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An Inflation Hawk's Case For Higher Interest Rates

Ever since the 2008 financial crisis, when the U.S. Federal Reserve began using unprecedented levels of monetary stimulus to boost the economy, critics have voiced fears that the Fed was increasing the risk of high inflation. Through quantitative easing, the Fed has more than quadrupled the size of its balance sheet and made trillions of new dollars available for lending by banks. The worry is that inflation could take off if too much of this money flows from banks into the economy too quickly.

So far, however, those fears have proved unfounded. Inflation has averaged only about 2 percent per year since the beginning of 2009, largely because of persistently high unemployment. Five years into a slow recovery, labor markets still aren't tight enough to promote the wage-price spiral that typically fuels an inflationary run.

But economist Peter Morici believes the danger of inflation in the U.S. remains very real – and is growing. He argues the Fed needs to take steps soon to make sure inflation doesn't gain a foothold in the economy. *OUTLOOK* spoke with Morici about his views and what he sees on the horizon.

OUTLOOK: Inflation has been a non-issue in the economy ever since the financial crisis, and yet you are worried about it. What is your reasoning?

Peter Morici: The Fed is getting dangerously close to letting it spin out of hand. Inflation has accelerated in recent months and averaged 3.5 percent for the three months ending in June. That's nothing to sneeze at. If the Fed increases rates now and slows money creation, we stand a better chance of keeping inflation in check.

OUTLOOK: The economy has been plagued by slow growth in recent years, and unemployment is still high. Won't monetary tightening exacerbate those problems?

PM: Easy money has not stimulated growth. The Obama recovery has been no different than the Bush recovery – a little better than 2 percent – and it's not likely to outperform that growth this year. In fact, during the Bush/Obama years, we have been growing at half the pace we did during the Reagan/Clinton years. Easy money is just not the answer.

Easy money has not stimulated growth.

About this article



Peter Morici is an economist and professor at the Smith School of Business, University of Maryland, and a national columnist. He is the five time winner of the MarketWatch best forecaster award and tweets @PMorici1.

Moreover, even if the Fed raises short-term rates, it won't have a powerful impact on longer-term rates because so much money is coming in from abroad. [Fed Chair] Janet Yellen won't be able to tighten as much as she likes because the United States is still the safe haven for capital.

OUTLOOK: Quantitative easing is scheduled to come to end in October. Has that program been successful in your view? What will happen when the Fed stops buying bonds?

PM: Quantitative easing served a purpose. At a certain point in the crisis, it was necessary to put a lot of money in the system. And it wasn't just the bond buying program, but also taking assets off the books of the banks. Those were necessary things to do in a crisis.

We are now five years into the recovery and still buying bonds. Moreover, we have kept short-term rates near zero, which is far too long. Given recent inflation data, now is the time to return interest rates to a more normal posture.

OUTLOOK: From your perspective, what is the appropriate indicator of inflation for monetary policy? Are the various indicators sending different signals?

PM: No single indicator is best. You have to look at both the Consumer Price Index, which measures prices, and personal consumption expenditures (PCE), which measure spending. It's important to look at both the headline number and the core, which excludes food and energy because these may move more erratically than other components. Most important, it's important to evaluate these in terms of what's going on in the markets.

In looking at the marketplace, wages are not increasing and therefore are not contributing to inflation. It's being caused by shifts in the economy among those who have products and services that are in demand – simple supply and demand. Also, government regulations are increasing the cost of doing business, as are higher state and local taxes, both of which contribute to rising prices. And government is turning a blind eye to monopolistic practices, such as those of cable TV. All of these factors are getting extra push from the Fed, which is printing so much money.

OUTLOOK: Are rising food prices a signal of inflationary pressure? What other signals do you see out there?

PM: Food prices are rising, but more due to reasons outside of monetary policy.

FEDERAL RESERVE BALANCE SHEET



Source: Federal Reserve

One is the ethanol program, which puts 40 percent of the corn harvest in our gas tanks. There are many people that can feel good about an ethanol program, but in reality it's a rock on the back of the working poor that serves little effect.

Another is appeasing China on currency so it can buy corn cheaply. An undervalued currency gives China not just a trade surplus but also lots of dollars at its disposal, and they're using these dollars to buy U.S. corn. They're taking corn off the market here and that drives up the price of feed for livestock and other basic consumer items – cereals, beef, pork, and milk. It's an insidious tax on working class people and the poor because they're the ones who can least afford high food prices.

