

FEDERAL RESERVE NOTES AND GOLD RESERVES.

A Discussion of the Practical Operations of the  
Currency Provisions of the Federal Reserve Act.  
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Since the establishment of the Colonies, the American people have almost continuously paid dearly for experiments with unsound currency. It seems as though the costly lessons of experience in other countries had been rejected by our government and banks and that American ingenuity had been directed to devising new currency expedients equally expensive and disastrous. Our trade with the Indians was first conducted by the use of beads and wampum and the enumeration of what has since been employed as "money" from that day to the present sounds almost grotesque. We have used bales of pelts, hogsheds of tobacco, irredeemable Colonial notes, (which were generally repudiated), irredeemable Continental currency, coins of foreign nations, wild cat bank notes, shin plasters, postage stamp currency, greenbacks, Treasury notes and occasionally clearing house notes, not to mention the present bond-secured bank notes and long years of experiment with bimetallic currency.

Throughout a considerable part of this period, the losses sustained by the American people were enormous. Not only was there the direct loss caused by the repudiation or depreciation of notes issued by the Colonial and state governments and by the Continental Congress and later by the failure of state banks of no responsibility, but there was the much greater indirect loss resulting from the expulsion of gold from the country, with the consequent derangement of prices and trade.

The unfortunate inheritances of the present generation from these past days are both tangible and intangible. The tangible legacy consists of

United States notes (greenbacks).....	\$346,681,016
Silver certificates (Sept. 1, 1916).....	482,006,557
Treasury notes.....	2,079,799
National bank notes (Sept. 1, 1916).....	<u>734,493,851</u>
Total.....	\$1,565,261,223

The intangible legacy consists of the great crop of disordered notions about our currency which it seems impossible to fully eradicate. Fortunately, the sound money campaign laid the bogey of bimetallism in the dust and the five years of agitation for banking and currency legislation of 1908 - 13, resulting in the passage of the Federal Reserve Act, has at last prepared the way for the final settlement of this perplexing currency question.

The Federal Reserve Act has among its objects, two, which are most important and fundamental: One, the laying of a foundation upon which will be based a complete reform of our inelastic currency; the other, the creation, through the instrumentality of reserve banks, of a sound and adequate system of gold banking reserves. The following treats of the first of these objects.

Congress could not or, at least, did not undertake at one stroke to dispose of the existing assortment of nearly \$1,600,000,000 of currency, some part of which should never originally have been issued and all of which once having been issued should have been retired as rapidly as the development of the country's resources and the growth of the government's credit permitted.

So the effort of the present legislation was limited, first, to the gradual retirement of about two-thirds of the national bank notes and, second, to the introduction of a new and elastic element into the currency by the creation of Federal reserve note issues. The language employed for these purposes is somewhat obscure and the operations involved are rather complicated, but it is only necessary to get a clear general understanding of what the law in its present shape permits of accomplishment, limited though it is, and then form our conclusions as to the character of evolution which must be relied upon to perfect the law and ultimately complete this reform. Short-sighted criticism must not be allowed to discredit a great piece of legislation or mislead the public as to what it may accomplish. Most of the criticism of the Federal Reserve Act has been of minor importance, considering the broad plan of the legislation, but in one important matter those directing the policy of the reserve banks have been charged with failure to observe the spirit, if not the letter, of the law. It is claimed that issues of Federal reserve notes in exchange for gold are being made by a method not authorized by the statute, and that this process constitutes inflation and is not in harmony with the theory of elasticity.

As to the charge of inflation, it may be disposed of in a few words: The Federal reserve banks had received from the government at October 6th, 1916, \$220,490,000 net, of notes which amount constituted the entire outstanding issue to that date. These notes are secured by the pledge of \$204,476,000 of gold and \$16,014,000 of commercial paper, and the banks' net liability of \$15,523,000, as reported Oct. 6th, 1916, (which is simply for such of the notes as are secured by commercial paper), is offset by

\$15,225,000 of notes which the twelve Federal reserve banks held in their cash, so that if all the notes held in their tills were simultaneously surrendered or presented for redemption, the net issue to-day would not represent one dollar of inflation. About \$204,000,000 of Federal reserve notes, which cannot be counted as reserves by the banks of the country, have been substituted in circulation for a like amount of gold which otherwise would count as reserve and which would form the basis, in time, of a very considerable expansion of credit. It is this issue which suffers the indictment of "inflation". How ridiculous! Had the entire \$204,000,000 of notes been issued against discounted paper, every dollar would have been added circulation and "inflation" - if increased circulation even though it be legitimate and necessary can be termed "inflation."

