Obama Administration early on and said, “Look, if you’re going to do that, we need a requirement that everyone except those covered by Medicare, Medicaid, or employer-sponsored plans must have coverage. Otherwise, the sickest will disproportionately seek coverage and that will drive up premiums to unaffordable levels. That led to the individual mandate, requiring individuals to show that they have health insurance coverage.

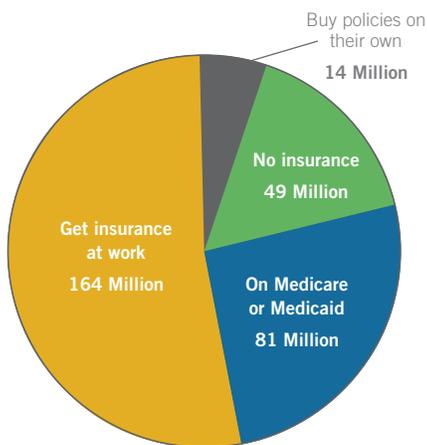
There’s a requirement for businesses employing 50 or more full-time workers to provide coverage that meets certain standards, which will vary from state to state based on regulations. The companies must provide a minimum portion of the cost of that insurance as a fringe benefit. Also, in order to carry out the requirement that individuals have insurance, the law establishes health

About this article



Henry J. Aaron is a senior fellow in economics at the Brookings Institution. He originally joined the Brookings staff in 1968. From 1990 through 1996 he was director of Brookings’ Economic Studies program. Mr. Aaron also taught at the University of Maryland for 22 years, served as the Assistant Secretary for Planning and Evaluation at the U.S. Department of Health, Education and Welfare in the late 1970s and chaired the 1979 Advisory Council on Social Security. He is a member of the Institute of Medicine, the American Academy of Arts and Sciences, the advisory committee of the Stanford Institute for Economic Policy Research, and the visiting committee of the Harvard Medical School.

WHO'S COVERED?



Source: Commonwealth Fund

insurance exchanges, which are essentially regulatory agencies to supervise the marketing of the insurance, and to provide subsidies to low- and moderate-income households in order to hold down the cost of insurance.

OUTLOOK: Are there any other key benefits?

HA: Lots of them, and some are quite important. Some are also quite controversial. Those include the independent payment advisory board, which will have duties only if per capita Medicare costs rise faster than targets specified in the law – eventually growth of per capita Gross Domestic Product plus 1 percentage point a year. If Medicare spending growth exceeds that level, the IPAB must recommend ways to hold down the growth of spending in ways that do not ration care or reduce benefits of enrollees. If Congress disapproves of the way the IPAB proposes to control spending, it can legislate alternative controls.

There also will be an increase in federal funding for comparative effectiveness research, which will evaluate how effectively alternative forms of care achieve medical outcomes. The legislation does not empower anyone to deny or limit care in any way, but comparative effectiveness research will give everyone information on how to provide the best care at given costs.

And there will be various pilot programs to change the way physicians practice medicine to bring them into patterns of practice that are generally recognized to provide superior care. Accountable care organizations will encourage varying specialties to join together under one centralized management so people get a full range of care for a particular condition from one organization. There will also be pilot programs testing new ways of paying physicians so they are paid not for individual, micro-defined services, but for broad classes of conditions. For instance, there might be a bundled payment for the treatment of someone who had a heart attack, rather than separate payments for angioplasty, other hospital care, physician fees, follow-on care and drugs.

 [If] provisions of the law don't work right or inflict hardship, the thing to do is fix them, not repeal the law.

OUTLOOK: *The law imposes financial penalties on businesses if their employees qualify for subsidies. How burdensome will that be?*

HA: The simplest way to comply with the law and avoid the risk of any penalties is to provide a health plan that meets state regulations. I think the way to approach such provisions, if they result in hardship or draconian penalties, is to amend the law. It's not a reason to abandon the very significant and constructive reforms in the legislation. There aren't very many supporters of the Affordable Care Act who will insist the legislation was drafted in an ideal fashion or is free of mistakes. But they will say it represents an enormous step forward for improving health insurance coverage and the practice of medicine in the United States; those reforms need to be preserved, and where provisions of the law don't work right or inflict hardship, the thing to do is fix them, not repeal the law.