OUTLOOK: How would an increase in short-term rates be felt in the economy?

PM: Certainly, businesses would have to be more careful about decisions because they wouldn't be able to get money cheaply. You would likely see some problems in the junk bond market but that's not necessarily a bad thing. It would slow growth a bit. We have to remember, we're not getting a lot of growth out of all of this but we're going to get a lot of inflation. The question is do we want to slow growth from 2 percent to 1.5, or increase inflation from 2 to 4 percent. I would suggest that increasing inflation from 2 percent to 4 percent will do more to hurt lower income people and increase inequality than slowing growth.



We're enabling irresponsible behavior.

By printing so much money, the Federal Reserve is like a parent that enables a juvenile delinquent. The Fed is enabling Congress and the President to not tackle the trade deficit with China and Japan, develop domestic energy, develop more streamlined and cost-effective regulations, and have a reasonable climate-change policy that says we'll do something if China does, but focus on mitigation if it doesn't. Those decisions won't be popular either with the progressives on the left nor the right wing of the Republican Party, but it's what needs to be done.

It's a trade off in the sense that in the short term, there will be a little bit less growth. But by keeping interest rates low, we're permitting the President and Congress not to act. We're enabling irresponsible behavior.

OUTLOOK: How close do you think we are to an inflationary spiral?

PM: We are dangerously close. I can't say when inflation will spin out of control any more accurately than I can say when the stock market will rise another 50 percent. However, we are very close right now to letting inflation get out of control. The numbers we have been seeing lately indicate that we're doing the wrong thing.

OUTLOOK: What are the dangers of leaving things unchanged?

PM: Once you get to 4 percent inflation, it's very easy to go 6 to 8 or even 10 percent. It's very difficult to bring under control because then the trade-off becomes thrusting the country into another recession. That is something we can ill afford given how weak the recovery has been and how few jobs we have created this century.

OUTLOOK: How, specifically, would an increase in short-term rates be felt in the economy?

PM: If we were to raise rates, we would likely cause some businesses to fail that have been papering over their problems with low-cost money. But at some point, we have to normalize interest rates or we won't have the option of monetary policy the next time we get into a problem, which we will. We can't go lower than zero, which is essentially where we are now.

OUTLOOK: Prices in the sales of existing homes are increasing but new home starts are significantly down. How would an increase in interest rates affect the housing industry?

PM: Low rates don't solve the housing market's problem. We don't need near zero interest rates to facilitate housing starts. We need to fix what's broken in the economy. You have to get the economy going again to sell houses, not the reverse.

In the last decade before the crisis, we were too dependent on the housing sector. The economy had lost its competitiveness internationally because of an overvalued currency. Now we must reverse that process. We must get our currency back down, resolve our trade problems with China and Japan and manufacture more things here. We have to produce the energy we use here in America. And we have to do it sanely, not by handicapping industry with requirements that are not present abroad. In turn, that will create jobs that will employ our young people and permit them to buy houses. Just because housing led the recovery in the past does not mean that it can lead it in the future.

That said, if we don't fix underlying structural problems in the economy, it would be very negative on the housing market.

OUTLOOK: Where do you think interest rates should be?

PM: The current target is between zero and 0.25 percent, and it comes out at about 0.125 percent. If the economy is growing at a nominal rate of 5 percent a year – 3 percent growth, 2 percent inflation – then the loan rate should be 5 percent. Trailing down from there, the short rate should be 2 or 3 percent and we're well below that right now.

In fact, we're probably looking at a nominal rate of growth of 6 percent. If the target rate of inflation is two and you can get the economy growing at three or four – which it should long-term – we should have longer-term rates in the range of 5 to 6 percent.

Realtors, of course, aren't going to like that at all. In this environment, you can't sell houses at those rates. The point, however, is that the structure of modern economic theory and monetary policy is built on the basis of a sound economy underneath. In an economy where you have bad regulations, bad banking, bad energy policy, a bad international trade policy, and extraordinary disincentives to work, what economic theory says about monetary policy becomes irrelevant. Monetary policy becomes a rubber sword against a steel saber. It becomes useless and that is exactly what we're witnessing.

OUTLOOK: What are the Fed's primary concerns right now? What kinds of discussions are going on at the Fed?

