

ANNUAL REPORT

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FEDERAL RESERVE BANK OF CLEVELAND

The Federal Reserve System is responsible for formulating and implementing U.S. monetary policy. It also supervises banks and bank holding companies, and provides financial services to depository institutions and the federal government.

The Federal Reserve Bank of Cleveland is one of 12 regional Reserve Banks in the United States that, together with the Board of Governors in Washington, D.C., comprise the Federal Reserve System.

The Federal Reserve Bank of Cleveland, its two branches in Cincinnati and Pittsburgh, and its Columbus Office serve the Fourth Federal Reserve District. The Fourth District includes Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.

It is the policy of the Federal Reserve Bank of Cleveland to provide equal employment opportunities for qualified persons regardless of race, creed, color, national origin, age, gender, or disability.

FEDERAL RESERVE BANK OF CLEVELAND

ANNUAL REPORT 1994

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News reports of actions by the Federal Reserve System to contain inflation help to shape the public's views of the central bank. The pen and ink creations of editorial cartoonists staffing the nation's newspapers and magazines are another source of commentary on economic issues. While they do not necessarily present an accurate reflection of the Fed and its policymaking decisions, the works of three editorial cartoonists serve as illustrations for an essay on how Federal Reserve policy promotes growth, beginning on page 5 of this report.

Amid significant political and economic developments that made 1994 a watershed year for the nation, the economy of the Fourth Federal Reserve District saw important gains and was among the strongest in the United States.

Ratification of the North American Free Trade Agreement and U.S. approval of the General Agreement on Tariffs and Trade promise expanded access to international markets for manufacturers and consumers. These pacts are of particular importance to the Fourth District, where a large industrial sector is already benefiting from strong foreign demand for capital goods.

Regional manufacturing output continued to surge in 1994, largely as a result of increased exports and production efficiencies. Capital goods and steel producers operated at near capacity, and automotive suppliers continued to post solid production gains.

Among several indicators of economic health, employment growth accelerated nationally and within our region. As the U.S. jobless rate fell to 5.4 percent, Ohio's year-end unemployment rate of 4.3 percent was the state's lowest in 20 years. The latest available rates for other areas of the region were Kentucky, 4.8 percent; Pennsylvania, 5.9 percent; and West Virginia, 7.7 percent.

The robust regional economy is a major factor in helping the financial institutions of the Fourth District remain among the strongest and most profitable in the nation. Banks in the District experienced a third consecutive year of superior earnings, with many reporting record profits. Many institutions had solid loan demand for both business and consumer credit, and commercial banks reasserted themselves in the credit process.

The Federal Reserve Bank of Cleveland opened a new chapter in its history in 1994 with the groundbreaking for a new operations center, the first phase of a four-year construction and renovation program. This first significant alteration or addition since the 1923 completion of our headquarters building will provide space and state-of-the-art technology needed for us to serve the region well into the next century. The new operations center adjacent to our main building will house cash, check, and wire transfer operations.



Sandra Pianalto, first vice president; A. William Reynolds, chairman; Jerry L. Jordan, president; and G. Watts Humphrey, Jr., deputy chairman.

Keeping our internal focus on quality, cost efficiency, and customer service in 1994, we maintained our status of having the lowest unit costs of all 12 Federal Reserve Banks and made further progress toward achieving the Bank's "value-added" supervision objective. As part of the Bank's mission to provide high-quality, value-added services in all aspects of its operation, our banking supervision strategy seeks to enhance the already strong condition of Fourth District financial institutions through improved responsiveness and greater opportunities for education on regulatory topics.

During the year, we expanded Electronic Delivery Services, established internal and external quality task forces, created a special customer services unit for large institutions, and completed a complex relocation of data processing applications to the Federal Reserve Automation Services in Richmond, Virginia.

