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Statement of

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Finance

of the

Committee on Banking and Currency

House of Representatives

January 21, 1964

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Mr. Chairman and Members of the Committee:

We welcome the inquiries into the Federal Reserve System that are conducted each year by various Committees of the Congress, believing as we do that every gain made in knowledge of the System will be beneficial to us all. Your present inquiry is especially timely, coming as it does shortly after the 50th anniversary of President Wilson's signing of the Federal Reserve Act on December 23, 1913. We are pleased on this occasion to join with you again in considering the merits of the present structural arrangement of the System, and to aid in your consideration in any way we can.

We do not claim the System is perfect or infallible. Being a human institution, it is neither. It has made mistakes, and undoubtedly it will make more of them, for the mind of man has not yet managed to devise any means of excluding error. In its half-century of existence, encompassing the ordeal of two world-embracing wars and between them the anguish of boom, crash, and depression, the System has experienced failures as well as successes. But it has also learned from experience, and I believe we can find considerable satisfaction today in the extent to which the Federal Reserve System over the years has accomplished the objectives set for it by the Congress.

Clearly, the System has achieved the goal uppermost in the minds of its creators, by providing the country with an elastic currency, for which it had vainly sought during most of its earlier history. To be sure, this and other goals were attained by the System

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only over time, through a process of evolution, innovation and experimentation as experience demonstrated errors in the assumption prevalent fifty years ago that the supply of money and credit could be geared automatically to the needs of the country through adherence to the "real bills" doctrine. Yet the framers of the Federal Reserve Act, like those of the United States Constitution, wrought exceedingly well when they created a structure capable of adaptation and development as the economy itself developed--a structure that places trusteeship over the creation of money in a body that is insulated from shortsighted pressures for abuse of that power; one that combines the advantages of regional units with central supervision and coordination; and one that ingeniously engages public and private participation in a democratic effort to serve the interests of the people as a whole.

Having twelve regional banks in the System has aided the System greatly in keeping in close touch with developments and trends in credit and business throughout the country. Furthermore, the regional system has enabled us to bring into focus a wide range of views, enhancing flexibility in adapting to economic changes. Perhaps the development of open market operations as a method of supplying or absorbing bank reserves, the base on which bank credit rests in this country, is the most striking example of what has been accomplished by that process. Authorized initially for the chief purpose of enabling investments to make the individual Reserve Banks financially self-supporting, open market operations evolved gradually as a major tool

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of monetary policy, with the operations of the twelve regional banks coordinated today through a single, broad-based committee that pools in the public behalf the economic and human resources of the entire System. At present, the System is again breaking new ground in establishing a network of currency interchange arrangements with central banks in other countries as a means of protecting the dollar on the foreign exchanges and contributing in the long run to a stronger international payments mechanism.

I believe that a good part of the Federal Reserve's strength is derived from this unique blend of public and private participation, regional initiative and central supervision. Obviously, the System is open to improvement, and it has been improving as a result of evolution. Change is inevitable, but we should make sure it is change for the better. Change purely for the sake of making the System conform more closely to the structure of the standard Government agency would, in my judgment, slow our progress toward achievement of the goals set forth in the Federal Reserve Act and the Employment Act of 1946.

One constructive step that you could take to remove the last vestige of the now-obsolete "real bills" doctrine, to which I referred earlier, would be to pass legislation that the Board recommended last August 21. That legislation would permit the Federal Reserve Banks to make discounts or advances on sound collateral without imposing a penalty merely because this collateral does not meet the archaic technical requirements of "eligible paper."

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According to the "real bills" doctrine, the supply of money and credit would be automatically expanded and contracted in step with the needs of the economy if reserve bank credit was based on short-term, self-liquidating "real bills" drawn to finance the production and distribution of the goods the economy produced. In keeping with this idea, the original Federal Reserve Act provided that member banks could obtain credit from their Reserve Banks only by discounting short-term, self-liquidating, agricultural, industrial, or commercial paper arising out of actual transactions.

The realization grew that the amount of "real bills" could be blown up disproportionately during times of inflationary bidding for goods, and, conversely, that it could constrict unduly during periods of depressed business conditions. Furthermore, the American economy was developing needs for new and more flexible credit forms--needs which could not be met within the old "real bills" framework.