In brief, the effect of exchanging Federal reserve notes for gold is to cause no change whatever in the volume of currency, although incidentally, it does impose some restraint upon the expansion of bank credits to the extent that gold has been withdrawn from bank reserves. So much for "inflation". Now as to the matter of elasticity of the new note issue:

Prior to the enactment of the Federal Reserve Act, the country clamored for an elastic currency. Elasticity in the currency means that the volume can be expanded to meet the demands of trade by some other method, of course, than by the importation of gold from foreign countries, or by its production from domestic mines. That is to say, currency must be issued in exchange for some kind of security other than gold. The Federal Reserve Act proposes that this be done by permitting the Federal reserve banks

to issue their notes, (for the payment of which the government has been unnecessarily obligated), upon depositing as security therefor certain classes of commercial paper which they have discounted. The principal limitation imposed upon the amount so authorized to be issued is the requirement that there shall always be on hand a gold reserve equal to at least 40 % of the issue. This is the theory of all elastic note issues and of course contemplates almost unlimited expansion as demands arise, provided always, that sufficient gold is in hand to comply with the 40 % minimum reserve requirement. But is there sufficient gold in hand to fortify note issues which may be required to meet whatever legitimate demands may arise, and if not, how may it be obtained? It is necessary to take into consideration the method of obtaining and the certainty of the sources of supply of this gold, for upon this will inevitably depend the amount of possible expansion, the degree of security and the adequacy of the reserve.

The member banks have now paid in to the reserve banks \$55,000,000 as capital and they, with the government, have also paid in about \$560,000,000 as deposits, the greater part originally consisting of gold. Of this \$615,000,000 of gold, the reserve banks have since paid out \$183,000,000 in acquiring discounts from member banks and investments in the open market - it will later be explained why these operations always necessitate gold payment - so that, allowing for other deductions, such as holdings of silver, United States notes and uncollected checks carried by the reserve banks, their net gold reserve to-day is about \$387,000,000, excluding the \$204,000,000 held by the Federal Reserve Agents against note issues above mentioned.

With \$183,000,000 invested, the reserve banks as a whole are earning their expenses and somewhat less than the 6 % dividends on the capital. To earn the full dividends on the capital and a margin for increased expenses, would require the investment at present interest rates of about \$70,000,000 to \$80,000,000 additional, which would involve the loss of a like amount of gold and leave the gold reserves of the twelve banks at, roughly, \$300,000,000. The minimum required reserve of 35 % for deposits (substantially no reserve being required for note issues as at present with gold security), amounts in round figures to \$200,000,000.

If, therefore, the banks held investments sufficient to pay all expenses and dividends, there would remain in their hands only about \$100,000,000 of gold in excess of the minimum reserve permitted by the statute, if we exclude the \$204,000,000 of gold obtained in exchange for notes issued. No one would for a moment advocate such a reckless policy for the reserve banks that their reserves would normally remain at anything like the minimum level, but assuming that a time of crisis justified such a policy, and further assuming that the reserve banks were able at such times to issue notes freely in payment for discounts to member banks instead of paying out their reserve money, the positive limit of elasticity to the Federal reserve note issue would at present be about \$250,000,000. This sum is only about one-half the combined totals of Aldrich-Vreeland notes and Clearing House loan certificates of the New York Clearing House Association alone, issued during the Fall of 1914.

How, therefore, may the reserve banks discharge the obligation resting upon them, and upon the performance of which the country has placed almost unlimited reliance, of supplying whatever demands for currency may arise, not only in normal times, but

growing out of possible disturbances resulting from the war? How, also, may the reserve banks be expected to furnish their members with some part of the \$600,000,000 of recently imported gold when the conclusion of the war results, as it may, in adverse exchanges and large gold exports? They can meet every demand in my opinion by regulating the note issue in accordance with sound principles as a means of accumulating gold; but this policy should not be made the excuse for expanding the amount of bank loans and credits for which at present there is no justification and which, taking the country as a whole, is already of unprecedented if not dangerous volume.

