

1992

Annual Report

FEDERAL
RESERVE
BANK OF
CLEVELAND

ANNUAL REPORT 1992

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William H. Hendricks
(left, standing);
John R. Miller
(right, standing);
Jerry L. Jordan
(seated)



President's Foreword

*I*n the second half of 1992, economic expansion resumed at a healthy pace. Although the structural adjustments that have hampered the recovery are not yet complete, there is no reason to expect that the current favorable trends will not continue.

Clearly, the emphasis on capital investment and the development of the nation's infrastructure, as well as government budget reform, will support the stable growth of the nation's economy. Because the Federal Reserve has fostered a low inflation environment for the past several years, we believe that monetary policy has contributed importantly to improving long-run growth.

Concern about the economy's potential for growth has brought other, related issues into sharper focus. One such issue concerns our nation's position in the world market and America's continuing prosperity, especially as these may be affected by the North American Free Trade Agreement (NAFTA). NAFTA, a United States-Canada-Mexico pact, will consolidate and extend the reductions in tariffs and other barriers to trade between the three countries, if it is approved by the three governments as expected later this year.

As has always been the case, the move toward more open trade brings controversy with it.

Some applaud the prosperity promised by less restricted trade among nations, while others decry the threat to investment and employment represented by such freedom. It is this controversy, based on different perceptions of the nature and effects of international trade flows, that makes NAFTA a particularly timely and worthwhile subject for this year's annual report essay.

In the essay, we explore the benefits of free trade, examine the probable effects of NAFTA, especially on the Midwest, and suggest ways that the Midwest can strengthen its competitive position. Given the context of the changing world economy, NAFTA will present a clear challenge, but a constructive response to change should ultimately strengthen the region.

The Federal Reserve Bank of Cleveland will continue to take a leading role in public policy discussions such as NAFTA, and continue to improve the efficiency and quality of our services to the depository institutions in our region. During 1992, the District was quite successful in these efforts due to the contributions of many people, including our 23 directors, representing banking, business, agriculture, consumer, and labor interests, our Small Bank and Small Business Advisory Councils, our officers, and our employees.

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In particular, the Bank has been fortunate to receive the guidance and leadership of William H. Hendricks, first vice president, who has retired from the Bank after having served the District and the Federal Reserve System for more than 34 years. Bill's contributions to the Fourth District and the Federal Reserve System are well-known – he played a significant role in creating the Federal Reserve System's automated clearinghouse system and in upgrading its electronic funds transfer network. Over the last few years, he spearheaded the development of the Federal Reserve System's new currency processing equipment. Bill brought a very high level of dedication and integrity to his varied responsibilities, and he will be missed.

I also want to express appreciation to John R. Miller (former president and chief operating officer of Standard Oil Company of Ohio), who served as chairman of our board of directors since 1991 and who was a member of our board since 1986. When John completed his term of service in 1992, he left the Bank in a stronger position to meet the challenges of the future. We are indebted to him for his wise counsel, leadership, and dedication.

We are grateful for the guidance of the Cleveland directors who completed their terms of service: Laban P. Jackson, Jr. (chairman of Clearcreek Properties), who served since 1987; and Frank Wobst (chairman and chief executive officer of Huntington Bancshares Incorporated), who served since 1987. Special thanks are due to the directors of the Fourth District's two branch offices who completed their terms: Clay Parker Davis (president and chief executive officer of Citizens National Bank), who served on the Cincinnati board since 1990; and William F. Roemer (chairman and chief executive officer of Integra Financial Corporation), who served on the Pittsburgh board since 1990.

Finally, I want to express my appreciation for the contributions made by the officers and the employees of the Fourth District during 1992.



Jerry L. Jordan

A Continent Without Borders

"TRADE IS IN ITS NATURE FREE,
FINDS ITS OWN CHANNEL,
AND BEST DIRECTETH ITS OWN COURSE;
AND ALL LAWS TO GIVE IT RULES AND DIRECTIONS,
AND TO LIMIT AND CIRCUMSCRIBE IT,
MAY SERVE THE PARTICULAR ENDS OF PRIVATE MEN,
BUT ARE SELDOM ADVANTAGEOUS TO THE PUBLIC."

An Essay on the East India Trade

Charles D'Avenant (1697)

The notion of goods and services, labor and capital flowing freely across the vast spaces of the United States is commonplace to Americans. Although the United States is stratified by countless layers of governments, most of which have some power to tax goods and services, our founders saw the benefit of unfettered commerce among the various political entities. Most goods and services are transported across government boundaries without restrictions of tariffs or quotas; businesses have free access to markets across the country; people can live and work anywhere they choose.

Yet, even within this highly integrated market economy, spatial distances, cultural differences, resource endowments, special skills or technologies, and simply the quirks of history lead to specialization and thus regional economic diversity. Free trade across state borders allows regions to do what they do best. Ohio produces steel products and automobiles in abundance; California and Florida grow oranges. The exchange of citrus products for steel girders or for cars yields gains to consumers and workers in all three regions.

