economic recovery and the cost-cutting efforts have improved firm and industry earnings and cash flow to the point where more extensive efforts to improve productivity can be undertaken. 

The next round of efforts will require investment of a more capacity-expanding character. Financial commitments will be heavier with a longer-term payoff than the cost-cutting improvements of the past several years. It would be much easier to achieve the next stage of restructuring if we had the assurance of adequate and a more certain economic environment than exists today. In my view, that is the significance of recent financial developments to the economy of the Fourth District.

The rise in interest rates, in an important sense, should be viewed as a symptom of more basic underlying problems. Unless these problems are resolved, saving simply will not be adequate to achieve our purposes. Saving is the part of current income not consumed; it represents resources available to build capital and ensure greater future consumption. Because federal borrowing is insensitive to interest rates and involves no credit risk to lenders, the federal sector generally stands first in the queue for credit-market funds. Consequently, over time the amount of private investment financed depends on the growth of private saving relative to the growth of federal credit demands.

For much of the period since 1960, the federal sector’s appetite for saving remained fairly subdued. Between 1960 and 1989, net federal borrowing rarely exceeded 1 percent of GDP; over the next five years, it averaged only slightly above 1 percent of GDP. In the past five years, federal borrowing rose dramatically to almost 6 percent of GDP in 1983. The situation is even more serious if one believes, as I do, that the huge trade deficit and the associated inflows of foreign capital cannot safely be extrapolated into the future.

The sharp rise in net federal borrowing has reduced funds available to finance additions to the private capital stock. While this may not have been a major problem when the economy was in recession, it could create problems down the road if current trends continue. The implications for the standard of living for future generations are not encouraging. The true burden of financing the federal budget deficit lies ahead. If society devotes more of its resources to the federal sector, fewer resources are available to the private sector. As the recovery proceeds, it should become increasingly clear that our saving is inadequate to meet both public and private credit demands in a low-interest-rate, noninflationary environment.

Stabilizing Economic Conditions

How the conflict is resolved is of utmost importance to the restructuring efforts in the Fourth District, because we must deal with the accumulated problems of past decades. High interest rates will not help restore economic vitality; indeed, high interest rates are merely symptomatic of other more basic problems. Saving is inadequate for all our needs, and the growing fear that more intense competition in capital markets lies ahead will severely discourage the restructuring of older industries. As I have indicated, our current problems are deeply rooted in the economic environment. An environment marked by inflation, uncertainty, fitful economic expansions, and periods of long-term productivity objectives. Nor does it encourage wise decisions that will have a major effect on national economic performance in the years ahead. Such decisions will determine whether we as a nation will succeed in our efforts to restore prosperity in an inflation-free environment. The outcome will have a profound influence on the success of the efforts under way to improve productivity and achieve the competitive position of our industries and their workers in the Fourth Federal Reserve District.

I would like to touch on some of the effects of interest rates on the economic recovery in the Fourth Federal Reserve District. I will then indicate in a general way why rising interest rates seem to me to be symptomatic of some of the underlying issues that confront private and public decisionmakers. Before I begin, I want to point out that the increases in interest rates are quite recent. It is possible, indeed some feel probable, that a significant moderation in the pace of the economic expansion will result from rising rates. To date, however, that moderation is not yet visible in economic statistics or in the experience of those with whom I speak. There has, nevertheless, been a substantial increase in uncertainty about the future course of the expansion, especially in the traditional capital-goods industries, residential construction, and industries confronting intense import competition. People are, in effect, saying that what we have feared is here—combined private and public credit demands cannot be satisfied within the constraints of a noninflationary monetary policy. Interest rates are therefore rising, and, unless the basic underlying causes are dealt with, further increases cannot be ruled out. This realization and the uncertainty of the eventual outcome may have a far more sobering effect on the strength and the character of the current expansion in the Fourth District than will the immediate consequences of the recent increases in interest rates.

Seeking a Stable Economic Environment

by Karen N. Horn

This Economic Commentary was abstracted from testimony presented by Mrs. Horn on June 8, 1984, before the U.S. House of Representatives, Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs.

Policymakers face many important decisions that will have a major effect on national economic performance in the years ahead. Such decisions will determine whether we as a nation will succeed in our efforts to restore prosperity in an inflation-free environment. The outcome will have a profound influence on the success of the efforts under way to improve productivity and achieve the competitive position of our industries and their workers in the Fourth Federal Reserve District.

I would like to touch on some of the effects of interest rates on the economic recovery in the Fourth Federal Reserve District. I will then indicate in a general way why rising interest rates seem to me to be symptomatic of some of the underlying issues that confront private and public decisionmakers. Before I begin, I want to point out that the increases in interest rates are quite recent. It is possible, indeed some feel probable, that a significant moderation in the pace of the economic expansion will result from rising rates. To date, however, that moderation is not yet visible in economic statistics or in the experience of those with whom I speak.