Stating the matter in plainest terms, the member banks of the country have deposited \$500,000,000 gold with the reserve banks, and that money is owing to the member banks in the form of book credits. Free issues of Federal reserve notes against deposits of gold, dollar for dollar, would simply mean that indirectly the public, which requires currency for daily transactions, would also deposit gold with the reserve banks and in exchange accept notes for the purpose of their trade, instead of the book credits used by the member banks. The book credits which are owing to the member banks are usually more convenient to them for the settlement of accounts between themselves and their customers and to a great extent between each other. The currency is more convenient for pay rolls and the retail trade of the public. Both forms of credit, as furnished by reserve banks, serve to impound gold in their vaults. This operation of accumulating gold by note issues involves no "inflation", does not alter the volume of currency one

dollar, nor violate any sound banking principle. What it will do, is to vastly increase the power which the reserve banks may exercise in time of need. It will enable them when crisis or emergency threatens, to extend credit to the member banks of the system and (through the banks), to issue currency to the people of the country, these being the customers and beneficiaries of the system.

If, in addition to the \$500,000,000 deposits now made by the member banks, the public also deposits, say, \$500,000,000 of gold, for which it accepts notes, then when the demand comes, the resulting "inflation" of the note issue - if again the term "inflation" applies to issues of notes against assets, as in the case of the Aldrich-Vreeland notes - will be sufficient to meet demands, will be based upon an adequate gold reserve to support its issue and will be acceptable to those who demand its use. There would still remain in circulation and in bank reserves, over \$1,500,000,000 of gold, exceeding the total stock of any other nation.

No fear need be entertained that this enlargement of the gold reserves of the reserve banks means an unlimited expansion of credit or enlargement of fiduciary note issues. None of the many restraints imposed by law upon reckless expansion of credit or inflation of note issues are as effective as is the good judgement and common sense of those who are managing the system. They have ample powers to indulge in all sorts of reckless experiments which would discredit the system and bring about its downfall. The restraint of public opinion and a proper sense of responsibility can be relied upon to prevent misuse of powers which are necessarily broad, and convincing evidence of the exercise of this conservatism

is afforded by the moderate earnings of the reserve banks, during a period when there is strong incentive for them to make a good showing of earnings. They have demonstrated their unwillingness to press their funds upon a market already gorged with credit.

Various suggestions have been made, however, for preventing undue expansion of note issues by express provision of law, and it may be necessary, but only in order to satisfy public opinion, to surround the discretionary powers of the reserve banks with such restraints. Those proposed have generally been either to impose a tax of some kind upon issues of notes as they expand, or to fix an arbitrary limit on the total beyond which issues cannot be made. Neither of these plans would be satisfactory. A tax upon note issues would begin to operate when the reserve banks had become extended and were consequently earning large profits, a part of which would go into the United States Treasury. A tax would not, therefore, have a restraining influence when the banks were already paying large profits to the government, as they would be indifferent whether these payments were made as a tax upon notes, or simply as a proportion of surplus earnings.

Fixing a statutory limit to the note issue would be equally unsatisfactory. It would have no relation whatever to the condition of the reserve banks or their reserves. It has been estimated that had the tax proposed by the Aldrich Bill been applied to issues of national bank notes less than two decades ago, the maximum tax of 6 % would already apply to a considerable portion of the bank notes now in circulation.

The growth of our country and of its banking resources is too rapid to justify any such arbitrary limitation with the inevitable and unfortunate necessity for periodical revisions. A brake, however, might be applied to expansion at the point where expansion arises, - that is, by an automatic increase in the discount rate charged to member banks whenever the reserves of the reserve banks are reduced below a fixed statutory minimum. That is the kind of restraint which would be effective, as it would apply as a penalty to those who are responsible for the expansion.

But the greatest safeguard against misuse of the credit power of the Reserve System is, as already stated, the character of its supervision, and in that respect the System is most fortunate, and does not need the steel bands of minute statutory limitations.

