

THE PRESENT POSITION AND FUTURE DEVELOPMENT OF THE FEDERAL RESERVE SYSTEM

ADDRESS OF

W. P. G. HARDING

GOVERNOR FEDERAL RESERVE BOARD

BEFORE THE FORUM OF THE NEW YORK
CHAPTER, AMERICAN INSTITUTE
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An intelligent treatment of this subject seems to require a brief review of our banking history during the past two years and an analysis of present conditions, out of which reasonable deductions as to the future may be based. The fundamental principle of the Federal Reserve Act is the mobilization, in a scientific and effective manner, of the banking reserves of the country, not in one central reservoir, but in a number of them, distributed throughout the various sections. This process has not yet been fully accomplished, but is approaching completion. The next installment of reserves, which is the last that will be obligatory, and which will amount to about \$60,000,000, will be paid in on November 16. According to the most recent statement, October 28, 1916, the twelve Federal Reserve Banks held \$407,955,000 in lawful money, while the national banks of the reserve and central reserve cities, on September 12, 1916, held \$515,690,000. These last named institutions held \$671,768,000 according to the last statement issued before the organization of the Federal Reserve Banks. There is, of course, no basis for comparison between these figures and those applicable at the present time, owing to the great industrial and financial changes which have taken place during the past two years; and, as bank deposits are subject to the influence of external changes of various kinds, it is obvious that any attempt to isolate the effect of the establishment and operation of the Federal Reserve System upon these holdings of cash would be useless. We can, however, say with certainty that there is to-day a coordinated and efficient system of reserves available for the ordinary requirements of member banks, as well as for their necessities in times of stress.

Three years ago there was a very general fear on the part of bankers that the transfer of reserves would be accompanied with serious inconvenience and loss, and the manifestation of this apprehension is responsible, no doubt, for the gradual rather than immediate transfer of reserves that was provided for in the Federal Reserve Act. The figures already given show, however, that no inconvenience or hardship has been incurred, but that on the contrary the strength of the member banks and the growth of their deposits and banking power have advanced step by step with the progress and de-

velopment of the Federal Reserve System. You will note that I have not said because of the Federal Reserve System, although I might perhaps properly have done so. Even the most prejudiced critic must admit the coordinated growth of the member banks and of the Federal Reserve Banks, and must concede that the establishment of a great system of mobilized reserves, amounting at present to \$407,955,000, the actual and potential value of which is no longer open to doubt, has been effected without even a seeming setback to the member banks out of whose resources this great reserve has been constructed. The foundation of this reserve with its assurance of safety to the banks and to the public is the first and fundamental achievement of the Federal Reserve System. It is the point of tangency between our new banking system and the well-tried systems of other countries, where it has become possible for us to attain the object long ago found desirable and necessary by advanced modern nations—the establishment of an effective and properly controlled system of credit accommodation, available for the immediate conversion into cash or credit of short-time paper of a commercial and liquid character—in other words, the creation in this country of a broad and dependable discount market.

Closely connected with the foregoing is the provision for an elastic note currency. Through the Federal Reserve Banks there has been provided an adequate method for supplying a circulating medium of exchange based upon commercial transactions in an amount to be determined by the volume of business and by the ability of the banks to supply the requisite gold reserve. There are outstanding \$234,876,000 of Federal Reserve notes, to secure which the Federal Reserve Agents hold \$219,502,000 in gold certificates and coin and \$15,817,000 in commercial paper. The Federal Reserve Banks themselves hold \$407,955,000 in gold and lawful money and \$107,216,000 of commercial paper, including rediscounts for member banks and purchases of acceptances on the open market, nearly all of which, under the recent amendment to the Federal Reserve Act, are available for Federal Reserve note issues. The free gold—that is, the amount in excess of reserves against Federal Reserve notes outstanding and against deposits held by the Federal Reserve Banks—amounts to \$231,377,000, so that the potential note issuing power of all the Federal Reserve Banks, based upon the minimum reserves of 35 and 40 per cent, respectively, is to-day about \$578,442,000. This, of course, presupposes a demand for the notes which would first be evidenced by the acquisition of commercial paper to a corresponding degree. Of the Federal Reserve notes so far issued all but \$15,374,000 have a full 100 per cent gold cover in the hands of Federal Reserve Agents, so that the comparatively small amount actually outstanding as Federal Reserve notes may properly be

