CoBANK

OUTLOOK Economic Data and Commentary

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Protectionism vs. Free Trade

In 2009, the United States exported more than $1 trillion in agricultural commodities, manufactured goods and other products to countries across the globe, representing about 7.4 percent of the nation's Gross Domestic Product for the year. Political and industry leaders are eager to see that number rise; in fact, President Obama has set a goal of doubling U.S. exports by 2014.

But foreign trade is a tricky issue to get right, and it can take years, even decades, for free trade programs to pay off. Since the end of World War II, most developed countries have agreed to set a course of reducing tariffs, duties, trade quotas and other explicit obstacles to free trade. And, for the most part, the world economy has prospered over the last 60 years as trade barriers have come down.

But many nations – including the United States – still use protectionist policies to shield favored industries from the perceived threats of international competition. Last year, for instance, the Obama administration earned headlines for imposing tariffs on tires made in China following a trade complaint lodged by the United Steelworkers union.

OUTLOOK recently spoke with Douglas A. Irwin, professor of economics at Dartmouth College, about the history of protectionism and the outlook for global free trade as the economy climbs out of recession. Irwin is the author of *Free Trade Under Fire*, published in 2009, and *Peddling Protectionism: Smoot-Hawley and the Great Depression*, due to be published in 2011. Irwin also serves as a research associate of the National Bureau of Economic Research and is a member of the board of advisors for the Cato Institute's Center for Trade Policy Studies.

OUTLOOK: How have tariffs and duties been used throughout history?

Douglas Irwin: Tariffs historically have been used for three purposes – revenue, restriction and reciprocity. The first reason, revenue, is to raise funds for the government. The second one, restriction, means a government would restrict imports into the domestic market to help domestic producers of similar goods. The final reason why countries have used tariffs is for reciprocity, which is sort of like bargaining. For instance, we would impose tariffs on another country's goods in order to negotiate over their tariffs on our exports.

When we talk about protectionism, we are really talking about the second use of tariffs – restriction. When a country imposes a tariff for protectionist purposes, it is trying to increase the price of foreign goods in the domestic market to shift consumers to buying domestically produced substitutes. You're trying to help a domestic industry that is competing against foreign producers and protect them from that foreign competition. As Adam Smith pointed out in *The Wealth of Nations* in 1776, one of the major reasons why governments do this is not to help consumers, who generally want to choose from as many options in the market as possible, but to help interest groups and industries that want to be protected from foreign competition. They lobby the government to impose those restrictions.

OUTLOOK: What are some examples of protectionism throughout history?

DI: One good example comes from the British Corn Laws, which were import tariffs on grains that dated back to the 1600s. After the Napoleonic Wars, in 1815, they dramatically tightened the Corn Laws and limited imports of wheat and other agricultural commodities. It was controversial in Britain because landowners wanted those restrictions and urban consumers did not. Of course it raised the price of food in Britain and had a lot of adverse consequences for the economy. It wasn't until the 1840s, when potato blight caused a massive famine in Ireland, that the government began to seriously consider repealing the Corn Laws.

In the U.S., the most famous example of protectionism is the Smoot-Hawley Tariff in 1930, which is often linked in peoples' minds to the Great Depression. It also, like the Corn Laws, has origins in agriculture. What happened is that food and commodity prices fell during the 1920s to fairly low levels. A lot of farmers had expanded under the high prices they had received during World War I, and they hadn't anticipated that prices would fall so much after the war. The whole rural economy was hurting during the 1920s – a lot of debt, a lot of mortgage foreclosures and a lot of bankruptcies. Congress was groping for some way to help farmers. They twice passed legislation to establish government price supports for agricultural commodities. President Coolidge vetoed the measures. In desperation to help the farm economy, Congress, having failed to enact price supports, decided to impose a tariff on agricultural imports – the Smoot-Hawley Tariff.

There were two problems with Smoot-Hawley. The first problem is that most farmers were export-oriented and dependent on sales to foreign markets – particularly cotton, wheat and tobacco. At the time, we imported different types of agricultural commodities than we produced domestically. Raising the import tariff on commodities couldn't really help farmers all that much. They weren't going to get a higher price by imposing a tariff. So the whole point of Smoot-Hawley was misguided.

About this article

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A second problem was that, although Smoot-Hawley was supposed to help farmers, once Congress got in the act of raising tariffs, a lot of other industries went to Congress and asked for higher tariffs, too, which drove up the price of manufactured goods. That actually hurt farmers, because they used a lot of these industrial goods as part of their cost of production – farm machinery, leather, shoes and things of that sort. So Smoot-Hawley didn't help farmers on their prices and it raised their costs.