The potential of an integrated economy is much greater than the sum of each region's isolated efforts. By linking these diverse

regions into a tightly integrated economy, free trade within the borders of the United States has allowed our country to approach its fullest economic potential. The nation's grand experiment of internal free trade, steered by market forces, has helped make our economy the largest and most productive in the world, which is a splendid testimony to D'Avenant's seventeenth-century observation.

BORDERLESS TRADE

Within the last few years, two opportunities have arisen to expand free trade beyond the borders of the United States to include Canada and Mexico. In 1987, Canada and the United States entered into a free-trade agreement, which set up a schedule to eliminate tariffs and quotas on most goods shipped between the two countries. On August 12, 1992, Mexico joined Canada and the United States in announcing a trilateral agreement to create a free-trade zone that would encompass the entire North American continent.

Although trade is already well established among the three countries, the flow of goods and services is still restricted by some tariffs and barriers. The North American Free Trade Agreement (NAFTA), if ratified, would eliminate tariffs on most shipments between the

three countries within 10 years. It would also remove limits on international investment, liberalize trade in services (including banking), protect intellectual property, and establish environmental and worker safety standards.

As a result, trade among the three nations could approach the high level of mobility of merchandise and factors of production (except labor) that has flourished within the United States for more than two centuries.

NAFTA has been heralded as a major step in unleashing the combined competitive powers of the three North American economies. By linking the United States with its first- and third-largest trading partners, NAFTA would create the world's largest trading bloc, with 370 million consumers and \$6 trillion in output.

The further integration of the three economies promises to raise the standards of living of all three nations. The benefits spring from each nation's ability to focus on producing those goods and services for which it has a comparative advantage, reducing costs by spreading large investments over larger markets, and inducing more efficient operations through stiffer competition. As a result, U.S. businesses will not only be more efficient in providing goods and services to U.S. consumers, but they also will be more competitive with Asian and European companies, further bolstering growth and prosperity at home.

On the other hand, not everyone shares the same enthusiasm for the passage of NAFTA. While many see NAFTA as a continuation of the liberalization of North American trade begun by the Canada-U.S. Free Trade Agreement (FTA) of 1987, others see a serious threat in including Mexico in the pact.

Canada, with its similarities to the United States in wages and other economic aspects, and its long-standing trade relationships with

the United States, has presented few adjustment problems in a more open trading environment. Mexico, in contrast, with its lower labor costs and less-developed economy, is seen by some to be a threat to U.S. jobs. Opponents assert that eliminating trade barriers between Mexico and the United States would invite the exodus of jobs to Mexico, as well as introduce a host of problems regarding the environment and worker safety.

MIDWEST JOBS

While critics generally agree that NAFTA will raise overall well-being, they argue that the costs are borne disproportionately by workers in specific industries and in certain regions. They point out that the hardship experienced by a single worker displaced from his or her job because of increased competition will greatly exceed the gains realized by any one consumer who enjoys the benefits of lower prices.

Many Midwest workers feel particularly vulnerable to NAFTA. They fear that much lower wages and less stringent regulations in Mexico will lure businesses and jobs away from this region, leaving them with fewer job prospects and lower wages. Their fears have been fueled by the lackluster growth of Midwest manufacturing employment, by the well-publicized downsizing of many large corporations, and by the rapid growth in the number of production facilities just inside the Mexican border.

This essay focuses on a narrow but important issue: What effect will free trade with Mexico have on Midwest jobs? The perspective offered is framed in terms of competitive advantage and adjustment to change. How does a region create and sustain a competitive advantage in products and industries that yield high-paying jobs and thus a high standard of living? How can businesses and workers prepare for the opportunities afforded by freer trade in general and by NAFTA in particular?

Fear of Free Trade

The potential loss of certain types of jobs resulting from the series of trade liberalization initiatives, of which NAFTA is the most recent and most publicized, is a solemn reminder of the wrenching restructuring the Midwest has experienced during the past several decades. Increased competition came first from regions within the United States, and more recently from foreign economies.

Perhaps the Midwest's most effective competitor has been the southern states. This was not always the case. During the first half of this century, tens of thousands of workers from the rural South were drawn into the higher-paying factory jobs in the Midwest. For example, at the turn of the century, steel workers in the Midwest earned nearly 70 percent more than their counterparts in the South.

