

**RETIREMENT OF \$30 BILLION OF GOVERNMENT
BONDS HELD BY THE FEDERAL RESERVE BANKS**

HEARINGS
BEFORE THE
COMMITTEE ON BANKING AND CURRENCY
HOUSE OF REPRESENTATIVES

EIGHTY-NINTH CONGRESS

FIRST SESSION

ON

H.R. 7601

**TO PROVIDE FOR THE RETIREMENT OF \$30 BILLION OF
INTEREST-BEARING OBLIGATIONS OF THE UNITED STATES
HELD BY THE 12 FEDERAL RESERVE BANKS**

JULY 6 AND 7, 1965

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RETIREMENT OF \$30 BILLION OF GOVERNMENT BONDS HELD BY THE FEDERAL RESERVE BANKS

TUESDAY, JULY 6, 1965

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Multer, Barrett, Reuss, Moorhead, Stephens, Gonzalez, Minish, Grabowski, Gettys, McGrath, Hansen, Annunzio, Widnall, Fino, Talcott, Stanton, and Mize.

The CHAIRMAN. The committee will please come to order.

Today, the committee begins hearings on H.R. 7601, a bill providing for the retirement of \$30 billion of interest-bearing obligations of the United States held by the 12 Federal Reserve banks.

(H.R. 7601 follows:)

[H.R. 7601, 89th Cong., 1st sess.]

A BILL To provide for the retirement of \$30,000,000,000 of interest-bearing obligations of the United States held by the twelve Federal Reserve banks

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the twelve Federal Reserve banks shall transfer to the Secretary of the Treasury interest-bearing obligations (including discounted obligations) of the United States in the aggregate principal amount of \$30,000,000,000. The respective amounts of the several issues to be transferred, and the valuation of discounted issues, shall be determined by the Secretary of the Treasury, and the respective amounts to be transferred from the several banks shall be determined by the Board of Governors of the Federal Reserve System. Obligations transferred to the Secretary of the Treasury pursuant to this section shall be canceled and retired.

SEC. 2. Each Federal Reserve bank shall be relieved of its liability upon an amount of Federal Reserve notes issued to it equal to the valuation at which the obligations transferred by it to the Secretary of the Treasury pursuant to the first section are carried on its books, and the Secretary of the Treasury shall transfer an equal amount, on the books of the Treasury, from contingent liability on Federal Reserve notes to direct currency liability.

The CHAIRMAN. We have as our first witness, Mr. William McChesney Martin, Chairman of the Federal Reserve Board.

Before Chairman Martin begins, I believe it will be helpful to all to refresh our memories a bit concerning the economic significance of the open market portfolio.

Currently, the open market portfolio, held by the Federal Open Market Committee, amounts to a massive total of \$38.5 billion. As pointed out by myself and others, including Marriner Eccles, a former Chairman of the Federal Reserve Board, the open market portfolio

bonds have been purchased by the Federal Reserve Bank of New York which is an agency of the U.S. Government.

Of great significance is the fact that these bonds were purchased on the credit of the U.S. Government and payable ultimately, if required, in Federal Reserve notes. In other words, they have been paid for entirely in cash or credit of the Nation, and therefore, as is the thrust of this bill, these bonds should be canceled.

Instead, however, these bonds remain in the hands of the Federal Reserve where they continue to draw interest from the people of the United States. Moreover, in the case of the Federal Reserve, it can sell and buy back these bonds over and over again. This is like an individual who engages a broker to pay off his mortgage, and then finds that the broker, after paying the mortgage holder, has retained the mortgage for himself, continuing to collect the interest, and asserting the right to come around and collect the principal again when the mortgage matures.

The interest on the open market portfolio is costing the American people \$1.3 billion a year, which is paid to the Federal Reserve by the U.S. Treasury from money collected from the taxpayer. If these bonds were canceled as required in my opinion by proper legal and accounting procedure, the public debt would be almost \$30 billion lower and we would not have the ridiculous problem of having to lift the debt ceiling year after year.

It does not, in my opinion, alleviate the situation to point out that the Federal Reserve pays the unused portion of the interest over to the Treasury, because prior to so doing the Fed uses as much as in its judgment it needs without benefit of appropriation, congressional sanction, or executive department approval. This procedure, as we all know, is normally required of the other agencies of Government.

Chairman Martin, and many of the committee members, will recall that during consideration of the "vault cash" bill in 1959, the Federal Reserve Board proposed turning over \$15 billion of the then existing Open Market Committee bond portfolio of \$24 billion to the commercial banks. One of the justifications advanced for this proposal was that the portfolio was too big at that time and not needed. I agree with that; and it necessarily follows that if it was too big then it is much too big now.

There will never be any foreseeable use for this vast amount of bonds. Furthermore, since we are a growing country and require a growing money supply, and since the money supply is increased primarily through increasing bank reserves by open market bond purchases, it stands to reason that this portfolio will have to continue to grow ever larger and larger.

Practical economics dictate that it cannot be sold because, if the Federal Reserve ever tries to sell a substantial quantity of it, it would cause a depression very quickly by shrinking the money supply and raising interest rates.

Chairman Martin, I believe what I have said is factually and economically correct. I know that where matters of judgment are concerned there can be differences of opinion, but I do not believe this case is one of judgment.

Now, in order to realize the size of \$38.5 billion, may I suggest that if it were converted into \$1 bills and laid end to end, it would circle

the earth 144 times. It means as much as 2 years' production of the automobile-producing companies—2 years' production of automobiles. It is more than the national debt of the United States prior to the year 1938. It is equal to \$200 for every man, woman, and child in America.

In our fight today against poverty, ignorance, and disease, \$38.5 billion would go a long way toward building schoolhouses and training the poverty-stricken for jobs and making skilled people out of them, providing hospitalization, and so forth.

Now, Mr. Martin, you have a prepared statement, I believe, and we are glad to have you, sir.

Mr. Widnall?

Mr. WIDNALL. Mr. Chairman, I would like to make an opening statement on this bill, too.

The CHAIRMAN. Certainly. You want to do this preceding Mr. Martin's statement?

Mr. WIDNALL. Yes, sir.

The CHAIRMAN. Go ahead.

Mr. WIDNALL. In my considered judgment, your bill, H.R. 7601, which is before us today, potentially is the most dangerous monetary proposal ever to receive formal consideration by this committee in all the years that I have been privileged to serve as a member.

The proposal introduced on April 26, 1965, by our chairman provides for the outright cancellation of \$30 billion of Federal debt held by the 12 Federal Reserve banks.

In the eyes of the world, such governmental action would be taken as inaugurating a policy of repudiation of our national debt. It would destroy confidence in the integrity of our monetary system. It would invite a worldwide monetary crisis.

The bill would relieve the Federal Reserve banks of Federal Reserve note liability in the amount of \$30 billion by transferring that liability directly to the Treasury. But the problem is not that simple. By itself, this bill would convert our currency to a fiat money system—to unlimited printing press money.

Unless the administration promptly and publicly repudiates this proposed policy it must bear full responsibility for the consequences of its failure to act. Uncertainties in our economy at the moment dictate against a further period of official administration silence.

I think it is imperative that the Secretary of Treasury, the Secretary of Commerce, the Chairman of the Council of Economic Advisers, and the Director of the Bureau of the Budget be summoned without delay as witnesses to make known the official views of the President on this potentially devastating proposal.

Unless these administration witnesses are called and called promptly, I serve notice here and now that although I am opposed to this bill, I shall vote, and recommend to the minority committee members that they likewise vote to report this bill to the floor of the House in order that the final outcome be promptly determined rather than remain uncertain.

Mr. MULTER. Mr. Chairman?

The CHAIRMAN. Mr. Multer.

Mr. MULTER. I would like to reserve any remarks I might make until we get through the questioning of Mr. Martin. But I must say this in answer to what Mr. Widnall has said. Although I agree with some

of the things he has said, this is not an administration bill. There is no message from the administration on the bill and I do not think that the administration can be charged with supporting this bill unless and until we hear from the administration to that effect. I am sure Mr. Martin is going to give us his views and those of the Board of Governors as to the merit or lack of merit of the bill. I agree with Mr. Widnall that other administration witnesses should be called, but I do not like the tone of his statement when he says that unless they are called, this will be deemed an administration bill. It is far from that.

The CHAIRMAN. The bill has never been discussed with the administration.

Mr. Martin, we will hear from you first, please.

STATEMENT OF HON. WILLIAM McCHESNEY MARTIN, JR., CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; ACCOMPANIED BY JOHN R. FARRELL, DIRECTOR, DIVISION OF BANK OPERATIONS; AND GUY E. NOYES, ADVISER TO THE BOARD

Mr. MARTIN. Thank you.

Mr. Chairman, H.R. 7601 provides that "the twelve Federal Reserve banks shall transfer to the Secretary of the Treasury interest-bearing obligations (including discounted obligations) of the United States in the aggregate principal amount of \$30,000,000,000."

After providing that the Secretary of the Treasury is to determine how much of each issue is to be transferred—and, for discounted issues, at what value—and that the Board of Governors of the Federal Reserve System is to decide how much of the total is to come from each Reserve bank, the bill provides that the obligations transferred "shall be canceled and retired." Section 2 of the bill would relieve each Reserve bank "of its liability upon an amount of [its] Federal Reserve * * * equal to the valuation at which the obligations transferred by it * * * are carried on its books, * * *."

Rounding out the picture, the Secretary of the Treasury would be directed to "transfer an equal amount, on the books of the Treasury, from contingent liability on Federal Reserve notes to direct currency liability."

Section 16 of the Federal Reserve Act, which authorizes the issuance of Federal Reserve notes, contains provisions for collateral and gold reserves which are not specifically amended by H.R. 7601. Before a Reserve bank may obtain Federal Reserve notes for issuance, it must tender "collateral in an amount equal to the sum of the Federal Reserve notes thus applied for." While this collateral may take several forms under the statute, in practice it consists almost wholly of gold certificates and Government securities. As of May 31, about \$38 billion was pledged in the collateral account—about \$7 billion from the Reserve banks' holdings of \$14 billion of gold certificates, and \$31 billion of their \$38.5 billion of Government securities. To simplify operations, the Reserve banks maintain collateral at levels somewhat higher than the Federal Reserve notes they have received for issuance; this accounts for the fact that \$38 billion in collateral is pledged whereas only \$37 billion of Federal Reserve notes have been issued to the Reserve banks.

In addition to the collateral requirements, section 16, as recently amended by the gold reserve legislation—Public Law 89-3—considered by your committee, requires each Reserve bank to maintain reserves in gold certificates of not less than 25 percent against its Federal Reserve notes in actual circulation, which amount to about \$35 billion. The Reserve banks are thus required to maintain, at present, about \$9 billion in gold certificates as reserves against currency in circulation. In accordance with the statute, gold certificates pledged as collateral “are counted as part of the—gold certificate—reserve.”

While H.R. 7601 makes no specific change in these provisions, it does provide that the Reserve banks’ liability on \$30 billion of Federal Reserve notes shall be canceled. Presumably, therefore, the intent would be to relieve the Reserve banks of their present duty to maintain 100 percent collateral and 25 percent gold certificate reserves with respect to \$30 billion of the Federal Reserve notes now circulating, but to continue these requirements with respect to the remaining \$5 billion of notes now in circulation. Thus, it would appear that of the \$35 billion of identical Federal Reserve notes that would continue in the hands of the public, one-seventh would be secured and six-tenths would not.

A second effect of this bill would be to add \$30 billion to the amount of new borrowing that could be carried out under the debt limit. The obligations that would be canceled under the bill were issued under the Second Liberty Bond Act. The provision commonly referred to as the public debt limit—section 21 of that act—limits the amount of obligations that may be outstanding under the act. Thus, canceling \$30 billion of securities previously issued would, of course, be equivalent to enacting a permanent increase of the same amount in the debt ceiling.

If this analysis is correct, the bill would thus alter decisions recently made by the Congress and the President with respect to both the debt limit and the backing for currency. Public Law 89-3 expressly retained the gold certificate reserve requirements as to circulating Federal Reserve notes; H.R. 7601 would repeal them for about six-sevenths of the notes now in circulation. Public Law 89-49 increased the temporary debt limit by \$4 billion to \$328 billion, while maintaining the permanent debt limit at \$285 billion; H.R. 7601 in effect would raise both the permanent debt limit and the temporary ceiling by \$30 billion.

The Congress is, of course, entitled to change its mind about these matters. It is conceivable that—with self-restraint on the part of everyone—sound monetary and fiscal policies could be maintained without any constraints in law. But traditionally, at least, the American people and their elected representatives have felt that the chances of success in their endeavor to keep the dollar sound are enhanced by some limitations on the discretion of those who are entrusted with monetary and fiscal operations.

In my judgment, the provisions of existing law with respect to the issuance and collateralization of our currency are well designed to avoid misunderstanding and mistrust.

In essence, these provisions insure that the Federal Reserve banks will hold highly marketable assets equal in value to the liabilities they propose to incur by issuing currency. Interest-bearing U.S. Govern-

ment bonds, which were sold in the first instance to willing buyers in the open market, make up over three-fourths of this collateral, as I have mentioned.

Among its advantages, this requirement serves to keep the function of maintaining the supply of currency needed to meet the needs of commerce, industry, and agriculture—and such profit or loss as may accrue to the Government in the performance of this function—entirely separate from the function of financing such deficits as may arise as a result of Government expenditures in excess of current receipts (and the cost of this borrowing).

In other words, this arrangement is one element in a framework of safeguards designed to assure people who use and hold dollars that their value will not be depreciated by the creation of additional money to finance the Federal Government's deficits. Put another way, it means that deficits must be financed by market borrowing, in which the credit of the U.S. Government in the eyes of our own citizens is continuously put to the test, so that any deterioration in that credit is immediately evident for all to see. It means that neither the Congress, the administration, the Federal Reserve, nor the people can be deceived nor can they wishfully deceive themselves as to the financial status of their Government. I happen to think this is a very good thing.

It should be clear, at the same time, that the proposed changes would not save the taxpayer a penny. All of the interest that the Treasury pays to the Federal Reserve on the \$30 billion of securities that would be canceled is repaid by the Federal Reserve to the Treasury as interest on Federal Reserve notes. In 1964 the System received about \$1.3 billion in interest on its portfolio of Government obligations. Out of these earnings, it paid about \$200 million in operating expenses and about \$30 million in dividends on Reserve bank stock—at 6 percent, as required by statute—the balance, roughly \$1.1 billion, was turned back to the Treasury.

If the System's portfolio were reduced by \$30 billion, the System's payments to the Treasury would be reduced by precisely the amount that the Treasury "saved" in interest payments on the securities involved. This is because the System's remaining income would be enough to meet expenses and dividends, with a little left over for payments to the Treasury. But, of course, what was left over would be \$1.1 billion less than it would be today. So the Treasury—and the taxpayers—would come out even.

In my opinion, the bill before you would serve no useful purpose and it could lead to serious damage to our financial position. On behalf of the Board of Governors, I recommend against enactment of H.R. 7601. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Martin, do you speak for the entire Board of Governors?

Mr. MARTIN. I speak for the entire Board of Governors.

The CHAIRMAN. Unanimous decision?

Mr. MARTIN. What's that?

The CHAIRMAN. Unanimous decision?

Mr. MARTIN. Unanimous.

The CHAIRMAN. What about the Open Market Committee? Do you speak for them?

Mr. MARTIN. I have no hesitation in speaking for the Open Market Committee, though this bill was not formally put in front of them.

The CHAIRMAN. Of course, naturally, the only additional members of the Open Market Committee other than the Board of Governors are the five presidents of Federal Reserve banks who were selected by representatives of the private banks. Naturally, they would go along. You would expect them to.

Now, Mr. Martin, the Open Market Committee was created under the law of 1935; that is correct, is it not?

Mr. MARTIN. That is correct.

The CHAIRMAN. And there is no guideline of any kind, there are no limitations, no restrictions of any kind on the power of the Federal Open Market Committee, is that correct?

Mr. MARTIN. The Federal Reserve Act is very clear. You have read it many times.

The CHAIRMAN. Just a minute. Let's confine it to the Open Market Committee. Mention one limitation or restriction placed upon the Federal Open Market Committee in that act.

Mr. MARTIN. They were given the discretion to operate in the open market account.

The CHAIRMAN. Discretion? Where is that language? Show the language to me.

Mr. MARTIN. I have no language in front of me, Mr. Patman. But you can get a copy of the bill and read it.

The CHAIRMAN. Now, you have here in your statement that the American people and their elected representatives have felt that the chance of success in their endeavor to keep the dollar sound are enhanced by some limitations on the discretion of those who are entrusted with monetary and fiscal operations. But there are no limitations. You say they should have it, but there is none.

Mr. MARTIN. Well, Mr. Patman, you are familiar with the requirements, you are familiar with the law, the 25 percent I spelled out.

The CHAIRMAN. I am talking about the Federal Open Market Committee, Mr. Martin.

Mr. MARTIN. This applies to them as well as to everybody else.

The CHAIRMAN. The Federal Open Market Committee has unlimited power to buy bonds with Government credit and money. They can even buy the entire national debt. That would be possible, would it not?

Mr. MARTIN. They have to keep within the——

The CHAIRMAN. I say it would be possible.

Mr. MARTIN. They have to keep—against those notes, they will have to meet these requirements.

The CHAIRMAN. Now, you have testified before that in the open market operations which are performed in the Federal Reserve Bank of New York, you in effect trade one form of Government obligation for another form of Government obligation, do you not?

Mr. MARTIN. How do you mean, trade?

The CHAIRMAN. You have testified on this a number of times in the past. I have asked you and Mr. Eccles before you. You have testified that you buy these U.S. Government bonds with Government credit. The Government credit is paid by the use of Federal Reserve notes. That is the only way you have of paying it, isn't it?

Mr. MARTIN. There is a very good description of this process in the very able hearings that you conducted in 1952, which I think would be—

The CHAIRMAN. Yes, you made this statement during the 1952 hearings and at other times.

Mr. MARTIN. It would be a good idea to put those in the record.

The CHAIRMAN. Of course, it is quite a volume, several volumes.

Mr. MARTIN. I think these hearings have constituted a number of volumes throughout the years.

The CHAIRMAN. Yes, and the effect is, and you have testified to it, Mr. Eccles testified to it, and others over the years, that you trade one form of Government obligation for another form of Government obligation. How many times do you expect the people to pay their national debt? Now, you want them to pay it twice or three times or four times. If your policy prevails, there is no limit to the number of times the people will have to pay their national debt.

Now, in 1959, you came before Congress—you had Mr. Balderston up here for you. He came with your sanction and consent, did he not? He was Vice Chairman of the Board.

Mr. MARTIN. In 1959?

The CHAIRMAN. Yes.

Mr. MARTIN. Whenever he has been up here, he has—

The CHAIRMAN. On the vault cash bill. And then you asked us to pass a law which would permit you to transfer \$15 billion of U.S. Government bonds—you held \$24 billion of them in the portfolio—to transfer \$15 billion of them without cost to the banks, to the private commercial banks by making a change in the reserve requirements that would permit them to do it. In your statement, you said the Federal Reserve did not need them and there was no chance in the foreseeable future that they would be needed. You would have \$9 billion left there for flexibility in open market operations if you needed them, which you considered enough, and you wanted to give the rest to the private commercial banks. That is a fact, is it not?

Mr. MARTIN. We did not want to give them to the banks, but we were advocating at that time a change in the reserve requirements for lower reserve requirements, which is part of the discretionary authority contained in the Federal Reserve Act.

The CHAIRMAN. And the effect of it would have been to transfer those \$15 billion in bonds to the banks without cost to the banks, is it not?

Mr. MARTIN. That is correct; the banks could use the freed reserves to buy bonds, but that does not mean they would get them free of charge.

The CHAIRMAN. That is correct about the freed reserves, but let's tie that down right there. It did not cost them a penny.

Now, then, you wanted to give them \$15 billion without cost and let them not only draw the interest on it instead of the Government getting it, but you would require the people to pay those bonds again when they become due, would you not?

Mr. MARTIN. No, there is no double payment.

The CHAIRMAN. Well, how would you get out of paying for them? If you had transferred those \$15 billion to the banks at that time, how would you keep the American people from paying for it twice?

Mr. MARTIN. There is no paying twice, Mr. Patman.