Of course, Smoot-Hawley was also one of the highest tariffs ever enacted. There was significant foreign retaliation against the United States, which further hurt farmers because they couldn't export their produce to foreign markets. Overall, it was a small contributing factor to the Great Depression.

OUTLOOK: What was the turning point where the developed countries turned away from tariffs and protectionism and embraced free trade?

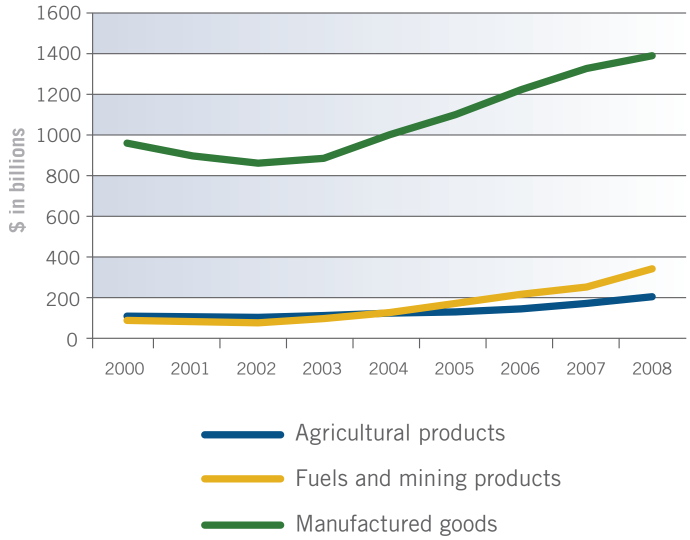
DI: It's been a process of evolution, but we can trace the origins of that evolution to the Great Depression. Smoot-Hawley was just a U.S. action, but a lot of other countries also imposed higher tariffs, import quotas and foreign exchange restrictions, all of which really reduced international trade. The whole world economy suffered immensely during the 1930s. It turned out that all these trade restrictions did not help countries recover from the Great Depression at all, even though the whole idea was to raise domestic output and domestic employment by stopping imports. If everyone does that, then the whole system collapses.

The General Agreement on Tariffs and Trade (GATT) emerged after World War II. The U.S. and other countries basically said that the Great Depression was a horrible experience, we don't want to go through that again and we have a chance to remake economic policies after the war. They decided to achieve that by trying to reduce trade barriers and expanding world trade. They didn't eliminate all trade barriers when they set up the GATT; about every 10 years or so a major trade negotiating round is held to reduce trade barriers further and limit the use of other protectionist policies.

OUTLOOK: Has the shift away from protectionism been successful?

DI: Absolutely. First of all, not only did protectionism not work during the 1930s in terms of bringing countries out of the Great Depression, but it made matters worse. What's happened since World War II is that world incomes have risen tremendously, and expanding world trade, which has been encouraged by the GATT and trade liberalization, has allowed that process to take place.

NORTH AMERICAN EXPORTS BY PRODUCT



Source: World Trade Organization

When we formed the GATT after World War II, it was mainly the U.S., Western Europe and a few other fairly rich countries. Developing nations generally rejected the GATT, figuring they couldn't compete with American, European and Japanese producers. They argued that the only way they could successfully industrialize was behind high trade barriers. But that attitude has changed, albeit late in the game. In the 1980s and 1990s, developing countries – the two biggest and most important examples being China and India – began to see that they weren't doing so well with these high trade barriers and decided to open their economies to foreign investment and international trade. Lo and behold, there's a reason why China was economically stagnant during the 1950s, '60s and '70s, and there's a reason China has been growing at double-digit rates in the 1980s, '90s and 2000s. Being open to trade has just made a world of difference for the people of China and other developing countries in terms of bringing them out of poverty.

OUTLOOK: Critics of free trade often argue that tariffs and other protectionist policies protect domestic jobs. How do you respond?

DI: That has been quite untrue over time, and a lot of evidence supports that. You may save jobs in one industry segment where there is direct foreign competition, but you lose jobs in other industries that you may not see. The net effect on employment is close to zero.

For example, the steel industry is often saying we need protection from foreign competition because China's steel industry has an unfair advantage of some sort. You may save some jobs in the steel industry by taxing Chinese steel imports, but we are also going to lose jobs in the automobile industry, the heavy equipment industry and any other industries that use steel. In the end, an import tariff on steel would raise their cost of production and handicap them in competing against their foreign competition.