regarded as merely an indication of the method through which currency may be obtained when desired from Federal Reserve Banks and is not to be taken as a measure of the relief that may be supplied through this means when the machinery of the system is fully called into play. Experience thus far, limited though it has been, has shown that the machinery for the issue of the notes provided for by the Federal Reserve Banks can work promptly and effectively, and there is no reason to doubt that whenever it may be called upon to render extended service in times of stress or difficulty it will be able immediately to meet the requirements of those calling for assistance through the medium of note issues.

Although not yet two years old, the Federal Reserve Banks have done much to standardize commercial paper in this country. The circulars and regulations of the Federal Reserve Board have supplied an authoritative definition of commercial paper of various kinds which has been lacking in our banking practice heretofore, while the efforts of the Federal Reserve Banks to bring about a larger use of credit statement forms by the member banks, and to secure the cooperation of banks and borrowers in putting their paper into shape to conform to the regulations of the Board, constitute the first organized effort to bring about uniformity of action and practice in the direction desired. That the steps already taken are having an important influence in standardizing methods of accounting and in bringing about a uniform understanding of the meaning of various commercial terms, is not, I think, open to question. Credit must therefore be given to the Federal Reserve System for having taken the first practical step toward bringing about a reform long desired by financial students and by practical business men—the standardizing of credit methods and commercial paper throughout the United States. The Federal Reserve System has operated also toward stability and uniformity in rates of interest throughout all sections of the country, as is evident at a glance at a table showing the official discount rates in all Federal Reserve districts.

To what extent the reduction in discount and interest rates that has taken place during the past two years is due to the establishment of the Federal Reserve Banks it is, of course, difficult to determine, for the net inflow of gold during that time has amounted to between \$600,000,000 and \$700,000,000, and this large addition to the basic money of the country has, of course, had a powerful effect upon rates. We have, however, seen low interest rates in bygone years in certain sections and on certain classes of paper at times when other sections and other borrowers were not included in the scope of the interest reduction. It may be claimed with confidence that the Federal Reserve System has operated toward stabilizing interest rates and toward making them more uniform. It is pointed out by

economists that the rate of interest is made up of three distinct elements; one providing a return for the labor and amount of investigation involved in analyzing and consummating any particular operation, or the overhead cost; the second is concerned with the remuneration necessary to induce the owners of capital to part with it, while the third is connected with the risk involved and the insurance against the risk. In general, reduction of interest rates through the operation of Federal Reserve Banks is in part a reduction of this last element of cost, a lowering of the element of risk, as the Federal Reserve System has provided a method for the recognition of unquestionably good paper and for the adjustment of the rate of interest on such paper, so that it will more nearly correspond with the actual value of the funds employed.

In other words, methods have been provided whereby legitimate and conservative borrowers all over the country can obtain accommodations at rates approximating a standard on the kind of paper that they have to offer and are relieved of the necessity of paying more in the proportion that they are able to demonstrate their own responsibility and solvency. The advantage of this reduction has been most appreciated by the small business man, who in the past may have been unable to obtain the rate of interest to which the character of his paper and his own personal standing, efficiency, and general condition of solvency entitled him. Besides meeting the needs of the general public and of the business community, the Federal Reserve System has rendered also a direct and important service to the banks themselves, not only in making it safer for them to do business, but in actually extending their field of operations and their avenues for profit. Three distinct lines of business are now open to national banks from which, before the passage of the Federal Reserve Act, they were absolutely barred. As you are well aware, national banks are now permitted to do an acceptance business, making their acceptances either against transactions involving the importation or exportation of goods, or against certain domestic transactions, as provided by the Federal Reserve Act and defined by the regulations of the board. Then again, wherever not contrary to State law, national banks may, by conforming to certain regulations, exercise fiduciary powers, which functions were formerly forbidden them. Finally, the new law has enabled a large proportion of the national banks to make loans under safe and conservative conditions upon real estate, not only upon farms, but also for periods not longer than 12 months upon other kinds of improved property.