The CHAIRMAN. Let's stay with the \$15 billion.

Mr. MARTIN. Well, why don't we finance the whole Government by simply issuing bonds and forgetting about paying out?

The CHAIRMAN. You are trying to confuse the issue.

Mr. MARTIN. No, you are the one trying to confuse the issue.

The CHAIRMAN. Do not try to confuse the issue. Let us stay with the \$15 billion. You said they ought to be transferred to private banks, they needed them, the Federal Government did not need them. You were advocating when interest was paid on those bonds, instead of going over to the Treasury as it does now, you were advocating that it go over into the private profits of the commercial banks.

Now, if you had been successful in doing that, and you came mighty near doing it, had it not been for a few of us making legislative history against it, I think it would have been done. But you did not transfer them over.

But suppose you had. If you had, the banks would have gotten the interest on those bonds, would they not? That is correct, is it not?

Mr. MARTIN. The banks would get the interest on the bonds, but I deny your entire thesis, Mr. Patman, and I shall be glad to prepare a paper on it.

The CHAIRMAN. Let's take it a part at a time.

You say now they would have gotten the interest. Now, then, who would have paid those bonds when they were due? The taxpayers would have paid it, would they not?

Mr. MARTIN. Are you suggesting on this \$1.3 billion and the Open Market Committee—

The CHAIRMAN. You are getting off the trail again.

Mr. MARTIN. You and I have been around this labyrinth many times.

The CHAIRMAN. That is the reason I know what you are doing, Mr. Martin, I have been interrogating you a long time and I can see your tracks.

Mr. MARTIN. You and I are old hands at this and we are very good natured about it.

The CHAIRMAN. We have good fox hunts down in Texas and we have good dogs—good fox dogs for chasing the fox.

Mr. MARTIN. That is right.

The CHAIRMAN. And whenever a raccoon runs across the trail and a few of these dogs that are not good fox dogs chase the coon—when this happens we do not use those dogs anymore, the ones that are not good fox dogs.

Let us stay on the trail of the fox.

Mr. MARTIN. We are not on the trail in the sense that I deny there is any double payment here.

The CHAIRMAN. Well, I have not gotten to that exactly. I am getting to it, though.

Mr. MARTIN. All right, you go around the circle and get the fox cornered.

The CHAIRMAN. Those bonds should have been canceled because whenever you, if you owe a mortgage on your home, a 40-year mortgage, the people who hold it say, "I would rather have a 30-day

mortgage," and you give them a 30-day mortgage, are you not going to get that 40-year mortgage and tear it up right quick? You do not want both of them out.

Here you are letting both of them stay out, the Federal Reserve notes which are Government obligations, and also the bonds are not canceled.

I want to know what language is needed in this bill, if any, that will permit the cancellation of these bonds? If there is any language this bill is lacking, as a trustee—you say you are—for the administration of the Government's monetary policy, do you not think you ought to suggest the language to us?

Mr. MARTIN. I have no language to suggest that would clear up the labyrinth you have gotten yourself in, Mr. Patman.

The CHAIRMAN. Gotten myself in? I think you have gotten yourself in it.

Mr. MARTIN. When a commercial bank, Mr. Patman, wants to get Federal Reserve notes, it goes to a Federal Reserve bank and its account is charged for those notes. There is no double payment involved.

The CHAIRMAN. I understand that.

Mr. MARTIN. The collateral here is gold certificates—

Mr. MULTER. May I respectfully suggest, some of the older members on this committee have heard this time and time again.

The CHAIRMAN. No, you have not.

Mr. MULTER. The new members have not had that opportunity. I think Mr. Martin ought to be given an opportunity to answer each of these questions in full.

The CHAIRMAN. Why, certainly. I think I should have an opportunity to ask a question.

Mr. MULTER. I agree, but I think Mr. Martin ought to be permitted to answer the questions fully. These questions cannot be answered categorically yes or no. If he has not answered your question fully or properly or has evaded it, then continue, but I think he should be given an opportunity to make a complete answer to each question before putting another question.

The CHAIRMAN. He will have plenty of time, running on into the night and Saturdays and Sundays if needed.

Mr. MARTIN. I shall be glad to give you a written answer to this question, Mr. Patman.

(This material was subsequently supplied; see p. 24.)

The CHAIRMAN. On page 221 of the hearings you spoke of, you carry these Federal Reserve notes as liabilities of the Federal Reserve banks. They are secondary liabilities of the Federal Reserve banks, but primarily, they are liabilities of the U.S. Government, are they not, Mr. Martin?

Mr. MARTIN. They are indeed, obligations of the United States—

The CHAIRMAN. Primarily they are obligations of the U.S. Government. They are indeed.

Well, how would the U.S. Government be helped by putting up double the amount of bonds? You say that these bonds will be put up in addition to the currency. Why would that help anybody? You see the U.S. Government guarantees these Federal Reserve notes which are a Government obligation just exactly the same as bonds, except

they do not provide interest. So how would they be helped by also putting up bonds?

Mr. MARTIN. As I pointed out, in order to maintain the credit of the United States provisions were made for collateralization. The collateralization consists of gold certificates and Government securities. I simply want to point out that there is no double payment here. If you can just cancel this collateral, let's just cancel the whole debt. Let's not worry about any of it.

The CHAIRMAN. How would you consider the \$15 billion bonds? Were they canceled? No, they were not canceled. They were to be transferred over to private profit organizations and the interest collected on the bonds again.

Mr. MARTIN. You are confusing things, Mr. Patman. The same liability remained on the \$15 billion as remains on any other Government securities. The problem of money here is simply one of how it is issued. I simply say that there is no double payment here or no double liability. This is purely a matter of collateralizing for these notes.

The CHAIRMAN. What do you propose to do with these bonds if you are not going to cancel them? You have enough bonds there to cause 10 depressions if you were to put them on the market. You certainly do not intend to put them on the market, although you could.

This is just what bothered me about your June 1 speech, not only what you said but, in addition, to the other powers you have. That is what scares me and scares a lot of other folks and I suspect influenced the stock market a lot, too, caused it to take a nosedive. You have the power to put this into effect. You have enough bonds there to cause 10 depressions.

Now, then, what are you going to do with all those bonds? Naturally, as the country grows and as the need for reserves for the banks increases, you have to create more reserves and you will buy more bonds. You first induced Congress to let the banks use vault cash, which obviously shows that you wanted all profits to go to the banks at the expense of the people. You could have bought \$2 billion worth of bonds and served the same purpose and then the interest on those bonds would have gone into the Treasury. But you preferred to talk Congress into permitting the banks to use vault cash, which they did. Now, then, the banks count their vault cash as reserves. If the Fed buys bonds, more bonds are going to accumulate; first thing you know, you will have \$100 billion worth of bonds. What are you going to do with those bonds?

Mr. MARTIN. I think it is rather interesting that during this year, for example, the banks have tended to dispose of their bonds and bank credit has increased by nearly \$2 billion since the first of the year.

The CHAIRMAN. Yes, and you know what they are doing with that money? Just like one time you gave the banks additional reserves to have a business expansion of \$10 billion and they put every bit of it in Government bonds, none of it in business expansion. That was in 1958.

Now, then, as the commercial banks sell Government bonds, you know what they put the funds in. They put it in tax exempt bonds.

You know the commercial banks have the power to manufacture money. They manufacture money on the credit of the Nation. And

for them to buy any kind of long-term bonds I think is clearly out of order. It was never intended that a bank should be allowed to use the Government's credit free and buy long-term bonds. It was never intended. But now not only are they buying long-term bonds, but they are buying long-term tax exempt bonds with the Government's credit, and, in addition, they pay no taxes on them. A 3.5-percent bond is equal to 7.2 in returns. So that is what they are doing with it, Mr. Martin.

Mr. MARTIN. Business loans by commercial banks have increased in the first half of 1965 at an annual rate of 23 percent and the U.S. Government securities held by the banks have gone down at an annual rate of 12 percent.

The CHAIRMAN. Sure they have gone down, because they are putting them in tax exempt bonds. Don't you think you ought to do something about that?

Mr. MARTIN. I have testified against tax exemption. That is an entirely different subject and does not relate to this.

The CHAIRMAN. Yes; what disturbs me is this. We had hearings last week here on the supervisory agencies. We have three supervisory agencies: the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, FDIC. And you know, every one of them has gotten out from under the Government. They claim to be independent. When they get their own money, as they all do—without going through the appropriation process—the first thing they say is that they are independent of the Government. They have gotten to be independent, all three of these supervisory agencies.

The facts are that the public, the people have no protection.

Having studied these three supervisory agencies in detail, yours and the other two, I find you never bring any suit or you never punish any bank for charging usurious interest or extortionate rates of interest. You never say anything about it. When you catch them charging excessive service charges, you do not say anything about it, you just keep it quiet.

The same way with the other agencies. The people have no protection from these supervisory agencies for the simple and only reason that they are bypassing Congress contrary to the Constitution, absolutely unconstitutional, and they are thumbing their nose at Congress, saying, "We are going our own way, we are independent, we are not paying any attention to Congress, therefore, Congress cannot make us protect the rights of the people; we serve the banks." That is what is going on in this country.

You take for instance in that hearing that you talked about. On page 538, I believe it is 536—Mr. Sproul said about this independence—he was president of the Federal Reserve Bank of New York for about 14 years, was he not?

Mr. MARTIN. He was.

The CHAIRMAN. Of course, as president of that bank, he really controlled the Federal Reserve System. The rest of the System does not count for anything. They have no power.

Mr. MARTIN. That is your interpretation.

The CHAIRMAN. Well, we shall proceed to determine whether or not it is true. They have nine directors of that board. Six of them are elected by private banks, are they not?

Mr. MARTIN. They are.

The CHAIRMAN. Six of them run it. They elect the president. The president is selected by representatives of the private banks, because six out of nine are selected by them. Now, then, all the purchasers of Government bonds are made there in the New York Federal Reserve Bank. They have \$38.5 billion in bonds there. Is anybody under bond for these bonds, Mr. Martin?

Mr. MARTIN. Do you suggest that the other members of the Open Market Committee have no influence?

The CHAIRMAN. You will recall that when the law was changed in 1935, the president of the New York Federal Reserve Bank was given complete power and control over the bank and all its personnel and operations. This same president also directs the entire open market operation. All of it is done right there in the New York bank under that one roof. And the other 11 banks do not even know their condition until they get word from the New York bank. The bookkeeping is kept there, the money is kept there, the bonds are kept there. The other 11 banks do not even know their condition until the New York bank tells them.

Mr. MARTIN. You mean we are wasting our time every 3 weeks when we have a meeting, that we really do not have to have a meeting?

The CHAIRMAN. You mean that secret meeting down at the Federal Reserve Board?

Now, let me read you the law, and let's see who has charge of this Federal Reserve Bank in New York. It says, "The President"—that is Mr. Hayes—" * * * shall be the chief executive officer of the bank and shall be appointed by the Board of Directors with the approval of the Board of Governors of the Federal Reserve System for a term of 5 years and all other executive officers and all employees of the bank shall be directly responsible to him."

That is the law, Mr. Martin. Therefore, your Open Market Committee is being administered under that roof—that is, in the charge of a man who is selected by the private banks of New York. They have control of that \$38.5 billion. They have complete control of the Open Market Committee. All the employees of the Open Market Committee are employees of that bank. Is that a fact or not?

Mr. MARTIN. I think if your premise is correct, we should really disband the Federal Reserve System.

The CHAIRMAN. Just answer the question. Don't change the subject. You are getting off on a coon trail.

Mr. MARTIN. No, I am not changing the subject. It is directly on the subject.

The CHAIRMAN. No, it is not.

Mr. MARTIN. The Federal Reserve Bank of New York is subordinated to the Federal Reserve Board in Washington.

The CHAIRMAN. But the law states differently. The law says that the president shall have charge of that bank and all the officers, executive officers, and they use the phrase "and all employees" shall be directly responsible to him. This is the law.

Mr. MARTIN. Mr. Patman, I have with me Mr. Noyes, who is an employee of the Federal Open Market Committee.

The CHAIRMAN. We do not need Mr. Noyes, we need the Chairman of the Board.

Mr. MARTIN. He is not with the Federal Reserve Bank of New York. Some of the people who have been suggested for president of that bank have been turned down by the Federal Reserve Board. We jointly, with the directors of the Federal Reserve Bank in New York, select the president and the president could be—his salary could be stopped by us tomorrow.

The CHAIRMAN. The law does not say that.

Mr. MARTIN. We have complete control.

The CHAIRMAN. You cannot get rid of Hayes tomorrow. There is no way you can get rid of him. He is going into international affairs now. He is getting out statements that the Board ought to be getting out and you cannot do anything about it, because the law is against you, Mr. Martin.

Mr. MARTIN. The law is not against us. The law was changed in 1935 because Senator Glass and others were quite upset by the Federal Reserve Bank of New York's role and the Federal Reserve Bank of New York was completely subordinated to the Federal Reserve Board and no officer of the Federal Reserve Bank of New York could go abroad if we disapproved.

The CHAIRMAN. Then where did I get the language and what does it mean?

Mr. MARTIN. I do not know where you got it.

The CHAIRMAN. I will guarantee you it is the law. There is no question about it.

Mr. MARTIN. I will guarantee you the law says the Board shall have general jurisdiction over Federal Reserve banks. Let's look the law up because there is no point in quarreling about this.

The CHAIRMAN. That is in the 1913 act. I am talking about the 1935 act. The law was changed.

Mr. TALCOTT. Mr. Chairman, where are you reading from?

The CHAIRMAN. This was copied from the law.

Mr. TALCOTT. Which law, the Constitution of the United States or the regulations of the banking—

The CHAIRMAN. Just a minute. Let me pursue this and turn this book over to you.

You know, this matter of Federal Reserve independence—we never heard much of that until the last few years. The Fed is trying to make it come true just by saying it is so. You know, like that other riddle, suppose a dog's tail was a leg, how many legs would he have? The answer is he would still have four legs because you cannot call a tail a leg and make it a leg. They keep on calling it independence, but it is not independence.

In this hearing you are talking about, Mr. Martin, questions were asked Mr. Sproul, who was president of the Federal Reserve Bank of New York at the time, about this independence of the Federal Reserve. He said:

As I tried to indicate, you cannot be dogmatic, you cannot be sure you are right. There was a question of the large debt and huge refundings and so forth. We had to exhaust all the possibilities of agreed-upon action. But when we came to August 18, 1950—

you see, you have been talking about March 4, 1951, all the time, for independence. This is Sproul. He said:

When we came to August 18, 1950, when the situation appeared to us, seemed to us to be so clear that there could be very little reason for doubt, we then did

take action. It was not in March 1951, it was in August 1950, when we decided to go our own way—

that is Sproul, said we—that is the Board. Open market credit—

despite what the Treasury had done with respect to the terms of financing and took the risk involved in that decision.

Therefore, you seceded from the Government on August 18, 1950. There was a revolution. I say that respectfully. I do not call you Castro or anything like that. But it was a revolutionary act.

Mr. MARTIN. It's not important, Mr. Patman, but I was Assistant Secretary of the Treasury at that particular time.

The CHAIRMAN. I know you were, and for some unknown reason, you got to be the Chairman of the Board of the Fed. This so-called accord that you got was not any accord at all. Because when you have accord, all the parties have to agree. The President has the power to fix interest rates on long-term bonds. That is right; is it not?

Mr. MARTIN. Yes, sir.

The CHAIRMAN. All right, we will drive down a peg there. The President was not a party to that accord, was he?

Mr. MARTIN. The President was a party to that accord.

The CHAIRMAN. How could he be a party to it when he called you fellows in there and gave you a scolding? I mean the Board? He said you have no business making out like you are going to break these—

Mr. MARTIN. I say respectfully that I was closer to that incident than you or any other member of this committee.

The CHAIRMAN. Now how could you have gotten to be Chairman of the Board in view of those circumstances?

Mr. MARTIN. I do not know how I came to be Chairman of the Board. That is a different story. But I can assure you the accord was legitimately negotiated. There were Federal Reserve participants and Treasury participants. You have been over that many times.

The CHAIRMAN. I know the record.

Mr. MARTIN. I again refer you to volume 1 that you have up there—part 1, Senate Document No. 123, 82d Congress, 2d session. I think it gives the statement clearly.

The CHAIRMAN. Then I asked Mr. Sproul this question. I was pursuing this, because I knew the whole intent was to raise interest rates on the people. I asked Mr. Sproul:

Specifically with reference to interest rates, you expected Government rates to rise?

Mr. SPROUL. Yes.

That was in those hearings. So the whole Federal Reserve, all these years, has been increasing the burdens on the people in interest rates. During the Eisenhower administration, interest rates were raised until today, if they had been kept as they were in 1952, under the Roosevelt-Truman rates, our national debt today would be \$40 billion less and our interest rates annually would be \$6 billion less. So that is what high interest has amounted to in this country. High interest rates are bad for the country. The Federal Reserve all along has been in favor of higher and higher and higher interest rates.

Back to the legislation at hand; how in the world can you say that it is all right—under your vault cash proposal—to transfer these bonds to the private banks free of charge and let them collect interest and collect the bonds again, but if it is proposed that the people get the benefit of it by canceling the bonds because they have been paid once, you scream to high heaven and say it is all kinds of inflation and printing press money and everything else? I cannot see the reasoning or the logic of your argument, Mr. Martin.

Mr. MARTIN. Mr. Patman, let me respectfully say that you have a tendency to exaggerate these things. I notice in one of your statements, you say the Fed is the root of all financial evil. That is a pretty strong statement.

The CHAIRMAN. I think it is and I think it is justified.

Mr. MARTIN. I really think that it is a slight exaggeration.

The CHAIRMAN. I believe it is justified and proven. You have taken over the power of buying Government—

Mr. MARTIN. Do you—

The CHAIRMAN. Let me finish this and then I will let you.

You take our Bureau of Engraving and Printing money over here and trade it for Government obligations bearing interest and you collect the interest of \$1.3 billion a year. You spend that money without the benefit of Congress review, you bypass Congress, thumbing your nose at them if you want to, and spend it any way you want to. The remainder of what you don't spend goes to the Treasury. Then you say these bonds—which are Government obligations and which have been paid for with other Government obligations—should be paid for by the people again, after they have been paid for once. That is something I cannot understand, Mr. Martin. If you can make us pay for them twice, you can sell them in the market again, buy them back one time, twice, three times, four times, five times, and make us pay our debts five times. It is possible under current procedure.

Mr. MARTIN. I can assure you if it were as easy as you say it is, it would have been done long ago. But let me ask you this question.

The CHAIRMAN. Why would you have done that long ago?

Mr. MARTIN. Why would we have wasted our time having all these meetings? We have the Federal Reserve Bank of New York that can do it all. We do not need all the other 11 banks.

The CHAIRMAN. These meetings do not consist of too much.

Mr. MARTIN. Do you contend that the Federal Reserve Act is unconstitutional?

The CHAIRMAN. No, I do not contend it is unconstitutional, but I insist the Constitution should be observed. The Congress, in passing the Federal Reserve Act, did not put you down there in President Johnson's seat for the purpose of executing the laws concerning monetary policy. You are assuming that power. You are assuming the power of controlling the monetary system contrary to the Constitution. The Constitution is very clear that the Executive executes the laws, the President of the United States, not William McChesney Martin.

Now, the Congress makes the laws and you are a servant of Congress. That is right, is it not?

Mr. MARTIN. That is right. I am a servant of Congress.

The CHAIRMAN. You have admitted that before.

Mr. MARTIN. I cannot take you seriously when you say that the Fed is the root of all financial evil. Do you really mean that seriously?

The CHAIRMAN. I would change that to this extent—not every little old financial evil, but all the major ones.

Mr. MARTIN. I am glad I can get a concession out of you, anyhow.

The CHAIRMAN. Yes, sir. It is not much of a concession.

All the major financial evils. This is so because the bankers have gotten control of the Fed and they are running the System like they want it run. They are imposing interest burdens on the people that are substantially too high. There has to be a limit to it.

Now, the banks and bankers—I do not see any reason why you should be so happy with them. Certainly we want a good private banking system. But it has not been as it should be. But we have had a profitable banking system, which we all must admit we must have. I am strongly in favor of a profitable banking system. That is the only kind that would be any good. But there is no use in just piling one subsidy on another to the banks and just giving them things that they should not have.