OUTLOOK: Obviously we've developed a global economy by promoting free trade, but many countries still utilize some protectionist policies. Where do we stand in terms of free trade vs. protectionism?

DI: There has been substantial liberalization over the past few decades in terms of trade in manufactured goods. U.S. tariffs, European tariffs and tariffs from other countries are at pretty low levels. I would say that world commerce is pretty open and there is a lot of world trade, but there is still quite a bit of government intervention in trade. In manufactured goods, there are still a lot of implicit policies that favor domestic industries. For instance, even if China doesn't have an import tariff on a particular item, they still can provide subsidized bank credit or have other means of promoting domestic firms. The

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U.S. still does this, too, through the Export-Import Bank of the United States, which provides subsidized export financing to companies like General Electric and Boeing. We also have some trade restrictions and remaining high tariffs for labor-intensive manufactured goods, like shoes and clothing.

There are also still a lot of trade restrictions and domestic subsidies for agriculture. The U.S. protects a wide range of agricultural industries with price supports and other subsidies. For American producers, the Japanese rice market is very closed; South Korea's rice market is closed and is also closed for U.S. beef; and Europe still has restrictions on U.S. beef imports.

OUTLOOK: Given that fewer countries use tariffs, duties and other obvious tools to restrict free trade or protect domestic industries, are there more subtle ways that countries engage in protectionism today?

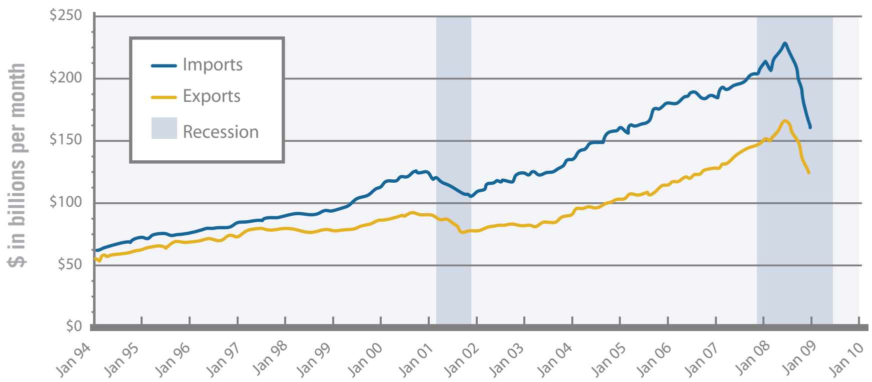
DI: You almost have to take it on a country-by-country, industry-by-industry basis. The banking industry in China is still to a large extent government controlled. They control credit and access to credit for various firms, which means they can provide a lot of credit to industries they favor. That allows those industries to build capacity, and that excess capacity can sometimes depress world prices. As an example, some people claim there is excess capacity in the steel and chemical industries as a result of China's accommodative banking policies for those industries. That creates problems in the West, because domestic industries that do not get subsidies are competing against capacities that are built up in China and other developing countries as a result of cheap government credit. In some cases the money doesn't even have to be repaid; there are a lot of nonperforming loans at Chinese banks.

You might also say that Airbus in Western Europe is an example of a protectionist policy. Airbus gets subsidized credit from E.U. countries, and European airlines have a financial incentive to buy from Airbus as opposed to Boeing. There is just a lot of implicit government support for that large firm.

OUTLOOK: Most experts agree that we are tentatively coming out of a recession. There are still some industries that are struggling. Are we seeing any calls for new protectionist policies in the global markets?

DI: Remarkably, the answer is no. I think that's largely because imports fell dramatically when the U.S. went into the recession, and the trade deficit was cut almost in half in late 2008. While, yes, a lot of domestic industries were and still are hurting, they couldn't really blame foreign competition. If you can't

U.S. IMPORTS/EXPORTS



Source: U.S. Department of Commerce

blame foreign competition, then protectionism is not a remedy. What you see in the papers in recent weeks is a bit of a controversy about the recovery, because business profits are very high even though firms are not hiring workers. Since business profits are high, it indicates that competition from imports is not really a problem. We really haven't seen a surge of imports that typically triggers a move by domestic industries to get more protection from the government. Unlike the Great Depression, this big recession has not been characterized by very intense protectionist pressures.