Commercial banking changed to meet these needs. Congress also changed the law to free Federal Reserve credit from being based on "real bills" alone. Today, when member banks borrow from a Federal Reserve Bank, they have three choices as to the collateral they may offer: (1) obligations of the United States, (2) eligible paper, or (3) other paper satisfactory to the Reserve Bank. If, however, they take the third choice, they must pay a penalty rate of interest, one-half of one per cent higher than the rate that applies in the other two cases. Member banks have had no difficulty making this choice, and have shown an overwhelming preference for the simpler,

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less expensive method of offering U. S. obligations as security for their borrowings.

The technical requirements of present law, such as those with respect to maturity and relation to "actual" commercial transactions, exclude large volumes of perfectly sound paper as a basis for Federal Reserve credit, except at a penalty rate of interest. The reasons the Board advocates a change in these provisions are set forth in the following excerpt from our letter of August 21, 1963, to your chairman, transmitting a draft of the proposed bill, which has been introduced in the House by Mr. Kilburn (H.R. 8505) and in the Senate by Senator Robertson (S. 2076):

> "As long as member banks hold a large enough volume of Government securities, they need not, of course, be particularly concerned as to the eligibility for discount with the Reserve Banks of customers' paper held by them. Since World War II, however, there has been a sharp net decline in the aggregate holdings of Government securities by member banks. If any substantial increase in economic activity should cause banks to reduce their holdings of Government securities in order to meet increased credit demands, many banks would be obliged to tender other kinds of collateral if they should seek to obtain Federal Reserve credit.
>
> "If such a situation should develop, the Reserve Banks could accept technically 'ineligible' paper as collateral for advances to their member banks only under section 10(b) of the Federal Reserve Act at a rate of interest one-half of one per cent above the regular discount rate. However, the necessity for distinguishing between 'eligible' and 'ineligible' paper would give rise to cumbersome administrative procedures that are not warranted by the exigencies of current banking conditions. In order to avoid these problems, it would clearly be preferable to move in advance and to revise and up-date the law so as to eliminate the existing restrictions with respect to 'eligible paper'.

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"The Board of Governors and the Federal Reserve Banks believe that such a revision of the law would be desirable so that the Reserve Banks will always be in a position to perform promptly and efficiently one of their principal responsibilities - the extension of appropriate credit assistance to member banks to enable the latter to meet the legitimate credit needs of the economy."

I hope that this legislation will be given favorable consideration by your Committee.

You have asked for comments on two other bills. One of these, H.R. 9631, would abolish the Board of Governors and the Federal Open Market Committee. It would establish a new twelve-member Federal Reserve Board under the chairmanship of the Secretary of the Treasury. It would increase the Federal Advisory Council from twelve members to as many as fifty-two and include among them the Comptroller of the Currency and the Chairman of the Federal Deposit Insurance Corporation. Finally, it would provide for an annual audit of the Federal Reserve System by the General Accounting Office.

While time to study this bill has been limited, since it was introduced only six days ago, the issues it raises have been studied intensively over the years.

As we look back today on the 50th anniversary of the signing of the Federal Reserve Act, we are approaching other anniversaries. On January 29, twelve years will have elapsed since I transmitted to your chairman replies by the Board of Governors to an extensive and searching questionnaire he addressed to us in his capacity as chairman of the Subcommittee on General Credit Control and Debt Management of the Joint Committee on the Economic Report, now the Joint Economic Committee.

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Coincidentally, January 29 will also be the first anniversary of the opening of your Committee's first hearing under your present chairman, at which I had the pleasure of introducing to you my fellow Board members and the presidents of the Federal Reserve Banks. You may recall that at that time I commended to your attention the comprehensive study of the Federal Reserve that Mr. Patman directed in 1952. In commenting on the issues before you today, I shall borrow freely from the material developed by that study.

At the outset, H.R. 9631 raises the issue of whether the Secretary of the Treasury should exercise control over the Federal Reserve System. To oversimplify only slightly, the question is whether the principal officer in charge of paying the Government's bills should be entrusted also with the power to create the money to pay them. The Congress concluded in 1935 that Secretaries of the Treasury should not be faced with a conflict of interest of this magnitude, and amended the Federal Reserve Act to discontinue their service on the Board of Governors. In debate on the Banking Act of 1935, the then chairman of the Senate Banking and Currency Committee, Carter Glass, speaking from the experience he had gained from service as chairman of your Committee and as Secretary of the Treasury, commented as follows:

> ". . . With respect to the Secretary of the Treasury, it was urged--and I know it to be a fact, because I was once Secretary of the Treasury--that he exercised undue influence over the Board; that he treats it rather as a bureau of the Treasury instead of as a board independent of the Government, designed to respond primarily and altogether to the requirements of business and industry and agriculture, and not to be used to finance the Federal Government, which was assumed always to be able to finance itself."