After World War II, the tide turned. As transportation costs declined with new investment in highways and railroads, the South's lower wages and less restrictive labor practices attracted businesses away from the Midwest and other

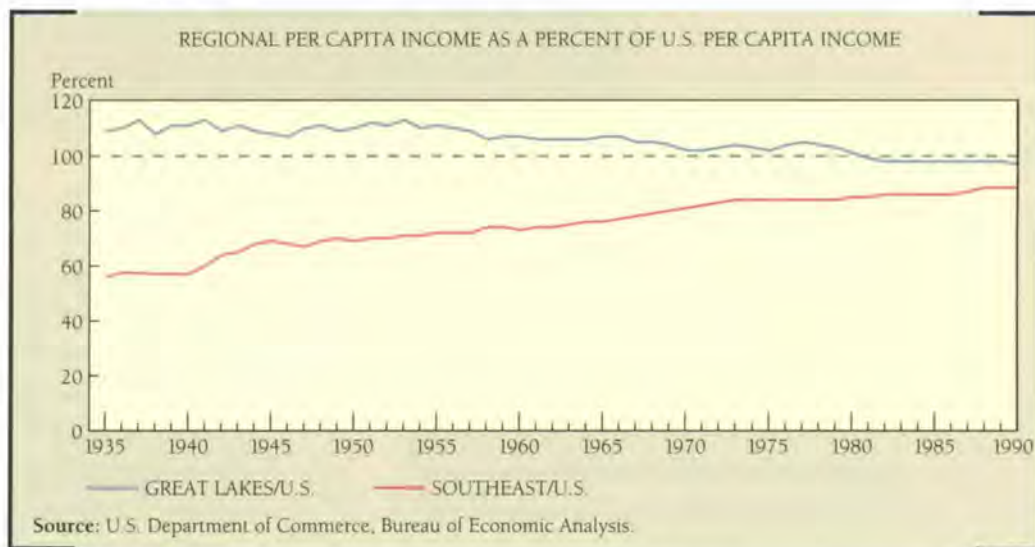
regions of the country. During the 1960s and 1970s, the South gained close to two million manufacturing jobs relative to the rest of the nation. Much of this increase came at the expense of the Midwest.

The reallocation of resources, particularly the infusion of new investment, helped raise living standards in the South. The region's per capita income rose from 30 percent below the national average in 1950 to 10 percent below in 1990. During the 1950s and the first half of the

1960s, the Midwest maintained an advantage over much of the rest of country, enjoying per capita income as much as 10 percent higher than the national average. Since then, the Midwest's advantage has steadily eroded and is now slightly below the national average.

ADAPTING TO CHANGE

What happened to the Midwest's dominance in key industries that supported the region's standard of living? Some have argued that the region simply could not compete with the lower wages of the South. Others add that the products that built this region and this country – steel, automobiles, tires – are no longer the cornerstone of U.S. economic development.



Both explanations are valid, but they raise a more basic question: Why was the Midwest unable to generate new ventures that could spawn the next generation of productive industries? The answer lies at the root of competitive advantage.

A region's competitive advantage is not measured by specific industries or products, but by the talents and resources that allow a region to replace declining, less efficient industries with expanding, more productive

ones. The Midwest attained and preserved its dominance for decades primarily through innovation – by discovering and implementing new and better ways to compete and by successfully bringing these ideas to market.

The advantage of low factor costs, principally low wages, is only secondary to the advantage of profitable ideas. Economies expand and develop by adding new kinds of activities.

History is full of examples in which regions have been propelled by the cumulative effect of incremental ideas. Henry Ford saw the advantage of assembling automobile parts built by small local suppliers. From this initial effort, the auto industry was born. Andrew Carnegie started the organization that would eventually become

U.S. Steel by acquiring a small forge that made axles for a local railway car builder.

Both industries flourished in the Midwest, because the region's

businesses made better products and produced them more efficiently than anyone else. In return, these ventures yielded high returns and high wages.

But the success and dominance of these Midwest industries unintentionally retarded the further development of innovations and crippled economic growth for basically two reasons. First, the region's dominant industries kept skilled labor and entrepreneurial motivation in short supply. As long as these industries offered sufficiently high-paying, secure job opportunities to area workers, there was little unemployed talent and little incentive to develop new products or to improve substantially upon existing processes. Yet, as many of these industries reached maturity and unions controlled access to the relatively few new jobs created by these industries, the region did not attract the immigrants that it had earlier.

Second, local special interest groups, including labor unions, trade associations, and political coalitions, lobbied for protectionist legislation and administrative rules, or acted in collusion to influence prices and wages. Such measures may have appeared at first to be successful in preserving the benefits derived earlier, but in the end they resulted in higher costs and less innovative activity, both of which reduced the competitiveness of the region and its ability to adapt to changing circumstances and opportunities.

Change is inevitable in a dynamic market economy. As industries mature, their products, which initially embodied new and unique technologies, are more easily replicated. Regions, and nations, with low factor

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costs, particularly low wages, are able to replicate the production process even though their workers may not necessarily be as skilled nor their managers as creative.