OUTLOOK: *What's the risk that employers that no longer want to deal with the rising cost of health insurance will shift the burden of health insurance to the government?*

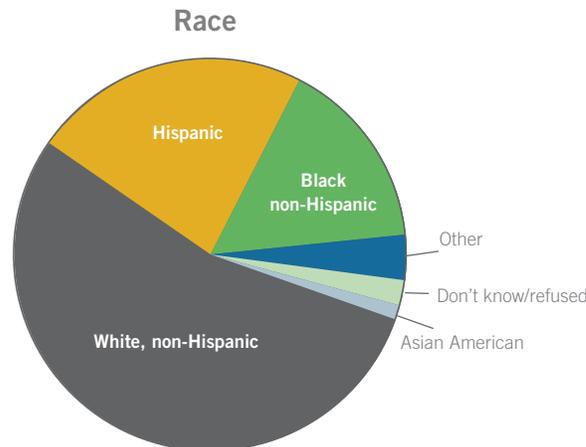
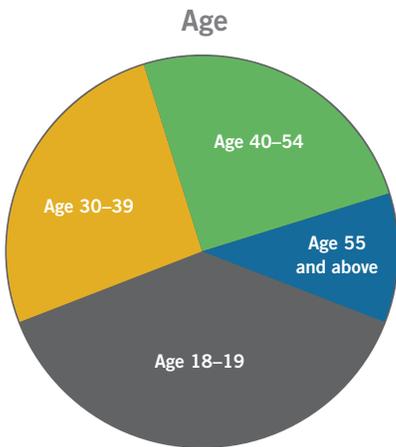
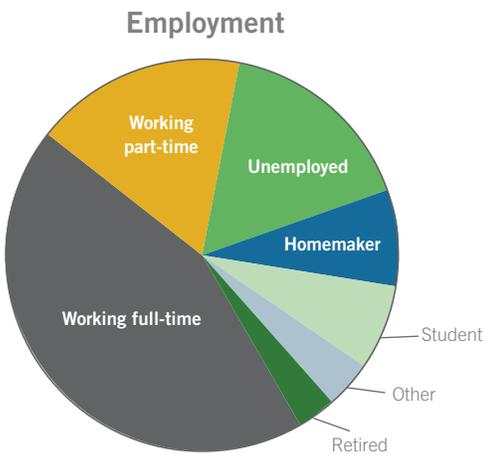
HA: Most research has suggested employers are unlikely to stop sponsoring health insurance plans to any significant degree. The best outside analysis was done by MIT professor Jon Gruber, who concluded that only a few employers will drop coverage. However, some employers also will start offering coverage so that, on net, the shift will be very small. Estimates by the Congressional Budget Office reach similar conclusions.

I'm not going to say the scenario of employers shifting the burden of insurance to the government is an impossible one, but it's been looked at very carefully. And most analysts and business owners understand that businesses provide insurance because it's a good way to attract good employees and they're unlikely to drop it wholesale. Some will begin offering health insurance because they will be able to access it on better terms than in the past. They may need to do so to compete with other firms.

OUTLOOK: Is it fair to say that employers dropping coverage could emerge as an unintended consequence?

HA: This is a large piece of legislation, and whenever we have a large piece of legislation, there are uncertainties. We are moving into unfamiliar territory. People are going to be subject to rules they haven't faced before. They are going to modify their behavior, and when they change their behavior, they are going to influence others. Analyzing those kinds of effects is extremely difficult.

WHO ARE THE UNINSURED ADULTS?



Source: PBS/The Kaiser Family Foundation

It's going to be hell on wheels to put into effect. The enrollment of 15 million people in Medicaid, getting the health insurance exchanges up and running, paying out subsidies, recovering improperly paid subsidies – all of these things are extremely difficult.

OUTLOOK: *Most of the key provisions of the law don't take effect until 2014 and beyond. Assuming the law isn't struck down or repealed, how challenging will that be from an administrative standpoint?*

HA: It's going to be hell on wheels to put into effect. The enrollment of 15 million people in Medicaid is going to strain state Medicaid administration. Getting the health insurance exchanges up and running, paying out subsidies, recovering improperly paid subsidies, making sure the health insurance offerings are understandable to potential customers – all of these things are extremely difficult.

The states are going to face very significant administrative responsibilities. I would be the last person in the world to say this is easy.

In fact, this whole debate is very, very far from over because the administrative challenges that will have to be surmounted are so formidable.