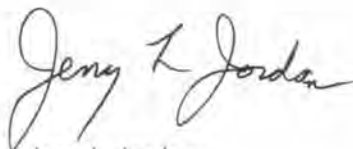
The Bank's efforts to ensure fair and equal access to credit for all of our citizens were aided by launching the Cleveland Residential Housing and Mortgage Credit Project. A model for other communities, this initiative brings together all components of the home mortgage market in a program of involvement and discovery designed to eliminate potential discriminatory practices in the home-buying process.

Throughout the year, the Federal Reserve's actions to contain inflation made news. Unfortunately, many reports of monetary policy moves gave the erroneous impression that the Fed is willing to sacrifice economic growth. In fact, reducing inflation in order to maintain the purchasing power of currency is a primary goal of the central bank because it will promote economic growth. Indeed, the Fed's efforts to restore confidence that the value of the dollar will be maintained in the future may, with hindsight, prove to have been a key contributor to the economy's rapid growth in the last year or two. We present a discussion of the relationship between price stability and prosperity in an essay beginning on page 5 of this report.

None of the year's accomplishments would have been possible without the guidance and support of our 23 directors, who represent a variety of banking and business interests from throughout our District. Special thanks are extended for the participation of the members of our Business and Small Bank Advisory Councils.

I especially want to thank six directors who completed their terms of service in 1994 — Bill McConnell (chairman and chief executive officer, The Park National Bank) and Doug Olesen (president and chief executive officer, Battelle Memorial Institute) for service on the Cleveland Board; Ray Bradbury (retired chairman, Martin County Coal Corporation) and Marv Stammen (president and chief executive officer, Second National Bank), who served on the Cincinnati Board; and Dave Dahlmann (president and chief executive officer, Southwest National Corporation) and Jack Piatt (chairman, Millcraft Industries, Inc.) for their service on the Pittsburgh Board. Messrs. McConnell, Olesen, and Piatt have served on their respective boards since 1989. We are pleased that Dave Dahlmann will continue to serve the District as a new member of the Cleveland Board.

Finally, I am grateful to the officers and staff of the Fourth District for their energy, resourcefulness, and commitment in making 1994 a successful year.



Jerry L. Jordan
President

Federal Reserve Policy Promotes Growth

The U.S. economy performed in stellar fashion in 1994. Employment increased by more than 3 million, economic output grew rapidly, and inflation edged further below 3 percent. After the disappointing pace of expansion in 1992 and 1993, last year's prosperity was very welcome indeed.

Unfortunately, even as more Americans were working, earning higher incomes, and producing more goods and services, there was uneasiness about where it would all lead. Some analysts expressed concern that the robust growth would lead to accelerating inflation. Others said that policy actions to restrain inflation would (or should) halt the growth. Still others said we would end up with the worst of worlds—stagflation—rising inflation and falling output and employment.

Such views suggest substantial disagreements about the causes of economic growth and inflation and about the appropriate role of the Federal Reserve. The debate over these issues is crucial to assessing the prospects for the economy during the next few years.

At the core is a fundamental disagreement about the natural tendencies of a market economy. The dominant view since World War II has been that without actions by governments or central banks, the economy will be deficient in creating jobs, generating incomes, and fueling economic growth. That is not our view. On the contrary, we believe a market economy has an inherent tendency to expand. Economic policies should create the conditions in which the natural incentives of a capitalist system foster the creativity and ingenuity necessary for innovation and capital accumulation.

Our view of the relationship between monetary policies and the economy can be summarized by four key points: 1) the Fed seeks to restrain inflation in order to promote economic growth in the conviction that inflation hampers growth; 2) growth is not sacrificed in order to maintain price stability; 3) monetary policy is the only tool for preventing inflation; and 4) even 1994's low rate of inflation is too high for the nation's long-term good.

What to Believe?

Numerous media reports last year asserted that the Federal Reserve's actions in 1994 were designed to slow the economy to head off inflation. For example, *The New York Times* stated in September that "...reports [of vigor in housing and employment] fanned fears that overly rapid growth could revive inflation."¹ At the same time, *The Wall Street Journal* reported that "the Fed's current goal is to slow the economy to an annual growth rate of about 2.5 percent to avoid a significant acceleration of inflation."² Actually, they had it backwards: Monetary policies are geared to creating less inflation so that there will be more growth.

