OUTLOOK Economic Data and Commentary

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The Looming Fiscal Cliff

At the end of 2012, two events are scheduled to occur that many fear will deliver a real shock to the fragile U.S. economy. One is the expiration of the Bush-era tax cuts, which will increase income, dividend, estate and capital gains tax rates for a substantial majority of American taxpayers. The other is mandatory cuts to domestic and military spending programs that were agreed to as part of the congressional debt-ceiling negotiations last year.

The combination of spending cuts and tax hikes will remove an estimated $600 billion from the U.S. economy in the first year alone. The only way to avoid this economic double-whammy – the so-called "fiscal cliff" – will be a bipartisan agreement in Washington, D.C. Whether that's possible in the middle of a presidential election year remains to be seen.

For background on the issue, *OUTLOOK* talked recently with Kevin A. Hassett an economist with the American Enterprise Institute. Hassett, who is also a columnist for the *National Review* and an advisor to Republican presidential candidate Mitt Romney, believes the nation could be in for a rough ride if the fiscal cliff isn't averted.

OUTLOOK: We hear a lot of talk these days about a "fiscal cliff" approaching. What does it refer to?

Kevin Hassett: The fiscal cliff is coming at the end of this year, when all of the tax cuts that have been enacted basically going back to President Bush's first term will sunset. What that means is there will be big, big tax increases for everybody. And at the same time there will be a large reduction in government spending that was agreed to as part of the debt deal last year. All of those factors are giving a lot of people pause because tax hikes are a negative stimulus and government spending reductions are a negative stimulus.

OUTLOOK: How big will the tax hikes be? Who will be affected?

KH: Nearly every taxpayer will be affected. The expiration of a two-year tax cut extension passed in 2010 will lead to an increase in the marginal tax rates in all income brackets: the lowest bracket will go from the current 10 percent to 15 percent; the current 25-percent bracket will increase to 28 percent; the current 28-percent bracket will be replaced with a 31-percent bracket; the

About this article

Kevin A. Hassett is senior fellow and director of economic policy studies at the American Enterprise Institute. He has advised presidents, presidential candidates, members of Congress and federal agencies on issues relating to macroeconomics and tax policy.

Before joining the American Enterprise Institute, Mr. Hassett was a senior economist at the Board of Governors of the Federal Reserve System, and he has served as an associate professor of economics and finance at Columbia University. During the George H. W. Bush and Clinton administrations, Mr. Hassett was as a policy consultant to the U.S. Treasury Department. In addition, he has served as an economic adviser to the presidential campaigns of George W. Bush, John McCain and now Mitt Romney.

His most recent book is "Toward Fundamental Tax Reform." His scholarly articles have appeared in numerous professional journals, and he also writes a weekly column for *Bloomberg.*

33-percent bracket will increase to 36 percent; and the current top bracket of 35 percent will be replaced with a top bracket rate of 39.6 percent.

Another hit to workers will be the expiration of a temporary payroll tax reduction that Congress passed in 2010.

Capital gains and dividend taxes will go up for most Americans, as well. Currently, the maximum federal rate on long-term capital gains and dividends is 15 percent, but this is set to increase to 20 percent, with the top tax on dividends set to increase to 39.6 percent. Workers in the lowest two tax brackets currently pay no taxes on dividends or capital gains, but with the expiration of these rates, they will pay 10 percent on capital gains and 15 percent on dividends for the lowest bracket, and 28 percent on dividends for the second lowest bracket of income earners.

Other tax increases include a higher estate tax and the end of an estate tax exemption for properties between $3.5 million and $5 million; the end of a patch on the Alternative Minimum Tax; and the end of tax rates for married couples which eliminated the "marriage penalty" on couples filing jointly.

In total, revenues are expected to go up by $494 billion next year if all of these tax changes occur.

OUTLOOK: Are corporate taxes affected by the expiration of the Bush tax cuts?

KH: Corporate tax rates are not directly affected by the expiration, except in the expiration of some provisions allowing for businesses to fully expense investments in capital. That was part of the 2010 compromise legislation allowing an extension of the Bush-era tax cuts. However, the expiration of the Bush tax cuts will have a big impact on the many small businesses that pay taxes through the individual tax code.

OUTLOOK: You've written that we should fundamentally reform our corporate tax structure.

KH: That's another big negative right now. The easiest way to see how crazy U.S. policy is that, other than the Republic of the Congo and Guyana, we have the highest corporate tax on Earth, and at the same time our corporate tax revenue as a percent of GDP is the lowest it has ever been. So we've got the most punitive high tax and the least revenue we've ever had. And the reason we're in first place among developed nations is because everyone else has recognized that capital income is mobile and if you have a high rate then capital income will run to a different place. And this is one of the things we'll have to fix if we want to generate positive growth that is better than 1 percent or so because right now wealthy multinationals are reluctant to locate new plants in the United States given the punitive taxes that we have.

> Blue collar workers should be rioting right now in favor of lower corporate rates because they're the ones who would benefit.

What is the "fiscal cliff?"

Because of a deal that President Obama cut with congressional Republicans in 2011, the Bush tax cuts – and dozens of other tax provisions – will expire in December, raising taxes for virtually every U.S. household next year. Meanwhile, last year's debt-limit deal also included a plan to implement $110 billion in automatic spending cuts next year.

What will happen

If Congress does not act, on January 1, 2013:

- The George W. Bush-era tax cuts will expire, raising rates on investment income, estates and gifts, and earnings at all levels.
- The value of the child credit will drop from $1,000 to $500.
- The marriage penalty for joint filers would rise.
- The Social Security payroll tax will pop back up to 6.2 percent from 4.2 percent.
- New Medicare taxes enacted as part of President Obama's health-care initiative will, for the first time, strike high-income households.
- The 15 percent tax on dividends and capital gains would increase to 20 percent or more.