If you feed your dogs too well before you go hunting, they will not hunt very good. So when you keep on giving these banks all these subsidies, \$5 billion a year and everything else, it does not help the people at all—only the banks.

The American people are the captives of the banks. That is the only place that you can go if you want a checking account. You cannot get one any other place.

Furthermore, the law is that you have to give the banks the free use of your money when you want a checking account. This was written into the law in the depths of the depression. Therefore, you make the people use the banks if they want a checking account; and you deny them the right of private contract with the banks, to get a little half of 1 percent or 1 percent for that money. You make it unlawful for them to get any interest on that money.

So you are giving the banks privileges that are worth a lot and then, having all this power we find, for example, that the small business people have not been able to get credit. We had to establish agencies to help them get credit. The farmers cannot get credit. We had to establish the Farmers Credit System. The most troublesome problem here, Mr. Martin, and I hope you think about this, put this on your conscience: Here are these bankers using the credit of the Nation free of charge. If they were to pay 2 percent like the REA does, we could pay a pretty good part of the national debt each year. But they pay nothing.

Now, some enterprising young people have plans to go into business. They phone the banker, they cannot even get to see him. They file an application, no consideration. And here is a case where there is no appeal.

That poor fellow who is entitled to that credit can help his community, perhaps he could put up a small plant, something that is constructive and helpful; he cannot get any credit; cannot even get consideration of it.

Do you not think that people in a case like that, where the Government's credit is being used to allow the banks to create money, should have some right to appeal to somebody to right a wrong that has been done to him?

Mr. MARTIN. Do you think that nobody has been getting any credit in the last couple of years?

The CHAIRMAN. Yes, but—

Mr. MARTIN. Remember 2 years ago, Mr. Patman, when you told me small businesses were popping like firecrackers all over and the Martin recession was on top of us. That was just 2 years ago.

The CHAIRMAN. That was 1961?

Mr. MARTIN. Yes, 1961, 1962, 1963.

The CHAIRMAN. Let's not go too fast. In the Eisenhower administration, there were three recessions.

Mr. TALCOTT. That was in the 1950's, was it not?

Mr. MARTIN. I am talking about 1961, 1962.

The CHAIRMAN. It was 1960-61, was it not?

Mr. MARTIN. That is right.

The CHAIRMAN. That was the last one, was it not?

Mr. MARTIN. That is right.

The CHAIRMAN. Now, you told me we have had the longest period in peacetime history of prosperity without recession. Your June 1 speech is calculated to make an about-face on that.

Mr. MARTIN. Is it not true that you told me that small businesses were popping like firecrackers in 1962?

The CHAIRMAN. No, I did not know that. I think you are mistaken.

Mr. MARTIN. I think we had better look up the record.

The CHAIRMAN. Well, why were they popping? What had the Fed done to make them pop?

Mr. MARTIN. The Fed has kept them from popping. I would say on the record of the last few years, I do not think you can say that the Fed has destroyed small business—we have had a pretty good Martin recession for the last 3 years.

Mr. WIDNALL. I think I should make this suggestion, Mr. Chairman.

Mr. Martin has not actually had a chance to answer any question that has been propounded to him yet. I think for the benefit of the committee and for expediting the business of the committee, it would be well to give him time to make his answer.

The CHAIRMAN. He had a statement. He read his statement.

Mr. WIDNALL. I know he did, but you ask him a question and as he starts to answer, you ask him another question.

The CHAIRMAN. All right, go ahead and answer any question you want to, Mr. Martin.

Mr. MARTIN. I cannot really take this bill seriously that I am testifying on today, Mr. Patman, because I think it would be unfortunate to give the impression to the world that we are just going to cancel \$30 billion of Government securities. There is not any basis for it or any justification for it and it seems to me that it would be a mistake for us to take it seriously.

The CHAIRMAN. Well, please explain this, Mr. Martin. How can this proposal be a mistake when the people are getting the benefit of it by stopping interest payments and canceling debts that have al-

ready been paid once? Your logic is at fault. It was all right when you wanted to transfer the bulk of the open market portfolio to the private banks. You say that can be justified? You proposed to allow the commercial banks to count vault cash as reserves and then you were going to transfer the open market portfolio to them for nothing. Then the banks would collect the interest every year and get the payment of the bonds when they are due.

How were the people to benefit?

This proposal is wrong, you must believe, because the people would benefit. But when the banks benefit, as you proposed in the vault cash bill in 1959, then you thought it wonderful. Please explain that?

Mr. MARTIN. The people would not get any benefit from this bill. The interest that is paid on the \$30 billion is repaid to the Treasury, so canceling the obligations would not reduce the cost of servicing the debt.

Now, so far as the reduction in reserve requirements is concerned, this is to make it possible for banks to lend more money and possibly is one of the reasons that we have the great expansion in lending that we have this year. It has been made within the current framework. It seems to me the banking system has been performing well.

The CHAIRMAN. But, Mr. Martin, you said you wanted these bonds, \$15 billion of them then, which is now in a relative sense comparable to \$30 billion—you wanted them transferred to the private banks. This you proposed to do by giving the banks free reserves, allowing banks to count vault cash as reserves, and by reducing reserve requirements. Then the banks would have the necessary reserves for you to transfer to them, free, \$15 billion in Government bonds upon which they would collect the interest and principal, instead of the Government.

Mr. MARTIN. Mr. Patman, I am not up here testifying on the vault cash bill at the moment, but let me say respectfully that that was an act of Congress and not an action of the Federal Reserve Board.

The CHAIRMAN. At your request and suggestion and your recommendation.

Mr. MARTIN. But it was the Congress that enacted it.

The CHAIRMAN. Yes.

Mr. MARTIN. It was not the Federal Reserve Board.

The CHAIRMAN. And I think the Congress was wrong in passing it. I filed a dissenting opinion.

Mr. MARTIN. I am glad the Congress makes mistakes, too.

The CHAIRMAN. I know, but we stopped you on one thing. You did not transfer the Open Market Committee's portfolio to the banks because of the legislative history established.

Mr. MULLEN. Mr. Chairman, I think the record ought to show that the Federal Reserve Board, and Mr. Martin was the Chairman, for many years resisted any change in the Federal Reserve requirements.

Mr. MARTIN. That is right.

The CHAIRMAN. This was not true in 1959. You asked the Congress then to reclassify the banks so it would help the banks with lower reserves. Now, instead of 6-to-1 reserve credit creation power for the banks you have approximately 10 to 1, do you not? This is taking into account time deposits which now are almost equal to demand deposits. And on demand deposits, the highest reserve is 16.5 percent.

(The following table was inserted in the record by Mr. Patman :)

Demand and time deposits for Reserve city banks and other banks, and average weighted reserve ratio required by the combined total of deposits

	Member banks deposits and reserves, Apr. 28, 1965					
	Deposits in billions of dollars			Required reserves percent of deposits		
	Demand	Time	Total	Demand	Time	Weighted
Reserve city.....	68.5	63.1	131.6	16.5	4	10.5
Country.....	49.0	47.2	96.3	12.0	4	8.1
Total.....	117.6	110.3	227.9	14.6	4	9.5

Mr. MARTIN. If you average it out.

The CHAIRMAN. And the time deposits are 4 percent. Whenever you put the 4 with the 16 or the 12, half of that is much less than 10. It is about 9.5. So you could issue more than 10 to 1 on every dollar of reserve; can you not, Mr. Martin?

Mr. MARTIN. We can put the figures in the record, Mr. Patman. But the time deposits—what is it, 4 percent against time deposits now?

The CHAIRMAN. That is it, that is uniform.

Mr. MARTIN. Against demand deposits, Reserve city banks must maintain 16.5 percent reserves and country banks 12 percent. For time deposits, it is 4 percent.

The CHAIRMAN. Let me use the word "commingle." They commingle this for reserve purposes. And that is by regulation of the Federal Reserve, I assume.

Mr. MARTIN. According to this table, the money supply in the first half of the year, including time deposits, went up at an annual rate of 7.9 percent. Excluding time deposits, it was 2.5 percent.

The CHAIRMAN. Let me read to you this conference report that stopped you from transferring the \$15 billion. You wanted transfer of them. You had it in your heart to do it. But we stopped you. Here is the language that stopped you.

Mr. MARTIN. Mr. Patman, you can psychoanalyze me better than any psychiatrist I ever ran into. I do not know what was in my mind at that time.

Mr. MULTER. Is this still the \$15 billion that they did not do anything about?

The CHAIRMAN. That they did not transfer. This is the reason they did not transfer it. We made legislative history then that stopped them.

You will recall the House and Senate had a conference on the vault cash bill. We put in the conference report to the House the last paragraph here—the statement is by the managers on the part of the House—that—

During the debate on this bill in the House, questions were raised as to whether the purpose of this bill was to transfer Government securities held by the Federal Reserve banks to privately owned commercial banks. To avoid any possible misunderstanding on this, the managers on the part of the House wished to emphasize that it is not the intent of this legislation to encourage or cause the Federal Open Market Committee to reduce the Federal Reserve System's hold-

ings of Government securities. As was made clear in the House debate, the purpose of this bill is simply to make needed reforms in the structure of the reserve requirements.

That is what stopped you, Mr. Martin. You could not do it then, because legislative intent stopped you from what you wanted to do.

Mr. MULTER. What does that \$15 billion that was not transferred have to do with this \$38 billion in this bill?

Mr. MARTIN. Not a thing.

The CHAIRMAN. It shows that they were willing to transfer it to help the banks and that was all right, no questions raised. But if you try to transfer it to help the people, then they are not for it. That is the difference. One side is the banks, the other side is the people. It is just that clear.

Mr. MULTER. It is perfectly not clear to me, Mr. Chairman. I wish someone would explain it to me.

The CHAIRMAN. Well, I think it is pretty clear that the Federal Reserve was perfectly willing to take \$15 billion of this portfolio of \$24 billion at that time and transfer it to the commercial banks without cost to them by manipulating reserve requirements and counting vault cash as reserves. The banks were to get that \$15 billion without any cost to them at all. Then on those \$15 billion in bonds, they would collect the interest; then they would collect the principal on the bonds when they became due.

Now, then, we have a bill here in which, instead of transferring \$30 billion in bonds to the banks, we are canceling \$30 billion in bonds because it has been paid for once. Mr. Martin raises all kinds of objections, he said it would upset the whole country and the Federal Reserve System and everything else. As long as it is helping the banks, it is OK, fine, wonderful. But if it is helping the taxpayers or the people, it is just no.

Mr. MULTER. What I do not see is that if some years ago we should not have transferred and did not transfer \$15 billion of bonds, why does that mean that we should now cancel \$30 billion of bonds?

The CHAIRMAN. Because we should never have talked about transferring the \$15 billion, we should have talked about canceling them at the time. Canceling the bonds is right because they have been paid for once.

Mr. MARTIN. Whenever we have reduced the reserve requirements the banks have had more funds that they could use to buy more Government securities. Unquestionably, this has happened.

The CHAIRMAN. Of course, the practical effect would have been, Mr. Martin, you could have reduced the reserve requirements, yes. You would have, as you said in your statement, that you would reduce the reserve requirements and permit the banks to buy these \$15 billion in bonds without cost to the banks. They needed the money; the Federal Reserve did not need it so your report said. That attempt shows that the Fed is looking after the banks and not the people.

If they had been looking after the people, you would have jumped at the proposition of canceling those bonds, because it would have saved the people money. You would jump at the proposition of canceling the \$30 billion because it saves the people interest and saves them a payment on a debt. It is absolutely wrong to pay your debts

twice. It is hard enough to pay your debts once. Certainly the people should not be required to pay it two or more times.

Mr. MULTER, do you have some questions?

Mr. MULTER. Mr. Chairman, are we going to have equal time?

The CHAIRMAN. We will see what happens.

Mr. MULTER. Mr. Martin, if you sell a bond or a mortgage, if one person who owns the bond or mortgage sells it to another, or a bank sells it to another bank or to an individual, does that cancel the debt?

Mr. MARTIN. No.

Mr. MULTER. And bonds and mortgages are commodities the same as any other personal property that one might deal with?

Mr. MARTIN. That is correct.

Mr. MULTER. In effect, what you do when you buy and sell your bonds, you are buying and selling a commodity?

Mr. MARTIN. Yes.

Mr. MULTER. If you were selling personal property, tangible personal property, when sold by one to another and the original seller buys it back and puts it back in stock, he does not destroy it, he holds it and sells it at a later date?

Mr. MARTIN. That is right.

Mr. MULTER. That is what you are doing, in effect, with these bonds that this bill is seeking to cancel?

Mr. MARTIN. That is right.

Mr. MULTER. Now, I would like to have you indicate to us, Mr. Martin, the independence of the Federal Reserve Board. Is it true that the act sets you up as an independent agency, responsible and responsive to the Congress?

Mr. MARTIN. That is correct. And we have stated repeatedly independence with the Government, not independent of the Government.

The CHAIRMAN. Where is that in the law, Mr. Multer?

Mr. MULTER. Is there any doubt that the Federal Reserve Board is set up as an independent agency of Government? Within the Government?

The CHAIRMAN. Where is that in the law? There is a doubt in my mind. Not only that, I do not think it is true at all.

Mr. MULTER. I thought everyone agreed that the Federal Reserve Board and the Federal Reserve banks are independent agencies within the Government.

The CHAIRMAN. No, they are not, not anymore than the Interstate Commerce Commission, the FCC, they are all created by the Congress as agencies within the Government under the Constitution.

Mr. MULTER. Is there any instance that you know of, Mr. Martin, in the history of the Federal Reserve Board or banks, when they did not act under the direction of the Congress, by laws duly enacted?

Mr. MARTIN. None that I know of.

Mr. MULTER. There have been times, of course, when Members of Congress have indicated differences of opinion. You did not follow those opinions when they did not coincide with that of the Board?

Mr. MARTIN. That is correct and I have repeatedly stated that the Congress can change the Federal Reserve Act at any time it sees fit.

Mr. MULTER. Now, the chairman referred to part of the act in questioning you and I think we ought to put it right in the record. I read

from page 42 of the Federal Reserve Act as amended to October 1961. These words I do not think have been amended since 1961. First:

No Federal Reserve bank shall engage or decline to engage in open market operations under section 14 of this Act except in accordance with the direction of any regulations adopted by the Committee. The Committee shall consider, adopt, and transmit to the several Federal Reserve banks regulations relating to the open market transactions of such banks.

That is the law, is it not?

Mr. MARTIN. That is the law.

Mr. MULTER. That is the way the Open Market Committee has been operating?

Mr. MARTIN. That is exactly the way it operates.

Mr. MULTER. If the Congress should ever see fit to enact a law which changes that, the Federal Reserve Board and the banks would be bound by it?

Mr. MARTIN. Completely bound.

Mr. MULTER. There are certain instructions set out in this act. Do you know of any time the Open Market Committee has violated those instructions?

Mr. MARTIN. None whatever. It is a matter of judgment that the Committee exercises with respect to what is the most effective way of achieving that result.

Mr. MULTER. There have been differences of opinion many times offered by individual Members of Congress and sometimes by committees, but the Congress never saw fit to change the law to take away from that Open Market Committee any of those powers or duties as imposed by the statute?

Mr. MARTIN. None whatever and there have been differences of opinion within the Open Market Committee and within the Federal Reserve Board.

The CHAIRMAN. Mr. Multer, would you yield briefly on that point?

Mr. MULTER. Surely.

The CHAIRMAN. About the Congress taking away powers, you see, you run into a lot of difficulties when you try to take away powers. In a democracy, which we think, a democracy and a republic form of government are the finest on earth, there are a lot of people who have equal power who can say "No," but there is no one who can say "Yes" and make it stick. So when you criticize Congress and leave the impression that Congress should have taken the power away under certain conditions, you are imposing a tremendous burden upon them, one that is almost impossible to get done in a democracy. As good as it is, it has that—I would not say weakness; it is probably strength. But you must take into consideration that a lot of people can say "No" all along the road but not many can say "Yes" and make it stick.

Mr. MULTER. I do not agree with that at all, because we in the Congress, under the Constitution, are charged with overseeing these agencies, the Federal Reserve Board and the Federal Reserve banks, and all the other agencies of Government, and it is our duty to change the law any time we want them to do something different. If they violate the law, it is our duty to impeach them under the impeachment power in the Constitution or go to the President and ask that they be removed. I do not know of any instance where there has been a violation of law by the Federal Reserve Board or any attempt or any mention by the chairman that the officers of the Federal Reserve bank

should be removed because they are violating the law or doing things they should not do. If they are operating under a law that is bad, let us change the law and make it good.

On the other hand, if they are violating the law, there are other actions we can take. I do not think there have been any instances yet brought to our attention, since I have been on this committee, and that goes back to 1947. I have differed with the Federal Reserve Board and Mr. Martin, too. But I respect his opinion and I hope he respects mine. I have never heard him accused of doing anything wrong or unlawful. He has followed his conscientious beliefs as to what was best for our country.

I would suggest, Mr. Martin, it is going to be a very tough job, but I would suggest that when you review this record, you take apart some of these questions that the chairman put to you one on top of another that you did not have a chance to answer and give us the answers. We have many new members on this committee who have not heard these arguments about the history of the Federal Reserve System and may not have the time to go back and read all the record. I would hope you would elaborate on the questions and—

Mr. MARTIN. I shall be glad to take the record and answer each point fully.

(The information requested follows:)

BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM,
OFFICE OF THE CHAIRMAN,
Washington, August 19, 1965.

HON. WRIGHT PATMAN,
*Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.*

DEAR MR. CHAIRMAN: At your recent hearings on H.R. 7601 I was asked to supply additional information as to transactions in Government securities, particularly with reference to whether the Federal Reserve System forces the Government to pay its debts more than once, or had advocated giving away Government securities to commercial banks.

I am attaching comments on these points for the record of your hearings. Briefly, my views are that—

(1) Interest-bearing obligations of the United States are issued by the Treasury, and can be paid off only by the Treasury;

(2) The Federal Reserve banks pay for the Government securities they buy by assuming a deposit liability to a commercial bank—not, as you have stated, by issuing Federal Reserve notes;

(3) Federal Reserve notes are direct liabilities of the Federal Reserve System, and only contingent liabilities of the Treasury.

(4) The System pays for the securities it buys, but cannot be said to pay them off unless one treats the liabilities of the System as if they were liabilities of the Treasury;

(5) Distinguishing the assets and liabilities of the System from those of the Treasury is essential to keep the credit functions of the System separate from the borrowing functions of the Treasury;

(6) Your assertion that the System in 1959 advocated giving away \$15 billion of its Government securities to commercial banks, whereas it now opposes saving taxpayers \$1.1 billion a year in interest costs by transferring \$30 billion of its securities to the Treasury, is unfounded because—

(a) the System has never advocated giving away any of its Government securities, let alone \$15 billion of them, and

(b) H.R. 7601 would not save the taxpayers a penny.

The attached comments open with a case history of a U.S. Government security, as requested by several members of the committee, that provides a background for the other comments that follow.

Sincerely yours,

WM. MCC. MARTIN, JR.

ATTACHMENT 1

A CASE HISTORY OF A U.S. GOVERNMENT SECURITY

The U.S. Treasury issues interest-bearing obligations of the U.S. Government, either for cash, when it needs money to cover current expenditures, or to finance maturing obligations as they come due. There are usually special provisions in the case of a refinancing which permit holders of the maturing securities to exchange their holdings for the newly issued securities. Hence, for the sake of simplicity, let us consider only the case where the securities are being sold to raise new cash.

Such securities are sold to the public—in the broadest sense of the word. Anyone may subscribe. If—as is practically always the case—total subscriptions exceed the amount offered, the available securities are allotted by the Treasury. Smaller subscribers are usually allotted 100 percent and the remainder is divided pro rata among the larger subscribers. There are no fees or commissions in connection with these offerings. A buyer may subscribe through his bank, as a matter of convenience, or he may go directly to a Federal Reserve bank, if he prefers.

Let us assume that the XYZ Insurance Co. purchased a $4\frac{1}{4}$ percent, 20-year \$100,000 bond in such an offering. It would, of course, get the bond; its account at its bank would be debited \$100,000; and, in turn, the bank's account at the Federal Reserve would likewise be debited and the account of the U.S. Treasury credited. The Treasury could then draw checks on this account to make the payments for which it borrowed in the first instance, so that the money would finally end up in the account of someone who had sold goods to or performed services for the Government.