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Monetary policy should be directed toward gearing the supply of money and credit to the needs of the economy as a whole, not the needs of the Treasury. This principle was laid down more precisely in 1950 by the Douglas Subcommittee on Monetary, Credit, and Fiscal Policies, quoted with approval in the 1952 Report of the Patman Subcommittee, as follows:

> "We recommend that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of the principal methods used to achieve the purposes of the Employment Act. Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability. The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities. As a long run matter, we favor interest rates as low as they can be without inducing inflation, for low interest rates stimulate capital investment. But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes."

This is not to say that the Federal Reserve should operate in isolation from the Treasury. On the contrary, we enjoy cordial and close relations with the Secretary and we are working together in harmony to meet our separate responsibilities.

Another question thoroughly explored in 1952 was the role of the Federal Open Market Committee. The Board's replies to the

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Patman Subcommittee Questionnaire included the following statement on this subject:

> "The present arrangement, however, under which open market operations are placed under the jurisdiction of a committee representing the Reserve Banks as well as the Board is consistent with the basic concept of a regional Federal Reserve System. It provides a means whereby the viewpoints of the Presidents of the Federal Reserve Banks located in various parts of the country, with their technical experience in banking and with their broad contacts with current credit and business developments, both indirectly and through their boards of directors, may be brought to bear upon the complex credit problems of the System. It promotes System-wide understanding of these problems and closer relations between the Presidents and the Board in the determination of System policies. In practice the open market policies of the Open Market Committee and the credit policies of the Board have been coordinated and the existing arrangement has worked satisfactorily."

The 1952 Patman Subcommittee Report concluded that "the present arrangement serves a useful purpose and there is no reason to disturb it." I concur in that conclusion.

In my judgment, the present arrangement governing membership on the Open Market Committee has produced a body of capable, qualified men, beholden to no group or faction in private or public life, and dedicated exclusively--in accordance with the oath taken by every one of them--to the service of the whole American public. It pleases me that you will have the opportunity to become better acquainted with them as these hearings progress.

A third issue raised by H.R. 9631 relates to the number of members of the Board, and the length of their terms. In my judgment, a twelve-man Board would be unwieldy--and I might add parenthetically that the same would be true of a fifty-two member Federal Advisory

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Committee, as provided for in section 2 of the bill. If any change is to be made in the size of the Board, I would favor reducing it, possibly to five members, rather than enlarging it. In our reply to the 1952 Patman Subcommittee Questionnaire, the Board commented as follows concerning terms of members:

> ". . . A considerably shorter term, say a term of 6 years, without any prohibition against reappointment, might be sufficiently long and might be more practicable. The elimination of the prohibition of the law against re-appointment of a member at the expiration of his term would permit the maintenance of a Board membership over the years having the requisite knowledge and experience regarding the Board's problems."

H.R. 9631 also would provide that the new Federal Reserve Board members be appointed with "due regard to a fair representation of the financial, agricultural, industrial, commercial, labor, and consumer interests, and geographical divisions of the country." This would continue the present provisions regarding qualifications for appointment to the Board of Governors, except that reference to labor and consumer interests would be added, and the present prohibition against appointing more than one member from a Federal Reserve district would be dropped. I would favor dropping from the Federal Reserve Act any reference to representation of particular segments of our society. Our efforts should be bent toward obtaining qualified men who will act in the interest of the nation as a whole. Repealing the restrictions based on district lines would assist in this primary goal of appointing the best men available for service on the Board.

Another provision of H.R. 9631 would require an annual audit of the Board and the Reserve Banks by the General Accounting Office.

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Until 1933, the GAO audited expenditures by the Board, but not the Reserve Banks. The Banking Act of 1933, however, provided that the "Board shall determine and prescribe the manner in which its obligations shall be incurred and its disbursements and expenses allowed and paid . . . ." The House and Senate Committee reports said the change was made in order to leave "to the Board the determination of its own internal management policies." Thus, Congress in 1933 freed from GAO audit the only part of the System that was ever subject to it.