Source: AP, Washington Post, Washington Times

In the current system if a U.S. multinational makes some money in Ireland it won't pay U.S. tax until it mails the money home. But because Ireland has such a low corporate tax rate, about 10 percent, there's a strong incentive to locate your profits in Ireland. So what that means is that if the multinational locates a lot of activity in Ireland then it can have its U.S. parent buy a lot of stuff from its subsidiary in Ireland and pay exorbitantly high prices for these things and the result will be very little profit in the U.S. but lots and lots of profit in Ireland. And those games are part of the U.S. tax code.

Blue collar workers should be rioting right now in favor of lower corporate rates because they're the ones who would benefit. Factories tend to get built in countries with lower rates and those factories bid up salaries for blue-collar workers.

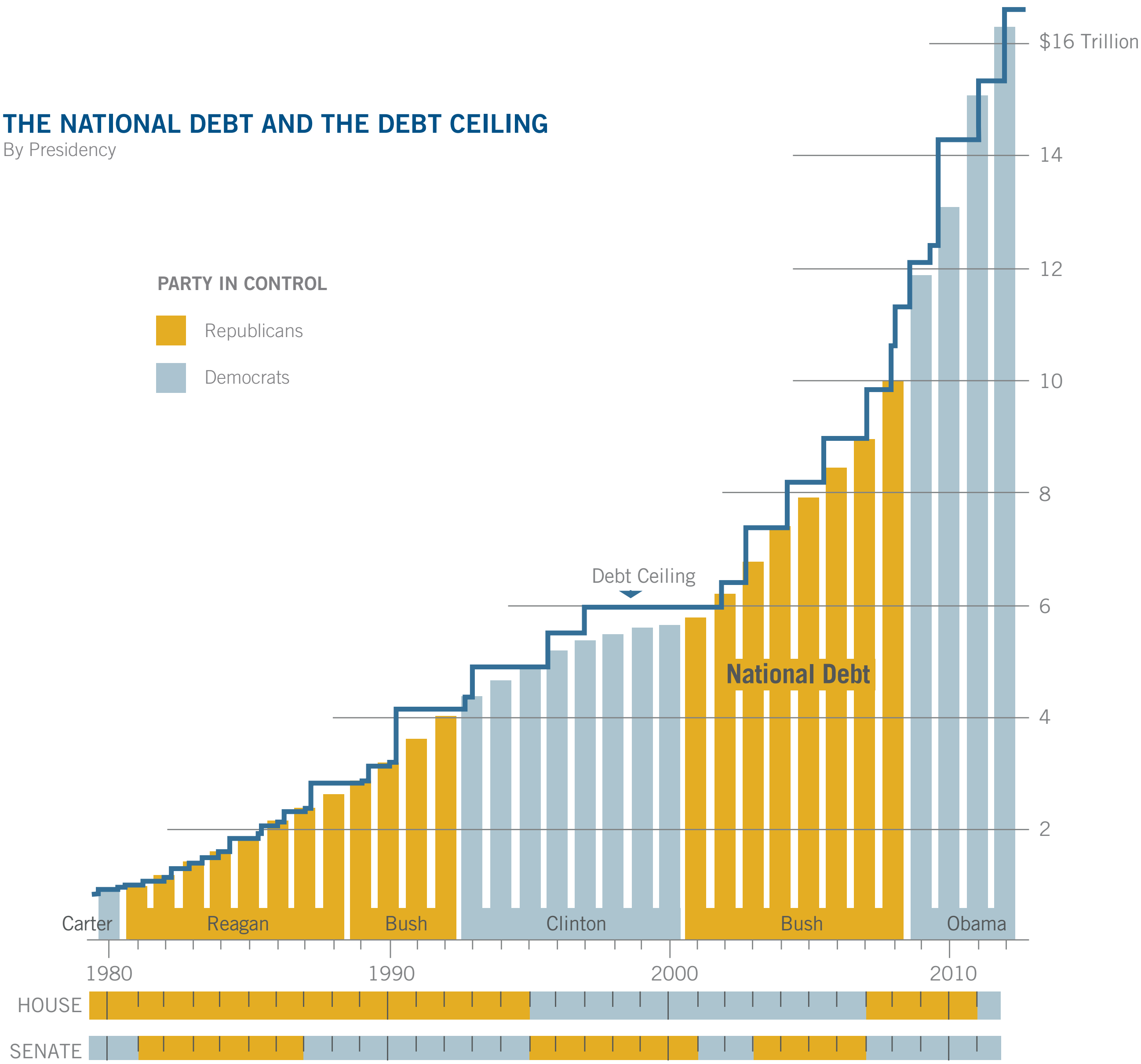
OUTLOOK: Talk about the scale of the spending cuts and where they will occur.

KH: Beginning in 2013, parts of the Budget Control Act passed in 2011 will take effect, creating caps in spending for certain programs that will total $1 trillion between 2013 and 2021. In 2013, $54.7 billion in cuts will come from discretionary programs and entitlement programs, including some cuts in payments to providers in the Medicare program, farm price supports, and student loans, along with proportional cuts in discretionary programs. Another $54.7 billion will come from defense programs, including proportional decreases in many programs with the exception of war spending, which is effectively exempt from cuts.

After 2013, the same amount of money will come from statutory caps on defense and discretionary spending, but in contrast to 2013, the cuts won't necessarily be proportionally distributed. While equal amounts will come from defense and discretionary spending, the Appropriations committees can distribute cuts in whatever fashion they decide upon, except for mandated cuts in entitlement spending which will continue from 2013.

THE NATIONAL DEBT AND THE DEBT CEILING

By Presidency



Source: Washington Post/White House

OUTLOOK: Which will have the bigger impact, the tax hikes or the spending cuts?

