

Russia's Future in the World Economy

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Every day, Americans are bombarded with headlines about the rise of China and India as new economic powerhouses on the global stage. It's easy to forget that another behemoth in Asia - Russia - occupied the central spot in our nation's foreign policy consciousness for almost five decades after World War II.

But Russia still matters. In August, global wheat prices surged to two-year highs after Prime Minister Vladimir Putin announced a ban on exports due to weather-driven supply shortages there. And the country remains a dominant supplier of oil and natural gas to the world market. Unlike China, however, the former Soviet Union has not been nearly as successful in making the transition from the communist era to a more market-based economy.

According to Russia expert Bruce Parrott, not even the Russians are sure just what they want to be going forward. Parrott, a professor at Johns Hopkins University who has served as a consultant to both the U.S. State Department and Department of Defense, recently talked with Outlook about a nation deeply ambivalent about its future and jealous of its superpower past.

OUTLOOK: What do Russians see as their place in the world today?

Bruce Parrott: They're uncertain. They were profoundly shocked by the collapse of the Soviet state. That's something that's very hard for Westerners to understand. Most of us have lived our whole lives in countries with stable governments based on fixed territories. Most of the national disappointments that we as Americans have experienced, however discouraging, have been small blows compared to the traumatic effects of the breakup of the Soviet Union on Russians' psychology.

OUTLOOK: But didn't the Soviet collapse bring the promise of political and economic freedom to ordinary Russians?

BP: As Americans, we found that idea very satisfying because it vindicated our own personal values. Most Russians initially accepted the breakup of the Soviet Union as a necessary way of getting free from the Soviet system's intrusive control of their daily lives. But Russians were never as



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Special Report: Outlook for the U.S. Livestock Sector

A recent jump in commodity prices – spurred in part by a historic drought in Eastern Europe and Russia – has sparked anxiety among the livestock and dairy sectors. Jim Robb, agricultural economist and Vice President of Industry Research and Analysis in CoBank's Knowledge Exchange Division, gives his perspective.

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enthusiastic about the dissolution of the Soviet Union as some non-Russian ethnic groups, such as the Ukrainians or the Baltic minorities. And over time, when the economic upheavals of the 1990s turned out to be tumultuous and extremely painful for many Russians, the Soviet era began to look better and better to them.

It also began to sink in that Russia had experienced a tremendous decline in its international status. When NATO began

to expand its membership and other countries began ignoring Russia's international preferences, Russians realized that they had suffered a major loss of international power. Today, there's a marked desire in the general population for Russia to return to its status as a great power.

OUTLOOK: How realistic are those dreams?

BP: The likelihood of reestablishing a Soviet-style state is extremely small. Despite the nostalgia for past greatness, the members of the current Russian elite don't have the kind of ideological drive for international dominance that the Soviet elite had. Many are preoccupied with advancing their own economic interests rather than establishing Russia as a powerful international actor. Ordinary Russians may like the idea of Russia as a great power, but they don't have the stomach for the kind of economic sacrifices that would be required to do this. The net result is that there's going to be a mood of self-assertion, but Russia probably will behave fairly cautiously over the next five or 10 years because of the state of its internal affairs.

On the other hand, what they most want to do is exercise primary influence among the neighboring countries that were once Soviet republics, and they are very wary of outside influence in those countries, particularly U.S. influence and Chinese influence.

OUTLOOK: Who do Russians view as a greater threat to their position, the U.S. or China?

BP: The United States, clearly. We are, after all, at least for the moment, the sole surviving superpower. Russians have traditionally focused on the United States as a kind of yardstick of their own accomplishments. They were proud in the 1970s when it seemed that nothing could be done around the world without Soviet as well as American agreement. After the collapse of the Soviet Union, the experience of being lectured on how to organize their economic and political systems spilled over into resentment of the U.S., as did the unilateralism of the Bush years. In a recent poll of young Russians,

About this article

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something like 65 percent of them saw the United States as an enemy and a rival. That's a huge change from the early 1990s, when [then-president Boris] Yeltsin was talking about making Russia part of the West.

OUTLOOK: Do they see China as a friend?

BP: In the same poll, half saw China as a friend and only 25 percent as an enemy, even though the two countries share a long border. Remember, China didn't try to give Russia a blueprint for economic and political reform, and it hasn't been trying to reshape the countries along the Russian periphery the way the United States has been attempting to do.

On the other hand, there's a certain distrust of China stemming from the Mao era, and a certain racism and fear of the "yellow peril." In the long run, members of the Russian elite are quite concerned about the rise of China because it's so dynamic. They see their own faltering economic progress, while China forges ahead year after year and decade after decade, and the contrast makes them nervous. That's one reason why Putin took steps to achieve a complete border demarcation with China in 2004. He wanted China to sign on the dotted line before it acquired more power and had second thoughts about territories that once were contested.

OUTLOOK: So what's holding Russia back from a China-style boom, considering its size, population and all of its oil and other natural resources?

BP: A lot of political observers believe that abundant natural resources can be a curse as well as a blessing. Natural riches can thwart the development of other economic sectors by siphoning off investments and entrepreneurial initiative. If you're an aspiring entrepreneur, you'll probably get involved in energy, not machine tools. And if your country is exporting large amounts of oil and gas, this increases foreign buyers' demand for the currency, which in turn strengthens the currency and undercuts your country's ability to sell non-energy exports abroad.

Moreover, most of the manufacturing industries Russia inherited from the USSR are technologically backward and not as dynamic as those of other major countries. There are a lot of outdated plants, and it's hard to get them on a solid technological footing. Corruption and mismanagement are also serious problems. In other words, natural resources are valuable, but by themselves they're not a solution to Russia's problems.