Monetary policies of the Federal Reserve reflect the belief that maintaining price stability does not require high interest rates and less growth. On the contrary, a stable purchasing power of the dollar will promote lower long-term interest



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rates, faster real economic growth, more employment, and higher standards of living.

We agree with Milton Friedman, one of the most celebrated economists of this century, who has argued that a monetary policy

geared to the "avoidance of either inflation or deflation of prices... would provide a monetary climate favorable to the effective operation of those basic forces of enterprise, ingenuity, invention, hard work, and thrift that are the true springs of economic growth."³

Long-run economic growth occurs when there are more or better-trained workers, when the stock of capital (such as buildings and machinery) is growing, when technology such as software is improving, and when business enterprises become more efficient.

Economic growth is natural because most people want to improve their standard of living. To do so, they seek education and work skills for themselves and their children; they save and invest in order to obtain higher incomes in the future; they acquire tools, buildings, and machinery to increase their ability to produce goods and services for themselves or to sell to others; and they invent new technologies and work methods so they can produce more with less. These are activities that require no prompting from government.

The necessary role of government is to provide an environment in which the natural process of economic commerce is unimpeded. Government should both protect and respect private property rights, institute courts to help enforce contracts, and provide patent and copyright protections. It should provide for national defense and internal law and order as well as guarantee civil liberties such as freedom of speech, press, religion, petition, movement, and association. Government should uphold economic liberties such as freedom to invest and to choose one's field of study, occupation, and employment. Finally, it should provide a reliable unit of money for people to use in their personal and business transactions—a unit whose purchasing power remains constant over the years and decades and whose value is neither eroded by inflation nor augmented by falling prices.

Governments depend on their monetary authorities to uphold the value of their currencies. In the United States, Congress has assigned this responsibility to the Federal Reserve System, an independent central bank (see "By Act of Congress" at left). Providing a reliable unit of money is the primary way in which the Federal Reserve supports the natural process of economic growth. When the value of the currency is altered by either inflation or deflation, the economy cannot perform at its optimum level.

Defining Inflation

Inflation means that the purchasing power of a dollar is shrinking over time. This occurs when the average of all prices of the items purchased with money rises—that is, when the general level of prices moves up. The price level is usually measured by an index, such as the Consumer Price Index, which is a weighted average of prices for a large number of goods and services that are desired by consumers. Not all prices rise during inflation, and those that rise do not all increase at the same pace.

Inflation is a *persistent* rise in the general level of prices, not a temporary increase in the price of one or even several goods. For example, when last year's freeze in Brazil damaged the coffee crop, the prospects of a smaller harvest led to a rise in coffee prices. But the higher prices will hold only until the next normal-sized crop comes to market. Moreover, even if the rise in coffee prices is not reversed, it will not lead to a general decline in the value of money. It is only when the overall price level *continues* to rise that we have inflation—a sustained slide in the purchasing power of money.

As in the case of coffee, a higher price for one item cannot continuously raise the average of all prices.

The Employment Act of 1946 requires the federal government to pursue "maximum employment, production, and purchasing power."⁴ Responsibility for achieving the goals of the Act was not assigned to any specific government entity or to the Federal Reserve System. Rather, the Act expressed appropriate goals for policymakers to strive for using the knowledge and tools available to them.

The Employment Act was amended by the Full Employment and Balanced Growth Act of 1978, also known as the Humphrey-Hawkins Act. That law requires the federal government to pursue several national goals, including "...full employment and production, increased real income, balanced growth, a balanced federal budget, adequate productivity growth...an improved trade balance...and reasonable price stability..."⁵

Like its predecessor, Humphrey-Hawkins states only general goals for the government rather than assigning individual responsibilities for achieving those goals. However, Humphrey-Hawkins is more specific in that it requires the President to establish economic goals consistent with eventually achieving total and adult unemployment rates of 4 percent and 3 percent, respectively.