While there are twelve Federal Reserve Banks, each governed by its own board of directors, and each an independent unit, they are all coordinated through the Federal Reserve Board, to which body has been given extensive powers of supervision. The banks, though

each is independent within its own district, in the general conduct of its business, are the component parts of a great system and the law has provided means for an effective mobilization of the resources of all for the relief of any; and, while it has never yet been necessary for one Federal Reserve Bank to call upon another to rediscount paper for it, facilities have been provided and are ready, so that the strength of the entire system is available for the support of any particular district which may at any time experience a demand that would tax its own resources. The fact that no such action has been necessary thus far is strong testimony as to the sound workings and beneficial influence of the system itself, but it is worth while to note that machinery for this kind of relief is always available and in working order. Without attempting any specific enumeration, I will ask you to think of some of the sensational and grave events that have transpired at various times during the past two years, which have threatened crises, not only in our relations with foreign countries, but in our domestic affairs as well. Through it all there has been no disturbance whatever in our money markets; no abnormal fluctuations in discount rates, and no panicky conditions. Do you think that before the establishment of the Federal Reserve System it would have been possible for our financial community to have remained unruffled and serene in the face of such tremendous shocks, or to have undertaken the vast credit operations that have been engaged in so successfully?

The Federal Reserve System is already an important factor in the development of our foreign trade, and is destined to play a much larger part in this particular field. I have already made a brief reference to the acceptance powers of national banks. The acceptance has long been recognized abroad as a most convenient as well as essential piece of machinery in carrying on international transactions, but until recent years its use in this country was practically unknown. The national banks and State institutions in some of the States now have the power to accept, so that when we contemplate the future development of the Federal Reserve System, there is hardly any banking function that will play a more important part than the acceptance business.

Figures recently compiled by the board show that there are now outstanding about \$175,000,000 of drafts accepted by American banks and bankers, of which about \$100,000,000 have been accepted by New York banks and bankers. These acceptances have found a ready sale at low rates in the open market and about \$86,000,000 of them are now held by Federal Reserve Banks, having been taken under regulations issued by the board, but it must be remembered that the regulations of the board are necessarily broad in their scope and are not intended to deal with specific cases. They are intended to be permis-

sive within the limitations defined, but the extent to which Federal Reserve Banks should invest in any class of "eligible" paper is a question to be determined as a matter of policy, in accordance with the changing position and requirements of the Federal Reserve System as a whole. While the Federal Reserve Banks have been and doubtless expect to continue to be liberal purchasers of acceptances, the directors of these banks are charged under the law to "administer the affairs of said banks fairly and impartially and without discrimination in favor of or against any member bank or banks, and shall, subject to the provision of law and the orders of the Federal Reserve Board, extend to each member bank such discounts, advances, and accommodations as may be safely and reasonably made, with due regard for the claims and demands of other member banks." They must, therefore, in view of possible calls upon them, keep in mind some limitation of their investments in paper which is not in the highest sense self-liquidating or is not of an intrinsically liquid character, however secure and however certain its ultimate payment; and while the member banks have entire freedom of discretion as to transactions in which they may lawfully engage and as to investments which they may legally make, they should not forget that there are certain kinds of paper which will always be preferred by Federal Reserve Banks over other forms of credit, and which can be negotiated at lower rates.

We are no longer a debtor nation. Our current obligations to Europe were liquidated many months ago. We have already absorbed the larger part of the American securities that were held in Europe when the war broke out, and our advances to other countries now exceed \$1,900,000,000. Furthermore, our exports to foreign nations are now in so vast a volume as to render full and immediate settlement in gold impossible. We are absorbing every month more than the world's total new production of gold, and we are receiving large sums from the hoarded stocks of nations now debtors to us. But even with this, large credits are necessary to sustain our exports. Through force of circumstances the United States is now the world's banker and must continue to act in that capacity for a long time to come, and if we make proper use of our opportunities we can remain permanently at least as one of the bankers of the world. We must expect to be called upon abroad to render much of the service that has hitherto been performed very largely by England in extending those short-term credits which the world requires in the production and transportation of all kinds of goods. The nature of the acceptance business is such that it can best be carried on by those countries that have the lowest discount rates and have the freest and most reliable gold markets.