At this point, the net change is that the insurance company has given up cash in exchange for a promise from the Treasury to repay in 20 years, with interest, and the Treasury has discharged a debt for which payment was due and taken on an obligation to pay in 20 years, with interest.

Government bonds of this sort, as distinct from savings bonds, are completely negotiable. Anyone can sell them anytime to anybody at any price. They are also widely used as collateral for loans.

They may be sold directly by one individual to another, by a bank to an individual, or they may move through the hands of a dealer who specializes in buying and selling these securities. Unlike stockbrokers, these dealers do not charge a commission. They hope to cover their expenses and make a profit from the spread between the prices at which they buy and those at which they sell, and sometimes from the fact that the yield on the securities they carry in inventory is higher than the cost of the money they have to borrow in order to carry them.

There are no restrictions on entry into this business and no license is required. The only requirements are that the dealer have enough capital so that those who do business with him can be confident he will be able to honor his commitments and that he is prepared, in fact, to "make a market" in Government securities. The Federal Reserve Bank of New York, as agent for the Open Market Committee, will buy from or sell to any dealer who meets these qualifications.

Thus, if the XYZ Insurance Co. wishes to sell its Government bond, say to make a mortgage loan or to pay a beneficiary, it can sell to anyone it chooses for the best price it can get. This may be more or less than \$100,000, depending on the yields on alternative investments at the time it sells. It is possible, perhaps likely, that it can do better by selling to a dealer than to any other purchasers it can readily locate. So, it sells to the ABC Securities Co. Since no dealer ordinarily has enough capital to carry his entire inventory, ABC would, in all likelihood, pledge the bond as security for a loan from its bank, using the proceeds of the loan, in effect to pay XYZ Insurance Co.

The dealer now has the bond, along with many others, "in stock" and he is constantly in touch with customers who are interested in investing part of their resources in Government bonds. He may sell it again in a few minutes, a few days, or may hold it for some months.

Now, for reasons which are set forth in various readily available publications (e.g., the Federal Reserve System—Purposes and Functions), from time to time

the Federal Reserve System buys Government securities to inject funds into the economy or sells them to absorb funds that would otherwise constitute an oversupply. Generally, these transactions are in Treasury bills, with maturities of 1 year or less, but on occasion the System does buy or sell longer term coupon issues. Thus the "desk" at the New York Federal Reserve Bank, which trades for the System account, might decide to buy bonds while the \$100,000 bond was being offered for sale by ABC Securities Co. Accordingly, ABC's bond might be included in a package to be sold to the System. In this case, ABC would have the bond released from its collateral account at its bank by paying off a corresponding part of its loan or substituting another bond so that the released bond could be delivered to the Federal Reserve bank. The Reserve bank would pay for the bond by crediting the reserve account of a commercial bank designated by ABC, and this bank would, in turn, credit ABC's checking account. There would, of course, be no change in the Treasury's account, since this time the Treasury played no part in the transaction.

The securities acquired for the open market account are allocated among the 12 Federal Reserve banks; let us assume that the \$100,000 bond ends up in the account of the Federal Reserve Bank of Minneapolis. In order to include a transaction that is closely related to H.R. 7601, let us assume that at about the same time the Federal Reserve Bank of Minneapolis is anticipating that member banks in its district will be calling on it for more currency to meet the needs of individuals and businesses in its area. It could decide to use this bond as part of the 100-percent collateral it is required to post for every Federal Reserve note it issues. In this case, the bond would go over into the Federal Reserve agent's account, where it would have to remain as collateral as long as the corresponding Federal Reserve notes were in circulation. Of course, this specific bond could be withdrawn and another substituted for it. The currency issued to the commercial banks would be charged to their reserve accounts when it was issued.

Nowhere in this process has the bond been paid off.

At some stage, let us assume, as happens after the Christmas holidays, less currency is needed in the Minneapolis district. Banks return to the Reserve bank the currency that is no longer needed and, in return, gets credit for it in their accounts. The Reserve bank can "retire" the currency (Federal Reserve notes) thus turned in and get back from the Federal Reserve agent's account the bond it had posted as collateral for these notes. About the same time the Open Market Committee may decide that economic conditions require sale of some of the System's bond holdings to reduce reserves of member banks. The bond it had purchased from the ABC Securities Co. may be in a package sold back to ABC. ABC pays for securities through its checking account at its bank, and that bank's reserve account is charged the same amount; reserves are reduced, just as they were increased when the System bought. Finally, let us say that ABC sells the bond to MNO pension fund, which holds it for the remainder of its life.

At maturity MNO can present the bond at any Federal Reserve bank for redemption. As agent for the Treasury, the Reserve bank will give MNO a check drawn on the Treasurer of the United States, which MNO will deposit in its bank. The bank will present the check to the Reserve bank for credit to its reserve account, and the Reserve bank will charge the amount of the check to the same Treasury account it credited when the bond was originally sold to XYZ Insurance Co. The bond is then paid off, for the first and last time.

During its lifetime, interest, represented by coupons attached to the bond, falls due. This interest goes to the legal owner of the bond at the time—whether he is an individual, a bank, an insurance company, a pension fund, or a Federal Reserve bank. It is collected by presenting the coupon for redemption in the same way the bond is redeemed at maturity. If the interest is paid to the Federal Reserve System all of it, after expenses (including dividends and payments into surplus), is returned to the Treasury. To any other holder, bank or nonbank, interest received is no different from any other taxable income.

Obviously, there are literally hundreds of other possible transactions that might take place in the life of a bond, and hundreds of ways in which the proceeds might be paid and used. This is only an illustrative exposition—simplified but covering the essentials—of transactions that go on every day.

ATTACHMENT 2

DOUBLE PAYMENT OF PUBLIC DEBT?

The contention has been made that when the Federal Reserve System buys Government securities, such securities are subject to "double payment" by the Government and, hence, should be canceled.

This conclusion apparently is reached by reasoning along the following lines:

(1) If the holder of a Government security decided to exchange that security for another—with a different maturity date, for example, as he could in an advance refunding offer—he would have to turn in the original security to the Treasury in order to get the new security. Under such circumstances, the Treasury would cancel the original security and no further interest payments would be made on it.

(2) The Federal Reserve System uses Federal Reserve notes to pay for its open market purchases of Government securities.

(3) Federal Reserve notes by statute are an obligation of the U.S. Government. Therefore, when the Federal Reserve System uses Federal Reserve notes to acquire Government securities, it is merely exchanging one form of Government obligation for another.

(4) This exchange is similar to that described in paragraph (1) and, accordingly, to avoid double obligation by the United States on the same debt, Government securities acquired by the Federal Reserve System in exchange for Federal Reserve notes should be canceled.

This line of reasoning involves two basic misunderstandings.

The first misunderstanding is that open market purchases of Government securities by the Federal Reserve System are paid for with Federal Reserve notes. Actually, the payments are made through immediate credit in the reserve accounts of member banks designated by the dealer from whom the securities are purchased.

The System's open market transactions are handled through 19 dealers, of whom 7 are banks. The nonbank dealers have standing arrangements that when they sell securities to the Federal Reserve System the Federal Reserve Bank of New York will credit the reserve account of a designated member bank and that bank will credit the dealer's account.

The point to be noted here is that, while Federal Reserve notes, by statute, are "obligations of the United States," balances in reserve accounts of member banks are not. When the Federal Reserve System purchases a Government security and pays for it by a credit in the reserve account of a member bank, it has become a holder in due course and there has not been in any sense a payment by the United States.

The difference between paying for System purchases of Government securities by issuing Federal Reserve notes or by giving credit in member bank reserve accounts is not merely a bookkeeping matter. An important difference in objectives is involved. Federal Reserve notes are put into and retired from circulation as the needs of the public for hand-to-hand currency rise and fall. These needs fluctuate in response to factors that are different from—sometimes in conflict with—the factors that lead to purchases or sales of Government securities, which are made to implement monetary policy.

The second of the two misunderstandings I mentioned earlier is with respect to the effect the statutory provision that Federal Reserve notes are obligations of the United States has on operating procedures. The cause of concern apparently stems from an assumption that Federal Reserve notes are like any other Government obligation except that they bear no interest.

The fact is, that Federal Reserve notes are not like other Government obligations. The financial operations of the Treasury are not affected by redemptions of Federal Reserve notes, because the Treasury does not pay for them. The Reserve banks themselves pay for such redemptions, usually by assuming a deposit liability for which the Treasury has no obligation.

As stated in the circulation statement of "United States Money" published by the Treasury Department, "Federal Reserve notes are contingent liabilities of the United States." The only exception to this—the only instance in which the Treasury has direct liability for redeeming Federal Reserve notes—results from the Old Series Currency Adjustment Act, approved June 30, 1961. Under that act, the Federal Reserve banks paid into the Treasury about \$36 million, the amount then outstanding of Federal Reserve notes issued before July 1, 1929

(the old large-size bills). Under section 5 of the Old Series Currency Act, this payment transferred to the Treasury the liability for redeeming the notes. Section 2 of H.R. 7601 similarly provides that the liability for \$30 billion in Federal Reserve notes would be transferred "on the books of the Treasury, from contingent liability on Federal Reserve notes to direct currency liability." These examples confirm that in the first instance Federal Reserve notes are a liability of the Reserve bank that issues them, and that an act of Congress is required if this primary liability is to be transferred to the Treasury.

Let us now consider the present statutory provisions governing liability on Federal Reserve notes. Paragraph 1 of section 16 of the Federal Reserve Act provides that Federal Reserve notes "shall be obligations of the United States * * *." In addition, however, paragraph 2 of the same section provides that, before Federal Reserve notes can be issued to a Reserve bank, the applying bank must tender "collateral in an amount equal to the sum of the Federal Reserve notes thus applied for * * *"; paragraph 4 of the same section provides that "Federal Reserve notes issued to any such bank shall, upon delivery, * * * become a first and paramount lien on the assets of such bank"; and paragraph 2 of section 7 provides that should "a Federal Reserve bank be dissolved or go into liquidation, any surplus remaining, after the payment of all debts, dividend requirements as hereinbefore provided, and the par value of the stock, shall be paid to and become the property of the United States * * *."

When all of these provisions are considered together, it seems clear that their intent is—

- (1) To provide assurance that the current liability for Federal Reserve notes could always be met by the collateral required to cover such notes.
- (2) To put the statutory obligation of the United States for Federal Reserve notes in the form of a contingent liability that would only materialize in the extremely unlikely event of a Federal Reserve bank being liquidated under such conditions as to make the assets of such bank, including the collateral behind its Federal Reserve notes, insufficient to meet its liability for such notes.

Since the Treasury has no current liability for the redemption of Federal Reserve notes, it likewise seems clear that no double payment by the Treasury would be involved even if the System used Federal Reserve notes in paying for Government securities purchased in the open market.

A step-by-step illustration of these transactions follows:

Illustration

(1) Treasury announces a new bond issue, and Community Bank of Cooperstown, N.Y., wishing to invest idle funds sends to the Federal Reserve Bank of New York ("New York Fed") an instruction to subscribe for \$100,000 of new bond issue. New York Fed issues the \$100,000 bond to Community Bank as agent for Treasury, and transfers \$100,000 from the reserve account of the Community Bank to the account of the Treasurer of the United States.

(2) Community Bank, seeking funds to make business loans, sells the \$100,000 bond to ABC Securities Co., a security dealer in New York. In payment, ABC sends to Community Bank a check drawn on the Metropolitan Bank, New York City. The collection of the check results in Community's reserve account at New York Fed being increased \$100,000, and Metropolitan's reserve account at New York Fed being decreased \$100,000.

(3) New York Fed, as agent for the Federal Open Market Committee, buys the \$100,000 bond from ABC Securities Co. (In actual practice this bond would be one of a package usually totaling several hundred thousand dollars or more. For simplicity's sake, let us assume the bond is allocated to New York Fed rather than one of the other Reserve banks.) This transaction increases ABC's checking account at Metropolitan Bank by \$100,000 and Metropolitan's reserve account at the New York Fed by the same amount.

(4) The \$100,000 bond matures and is paid off out of the Treasury's account at the New York Fed. The canceled bond is removed from the assets of the New York Fed.

(5) Community Bank requisitions \$100,000 in Federal Reserve notes from New York Fed and authorizes the Fed to charge its reserve account for these notes.

(6) Community Bank turns in to the New York Fed for redemption \$100,000 in Federal Reserve notes so worn from usage that they are not fit to continue in circulation. This deposit is credited to Community's reserve account, and thus the Fed reduces its liability for Federal Reserve notes outstanding and increases its deposit liability.

Recapitulation

[In thousands of dollars]

Transaction No.	Effect of transaction	Increase or decrease in	
		Assets	Liabilities
TREASURY			
1	Increased bond debt.....		+\$100
	Increased balance with Fed.....	+\$100	
4	Decreased bond debt.....		-100
	Decreased balance with Fed.....	-100	
	Net change.....		
NEW YORK RESERVE BANK			
1	Decreased balance due Community.....		-100
	Increased balance due Treasury.....		+100
2	Increased balance due Community.....		+100
	Decreased balance due Metropolis.....		-100
3	Acquired Government bond.....	+100	
	Increased balance due Metropolis.....		+100
4	Gave up Government bond.....	-100	
	Decreased balance due Treasury.....		-100
5	Increased Federal Reserve notes outstanding.....		+100
	Decreased balance due Community.....		-100
6	Decreased Federal Reserve notes outstanding.....		-100
	Increased balance due Community.....		+100
	Net change.....		
COMMUNITY BANK			
1	Decreased reserve balance.....	-100	
	Acquired Government bond.....	+100	
2	Gave up Government bond.....	-100	
	Increased reserve balance.....	+100	
5	Decreased reserve balance.....	-100	
	Acquired Federal Reserve notes.....	+100	
6	Gave up Federal Reserve notes.....	-100	
	Increased reserve balance.....	+100	
	Net change.....		
ABC SECURITIES CO.			
2	Decreased balance with Metropolis.....	-100	
	Acquired Government bond.....	+100	
3	Gave up bond.....	-100	
	Increased balance with Metropolis.....	+100	
	Net change.....		
METROPOLIS BANK			
2	Decreased balance due ABC.....		-100
	Decreased reserve balance.....	-100	
3	Increased balance due ABC.....		+100
	Increased reserve balance.....	+100	
	Net change.....		

ATTACHMENT 3

“\$15 BILLION GIVEAWAY”?

Part of the argument put forth for canceling \$30 billion of the System's portfolio is an allegation that the Federal Reserve has tried to devise methods of giving its Government securities away to the commercial banks that are members of the System. To prevent this, it is argued, the securities should be canceled.

As proof of this danger, Mr. Patman has said that the Federal Reserve System sponsored legislation in 1959 to give away \$15 billion of its portfolio to member banks. It is true that the Board submitted a bill, ultimately enacted in amended form as Public Law 86-114, on July 28, 1959. This bill as proposed by the Board—

- (1) Authorized the Board to permit member banks to count the currency or coin in their tills as reserves;

(2) Authorized the Board to classify individual banks in central reserve and reserve cities as "country banks" with lower reserve requirements if the nature of their business justified such treatment; and

(3) Reduced the minimum reserve requirement for central reserve city banks from 18 to 10 percent and the maximum from 26 to 20 percent.

When the Congress acted on this bill the vault cash holdings of all member banks amounted to about \$2 billion. There were at the same time some small banks in central reserve cities and reserve cities whose business was similar to that of a typical country bank. The Board, as a matter of equity, felt that member banks should be allowed to count their vault cash as part of their reserves, as was already the case for most nonmember banks, and that small banks in large cities should be allowed to meet the lower reserve requirements that applied to country banks.

Nothing in the bill, as proposed or as enacted by the Congress, constituted a "giveaway." Its purpose, as stated by the House Banking and Currency Committee was "to create a more rational and equitable structure of reserve requirements." The commercial banks legally own the reserves they maintain with the Federal Reserve, just as much as they own any other asset on their books. The bill gave them nothing they did not already own. It did permit them, in the long run, to lend or invest a somewhat larger percentage of their funds. This has in fact resulted in banks increasing their loans to commerce, industry, and agriculture, rather than their portfolios of Government securities.

The bill, as reported out by the committee and passed by the Congress, contained a provision to remove the central reserve city classification. This resulted in lowering the reserve requirement for central reserve city banks from 18 to 16½ percent. This amendment to the original bill, which was proposed in the course of the hearings by representatives of New York and Chicago banks, was specifically opposed by the Federal Reserve Board.

Despite charges by Mr. Patman that the Federal Reserve is dominated by bankers, Vice Chairman Balderston, testifying for the Board during the House hearings on the legislation, opposed "the proposals for changes made by the Economic Policy Commission of the American Bankers Association and * * * other plans for fundamental revisions of the reserve requirement structure." He stressed that drastic changes were not needed, and characterized the bill as a means of "removing from the present law some structural inequities and difficulties of administration." When the House Banking Committee amended the bill, over the Board's opposition, to do away with the "central reserve city" classification for reserve purposes, Mr. Patman circulated a letter headed "S. 1120 as Reported Enacts American Bankers Association Plan Over the Vigorous Protest of the Federal Reserve Board."

How Mr. Patman figures the bill authorized a giveaway of \$15 billion (or \$25 billion, the figure he originally used) has never been clear. Even if one accepts the premise that lowering reserve requirements is a giveaway, and that the Federal Reserve was bent on using its authority to cut reserve requirements to the bone, it is difficult to see how the vault cash bill would have played much of a role in this effort. When the bill was proposed, the Federal Reserve already had authority to lower reserve requirements much more drastically than the bill permitted.

This is clearly shown in a table Mr. Patman included in his dissenting views in the committee report on the bill (H. Rept. 403, 86th Cong., 1st sess., pp. 26 and 27). In this table, Mr. Patman showed that without any legislation, the Board could have cut reserve requirements by about \$6.5 billion. The bill, of course, freed about \$2 billion of member banks' reserves by allowing them to count their vault cash as reserves. Mr. Patman's table indicates that the bill would have authorized release of about \$2.8 billion more by a further cut in reserve requirements; he calculated this by assuming that the Board would use its authority to reclassify certain individual banks in reserve cities, as granted by the bill, to reclassify every member bank in the country as a "country bank" entitled to the minimum country bank reserve requirement of 7 percent. This result was never contemplated by anyone but Mr. Patman, and of course it did not occur.

What has happened as a result of the bill? As required by the committee amendment, New York and Chicago banks have had their reserve requirements reduced from 18 percent to 16½ percent on demand deposits. As Mr. Balder-

ston had testified,¹ this necessitated an increase from 11 percent to 12 percent in the reserve requirements of country banks on demand deposits. The System's portfolio of Government securities has not been reduced by \$15 billion, or \$5 billion, or \$1; it has risen by about \$11 billion. Member banks' holdings of Governments have dropped and their business loans have risen.

Mr. Patman's explanation of why the "\$15 billion giveaway" did not take place is that the conference report on the bill included a statement that "it is not the intent of this legislation to encourage or cause the Federal Open Market Committee to reduce the Federal Reserve System's holdings of Government securities. As was made clear in the House debate, the purpose of this bill is simply to make needed reforms in the structure of reserve requirements." Mr. Patman concludes that this statement, even though it simply repeated testimony previously given by Mr. Balderston on behalf of the Board, somehow prevented the Board from doing what Mr. Patman believes the Board wanted to do. Why the statement in the conference report was any more binding on the Board than previous statements in Mr. Balderston's testimony, in the report of the majority of the committee, and by the bill's supporters in the House debate is not clear. But it is perfectly clear that, contrary to Mr. Patman's assertion, the Board did not advocate giving away \$15 billion of its Government securities.

ATTACHMENT 4

DOES THE FEDERAL RESERVE FAVOR BANKS OVER TAXPAYERS?

Accompanying the "\$15 billion giveaway" accusation discussed above is the companion charge that the Federal Reserve, while advocating help for banks, refuses to help the taxpayer.

H.R. 7601 would not save the taxpayer a penny. This is because the System's income from interest on its portfolio of Government securities is paid back to the Treasury, in the form of interest on Federal Reserve notes, after paying expenses and the statutory 6-percent dividend on Federal Reserve Bank stock and setting aside enough to maintain a surplus equal to paid-in capital. In 1964, the Reserve banks' income from interest on Government securities amounted to about \$1.3 billion. After paying expenses of about \$197 million and dividends of about \$31 million, the balance was paid back to the Treasury.