Workers have a choice as industries mature and market conditions change. They can either remain competitive by accepting lower wages or by applying and enhancing their talents to increase productivity and thus command higher wages. Southern workers initially were willing to accept half the wage rates of Midwest workers. The cost advantage lured mature industries to the South. First came textiles from New England, followed by tire and automotive products from the Midwest.

But factor supply conditions continually change, and competitive advantage based primarily on factor costs is fragile. With few impediments to shelter uncompetitive industries, as is the case with the borderless nature of

interstate commerce, the leadership of industries sensitive to factor costs often shifts rapidly. Today's low-labor-cost region may be displaced by a different region tomorrow.

The South has lost its clear cost advantage over the Midwest as the wage gap between the two has narrowed. At the same time, southern industries, such as textiles and apparel, have increasingly come under stiff competition from lower-wage Asian countries. Like the Midwest, the South faced the same choice: competitiveness through low wages or through higher productivity. Over time the South has improved in other areas, such as its development of a more highly skilled labor force, its investment in a more extensive infrastructure, and its creation of more technologically advanced industries.

LESSONS FROM THE PAST

*T*he basic lesson drawn from the Midwest's experience with interregional competition is

The Road to Free Trade

*O*n October 7, 1992, the heads of state from Canada, Mexico, and the United States met in San Antonio, Texas, to announce the completion of two years of negotiations for a North American Free Trade Agreement. Despite the significance of the October ceremony, completion of negotiations among the three nations did not signal the beginning of trade liberalization within North America. It simply ratified an ongoing process between the United States and its North American neighbors that had been evolving since the mid-1980s.

In 1985, while the United States and Canada were negotiating the Canada-U.S. Free Trade Agreement, Mexico was undergoing the most dramatic unilateral dismantling of trade barriers ever initiated. As part of this effort, it negotiated an understanding with the United States that limited certain Mexican subsidies.

that a region's competitive advantage is more enduring when it is built on the skills, knowledge, and ingenuity of its people rather than when it is based on low factor costs. Therefore, the issue facing the Midwest in particular, and the nation in general, is much broader than simply the question of whether these regions will lose jobs to Mexico.

The question is whether or not Midwest businesses and workers are prepared to break with the past and develop new products and new processes that will allow this region to capitalize on its competitive advantages. Many Midwest manufacturers have made significant progress toward improving their competitive advantage during the last 10 years. Continuing to do so will increase the region's competitiveness not only with Mexico, but also with the rest of the world, including other parts of the United States.

Mexico also joined the General Agreement on Tariffs and Trade (GATT), which brought it into compliance with international standards.

By 1989, the percentage of items requiring export licenses fell from 92 percent to 22 percent, the maximum tariff was lowered from 100 percent to 20 percent, and the trade-weighted tariff was halved. A year later, 80 percent of Mexican goods entered North American markets under preferential or zero tariffs. Mexico also dismantled investment controls and encouraged privatization of state-controlled enterprises.

INCREASED TRADE

*S*hipments among the three countries have increased considerably since trade liberalization began in the mid-1980s. Mexico

is the fastest-growing major U.S. export market. U.S. exports to Mexico topped \$33 billion in 1991, nearly three times more than in 1986. Mexico recently surpassed Japan to become the second-largest market for U.S. manufactured goods. Conversely, more than 80 percent of Mexican exports are destined for the United States, making the United States Mexico's largest foreign market.

This increase in trade reflects more than simply the worldwide trend toward greater trade; it demonstrates that a reduction or elimination of tariffs has a stimulative effect. U.S.

exports of textiles and apparel to Mexico more than doubled since 1986, as a direct result of tariff reductions and an expanding Mexican market. Overall, U.S. exports

to Mexico have increased at nearly twice the rate of U.S. exports to the rest of the world. As a result, the share of U.S. exports to Mexico has risen from 5.5 percent in 1986 to 7.9 percent in 1991.

U.S. INVESTMENT

As trade between the two nations has grown, so has U.S. investment in Mexican production facilities. Investment has provided a needed infusion of capital into Mexico while linking Mexican production to the vast network of U.S. operations, contributing to the integration of the two economies.

Through their international production networks, U.S. companies transfer inputs and products among regionally dispersed facilities, benefiting from cross-regional specialization, economies of scale, and increased competition.

U.S. investment in Mexican plants and equipment has contributed to much consternation among midwesterners because of the fear that businesses will pick up en masse and move their operations to Mexico to take advantage of low labor costs. In reality, with the close linkages between domestic companies and their affiliates, the net effect of U.S. investment in Mexico has been to create additional jobs in the United States by expanding export opportunities. For instance, domestic companies export more to their Mexican affiliates than their Mexican subsidiaries ship back to the United States.

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The Midwest has particularly benefited from direct investment in Mexico, since a large share of the capital goods required to build and equip plants in Mexico are produced in the Midwest. For example, Ohio's exports to Mexico increased 140 percent between 1987 and 1991, whereas Ohio's exports to the rest of the world increased only 68 percent. Industrial machinery accounted for the largest share of Ohio's exports to Mexico, and increased 160 percent during those five years.