The legal basis for the present method of issue of notes against gold has been established to the satisfaction of the Federal Reserve Board and of the officers and directors of the Federal Reserve Bank of New York, and the process has been elaborately explained in former statements. No explanation has so far been made, however, of why the Federal Reserve Act and our currency laws at times cause the operations of the twelve reserve banks to develop a tendency to drain the reserve banks of gold; which will be the case so long as we have outstanding such a miscellaneous assortment of currency and so long as the Federal reserve notes are limited in their legal tender quality and cannot be counted as reserve money by the member banks.

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In a former article, I have endeavored to explain some of the difficulties encountered by the management of the Federal Reserve Bank of New York in connection with issues of Federal reserve notes and why it seems desirable to urge upon Congress the adoption of amendments to the Federal Reserve Act in respect of that matter.

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Issues of Federal reserve notes by the present method, or by any other authorized method, have nothing whatever to do with this loss of gold and accumulation of silver certificates and United States notes. The reserve banks all lose gold whenever they have payments to make, either for investments or for settlements through the Gold Settlement Fund, and they all accumulate United States notes and silver certificates whenever they have payments made to them through Clearing Houses which settle balances in other kinds of currency as well as gold or gold certificates. The reason is obvious. For example, when the Federal Reserve Bank of New York buys \$5,000,000 of New York City revenue warrants, it pays for them by handing to the broker or city authorities a check for \$5,000,000. This check is presented to the Federal Reserve Bank through the New York Clearing House, and unless the bank happens to have \$5,000,000 of silver certificates and United States notes it must, of course, meet the check by settling its debit balance with gold certificates. If it handed Federal reserve notes to the broker or to the city authorities, the notes would be deposited in banks and by banks would immediately be presented for redemption and the gold would be paid out in redeeming them instead of in settlement of the Clearing House debit balances.

Even if the resulting debit balance at the Clearing House could be settled by the use of Federal reserve notes, nothing would be accomplished, because the notes do not count as reserve for the banks and such banks as received them in settlement of credit balances, (unless they happened to have a demand for currency at the moment,) would promptly present them for redemption and we would lose

the gold just the same, having first made a series of useless and expensive motions. In other words, the reserve banks must pay out gold for their investments and cannot pay out Federal reserve notes.

The loss of gold when discounts are demanded by member banks is substantially similar to that which occurs when the reserve banks invest in the open market. The proceeds of discounts are credited to the accounts of member banks, which have probably borrowed for the purpose of making additional loans or meeting demands of depositors; that is, to create larger balances or restore reserves already depleted. Against the credits so made to the member banks' accounts, they draw, or have already drawn, checks which are also presented through the New York Clearing House where settlement is made by the reserve bank in gold, unless it happens to have United States notes or silver certificates which it can use for the purpose. No issues of notes are made to the discounting banks unless their customers happen to need currency, which is seldom the motive for borrowing. Discounting, therefore, also causes a loss of gold, and when these investments and discounts fall due, the checks received in payment are collected through the Clearing House, thus creating credit balances which are settled principally in silver certificates and United States notes, this causing the substitution of that kind of money in place of the gold which was originally paid out when the investments or discounts were made.

But the principal loss of gold arises from quite a different cause and again has no direct relation to the note issue: A large part of the present unusual business activity in the United States arises from the production and manufacture of goods for export

to Europe. These goods largely leave from the Atlantic Seaboard and principally from the Port of New York. Almost all payments by purchasers abroad in settlement for exports are made through New York banks, which are being drawn upon by their interior correspondents or are remitting to the interior points from which the goods were originally shipped and where ultimate payment must be made. On the other hand, European nations and institutions are borrowing large sums in this country, almost entirely through New York. The loans are distributed throughout the country and banks at interior points are remitting to New York in payment. The flow of exchange back and forth occasioned by these tremendous currents of trade and finance, added to our normal seasonal trade, results at times in the reserve banks of the interior shipping to the Federal Reserve Bank of New York very large amounts of New York exchange. The checks sent us are presented by the Federal Reserve Bank of New York to the drawees through the New York Clearing House and the credit balances arising are paid to the Federal Reserve Bank largely in silver certificates and United States notes and to a small extent in gold. The resulting credit balances on the books of the Federal Reserve Bank of New York in favor of the interior reserve banks, however, are settled through the Gold Settlement Fund, always in gold, as our currency laws do not permit the issue of other forms of money in large denomination "order certificates", which must be employed for the settlement of balances between the reserve banks by this most economical method of settlement. It should be understood that the gold which has so far moved to the interior represents the net balances arising from this offsetting flow of exchange between

New York and the interior. The consequence, therefore, of receiving payment in silver certificates and United States notes from our debtors through the Clearing House of New York and making payment in gold to our creditors through the Clearing House in Washington is to cause at times an accumulation of the less desirable money by the New York bank. Issues of Federal reserve notes have no relation to the matter whatever.