KH: People can argue which one will have the bigger effect but if you're doing both then it should arouse anxiety on the part of everyone. On top of all this there is likely to be the need for another debt limit increase at about that time.

So pretty much every single possible fiscal variable is going to be in play in December with a lame duck Congress.

OUTLOOK: How do the debt ceiling negotiations affect the picture?

KH: Congress sets the total amount of government debt that we can have and when we run deficits then over time we get close to the limit. If we're going to be able to borrow again then Congress has to pass an increase in the limit. And if Congress doesn't it can put a significant constraint on what government can do. Ultimately it won't even be able to write checks.

When people don't know what the rules of the game are they simply put off making decisions until the rules are defined.

If you go back and look at the data last summer when we had the debt limit debate in Congress there was a lot of anxiety that maybe Republicans would not raise the limit and then the government would have to shut down. It's pretty clear that the anxiety was a big negative for the economy. I'm not saying that it was a worse negative than for the nation to go bankrupt, which could happen if we don't try to get ahead of the curve on spending. But the fact is some economists at the University of Chicago estimated that the debt limit debate last year probably cut 1.5 percent off GDP growth. This year we've got another debt limit showdown and it's going to happen at the same time when virtually everything else is up in the air as well. So if you think last summer's debt limit debate was bad for the economy then you should be even more concerned this year.

OUTLOOK: How does anxiety reduce growth? Because investors keep their powder dry?

KH: Exactly. If you don't know what the rules are going to be it's hard to do the math to justify a capital investment. Consider even the example of government workers. If they're anxious about not getting their checks then maybe they don't buy automobiles. The private sector is affected too. When people don't know what the rules of the game are they simply put off making decisions until the rules are defined. We are going to be in a period between now and December when there is extreme uncertainty about what's going to happen next.

OUTLOOK: What should Congress do to eliminate the uncertainty? Can we avoid the fiscal cliff?

KH: We need to recognize that in an election year it's almost impossible to do anything between now and November. And whoever wins is going to have a very strong incentive in the lame-duck session to push decisions into the next Congress. So if it were me, especially since the economy is perched so close to the edge, what I would do is pass an extension right away. I would extend all of the Bush tax cuts and the payroll tax cut and suspend the spending cuts into the summer of next year. That way, the new Congress and the new president, or the existing president with a new Congress, will have a good chunk of time to finally get a grip on these things.

OUTLOOK: Is a compromise likely or unlikely to occur in your view?

KH: The lame duck session will almost surely be able to kick all of these problems into next year. Whether a long-term fix or another short-term patch is pursued by the next Congress will, of course, depend on the election. To the extent that power is divided approximately evenly, it may be difficult to aim high.

OUTLOOK: When Congress does get around to addressing these issues for the long term, what should it do?

KH: What Congress needs to do is to sort of start from scratch rather than playing small ball. I was at an event with President Bush a couple of months ago in New York and he said he wished they weren't called the Bush tax cuts because that means automatically there are a lot of people who hate them even though normally they might be disposed to like them. So we need to start over and seek common ground by broadening the base and lowering the tax rates and putting entitlements on a more sustainable path by making some tough long run decisions. To the extent that you do that, you just call it sound, bipartisan policy.

OUTLOOK: Would you include additional revenues in the mix or would you want the reform to be revenue neutral?

KH: Given how much debt has increased and given the massive deficits we currently face, taking revenue off the table seems like a difficult position to defend.

Here at AEI we looked at all of the "fiscal consolidations" that have happened in recent history – by which I mean situations where countries faced an unsustainable deficit like ours and passed a big policy change that tried to fix it. Then we looked at whether the policy worked and the deficit went down. The typical successful consolidation was 85 percent spending cuts and 15 percent tax increases. So that's the trade I'd be wiling to accept, 85 to 15. And the tax increase doesn't necessarily have to be something that involves a marginal rate increase.

OUTLOOK: Yet higher taxes on the wealthy seem to be popular. For example, people tell pollsters they like the Buffett Rule (which would impose a minimum rate of 30 percent on all income above $1 million).

KH: The Buffett rule is very unlikely to ever become law because it's just a backdoor way to increase taxes on capital gains. I think it's a politically motivated discussion by President Obama and his team, who think it's a conversation that will win votes. But historically members of both parties,

> The odds of recession in the second half of the year are roughly 50-50.

including former President Bill Clinton, have understood the economic benefits of low taxes on capital and capital gains. If you have high taxes on capital gains you get a lock-in effect where people don't take their capital gains out and invest in anything. It congeals economic growth and that's been the bipartisan consensus going back decades. I think it would have a very difficult time even getting widespread support in the Democratic Party.

As for other schemes to tax the rich, Obama has of course called for the repeal of the Bush tax cuts for the wealthiest since the last campaign. But he had an opportunity to act on that. He had a supermajority in the Senate that would have allowed him in the first two years to extend all of the Bush tax cuts except the top ones and he chose not to do it. I think one of the reasons he chose not to do that during the recession is he was anxious that if they increased the top tax rate it might harm the economy. My guess is that that concern is gong to be equally valid this year.

OUTLOOK: What are the risks of a recession in the U.S. this year?

KH: I think the odds of recession in the second half of the year are roughly 50-50. If you remember what those University of Chicago professors found about uncertainty lopping 1.5 percent off growth last year and that we're heading into a similar situation the second half of this year, then we could easily wind up in negative territory when you consider how many more issues are on the table this time.