Some may question whether more jobs would have been created in the United States, and the Midwest, if U.S. companies had not moved some operations to Mexico. But the reality is that if U.S. companies are restricted from investing in Mexico, they will invest in other countries that are much farther from our borders and less likely to integrate with our economy.

Opening Borders

Even with these great strides in opening the border between Mexico and the United States over the last decade, restrictions still remain in key industries, including automobiles and agriculture. NAFTA negotiations have paved the way to reduce these tariffs in the next ten years. Furthermore, the agreement institutionalizes the policy changes and confers a degree of permanence by locking in domestic policy changes with international treaties. The effect of NAFTA on the Midwest, if and when it is ratified by Congress and the legislatures of the other two countries, depends on two basic factors: the competitive advantage of the various industries in Mexico and the Midwest, and the extent to which NAFTA further reduces trade barriers.

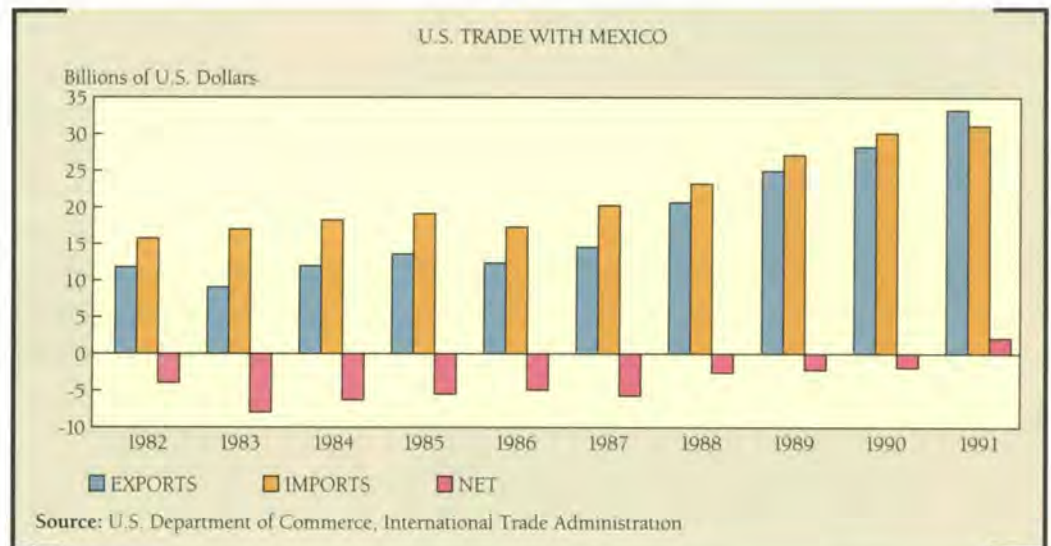
COMPETITIVE EDGE

Mexico's single greatest advantage over the Midwest, and over the entire United States, is significantly lower labor costs. Labor compensation in Mexico is only one-seventh that in the Midwest. However, low labor costs is only one of many factors that determine the competitive advantage of a region or a country. The quality of the labor force, the capacity to produce new technologies, the ease of access to markets, the condition of the region's public infrastructure, and the cost of materials also weigh heavily in that decision.

With respect to these attributes, the Midwest has a sizable advantage over Mexico. Since the Midwest is representative of the U.S. economy,

U.S. figures will be used for comparisons. For example, the United States' overall productivity is five times higher than Mexico's, which reflects both a higher quality labor force and more intense capital investment. The United States will likely maintain this advantage, since it devotes five times more of its gross domestic product (GDP) to research and development than does Mexico, and it spends twice the share of GDP on public education.

Not only is the Midwest's competitive edge broader-based than Mexico's, but it is also in key areas that are more likely to sustain it, and that yield higher returns and wages. As the world prepares to enter the twenty-first century, most agree that a nation's competitive advantage will depend on the skills of its people. They generate the ideas, put them into practice, and make sure that the final products are of the highest quality and are most efficiently produced.



WINNERS AND LOSERS

Given the differences in wage rates between Mexico and the United States, one would expect labor-intensive sectors in the United States to lose from NAFTA, and capital-intensive sectors to gain. Studies

using sophisticated models confirm this rule of thumb.

The clear losers from the U.S. perspective are likely to be the apparel, furniture, and glass products industries. The net gainers for the United States will probably be chemicals, capital equipment, metals, and rubber and plastics.

In every case, the industries that are slated to lose to Mexican production offer considerably lower wages and achieve lower productivity than the industries that are apt to be net winners. In fact, with the exception of the rubber and plastics industry, industries that are net winners offer among the highest wages of any manufacturing industry.