PM: Unfortunately, I think that the Fed is entirely misfocused. It should be speaking out about the structural problems that have caused its monetary policy not to work instead of pretending they don't exist.

They're not talking about structural remedies for the banks, capital markets, labor markets, goods markets, energy markets, or environmental and business regulation. Instead, they are pretending that by tweaking

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interest rates, they can somehow save America from a generation of policy irresponsibility by the occupants of the Oval Office and positions of leadership on Capitol Hill.

OUTLOOK: *Talk about the notion of stagflation – slow economic growth, high unemployment and rising prices. Do you see a scenario that could get us to where we were with inflation in the 1970s?*

PM: We're in danger of getting to stagflation because the problems with growth get worse the longer we let these problems fester. If we don't do anything, instead of the economy growing at 2 percent as it has over the last five years, it's going to start to slow down even more. It might speed up for a while but then we'll have a recession. Growth averages will continue to diminish as we go forward and will gradually deteriorate into the kind of very low growth that Japan has.

At the same time, by pumping so much money into the system, we will create inflation. We'll have the worst of all possible worlds – growth at 1 percent and inflation above 3, perhaps 4 percent. Older people simply won't be able to retire because they'll have no place to invest their money to obtain a decent return.

OUTLOOK: *What are other developed countries experiencing in terms of interest rates and inflation?*

PM: There isn't terribly high inflation in any developed countries right now. Euro Zone inflation rates are very low. England has a bit higher inflation rate than the Euro Zone but, by and large, European inflation rates are fairly tame right now. However, they are more economically depressed than we are.

OUTLOOK: *Where would you start in solving these problems?*

PM: I would start by revaluing the dollar against the yuan. People say that China can set its currency anywhere it wants – so can we.

I would also advocate taxing the conversion of the dollar into yuan, whether it's for the purchase of goods or for investments, so that the price of buying China is what it should be. I would implement a tax of about 30 to 40 percent, which is my rough estimate of the undervaluation of the yuan. I would do the same with regard to the Japanese yen.

PERSONAL CONSUMPTION EXPENDITURES DEFLATOR

Percent change from year earlier (monthly seasonally adjusted)



Monthly personal consumption expenditures deflator (2009=100); core excludes food and energy

Source: Knowledge Exchange Division, CoBank, ACB
(confidential and proprietary)

I would open up drilling off the Atlantic, Pacific, and Eastern Gulf coasts for the express purpose of ending U.S. dependence on imported oil. Possible exceptions are Mexico and Canada, with which we could also export an equal amount. The United States does not need to import energy but for obstinate thinking on Capitol Hill.

Our carbon (CO₂) policy has to be in line with the rest of world. If China will not cut its CO₂ emissions, we should focus more on abatement of the effects of global warming because, otherwise, whatever we do will have no positive effect. The President's goal is to cut U.S. emissions by about 17 percent from 2003 levels by 2020, or so. We have already cut out about 9 percent just through market

forces from using more natural gas. But handicapping American industry with high utility rates will simply send jobs to China; and we'll end up increasing emissions because manufacturing is dirtier in China.

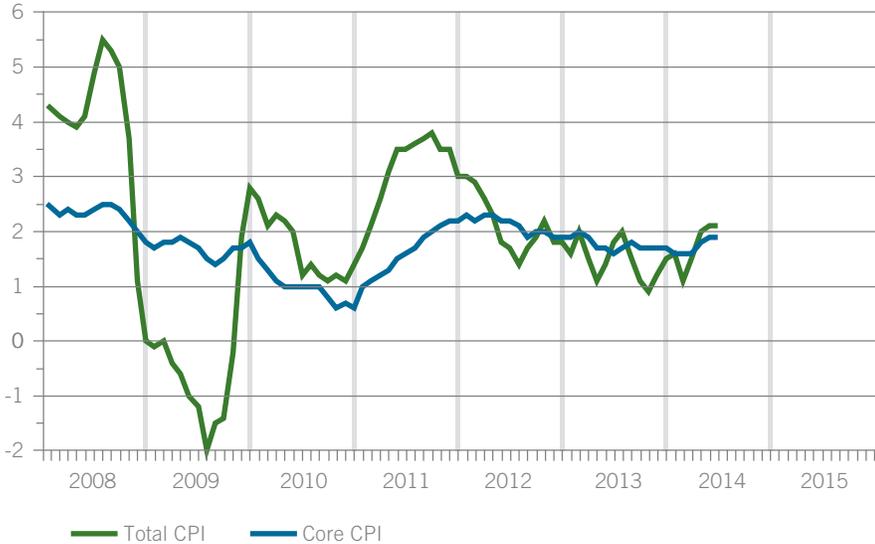
I would also resurrect Glass-Steagall in some form. I would break up the large banks and bring some discipline to executive compensation. They simply should not be paid the kind of money they're being paid for being too big to fail and putting so much risk on taxpayers.