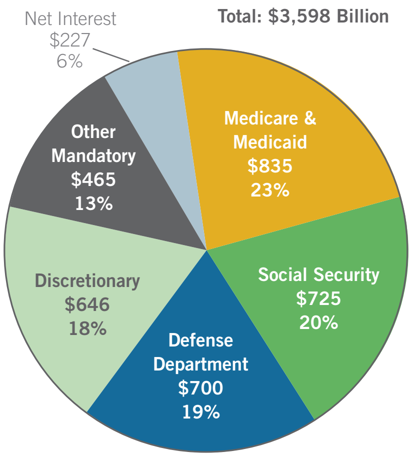
OUTLOOK: You once wrote that coming out of a financial crisis takes more time than a normal recession. Is that the cause of the slow growth or are the president's policies to blame, as Republicans contend?

KH: It's a bit of both. Fiscal policies have been very ill advised. But it's not just President Obama. It goes back to President Bush himself who was also very Keynesian and pro-stimulus at the end. The recipe one needs to follow to produce a sustained recovery was just taken off the table by both presidents' economic teams, and we're paying the price right now.

Let's say you implement a Keynesian policy and have the government spend $100 billion extra this year. And let's say you're an optimist and believe you'll get $200 billion in GDP out of it because the multiplier is two, so GDP goes up this year because you spent a lot of money. But next year

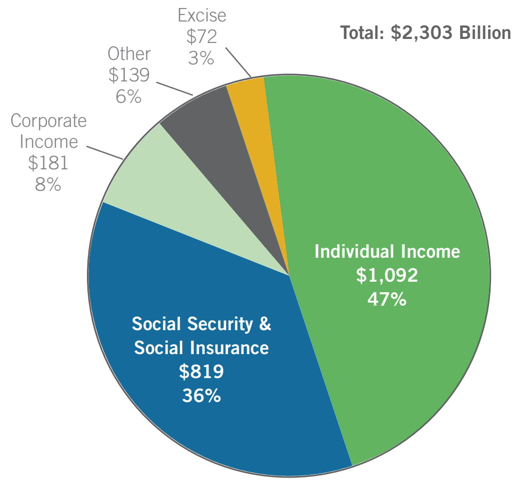
U.S. FEDERAL SPENDING

Fiscal year 2011 ($ Billions)



U.S. FEDERAL TAX RECEIPTS

Fiscal year 2011 ($ Billions)



Source: CBO Historical Tables

when you take that $100 billion away then GDP will go down by the same amount, right? GDP growth will drop $200 billion next year just like it gained $200 billion this year. And the problem is that Keynesian policy doesn't just have these two steps, it has three. It has the stimulus, the equal and opposite contraction and a third period when you pay for it with higher taxes or higher ongoing borrowing costs – and that's a negative as well. So if you look at the Keynesian stimulus as a whole – and this is totally apparent in the Congressional Budget Office analysis – over a decade the stimulus is a negative.

What we need to do is put in fixes in long-term policy that will put us on a higher growth path going forward without inducing a hangover.

OUTLOOK: Why are financial crises different from other kinds of recessions?

KH: Financial crises tend to create circumstances where financial institutions end up sitting on huge piles of bad assets. As they recapitalize, they tend to ratchet lending down significantly, putting a damper on growth for an extended period of time. Governments also inevitably take on large debts as they bail out financial institutions. Those debts crowd out private investment, and also reduce growth. It takes about 10 years to really clean up the mess.

OUTLOOK: The economist and New York Times columnist Paul Krugman has an entire book out saying we can spend our way back to higher growth. Is he in a minority among economists or is the profession pretty evenly split?

KH: I think there is very little academic support for what Krugman says or for what even the Obama team says. If you look at the academic literature you will find that stimulus is hard to time and not very successful.

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OUTLOOK: If austerity is the way to go, why hasn't it worked better in Europe?

KH: If austerity measures are designed correctly, they can set the stage for long-term growth without creating a near-term slow down. Nations that have had big fiscal consolidations are not growing slower than everybody else and more or less look much the same as everyone else. Those big fiscal consolidations have two effects. On the one hand, if government spending goes down that's contractionary because government spending is part of GDP. But on the other hand there is a positive expectational effect because if you have a government that looks like it is less feckless then we become more optimistic about the future and start to invest.

And so the fact that nations with big fiscal consolidations look like everyone else is really positive because it means that the positive expectational effects that will lead to higher long-term growth are big enough to counteract even the short-term Keynesian effect. And so you can buy long-term growth if you put your house in order without being worried that you'll go into recession. That's the exact opposite of what Krugman's been saying.

OUTLOOK: What role does government regulation have in creating uncertainty? Can it inhibit growth?

KH: Regulation can be very important but of course it's very difficult to measure and so there's much less convincing literature on exactly which regulations are causing the most harm. But we've got the Dodd-Frank financial regulations coming in with a lot of rule-making uncertainty still in play. We've got the EPA getting ready to regulate greenhouse gases a little more aggressively. It's already imposed some pretty strict rulings on coal-fired power plants. And so you can definitely cite anecdotes where regulations are a problem and contribute to uncertainty. But we'll never be at the point where we can say that regulations have reduced economic growth by, say, 1.7 percent this year. That's the sort of precise knowledge we'll never have.

OUTLOOK: Talk about the column you co-authored in The New York Times describing what you see as a crisis of long-term unemployment.

KH: Historically the U.S. hasn't had a problem with long-term unemployment because we'd had such a vibrant labor market with millions of jobs being created and destroyed every month. So there's this massive churn historically in the U.S. labor market. But right now the churn has stopped. We're seeing net job creation every month – that is, job creation minus job destruction – of 80,000 to 100,000, while gross job creation – meaning new jobs that didn't exist last month – is below where it was during the trough of the recession. Firms are creating fewer jobs right now than they did even when times were as bad as you can remember.

In fact, the only reason we're creating net jobs at all is because nobody is quitting their job – quits are at an all-time low – because they're so anxious that they won't get hired somewhere else. So people get stuck out of the workforce for a long time.

