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 intimate 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 future consumption. Because federal borrowing is insensitive to 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.

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 make 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.
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 $0.58 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 $0.70 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 equalled $694 billion in 1983, compared with $427 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 domestic competitors that have used imported technology are also factors. U.S. and European antidumping actions against dumping by Japan and Korea have not eliminated the problem, as we can see from the data presented in Chart 1 Employment Recoveries, Percentage index.

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 others. Industrial 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 price competitiveness; management and marketing skills; relative management and old and obsolete capital stock have been major contributors. These influences can be quantify separately as structural and competitive categories or into their relative importance; in any event, the situation varies among industries and across the District.

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 unimagina-

able 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 importance; in any event, the situation varies among industries and across the District.

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 obsolescent plants have been closed, the process is not complete. Changes in organization and practices in offices and on assembly lines are being made. The