In contrast to the generalities of the Employment Act and the Humphrey-Hawkins Act, a 1977 amendment to the Federal Reserve Act assigns some specific objectives to the Federal Reserve. The Fed is required "...to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."⁶ It is left to the Fed to decide how best to pursue those goals.

This is true even if the price increase results from greater demand rather than from reduced supply. For example, suppose the producer of an individual product raises the price in response to greater demand. People who still buy that higher-priced product then have less available to spend on other products. The demand for other products drops, so prices of those products also decline (or rise less than they would otherwise), leaving the overall price level unchanged. This must happen unless the public's nominal purchasing power is increased through excess money creation.

ular way to express Friedman's view is that inflation is the result of "too much money chasing too few goods." Nevertheless, periods when goods are produced at a rising pace, such as 1994, often generate concerns about inflation. But it is not the more rapid economic growth that causes the value of money to fall. At first glance, it seems strange to even think that expanding the output and availability of goods can cause the prices of goods to rise. Increases in the supply of particular commodities such as wheat or computer chips obviously reduce their prices.

goods will fall. Only if policymakers have allowed the money supply to expand at an excessive pace will price increases become permanent. Without excessive monetary growth, long-run price stability can be achieved despite transitory, cyclical ups and downs in prices of specific commodities, manufactured goods, and services.

The mistaken belief that growth causes inflation stems in part from confusion about *real* growth and *nominal* growth. Real growth is an increase in the physical volume of goods and services produced. Nominal growth, on the other hand, is an increase in the dollar value of output, whether that rise involves greater real output, a higher price level, or both. If nominal growth exceeds real growth, inflation is occurring. However, achieving price stability does not require less real growth. Instead, it requires that spending does not persistently rise faster than the rate of real growth. Central bank actions to combat inflation are not intended to limit real output growth, but to prevent nominal growth that would result in a rising price level. For a further discussion of misperceptions surrounding growth and inflation, see "No Trade-off" on page 8.



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Because price increases for individual items cannot compel increases in the money supply, they cannot cause inflation. As a former president of U.S. Steel Corporation once put it, "Steel prices cause inflation like wet sidewalks cause rain."⁷

Inflation's One Cause

Milton Friedman described inflation as "always and everywhere a monetary phenomenon."⁸ His point is that inflation cannot occur without excessive growth of the money supply. That is, only when a nation's central bank permits money to be created at a pace faster than people want to add to their money balances do we see inflation. The pop-

Clearly, expanded production is not the sole focus of concern. Rather, if increased production and employment are the result of accelerating demands for current output, excessive demands may spill over into rising prices. When manufacturers respond to increased orders and sales by stepping up production, they incur higher costs, capacity constraints may become binding, and the prices of many goods and services may rise. These effects, however, are only temporary and cannot lead to sustained inflation. In fact, at other times, demand for current output will grow more slowly and prices of many raw materials and final

Rising interest rates also do not cause inflation. The relationship is the reverse: Inflation (or, more precisely, expectations of inflation) can cause interest rates to rise when lenders demand compensation for the expected erosion in the value of money. Inflation premiums in interest rates add to the cost of borrowing, but only enough to offset the loss of purchasing power that is expected from inflation.

Higher interest rates add to production costs, but those cost increases are not inflationary, just as

other production cost increases are not inflationary. Rising interest costs pressure producers to restrain other production costs, to reduce profit margins, or to raise prices. If some producers do boost their prices, some other prices must fall so that the average of all prices remains unchanged—unless monetary policymakers allow the money supply to expand at an inflationary pace.

Another common misperception is that a falling foreign-exchange value of a currency can cause inflation. When the dollar depreciates against foreign currencies, as it did against the Japanese yen and the German mark during 1994, price increases for some imported goods are likely to follow. However, as explained earlier, increases in individual prices do not cause inflation. Unless monetary policy itself is inflationary, those individual price increases must be offset by declines (or smaller increases) in other prices.