In contrast, we saw a lot of protectionism during the early 1980s recession. A bunch of U.S. industries were being hit by foreign competition at the same time we were having that recession – the automobile industry faced competition from Japan; the steel industry had competition from Europe, Japan and Korea; and the textile industry was facing competition from developing countries. All those industries got a lot of trade protection in the 1980s because the dollar was strong and imports were still coming in despite the fact we had this recession. This recent recession is quite different, because the dollar did not strengthen dramatically and imports haven't been surging. But those three industries have also adjusted a great deal to foreign competition. Now, the auto industry is much more multi-national, the steel industry has picked out its niche in the market where it can compete most effectively, and the textile industry, while it has shrunk, has moved toward higher-end types of products, where there is less competition. Those three industries aren't demanding a lot of protection today, unlike the situation in the early 1980s.

OUTLOOK: How has the Obama Administration's stance on protectionism and free trade differed from previous presidents?

DI: I see a lot of continuity with the past in the sense that they haven't really changed anything. In fact, the Obama Administration hasn't really said much about trade policy. They've been more concerned about dealing with the recession, health care and financial reform. They've pretty much ignored trade policy.

President Obama inherited a couple of free trade agreements from the Bush Administration – one with Columbia and another with Korea. There are some others as well. Partly because of the power of unions in the Democratic Party, the Obama Administration has been very reluctant to try and push those through Congress. But in the last few weeks, largely for foreign policy reasons, they've begun to make some noise that they want to get Congress to pass

"Unlike the Great Depression, this big recession has not being characterized by protectionist pressures.

these things in the coming months. I think that is also because Korea and Columbia have been signing free trade agreements with other countries. To the extent that the U.S. doesn't ratify these agreements, then U.S. exports will be discriminated against in those markets. That could hurt U.S. farmers and manufacturers trying to sell in those two markets. I think they are beginning to realize there are commercial benefits to wrapping up those agreements.

OUTLOOK: Can monetary policy be used as a protectionist tool?

DI: I would not say that monetary policy is a direct protectionist tool because it cannot be targeted at a particular industry. That said, there is some controversy as to whether you can use monetary policy to keep one's exchange rate artificially low and therefore give an advantage to exporters and hurt imports. That doesn't affect a particular industry but broad parts of the economy. More generally, trade policies are dramatically different from monetary and fiscal policies. You really have to gear your trade policy toward long-run objectives. You are not going to come out of recession or go into one because of trade policies, which change very slowly and evolve over time. That's not the case for monetary and fiscal policy, which can be used to quickly influence the economy to dramatic effect.

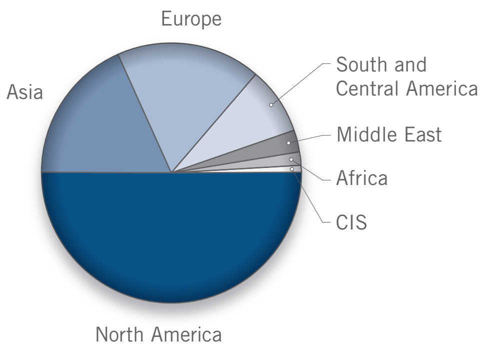
OUTLOOK: What are the long-term objectives of U.S. trade policy?

DI: First, consistently over the post-war period, we've operated under the premise that the U.S. economy is going to be stronger if we're engaged in international competition. Second, we operated with the belief that the world political system will be better and world economy will be better if the U.S. and other countries are engaged in world trade. Therefore, trade policy is used as a political tool to help countries that we want to help out.

For example, one thing the Bush Administration wanted to do was to have a free trade area in the Middle East. The idea was that if you can get those economies – many countries in the Middle East are not members of the WTO and have missed the globalization train – going and trading with one another, if you get those economies flourishing and more open, then that will lead to a more peaceful Middle East. That is a long-run objective, but not something you can measure in months or even years; the effects are measured in decades.

Also, history would suggest there is a link between increased trade and democratization. Mexico, after it signed the North American Free Trade Agreement, went from being a one-party state to being a multi-party democracy. After South Korea opened its economy, it went from being a military dictatorship to a multi-party democracy. After Chile opened its economy in the 1970s, they evolved from being a military dictatorship to a multi-party

NORTH AMERICAN EXPORTS BY DESTINATION, 2008



Source: World Trade Organization

democracy. I think the hope is that China will move in that direction, and that in the Middle East, if the countries open their economies, big economic changes will lead to big political changes. In China for instance, just having a flourishing private sector – so that not everything is state-owned – has led to huge advances in the freedom of individuals to pursue the types of careers and to start the type of businesses they want. That's a big step, but then the question is – when you have a flourishing private sector, does it eventually lead to demand for political freedoms as well? Only time will tell.