The expected inability of low-wage U.S. industries to compete with their Mexican counterparts underscores the importance of productivity in establishing an industry's competitive advantage. In every case, the low-wage industries (losers) have higher labor costs per unit of output than the higher-wage industries (gainers) because of much lower labor productivity.

On the basis of this list of industries, the scenario is relatively bright for industries and workers within the four Fourth Federal Reserve District states (Kentucky, Ohio, Pennsylvania, and West Virginia) and the Midwest. More than twice as many workers in Fourth District states are employed in industries that are likely to gain from NAFTA than in industries that are at risk of losing employment. Roughly 30 percent of the four states' manufacturing workers are in industries that are likely to expand because of open borders with Mexico. Sixty percent of these workers are concentrated in industrial machinery and primary metals industries.

However, Midwest industries will reap the gains from NAFTA only if they remain competitive with industries in the rest of the United States. At this point, Midwest steel and

industrial machinery operations are generally less efficient than their counterparts in other regions of the country, while rubber and plastics plants are slightly more efficient. Productivity improvements have been forthcoming in these and other Midwest industries. Continued productivity advances relative to the rest of the nation will strengthen the Midwest's prospects of benefiting from NAFTA.

THE AUTO INDUSTRY

The auto industry is a special case in the NAFTA negotiations. It is treated separately in the NAFTA agreement, in part because of its existing linkages with *maquiladora* industries of Mexico. Maquiladora refers to Mexican plants that are set up along the border primarily for the processing or secondary assembly of components imported from the United States. These components are imported duty-free and are subject only to a value-added tariff when shipped back to the United States, which is an attractive arrangement under the existing tariff structure.

Since the program first began in 1965, 143 auto plants have opened along the border, employing close to 100,000 Mexican workers. Because of the existing networks between Mexican and U.S. plants, reducing tariffs and quotas on autos and auto parts will not have much effect on U.S. production. But it will increase output in Mexico by integrating maquiladora industries with the rest of the Mexican economy.

Estimates of NAFTA-related job losses in the U.S. transportation industry are generally quite modest, typically at only about one-half of 1 percent of existing employment during the next 10 years. The real losers in the auto industry are likely to be countries that are not part of NAFTA. The greater increase in Mexican auto-related exports to the United States will be offset by fewer U.S. imports from other countries. At the same time, free

trade with Mexico will result in greater plant specialization, which will cause temporary displacement of workers, but will eventually increase the efficiency of the industry.

Increased efficiency of North American automakers will enhance their ability to compete with Japanese and European producers, ultimately saving U.S. jobs. In the meantime, the North American auto industry is grappling with the painful process of downsizing in order to reduce its chronic problem of overcapacity. Gaining access to a growing Mexican market for automobiles may help domestic firms deal with the overcapacity problem.

SMALL EFFECTS

In many ways, it is difficult to assess the impact of NAFTA on Mexico and the United States because the agreement is quite different from previous free-trade pacts. The European experience and the recent Canada-U.S. Free Trade Agreement joined countries of similar standards of living, wages, and technical proficiency, while the differences between Mexico and the United States (and Canada) are stark. The fact that Mexico's hourly labor compensation costs are only one-seventh those of the United States aptly sums up the differences.

Several mitigating factors, however, lead most analysts to conclude that the effect of NAFTA on the United States, and even on Mexico, will be small. Gains for the United States are estimated to be less than 1 percent of GDP over the 10-year period in which tariffs are reduced. Gains for Mexico may be as high as 10 percent of GDP, depending on the extent to which foreign investment and productivity increases are realized.

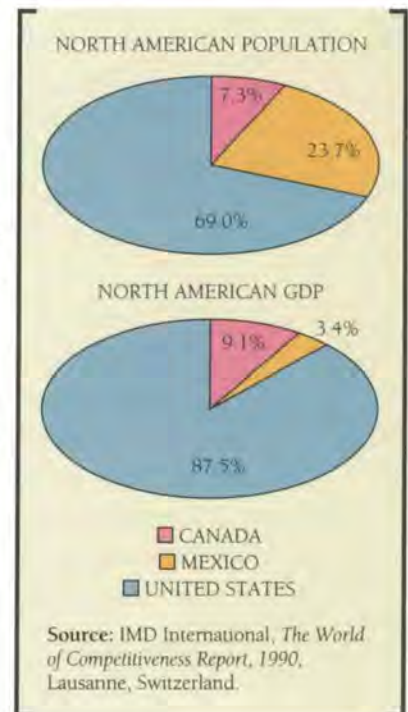
Even though Mexico stands to gain the most from open borders, since it is the smallest and least developed of the three economies, its

economic development benefits the United States directly. Increased prosperity promotes political stability and progress toward greater democracy in Mexico, which strengthens a political and economic partnership between the two nations. Formalizing these policies by entering into an international treaty further ensures that these initiatives will stay on course.

These relatively small gains reflect several moderating factors. Trade restrictions between the United States and Mexico have already been reduced to low levels.