Further development of the present collection plan will in time overcome some part of the difficulty. Interior banks which now carry balances with New York correspondents are inclined to resent the action of their New York correspondents in collecting interior items through the Federal Reserve Bank of New York, for reasons which need not be elaborated. The result is that the interior reserve banks which do collect a large volume of items payable in the New York District send more New York exchange to the Federal Reserve Bank of New York than that bank is able to offset by exchange sent to the interior reserve banks. There is also a considerable volume of New York exchange purchased outright by interior reserve banks whenever, as has frequently been the case, New York exchange is at a discount. This all contributes to cause the settlement through the Gold Settlement Fund to be adverse to New York practically all the time, and results in many of the New York member banks settling with their interior correspondents to some extent, direct, thus enlarging the constant gold drain on the New York Reserve Bank. When old collection arrangements are more generally abandoned, the Federal reserve bank exchanges will more nearly balance and save some part of the drain of gold.

One other disagreeable consequence of the operations described has been to transfer through the reserve banks and the Clearing Fund, something like \$200,000,000 of the recently imported gold first to other Federal reserve banks, through them to their member banks and finally by the member banks into general circulation. It seems unfortunate that means were not available to arrest this general distribution of gold and impound it in the reserve banks immediately upon its arrival, but no such result could be accomplished so long as the present limitations continue in regard to the reserve qualities of Federal reserve notes. The best that could be accomplished by the New York Reserve Bank was to effect exchanges through the courtesy of the member banks and of bankers who have controlled the gold importations, of such silver certificates and United States notes as accumulated in the reserves of the New York Reserve Bank, for the newly arrived gold and to further accumulate about \$75,000,000 of gold against direct issue of notes to the member banks. Much of the imported gold has simply gone to the interior to pay for some of the wheat, horses, automobiles and other goods exported to Europe from the interior.

It should not be supposed that the present total issue of, say, \$204,000,000 of Federal reserve notes has displaced a like amount of silver certificates and United States notes in circulation and developed a tendency to drive them into the vaults of the reserve banks. They displaced \$204,000,000 of gold certificates at the time of their issue, and once issued against the retirement of an equal amount of gold certificates, it is difficult to see how they could again displace further amounts of other kinds of currency.

It is easy to mistake or confuse the influences which determine how much of our many varieties of currency will continue in circulation in the hands of the public, or how much will find lodgement in bank reserves. About the most constant factor in currency circulation is the amount which will remain in general circulation outside of bank reserves, which amount fluctuates in total roughly in proportion to the volume of business and of seasonal demands. The strongest influence to control how much of any one kind of this currency finds its way into bank vaults and how much remains in circulation is the proportion in which the denominations of the different kinds of notes are issued.

One of the contributing causes, and probably the principal one, for the excessive circulation of gold certificates in the hands of the public and the excessive accumulation of silver certificates in bank reserves is the fact that too many gold certificates are issued in small denominations and too many silver certificates in large denominations for the best interests of the country. It is a significant fact that the great increase in volume of \$10 and \$20 bills now circulating throughout the country, appears to be in gold certificates, whereas, the excessive accumulation of silver in bank reserves which at times occurs consists usually of the larger denomination silver certificates. If our government would discontinue the issue of gold certificates of denominations of less than \$50, or even somewhat reduce the volume of tens and twenties now being issued and at the same time would increase the volume of small denomination silver certificates so as

to meet the constant and apparently unsatisfied demand for \$1, \$2 and at times, \$5 bills, we would very shortly see a stream of gold certificates flowing into the national banks to replace present holdings of silver certificates, thereby affording opportunity for considerable issues of Federal reserve notes against gold to partly take the place of the denominations withdrawn from circulation.