Neither the Treasury nor the taxpayer nor the public will be served by taking actions—such as that provided in H.R. 7601—that could be interpreted as repudiating the debt, or using Federal Reserve credit to finance Government deficits without regard to the effect on the economy, or removing safeguards against excessive issuance of currency. Perhaps this risk would be worth taking if it could be shown that some important benefit to the public would ensue. But the only tangible benefit claimed is a reduction of \$1.1 billion in interest payments on the debt. Since this reduction in payments by the Treasury to the Federal Reserve System would be exactly balanced by an identical reduction in payments by the System to the Treasury, this claimed benefit is illusory.

The CHAIRMAN. Will you yield briefly on that, Mr. Multer?

Mr. MULTER. Surely.

The CHAIRMAN. I shall give an illustration. Over the years, changes were made in Federal law, always giving the bankers more power and more control over monetary policy which is a right and responsibility of the Congress as set forth in the Constitution.

In 1935, the law was changed to where there would be seven members of the Federal Reserve Board, with a 14-year term, one appointed every 2 years. That did not become meaningful too much until Mr. Martin's term expired—when was that you were reappointed, Mr. Martin? Two years ago?

¹ "If requirements at central Reserve city banks were lowered to the present level of Reserve city banks, the effect would have to be absorbed by raising requirements for country banks." Hearings on H.R. 5237, Subcommittee No. 2, House Banking and Currency Committee, Apr. 7, 1959, p. 6.

Mr. MARTIN. On April 1, 1963.

The CHAIRMAN. Then the true significance of this law really fell on us. For the first time, we noticed what this meant.

It meant that when President Kennedy had the power to appoint a Chairman of the Board, one of the most powerful positions in the civilized world, he could not go out and select a person he wanted, the best man in the United States for that purpose. He found out that he had to pick one of the existing seven members of that Board. Most of them had been selected by Mr. Eisenhower. President Kennedy's hands were tied. He was in chains. He did not have freedom of choice.

I do not say that in view of the fact that he had no alternative except those on the Board, that he made a terrible mistake by appointing Mr. Martin. But still the fact is that he was restricted. He could not appoint anybody else except somebody already on the Board of Governors.

You cannot take something like that to the Congress very easily and get it changed. It just does not happen that way. Yet I do not think it is right. I think the Chairman of the Board should be selected by the President. I think this should be decided by the President and I do not think he should be forced to select his choice from the existing Board members. Although the Commission on Money and Credit said it should be, I think they were wrong.

Mr. MARTIN. We made some suggestions, going back to that hearing in 1952, there were some questions on that point.

The CHAIRMAN. I am aware of that, Mr. Martin, but if I recall your suggestion at that time, President Kennedy would still have had to choose his selection from the existing Board members.

Mr. MARTIN. If you will forgive me for a facetious remark here, the biggest laugh I have had recently came when you made this statement that I was not a Genghis Khan or an Adolph Hitler, I did not think I was—

The CHAIRMAN. No, I believe I said President Johnson.

Mr. MARTIN. That's right; you also said I was not President Johnson. One of my friends came to me and said, "Who does Mr. Patman think he is, that he can say you are not Genghis Khan. You have a perfect right to believe you're Genghis Khan if you want to."

Mr. MULTER. I might say in reference to that 4-year term, I have been putting in a bill to make it coterminous with that of the President of the United States. I have been putting that in for years. Let's call them before the committee and have hearings and determine what should be done.

The CHAIRMAN. What Mr. Martin wanted would still require the President to have to take the Chairman from the existing members of the Board. I want one where the President can select anybody.

Mr. MULTER. Let's call the bill up and have hearings and let the Congress determine. Mr. Martin can testify on it, but I am sure he is not going to write the bill.

With reference to that, Mr. Martin, has either President Kennedy or President Johnson suggested that you ought to resign as Chairman of the Federal Reserve Board?

Mr. MARTIN. No, neither one of them has suggested this.

Mr. MULTER. I think that should lay at rest the claim that they were forced to appoint you because they had no other choice.

Mr. BARRETT. Mr. Chairman, a parliamentary inquiry. Is it not fair to give the other members an opportunity to ask some questions?

The CHAIRMAN. Certainly. I thought the committee would be willing to bear with me since I have carried this burden over the years. I believe that I do know the basic facts in this situation. I did not think you would object. If any member objects, I shall just be silent from here on.

Mr. MULTER. Mr. Chairman, at the start I facetiously asked if you were going to give us equal time. I can go on for the next 2 hours in an effort to clarify this record. I am not going to do it. I will yield to other members.

The CHAIRMAN. Would it be all right to go around on the 5-minute rule at this time and then come back?

Mr. MULTER. It is all right with me, since I have taken 20 minutes. I certainly will not suggest it.

The CHAIRMAN. We will go around on the 5-minute rule and then each member can have all the time he wants.

Mr. Widnall?

Mr. WIDNALL. Thank you, Mr. Chairman.

First, I would like to clarify for my colleague, Mr. Multer, my original statement. I regret he interpreted my remarks as claiming that the bill had administration support. What I felt was extremely important was that the administration show that it did not support this, because I felt that there would be a tremendous impact, particularly overseas, if anybody had the feeling that this was an administration-supported bill.

Mr. MULTER. I agree with you, Mr. Widnall.

The CHAIRMAN. This bill in no way adversely affects the confidence of the dollar.

Mr. WIDNALL. Mr. Martin, in this morning's Washington Post, there is a story out of London by Robert H. Estabrook, entitled "Europe's Confidence in Dollar Remains Strong, Heller Says." According to the story, European banks show massive confidence in the stability of the dollar of the American economy. What would be the reaction of the world financial circles to passage or even serious consideration of this proposal before this committee this morning?

Mr. MARTIN. As I have testified, it would be very damaging, in my judgment.

Mr. WIDNALL. This is why I made the preliminary statement, as I felt that even the formality of a hearing could easily be interpreted by foreign nations as an administration proposal unless they made clear through responsible leaders of the administration that this is not an administration proposal. I would like to urge that the four that I mentioned be brought before this committee.

Now, continually, the chairman has suggested that there is a double interest payment and you have started to deny this and I have not heard the full answer yet. I believe I have in the past, but I wish you would give a full expression of your views on that right now.

Mr. MARTIN. Well, there is no double interest involved in this. When a member bank wants to get currency, it goes to a Federal

Reserve bank and its account is charged with that currency. The provision that we have had which could be changed, of course, is that there should be collateralization for that currency. The idea has been that currency—and up until the recent change in the law early this year, also deposits with Federal Reserve banks—should be guaranteed by something. So the law requires that we hold 25 percent in gold, which is held in the form of gold certificates, against the notes in circulation. And the balance has been held in Government securities.

Now, there is not any double payment of interest involved in this at all. This is merely collateral that is pledged.

Mr. WIDNALL. What is the single payment of interest, then?

Mr. MARTIN. The single payment of interest is what the securities carry, the coupons that the securities carry. As I have pointed out in this statement, interest on Treasury securities that have been held by the Federal Reserve has been paid to the Federal Reserve and about 90 percent of it is repaid to the Treasury as interest on the Federal Reserve notes. A relatively small portion has gone for the administrative expenses of the Federal Reserve. There is no double payment here involved at all.

Mr. WIDNALL. There was some discussion of the increase in interest rates from 1952 on, up through 1960. Those interest rates have continued to rise from 1960 to date, is that not true?

Mr. MARTIN. Bill rates have gone up. Actually, long-term rates have not gone up at all for 18 months.

Mr. WIDNALL. They have gone up since 1960-61?

Mr. MARTIN. They have gone up from 1960 to 1961, yes. But I am talking about 1964, the first half of 1965. We have had reasonable stability in interest rates for quite a period here. Insofar as there has been an increase in rates, it has been primarily at the short end of the market and this has been for balance-of-payments reasons.

The CHAIRMAN. Mr. Widnall, would you yield briefly on that point?

Mr. WIDNALL. Yes. I will yield.

The CHAIRMAN. In this morning's American Banker, New York, Tuesday, July 6, 1965, the headline says "Fed Succeeds in Raising Rates on Bills With Variety of Techniques."

NEW YORK.—The Federal Reserve open market trading desk apparently has been able to accomplish good-sized increase in bill rates during the past week even though it had to inject well over \$1 billion of reserves in the country's banking system in this period.

It did this by a variety of techniques which permitted it to add reserves without engaging in the usual practice of buying Treasury bills.

I will insert this in the record at this point.

(The article referred to follows:)

[From the American Banker, July 6, 1965]

FED SUCCEEDS IN RAISING RATES ON BILLS WITH VARIETY OF TECHNIQUES

NEW YORK.—The Federal Reserve open market trading desk apparently has been able to accomplish good-sized increase in bill rates during the past week even though it had to inject well over \$1 billion of reserves into the country's banking system in this period.

It did this by a variety of techniques which permitted it to add reserves without engaging in the usual practice of buying Treasury bills.

The end result, then, was a marked increase in bill yields because securities dealers, well stocked on bills in anticipation of Treasury purchases, became dis-

illusioned about prospect for a rate rise and were soon anxious to liquidate holdings.

Consequently, Treasury bills which had been marketed at an average rate of 3.78 percent a week ago, rose in yield to about 3.85 percent at the preholiday auction Friday. Dealers did not want to bid for more.

Instead of buying bills heavily, the Fed confined its purchases of these securities during the June 30 statement week to \$26 million. It also took on \$192 million of Treasury bonds due in 1 year or more.

To avoid making heavier purchases, the Fed did rely on \$45 million of repurchase agreements—considered to be light.

At the same time, the Fed allowed Treasury deposits to run down \$103 million during the week to \$672 million on Wednesday.

Also adding to banks' reserves was the effect of the British "swap" to obtain dollars, which also gave the Fed pounds and was reported as a decline in "other Federal Reserve accounts" of \$394 million.

There has been some dealer guessing about the state of the Treasury bond market since it was apparently possible to pick up a massive amount of coupon issues without raising prices.

Dealers reported, also, that the Fed subsequently made substantial purchases—perhaps as much as \$80 million—of coupon issues in the current statement week.

Meanwhile, the Fed this week also gets an assist from France which repays about \$279 million of debt and will be selling Treasury issues to raise the funds.

Mr. WIDNALL. If the interest rates had not been flexible and had not increased, would it have been necessary—would it not have been necessary at one point or another to have price controls?

Mr. MARTIN. It certainly would have made it more difficult so far as our balance of payments is concerned. There has already been pressure for funds to flow abroad because of higher interest rates abroad. I have repeatedly said it is not possible in the world we are living in today to be an isolationist on interest rates entirely, any more than it is in politics. Since we have had convertible currencies, which has been roughly from 1958 on, money markets have been subject to the attraction of differing interest rates in different places. We have tried to keep stability in our long rates here, but at the same time, to minimize incentives for our people to put short-term funds abroad. That has been our policy over the last 2 or 3 years.

Mr. MIZE. Will the chairman yield for a short question?

Mr. TALCOTT. Mr. Chairman, we cannot hear the witness. Persons in the rear are entitled to hear.

Mr. MIZE. Mr. Martin, is it not generally true that interest rates in the United States are lower than practically any other country in the world, generally speaking?

Mr. MARTIN. That is correct and I think that it is a fine thing that they are. I think that by and large, we have a greater per capita income in this country and the level of savings in this country is something that we are proud of. It has made it possible for us to have lower interest rates.

Mr. MIZE. Thank you.

Mr. WIDNALL. Mr. Chairman, my time is up.

The CHAIRMAN. On that point, I believe that Switzerland and West Germany and Belgium have lower rates.

Mr. MARTIN. Switzerland has had some lower rates, but by and large, in terms of the capital that you get, there is no country in the world that has—

Mr. MIZE. Particularly long term.

Mr. MARTIN. Long-term interest rates, yes.

The CHAIRMAN. Mr. Barrett?

Mr. BARRETT. No questions.

The CHAIRMAN. Mr. Reuss?

Mr. REUSS. Chairman Martin, it has been suggested here this morning that the mere introduction of the bill we are considering, plus the speech made in connection with it by the chairman of the Banking and Currency Committee, may have had a profound effect on the economy. Do you think it is possible that a mere speech by a prominent governmental figure in the financial field could have an effect on, let us say, the stock market?

Mr. MARTIN. Interpretations can be put by people on almost anything. I would say that if this bill were taken seriously, it would impair confidence in the credit of the United States. We have had a long history of building up the credit of the United States from the time when Hamilton struggled, along with Jefferson, with assuming the debts of the Colonies under the Assumption Act. We have succeeded in maintaining our credit. I think a bill that was taken seriously to just cancel \$30 billion of Government securities would have an impact.

But generally speaking, I do not think that unless it were taken seriously, it would have any impact.

Mr. REUSS. Well, let us take another current example. In May, the Dow, Jones industrial average was around 940. On June 1, you made a speech at Columbia. In June, the Dow, Jones went down to something like 840. Do you think that your speech had an effect on that Dow, Jones average?

Mr. MARTIN. I made no predictions in that speech, Mr. Reuss, as you know. I have been in the stock market a good many years, having been president of the exchange for a good many years. I do not make comments or predictions on stock prices.

Mr. REUSS. I realize that your speech made no predictions on stock prices. My question was: Do you think the giving of the speech and its interpretations, whether valid or not, had an effect on the stock market?

Mr. MARTIN. I do not know. I think you have to analyze a great many things. The stock market had reached its high, as you know, on May 14. This speech was given on June 1. The market was already going down when the speech was made. But I am not making any analysis of the impact of the talk on the market.

Mr. REUSS. So your answer would be that you just are not prepared to say whether it had any effect.

Mr. MARTIN. I am not prepared at all, right.

Mr. REUSS. On the bill, from my own hasty reading of it prior to the hearing, I am led to the tentative belief that its enactment would neither accomplish very much good nor do very much harm. However, in your statement this morning, you bore down rather heavily on harm that might be done under two headings, the debt limitation and the currency cover question. On debt limitation, would it not be possible in the legislation now before us to amend the Debt Limitation Act, lowering by \$30 billion the amount of debt limit, and thus take care of that problem? I am reserving judgment on the entire bill, but would not that problem be rather readily resolved by such an amendment?

Mr. MARTIN. That could be resolved.

Mr. REUSS. Equally, as to the currency cover point, in either event the real cover for the currency is the full faith and credit of the United States. And as you, yourself, I think, suggested earlier this morning, as long as it is quite clear that the United States obligates itself to meet the demands of its outstanding currency, it does not much matter whether that is done directly or at the first move by Congress to pay back the capital amount of securities which is issued. Is that not so?

Mr. MARTIN. That is correct.

Mr. REUSS. So really, assuming that these two problems could be taken care of, we are left with the basic question of whether this is a bill which would accomplish useful things or not?

Mr. MARTIN. That is right.

Mr. REUSS. It does not, even if enacted, meet one problem of some critics of the Federal Reserve, in that it would not require the Federal Reserve to pay over 100 percent of its income to the Treasury. It now pays something over 90 percent, I believe. But this would not be altered by the bill.

Mr. MARTIN. It pays 100 percent after expenses now.

Mr. REUSS. This bill would not alter the present arrangement under which the Federal Reserve System is not subject to congressional control over appropriations, or congressional disallowances of expenditures which the Congress might think extravagant.

Mr. MARTIN. That is right.

Mr. REUSS. This bill does not touch that?

Mr. MARTIN. No.

Mr. REUSS. Would you prefer that Congress address itself to those problems directly, or do so under a bill such as that now before us?

Mr. MARTIN. You mean as to——

Mr. REUSS. On the question of congressional control over Fed expenditures, and a requirement that the Fed pay over not merely 90 percent of its income.

Mr. MARTIN. I think they ought to be entirely disassociated. I do not think they have any connection.

Mr. REUSS. Thank you. My time is up.

The CHAIRMAN. Yes, sir. Mr. Fino?

Mr. FINO. Mr. Chairman, thank you for giving me this privilege to ask questions. I do not have any questions, but I did want to make an observation.

I understand that the Interstate and Foreign Commerce Committee is holding hearings across the hall and two very distinguished gentlemen are appearing before this committee testifying, Jack Dempsey and Rocky Marciano, former world heavyweight champions. In view of the exchange between the chairman and Mr. Martin, it might be a good idea to have these two gentlemen come here and try to referee the difficulties that exist between the chairman and Mr. Martin.

The CHAIRMAN. Mr. Moorhead?

Mr. MOORHEAD. Thank you, Mr. Chairman.

Mr. Martin, what is the total amount of the Fed's portfolio of Government bonds?

Mr. MARTIN. \$38.5 billion.

Mr. MOORHEAD. So this bill, if enacted, would leave the Fed with \$8 billion of Government bonds, is that right?

Mr. MARTIN. That is correct.

Mr. MOORHEAD. Now, if we were starting from scratch, how large a portfolio do you think the Federal Reserve should have to carry on its monetary functions?

Mr. MARTIN. I cannot answer that question, Mr. Moorhead, because it is hard to visualize circumstances in which you would want swings of more than, let us say, \$5 billion at the maximum. But I think it is purely conjectural as to the circumstances and conditions that would warrant shifts of even that amount. Through the years, this portfolio has been accumulated in relation to the overall requirements of the economy.

Mr. MOORHEAD. Mr. Martin, I am inclined to agree with both you and Congressman Reuss that this bill would not accomplish very much. But I am also inclined to agree with Congressman Reuss that except for the psychological factor, it would not do much damage.

Now, am I correct that this is also your opinion, sir, that you think that the psychological factor, as it is in so many monetary things, is so important that the enactment or serious consideration of the bill would be damaging?

Mr. MARTIN. That is my judgment.

Mr. MOORHEAD. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Gonzalez?

Mr. GONZALEZ. Mr. Chairman, with respect to this \$38-some-odd billion portfolio, and it is a question of accountability and independence, there is no outside audit by the General Accounting Office of this portfolio?

Mr. MARTIN. No; there is no GAO audit, Mr. Gonzalez. That was in the Banking Act of 1933. We were excluded from that. We do have outside auditors come into the System.

Mr. GONZALEZ. You do have outside auditors?

Mr. MARTIN. Yes, sir; we have Haskins & Sells now. Each year they audit the Board's books and observe our examination of an individual Reserve bank. And the Board has its own auditors. We have a specialized staff that examines each Reserve bank every year.

Mr. GONZALEZ. Would there be any serious objection to having an examination periodically by the GAO, since this portfolio represents such a big hunk of our debt structure?

Mr. MARTIN. There is nothing in the portfolio that would cause any concern. The \$38.5 billion—the auditing is taken on at the New York Bank. I believe that several of you have gone up to the New York Bank. Our own feeling, and I put it to you very bluntly, is that the Congress terminated GAO audit of the Board in the Banking Act of 1933, and in the absence of any showing that we are not handling ourselves correctly this decision ought not to be reversed.

Mr. GONZALEZ. Well, what about this \$7.5 billion security venture, I believe it was, in California 2 years ago, or a year ago, where the securities disappeared and there was no accounting for their disappearance?

Mr. MARTIN. We are the ones who turned that up. We reported it promptly. There has been no loss on that. That was over 2 years ago. A subcommittee of this committee went out to California and investigated it. Mr. Swan and the officers of the Federal Reserve Bank of San Francisco had been on top of it right from the start.

They have had help from the Secret Service and everybody else involved. Now, 2 years later, I think it is almost certain that the version of the San Francisco bank was correct, that there was no loss involved. This was just a mistake where something was torn up or thrown away.

Mr. GONZALEZ. Of course, that is not known for sure. There is still a possibility that some loss could result, conceivably.

Mr. MARTIN. It is getting more and more remote all the time, Mr. Gonzalez.

Mr. GONZALEZ. Let me ask you another question. This is not related directly to this line of questioning.

Do you believe our country will have a recession or a depression?

Mr. MARTIN. I do not know, Mr. Gonzalez.

Mr. GONZALEZ. Do you think one is imminent or around the corner?

Mr. MARTIN. I have made no prediction that a recession is imminent or around the corner. I have pointed out that there are certain things that ought to be watched and that we ought to do everything in our power to maintain the prosperity that we presently have. It seems to me that this is just simple prudence.