What we wrote about in *The New York Times* is what the new research says happens to people when they've been out of work for a year, or two years and what sort of damage that does to themselves and their families. The statistics are chilling. I think we're in the midst of a national emergency because we've got 5, 6, 7 million people who normally would have been back into the workforce by now but are at risk of being sucked into a downward spiral of separation from society. People identify with their occupation in the sense that their own sense of worth tends to come from it. So when you take away their occupation it can cause a real crisis.

OUTLOOK: What should we do about it?

KH: We need to reform job training. One program that I found particularly attractive is a German training program where very generous funds are given to firms that successfully place people who've been long-term unemployed. But the firms only get the funds if they successfully counsel them and transit them into employment. And it turns out that this kind of market-based solution in Germany is the most successful weapon against long-term unemployment that I've seen in the literature. And what I'm working on right this instant is a revision in its design so it would work in the U.S.

Monetary Solutions vs. Fiscal Problems

When its 2012 fiscal year ends in September, the U.S. federal government will have added more than $900 billion to the nation's total debt. Over the preceding 12 months, it will have spent approximately $3.8 trillion on entitlements, defense and other programs, while taking in only $2.9 trillion in taxes and other revenue. The shortfall will be made up through borrowing – issuing Treasury securities to domestic and foreign investors.

Over the past few years, one of the biggest buyers of U.S. debt has been the nation's own central bank – the U.S. Federal Reserve. In normal times, the Fed is a nominal buyer of Treasuries. In 2011, however, the Fed purchased a remarkable 61 percent of net Treasury issuances thanks to monetary stimulus programs like "Quantitative Easing" and "Operation Twist."

The Fed's highly interventionist approach offers cause for real concern to economist Lawrence Goodman. Goodman is head of the Center for Financial Stability, a New York-based nonpartisan think tank that promotes knowledge about financial infrastructure and the performance of markets for the benefit of officials, investors, and the public. Goodman argues that while the Fed is well intentioned, its actions are having unintended consequences in the capital markets and creating a false sense of demand for U.S. debt.

OUTLOOK recently interviewed Goodman for his views about deficits, the Fed's recent actions and the interplay between fiscal and monetary policy.

OUTLOOK: Last year Standard & Poor's downgraded U.S. sovereign debt for the first time in history, and there is an ongoing sovereign debt crisis in Europe. Characterize the scale of the public debt problem in the world's advanced economies and the risks you think it poses.

Lawrence Goodman: I believe strongly that the fiscal and debt crises in advanced economies are highly challenging and represent a serious threat to the health of the global economy.

I would not underestimate the importance of the sovereign downgrade of the U.S. last year. Analysts at Standard and Poor's thought long and hard before making the decision to downgrade the U.S. Quite frankly, U.S. fundamentals are significantly weaker than in years past. That is a fact of life. The downgrade is a reflection of reality.

There is a reluctance among officials in Europe and the U.S. to recognize the root cause of the problem. This reluctance and delays in confronting the source of the strain are essentially creating a problem that deteriorates with each passing day.

About this article

Economist Lawrence Goodman is head of the Center for Financial Stability, a New York-based think tank that promotes knowledge about financial infrastructure and the performance of markets for the benefit of public officials and the agencies they lead.

Previously, Mr. Goodman was managing director and global head of emerging market strategy at Bank of America, where he led analysis of emerging economies and currencies in Asia, the Americas, and Europe. Earlier in his career, he represented Bank of America on bank advisory committees, analyzing and negotiating sovereign debt restructuring agreements. Prior to that, he ran Quantitative Policy Analysis at the U.S. Treasury.

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What is quantitative easing?

The term "quantitative easing" refers to unconventional monetary policy adopted by central banks to stimulate a national economy when traditional measures have proven ineffective. When short-term rates are already at or near zero, quantitative easing enables the central bank to purchase longer-maturity assets and lower rates further out on the yield curve.

The U.S. Federal Reserve embarked on a first round of quantitate easing shortly after the September 2008 financial crisis. A second round, known as "QE2," occurred between November 2010 and June 2011.

What is Operation Twist?

Announced in the fall of 2011, Operation Twist involved selling $400 billion in short-term Treasuries in exchange for long-term bonds. It was designed to lower yields on long-term bonds while keeping short-term rates little changed. Ideally, it would push down interest rates on everything from mortgages to business loans.

Source: CNN.com, Wall Street Journal

OUTLOOK: What is the root cause? Do you think it is too much spending or too little revenue or both?

LG: It's more of a spending problem. Here in the U.S., public spending has increased to 25 percent of GDP. Traditionally it's been 20 percent of GDP or lower. The real trouble is in the future and represented by entitlements and the various contingent liabilities offered by the U.S. government. We need a serious restructuring of entitlement programs as well as an overhaul of our public financial management.

OUTLOOK: What lessons does Europe hold?

LG: The lesson is that advanced economies are not immune from debt crises. I want to be clear that the U.S. is a ways off from experiencing complications similar to those in Europe. But we are beginning to see some dangerous shifts. We are also beginning to see shifts in how the market perceives the U.S. versus alternative investments. We still have time to shift our fundamentals. But now is the time to act.