OUTLOOK: *Elaborate on that concern.*

HA: The two terms that come to mind are, first, "massive resistance" – the term used for Southern states resisting desegregation back in the 1950s and 1960s – and, second, a phrase former Senator Daniel Patrick Moynihan used for how people sometimes respond, which he called "dumb insolence." It's not refusing outright to administer the law, because if states do that, the federal government will take over and administer it. It's dragging their heels and not doing the job properly. That could cause very serious problems. I hope that doesn't materialize, but the way some state administrations have been talking recently, there's cause for concern.

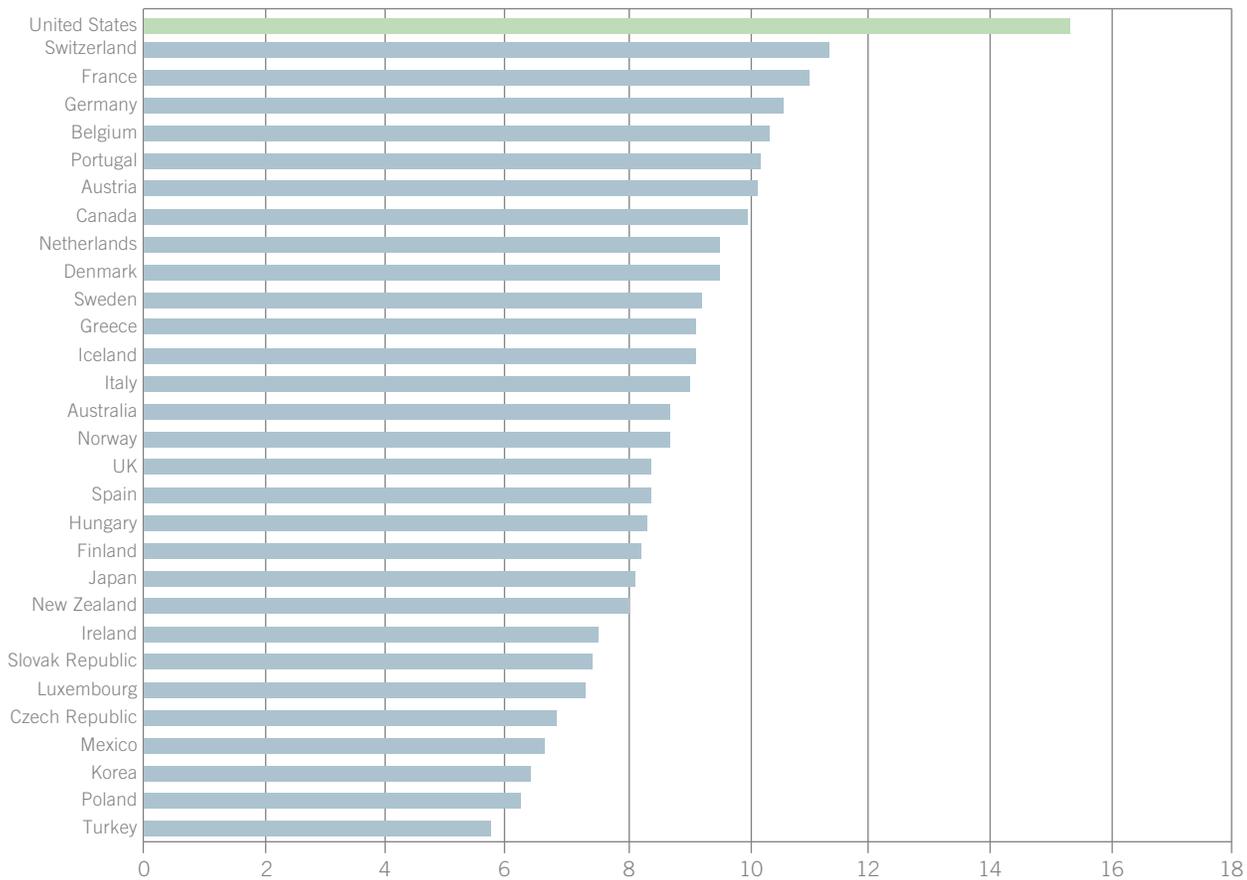
OUTLOOK: *Does the law adequately address the problem of the rising costs of health care?*

HA: Yes and no.

Yes, in that there really isn't anything that anybody has proposed as a way of slowing the growth of health care spending that isn't in this law in at least some form.

And no as well, for two reasons: First, not all of the ideas in the law are being pursued as aggressively as I think are desirable. I think the changes in the tax rules covering very, very generous health insurance plans could have been

HEALTH CARE SPENDING AS PERCENTAGE OF GDP



Source: Organization for Economic Cooperation and Development, *OECD Health Data, 2008* (Paris OECD, 2008).