Mr. GONZALEZ. Thank you, very much, my time is up.

The CHAIRMAN. Mr. Martin, if it is satisfactory with you, we would like to continue with you tomorrow morning at 10. We think we can get through with you tomorrow morning.

Mr. MARTIN. All right, I will be here.

The CHAIRMAN. We will have an executive session here of the Small Business Subcommittee of the Banking and Currency Committee now.

(Whereupon, at 11:45 a.m., the committee adjourned, to reconvene at 10 a.m., Wednesday, July 7, 1965.)

RETIREMENT OF \$30 BILLION OF GOVERNMENT BONDS HELD BY THE FEDERAL RESERVE BANKS

WEDNESDAY, JULY 7, 1965

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Multer, Mrs. Sullivan, Ashley, Stephens, St Germain, Gonzalez, Weltner, Grabowski, Gettys, Todd, McGrath, Hansen, Annunzio, Widnall, Fino, Mrs. Dwyer, Talcott, Johnson, Stanton, and Mize.

The CHAIRMAN. The committee will please come to order.

I have a brief statement.

The bill that we have before us is intended not by some mysterious way but in a regular and orthodox way to cancel \$30 billion of bonds held by the Federal Reserve Bank of New York for the open market account out of a total of \$38.5 billion. This is being advocated on the theory that that will leave \$8.5 billion that the Federal Reserve Open Market Committee can use in its open market operations.

It is not intended to deprive the Open Market Committee of the use of its open market flexibility. The theory behind the bill is somewhat misunderstood—I am afraid. Simply stated it is that the bonds bought by the Open Market Committee have been paid for once. Being paid for once any payment of interest on those bonds now is payment on a debt that should have been liquidated. Following, if we permit these bonds to be transferred to the commercial banks, that will require us to have to pay the debt twice, one time when the bonds were originally purchased, the other time when the commercial banks collect the interest, until the bonds mature and then, of course, they would be entitled to a payment of the principal.

Under the vault cash bill in 1959, vault cash was to be counted as reserves. These are high-powered "dollar reserves." Under present law each dollar of reserve could be used by the commercial banks, for the system as a whole, for the purpose of increasing their loans and investments—investments \$10 to every \$1 in reserve they have. That is the reason they are high-powered dollars.

Yesterday, several members had an opportunity to question Chairman Martin. Today we shall continue. Mr. Talcott, do you care to question the witness?

STATEMENT OF HON. WILLIAM McCHESNEY MARTIN, JR., CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM; ACCOMPANIED BY JOHN R. FARRELL, DIRECTOR, DIVISION OF BANK OPERATIONS; AND GUY E. NOYES, ADVISER TO THE BOARD—
Resumed

Mr. TALCOTT. Thank you very much, Mr. Chairman. I really haven't a question to ask. I would like to say that I was surprised but pleased that yesterday the gentleman from Texas, Mr. Gonzalez, brought up again the disappearance of the \$7.5 million in Treasury certificates from the Federal Reserve bank in San Francisco several years ago. I happened to be on the minority of that special investigating committee. I am getting used to being in the minority. The minority was 100 percent right. I am getting used to that, too, thank goodness.

The CHAIRMAN. I beg your pardon?

Mr. TALCOTT. I said, in effect, that the minority, in the investigation of the disappearance of the \$7.5 million of Treasury certificates from the San Francisco bank, was 100 percent right.

The CHAIRMAN. How can you say that you are 100 percent right? Those bonds could be used right now as collateral by banks over the country. It is possible—I would not say it is probable—that they are in existence right now.

Mr. TALCOTT. The possibility is very remote. Probability is not a fair or evidentiary description for it. But as each day goes by, I think we are proved to be more nearly 100 percent right. One hundred percent is a lot of right. We may have been only 99.99 percent right, but anyway I am pleased that Mr. Gonzalez brought this matter up again during the discussion of another subject involving the Federal Reserve System. This demonstrates that we need to have both sides of every subject. Perhaps there should be other witnesses called on the immediate subject. I would like to suggest that we have more witnesses on the subject so that we get all views.

Mr. MULTER. Will the gentleman yield at that point?

Mr. TALCOTT. I yield.

Mr. MULTER. If I recall correctly, the report of that investigation indicated very clearly that the numbers of all of those lost or destroyed bonds were known and listed with every bank in the country, so that they were put on notice that if they did turn up, they were not to be treated as valid and negotiable bonds; is that not so?

Mr. TALCOTT. That is true now. The likelihood of them ever turning up is very, very remote, and each day it becomes more remote. This is understood by the people, the experts who investigated at the time. My views only reflected the experts. But the fact that this incident was brought up again during this particular hearing is interesting to me.

I have no questions of Mr. Martin, although I would reiterate my suggestion of yesterday that maybe it would be good and helpful to the committee and other Members of Congress that the chairman actually prepare his views in regular form so we can have them all at one place at one time rather than by presenting them in part, getting answers to some of the things that Mr. Martin has to say. At least I

prefer to have your views all in order rather than piecemeal in sort of a dialog between Mr. Martin.

The CHAIRMAN. The gentleman will be accommodated.

Mr. TALCOTT. Very good. Thank you, Mr. Chairman. I have no further questions.

The CHAIRMAN. Mr. Todd.

Mr. TODD. Thank you, Mr. Chairman. No questions.

The CHAIRMAN. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman. I have no questions.

The CHAIRMAN. Mr. Mize.

Mr. MIZE. I have no questions. I have a comment. I could not ever support this bill, Mr. Martin. I am behind you 1,000 percent.

The CHAIRMAN. Mr. Grabowski.

Mr. GRABOWSKI. No questions.

The CHAIRMAN. May I suggest, Mr. Martin, yesterday I made a point out of the fact that the New York Federal Reserve Bank is run by the president, and I quoted the law. Today I shall read from the statute book itself.

You said that Mr. Noyes, who is with you, represented the Open Market Committee. On which payroll is he? Who does he get his pay from?

Mr. MARTIN. By the Federal Reserve Board here in Washington.

The CHAIRMAN. The Federal Reserve Board in Washington. He is not paid by the Federal Reserve Bank in New York.

Mr. MARTIN. That is correct.

The CHAIRMAN. All of the other employees are, are they not?

Mr. MARTIN. Oh, no; there are a number of others. Mr. Young, who is the Secretary of the Committee, is on the staff of the Federal Reserve Board.

The CHAIRMAN. But they operate in the New York Federal Reserve Bank.

Mr. MARTIN. Oh, no; Mr. Young operates in the Federal Reserve Board's offices here in Washington.

The CHAIRMAN. Mr. Holmes, he has charge of the account, does he not?

Mr. MARTIN. Mr. Holmes is the manager of the account who is designated by the Open Market Committee, not by the Federal Reserve Bank of New York.

The CHAIRMAN. Who is he paid by?

Mr. MARTIN. He is paid by the Federal Reserve Bank of New York.

The CHAIRMAN. Yes, that is what I say; that is precisely my point. He has charge of the open market account.

Mr. MARTIN. But he was designated by the Federal Reserve Open Market Committee, not by the Federal Reserve Bank of New York.

The CHAIRMAN. The law is: "The president"—of course that being the president of the Federal Reserve Bank of New York, in this case "shall be the chief executive officer of the bank and shall be appointed by the Board of Directors with the approval of the Board of Governors of the Federal Reserve System for a term of 5 years, and all other executive officers and all employees of the bank shall be directly responsible to him."

Now, you say that the manager of the open market account, Mr. Holmes, is an employee of the Federal Reserve Bank of New York.

How do you explain that he is not directly responsible to Mr. Hayes when the law says that he is directly responsible to him?

Mr. MARTIN. The law also says that I can suspend or remove Mr. Hayes.

The CHAIRMAN. Where is that in the law?

Mr. MARTIN. In the Federal Reserve Act.

The CHAIRMAN. Where is that?

Mr. MARTIN. It is in section 11 (f) of the Federal Reserve Act, "Suspension or Removal of Officers and Directors of Reserve Banks. [The Board shall have power] To suspend or remove any officer or director of any Federal Reserve bank, the cause of such removal to be forthwith"——

The CHAIRMAN. I can hardly understand you.

Mr. MARTIN. "To suspend or remove any officer or director of any Federal Reserve bank, the cause of such removal to be forthwith communicated in writing by the Board of Governors of the Federal Reserve System to the removed officer or director of said bank."

The CHAIRMAN. Have you ever removed one, Mr. Martin?

Mr. MARTIN. I do not know that I can bring a case——

The CHAIRMAN. I believe you said all the time that you leave the management and administration of a Federal Reserve bank to the officers of that bank. You have repeated that a number of times I take it.

Mr. MARTIN. Insofar as we can. That is good administration.

The CHAIRMAN. Yes.

Mr. MARTIN. But we exercise our authority, and we have the authority.

The CHAIRMAN. That bank is operated by these nine directors, six of whom are directed by the private banks. That gives the private banks considerable power and authority.

Mr. MARTIN. Under the general supervision of the Board. And, Mr. Patman, I do not like to point up inconsistencies, but yesterday you said I was the most important official in the civilized world, and today you seem to say I do not have any control over the Federal Reserve Bank in New York.

The CHAIRMAN. Well, look what your statement did to the stock market. That shows it is tremendous. It went down so many points. I do not think many people could make such a thing like that happen.

Mr. MARTIN. We are talking about my authority over the Federal Reserve Bank of New York, and I think it is perfectly clear in the law, and I think we can exercise it any time we decide to do it.

The CHAIRMAN. I want to clarify this for the record one more time, Mr. Martin. How in the world can you insist that bonds that are paid for once should continue in existence with the taxpayers having to pay interest on them and principal when they mature? This I cannot understand. Now, of course, you claim that these bonds have to be there to back up Federal Reserve notes. But that does not conform with your reasoning in 1959 when you presented to Congress a bill, and it was passed on by this committee, which said that you wanted the power to lower reserve requirements and count vault cash as reserves; and if you got that power, you would transfer \$15 billion of the then portfolio of \$24 billion to the private banks. You further stated that the private banks needed the income from these bonds, and that the

Federal Reserve does not need it. You do not need the \$15 billion. The remaining \$9 billion in the portfolio, as you stated in a staff report, would provide enough flexibility for you to operate. Now, then, when the Open Market Committee owns \$38.5 billion worth of bonds—which of course is about \$14.5 billion more—you insist that it is impossible for those bonds to be canceled, although \$15 billion under the same circumstances could be given to the private banks, after giving them the reserves to buy the bonds.

The Fed pays nothing for them; it merely creates new reserves. Then it continues to get interest on those bonds and, when the bonds become due, they can collect the principal again.

I cannot get the reasoning there at all, Mr. Marfin. If that makes sense, I am unable to comprehend it. Of course, there may be something in my background—lack of knowledge—that would account for it, but I do know this: No one should be compelled to pay his debts more than once, but in this instance you would compel the Government to pay its debts more than once. You would compel the Government to continue to pay interest on bonds that have already been paid for. When you bought these bonds, you paid for them. You will admit that, will you not, Mr. Martin?

Mr. MARTIN. The bonds were paid for in the normal course of business.

The CHAIRMAN. That is right.

Mr. MARTIN. And that is the only time they were paid for.

The CHAIRMAN. Just like we pay debts with checks and credits.

Mr. MARTIN. Exactly.

The CHAIRMAN. In the normal course they were paid for once, you will admit that, will you not?

Mr. MARTIN. They were paid for once, and that is all.

The CHAIRMAN. That is right.

Now then, if you go ahead and allow them to remain in circulation though, and you cause people to pay taxes in order to pay the interest, how do you justify that, if they have been paid for once? You are trustees of the Government; you are supposed to look after the Government's interest.

Mr. MARTIN. These bonds were not paid for by the Government. They were issued by the Treasury in the open market, and they were paid for at that time in the ordinary course of business. There is no double payment here at all, Mr. Patman.

The CHAIRMAN. And you have stated many times—and I will put the statements in the record—that you paid for them, in effect, with Federal Reserve notes. In other words, you paid one form of Government obligation for another form of Government obligation. That has been said by you. It has been said by Mr. Eccles a number of times, and there is no question about it. I will put them in the record.

Mr. MARTIN. You put them in the record, and I will file a written rejoinder as to what you say.

The CHAIRMAN. You certainly may do so.

Mr. MARTIN. What you say with respect to what I did in 1959 is not particularly clear in my mind, but I really do not think that it is germane. Actually I did not come here advocating that this be done as you suggest.

The CHAIRMAN. Well, it was stated in your staff report which was submitted to the committee and which the Board, of which you are Chairman, approved.

Mr. MARTIN. And the Congress was responsible for the act. It was not the Federal Reserve Board. They did not take the responsibility for that.

The CHAIRMAN. You had Mr. Balderston, the Vice Chairman, before us advocating it. Now then, after that law passed, why did you not transfer those \$15 billion in bonds? You said you were going to.

Mr. MARTIN. We never proposed to transfer any bonds to anyone.

The CHAIRMAN. The statement from the staff accompanying Mr. Balderston's testimony stated you would transfer them. It says—I am reading from the statement sent up and presented by Mr. Balderston—

To the extent necessary to avoid undue credit expansion, reserves released by any reduction in requirements could be absorbed by the Federal Reserve's sales of securities in the market. This would in effect shift earning assets from Federal Reserve banks to member banks.

Notice that—

this would in effect shift earning assets from Federal Reserve banks to member banks. The present system of portfolio is adequate to permit a substantial reduction and still leave enough to provide sufficient earnings to cover necessary expenses as well as for current purposes of policies. Any decrease in requirements, however, should leave the Federal Reserve with a portfolio adequate to cover possible future contingencies such as large gold inflow or economies in the use of currency that might add to the reserves in the excess of appropriated needs. In view, moreover, of the growing international outflows of this country, reserve base of member banks as well as the Federal Reserve should be maintained at a level which would permit further reduction in requirements if needed to cover a future drain on our gold reserves.

If you will notice, there you state that in transferring these bonds to the member banks, it would shift earnings. Now, that means that earnings now, they come to you, and after you pay all the expenses you want to pay without any audits, without any independent audits, and no restrictions as to expenses, after you pay all the expenses you want to, the remainder flows over into the Treasury.

If your wish had been carried out in the 1959 act, these bonds would have been transferred over to the commercial banks, and the earnings would have gone to them instead of paying the excess over expenses to the Treasury. That was said in the staff report that was given to us as guidelines by Mr. Balderston who testified at the time. So I will ask you again: Why did you not transfer any of those bonds after that act passed, Mr. Martin?

Mr. MARTIN. We did not propose to transfer any of the bonds.

The CHAIRMAN. You said here that the banks needed—

Mr. MARTIN. I do not have in front of me the material you are reading from, but there was no giveaway involved in this at all.

As Mr. Multer said during the debate in the House on the bill—

individual citizens, individual noncitizens, banks, companies can buy bonds if they have the money with which to pay for them. That is why there is not a giveaway in this bill.

The bill as passed by the Congress was a more liberal one than that recommended by the Board.

I do not think that the Board has to assume any responsibility for the broadening of this bill by the Congress. We gave you our best

judgment and testified on it. I was not with Mr. Balderston at that time. I was away.

The CHAIRMAN. But you and the Board approved what he said.

Mr. MARTIN. I am completely back of my Vice Chairman. I am sure he—

The CHAIRMAN. That is right.

Mr. MARTIN. You could not have a more capable man.

Mr. MULTER. But this was not even said by Mr. Balderston. This was a staff statement.

Mr. MARTIN. That is correct.

Mr. TALCOTT. Mr. Chairman.

The CHAIRMAN. Yes, presented and approved by the Federal Reserve Board.

Mr. TALCOTT. May I make a parliamentary inquiry? When do you intend to call the witnesses that were suggested by Mr. Widnall yesterday?

The CHAIRMAN. We will consider that and pass on it.

Mr. TALCOTT. Could you give us some idea when they will be called?

The CHAIRMAN. I am not ready to pass on it.

Mr. TALCOTT. Then may I inquire when you intend to have an executive session on this bill?

The CHAIRMAN. I do not know yet. It depends upon many factors.

Mr. TALCOTT. Mr. Chairman, if I may inquire respectfully, we have already spent more time on this bill than we have on some bills for which you have called executive sessions. I would think it would be proper to call an executive session for the purpose of getting ready to report this bill out. I think that we would be ready to report the bill out. At least I am ready.

The CHAIRMAN. At the proper time we will consider that, but we are not ready yet. We are right in the middle of hearings.

Mr. TALCOTT. This is the middle of the hearing?

The CHAIRMAN. Well, we are certainly not finished with them.

Mr. TALCOTT. Could you give us some idea when you would expect to call—

The CHAIRMAN. No; I could not give you an idea.

Mr. TALCOTT. It would be helpful to the committee if you could.

The CHAIRMAN. How helpful could it be?

Mr. TALCOTT. I would like to be present to hear the witnesses.

The CHAIRMAN. You will be notified and given ample time. We want you here.

Mr. TALCOTT. Thank you very much.

The CHAIRMAN. Now, Mr. Martin, one other thing for you and the others. Another paragraph in this same statement of the staff:

Any reduction in reserve requirements would permit banks to increase their earnings assets and thus provide larger earnings. This in turn would help banks to improve their capital positions. Even if the reserves were fully absorbed by the Federal Reserve open market sales so that no excess reserves were created, member banks could buy additional securities or make loans in an amount equal to the reserve released and thus increase their earnings.

The fact is, Mr. Martin, at that time, if you had carried out what was contemplated, transferred \$15 billion of those securities to the—

Mr. MARTIN. Mr. Patman, this was never contemplated. This was never contemplated. We said we could, but we made no proposal to transfer these securities.

The CHAIRMAN. The member banks needed it——

Mr. MARTIN. Even in testifying on it, I assumed Mr. Balderston, just as I would, would point out that, of course, it would help the member banks if this happened. But we never proposed to transfer——

The CHAIRMAN. You do not want to benefit the people by taking this burden off of them. That is the part that I do not understand.

Mr. MARTIN. This is your assertion that we do not want to benefit the people. Everything we do, in our judgment, is for the benefit of the people.

The CHAIRMAN. Well, I do not see how you benefit the people by giving interest-earning bonds to the banks and making the people pay their debts twice.

Mr. MULTER. Mr. Chairman, may the witness be permitted to complete his answer before another question is put to him?

The CHAIRMAN. I am perfectly in favor of that. Have you finished your answer, Mr. Martin?

Mr. MARTIN. I would simply like to say that I just do not like to hear you say—I am sure you do not mean to insinuate that we are trying to harm the people. Our actions——

The CHAIRMAN. Yes——

Mr. MARTIN. If you are——

The CHAIRMAN. You have been trying to help the banks unnecessarily. They did not need the help.

Mr. MARTIN. I simply deny that.

The CHAIRMAN. Perhaps I should say you did not intend to harm the people so much as you are trying to help the banks.

Mr. MARTIN. No.

The CHAIRMAN. Whenever you advocate letting the banks have these bonds without cost, that have been paid for once, and because the people do continue to have to pay interest on them until they are due, and then have to pay the principal again, that is harming the people. Your objective was, as set out, to help the banks.

Mr. MARTIN. No——

The CHAIRMAN. To help the banks by giving them earning assets which you did not need at the Federal Reserve but which you said the banks needed——

Mr. MARTIN. Well, I just——

The CHAIRMAN. At that time \$15 billion was equal to the combined capital stock of all the banks in the United States. That was quite a gift, quite a gift.

Mr. MARTIN. I just want the record to show that it was not done to help the banks, and there was no intention at any time, nor has there ever been on the part of the Federal Reserve, to give away anything.

The CHAIRMAN. Well, evidently the conferees of the House agreed with me or they would not have signed this statement which said:

During the debate on this bill in the House, questions were raised as to whether the purpose of this bill was to transfer Government securities held by the Federal Reserve banks to privately owned commercial banks. To avoid any possible misunderstanding on this, the managers on the part of the House wished to emphasize that it is not the intent of this legislation to encourage or cause the Federal Open Market Committee to reduce the Federal Reserve System's holdings of Government securities. As was made clear in the House debate, the purpose of this

bill is simply to make needed reforms in the structure of the reserve requirements.

Signed by Brent Spence, chairman; Paul Brown, Wright Patman, Abraham Multer, Gordon L. McDonough, William B. Widnall, E. W. Hiestand.