There has, nevertheless, been a substantial increase in uncertainty about the future course of the expansion, especially in the traditional capital-goods industries, residential construction, and industries confronting intense import competition. People are, in effect, saying that what we have feared is here—combined private and public credit demands cannot be satisfied within the constraints of a noninflationary monetary policy. Interest rates are therefore rising, and, unless the basic underlying causes are dealt with, further increases cannot be ruled out. This realization and the uncertainty of the eventual outcome may have a far more sobering effect on the strength and the character of the current expansion in the Fourth District than will the immediate consequences of the recent increases in interest rates.
Deterioration in U.S. merchandise from the nation’s has been the sharp District’s vantage point but also of every investment dollar, com-
munications, currently accounts for $0.47 of the investment dollar. The
vehicle and machinery, for example, which once accounted for
about $69.4 billion in 1983, compared with $42.7 billion in 1982. In the
first four months of this year, the trade deficit ran at an annual rate of
$126.8 billion. Some deterioration in the trade balance would, of course,
be quite normal because economic activity recovered sooner and much
more strongly last year in the United States than in most of our trading
partners. However, the deterioration in the U.S. trade balance during the
current recovery has been extremely severe because of international debt problems, eco-
nomic adjustment programs adopted abroad, and the dollar exchange rate.

Intense foreign competition has had a particularly severe impact on industries important to the Fourth District’s economy, especially steel, automobiles, and machinery tools. The competitive position of capital goods industries has deteriorated significantly. Since 1972, imports of capital goods nationwide have expanded at twice the rate of exports of similar items. Imports of machinery have risen, taking an increasing share of the domestic market for machinery.

However, we should not ascribe the competitive problems of the Fourth District capital-goods producers solely to deterioration in foreign trade. The growing pressures of competition both from foreign producers and from different parts of the country have been evident for a couple of decades now. I will return to this point a little later. But the strong dollar, bolstered by financial and confidence factors, has made serious problems worse.

Another disquieting feature of the recovery, not only from the Fourth District’s vantage point but also from the nation’s, has been the sharp deterioration in U.S. merchandise trade. The U.S. trade deficit equalled...
equipment investment has been largely located in high-technology or information-processing equipment, a continuation of a trend firmly in place for at least a decade. Motor vehicles and machinery, for example, which once accounted for about $0.60 of every national equipment investment dollar, now account for $0.38 of the investment dollar. Information-processing equipment, including communication equipment, office machinery, and instruments, currently accounts for $0.47 of every investment dollar, compared with about $0.20 in 1972. Since there still is a heavy concentration of traditional capital-goods industries in the District, these industries have been receiving a much smaller portion of the investment dollar.

Another disquieting feature of the recovery, not only from the Fourth District's vantage point but also from the nation's, has been the sharp deterioration in U.S. merchandise trade. The U.S. trade deficit equalled $69.4 billion in 1983, compared with $42.7 billion in 1982. In the first four months of this year, the trade deficit ran at an annual rate of $128.6 billion. Some deterioration in the trade balance would, of course, be quite normal because economic activity recovered sooner and much more strongly last year in the United States than in most of our trading partners. However, the deterioration in the U.S. trade balance during the current recovery has been extremely severe because of international debt problems, economic adjustment programs adopted abroad, and the dollar exchange rate.

Intense foreign competition has had a particularly severe impact on industries important to the Fourth District's economy, especially steel, automobiles, and machine tools. The competitive position of capital goods industries has deteriorated significantly. Since 1972, imports of capital goods nationwide have expanded at twice the rate of exports of similar items. Imports of machinery have risen, taking an increasing share of the domestic market for machinery.

However, we should not ascribe the competitive problems of the Fourth District capital-goods producers solely to deterioration in foreign trade. The growing pressures of competition both from foreign producers and from the United States have been felt at home as well. Over previous decades, industries important to the Fourth District have grown away from that same industry elsewhere in the United States.

The causes behind the slowdown have been studied and disputed by regional economists for many years. Some attribute the slowdown to relatively higher costs and to greater unionization of the labor force; others blame government regulations and increasing taxes; still others argue that unimagi- native management and old and obsolete capital stock have been major contributors. These influences cannot be neatly separated into structural and competitive categories or into their relative importances; in any event, the situation varies among industries and across the District.

growth patterns in the District
Changes in this region's economy have been occurring slowly over the past few decades, but they have accelerated in recent years. Over most of the post-World War II period, industries have grown more slowly in this District than in the nation as a whole. The puzzle is why the longstanding pattern of slower growth relative to the nation has accelerated so during the last two decades.

Regional growth disparities can be broken into two components. The first might be called a structural element. Structural changes cause some industries to expand faster than other industries. Structural changes include the shift of the District's economy from manufacturing toward service industries or the growing importance of computers nationwide. The second component is a competitive element that causes some industries in a region to grow more slowly than their counterparts elsewhere in the nation. Differences in costs and prices, for example, can cause an industry in Cleveland to underperform that same industry elsewhere in the United States.