If, however, the falling foreign-exchange value of the currency reflects a *domestic* inflationary process, other prices will not head lower. Nevertheless, the declining exchange value of the dollar is not the cause of the inflation. Instead, dollar depreciation against other currencies is one of the channels through which inflationary domestic monetary policy actions are reflected in a higher price level.

Inflation Hampers Growth

Inflation depresses real economic growth over time by causing inefficiency in the marketplace, discouraging saving and investment, and shifting investment toward short-lived capital goods. Moreover, because inflation that is *unanticipated* redistributes wealth, people and businesses divert productive resources from growth activities in attempts to protect themselves from landing on the losing end of the redistribution.

Inflation hampers market efficiency by reducing the clarity of price signals. When a price or wage rises during inflation, it is often unclear how much, if any, of the increase is relative and how much merely reflects the falling value of money. This lack of clarity reduces the efficiency with which individuals can make decisions about occupations, employment, and consumption and with which businesses can gauge output levels, materials, and equipment-labor ratios. To reduce these inefficiencies, individuals and businesses incur the costs of shopping around for current price information.

When policymakers tolerate even modest rates of inflation, uncertainty about future rates of inflation prevails. That uncertainty increases the risks of making investments, so lenders respond by adding a risk premium to interest rates. In turn, the higher rates suppress investment and shift it toward short-lived capital goods.

NO TRADE-OFF

Many people mistakenly believe that society must choose between a stable price level and rapid economic growth—that the two cannot co-exist. Some acquire this notion merely because it is repeated so often.

The belief that rapid real growth causes inflation can be traced back to the ideas that there is a trade-off between the inflation rate and the unemployment rate, and that the unemployment rate will be low only when growth is rapid.

When people believe in a trade-off between inflation and unemployment, they reason that economic policymakers must choose between twin evils and accept the combination that is most tolerable for the nation. According to this view, if policy-

makers want a little less unemployment, they can “buy” it by accepting or inducing somewhat more rapid inflation. But such trades are at best a short-run, transitory phenomenon.

Today, few economists think that there is any long-run trade-off between inflation and unemployment. In fact, countries that try to exploit the supposed trade-off usually wind up with both inflation and unemployment. Instead of a trade-off, most economists believe that, conceptually, there is a “natural” rate of unemployment and that no amount of inflation can permanently hold unemployment below such a rate. Unfortunately, even if the natural rate theory is correct, no one knows where that level is with sufficient certainty for use in eco-

nomics policymaking. Everyone agrees that many factors affect such a natural rate over time.

While most experts accept the notion of a short-run trade-off between inflation and unemployment, such a phenomenon occurs only when people are surprised by an increase in inflation. This means that even a transitory trade-off between inflation and unemployment can be exploited only with ever-higher rates of inflation. And, when people come to expect this constant acceleration, they can be surprised, if at all, only with inflation rates that mushroom into hyperinflation. Clearly, persistent attempts to artificially depress unemployment through an inflationary monetary policy would inflict long-term damage on the economy.

Furthermore, inflation interacts with the U.S. tax code to discourage saving and investment even more. Saving is discouraged because interest earned on savings placed in financial assets is fully taxable, even though part of the interest is merely an inflation premium,

this point, it helps to distinguish between the level of output and the standard of living. Imagine an increase in thefts in an economy that is already fully utilizing its productive resources. There is likely to be a decline in production of some other goods and services so that

mortgage in the last few years spent a substantial amount of time evaluating the relative merits of fixed- versus adjustable-rate mortgages, trying to guess how interest rates would change in the future—in essence, trying to forecast how much inflation there would be.



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intended to compensate for erosion of the purchasing power of principal. Investment is discouraged because business profits are overstated and therefore overtaxed—the result of a tax code that allows depreciation only of the original cost of capital equipment, not of its current, inflation-boosted replacement cost. Moreover, taxing the inflated value of assets with an unindexed capital gains tax results in a confiscatory tax on real productive assets. These disincentives are a further drag on economic growth.