RUSSIA BY THE NUMBERS

Population.....	140 million
Life Expectancy	66 years
Pop. Below Poverty Line.....	15.6%
Inflation Rate (2009).....	11.7%
GDP (2009)	\$1.25 trillion
GDP Growth (2009)	-7.9%
GDP by Sector	
Agriculture.....	4.7%
Industry	34.8%
Services	60.5%
Foreign Reserves	\$1.97 trillion
Labor Force	75.81 million
Unemployment (2009)	8.4%
Exports	\$303.4 billion
Imports	\$191.8 billion
Airports	1,213
Pipelines	
Gas.....	159,552 km
Oil	74,285 km
Refined Products	13,658 km
Railways	87,157 km
Roadways	940,000 km
Merchant Marine Fleet	1,074 vessels

Source: CIA World Factbook

OUTLOOK: We've all read about the new class of Russian billionaires. But how much is happening in terms of developing an entrepreneurial economy?

BP: The so called “oligarchs” have been enormously entrepreneurial in the sense of taking the initiative and going after resources and building economic empires. But a lot of that has come through political manipulation and corruption. A recent study showed Russia had the fourth largest number of billionaires in the world, but an economy which was somewhere between the 10th and 15th largest. And there hasn't been the level of small business entrepreneurship, as there was in, say, Poland after the end of communism. The major reason seems to be that small entrepreneurs are easy marks for corrupt officials and organized crime. It's very difficult to do business at that level in the Russian system. There are lots of barriers to entry. The level of small business per capita in Russia is much smaller than in most post-communist countries.

OUTLOOK: What about Russia's enormous agricultural output? Will Russian farmers challenge the United States for dominance in agricultural exports?

BP: Russia is a big exporter of some agricultural products, but their agriculture sector on the whole is highly inefficient. This is a long-lasting feature of Russia going back for centuries, and the past two decades have brought very little innovation or initiative to the sector. The country still has a very large rural labor force, but it consists mainly of women and old people. Young, ambitious people have gone to the cities. In the past several years, Russia has imported 3-4 times as much food and agricultural raw materials as it's exported. This year, of course, the country has experienced a severe drought, and the government had responded by prohibiting grain exports in order to ensure domestic supplies and check inflation. That ban is slated to last until late 2011. Although I'm no authority on agriculture, my hunch is that over the long term Russia's competitiveness in international agricultural markets is likely to decline.

OUTLOOK: Have Russians greeted economic troubles in the United States and Europe with any satisfaction?

BP: Initially, there was a certain amount of gloating, a feeling that the financial crisis had shown the American capitalist system was not nearly as good as advertised. But that gloating diminished markedly when the financial crisis spread to Russia with the decline in oil prices and the flight of foreign capital. It's worth noting that the financial crisis had a bigger impact on Russian GDP than on most other big countries. Russian GDP contracted by nearly 10 percent in 2009. It was a big shock. The Russian banking system is weak, and a lot of Russian oligarchs were very heavily leveraged and dependent on foreign loans

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that they couldn't repay without state assistance. So Russia's financial troubles during the past couple of years have borne more than a passing resemblance to the American defaults Russian observers initially criticized.

OUTLOOK: What kind of demographic challenges is Russia facing?

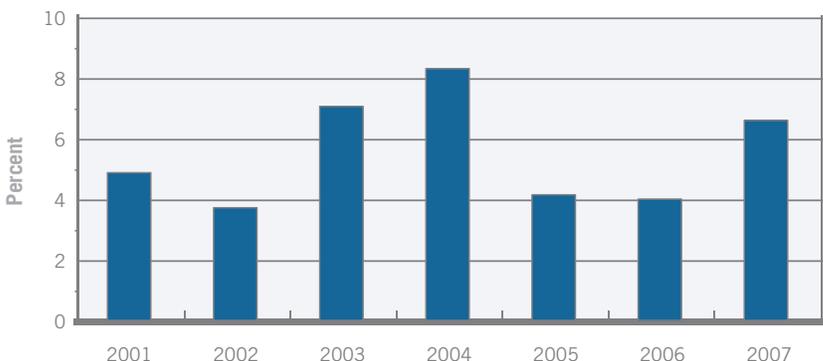
BP: Russia is undergoing a rapid decline in population due to low birth rates and serious health problems, such as heart disease, tuberculosis and AIDS. Since 1992 there have been about 13 million more deaths than births in Russia. The high death rate comes from a combination of self-destructive lifestyles and the deterioration of the health care system since the breakup of the Soviet Union. Faced with big budget deficits under Yeltsin, one of the places the government cut expenditures was health, and this had a harmful effect. But Russian demographers also emphasize that some important causes of mortality, such as heart disease, alcoholism, and accidental deaths, could be mitigated through better lifestyle choices by ordinary Russians. Of course, Russia isn't the only country facing lifestyle-related health issues – look at the United States and obesity.

The decline of Russia's population has been cushioned somewhat by immigration. Russia has the second largest population of illegal immigrants in the world, after the United States. Maybe 6 or 7 million people immigrated to Russia in the past 15 years. A lot of these came from other former Soviet republics; many were ethnic Russians. One way that Moscow may try to come to grips with the absence of domestic population growth is by fostering more legal immigration. But anti-

immigrant sentiment and xenophobia are on the rise in Russia – a pattern that has some parallels in other countries with static populations. Russia will have special difficulty attracting highly skilled workers, because the working and living conditions in other developed countries are more attractive. This is going to be a very hard problem to solve.

These trends have big implications for the economy and for Russian military power. One prominent Russian demographer estimates that over the next 15 years the native-born, working-age population is likely to decline by about

RUSSIAN INDUSTRIAL OUTPUT GROWTH (Annual Percent Change)



Source: World Bank

17 million people. That's a decline of about 25 percent from the 2009 employed population. Imagine your national workforce decreasing by a quarter in 15 years. This gives the immigration issue special bite. As for the military, the shrinkage of the population means a smaller cohort of young men eligible for the draft. And many young people are in poor health, so it's hard to find healthy recruits.