OUTLOOK: Describe the role and function of the WTO.

DI: For one, it serves as a forum for trade negotiations. It is currently a forum for the Doha Round of trade negotiations, which have been going on since 2001. There's no immediate prospect that the Doha Round will be concluded, which just shows you why trade policy is not like fiscal and monetary policy, because it's taken almost a decade and the Doha Round is still not even close to being wrapped up. International negotiations are very technical, detailed and politically sensitive. It takes a lot of time to get a consensus on how much countries want to open up their economies. Every country has political problems with that.

The second function of the WTO is to oversee the rules that have been agreed upon in the past. A lot of trade disputes get brought to the WTO for adjudication. The WTO has no enforcement power whatsoever. Once it has issued a finding, it is up to the countries that are engaged in the dispute to resolve it themselves.

OUTLOOK: What major international trade issues are percolating on the horizon?

DI: There are a couple of big trade disputes that could blow up. There has been an ongoing dispute between the U.S. and Europe over Europe's subsidies of Airbus. The question of how this Boeing-versus-Airbus dispute will be resolved is still up in the air. That's a big uncertainty in terms of the aircraft market, but it has ramifications for other industries where there are implicit industrial policies.

The other issue that is still unresolved is the U.S. dispute with China over its currency manipulation. China has recently said it will allow its currency to appreciate at a slow rate, but the question is whether that will be enough to mollify U.S. critics and the Obama Administration. There is still a danger that Congress will try to enact legislation that will retaliate against China for its currency practices. That could potentially start a trade war with China, and I don't think China would take that lying down. They would retaliate against the United States. It is a very dangerous situation that has to be handled carefully by the Obama Administration.

On more of a longer-term issue, there is a lot of discussion about so-called "green" tariffs, or carbon tariffs, if there is to be an international climate change agreement. If the United States were to pass environmental restrictions that impose costs on U.S. industries, the question is shouldn't other countries face similar costs? Tariffs would be one way of forcing other countries to regulate the environmental impacts of their industries as well. There is nothing on the table right now, but it is an idea that could become potentially important for international trade in the future.

OUTLOOK: A recent piece you wrote in the* Wall Street Journal *noted that protectionism has become an insult? Is that a positive development?

DI: I think it's very positive. The success of the post-World War II world economy owes a lot to the fact that international trade has been freed from a lot of restrictions that were imposed during the Great Depression. One of the major ways in which we can work toward ending poverty in this world is having developing countries participate more in world trade. In the past, they'd cut themselves off from world trade. Moving away from that isolation is good for people in developing countries because it means that their incomes will grow, they won't be malnourished and they can afford to send their kids to school. Those kids are the future consumers for American goods. U.S. exports are going to be much more important in the coming decades than they've been in the past.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 6/30/10. 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

2009	GDP	CPI	Fed Funds	2-year	10-year
Q4	5.60%	2.60%	0.12%	0.90%	3.50%
2010	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	3.00%	1.50%	0.13%	0.90%	3.70%
Q2	3.50%	0.30%	0.20%	0.90%	3.60%
Q3	3.00%	1.50%	0.25%	1.00%	3.70%
Q4	3.10%	1.70%	0.25%	1.10%	3.90%

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	0.53%	1.17%	1.33%	2.06%	2.57%	3.02%
0.25	0.96%	1.27%	1.50%	2.21%	2.70%	3.12%
0.50	1.34%	1.22%	1.65%	2.35%	2.81%	3.21%
0.75	1.80%	1.06%	1.79%	2.48%	2.91%	3.29%
1.00	0.95%	0.75%	1.89%	2.58%	2.99%	3.35%
1.50	0.67%	1.24%	2.30%	2.90%	3.24%	3.55%
2.00	1.74%	2.05%	2.81%	3.27%	3.51%	3.77%
2.50	2.13%	2.47%	3.13%	3.50%	3.70%	3.91%
3.00	2.57%	2.88%	3.43%	3.70%	3.86%	4.04%
4.00	3.24%	3.52%	3.85%	3.99%	4.10%	4.22%
5.00	3.63%	3.87%	4.07%	4.16%	4.26%	4.34%