Since 1952, the Board has been audited annually by independent certified public accounting firms, and their audit reports have been submitted to the two Banking and Currency Committees. Topflight auditors have been used (Arthur Andersen & Co., Price Waterhouse & Co., and now Haskins & Sells).

The Federal Reserve Act provides that the Board "shall, at least once each year, order an examination of each Federal reserve bank." The Board maintains a staff of examiners who devote themselves exclusively to this work. The Board's instructions to its examiners require, briefly, that the examination shall determine (a) each Bank's financial condition through appraisal of its assets and verification of its assets and liabilities; (b) its proper discharge of all its responsibilities; and (c) its compliance with all applicable provisions of law and regulations. Each year, an outside commercial auditor (currently Haskins & Sells) accompanies the Board's examiners on their examination of one of the Banks, to review and observe the examination procedures. Also, each Bank has a resident auditor, responsible directly to the

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Bank's Board of Directors, and not dependent on any of the Bank's officers for security of position. Throughout the year, he and his staff make comprehensive audits of all phases of the Bank's operations, reporting directly to the Board of Directors of the Bank. Copies of these reports are reviewed by the Board of Governors of the Federal Reserve System.

In sum, then, we have in each Reserve Bank an internal audit program conducted the year around by the Bank's resident auditor and his staff, who, by a deliberately established plan of organization, are directly responsible to the Board of Directors and independent of the Bank's operating management. In addition, a staff of examiners directly employed by the Board of Governors in Washington examines each Bank every year, and reports directly to the Board of Governors. We have the statement of certified public accountants of national repute that the examination procedures employed by the Board's staff fully conform with generally accepted auditing standards. This combination of internal and external scrutiny provides an audit coverage of the Reserve Banks that is unexcelled in any other organization, and is as objective and independent in approach as human ingenuity can devise. It is difficult to perceive how the GAO or any other audit group could achieve a more effective result.

You also have asked for comments on H.R. 3733, which would provide for the retirement of Federal Reserve Bank stock. As I testified at your hearings on this question in 1960, Federal Reserve Bank stock, while not an indispensable feature of the System, has

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served as a means of integrating member banks and bankers into the System. It has provided a business-like method for electing two-thirds of the directors of the Reserve Banks, and I see no reason to change it. The stock is an attractive investment for member banks. Without saying that it is a principal consideration in their attitude toward membership in the System, I feel that in view of the fact that most smaller State banks are not members and a number of smaller national banks are pressing for release from membership, it would be unwise to tip the scales further in the direction of making membership unattractive. Admittedly, other methods could be found for electing directors and retirement of the stock would increase the payments from Federal Reserve earnings into the Treasury, by roughly the amount of the dividend payments ($29 million in 1963). But I would earnestly advise against making this change, not only because of its potentially disruptive effect on relations with member banks but also because inevitably some observers would view it as a step toward nationalization of the banking system while others would read into it some other significant portent of basic monetary changes. Fear of public misunderstanding should not deter us from making changes for which there is a demonstrated need or prospect of real benefit, but, in my judgment, those conditions are not met by this proposal.

The purpose of the Federal Reserve System is to contribute--to the maximum extent that monetary policy can contribute--to the achievement of sustained high employment, stable values, and a rising standard of living for all Americans. It cannot of course achieve

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those goals alone, but it can contribute, and I can assure you that it is unreservedly dedicated to that end today.

In the last analysis, whether an institution renders good or bad public service will always depend more upon the character of the human beings engaged in its operations than upon its organizational form and structure. The solution of difficult and complex problems depends upon the ability of conscientious men to reconcile differences of opinion and come to a meeting of the minds on what best serves the public's good rather than upon the forms of institutional organization.

In his first inaugural address as President, Woodrow Wilson gave us some counsel about dealing with our economic system that I believe applies as well to the Federal Reserve itself. These are his words, as they are inscribed below his plaque in the Federal Reserve Building:

> "We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon; and step by step we shall make it what it should be, in the spirit of those who question their own wisdom and seek counsel and knowledge, not shallow self-satisfaction or the excitement of excursions whither they cannot tell."

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