Note: For countries not reporting 2006 data, data from previous years is substituted.

written more tightly and pushed harder to discourage such plans. Second, the current health care system itself could hardly have been designed better if the goal was to frustrate cost control. There is massive decentralization, no single center of power to force limits on the growth of health care spending, and very few incentives to do so. So there are very few levers to pull effectively at the present time. Developing those levers is going to take a lot of time and require a lot of change.

Congress actually did a reasonably good job with the tools that were available and, given the political divisions that separate the two parties and exist within each party, to limit the growth of spending. At the same time, I think we're going to see rapidly rising growth of health care spending, not because of the health reform, but because of the health care delivery system and payment arrangements that now exist. It is that system, not the reform legislation, that's going to put real pressure on both public and private budgets for many years to come.

OUTLOOK: Talk about the prospects of the legal challenge to the reform law.

HA: The court set aside a truly extraordinary amount of time for oral arguments, more than any case since 1966. The arguments were spread over three days.

The most important single issue is the debate about the constitutionality of the individual insurance mandate. Those arguing against the constitutionality have presented what has colorfully been characterized as “the broccoli argument,” which is “If you can require people to buy health insurance, where does it stop? Could Congress require them to purchase anything at all, even broccoli?” The lower courts have come down on different sides of that issue.

OUTLOOK: How do you think the court will rule?

HA: I’ve given a few talks and gotten a laugh by saying “No sensible person should forecast what the Supreme Court will decide, and here is my prediction.” I think that the court will not invalidate the law. If it rules on the individual mandate, I think it will probably sustain it by a vote of 7-2 or even 8-1. However, it might avoid a decision. It could do so if it rules that what people must pay if they don’t carry insurance is a ‘tax’ rather than a penalty levied to regulate interstate commerce. Under a law passed in 1867, taxpayers can’t sue to invalidate a tax until they have actually paid it. And since the mandate doesn’t take effect until 2014, no one could be forced to pay the tax until after that, and only then could they sue. Now, I could be wrong. The court could rule that what people pay is a penalty, not a tax, and the five conservatives might unite in declaring the mandate unconstitutional. The four liberal justices are almost to certain to say it’s OK, and that leaves everyone except Clarence Thomas in play. He’s pretty much a sure bet to say it’s beyond federal powers. I think the key vote is Scalia, and I think he’s likely to vote to sustain the bill. If he does, Chief Justice John Roberts isn’t going to want to be sitting out in the minority on this one, because this is a decision that’s going to mark the court for years and define his place in history as a chief justice. Then there’s Justice Kennedy, and I think if Scalia and Roberts were to affirm the constitutionality, Kennedy would as well. That leaves Alito, and he could be the second on the ‘no’ side.

If this bill is repealed, nothing is going to be enacted. The Republican alternative is thin. The ideas they have put forward are not estimated to have a very big effect on cost or coverage.

OUTLOOK: What are the prospects for a full repeal of the legislation in 2013 if a Republican wins the White House?

HA: I don't think Republicans are likely to take 60 seats in the Senate, so the filibuster shoe is likely to be on the other foot if that occurs. If Mitt Romney wins the White House, his steadfastness in adhering to his previous positions is decidedly limited. He's been on both sides of the health reform issue already. And anybody who calls for rolling back the Affordable Care Act – well, let me put it this way: If you break it, you own it. Right now, anything that goes wrong can be laid at President Obama's feet. If the health reform is scaled back or repealed, then anything bad that happens belongs to – for purposes of this discussion – the incumbent Republican president. So there's considerable risk in repealing the bill.

That said, the primary campaign has led all the Republican candidates into taking such hard and firmly stated positions that it's pretty hard to see how they could do anything other than call for repeal. Whether they'd get it is whether the Republicans are close to 60 in the Senate. Democrats are notoriously fragmented and I have no idea how they would behave in that environment.

OUTLOOK: If the law was fully repealed, or if it's struck down by the Supreme Court, are there other reforms out there that could help businesses or consumers?

HA: If this bill is repealed, nothing is going to be enacted, in my opinion. It would poison the atmosphere around health insurance reform in a very major way. I'm laying aside the possibility there's a Republican landslide; in that environment, they come into office with a very powerful mandate and could do many things and implement one variant or another of legislation embraced in the past.