Hitherto the country enjoying these facilities to the greatest degree has been England, and partly for that reason and partly because of

her command of the carrying trade she has been able practically to monopolize the short credits which her bankers had handled through the medium of acceptances. While we have an opportunity now to extend our business with all nations, including particularly those neutrals whose accustomed credit facilities have been cut off or curtailed, the services we render must necessarily redound to our own benefit from a banking standpoint, not only because the extension of proper credits is a sound and profitable business, but also because the establishment of an acceptance market, made up of traders and bankers from all over the world, will bring to us a new element of great strength. The proper financing of our foreign trade ought to prove a most efficient means of protection for us, whenever the golden tide now flowing so strongly toward our shores begins to ebb and finally to turn the other way, running out perhaps so fast as to reveal rocks and shoals whose existence we had forgotten. Under such circumstances, by the simple process of raising our discount rate we should be able to force foreign debtors to finance themselves elsewhere and to pay us off. The more the banks begin to participate in the development of the acceptance market, the more they will understand it and the more will grow their habit of purchasing these acceptances, recognizing in such paper the most liquid investment for which a broad and dependable market at minimum rates may always be expected, whether they expect to sell in the open market or to the Federal Reserve Banks. But the most important feature in the successful development of an acceptance market, in fact, a vital principle, must be the intrinsic liquidity of the paper dealt in.

It should be plainly understood that an acceptance transaction is essentially a loan of credit rather than of money, and it is of the essence of an acceptance in its true sense that the drawer shall place the funds in the hands of the acceptor on or before the due date of the acceptance, so that the acceptor will not be called upon to use his own funds in paying the maturing obligation. That is an eventuality which should arise only in the case of the drawer's bankruptcy, and against which the acceptor should be well protected by the security taken before the acceptance is made. In the free and natural development of a discount market the drawer or indorser of the acceptance should be the one to rediscount the paper or to offer it on the market, and it should not be the acceptor even though possibly there may be exceptional conditions under which the acceptor would be justified in purchasing his own obligation in order to withdraw it from the market. It is not the custom abroad for acceptance houses, in the usual course of business, to purchase their own acceptances and to offer them after having once acquired them. In the regular course it is distinctly understood that the accepting firm does not offer on the market for its own account its obligation created by its

acceptance, and the practice is quite the contrary. The acceptor may reside in London and the holder by purchase may be in Paris, Berlin, Liverpool, or New York, retaining the bill in his possession until it matures.

This process up to the present time has not been emphasized in this country, but it is essential for the proper development of the discount market that the business should take this course. We should be careful not to confuse commercial banking with investment banking, nor should we permit our discount market to become so saturated with offerings intrinsically of an investment character as to influence discount rates and impede its free operation. The Federal Reserve Act distinguishes clearly between these two forms of banking and specifically excludes from purchase or discount "notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds or notes of the Government of the United States." The Federal Reserve Act applies particularly to commercial transactions, and lays stress upon the importance of liquidity by stipulating that Federal Reserve Banks must not buy bankers' acceptances having more than 90 days to run, and in its original form it provided that acceptances should be given only in transactions involving the importation or exportation of goods. The recent amendment to the act has extended the acceptance power so as to apply to transactions growing out of or involving "the domestic shipment of goods, provided shipping documents conveying or securing title are attached at the time of acceptance, or which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples."

It is clear that the intent of the act is to safeguard the self-liquidating character of acceptances, as securities of an investment nature are barred, and provision is made that the transaction should be based upon either an actual sale of goods or upon the conveyance of legal title to goods which can be readily marketed so as to protect the acceptor. Quite naturally, under conditions now existing throughout the world, the board was, soon after the establishment of the Federal Reserve Banks, called upon to consider the question of renewals of acceptance credits. In European countries there are practically no legal restrictions governing the acceptance business, and in order to establish dollar acceptances in competition with sterling bills, or with those drawn in francs or marks, the board ruled that certain renewals of acceptance credits, which clearly grew out of the shipment of goods in the first instance, need not, as a matter of principle, be excluded, and Federal Reserve Banks were advised that they might consider as "eligible" bills having not longer than three months to run and drawn under such credit arrangements. The American ac-

ceptance is now quite well established in the world's markets, being well known in almost all parts of the globe, and even in those countries which three years ago had a monopoly of the acceptance business American credit facilities are now being used.