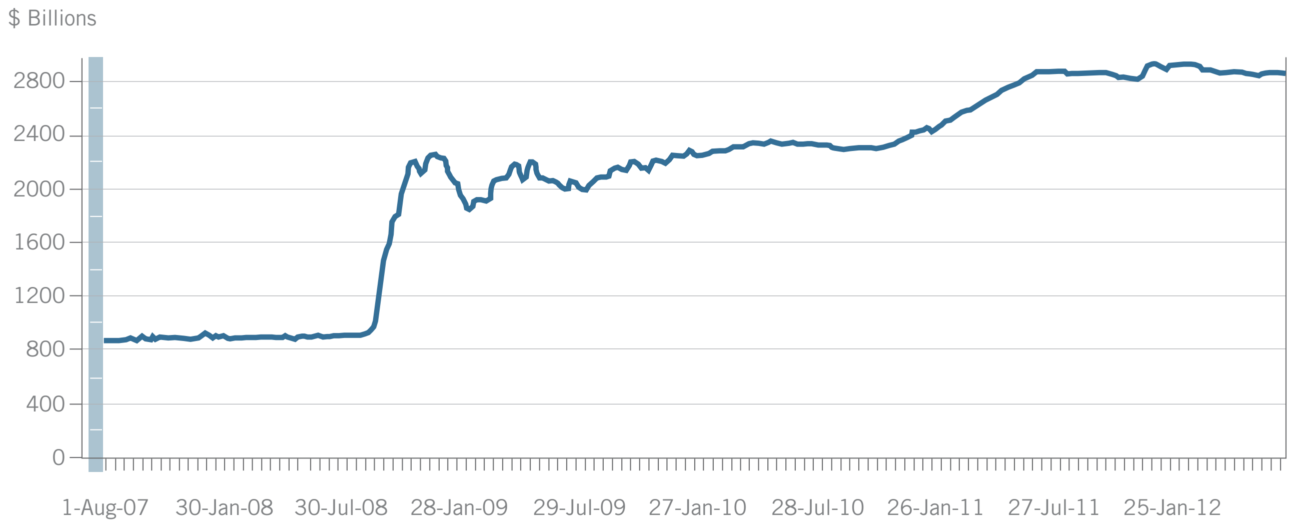
OUTLOOK: How dependent is the United States on the financial markets to pay its bills?

LG: We did a study where we evaluated the net issuance of U.S. Treasury debt over decades from the 1950s through the present. "Net issuance" is simply the increase in debt, measured in dollars, from January 1 to December 31 – how much more Treasury paper has been issued relative to how much has expired or been paid off.

The lowest increase was 0.6 percent of GDP during the 1960s, and the high, until recently, was 3.9 of GDP percent during the 1980s. Between 2008 and 2011, the net issuance of Treasury debt averaged 9.3 percent of GDP. So the recent net issuance of Treasury debt is more than double the largest amount relative to GDP previously experienced for an entire decade.

FEDERAL RESERVE BALANCE SHEET

August 2007 through July 2012



Source: Federal Reserve

OUTLOOK: Why has it gone up so much?

LG: A couple of reasons. The first is that the government has actively engaged in policies to stimulate the economy by spending and incentives. Secondarily, revenues have fallen coincident with a slowdown in the economy. Lower growth translates to reduced tax proceeds.

OUTLOOK: We've had other downturns, including a very bad one in the early 1980s. Why was this one so much worse in terms of driving higher levels of public indebtedness?

LG: There has been a substantial expansion in public spending as a mechanism to combat recessionary forces. The fiscal effort coincident with the 2007 recession was substantially greater than the 1982 recession, or even the Great Depression back in the 1930s.

OUTLOOK: In a recent Wall Street Journal article, you argued that foreign and private investors have become less willing to fund our government. How do you reach that conclusion?

LG: To clarify, I said that *at these low interest rates*, foreigners and private investors have been less willing to fund the government.

In normal times, the Fed is a net buyer of Treasury paper to carry out its open market operations. But typically those numbers are extremely small – less than 0.4 percent of GDP. One of the unintended consequences of the Fed's quantitative easing policy has been to push Fed purchases to over 4 percent of GDP, or 61 percent of Treasury net issuance. QE accomplishes the Fed's objective of keeping rates low. But it also crowds out foreigners and the private sector who would ordinarily be stepping in to purchase those obligations – albeit at much higher rates.

"Uncertainty is clearly restraining economic output. Many corporations are sitting on cash due to many uncertainties muddying potential investment opportunities. One of those uncertainties is Fed policy.

OUTLOOK: How are the Fed's actions impacting the yield curve?

LG: Typically the Fed implements policy by targeting the Federal funds rate or by setting the overnight interest rate to its desired level. But at present the Federal Reserve is active in setting rates across the curve via previous QE and the present "Operation Twist." So the normal market price discovery that is instrumental to derive market-determined yields has changed substantially due to the presence of a large buyer – the Federal Reserve – in the market. Rates across the curve are artificially low. And that naturally raises future policy management challenges regarding how the Fed exits from this unusual situation for market participants.

OUTLOOK: Is it an overstatement to say the Fed is setting rates rather than the market?

LG: We do have market interest rates, but they are heavily influenced by the visible hand of the Fed. The actions of a large single player are influencing rates across the curve.

The question becomes, what happens if the economy continues to remain sluggish? Will the Fed engage in another round of quantitative easing? And if so, how do they engineer that? And how does that fit with the Fed's mandate? Conversely, how will the Fed respond if inflationary pressures remain less temporary than many believe?

OUTLOOK: How are securities market participants affected by the Fed?

LG: In order to help push the unemployment rate lower, the Fed is resorting to unorthodox monetary policies that are highly discretionary in nature. They are acting in a manner that is new and untested for market participants.

The disciplined and rules-based approaches to monetary management that the market has grown familiar with since Chairman Paul Volcker's days at the Fed gave investors, corporations, and individuals a degree of comfort and a level of certainty. As policy becomes more discretionary, the level of uncertainty increases. At present, uncertainty is clearly restraining economic output. For instance, many corporations are sitting on cash. They are not putting cash to work in part due to many uncertainties muddying potential investment opportunities. One of those uncertainties is Fed policy.

> If the problems in the economy are structural, monetary policy will prove ineffective in reducing unemployment on a sustained basis and the byproduct will be a swollen central bank balance sheet.

OUTLOOK: Obviously the Fed believes it is doing the right thing. What is the goal of these interventionist policies, from their standpoint?