But the Republican alternative program on health reform is thin. The ideas they have put forward are not estimated to have a very big effect on cost or coverage. I think the likelihood of a landslide Republican victory is not great, and if they win narrowly, we have gridlock in the other direction. The most likely change to be debated is to convert Medicaid from its current format into a block grant program; I would expect to see a Republican White House push for that proposal. And another is to replace Medicare with a voucher program; I think that will be debated seriously after the election.

Health reform initiates what will be a decades-long journey to assure all Americans access to care, to control the unsustainable growth of health care spending, and to improve the quality of care Americans receive.

OUTLOOK: If President Obama is re-elected, what do you expect to see then in terms of implementation of the law?

HA: I believe that a second Obama administration will produce political trench warfare even more intense than we have already seen. The 2016 presidential campaign will begin the day after the votes are counted in November. It now appears that both houses of Congress will be closely divided. The health reform will proceed, as there will be no prospect of repeal. But some states will lack the ability or the will to enforce it effectively. Even with the best of will, the law would be a real challenge to administrators. So, one should expect myriad implementation problems, political back-biting, and controversy. But we should never have expected anything else.

People care deeply about their health care. They spend a lot of their income on it, often without fully realizing how much. Millions of people derive their income from providing health care. Lots of dollars are getting shifted around because of health reform. Lots of professionals are going to face incentives to make uncomfortable changes in the way they operate. Health reform initiates what will be a decades-long journey to assure all Americans access to care, to control the unsustainable growth of health care spending, and to improve the quality of care Americans receive. It will not be a smooth or easy trip, but it is a journey we have to take and that President Obama's health reform has begun. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 02/29/12. 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

2012	GDP	CPI	Funds	2-year	10-year
Q1	2.10%	2.00%	0.09%	0.20%	2.00%
Q2	2.20%	1.80%	0.10%	0.30%	2.10%
Q3	2.40%	2.20%	0.13%	0.30%	2.10%
Q4	2.60%	2.00%	0.13%	0.30%	2.20%
2013	GDP	CPI	Funds	2-year	10-year
Q1	2.50%	2.20%	Forecast Extended through 2013 next month		

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	0.49%	0.49%	0.68%	1.12%	1.59%	2.07%
0.25	0.39%	0.49%	0.74%	1.21%	1.68%	2.14%
0.50	0.49%	0.54%	0.83%	1.32%	1.77%	2.21%
0.75	0.52%	0.58%	0.93%	1.41%	1.85%	2.29%
1.00	0.56%	0.62%	1.03%	1.54%	1.97%	2.37%
1.50	0.63%	0.73%	1.25%	1.78%	2.16%	2.52%
2.00	0.75%	0.92%	1.51%	2.02%	2.33%	2.67%
2.50	1.06%	1.24%	1.79%	2.25%	2.52%	2.80%
3.00	1.38%	1.55%	2.07%	2.48%	2.71%	2.94%
4.00	1.94%	2.09%	2.58%	2.83%	3.01%	3.16%
5.00	2.51%	2.63%	2.95%	3.11%	3.23%	3.31%

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	5	5	6	6
90	5	10	12	12
180	5	14	21	22
365	11	30	42	42

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.

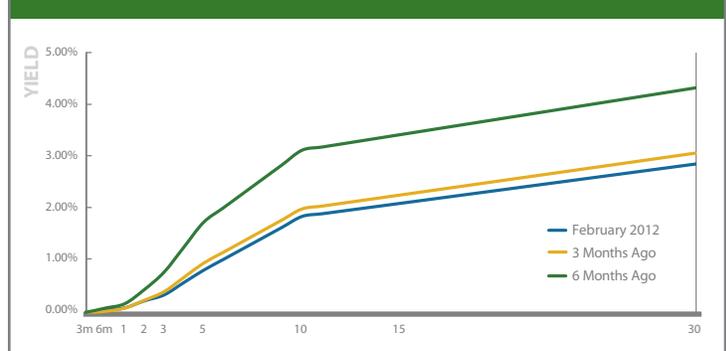
3-MONTH LIBOR



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 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 serving more than 70,000 farmers, ranchers and other rural borrowers in 23 states around 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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Register Now for CoBank's 2012 Customer Meetings

Registration continues for CoBank's remaining 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, please visit cobank.com/meetings.

Here's the list of upcoming customer meetings:

- **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 by emailing corp.comm@cobank.com or by calling 303-740-6456. ■