We really do need to reform entitlements and raise the minimum wage to some reasonable amount – not \$10.10 an hour, maybe \$8.25. Our entitlement system is discouraging people from improving themselves and working full-time.

I've gotten emails from many people who complain that I was against the extension of long-term unemployment benefits. These people said they needed the benefits because they couldn't afford to take a full-time job because of the loss of benefits. In other words: *Benefits are keeping me from going to work, so I want more benefits.* We need to reform entitlements so the marginal tax rate for increasing income at the low levels is not 40 to 50 percent.

CONSUMER PRICE INDEX

Percent change from year earlier (monthly seasonally adjusted)



Monthly consumer price index (1982-84=100); core excludes food and energy

Source: Knowledge Exchange Division, CoBank, ACB
(confidential and proprietary)

Basically, I would reform the entitlements by eliminating a lot of the programs and replace the current income tax system with a value-added tax and give every man, woman, and child \$5,000 a year regardless of their income level. That would put a floor under everybody's income and impose no penalty for working more or earning more.

OUTLOOK: Now, relate all of these fixes back to the primary issue of rates.

PM: Without fixing these problems, we become addicted to low interest rates to avoid taking our medicine, so to speak, and we will evolve into a world where growth is about 1 percent a year. Unemployment rises every year and we have a combination of high unemployment and high inflation.

OUTLOOK: How much pain is involved in dealing with these structural issues?

PM: There's a lot of political pain, but there's not as much economic pain.

It's politically painful because both the Republicans and Democrats have to disappoint the more extreme wings of their parties. That's part of the problem. You can't please the hard left or the hard right to do these things. You've got to do them and then let the economy fix itself.

Americans are enormously resourceful people and when given the chance and the opportunity, they will behave in reasonable ways. But people are not properly incentivized right now so they're not doing the right things. They're reacting to structural flaws in the system. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 6/30/14. 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

	2014	GDP	CPI	Funds	2-year	10-year
Q2	3.70%	2.30%	0.10%	0.46%	2.53%	
Q3	3.10%	2.10%	0.11%	0.60%	2.93%	
Q4	3.10%	1.90%	0.14%	0.76%	3.12%	
	2015	GDP	CPI	Funds	2-year	10-year
Q1	3.00%	2.00%	0.19%	0.91%	3.24%	
Q2	3.00%	2.00%	0.32%	1.12%	3.39%	

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	0.24%	0.30%	1.05%	1.78%	2.26%	2.71%
0.25	0.25%	0.38%	1.25%	1.93%	2.38%	2.81%
0.50	0.29%	0.52%	1.44%	2.09%	2.51%	2.91%
0.75	0.40%	0.71%	1.64%	2.25%	2.64%	3.00%
1.00	0.59%	0.94%	1.85%	2.41%	2.77%	3.10%
1.50	1.05%	1.46%	2.23%	2.71%	3.00%	3.29%
2.00	1.59%	1.96%	2.59%	2.97%	3.21%	3.45%
2.50	2.04%	2.32%	2.84%	3.16%	3.36%	3.57%
3.00	2.49%	2.68%	3.10%	3.35%	3.52%	3.68%
4.00	2.95%	3.16%	3.44%	3.61%	3.74%	3.85%
5.00	3.31%	3.48%	3.67%	3.78%	3.89%	3.97%

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

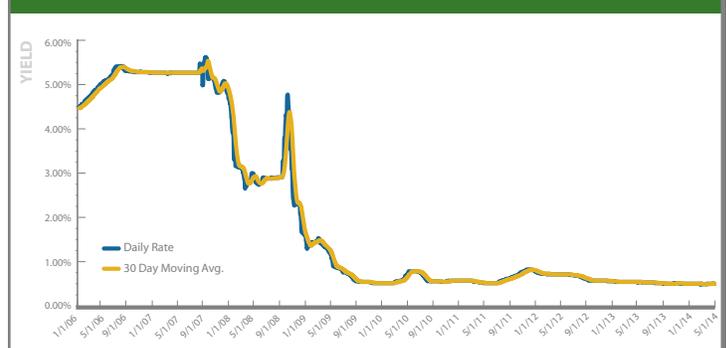
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	8	8	8	6
90	18	20	19	13
180	33	38	35	25
365	78	79	69	48

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.