Inherited notions, as well as ignorance, in regard to our currency have proven an obstacle to a correct understanding in this country of the real function of a bank note and a bank deposit. Originally, banks extended credit almost entirely by note issues and their profits arose from making issues of notes for loans extended to borrowers. The enlarged use of current accounts against which checks are drawn has driven the bank note out of its former supreme position as the instrument for extending credit and effecting exchanges so that notes are now used by the public only for hand to hand payments and by banking institutions for settling differences between amounts owing to each other, - that is, the Clearing House exchanges. The volume of currency or bank notes in hand to hand circulation remains fairly constant, much more so in fact, than bank deposits do, but they should be looked upon as a claim upon a bank just as a deposit account is, always however, with this qualification; the ownership of a bank note when it has legal tender qualities, is involuntary, as one must accept such notes in payment of debts; a bank deposit results from a purely voluntary relationship between the depositor and the bank, no creditor being obliged to accept a check from his debtor in payment of a debt, and when suspicion of weakness of his bank is entertained by the depositor, he is at liberty to remove his account to some other bank.

Consequently, the circulation of bank notes must depend for its success upon a large gold reserve and not, as in this country, upon a reserve consisting of the various kinds of money which we have so long allowed to remain in circulation and which must be presented to the Treasury for redemption in order to get gold, sometimes when it is most inconvenient for our government to furnish it. Therein lies the weakness in this country's currency system, resulting from the issue of \$1,600,000,000 of currency without adequate gold backing, a large part of which is counted as cash reserve by banks.

The introduction of an elastic currency to take the place of our inelastic currencies can only be brought about by the withdrawal of some part of present issues so as to create a void to be filled by Federal reserve notes. A larger proportion of ultimate reserve money, that is, gold, should be held by the reserve banks and the kind of money which should be used for hand to hand payments by the public, should be in larger proportion the elastic currency, that is, the Federal reserve notes, the volume of which will expand and contract as demands for its use arise. If the latter has adequate gold backing, it can likewise be made with safety to count as reserve money for the member banks.

The time to commence correcting these inherited defects in thorough-going fashion is right now, when the people of the United States have at their command the largest supply of gold of any nation of the world and the largest ever held in this country. The various steps in completing the reform of our currency position will result in assembling some of this gold, and serve also, to strengthen us to meet the need for its later return to Europe.

It seems that the object of the recently proposed amendments to the note issue provisions of the Federal Reserve Act must have been misunderstood, when it is claimed that the failure of Congress to enact the amendments constituted a rebuke to the managers of the system for permitting the present method of issuing Federal reserve notes. The amendment was designed to accomplish two needed changes in the Act. The important change was to authorize the reserve banks to count gold accumulated by note issues as part of their assets and to treat the notes so issued as part of their liabilities and thereby immensely strengthen their reserves. This was the real object sought by the amendment. Of less importance, and having the effect simply of saving much clerical work and inconvenience, was the proposed amendment authorizing direct exchange of notes for gold without so many bookkeeping motions involved by the preliminary pledge of commercial paper. Congress certainly failed to adopt the suggestion about the gold counting as reserve, but had it intended this as disapproval of the method now authorized by the law, which was fully and clearly explained, it would have amended the statute so as to have prevented its continuance by the present less convenient method.

On the whole, the people of the country and the press have given whole-hearted and very welcome support to the efforts of the management of the reserve system to make it an unqualified success. Unfortunately, the task has been so immense that there has not been sufficient time for the officers of the reserve banks to explain in a careful and accurate way the various complicated operations with the inauguration of which they have been charged.

It is equally unfortunate that those writing criticisms of the system have been willing to do so without definite information on some of these matters, and which they have at times been unwilling to make effort to obtain. Lack of information explains most of the criticism which has so far appeared, although in some cases our critics have been guilty of a species of mental hibernation which it is difficult to comprehend.

The Federal Reserve System is not going to be a success - it is a success. It is largely the product of many years of study and thought by the business men and bankers of the country who were interested in promoting this great reform; their views have finally been crystallized by the committees of Congress in the present legislation. Its deficiencies will be remedied, but let us hope not as an outgrowth of unfortunate and costly experiences, but as the result of the recommendations of those who are giving the best years of their lives to bringing about a much needed reform.

By Mr. Strong

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