Shifting Wealth

Inflation that is not accurately predicted redistributes wealth. If inflation is greater than expected, wealth is shifted from lenders to borrowers as the purchasing power of the funds used for repayment declines.

Not only is the redistribution of wealth arbitrary and unfair, but it also lowers the standard of living and restrains growth. To illustrate

production of door locks and car alarms can be increased. Although there is no change in the *level* of real output, the standard of living will be lower because some productive resources must be redirected to thwarting thieves. Moreover, there will be less growth over the long run because some investment expenditures will be diverted from, say, purchasing productive factory machinery to building higher fences to protect the factories.

Similarly, inflation leads to socially wasteful but personally necessary actions to avoid loss (or to obtain gain) from the resulting redistribution of wealth. Households hedge against inflation by buying houses, land, and nonproductive assets such as gold more than they otherwise would. Firms increase their inventories, analysts sell forecasts to help people anticipate inflation, and financial institutions develop inflation-hedging products such as adjustable-rate mortgages. Most people who refinanced a home

Although these activities are sensible for the people who engage in them, they are socially wasteful because they merely alter the pattern of inflation's redistribution of wealth, rather than adding to wealth. Even if this activity involves no reduction in the measured level of real output, the standard of living will be lower because some productive resources will have to be redirected. In addition, there will be less growth over the long run because some growth-enhancing resources must be diverted to these inflation-hedging activities.

The challenge of preventing all of these anti-growth consequences of inflation is assigned to central banks. The Federal Reserve and other central banks should seek to maintain a stable price level—a stable value of each nation's currency—because that is the greatest contribution that monetary policy can make to maximizing standards of living over time. When people have confidence that the price level will be stable (the inflation rate will average zero over time), they can make plans for the future without the need to use productive resources to guard against changes in the purchasing power of money.

The Only Tool

Sound monetary policy is the only way to achieve and maintain a stable price level. Because inflation is a monetary phenomenon, and because the Fed is responsible for controlling the growth of the nation's money supply, only the Fed has the ability to prevent inflation and erosion of the dollar's purchasing power.

Moreover, producing price stability is the most important task that can be assigned to monetary policy. Unfortunately, some people believe that when the economy slides into recession it has a natural tendency to stay there, and so monetary and fiscal policy actions are needed to augment private demand in order to get back to full employment. Such notions about the possible inadequacies of aggregate demand emanating from businesses and households are inconsistent with our view that a market economy is inherently resilient.

That is, if an unexpected economic shock results in an increase in unemployment, the economy will naturally move back toward full employment without any policy stimulus to total spending. This will happen because unemployed workers and owners of idle productive resources have an obvious incentive to increase their skills and efficiency or lower their wages and prices so that they can again earn income.

The use of monetary policy to maintain the value of the dollar is consistent with the goals that Congress has established for the Federal Reserve System. The underlying purpose of the congressional mandates is to promote improvement in the standard of living. Since economic growth leads to higher living standards, and since price stability promotes economic growth, a monetary policy that fosters price stability is fully consistent with congressional intent. Furthermore, actions that preserve the value of the currency are the only way for monetary policy to ultimately satisfy the congressional mandate to pursue maximum employment and moderate long-term interest rates.

Almost Is Not Enough

The recent U.S. inflation rate of about 3 percent seems quite low to many people, especially when compared with the high-inflation era of the 1970s and early 1980s. Unfortunately, many economists as well as the general public expect the inflation rate to head higher. That means the central bank's commitment to achieve price stability does not enjoy credibility. If businesses and households base their everyday decisions on the expectation that the value of money will fall, while the central bank acts to preserve the value of money, performance of the economy is impaired. That possibility leads some observers to argue that moderate rates of inflation should be tolerated because it is too hard to convince people that inflation can and will be eliminated.

Few people would argue that it would not be preferable to have stable purchasing power for the dollar, just as few would argue that it would be desirable to change the length of an inch or yard from one year to the next. Nevertheless, many contend that an eroding value of the currency has gone on for so long and has become so built in to people's behavior that it is best just to live with it.