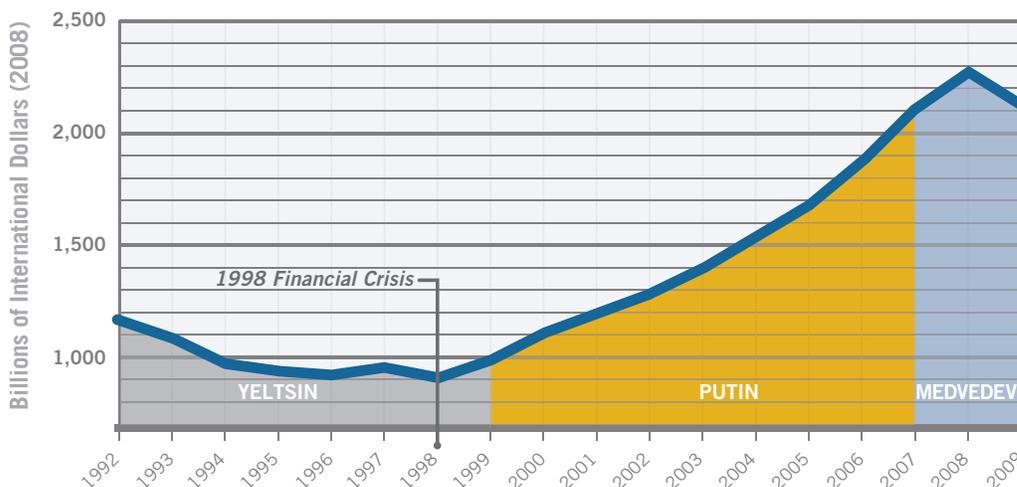
OUTLOOK: What has happened to all the nuclear weapons Russia stockpiled from the Cold War?

BP: When the Soviet Union broke up there was a lot of worry about what would happen to the weapons. The strategic weapons were located in Russia and a few other Soviet republics, such as Ukraine and Kazakhstan. Those weapons were ultimately shipped to Russia and added to its arsenal, but the Russian nuclear arsenal has very little utility in diplomatic terms. Conventional military forces are really what matters when you're dealing with another country, unless that country happens to be threatening you with a nuclear attack. And Russia's conventional military power has declined dramatically. The military establishment has shrunk; it's shot through with corruption. They've been talking about reforms for 20 years and the consensus among outside observers is that the military is still in terrible shape.

OUTLOOK: To an outsider, Russian President Vladimir Putin seems an enigmatic figure. What do you believe he envisions for Russia's future?

BP: We've had about a decade to observe Putin as the leader of Russia. I think his objectives are fairly clear. He came to office determined to restore domestic order after the upheavals of the 1990s. His idea was to build a strong state under the rubric of sovereign democracy – that became the official slogan. This term stands for a state which is nominally democratic, but which doesn't follow most of the practices we in the West associate with democracy. Putin has opted to circumscribe democratic freedoms in exchange for order. This is a natural instinct, given Putin's background in the Soviet security apparatus.

RUSSIAN GDP SINCE FALL OF SOVIET UNION



Source: International Monetary Fund

Putin wants to restore Russia as a great power, and he wants to do this by building an authoritarian state with a flourishing capitalist economy. The problem is that this formula is probably unworkable.

At the same time, it's important to emphasize that the Russian state today is very different from the Soviet state. There are many contrasts. Take international travel, for example. In Soviet times travel abroad was almost impossible to arrange, whereas now anybody with the cash can travel anywhere. Also, ordinary Russians enjoy a considerable amount of free speech – at least on a personal level. You can complain about government leaders and nobody's going to report you. The Kremlin closely controls most media outlets, especially the broadcast media, to make sure that dissatisfaction can't find organized political expression; but there is a degree of personal freedom that didn't exist in the Soviet Union.

As for Putin's vision of the future, he wants to restore Russia as a great power, and he wants to do this by building an authoritarian state with a flourishing capitalist economy. The problem is that this formula is probably unworkable. The authoritarian side of the formula tends to increase corruption, and it undercuts economically productive entrepreneurship.

OUTLOOK: Hasn't China succeeded at that game?

BP: There's no denying that China is incredibly dynamic. When I go there I'm just amazed at what's happening. I'm not a China expert, but I do think at some point even in China there's going to be a crunch when the political system can't manage all the social forces that it's unleashed. So far the Chinese leaders have managed this challenge remarkably well. But in the long run I think there's going to be a disruptive transition. In any case, China started its modernization drive with several advantages. The most important was the availability of a huge supply of cheap labor that could be used to attract Western investors – something that Russia lacks. Moreover, China had the benefit of having been ruled by communist central planners for only about half as long as long as Russia was. In Russia those extra decades gave central planners time to build a large industrial economy based on economically irrational decisions, and that economic legacy didn't disappear with the fall of the USSR. The legacy is still physically present in the form of many aging plants built on outdated technology and sited in the wrong locations.

OUTLOOK: What surprises you when you go there now, as opposed to 25 years ago?

BP: Visually, the spectacular growth of Moscow. There are all kinds of wealth and displays of wealth that weren't there 25 years ago. The city has grown at the expense of other cities and regions in Russia. The country's becoming more and more centered on Moscow. Something like 40 percent of foreign direct investment goes into the Moscow region, so it's booming even though many parts of the country are in bad shape.

The other big surprise seems to directly contrast with the glitter and worldliness of Moscow. It's the attitude of the new generation of young adults. Under Yeltsin during the 1990s there was much talk of making Russia a "normal country." Young Russians are turning away from that vision, and away from the people who introduced reforms. The young generation of Russians tends to be fairly nationalistic and xenophobic by comparison with their elders. This goes against our cherished view that over time people become more enlightened and eager for freedom – in other words, more like us. With the attitudes prevalent in Russia right now, it's hard to see how Russians are going to move decisively beyond their authoritarian past. I don't predict a return to communism, but I'm not sure a liberal democracy is in the cards, either. ■

Outlook for the U.S. Livestock Sector

When prices for corn, soybeans and other agricultural commodities spiraled to historic heights in 2006 – 2008, it left U.S. livestock producers reeling. Feedstuffs are the biggest cost driver for anyone that raises animals, and the run-up in grain prices created shockwaves among industries unaccustomed to such price volatility. The run-up may have been a boom for the U.S. grain complex, but nearly meant bust for many parts of the protein sector.