The combined influence of these factors has been a pronounced lag in our region's economic growth rates and a corresponding decline in the competitiveness of our region's industries relative to their counterparts elsewhere in the country. For example, which once accounted for about one-third of the district's labor force; others blame government regulations and increasing taxes; still others argue that unimaginative management and old and obsolete capital stock have been major contributors. These influences cannot be neatly separated into structural and competitive categories or into their relative importances; in any event, the situation varies among industries and across the District.

The uncertainty brought on by varying rates of inflation has been particularly damaging to the Fourth District. Our heavy manufacturing industries are capital-intensive and must, of course, rely on external financing.
economic recovery and the cost-cutting efforts have improved firm and industry earnings and cash flow to the point where more extensive efforts to improve productivity can be undertaken.

The next round of efforts will require investment of a more capacity-expanding character. Financial commitments will be heavier with a longer-term payoff than the cost-cutting improvements of the past several years. It would be much easier to achieve the next stage of restructuring if we had the assurance of adequate savings and a more certain economic environment than exists today. In my view, that is the significance of recent financial developments to the economy of the Fourth District.

The rise in interest rates, in an important sense, should be viewed as a symptom of more basic underlying problems. Unless these problems are resolved, saving simply will be inadequate to achieve our purposes. Saving is the part of current income not consumed; it represents resources available to build capital and ensure greater future consumption. Because federal borrowing is insensitive to interest rates and involves no credit risk to lenders, the federal sector generally stands first in the queue for credit-market funds. Consequently, over time the amount of private investment financed depends on the growth of private saving relative to the growth of federal credit demands.

For much of the period since 1960, the federal sector’s appetite for saving remained fairly subdued. Between 1960 and 1989, net federal borrowing rarely exceeded 1 percent of GNP; over the next five years, it averaged only slightly above 1 percent of GNP. In the past five years, federal borrowing rose dramatically to almost 6 percent of GNP in 1983. The situation is even more serious if one believes, as I do, that the huge trade deficit and the associated inflows of foreign capital cannot safely be extrapolated into the future.

The sharp rise in net federal borrowing has reduced funds available to finance additions to the private capital stock. While this may not have been a major problem when the economy was in recession, it could create problems down the road if current trends continue. The implications for the standard of living for future generations are not encouraging. The true burden of financing the federal budget deficit lies ahead. If society devotes more of its resources to the federal sector, fewer resources are available to the private sector. As the recovery proceeds, it should become increasingly clear that our saving is inadequate to meet both public and private credit demands in a low-interest-rate, noninflationary environment.

Stabilizing Economic Conditions

How the conflict is resolved is of utmost importance to the restructuring efforts in the Fourth District, because we must deal with the accumulated problems of past decades. High interest rates will not help restore economic vitality; indeed, high interest rates are merely symptomatic of other more basic problems. Saving is inadequate for all our needs, and the growing fear that more intense competition in capital markets lies ahead will severely discourage the restructuring of older industries.

As I have indicated, our current problems are deeply rooted in the economic environment. An environment marked by inflation, uncertainty, fitful economic expansions, and the associated inflows of foreign capital cannot safely be extrapolated into the future.

Policymakers face many important decisions that will have a major effect on national economic performance in the years ahead. Such decisions will determine whether we as a nation will succeed in our efforts to restore prosperity in an inflation-free environment. The outcome will have a profound influence on the success of the efforts under way to improve productivity and to maintain the competitive position of our industries and their workers in the Fourth Federal Reserve District.

I would like to touch on some of the effects of interest rates on the economic recovery in the Fourth Federal Reserve District. I will then indicate in a general way why rising interest rates seem to me to be symptomatic of some of the underlying issues that confront private and public decisionmakers. Before I begin, I want to point out that the increases in interest rates are quite recent. It is possible, indeed some feel probable, that a significant moderation in the pace of the economic expansion will result from rising rates. To date, however, that moderation is not yet visible in economic statistics or in the experience of those with whom I speak.

There has, nevertheless, been a substantial increase in uncertainty about the future course of the expansion, especially in the traditional capital-goods industries, residential construction, and industries confronting intense import competition. People are, in effect, saying that what we have feared is here—combined private and public credit demands cannot be satisfied within the constraints of a noninflationary monetary policy. Interest rates are therefore rising, and, unless the basic underlying causes are dealt with, further increases cannot be ruled out. This realization and the uncertainty of the eventual outcome may have a far more sobering effect on the strength and the character of the current expansion in the Fourth District than will the immediate consequences of the recent increases in interest rates.

Karen N. Horn is president of the Federal Reserve Bank of Cleveland. The views expressed here are those of Mrs. Horn and not necessarily those of the Board of Governors of the Federal Reserve System.