Speaking, not so much from the standpoint of the Federal Reserve Banks, but from that of the American banker generally, it would seem proper to extend acceptance credits in liberal amounts to facilitate commercial transactions all over the world, and while we may expect to see this acceptance business grow into very large figures, we must not permit either our ambition, our desire to assist others, or considerations of profit, to run away with us and to cause us to disregard long established and sound banking principles, the observance of which is so necessary for the safety of our Federal Reserve Banking System. There are two rules in this connection which it may be well to emphasize. One is that acceptances should finance the drawer and not the accepting bank. When a banker makes a cash advance at a given rate of interest for a certain length of time, he should not ask his debtor to draw upon him for the purpose of enabling the banker to reimburse himself by the sale of his acceptance for the advance which he has made to the debtor. Such a process would make it possible for a long-term borrowing to be financed by an accommodation bill drawn for the benefit of the banker. Such a draft would not be essentially self-liquidating. The real borrower may have secured the advance by renewal agreements for eighteen months or two years, at a fixed rate for the entire term and not subject to readjustment at any renewal period. He is not concerned in the discount transaction, and when the first bill matures the advance will continue to run and attempts will be made to rediscount or sell the draft.

A bill of this kind is known as a finance draft, and other bills, which also may be called finance drafts, are drawn by brokers or individuals upon a banker and accepted against the deposit of investment credits. Drafts of the description last mentioned may be attractive where the transactions offer handsome profits because of the great difference in interest rates prevailing in two countries and by reason of tempting fluctuations in foreign exchange rates. It is clear that banking prudence requires abundant security in transactions of this kind if they are to be engaged in at all, and that a bill so created has no place in the portfolio of a Federal Reserve Bank. A foreign draft, based originally upon importations of goods from this country and drawn upon an American banker with a definite agreement on the part of the domestic banker for several renewals at an interest rate fixed for the entire period covered by the renewals, does not give the chief advantage which should accrue to the banks of a country granting foreign acceptance credits, because, no matter to

what point the Federal Reserve Banks, if this country be concerned, or the central banks, in case of other nations, might raise the discount rate, it would have no effect upon the foreign debtor, for, having provided at a given rate for his requirements until the expiration of the last renewal, no increase in rates would move him to cover his acceptance and seek accommodation in his own country, because during the term of the extended credit he would have no interest in the discount rate of the country upon which he has drawn. Not the original debtor but the acceptor would be the borrower in the discount market, and as regards the original borrower, the acceptance would become merely an accommodation draft for the benefit of the acceptor, who alone would be subject to the changing vicissitudes of the discount market.

It is equally clear that drafts drawn in one country upon another against long-term securities are not self-liquidating, no matter how short a time the drafts themselves may have to run. Where acceptances are based upon actual commercial transactions, the sum total of acceptance bears a definite relation to and is regulated by the volume of international trade, but if bills are accepted against securities, this automatic regulation is lost, and if finance drafts are permitted to be drawn without discrimination, they would continue to pile up just as long as there is a substantial difference in the interest rates of the two countries involved. It is entirely natural and proper that countries or sections where wealth has accumulated and which have large holdings of gold should afford credit facilities to their neighbors. As between nations this can be done through short commercial credits by means of bankers' acceptances, where the acceptance is liquidated out of funds coming from the borrower before maturity; or as an investment proposition, by transactions outright in securities issued or held by citizens of the borrowing country. There is no reason why both methods should not be perfectly sound, but the lenders of credit should distinguish clearly between the two transactions. The discount market, which is intended to deal with short term and commercial borrowings, should not be used or abused so as to serve as an adjunct of the investment market.

It may not be possible, of course, always to apply these principles with absolute rigidity. We are living in abnormal times and there may be abnormal conditions when temporary exceptions to rules governing normal times may be expected, but such exceptions, whenever permitted, should be kept within reasonable bounds, nor should it be forgotten that they are exceptions and do not constitute the rule. However anxious we may be to continue as a world factor in trade and finance, and however desirous we may be that the wonderful prosperity which we are now enjoying should continue indefinitely, we should remember still that if the time should ever come when our

debtors can no longer offer us satisfactory settlements or when our own power of absorption may have reached its limit, that whenever that moment should arrive it would be more satisfactory to contemplate some slowing down of our enormous business than to buy its continuance at the expense of undue hazard, and that the loss of interest on idle gold is better than the loss of principal.