In the intervening years, commodity prices have retreated from those record levels but remain elevated compared to historic norms. The retreat has been a welcome breather, giving the livestock sector time to recover, cull herds and adjust balance sheets to the new, elevated cost environment. For the most part, 2010 has been a year when, despite lingering economic challenges, the industry has begun to recover from those difficult years and return to profitability. That's why a recent jump in commodity prices – spurred by a historic drought in Eastern Europe and Russia – has sparked anxiety among the livestock and dairy sectors. Could another run-up in grain prices be around the corner? Would it threaten to destabilize industries that are just regaining their footing?

For perspective, we turn to agricultural economist Jim Robb, vice president of industry research and analysis in CoBank's Knowledge Exchange Division. Before joining CoBank in June 2010, Robb spent nearly 20 years as director of the Livestock Marketing Information Center, a livestock and dairy economic analysis cooperative involving 28 land-grant universities, six federal agencies and seven industry organizations.

QUESTION: We've seen an uptick in recent weeks in prices for agricultural commodities. What's driving that?

JIM ROBB: This is a story that starts with the wheat crop but has implications for other commodities, including feed-grain crops like corn and soybeans. If we look at the broad belt from the Baltic States up into Russia and into Eastern Europe, we are talking about, depending on how you draw the lines, 20 to 25 percent of the world's wheat crop. It is a very large and growing part of the worldwide base for wheat production. As we moved into harvest, especially through Eastern Europe and into Russia, the season turned out much less productive than anticipated. The summer drought continued to decrease wheat crop potential. Overall world supply tightened very quickly, and surprisingly so. Obviously, when supplies are tight, prices go up.

About this article

Jim Robb is an agricultural economist and Vice President of Industry Research and Analysis in CoBank's Knowledge Exchange Division.



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Russia placed an embargo on wheat exports and was unable to meet their export commitments to Egypt and other foreign markets. Those tightened world situations quickly spilled over into the U.S market, where we saw additional export opportunities for U.S. producers. In Eastern Europe and Russia, a large proportion of the wheat crop is used for feedstuffs for livestock. Additionally, the drought in that part of Europe impacted other feedstuffs, including their corn yield potential. That, too, spilled over into the U.S. feed grain markets, especially in early August. Problems with the wheat crop in Russia were the spark that ignited the agricultural commodities markets in August and added momentum to prices across the board.

Q: Most livestock producers rely on the corn and soybean crop for their feedstuffs. How is the U.S. crop shaping up as we move into the fall harvest season?

JR: As we got into August, the corn and soybean crops in the U.S. were moving in slightly different directions. We were seeing the yield potential in the corn crop declining, not abruptly, but certainly losing important crop production potential. We started off the year with super yield potential in the corn crop, maybe the best ever, with great early season planting and excellent soil moisture conditions. As we got later in the year, we found out we had a few more problems than we anticipated in terms of the spottiness and development of this year's corn crop. Then we had some very hot weather in August that seemed to take away more yield potential in corn than we would normally see. Now we're looking at a corn crop of about 13 billion bushels, which is on the threshold of a record-large crop, but we're not really making the potential that the market anticipated.

For soybeans, we also had a very good planting season, but the yield potential was improving in major soybean growing areas as we move through August. The potential of the soybean crop has increased, at least compared to market expectations earlier in the summer. We expect the soybean harvest to be about 3.4 billion bushels, which is in record territory.

Q: How does this year's grain crop contrast to last year's crop?

JR: Last year was a record crop, but we have to remember that the conditions we had last year were quite different than conditions this year as we move into fall. Last year, we had a slow-maturing crop across corn and

OMAHA CORN PRICES (weekly)



Data Source: USDA-AMS, Compiled by LMIC

soybeans, and we had major problems with the quality of the crop and the timeliness of harvest. This year it looks like the markets are shaping up so we actually have an earlier-than-normal harvest. In some areas we still have some quality problems, but, again, not to the magnitude nationwide that we saw last year, which was really almost an unprecedented problem year at harvest time. So the quality will be greatly improved compared to last year's crop as we look at corn, soybeans and the other fall-harvested crops. We're still struggling in September with moving last year's low-quality corn crop. Much of that is going to be blended with this year's high-quality crop so it is a more marketable product, especially in export channels.

Q: What's the outlook for pricing?

JR: Prices historically soften as we get into fall harvest, but that hasn't necessarily been the trend in recent years. We have to remember we still have this huge demand base in the grain sector that we didn't have 5 to 10 years ago to support the ethanol industry. So we expect prices will soften into harvest, but maybe not as much as we've seen in long-term historical records. Even though we have a very large crop, we also have a very large demand for these crops.

September's corn prices were running fully \$1 per bushel higher than they did a year ago and about \$1.50 per bushel higher than the prior five-year average. Those kinds of general relationships will probably hold through the end of the third quarter, but I would look for fourth quarter harvest prices to be 25-cents to 50-cents per bushel higher than last year.

Soybean meal prices recently were running about \$25 per ton lower than last year, but about \$75 per ton higher than the prior five-year average. As we look into the fourth quarter, we could see soybean prices struggle to eclipse last year.