Mexican goods coming across our border are subject to an average tariff of only about 5 percent, while U.S. products going into Mexico are taxed at only about a 10 percent rate. Furthermore, much of the trade among the three countries is not subject to tariffs: Nearly 85 percent of Mexican products currently enter the United States duty-free.

Since Mexico's economy is quite small relative to that of the United States, increased Mexican exports will have a relatively small effect on U.S. production. Labor and capital will move extensively across sectors within Mexico, leading to substantial displacement of Mexican workers, but much less displacement of U.S. workers. In addition, the impact on the United States will be further limited because part of the increase in imports from Mexico will substitute for imports from other low-wage countries.



Adjusting to Free Trade

The gains from integrating two economies with vastly different levels of capital and labor skills result primarily from increased specialization and relocation of production facilities. NAFTA is expected to boost U.S. employment within the range of 100,000 to 300,000 workers during the next 10 years as a result of greater efficiencies from specialization and economies of scale.

However, these estimates represent net gains, in which jobs gained due to increased exports are offset by jobs lost due to increased imports. Some labor organizations place the number of displaced workers close to 500,000. A widely cited study foresees about 110,000 displaced workers nationwide from increased imports.

THE LESS-SKILLED

Displacement is by no means a unique result of free trade. During an economic downturn, the proportion of the unemployed who lost their jobs involuntarily has climbed to as high as 60 percent. Moreover, upwards of 20 percent of all jobs in the economy change hands in any one year. To put these estimates into perspective, U.S. employment declined by 1.6 million from the time the economy peaked in mid-1990 until year-end 1992.

Less-skilled workers will be most affected by industrial restructuring resulting from NAFTA. Industries that are likely to directly compete with Mexican firms offer the lowest wages and have the lowest productivity.

Workers with a high school education or less have experienced a decline in real earnings over the past decade, while college graduates have enjoyed a gain in real wages. This income disparity arose because the supply of low-skilled workers exceeded their demand, while

the supply of high-skilled workers could not keep up with the increase in demand.

The excess supply of low-skilled workers is partly attributable to Mexican immigration, which accounts for about 10 percent of the increase in low-skilled workers during the past decade. Most of the problem simply reflects the fact that more sophisticated technology and the shift to a service- and information-based economy require skills beyond those that can be obtained with only a high school education. Although a greater percentage of high school graduates now go on to college, companies are still unable to find enough workers with sufficient skills to fill their needs.

NAFTA will not intensify the problem, at least not from the supply side. It has no provision for an increase in immigration. On the contrary, one purpose of NAFTA is to provide viable employment opportunities for Mexicans in Mexico, which will reduce the incentive for them to seek employment in the United States.

WORKER ASSISTANCE

Although the net employment effects of NAFTA are expected to be small, workers will be displaced. Even for workers who have the necessary skills to meet the requirements of the new jobs that will be created from trade, searching for a job is costly, particularly if it entails searching for employment in other industries, in new occupations, or in other communities.

Low-skill workers will have more difficulty finding employment, and they will require extensive training in order to be productive in the workplace. These people need assistance to pay tuition as well as to support themselves and their families while completing a course of study.

Worker assistance remains one of the major issues to be taken up by Congress before NAFTA can be ratified. Experience has shown that the most effective programs reach dislocated workers as soon as possible, provide job search assistance to workers who have the skills and backgrounds they need for new jobs, offer occupational retraining and basic skills training, and provide supplemental income during the relocation process.

Several existing government programs already provide such services, including Trade Adjustment Assistance (TAA), Economic Dislocation and Worker Adjustment Assistance (EDWAA), Job Training and Placement Assistance (JTPA), and unemployment insurance benefits. Of these programs, only TAA was enacted specifically to provide training and income supplement to workers displaced by liberalized

trade. In the next several months, Congress will evaluate the adequacy of these programs in redistributing some of the gains from free trade and in providing the training and job placement services necessary for an efficient transition.

Government programs alone cannot solve the problem of a poorly trained labor force. Greater involvement of the private sector in the educational system would help improve the training received by workers, as well as the education received by students before they enter the work force. Businesses have the most immediate knowledge concerning the skills required in the workplace. Cooperation between businesses and schools would help to close the gap between what is offered in training programs or in schools and what businesses need in their employees.

Seizing Opportunities

The North American continent is well on its way to borderless trade. During the last decade, tremendous gains have been made in eliminating the barriers to the free flow of goods and services among Canada, Mexico, and the United States. We believe NAFTA will ensure that U.S. firms and workers will reap the full benefits of the market opportunities of free trade by improving on trade rules and providing a stable environment for future investment.

The success of the Midwest, and other regions of the country, in benefiting from NAFTA depends on the willingness of business leaders and workers to adapt to changing conditions by offering new products and implementing innovative production techniques.

