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economic commentary

Seeking a Stable Economic Environment

by Karen N. Horn

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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 restore the competitive position of our industries and their workers in the Fourth Federal Reserve District.[1]

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.

The District's Manufacturing Base

As you know so well, the Fourth District's economic base is concentrated in manufacturing, particularly in the production of producer and consumer durable goods. In 1983, nearly 18 percent of nonfarm employment in the Fourth District was dependent on such production, in contrast to 12 percent nationally. The District's economic recovery so far has been typical of the past recoveries, at least in an aggregate sense (see chart 1). Total nonagricultural employment in Ohio, which is representative of the Fourth District, has expanded at virtually the same pace since the trough in November 1982 as it has on average over past recoveries. Our recovery has also maintained its typical relationship with the national recovery.

A closer examination of specific industries, however, discloses that imbalances in the District's recovery are masked by the total employment data. For instance, the current recovery in capital equipment investment, while strong nationally, has been less beneficial to the producers of traditional capital goods (i.e., motor vehicles and machine tools) concentrated in the District. The recovery in capital

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The views expressed herein are those of Mrs. Horn and not necessarily those of the Board of Governors of the Federal Reserve System.

1. *The Fourth Federal Reserve District includes the state of Ohio, western Pennsylvania, eastern Kentucky, and the northern panhandle of West Virginia.*

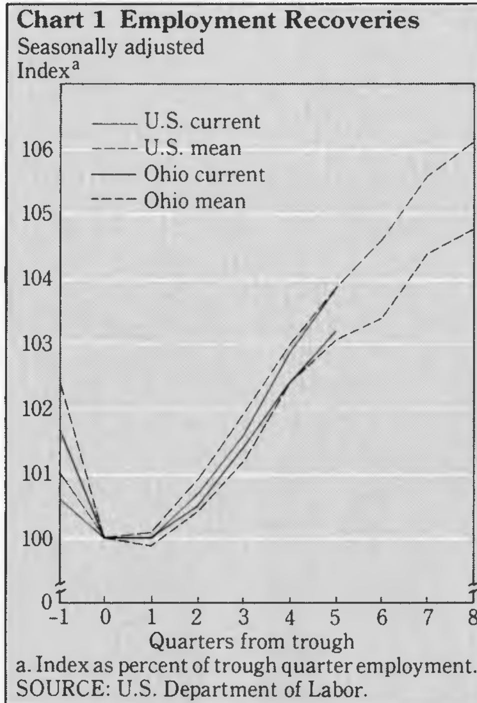


Chart 1 Employment Recoveries

a. Index as percent of trough quarter employment.
SOURCE: U.S. Department of Labor.

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 is still 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 equaled $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 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 other 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.

In spite of these disquieting features, the strength of the recovery thus far in the District has brightened attitudes and given hope to businesses and to workers. The recent increases in interest rates are worrisome, however, less for their impact today than for their implications for the effort under way to resolve the Fourth District's longstanding problems.

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 relative to the nation, a lag that can be traced back for more than three decades. Between 1949 and 1982, total employment in Ohio increased 1.7 percent a year on average, 1.5 percentage points less than the national average of 3.2 percent. Nearly 0.4 percentage

point of the shortfall is associated with Ohio's industrial structure. Ohio's industries were not rapid-growth industries, explaining about one-third of the disparity. The shortfall resulting from the underperformance of Ohio's industries is much larger—about 1.1 percentage points. Simply put, the competitive weakness of Ohio's industries relative to their counterparts elsewhere in the country accounts for about two-thirds of the shortfall.

Although these trends have been in place for a long time, they accelerated markedly in the 1970s. Ohio's employment growth rates in the 1970s fell behind national growth rates by more than 1.5 percentage points. During the 1960s, employment growth rates in Ohio's industries were almost equal to the national rates. The structural shift away from manufacturing and the competitive lag of most of Ohio's industries still were apparent in the 1960s, but the difference was much less pronounced (see chart 2).

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 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.

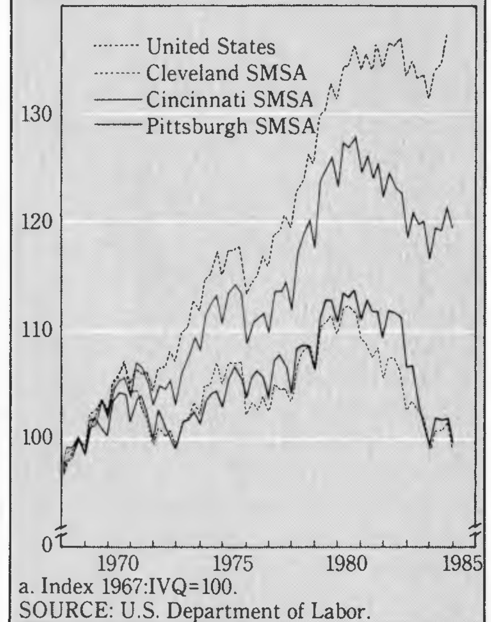
Unstable Economic Conditions

From my vantage point, however, there is another factor that is often overlooked and that seems especially relevant today. The decade of the 1960s was one of relatively low and stable inflation and only minor recessions. The 1970s was a period of high and accelerating inflation, severe recessions, and energy price shocks. The poor economic performance of industries of the Fourth District in the 1970s coincided with the most unstable and uncertain economic conditions of the post-World War II period.

For many years now, industries have had to deal with high and varying rates of inflation and, consequently, high interest rates. The Fourth District's industries are extremely sensitive to interest rates and inflation. While interest rates alone undoubtedly have a negative impact, it seems clear to me that the important issues of the problem lie elsewhere. An inflationary environment distorts, indeed frequently stifles, decisions and the necessary actions to maintain and improve productivity. High rates of inflation have contributed to increased production costs and have made it difficult to maintain profitability. Inflationary expectations found their way into the labor bargaining process, distorted the perceived rates of return on long-term capital investment, and confused reported profit figures. Businesses invested less in new plant and equipment than they probably would have with lower inflation and interest rates.

The uncertainty brought on by varying rates of interest and inflation has been particularly damaging to the Fourth District. Our heavy manufacturing industries are capital-intensive and must, of course, rely on external financing.

Chart 2 Total Nonagricultural Employment



a. Index 1967:IVQ=100.

SOURCE: U.S. Department of Labor.

When rates in the capital markets are high and unpredictable, businesses are less willing to make long-term investments. Instead, they make short-term investments that have short-term payouts, neglecting the longer-term investments necessary to reduce costs. The unstable economic environment since the 1970s has diverted attention from productivity and the need to remain competitive.

The need to improve costs and productivity to restore a competitive position is now recognized. I believe that much encouraging progress is being made, although it is not evident in the statistics yet and may not be for years to come. I see evidence of that adjustment in the attitudes of business and of labor. Although some obsolete plants have been closed, the process is not complete. Changes in organization and practices in offices and on assembly lines are being made. The

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 1969, 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 sharp recessions does not encourage risk-taking in pursuit of long-term productivity objectives. Nor does it encourage wise and prudent choices. It does not encourage decisions that are consistent with good economic performance. We are grappling with problems that can be solved only in a stable economic environment.

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