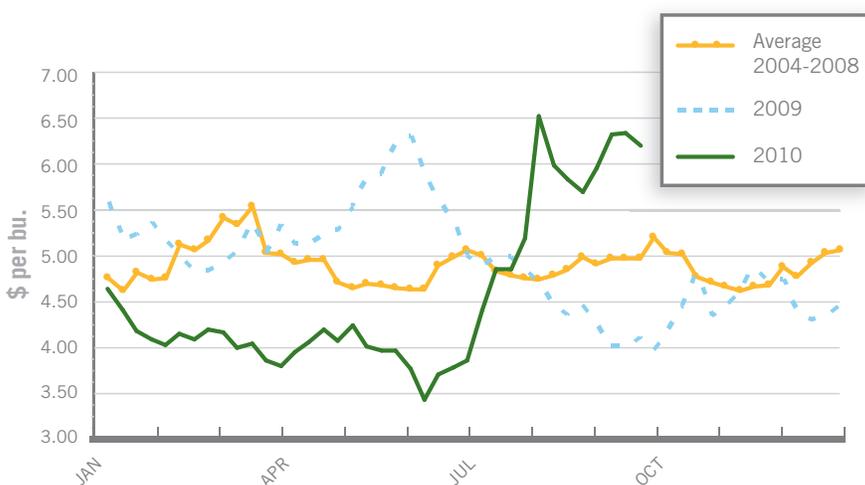
Q: Many livestock producers were put under pressure during the last run-up in grain prices. What can they expect if we do see higher feedstuff prices this season?

JR: Livestock and poultry operations across the U.S. have largely adapted to fundamentally higher feedstuff costs by adjusting the size of their breeding flocks and herds and their productive capacity. We've largely made the transition from an industry based on \$2- to \$2.50-per-bushel cash corn

prices to an industry that is based on \$3- to \$4-per-bushel corn prices. But even small movements in prices have a very quick impact on livestock producers, since the largest component of the cost of raising an animal is feedstuff costs. In the cattle industry, historically a 10-cent-per-bushel year-to-year increase in the cost of corn translates to, on average, a \$1-per-hundred-weight decline in the price of a steer calf that is typically produced by a rancher in the United States. Price swings still do matter, and in this tough economic environment livestock operations will attempt to adjust rather quickly should higher feedstuff costs start to turn their profits into the red. If we were to see an additional surge in feedstuff prices, then we would have rather abrupt and dramatic changes in the livestock industries.

In terms of response time in the livestock industries, it's largely driven by the biologic and economic nature of those industries. For instance, we tend to see movements in grain prices most quickly reflected by poultry producers, who can adapt over a period of months typically. The hog industry tends to adapt in a period of quarters to any increases in feedstuff prices, and the beef industry tends to respond over a period of years. It has to do with the nature of the production system and the nature of the animals. Poultry and swine require large amounts of high-energy and high-protein diets, so they are very dependent on both soybean meal and corn prices. The cattle sector is largely forage based, so typically it is only corn that directly feeds back into the economics of the beef industry.

DODGE CITY WINTER WHEAT PRICES (weekly)



Data Source: USDA-AMS, Compiled by LMIC

Even though we don't foresee a major 2008-type run-up in grain prices, there is potential for even more volatility in feedstuff prices as we move into 2011. Because of that wet fall last year, there were about 2 million acres of cropland typically planted to wheat in the Midwestern states that were, instead, planted largely to corn. With the increase in wheat price we are seeing this year, however, many of those acres will return to wheat production. Since you don't have those acres going to corn for 2011, you have the potential for the market trying to bid for those acres more directly between corn and soybeans in 2011, which often leads to more volatility in prices. So there's the potential here for volatility in feedstuff costs to be more apparent in 2011 than in 2010.

Q: Let's turn to the various protein sectors and how they are faring now. What are the main challenges and opportunities for the beef industry going forward?

JR: For the first time in many years, the beef industry – all major segments – is in the transition to making profits in 2010. The beef processing sector had a much better year after struggling in 2008 and 2009. Cattle feeders – feedlots that bring lightweight animals to market-ready weights – are going to make profits in 2010 for the first year consistently since 2003. The cow/calf operations, the fundamental producers, are also in better shape after they had two very tough years in 2008 and 2009. For producers, these losses were largely the result of the higher feed-grain price profile. In the process of losing money, we downsized the U.S. beef industry dramatically in recent years. In fact, on July 1 of this year, the U.S. beef industry, in terms of total numbers, was 1.2 million head smaller than a year ago.

One important point is that ranchers, the typical cow/calf producer, won't have the positive returns in their bank accounts until they sell their animals this fall. Even though this year is shaping up much better, most ranchers won't feel the real benefits of profitability until the money is in their pockets.

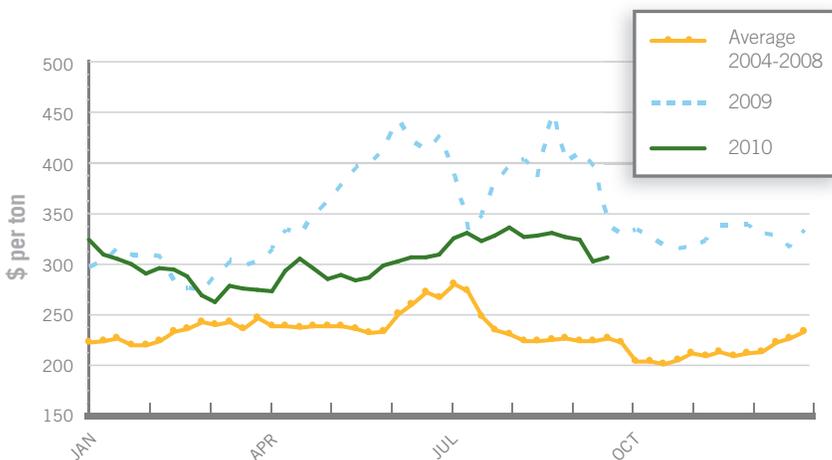
Going forward in 2011, it looks like it will be good for all sectors in the beef industry – even with some ratcheting up in feedstuff costs. We'll see narrower margins for the cattle feeders and feedlots, and due to the herd reductions, the beef processing industry is faced with smaller numbers of cattle to process. Both segments in 2011 won't do quite as well as they did

in 2010, but we can still look for a good year. In the cow/calf sector, we expect 2011 – barring the risk of a major drought that ruins the forage base – to be an even better year for them. This is largely reflecting tighter supply but also improvements on the demand side.

Q: What about the poultry industry?