Local industries and interest groups cannot successfully resist the directions that market forces are pushing the regional economy. As declining industries give way to growing ones,

some businesses will close their doors and some workers will be displaced. The evidence seems to indicate, however, that the passage of NAFTA would not open a floodgate of products into the United States, nor would it provoke a mass exodus of jobs into Mexico. NAFTA merely ratifies an ongoing trend.

Even the small net effects produced by NAFTA are likely to lead to some unemployment as adjustments are made. Instead of trying to preserve jobs that are less productive and lower paying, the better strategy is for workers to acquire the skills necessary to qualify for jobs in the growing, more competitive sectors. In a dynamic economy, both declining and advancing industries exist side by side. The diversity within and across regions, unimpeded by trade barriers, offers ample opportunity for the kind of industrial restructuring necessary to promote economic growth and to offer workers a better future.

STATEMENT OF CONDITION

For years ended December 31

ASSETS

	1992	1991
Gold certificate account	\$ 658,000,000	\$ 692,000,000
Special drawing rights certificate account	556,000,000	645,000,000
Coin	25,995,434	30,183,268
Loans and securities:		
Loans to depository institutions	-0-	-0-
Federal agency obligations bought outright	340,680,714	378,205,795
U.S. government securities:		
Bills	8,924,796,483	8,299,003,637
Notes	7,438,416,401	6,352,112,831
Bonds	2,205,304,963	2,022,987,976
Total U.S. government securities	\$18,568,517,847	\$16,674,104,444
Total loans and securities	\$18,909,198,561	\$17,052,310,239
Cash items in process of collection	442,406,029	353,848,298
Bank premises	35,939,937	34,300,807
Other assets	1,682,967,122	1,777,907,651
Interdistrict settlement account	1,420,144,348	1,765,980,255
TOTAL ASSETS	\$23,730,651,431	\$22,351,530,518

LIABILITIES

Federal Reserve notes	\$21,679,962,723	\$19,949,460,886
Deposits:		
Depository institutions	1,340,703,323	1,571,163,262
Foreign	8,451,200	7,755,000
Other deposits	14,900,693	87,808,726
Total deposits	\$ 1,364,055,216	\$ 1,666,726,988
Deferred availability cash items	220,326,754	269,814,840
Other liabilities	113,869,638	143,216,304
TOTAL LIABILITIES	\$23,378,214,331	\$22,029,219,018

CAPITAL ACCOUNTS

Capital paid in	\$ 176,218,550	\$ 161,155,750
Surplus	176,218,550	161,155,750
TOTAL CAPITAL ACCOUNTS	\$ 352,437,100	\$ 322,311,500
TOTAL LIABILITIES AND CAPITAL ACCOUNTS	\$23,730,651,431	\$22,351,530,518

INCOME AND EXPENSES

For years ended December 31

CURRENT INCOME

	1992	1991
Interest on loans	\$ 51,177	\$ 477,189
Interest on government securities	1,083,681,615	1,181,833,460
Earnings on foreign currency	127,851,245	129,935,784
Income from services	43,856,164	43,638,765
All other income	284,196	635,040
Total current income	\$1,255,724,397	\$1,356,520,238

CURRENT EXPENSES

Current operating expenses	\$ 74,893,149	\$ 77,244,050
Cost of earnings credits	7,166,749	8,545,603
CURRENT NET INCOME	\$1,173,664,499	\$1,270,730,585

PROFIT AND LOSS

Additions to current net income		
Profit on foreign exchange transactions	\$ -0-	\$ 21,833,126
Profit on sales of government securities	7,605,686	8,018,932
All other additions	4,203	935
Total additions	\$ 7,609,889	\$ 29,852,993
Deductions from current net income		
Loss on foreign exchange transactions	\$ 65,585,542	\$ -0-
All other deductions	10,279	6,240
Total deductions	\$ 65,595,821	\$ 6,240
Net additions or deductions	\$ 57,985,932	\$ 29,846,753
Cost of Unreimbursable Treasury Services	1,751,906	9,694,406
Assessments by Board of Governors		
Expenditures	7,795,200	6,028,900
Federal Reserve currency costs	18,485,886	16,602,497
NET INCOME AVAILABLE FOR DISTRIBUTION	\$1,087,645,575	\$1,268,251,535

DISTRIBUTION OF NET INCOME

Dividends paid	\$ 10,100,417	\$ 9,032,226
Payments to U.S. Treasury		
(interest on Federal Reserve notes)	1,062,482,358	1,223,419,259
Transferred to surplus	15,062,800	35,800,050
Total distributed	\$1,087,645,575	\$1,268,251,535

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As of December 31, 1992

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As of December 31, 1992



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CLEVELAND

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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.



Federal Reserve Bank of Cleveland

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This annual report was prepared by the Public Affairs and Bank Relations Department and the Research Department, Federal Reserve Bank of Cleveland.

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