But even a low rate of inflation would substantially shrink the purchasing power of the dollar over time. For example, it now takes nearly \$15 to purchase what \$1 would have bought when the Federal Reserve System was organized in 1914, even though annual inflation since then has averaged only 3.4 percent. If inflation were to continue at the 3 percent average annual rate of the last four years, the price level would double in less than 24 years. Moreover, with 3 percent inflation, at the end of the 21st century

it would take \$23 to buy what \$1 buys today and \$339 to buy what \$1 would purchase 80 years ago when the Fed was created.

Because the rate of inflation is already low, stabilizing the purchasing power of money is within our reach. Only the Federal Reserve System has the policy tools needed to achieve price stability, and achieving that goal is the greatest contribution the Fed can make to our nation's economic well-being.

Endnotes

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4. Employment Act of 1946, Section 2, as recorded in *United States Code: Congressional Service, Laws of 79th Congress, Second Session*, St. Paul: West Publishing Company, p. 20.
5. Full Employment and Balanced Growth Act of 1978, as recorded in *United States Code: Congressional Service and Administrative News, Laws of 95th Congress, Second Session*, vol. 1, 92 STAT., p. 1890, St. Paul: West Publishing Company.
6. This amendment to the Federal Reserve Act is included in the Federal Reserve Reform Act of 1977, as recorded in *United States Code: Congressional Service and Administrative News, Laws of 95th Congress, First Session*, vol. 1, 91 STAT., p. 1387, St. Paul: West Publishing Company.
7. Roger Blough, quoted by Malcolm S. Forbes in "Fact and Comment," *Forbes*, vol. 100, no. 3 (August 1, 1967), p. 18.
8. Milton Friedman, "Inflation: Causes and Consequences," in *Dollars and Deficits*, Englewood Cliffs, N.J.: Prentice-Hall, 1968, p. 39.

OFFICERS

As of December 31, 1994

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As of December 31, 1994

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 Cincinnati, Ohio



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 Monroeville, Pennsylvania

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 President & Chief Executive Officer
 Battelle Memorial Institute
 Columbus, Ohio



Alfred C. Leist
 Chairman, President &
 Chief Executive Officer
 The Apple Creek Banking Co.
 Apple Creek, Ohio



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Chairman & Chief Executive Officer
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Dayton, Ohio

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Eleanor Hicks

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Paris, Kentucky

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Second National Bank
Greenville, Ohio

PITTSBURGH

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Vice Chairman of the Board
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Apollo, Pennsylvania

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Southwest National Corporation
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Sandra L. Phillips

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Neighborhood Development
Pittsburgh, Pennsylvania

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Chairman of the Board
Millcraft Industries, Inc.
Washington, Pennsylvania

Randall L. C. Russell

President & Chief Executive Officer
Ranbar Technology, Inc.
Glenshaw, Pennsylvania

Wesley W. von Schack

Chairman, President &
Chief Executive Officer
DQE
Pittsburgh, Pennsylvania



COMPARATIVE FINANCIAL STATEMENT

STATEMENT OF CONDITION

For years ended December 31

1994

1993

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ASSETS

Gold certificate account	\$ 660,000,000	\$ 701,000,000
Special drawing rights certificate account	556,000,000	556,000,000
Coin	16,694,902	21,234,140
Loans and securities:		
Loans to depository institutions	-0-	-0-
Federal agency obligations bought outright	229,245,239	311,578,704
U.S. government securities:		
Bills	11,181,316,977	10,772,433,990
Notes	9,086,293,278	8,872,000,411
Bonds	2,710,415,171	2,658,156,406
Total U.S. government securities	\$ 22,978,025,426	\$ 22,302,590,807
Total loans and securities	\$ 23,207,270,665	\$ 22,614,169,511
Cash items in process of collection	268,936,471	274,834,436
Bank premises	45,580,606	37,373,597
Other assets	1,977,994,674	1,800,816,531
Interdistrict settlement account	-1,332,449,195	-3,321,205,721
TOTAL ASSETS	\$ 25,400,028,123	\$ 22,684,222,494