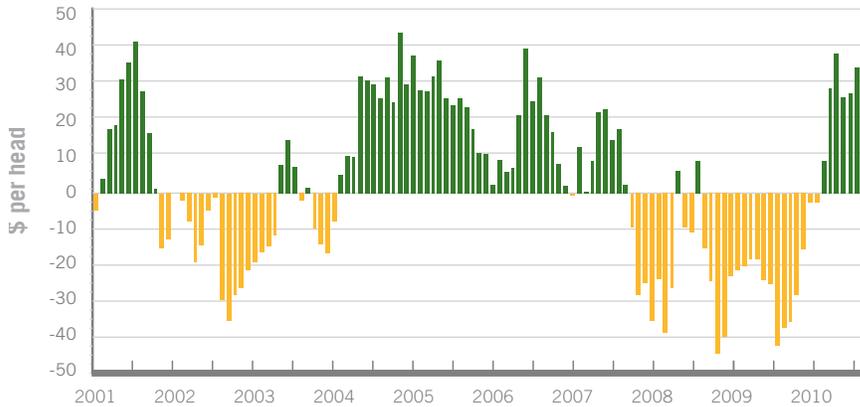
JR: The poultry industry is recording very strong profits in 2010. Within the poultry segment, the largest profits are being posted by the turkey industry, which made the most abrupt and dramatic adjustments to increased feedstuff costs. They reduced supply more than the chicken industry, but both segments will have a banner year in 2010. Higher feedstuff costs have already started to slightly affect some of their decision-making, especially the chicken sector. We have seen some dampening in the pace of growth of

CENTRAL ILLINOIS SOYBEAN MEAL (48%) PRICES (weekly)



Data Source: USDA-AMS, Compiled by LMIC

IOWA MARKET HOG PROFIT (Farrow/Finish, Monthly)



Data Source: Iowa State University

the U.S. breeder flock in the chicken industry as feedstuff costs have stayed rather high.

As we look ahead to 2011 in the poultry complex, we expect another year of profitability. But the chicken sector is increasing production, albeit at a slower pace than anticipated a few months ago, so the supply-side increase is probably going to dampen profitability some. Even with that, we could very well have another year of record profitability.

Q: What about the pork industry?

JR: The pork segment has returned from a very difficult time. The years 2008 – 2010 were probably the most difficult timeframe in history for the U.S. hog producer, and mostly that was

adapting to the new profile of higher feedstuff costs. Producers have finally had six or seven very strong months in terms of profitability. We also had very low profitability in pork processing, especially in 2009, and processors are just now returning to profitability. We’re not talking record levels for the U.S. pork sector, but it is a return to solid profitability. The industry has not yet fully recovered from the losses posted in recent years, but it’s certainly on the right track in 2010 and I expect it to carrying over into 2011.

That said, the pork industry, especially in the breeding herd, is starting to watch very closely the cost of feedstuffs. Pork producers are starting to grow the herd again – at a slower pace than the chicken segment – building the base for very measured growth beginning probably in 2011. But I expect producers will throttle back slightly until we get a better sense of this year’s crop and a sense of the size of the 2011 corn and soybean crops. As we look to profit potential in the U.S. hog processing industry, we see similar numbers of animals to process as in 2010 and fairly good demand. I’d expect similar profitability in 2011 as in 2010 – a good year for hog processing.

Q: Has the outlook for the dairy industry gotten any brighter?

JR: Unfortunately, in contrast to the other protein segments, producers have only returned to a break-even point, and we are not yet really making a dent toward working down and dealing with the losses incurred in previous two years. Last year in the third quarter, Class III milk prices barely averaged \$11 per hundred weight, fully \$4 to \$5 per unit lower than the typical producer’s cost-of-production. We adjusted the herd lower to reflect both the cost of feedstuffs and the demand profile in the dairy sector. This year, we have prices in late August and early September of about \$15 per hundred weight for Class III milk. Essentially, given the current cost of feedstuffs, that’s very close to break-even for milk producers on a Class III basis.

The improvements in market conditions – even at break-even levels – have caused producers to begin expanding the size of the U.S. dairy herd and also dramatically increasing the amount of milk production per cow. The amount of milk in the marketplace is increasing quickly, and that will start to burden the milk market as we move into the fourth quarter. This increase in production is probably to the detriment of profitability as we look ahead, especially given higher feedstuff costs than we anticipated a few months ago. For 2011, the dairy industry is in a grind-it-out market. It really has not made the production adjustments that are needed, so the return to profitability will be a very slow process.

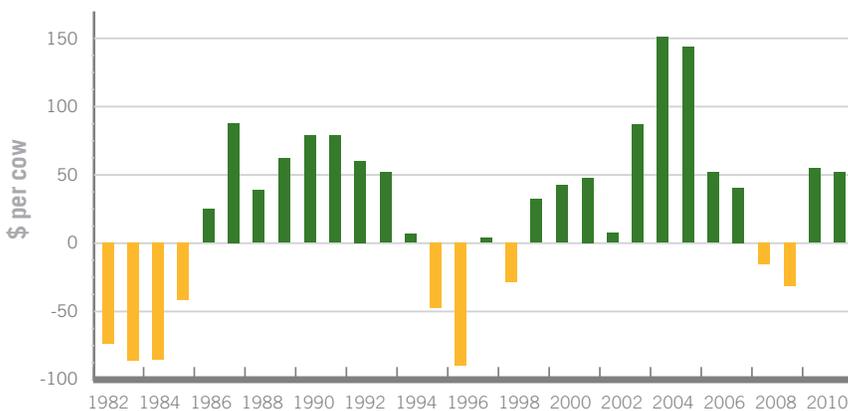
Milk processors, with increasing production and some improvement in the demand profile, will have a good year in 2011, but certainly the base producers, the people that own the dairy cows, are struggling in this break-even-at-best market environment. In terms of milk prices, we see them moving sideways over the next year as opposed to increasing. To see an increase in milk prices, we need a real surge in demand, which would probably have to be both domestic and foreign.