LG: The Fed believes that price pressures are tilting more towards deflation than inflation, which provides it with the need to engage in unorthodox policies to expand the size of its balance sheet and money in circulation. They believe these policies will be helpful at moving unemployment lower without sparking inflation. The Fed also believes that they can unwind these policies in a smooth and purposeful fashion.

OUTLOOK: What are the dangers inherent in the Fed's approach?

LG: If the problems in the economy are structural, monetary policy will prove ineffective in reducing unemployment on a sustained basis and the byproduct will be a swollen central bank balance sheet.

The danger relates to the potential for overconfidence by the Fed in its ability to be ahead of the markets. The risks extend beyond the Fed since other central banks around the world – the ECB, the Bank of England, the Bank of Japan – adopted similarly unusually large eases in monetary policy and associated expansion of balance sheets. This complicates the exit strategy for all.

Specifically, two important risks are at play. One is that the bank reserves that have been created by the Fed suddenly spark money demand, putting upward pressure on inflation. The size of the Fed's balance sheet has increased to $2.9 trillion dollars or roughly three times its pre-crisis size. And those reserves in the banking system can readily be liquefied and turned into money and inflation.

The other risk is that the Fed reduces balances too readily, creating a contraction in money which ultimately becomes deflationary. The issues are multi-fold and complex.

OUTLOOK: Are those significant risks in your view?

LG: The risk that the Fed falls behind the market is not insignificant.

At the Center for Financial Stability, we are working to provide the public and officials with better data to evaluate monetary policy. We now provide measures to evaluate the money supply and the shadow banking system in real time.

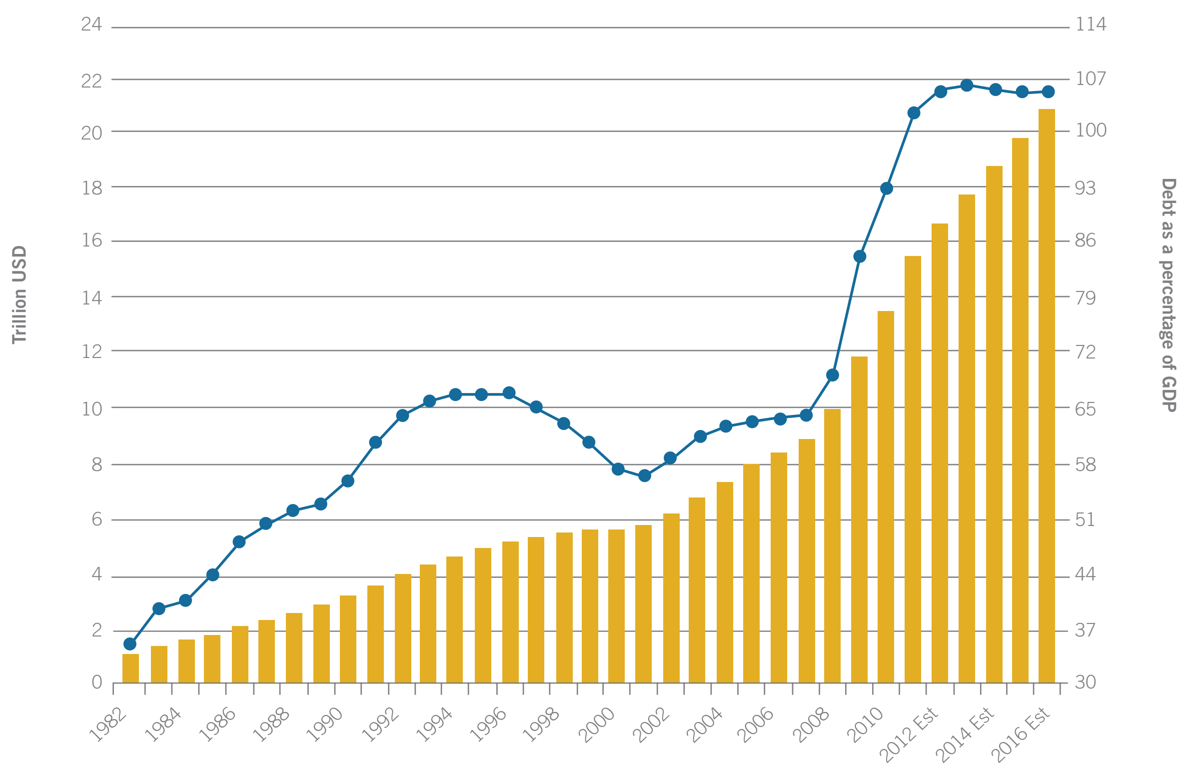
OUTLOOK: By holding interest rates low, does the Fed enable the government to avoid making hard decisions about deficits?

LG: Definitely. Borrowing costs have been kept artificially low, so Treasury's interest payments are restrained and there's been a ready source to purchase Treasury obligations. This has certainly had an impact on masking the true cost of funding the U.S. deficit, which in part leads to this greater reliance on, and vulnerability to, financial markets. When the big buyer is no longer present, there is the risk of a price adjustment – that bond prices push lower and yields push up.

OUTLOOK: What impact do the Fed's actions have on commodity prices?

LG: Commodities are traditionally a hedge for inflation, and there has been a deep linkage between the Fed's activities and commodity prices. Monetary expansions incent market participants to move funds to vehicles that protect against future inflation. So as the Fed has increasingly provided credit, the CRB index has rallied. As these unorthodox monetary policies experience a temporary reprieve, commodity prices fall.

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



Source: U.S. Office of Management and Budget

> Having a credible fiscal policy, where spending is more limited and there's a clear plan on the entitlement front, could actually unleash powerful growth in the U.S.

OUTLOOK: The Fed has indicated it could hold interest rates near zero through the end of 2014. What do you foresee in terms of the timing of monetary tightening?