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

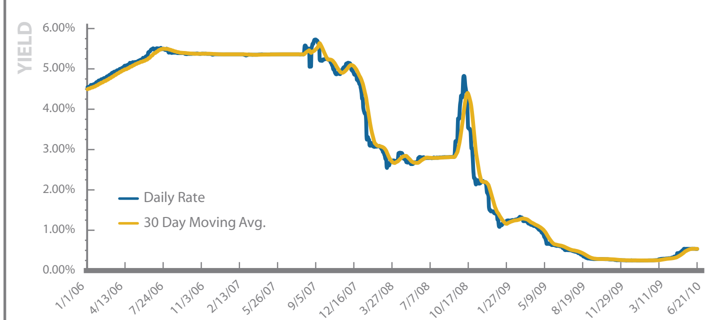
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	9	9	6
90	10	22	22	14
180	13	38	39	25
365	31	69	70	44

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.

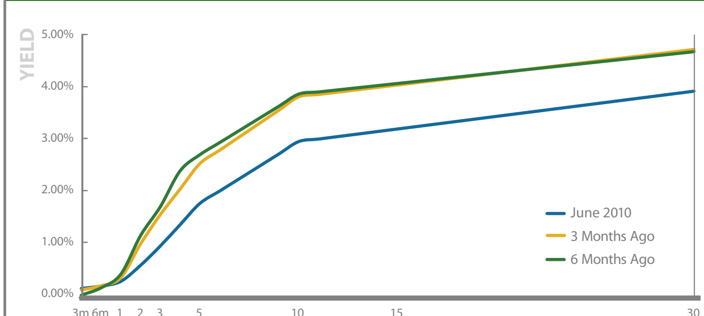
3-MONTH LIBOR



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 Executive Appointments

DIPOFI

McBRIDE

CoBank has announced that Chief Banking Officer Phil DiPofi will leave the bank later this year to become president and chief executive officer of Northwest Farm Credit Services, one of CoBank's four affiliated retail lending associations.

DiPofi will succeed Jay Penick, who is retiring from Northwest FCS after 21 years as its top executive. Headquartered in Spokane, Washington, Northwest FCS provides credit and financial services to farmers, ranchers and other rural borrowers in Washington, Oregon, Idaho, Montana and Alaska. With over $8 billion in total assets, Northwest FCS is one of the largest retail associations in the Farm Credit System, a nationwide network of financial services institutions chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. DiPofi's appointment is effective January 1, 2011.

"Since joining CoBank in 2001, Phil has made enormous contributions to our growth and success and helped us to build strong relationships with banks and associations across the Farm Credit System, as well as with our cooperative and other direct borrowers," said Robert B. Engel, CoBank's president and chief executive officer. "Phil's considerable talent and experience as a banking executive, combined with his strong appreciation for the mission of Farm Credit, make him uniquely qualified to lead Northwest FCS and enhance the value it delivers to its customers. On behalf of the entire bank, I extend our thanks and congratulations to Phil and our best wishes for continued success in his new role."

DiPofi will be succeeded by Mary McBride, currently the bank's chief operating officer. As chief banking officer, McBride will have responsibility for all of the bank's revenue-producing groups, including corporate and regional agribusiness, strategic relationships, banking services, electric distribution, power services and water, and communications.

McBride has been with CoBank since 1993 and has served in a variety of executive positions during her 17-year tenure. She has managed the bank's capital markets, corporate finance and operations divisions and spent six years as executive vice president in charge of its rural infrastructure

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.

banking groups before being named chief operating officer in 2009. Prior to joining CoBank, McBride worked as a senior vice president at Wells Fargo/ First Interstate Bank of Denver. Prior to that, she was with Bank of Boston.

"Mary's combination of back-office and relationship management experience at the bank and her deep understanding of our customers' needs make her an ideal choice for this position," Engel said. "I look forward to a seamless transition and to leveraging Mary's background, knowledge and commitment to delivering value to our customers as she assumes her new role."

McBride will begin transitioning to her new responsibilities immediately. DiPofi will remain with CoBank until October 31, 2010.

CoBank has served as the funding bank for Northwest FCS since 2003, providing it with wholesale loans and other products and services it relies on to meet the needs of individual retail customers within its five state service territory. CoBank is also the funding bank for three other affiliated Farm Credit associations that serve rural borrowers in the northeastern United States. In addition, the bank partners with a number of other banks and associations across the Farm Credit System through loan syndications and participations and the provision of leasing, cash management and other banking services.