Q: How is the continuing soft domestic economy impacting the protein complex? Are there any signs of improvement in domestic demand?

JR: Domestic demand in the U.S. for the protein and dairy sector has really followed the broader economy. Consumers are very cautious across all spectrums, including the food complex. Especially in the protein and dairy industries, the restaurant sector is a key component to the

demand profile. In many cases we've seen improvement in demand at the grocery store level for consumption at home. But we've seen a precipitous drop off in demand and a dramatic trading down in the types of items purchased in restaurants. Early in 2010, the restaurant sector seemed to be stabilizing and starting to improve in conjunction with the U.S. economy. But as the recovery has softened in recent months, we've seen a simultaneous step-down in restaurant demand – people eating less and eating less costly items when they go to restaurants. This is important to the protein complex, because about 50 percent of the consumer food dollar is spent in restaurants. The protein sectors are the most dependent on the restaurant industries compared to most other segments, and these tend to be center-of-the-plate items – steaks, pork chops, chicken breast, etc. In the dairy sector, these are

ESTIMATED AVERAGE COW/CALF RETURNS
Returns over Cash Cost (Includes Pasture Rent), Annual



Data Source: Livestock Marketing Information Center

As we look at the price levels we've achieved in 2010 – especially in the dairy and beef markets – it can be directly attributed to better-than-expected demand from key Asian economies.

also dessert items. What we've seen is that demand for hamburger and other low-cost items has been up at the restaurant level and grocery store, but demand for the high value steak, pork and chicken has eroded. This has been very disappointing. If you look at restaurant industry sales data, we are now seeing year-to-year declines in aggregate restaurant sales in the United States.

Looking ahead, as the economy maybe stabilizes, this is going to be one of the real key questions – do we start to regain some of this restaurant demand? We are expecting the U.S. economy to be in very much of a slow-growth environment, and that doesn't bode well for a quick turnaround in consumer spending, especially in restaurants. But consumer demand is already so low in the restaurant industry that even a little improvement can help the protein segment. If consumers do feel a little bit better and do spend a little bit more at restaurants, it will very quickly spread into the protein complex. We will see the signs there before we see it in some of the agricultural commodities.

Q: Economic growth is much stronger in China, India and other parts of Asia outside Japan. Do you expect that to continue and how will that affect export opportunities for American protein producers?

JR: As we look at the price levels we've achieved in 2010 – especially in the dairy and beef markets – it can be directly attributed to better-than-expected demand from key Asian economies. We wouldn't be at \$15 Class III milk prices today without surprisingly strong export levels for cheese and some of the other components in the milk industry. We would not have strong cattle prices today were it not for exports in the beef complex and in many related non-meat items – hides and livers for instance. We don't eat much liver in the United States anymore; we export that. Many non-meat items, like chicken feet, that come out of these industries are very dependent on export markets, especially Asia. Those Asian economies have turned around and dramatically added to demand for meat and meat byproducts. We've achieved levels of exports of beef to key Asian countries that we haven't seen since before the mad cow crisis, which really began impacting our exports in 2004. We are exporting key items in the dairy complex at levels we haven't seen since 2008, when exports were a driving force in delivering milk prices on a Class III basis that were over \$20 per hundred weight.

Largely the weakness in domestic demand has been more than compensated for in the protein complexes with demand by exports. The lagging component in exports has been poultry, mostly because Russia essentially has had bans in place against U.S. products. Even though we haven't had record levels of poultry exports, we have very quickly found markets other than Russia that have bought more products than anticipated. The overall picture has been surprisingly strong for exports, and it's a little bit of an under told story.

Q: How are exchange rates influencing U.S. exports?

JR: The dollar is a different story in different parts of the world. It's very strong compared to the Euro, but we don't export very much beef and chicken to Europe. We do export a lot to Asia, where it's more accommodative relative to other foreign currencies. For example in the beef sector, we have gained some market share at the expense of Australia in the Asian markets. In Eastern Europe and Russia, we have gained market share at the expense of Brazil, Argentina and Uruguay. Some of that has been related to the overall value of the dollar, but some of it has been – especially in South America – that their economies have been growing rather robustly, so they haven't had as much product available to export. That's allowed us to fill in to markets that have been traditionally dominated by some South American countries. The rate at which we've gained market share has been a pleasant surprise, particularly for the beef industry.

But there's much more to the story than exchange rates. I've described the U.S. drawdown of herd sizes with relation to feedstuff costs, but this was actually a worldwide phenomenon. The Australian cow herd has shrunk in tandem with the U.S. industry, as has the South American cow herd on aggregate. The European cow herd, which is much more tied to the dairy sector but also produces beef, is a much smaller industry due to the rationalization we've seen in recent years. So some of this export success is based on the fact that that the U.S. beef industry, even though we are smaller, is still very efficient and able to quickly access some of those export markets.

Taking a broad view, there are many things that influence our export markets. These are markets that can be very volatile and can soften quickly. We could see things like trade barriers being put up or new vital sanitary standards impact our exports. We could have something like H1N1, which had a major impact on the pork industry.

The real message here is that we need to temper our exuberance. Worldwide, economic conditions are slowing down, even in Asia, and some of the other endemic risks to our exports certainly have not dissipated. The very long-term view of the foreign demand is positive, but there needs to be some tempering of expectation as we move ahead to 2011.

Q: What long-term trends should the protein sector be watching and preparing for?

JR: The biggest risk in the U.S. protein complex is the cost of feedstuffs and the volatility of those prices. Any additional surge in those costs will very quickly be felt by the industry. The crop production potential is a key indicator to be watching. Monitoring the markets and using risk-management tools has certainly been a key to profitability in the livestock sector and will continue to be. If we look over the last couple of years across all these complexes, the risk-management practices in relation to feed input costs has really differentiated between those firms that have broken even and those that have lost a lot of money.