LG: Although it's difficult to have a clear vision out that far, I believe that the Fed will need to push rates to a more normal level substantially sooner than many expect. Fed policy will be a major driver of financial markets over the next several months.

OUTLOOK: Won't tightening by the Fed then become yet another a drag on growth in the overall economy?

LG: Under the right circumstances, no. In fact, a more certain macro environment could unleash stronger growth despite a move to normalize rates. Low, stable and predictable inflation rates often trigger higher growth rates over a long period. For instance, the period starting in October 1979, when Chairman Volcker moved to tighten money, sparked a period of 25 years with high growth in a low-inflation environment. So I don't see the tradeoff as so rigidly defined especially during this unusual period of time.

In fact, this phenomenon is true on the fiscal front too. The idea of having a credible fiscal policy, where spending is more limited and there's a clear plan on the entitlement front, could actually unleash powerful growth in the U.S. If there's a long-term credible plan to actively limit our debts and address contingent liabilities, namely entitlements, that plan could unleash a tremendous amount of confidence and growth.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 06/30/12. 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**
Q2	2.10%	1.60%	0.15%	0.30%	1.90%
Q3	2.20%	1.90%	0.15%	0.30%	2.00%
Q4	2.40%	2.00%	0.20%	0.40%	2.10%
2013	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.10%	2.10%	0.25%	0.50%	2.20%
Q2	2.50%	2.10%	0.25%	0.60%	2.30%

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	0.47%	0.50%	0.63%	0.96%	1.35%	1.78%
0.25	0.44%	0.51%	0.66%	1.04%	1.42%	1.84%
0.50	0.50%	0.54%	0.73%	1.12%	1.50%	1.91%
0.75	0.53%	0.56%	0.80%	1.21%	1.58%	1.98%
1.00	0.56%	0.59%	0.88%	1.29%	1.67%	2.00%
1.50	0.59%	0.66%	1.06%	1.49%	1.83%	2.18%
2.00	0.68%	0.79%	1.25%	1.69%	1.95%	2.31%
2.50	0.86%	1.03%	1.49%	1.88%	2.14%	2.44%
3.00	1.04%	1.27%	1.73%	2.08%	2.32%	2.56%
4.00	1.61%	1.73%	2.16%	2.41%	2.54%	2.77%
5.00	2.07%	2.20%	2.38%	2.68%	2.82%	2.94%

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

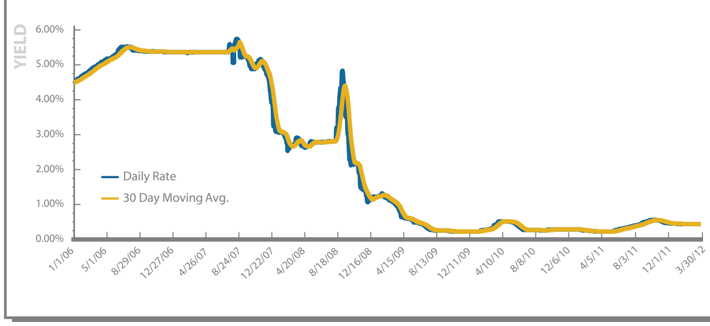
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	6	5
90	5	9	12	11
180	5	13	20	19
365	8	29	41	37

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

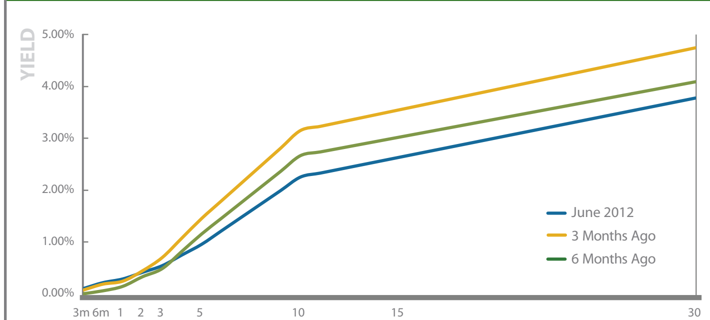
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE



CoBank Announces $3 Million Charitable Matching Fund For Cooperatives

CoBank has announced the creation of a $3 million charitable fund designed to benefit cooperatives and charitable groups they support throughout rural America.

Under the bank's new "Sharing Success" program, CoBank will match contributions by its cooperative customers to nonprofit organizations of their choice. Contributions made during the remainder of 2012 will be matched on a dollar-for-dollar basis, from a minimum of $1,000 up to a maximum of $5,000.

"Shared success is a hallmark of the cooperative business model, so we're absolutely delighted to be announcing this new program," said Robert B. Engel, CoBank's president and chief executive officer. "Throughout rural America, cooperatives of all sizes are working not only to provide value to their members but to improve the quality of life in their local communities. We hope all our cooperative customers will take advantage of this new fund, and use it to leverage the support they provide to worthy causes in the areas they serve."

The launch of CoBank's Sharing Success program coincides with the United Nations' "International Year of Cooperatives" in 2012. Throughout the year, the U.N. and cooperative organizations are using programs and special events to celebrate the many contributions of co-ops and the strength of the cooperative model.

"I commend CoBank for its generous decision to establish this fund," said Wilson Beebe, chairman of the National Cooperative Business Association. "I can think of no better way for a cooperative to take part in the International Year of Cooperatives than by participating in the Sharing Success initiative."

CoBank will begin formally accepting applications for funding from cooperatives on August 1, 2012. The program will run through December 31, 2012 or when the $3 million matching fund is exhausted, whichever comes first. Cooperative customers interested in participating should contact their CoBank relationship manager for an application and detailed program requirements. Additional information about the "Sharing Success" program is available at *www.cobank.com/sharingsuccess.*

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. 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.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank's web site at www.cobank.com.