In other words, all the conferees on the part of the House felt you were going to give the bonds to the banks and the conferees wanted to make it plain and sure this did not happen. I am positive in my own mind that that is the reason that these bonds were never transferred—because we made legislative history. You would have to go against legislative history in order to do it, and you did not attempt to do it, although it was your intention at the time.

Mr. MARTIN. Far be it for me, Mr. Patman, to take any credit away from you in anything that you have done. But insofar as these bonds being paid for twice—

The CHAIRMAN. I am not claiming any unique knowledge of these things, but I do know the difference between right and wrong. I know it is wrong for you to ask for people to pay their debts twice.

Mr. MARTIN. Well, I can do nothing more with that than simply to deny it is true.

The CHAIRMAN. That is your right, but, of course, the record is pretty plain.

Mr. MARTIN. Well, that is your reading of the record.

The CHAIRMAN. One more point, and I will yield to the other members. You said yesterday that you favored a law that would permit the term of Chairman of the Board of Governors of the Federal Reserve System to be coterminous with that of the President. I, of course, criticized your statement because the bill that I saw that you were in favor of—

Mr. MARTIN. I made no such statement yesterday. I may have made it on another occasion, but yesterday this did not come up as far as I am concerned.

The CHAIRMAN. I think the record will show that it did.

Mr. MARTIN. I am quite confident my memory is accurate that I was not asked any question on this yesterday.

The CHAIRMAN. You do not dispute the fact that you did say that you would be in favor of the President selecting the Board Chairman coterminous with his term. You said that, did you not?

Mr. MARTIN. We discussed that in the hearing in 1952 that I have referred to where we went over this at great length.

The CHAIRMAN. Well, I am asking you again. You said that, did you not?

Mr. MARTIN. I did, and I stick by it.

The CHAIRMAN. All right.

Mr. MARTIN. I assume that when a 4-year term for the Chairman of the Board of Governors and the Vice Chairman was established by the Banking Act of 1935 that it was done for some reason, and the reason was to make it roughly coterminous with the President's term.

The CHAIRMAN. You are going back 30 years. I am just bringing it right up to date now. You said you would favor that, did you not?

Mr. MARTIN. Yesterday I said that?

The CHAIRMAN. Well, I will not say yesterday.

Mr. MULTER. I said yesterday that I favored that, not that you favored it.

Mr. MARTIN. You may have said that yesterday. I just want the record to show—

The CHAIRMAN. Why do all this talking. You are either for it or against it. Are you for it or against it?

Mr. MARTIN. If it were appropriately worded and put together, I would be in favor of it.

The CHAIRMAN. Appropriately worded, that is the point.

Mr. MARTIN. But I am not going to—

The CHAIRMAN. Is it your requirement that the President would still have to pick that Chairman from one of the seven Board members? Is that not one of your—

Mr. MARTIN. No; that was not my requirement. A bill was sent up by the President to the Congress on this that was worked out in which I participated, in which it was very clear that that was not the case.

The CHAIRMAN. All right, you sent the bill—

Mr. MARTIN. You never had hearings on the bill.

The CHAIRMAN. If you will send the bill up here that will permit that term to be coterminous and not require the President to select one of the seven to put him in a straitjacket, just let him pick out the best man in the United States for it, that bill will receive first consideration from me above all bills in this Congress. Will you do that?

Mr. MARTIN. I will not make any commitment to do anything until I know what I am doing.

Mr. MULTER. Mr. Martin, I have been putting that identical bill in for at least the last three or four sessions. It is now in.

Mr. MARTIN. That is correct.

The CHAIRMAN. Does it require the selection to be made from the members?

Mr. MULTER. No, sir; it does not.

The CHAIRMAN. Let me see the bill.

Mr. MARTIN. This has been kicked around for years, Mr. Patman.

The CHAIRMAN. Now you have agreed to it, and I have agreed to make it the first order of business. Send the bill up.

Mr. MARTIN. I am not going to send any bill up. Mr. Multer is quite correct. The bill is already up.

The CHAIRMAN. I am awaiting the bill, and it will be given first consideration.

All right, Mr. Multer.

Mr. MULTER. Thank you, Mr. Chairman.

Mr. MARTIN, I do not know that we are going to be able to clarify the record completely, but I am going to try. In the first place the Federal Reserve Act provides that—

This is an Act to provide for the establishment of Federal Reserve banks to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States and for other purposes.

In addition to that this same act provides for the appointment of the Open Market Committee, provides how its membership shall be made up, who shall select the members of the Open Market Committee and what the Open Market Committee may do.

The CHAIRMAN. Would you yield for a correction, Mr. Multer?

Mr. MARTIN. That is correct.

Mr. MULTER. Yes.

The CHAIRMAN. You are quoting from the 1913 act of the Open Market Committee which in 1935—

Mr. MULTER. I am quoting from the 1961 act as amended.

Is anything that I have said thus far as to what the act provides in conformance with your understanding of the act?

Mr. MARTIN. That is my understanding of what the act says.

Mr. MULTER. And in addition to that the Open Market Committee is directed by this same act in the course of its operations to follow these governing principles. That is the title of this section, "Governing Principles."

I now quote this section :

The time, character, and volume of all purchases and sales of paper described in section 14 of this Act as eligible for open market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.

Do you know of any time when the Open Market Committee has not followed those principles or the Open Market Committee has been constituted by other than what is required by the act and in the manner required by the act?

Mr. MARTIN. The Open Market Committee has been meeting roughly every 3 weeks on the basis of this statutory provision, and despite Mr. Patman's views that only one bank counts in it, why the votes are taken periodically and recorded, and I think it has been functioning very effectively and efficiently as the statute intended it to function.

Mr. MULTER. Since I have been on this committee—which goes back to 1947—these discussions have been had on any number of occasions between you and Mr. Patman.

Mr. MARTIN. That is correct.

Mr. MULTER. Particularly with reference to the operation of the Open Market Committee.

Mr. MARTIN. Right.

Mr. MULTER. Now, to my knowledge there has never been a single bill presented to the Congress since 1947 nor has there been any hearing on any such bill in either House of Congress to change the composition of the Open Market Committee or the principles under which it is to operate, am I correct as to that?

Mr. MARTIN. I am not absolutely certain that there may not have been some bill presented at some time, but certainly none that had any hearing.

Mr. MULTER. In either body.

Mr. MARTIN. In either body. Of course, one of the bills considered by the Patman subcommittee during its hearings on the Federal Reserve System last year would have abolished the Open Market Committee, not just changed its composition.

Mr. MULTER. Now then, there was some mention made yesterday—and I do not have the exact language—that you indicated in your June 1, 1965, speech that you had some power to do something with reference to the stock market. Was there any such indication in that speech of yours?

Mr. MARTIN. I made no predictions in that speech at all, and the only reference to the stock market in the speech was that the margin requirements which we now have had made the credit situation in the stock market infinitely superior to what it was in 1929.

Mr. MULTER. If I recall the speech—and I have read it several times—there was nothing in that speech that indicated you or the Board had any power or intended to use any power that would in any way affect the stock market or the general economy.

Mr. MARTIN. I think there is no reference or no prediction of any sort on the stock market or the economy.

Mr. MULTER. Reference has been made to tax-exempt bonds. The Federal Reserve Board has no jurisdiction whatsoever as to whether bonds should be taxable or not, am I right?

Mr. MARTIN. That is correct.

Mr. MULTER. This also is done by statute.

Mr. MARTIN. It is governed by statute, and as I indicated yesterday, I have expressed my personal views against tax-exempt securities a number of times.

Mr. MULTER. And there is nothing in the Federal Reserve Act or in the National Banking Act that gives any of the regulatory authorities the right to say to a commercial bank that it shall or shall not invest in tax-exempt bonds.

Mr. MARTIN. That is correct.

Mr. MULTER. You do have a right to review them to determine whether or not the risk is good and make some recommendation there as a part of your examination of a bank. But you have no right in the first instance to say to a bank you may or may not or you shall or shall not buy tax-exempt bonds.

Mr. MARTIN. Correct.

Mr. MULTER. Now, with reference to the question of usury brought up here yesterday and the impoverishment of the country because of exorbitant interest rates, here too, your power is limited. Every State fixes usury rates or the maximum amount that may be charged as interest, in accordance with its own determination of what may be appropriate in that particular State area.

Mr. MARTIN. That is correct.

Mr. MULTER. And except for the provision for a maximum rate that may be fixed in Federal statute so far as Federal securities is concerned, or with reference to securities that are insured or guaranteed by the U.S. Government, there is no Federal statute that fixes the rate of interest.

Mr. MARTIN. That is right.

Mr. MULTER. And with reference to that, incidentally, I might indicate that yesterday's Wall Street Journal shows that the personal income for the country—that is the income of persons in our Nation—has risen from 1962 steadily to date, and it is up \$2 billion from April to May of this year. Is that in accordance with your knowledge of the facts?

Mr. MARTIN. That is roughly right; right.

Mr. MULTER. So there is very little impoverishment, if interest rates are up; is that right?

Mr. MARTIN. We have been in a period of progress and growth.

Mr. MULTER. And our entire economy has been growing through these last several years. Our employment is up. Our unemployment is down, and the general economy has been getting better all the time.

Mr. MARTIN. That is correct, and to refer to my speech, as has been done frequently, I opened up by saying when economic prospects are at their brightest, then is the time we have to guard the most against recklessness and complacency.

Mr. MULTER. So if usury rates or interest rates have been exorbitant, they have not shown up in the economy as yet.

Mr. MARTIN. They have not. Long-term interest rates in the past 18 months have shown no rise whatever.

Mr. MULTER. Now, with reference to the matter of banks being able to lend 6 times or 10 times their deposits, this again is a statement of a theory. This is theoretically possible that a bank may lend a certain multiple of its deposits. Am I right?

Mr. MARTIN. That is right. It is the fractional reserve system.

Mr. MULTER. Yes.

Mr. MARTIN. They may if they wish to. They do not have to.

Mr. MULTER. Well now, since the 1930's do you know of any commercial banks that have actually lent as much as twice the amount of their deposits?

Mr. MARTIN. Oh, I would have to check that, Mr. Multer.

Mr. MULTER. Let me place in the record at this time the following figures. This is for the end of the year 1964. The 1965 figures are not yet available. All of the insured commercial banks in the country have total capital, surplus, undivided profits, and reserves of approximately \$31 billion. They have commercial and time and savings deposits of approximately \$306 billion. I am rounding out the figures.

The total amount of loans and discounts by all of these insured banks for 1964 was \$178.5 billion. In other words—

Mr. CHAIRMAN. Mr. Multer, would you yield briefly there?

Mr. MULTER. Surely.

The CHAIRMAN. Now what is the relationship there to the reserves? It is about 10 to 1, the reserves at that time. The reserves now are about \$18 billion.

Mr. MARTIN. I think we are getting confused between reserves and deposits here.

The CHAIRMAN. He is relating it to the assets there, but I am ignoring that. But I think you will find that the expansion for deposits is still about 10 to 1 right now.

Mr. MULTER. Ten to one on what?

The CHAIRMAN. Against the reserves.

Mr. MULTER. What reserves are you talking about, bad-debt reserves or the reserves required by the Federal Reserve Act?

The CHAIRMAN. The reserves required by the Federal Reserve Act.

Mr. MARTIN. We are talking about reserves, and the tendency is for the banks, of course, to use the reserves—

The CHAIRMAN. Yes.

Mr. MARTIN (continuing). To build their credit. There is a difference.

Mr. MULTER. Just to emphasize the figures of the total amount of all commercial banks—and incidentally the Federal Reserve Board has no jurisdiction over any banks that are not insured, is that right?

Mr. MARTIN. Well, if they are member banks. If they are not insured, we would not have any.

Mr. MULTER. Are there any member State banks that are not insured?

Mr. MARTIN. They are required by law to be insured.

Mr. MULTER. Yes.

Mr. MARTIN. Right.

Mr. MULTER. So that any commercial banks over which the Federal Reserve Board has any jurisdiction is an insured bank, either a national bank—

Mr. MARTIN. That is right.

Mr. MULTER. Or a State member bank.

Mr. MARTIN. That is right—

Mr. MULTER. Now taking these same figures now and taking only the 50 largest banks, commercial banks, in the country—and I think it is important that these figures be in the record too—the total amount of capital accounts—and when we say capital accounts, we include the actual capital, the surplus and undivided profits, and the reserves—is a total of \$9.5 billion, and against that the total amount of deposits is \$104 billion.

As against that, the total amount of loans is \$92 billion. In other words, the point I am trying to make is despite this theoretical multiple of loans that are made by a bank because of its deposits and assets, none of these banks ever do get into actual practice where they take 6, 7, 8, 9, or 10 times the amount of deposits and lend it out. They are all well within the limits that you would fix as a good banker for liquidity and for soundness and safety of operation, is that not so?

Mr. MARTIN. And we see that our reserves are maintained. That is the purpose of our reserve requirements.

The CHAIRMAN. For clarification, Mr. Multer, would you yield?

Mr. MULTER. Surely.

The CHAIRMAN. You have mentioned assets. Assets of the banks have no relation to the loans and investments of the banks. The assets of the banks, of course, are important, but in the Federal Reserve System loans are related solely to reserves. That is correct, is it not, Mr. Martin?

Mr. MARTIN. That is right.

The CHAIRMAN. That is right. Mr. Multer, you have this matter confused.

Mr. MULTER. I do not think I am getting confused at all, but let us put the definition on the record.

When we talk about assets of a bank, we talk about its capital, its surplus accounts, its undivided profits, its reserves, and its deposits as well as its real estate and its equipments and so forth. That is the general definition. All of this is part of the assets, and then as part of that, when you get to the point of making a determination of soundness and liquidity and safety of operation, you must break it down

into their assets which are real estate and the like, take that out of your determination of soundness and liquidity, and you take into account the actual money on hand, its securities, the nature of the securities, how much it owes its depositors, what its capital accounts are, and then make a determination as to soundness of the operation and the like, am I not right, sir?

Mr. MARTIN. In general. Why do we not give you a general statement of that?

Mr. MULTER. That would be better. You give the statement.

Mr. MARTIN. Yes, sir. We will work one out for you.

Mr. MULTER. Fine. Thank you, Mr. Chairman.

(The statement referred to follows:)

RELATIONS BETWEEN ASSETS, LIABILITIES, AND CAPITAL ACCOUNTS OF BANKS

(1) As in the case of any other corporation, a bank's assets are what it owns, its liabilities are what it owes, and its capital accounts are essentially the amount by which the former exceed the latter.

(2) The items that make up these assets, liabilities, and capital accounts can be listed in various ways. One of the most usual listings is a "balance sheet" like that used for the "Report of Condition" that banks file several times a year. A copy of the form for a recent condition report is attached.

(3) As with any other corporation, a bank's assets cannot exceed the sum of its liabilities and capital accounts. The principal liabilities of the banking system (its deposits) are liquid claims that others are generally glad to hold as assets. Hence, the banking system, though not necessarily a particular bank, can to some extent acquire additional assets (e.g., loans and investment securities) by issuing additional liabilities. However, this process is sharply limited by several facts as outlined below.

(4) A member bank is required to maintain a "reserve" in the form of cash on hand or a deposit at the Federal Reserve bank, equal to specified percentages of the member bank's deposit liabilities. These "reserves" are limited in total amount, and the banking system cannot acquire any additional assets by issuing additional liabilities (deposits) unless additional "reserves" are available to be held against the deposits.

(5) Availability of reserves to the banking system is not necessarily the same as availability to a particular bank. At the same time that some banks are able to increase their reserves and deposits, others may be called upon to pay off deposits; i.e., lose reserves.

(6) A bank has an unconditional obligation to pay its deposits—and to pay them on demand or short notice. Hence, the bank must be prepared to absorb any losses that may occur on its assets, including those arising from noncollectibility or from sale at depreciated prices. In other words, when a bank acquires assets it assumes risks. The nature and amount of the risks depend on the nature and amount of the assets it acquires, as well as on the volatility of its deposits; i.e., the likelihood of its having to pay off deposits. Its ability to assume risks depends upon its management skills and also upon the amount of its capital accounts, since these accounts would have to bear losses that might be incurred on assets. It is essential, therefore, that a bank maintain suitable balance between its various kinds of assets and liabilities and its capital accounts. There are various methods of analyzing these relationships. One such method is indicated in the attached "Form for Analyzing Bank Capital."

(7) A bank not only incurs risks when it acquires assets in return for its deposits but in carrying on its operations it also incurs considerable expense, including interest on time and savings deposits and the expense of processing checks drawn on demand deposit accounts. Accordingly, it is economical for a bank to acquire additional assets, and issue additional liabilities in the process, only to the extent that it can earn enough on the additional assets to compensate it for the additional risk and expense.

Please Read Carefully "Instructions for the Preparation of Report of Condition"— Every item and schedule must be filled in. Printed items must not be amended. Amounts which cannot properly be included in the printed items must be entered under "Other assets" or "Other liabilities."

Report of Condition of _____ (Least title of bank)

of _____ (City) _____ (County) _____ (State) _____ (Zip Code) at the close of business on _____, 19_____

State Bank No. _____ Federal Reserve District No. _____

Table with columns: Description, DOLLARS, Cts. Rows include ASSETS (1-12), LIABILITIES (13-24), CAPITAL ACCOUNTS (25-30), and MEMORANDA (31-32).

I, _____ of the above-named bank do hereby declare that this report of condition (including the information below and on the reverse side hereof) is true and correct to the best of my knowledge and belief.

We, the undersigned directors attest the correctness of this report of condition (including the information below and on the reverse side hereof) and declare that it has been examined by us and to the best of our knowledge and belief is true and correct.

NOTE—This report must be signed by an authorized officer, attested by not less than three directors (or by at least two if there are not more than three directors) other than the officer signing the report, and forwarded within 10 days after receipt of request.

SCHEDULE OF OTHER ASSETS and SCHEDULE OF OTHER LIABILITIES. Two side-by-side tables with 6 rows each.