Overall, in this kind of environment, good back-to-the-basics business management becomes very important, and that has to do with managing financial situations. There are a number of simple strategies companies can adopt. Don't get yourself over-leveraged and be prepared from a financial perspective for the ups and downs that have become inherent in these industries.

Also, business must do their planning in much more of an ongoing process. For example, in the cattle industry, historically we've talked about the 10-year cattle cycles as how you position yourself in the industry. If you look at the last 10 years, though, the least important market mover has been the cattle cycle. The market shocks have been 9/11, which completely disrupted the demand side and we had a recession; we had the BSE situation; and then we had the international credit crisis in 2008, which curtailed exports dramatically. These types of things don't run with the cycles which the livestock sectors have tended to follow. Everyone needs to be re-evaluating every three to six months. That is key from a management sense, instead of sitting back at the end of the year and trying to figure out where we are in the cattle cycle. It's true for producers, processors and across all sectors of the protein complex. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 8/31/10. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC & Blue Chip Economic Indicators **US Treasury Securities**

2010	GDP	CPI	Fed Funds	2-year	10-year
Q2	2.40%	-0.70%	0.19%	0.90%	3.50%
Q3	2.40%	1.20%	0.19%	0.60%	2.80%
Q4	2.70%	1.50%	0.20%	0.50%	2.60%
2011	GDP	CPI	Funds	2-year	10-year
Q1	2.80%	1.70%	0.20%	0.50%	2.60%
Q2	2.90%	1.60%	0.25%	0.60%	2.70%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.30%	0.43%	0.95%	1.56%	2.04%	2.48%
0.25	0.40%	0.52%	1.10%	1.68%	2.14%	2.55%
0.50	0.47%	0.61%	1.22%	1.83%	2.25%	2.64%
0.75	0.55%	0.74%	1.39%	1.97%	2.38%	2.74%
1.00	0.64%	0.88%	1.53%	2.12%	2.47%	2.82%
1.50	0.96%	1.22%	1.87%	2.38%	2.70%	2.99%
2.00	1.30%	1.53%	2.17%	2.62%	2.89%	3.13%
2.50	1.63%	1.87%	2.45%	2.82%	3.05%	3.26%
3.00	1.96%	2.22%	2.73%	3.03%	3.21%	3.38%
4.00	2.54%	2.80%	3.15%	3.33%	3.45%	3.57%
5.00	2.96%	3.20%	3.41%	3.53%	3.61%	3.68%

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

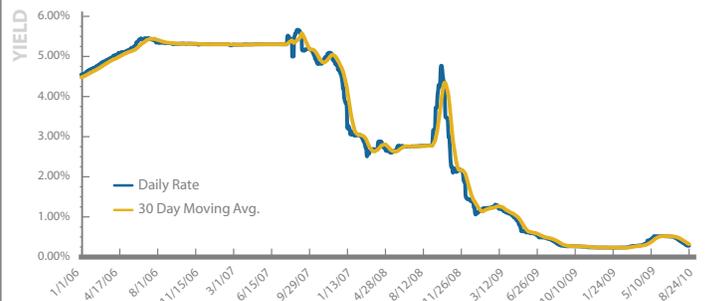
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	8	7	6
90	11	19	18	13
180	15	33	32	22
365	31	57	58	40

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.

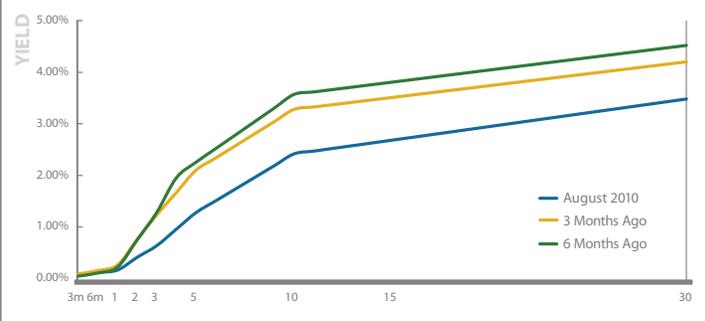
3-MONTH LIBOR



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 \$58 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. In addition to serving its direct borrowers, the bank also provides wholesale loans and other financial services to affiliated Farm Credit associations and other partners across the country.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore. For more information about CoBank, visit the bank's web site at www.cobank.com.

Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.

CoBank Announces 2011 Regional Customer Meeting Schedule

CoBank's 2011 customer meeting programs will feature leading experts on the economy, public policy, business management and other important topics and trends. The meetings benefit managers and directors of all CoBank's customers across rural America.

- | | |
|-----------------------|---|
| FEBRUARY 22-23 | Midwest Customer Meeting
Embassy Suites La Vista • Omaha, Nebraska |
| FEBRUARY 24-25 | Minnesota Customer Meeting
Sofitel Minneapolis • Minneapolis, Minnesota |
| MARCH 8-9 | Pacific West Customer Meeting
<i>In conjunction with the Agricultural Council of California</i>
Portola Hotel & Spa • Monterey, California |
| MARCH 13-14 | Texas Customer Meeting
<i>In conjunction with the Texas Agricultural Cooperative Council</i>
LaCantera Resort and Hotel • San Antonio, Texas |
| MARCH 17-18 | Central Customer Meeting
Bloomington-Normal Marriott • Bloomington, Illinois |
| MARCH 22-23 | Western Plains Customer Meeting
<i>In conjunction with the Kansas Farmers Service Association</i>
Hyatt Regency Wichita • Wichita, Kansas |
| MARCH 29 | Northeast Customer Meeting
<i>In conjunction with the Northeast Cooperative Council</i>
Doubletree Hotel • Syracuse, New York |
| JUNE 28-29 | Southeast Customer Meeting
Ritz-Carlton • Amelia Island, Florida |
| JULY 18-19 | North Dakota Customer Meeting
Ramada Hotel Fargo • Fargo, North Dakota |

Registration will be available beginning in December. Please visit the meetings section of our website at www.cobank.com/Meetings where additional information about the programs will be added as it becomes available. ■