In some important particulars the Federal Reserve Act has not thus far been applied at all. The law empowers the Federal Reserve Banks, with the consent of the Federal Reserve Board, to open and maintain banking accounts in foreign countries and to appoint correspondents and establish agencies in such countries for the purpose of purchasing, selling, and collecting bills of exchange, and to buy and sell with or without their endorsement, through such correspondents or agencies, bills of exchange arising out of actual commercial transactions having not more than ninety days to run, and which bear the signature of two or more responsible parties. Under conditions that have prevailed since the establishment of the Federal Reserve Banks it has been thought best to disregard any temptation of profit and to go slowly in entering the foreign field, so that up to this time the Federal Reserve Banks have no foreign accounts. Upon the close of the war, however, with the United States playing a more prominent part in the foreign trade, there will be a large field of important work to be covered by the Federal Reserve System in this connection before the Federal Reserve Banks can be regarded as having fully discharged the duties and responsibilities imposed upon them by the act. How great the importance of this phase of their activity may be can be judged only by those who have formed an adequate conception of the part that is to be played by this country in international trade after peace has been restored.

The business of the Federal Reserve Banks as fiscal agents for the United States Government is not yet fully developed. So far they are acting in a limited way only as fiscal agents, but in the future financial operations of the United States Government the Federal Reserve System will stand ready to discharge the duty of providing for issues of bonds, arranging for the retirement and refunding of existing indebtedness, and such other financial operations as may be necessary from time to time.. Its functions in the handling of routine business for the United States Treasury and the subtreasuries will no doubt be extended, as the Federal Reserve Banks become better able to render this service.

The clearing of country checks provided for under section 16 of the Federal Reserve Act has been a problem of peculiar difficulty and has been complicated by the desire of many of the member banks in the smaller towns particularly to retain their accustomed profits, and further by the fact that a large volume of the checks that must

be handled are drawn upon nonmember banks. The clearing of checks was undertaken in a very limited way immediately upon the establishment of the Federal Reserve Banks, and after a great deal of study and some experimentation the present clearing system was put into effect on July 15 last. Its operation has demonstrated that it is based upon correct principles, and the constantly expanding volume of business handled through it shows its efficiency. The underlying principle of the clearing plan is the discontinuance of the practice of carrying items in transit as reserve, and the requirement that each bank carry its own float.

One important result of the clearing system has been to bring the member banks into more frequent and intimate contact with their Federal Reserve Banks, so that the Reserve Banks are now regarded more and more as active and potential factors in the banking field and not so much as storage reservoirs for use only in emergencies. Very largely, no doubt, because of the abnormally low rates for money that have prevailed during the past 18 months, which have made it difficult for member banks to make satisfactory earnings, there has been a feeling in some quarters that the Federal Reserve Banks are dangerous competitors, actual or potential, of their own member banks, but with the development of our foreign trade and with the constantly increasing activity of our domestic business, this feeling is gradually passing. The managements of the various Federal Reserve Banks and the members of the Federal Reserve Board, with an appreciation of the value of thorough cooperation and complete understanding, have kept in close touch, both by correspondence and by frequent personal contact, so that the board has been kept informed of local conditions and the Federal Reserve Banks are made familiar with the viewpoint of the board on matters of policy. Just as this cooperation and understanding between the board and the banks is necessary for the best development of the Federal Reserve System, so is it essential that there should be the same close relationship between each Federal Reserve Bank and its own member banks.

The scope of the Federal Reserve Banks and the activities in which they may properly engage, and the functions which they were created to discharge, are all being better known as time passes. Some who, at the beginning, were its severest critics, are now among the strongest advocates of the system. There are few to-day who would wish to wipe it out or to reconstruct it radically, and when again conditions throughout the world approach the normal, it will be the most powerful agency in assuring to the United States a sound financial position at home, and in securing for our country its proper place in the realm of world finance.