LIABILITIES

Federal Reserve notes	\$ 22,542,394,720	\$ 20,161,201,280
Deposits:		
Depository institutions	1,813,652,367	1,556,106,868
Foreign	9,266,587	8,020,300
Other deposits	40,656,808	14,204,742
Total deposits	\$ 1,863,575,762	\$ 1,578,331,910
Deferred availability cash items	222,309,262	339,713,652
Other liabilities	256,692,279	157,918,052
TOTAL LIABILITIES	\$ 24,884,972,023	\$ 22,237,164,894

CAPITAL ACCOUNTS

Capital paid in	\$ 257,528,050	\$ 223,528,800
Surplus	257,528,050	223,528,800
TOTAL CAPITAL ACCOUNTS	\$ 515,056,100	\$ 447,057,600
TOTAL LIABILITIES AND CAPITAL ACCOUNTS	\$ 25,400,028,123	\$ 22,684,222,494

INCOME AND EXPENSES

For years ended December 31

1994

1993

CURRENT INCOME

Interest on loans	\$ 137,807	\$ 181
Interest on government securities	1,227,039,616	1,105,592,400
Earnings on foreign currency	58,356,750	72,384,137
Income from services	45,499,574	44,464,874
All other income	401,259	229,592
Total current income	\$ 1,331,435,006	\$ 1,222,671,184

CURRENT EXPENSES

Current operating expenses	\$ 83,758,408	\$ 79,232,490
Cost of earnings credits	12,381,212	10,756,840
CURRENT NET INCOME	\$ 1,235,295,386	\$ 1,132,681,854

PROFIT AND LOSS

Additions to current net income		
Profit on foreign exchange transactions	\$ 159,216,132	\$ 15,319,310
Profit on sales of government securities	—0—	2,556,007
All other additions	33,927	2,776,384
Total additions	\$ 159,250,059	20,651,701
Deductions from current net income		
Loss on sales of government securities	\$ 1,510,117	\$ —0—
All other deductions	5,063	33,032,393
Total deductions	\$ 1,515,180	\$ 33,032,393
Net additions or deductions	157,734,879	—12,380,692
Cost of unreimbursable Treasury services	1,964,554	1,685,403
Assessments by Board of Governors		
Expenditures	9,693,400	8,215,500
Federal Reserve currency costs	21,583,556	23,192,101
Total assessments by Board of Governors	31,276,956	31,407,601
NET INCOME AVAILABLE FOR DISTRIBUTION	\$ 1,359,788,755	\$ 1,087,208,158

DISTRIBUTION OF NET INCOME

Dividends paid	\$ 14,283,474	\$ 12,010,618
Payments to U.S. Treasury		
(interest on Federal Reserve notes)	1,311,506,031	1,027,887,290
Transferred to surplus	33,999,250	47,310,250
Total distributed	\$ 1,359,788,755	\$ 1,087,208,158

SMALL BANK ADVISORY COUNCIL, 1993-94

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Wheeling, West Virginia

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President & CEO
The Peoples Banking Company
Coldwater, Ohio

E. Eugene Lehman
President & CEO
The Union Bank Company
Columbus Grove, Ohio

Norma J. Linville
President & CEO
Farmers & Traders Bank of Mt. Olivet
Mt. Olivet, Kentucky

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The Andover Bank
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Robert A. Rimbey
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Evans City, Pennsylvania

David Voight
President & CEO
The Citizens Banking Company
Sandusky, Ohio

Benedict Weissenrieder
President & CEO
Hocking Valley Bank of Athens
Athens, Ohio

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Cleveland, Ohio

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Cheryl & Company
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Newark, Ohio

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Dynamet, Inc.
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This annual report was prepared by the Corporate Communications & Community Affairs Department and the Research Department, Federal Reserve Bank of Cleveland.

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