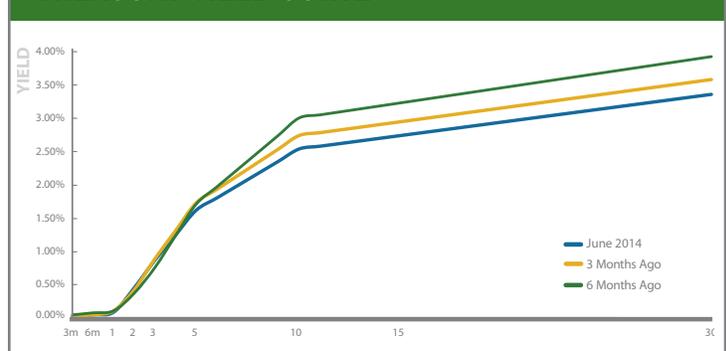
3-MONTH LIBOR



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 \$102 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. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving 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.

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 Joins USDA in New Public-Private Partnership

Bank Commits \$10 Billion Of Balance Sheet Capacity To Support “U.S. Rural Infrastructure Opportunity Fund”

CoBank has joined with the U.S. Department of Agriculture in the formation of a new public-private partnership focused on infrastructure investment in rural America.

The new “U.S. Rural Infrastructure Opportunity Fund” will serve as a source of private-sector capital to partner with USDA on wide variety of infrastructure projects in rural communities. CoBank will act as anchor investor and has committed \$10 billion of balance sheet capacity to co-lend with the fund.

The fund was formally launched on in Washington, D.C. at a July 24 White House event focused on rural economic development featuring U.S. Secretary of Agriculture Tom Vilsack. “This fund represents a new approach to our support for job-creating projects across the country,” Vilsack said.



Robert B. Engel with U.S. Secretary of Agriculture Tom Vilsack

“USDA and other agencies invest in infrastructure through a variety of federal initiatives, but our resources are finite and there are backlogs of projects in many parts of the economy. We know where investment opportunities exist, so we are in a position to help promote these projects among investors. With new efforts like this we can move beyond existing programs and help encourage substantial private investment in projects that grow the economy and improve quality of life for millions of Americans.”

“We’re extremely pleased to join with USDA in this important initiative,” said Robert B. Engel, CoBank’s chief executive officer. “It will enhance access to capital for a wide array of vital infrastructure projects around the country and speed up the process of rural infrastructure improvements. It is completely aligned with our mission of service to rural America, and we believe it represents a meaningful long-term growth opportunity for CoBank and our partner organizations in the Farm Credit System. We look forward to seeing the benefits the fund will deliver to rural communities.”

CoBank's co-investments with the fund are designed to complement existing government loan and grant programs. The fund's investment activities will include:

- Recruiting new sources of private capital to support rural infrastructure projects;
- Serving as a co-lender for borrowers financing projects where the government's program limits or resource constraints warrant the fund's involvement; and,
- Private lending in support of projects capable of meeting market terms.

Target investments will include rural community facilities, water and wastewater systems, rural energy projects and rural broadband. The fund will be managed by Capitol Peak Asset Management, an independent asset management firm. CoBank will have the opportunity to review and approve each transaction individually, on a case-by-case basis. Loans made by CoBank side-by-side with the fund will remain on CoBank's own balance sheet or be syndicated to Farm Credit institution partners, and will be supplemented by additional capital provided by investors brought in by the fund manager, including pension funds, endowments, sovereign wealth funds and other institutional investors. CoBank may also act as the servicer of some loans made through the fund.

"The continued success of the U.S. rural economy and the improvement of rural communities depend on the strength of our infrastructure," Engel said. "To remain competitive, we must develop innovative financing strategies that will ensure infrastructure investment keeps pace with the needs of agriculture and other key rural industries. We strongly believe this public-private partnership will facilitate the flow of capital to deserving projects and promote the health of rural America." ■