The original and one copy of this report should be sent to the FEDERAL RESERVE BANK and one copy sent to the Fiscal Agent, FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D. C. 20429

SCHEDULE A—LOANS AND DISCOUNTS (including rediscounts and overdrafts)		DOLLARS			Cts.	
1. Real estate loans (include all loans secured by real estate, whatever the purpose):		XXX	XXX	XXX	XX	1
(a) Secured by farm land (including improvements)						(a)
(b) Secured by residential properties (other than farm) and insured by Federal Housing Administration						(b)
(c) Secured by residential properties (other than farm) and insured or guaranteed by Veterans Administration						(c)
(d) Secured by residential properties (other than farm) and not insured or guaranteed by FHA or VA						(d)
(e) Secured by nonfarm nonresidential properties (e.g. business, industrial, hotels, office buildings, churches)						(e)
2. Loans to financial institutions:		XXX	XXX	XXX	XX	2
(a) To domestic commercial and foreign banks						(a)
(b) To other financial institutions (include loans to savings banks, insurance and mortgage com., factors, mutual savings banks, savings & loan socs., Fed. lending agencies, and all other business and personal credit agencies)						(b)
3. Loans for purchasing or carrying securities (secured or unsecured):		XXX	XXX	XXX	XX	3
(a) To brokers and dealers in securities						(a)
(b) Other loans for the purpose of purchasing or carrying stocks, bonds, and other securities						(b)
4. Loans to farmers (include secured and unsecured loans to farmers, except loans secured by real estate above):		XXX	XXX	XXX	XX	4
(a) Loans directly guaranteed by the Commodity Credit Corp. and certified of interest representing ownership thereof						(a)
(b) Other loans to farmers (include loans for household and personal expenditures, except loans secured by real estate)						(b)
5. Commercial and industrial loans (include all loans for commercial and industrial purposes, secured or unsecured, except those secured by real estate above)						5
6. Loans to individuals for household, family, and other personal expenditures (exclude business loans, loans to farmers, and loans secured by real estate):		XXX	XXX	XXX	XX	6
(a) To purchase private passenger automobiles on instalment basis (include purchased paper)						(a)
(b) To purchase other retail consumer goods on instalment basis (include purchased paper)						(b)
(c) Instalment loans to repair and modernize residential property						(c)
(d) Other instalment loans for household, family, and other personal expenditures						(d)
(e) Single-payment loans for household, family, and other personal expenditures						(e)
7. All other loans (incl. overdrafts). (To churches, hospitals, charitable or educational institutions, etc., not secured by real estate)						7
8. LOANS AND DISCOUNTS, GROSS (total of items 1 to 7)						8
9. Less reserve for bad debts, unallocated charge-offs, and other valuation reserves						9
10. LOANS AND DISCOUNTS, NET (item 8 minus item 9) (must agree with item 6 of "Assets")						10

SCHEDULE B—UNITED STATES GOVERNMENT OBLIGATIONS, DIRECT AND GUARANTEED						
1. Treasury bills						1
2. Treasury certificates of indebtedness						2
3. Treasury notes: (a) Maturing within one year from date of call report						3(a)
(b) Maturing after one year from date of call report						(b)
4. U.S. nonmarketable bonds (savings series F, G, J, K; investment series A-1955, B-1975-80; and depositary bonds)						4
5. Other United States bonds maturing within 1 year from date of call report						5
6. Other United States bonds maturing after 1 but within 5 years from date of call report						6
7. Other United States bonds maturing after 5 but within 10 years from date of call report						7
8. Other United States bonds maturing after 10 years from date of call report						8
9. Securities guaranteed by U.S. Government						9
10. TOTAL UNITED STATES GOVERNMENT OBLIGATIONS (must agree with item 2 of "Assets")						10

SCHEDULE D—CASH, BALANCES WITH OTHER BANKS, AND CASH ITEMS IN PROCESS OF COLLECTION						
1. Cash items in process of collection and unposted debts drawn on the reporting bank—total:						1
(Banks electing to report balances (a) and (b), or (a) and (c)—see Instructions)						
(a) Cash items in process of collection including exchanges for clearing house (item 1 less subitem (b) or (c))						(a)
(b) Actual amount of all unposted debits or single factor % of item 19		XXX	XXX	XXX	XX	(b)
(c) Separate amount of unposted debits or separate factors:						
(1) Actual amount for Demand Deposits or % of item 9, Schedule E		XXX	XXX	XXX	XX	(c-1)
(2) Actual amount for Time and Savings Deposits or % of item 10, Sched. F		XXX	XXX	XXX	XX	(c-2)
2. Demand balances with banks in the U.S.						2
3. Other balances with banks in the United States (including private banks and American branches of foreign banks)						3
4. Balances with banks in foreign countries (including balances with foreign branches of other American banks)						4
5. Currency and coin						5
6. Reserve with Federal Reserve Bank						6
7. TOTAL of items 1 to 6 (must agree with item 1 of "Assets")						7

SCHEDULE E—DEMAND DEPOSITS						
1. Deposits of individuals, partnerships, and corporations						1
2. Deposits of foreign governments and official institutions, central banks and international institutions						2
3. Total of items 1 and 2 (must agree with item 13 of "Liabilities")						3
4. Deposits of United States Government						4
5. Deposits of States and political subdivisions						5
6. Deposits of banks in the U.S. (including % deposits of mutual savings banks)						6
7. Deposits of banks in foreign countries (including balances of foreign branches of other American banks)						7
8. Certified and officers' checks, travelers' checks, letters of credit, etc. (must agree with item 15 of "Liabilities")						8
9. TOTAL DEMAND DEPOSITS (items 3 to 8) (must agree with item 19(a) of "Liabilities")						9

SCHEDULE F—TIME AND SAVINGS DEPOSITS						
1. Savings deposits						1
2. Deposits accumulated for payment of personal loans						2
3. Other time deposits of individuals, partnerships, and corporations						3
4. Deposits of foreign governments and official institutions, central banks and international institutions						4
5. Total of items 1 to 4 (must agree with item 14 of "Liabilities")						5
6. Deposits of United States Government						6
7. Deposits of States and political subdivisions						7
8. Deposits of banks in the United States (including % deposits of mutual savings banks)						8
9. Deposits of banks in foreign countries (including balances of foreign branches of other American banks)						9
10. TOTAL TIME AND SAVINGS DEPOSITS (items 6 to 9) (must agree with item 19(b) of "Liabilities")						10

SCHEDULE FDI—OTHER DATA FOR DEPOSIT INSURANCE ASSESSMENTS						
1. Uninvested trust funds (cash) held in bank's own trust department						1
2. Unposted credits (see Instructions):		XXX	XXX	XXX	XX	2
(a) Actual amount of all unposted credits or single factor % of item 19						(a)
OR						
(b) Separate amount of unposted credits or separate factors:						
(1) Actual amount for Demand Deposits or % of item 9, Schedule E						(b-1)
(2) Actual amount for Time and Savings Deposits or % of item 10, Schedule F						(b-2)

SCHEDULE FF—AFFILIATES					
Banks and other organizations which are "affiliates" or "holding company affiliates" of this bank within the meaning of Section 2 of the Banking Act of 1933, as amended. Number for which reports (Form 220) are required. (If none required, write "None")					

FR 363
April 1956

FORM FOR ANALYZING BANK CAPITAL
(See Notes on Reverse Side)

BANK: _____

LOCATION: _____ DISTRICT NO. _____

BASED ON REPORT OF EXAMINATION AS OF _____ (Dollar Amounts in Thousands)

	AMOUNT OUTSTANDING	CAPITAL REQUIREMENT		LIQUIDITY CALCULATION
		Per Cent	Amount	
(1) PRIMARY AND SECONDARY RESERVE				
Cash Assets	\$ _____	0%		47% of Demand Deposits i.p.c. \$ _____
Quar. Portion of CDC or V-loans	_____			38% of Time Deposits i.p.c. _____
Comm. Paper, Bk Acct. & Brks' Lns	_____			100% of Deposits of Banks _____
U.S. Govt. Secs:		0.5%	\$ _____	100% of Other Deposits _____
Bills	_____			100% of Borrowings _____
Certificates, etc. (to 1 yr.)	_____			Allow. for spec. factors, if info. available (+ or -)
Other (1-5 yrs.) (Incl. Treas. Inv., Series A & B)	_____			A. Total Provision for Liquidity _____
Other Secs. Inv., Rtngs 1 & 2 or Equiv. (to 3 yrs.)	_____	4.0%	_____	B. Liquidity available from Prim. and Secondary Res. ("amt. outstanding" less cap. required thereon) _____
TOTAL	\$ _____			
(2) MINIMUM RISK ASSETS				
U.S. Govt. Secs. (9-10 yrs.)	_____			C. Liquidity to be provided from assets in Groups 2, 3 or 4 (zero if B equals or exceeds A, otherwise A less B) _____
Ins., Portion FHA Rep. & Mod'n Loans	_____			
Loans on Pass'ks, U.S. Secs. or CSV	_____			
Life Ins.	_____			
Short-term Municipal Loans	_____			D. Liquidity available from Min. Risk Assets (90% of "amt. outstanding" in line 2) _____
TOTAL	\$ _____	4%		
(3) INTERMEDIATE ASSETS				
U.S. Govt. Secs. (Over 10 yrs.)	_____			E. Liquidity to be provided from assets in Groups 3 or 4 (zero if D equals or exceeds C, otherwise C less D) _____
FHA and VA Loans	_____			F. Liquidity available from Intermediate Assets (85% of "amt. outstanding" in line 3) _____
TOTAL	\$ _____	6%		
(4) PORTFOLIO ASSETS (Gross of Res.)				
Investments (not listed elsewhere)	_____			G. Liquidity to be provided from Portfolio Assets (zero if F equals or exceeds E, otherwise E less F) _____
Loans (not listed elsewhere)	_____			
TOTAL	\$ _____	10%		
* Plus 15% of 1st \$100,000 of portfolio, 10% of next \$100,000 and 5% of next \$300,000.				
(5) FIXED, CLASSIFIED & OTHER ASSETS				
Gk Prem., Fns. & Fint., Other Real Est.	_____			Extra Capital Required on Any Assets in Groups 2-4 Used for Liquidity
Stocks & Defaulted Secs.	_____	100%		6.5% of line C _____
Assets Classified as "Loss"	_____			4.0% of line E _____
Assets Classified as "Doubtful"	_____	50%		9.5% of line G _____
Assets Classified as "Substandard"	_____	20%		
Accruals, Fed. Res. Bk. Stock, Prep. Expen.	_____	0%		
TOTAL ASSETS	\$ _____			
(6) ALLOWANCE FOR TRUST DEPT. (Amt. equal to 300% of annual gross earnings of Department)				
(7) EXTRA CAP. REQD. IF ANY ASSETS IN GROUPS 2-4 USED FOR LIQUIDITY (zero if line 4)				
Liquidity Calculation is zero, otherwise Total in line 4)				
(8) ALLOW. FOR SPEC. OR ADDIT. FACTORS, IF INFO. AVAILABLE (+ or -)				
(See notes on reverse side)				
(9) TOTAL CAPITAL REQUIREMENT (1 thru 8)				
			\$ _____	
(10) ACTUAL CAP., ETC. (Sum of Cap. Stock, Surplus, Undiv. Profits, Res. for Conting., Loan Valuation Res., Net unapplied Sec. Valuation Res., Unallocated Charge-offs, and any comparable items) (Exclude Depreciation and Amortization Reserves)				
				\$ _____
(11) AMOUNT BY WHICH ACTUAL IS:				
{ MORE than requirement (10 minus 9) _____ + \$				
or				
{ LESS than requirement (9 minus 10) _____ - \$				
(12) RATIO OF ACTUAL CAPITAL, ETC. TO REQUIREMENT (10 divided by 9)				

NOTES REGARDING FORM FOR ANALYZING BANK CAPITAL

A thorough appraisal of the capital needs of a particular bank must take due account of all relevant factors affecting the bank. These include the characteristics of its assets, its liabilities, its trust or other corporate responsibilities, and its management—as well as the history and prospects of the bank, its customers and its community. The complexity of the problem requires a considerable exercise of judgment. The groupings and percentages suggested in the Form For Analyzing Bank Capital can necessarily be no more than aids to the exercise of judgment.

The requirements indicated by the various items on the form are essentially "norms" and can provide no more than an initial presumption as to the actual capital required by a particular bank. These "norms" are entitled to considerable weight, but various upward or downward adjustments in requirements may be appropriate for a particular bank if special or unusual circumstances are in fact present in the specific situation. Such adjustments could be made individually as the requirements are entered for each group of assets; but it usually is preferable, particularly for future reference, to combine them and enter them as a single adjustment under Item 8, indicating on the Analysis Form or an attached page the specific basis for each adjustment.

The requirements suggested in the Analysis Form assume that the bank has adequate safeguards and insurance coverage against fire, defalcation, burglary, etc. Lack of such safeguards or coverage would place upon the bank's capital risks which it should not be called upon to bear.

ITEM (4) — PORTFOLIO ASSETS

Concentration or Diversification. — The extra requirement of 15% of the first \$100,000 of portfolio, 10% of the next \$100,000, and 5% of the next \$300,000, as specified in item 4, is a rough approximation of the concentration of risk (lack of diversification) which is likely in a smaller portfolio, and which is usually reflected in the somewhat larger proportion of capital shown by most banks with smaller portfolios. This requirement is applied to all banks, but is naturally a larger portion of the total capital requirements of banks with smaller portfolios. However, a particular portfolio, whatever its size, may in fact have either more or less concentration of risk than other portfolios of similar size. If there is in fact substantially greater or lesser concentration of risk in the portfolio assets of the particular bank—as for example dependence upon a smaller or larger number of economic activities—it would be appropriate to increase or decrease requirements correspondingly.

Drafts Accepted By Bank. — When drafts have been accepted by the bank, ordinarily the customers' liability to the bank should be treated as Portfolio Assets if the acceptances are outstanding, or the acceptances themselves should be so treated if held by the bank.

ITEM (5) — FIXED, CLASSIFIED, AND OTHER ASSETS

Rental Properties. — Bank premises, furniture and fixtures, and other real estate are assigned a 100% requirement as a first approximation, since these assets usually are not available to pay depositors unless the bank goes into liquidation, and even then they usually can be turned into cash only at substantial sacrifice. However, some properties which bring in independent income, such as bank premises largely rented to others, may be more readily convertible into cash by selling or borrowing on them, and in such situations it may be appropriate to reduce the 100% requirement by an amount equal to an assumed "sacrifice" value, such as, say, two or three times the gross annual independent income.

Stocks. — In the case of stocks, their wide fluctuations in price suggest a 100% requirement as a first approximation. However, in some cases it may be appropriate to reduce the 100% requirement against a stock by an amount equal to an assumed "sacrifice" value, such as the lowest market value reached by the stock in, say, the preceding 36 or 48 months.

Hidden Assets. — In some cases assets may be carried at book values which appear to be below their actual value, and may thus appear to provide hidden strength. However, any allowance for such a situation should be made with great caution, and only after taking full account of possible declines in values and the great difficulty of liquidating assets in distress circumstances.

ITEM (6) — ALLOWANCE FOR TRUST DEPARTMENT

Deposited Securities. — The requirement for the trust department should in no event be less than the amount of any securities deposited with the State authorities for the protection of private or court trusts, since such securities are not available in ordinary circumstances to protect the bank's depositors.

LIQUIDITY CALCULATION

Percentages of Deposits. — The provision for 47% liquidity for demand deposits of individuals, partnerships and corporations actually represents 33-1/3% possible shrinkage in deposits, plus 20% of the remaining 66-2/3%. 36% of time deposits i.p.c. represents 20% shrinkage, plus 20% of the remaining 80%. In both instances, the provision for 20% liquidity for remaining deposits is to help the bank continue as a going concern even after suffering substantial deposit shrinkage.

Among possible special factors to be considered in connection with the liquidity calculation would be concentration or diversification of risk among deposits. This might be due to such things as dependence upon a smaller or larger number of economic activities, or preponderance of large or small deposits—large deposits usually being more volatile.

Liquidity Available from Assets. — Liquidity available from primary and secondary reserves is assumed to equal the amount of those assets less only the regular capital required thereon, since the regular capital specified for these assets assumes forced liquidation. However, the regular capital specified for other assets (i.e., those in Groups 2-4) is only a portion (approximately 40% of that required for forced liquidation). Therefore, in determining the liquidity available from such other assets, the amount of such other assets must be reduced by more than the regular specified capital.

Extra Capital Required. — This extra capital is to cover possible losses in forced liquidation of assets other than primary and secondary reserves in case they had to be used to provide liquidity. The 4% indicated for Line E amounts to an automatic addition to the 6.5% that has already been applied to Line C, and results in a total extra requirement of 10.5% of the liquidity to be provided from Intermediate Assets. Similarly, the total extra requirement on the liquidity to be provided from Portfolio Assets is 20%. If the same amounts of extra capital were stated as percentages of the assets to be liquidated rather than of the liquidity to be provided, the percentages would be smaller, namely, 6% of Minimum Risk Assets, 9% of Intermediate Assets, and 15% of Portfolio Assets.

The CHAIRMAN. Mr. Widnall.

Mr. WIDNALL. No questions at this time.

The CHAIRMAN. Mrs. Sullivan.

Mrs. SULLIVAN. No questions, Mr. Chairman.

The CHAIRMAN. Mr. Ashley.

Mr. ASHLEY. No questions.

The CHAIRMAN. Mr. Fino.

Mr. FINO. Mr. Martin, much has been said in the press of late about the outstanding success of our balance-of-payments program. Reports have been made that the gold losses have been cut down and that the picture looks a little more favorable. What I am interested to know is at what long cost to our future balance of payments has this affected this whole program?

Mr. MARTIN. Well, our voluntary foreign credit restraint program, which the Federal Reserve has been operating with respect to credit, and the Commerce Department with respect to direct investments, has been successful to date. We believe, as I stated in a little talk I made in Rutgers last week, that we have been in equilibrium for the last 3 or 4 months. But we do not think that this is a permanent solution, and Secretary Fowler has been hammering away at the theme that we have got to resolve this problem and work it out on a more permanent basis.

Mr. FINO. Well, we have found—at least this is the conclusion that has been reached—that the imbalance of payments has been caused by tourist money going abroad, of course, foreign aid, military aid, and also mention was made that our foreign investment has created that.

I would like to read to you your testimony of February 1 in connection with hearings on H.R. 3818, a bill to eliminate the requirements of Federal Reserve banks maintaining certain reserves in gold certificates against gold deposits, and in answer to a question, you said:

Well, the direct investment abroad is clearly a good thing in a sense. I think our earnings—I do not have the figures right at hand—but our earnings from our direct investment abroad are \$6 billion plus, and our outgo on investments that foreigners have in this country is substantially less. I would say less than \$2 billion. So we have a net advantage—if my figures are roughly correct—we have an advantage of about \$4 billion.

Do you recommend and suggest that we cut down on these foreign investments?

Mr. MARTIN. I think that temporarily we have to cut down on it because of the seriousness of our general position. But I hope that we will not give up having foreign investment abroad because, as you point out and I point out in that statement, it is a net advantage to us.

But our situation at the present time is so serious that we have got to deal with it.

I pointed out that the balance-of-payments problem to me today is very similar to what the problem of inflation was in 1951-52. We have to use all the weapons in our arsenal to deal with it, but certainly the voluntary foreign credit restraint program is no permanent solution to the problem. In fact, we must get back to the Bretton Woods goals of multilateral, nondiscriminatory trade in convertible currencies on a broad scale if we want a higher standard of living for everyone, which is what our overall goal is, and I am sorry that we have to resort

to this type of operation, but I believe it is necessary and essential because of the seriousness of the present situation.

Mr. FINO. As between the foreign aid and military aid programs and other programs, do you not think that the more palatable program would be this foreign investment?

Mr. MARTIN. The more palatable? I could not make that—you mean the more palatable to cut out?

Mr. FINO. No, to continue.

Mr. MARTIN. To continue? Well, that is a judgment that the administration has to make with respect to what their goals and objectives are. We have military expenditures, as you say, and we have foreign aid expenditures. We have the tourist expenditure. But this is the judgment that they have to decide on. It may be in the long run we will have to cut those, too.

Mr. FINO. What do you anticipate the period of time of cessation of this program to be?

Mr. MARTIN. Oh, I would hesitate to put any time on it because circumstances are changing right along. It has been going on since the 18th of February now, and we have made progress.

Mr. FINO. Could this become a permanent thing?

Mr. MARTIN. In my judgment it would be most unfortunate if it became a permanent thing, and I do not think it would work permanently.

Mr. FINO. Thank you.

The CHAIRMAN. Have you finished, Mr. Fino?

Mr. FINO. Yes.

The CHAIRMAN. Mr. St Germain.

Mr. ST GERMAIN. No questions.

The CHAIRMAN. Mr. Weltner.

Mr. WELTNER. Thank you, Mr. Chairman.

Mr. Martin, the bonds you have now are \$38.5 billion?

Mr. MARTIN. Of Government securities.

Mr. WELTNER. Of Government securities.

Mr. MARTIN. Yes.

Mr. WELTNER. What is the income, roughly, the income derived on that per year?

Mr. MARTIN. \$1,323,840,000 last year; \$1.3 billion.

Mr. WELTNER. That \$1.3 billion is subject to expenditure by the Federal Reserve for meeting all of its expenses, and the remainder is paid into the Treasury; is that correct?

Mr. MARTIN. That is correct.

Mr. WELTNER. Mr. Martin, I have a copy here of the Annual Report of the Comptroller General of the United States for the year 1964. One portion that interests me is that appearing on page 433 under the title "Restrictions on Audit Authority." Under that title is this, which I would like to read:

Organizations not subject to audit: The financial transactions and activities of the following organizations of the Federal Government are not subject to audit by the General Accounting Office.

They are listed:

Office of Alien Property, Office of the Comptroller of the Currency, exchange stabilization fund established by the Gold Reserve Act of 1934, Federal land banks, Federal Reserve System, Smithsonian Institution trust funds, U.S. Soldiers' Home trust fund.

Now, as I understand it, the Office of Alien Property is under the jurisdiction of the Attorney General. The Office of the Comptroller of the Currency, of course, is under the jurisdiction of the Secretary of the Treasury. The same holds true for the stabilization fund, I believe, created by the Gold Reserve Act. The Federal land bank is under the Farm Credit Administration. Trust funds in both the Smithsonian Institution and the U.S. Soldiers' Home, according to my understanding, are private contributions, not public moneys.

What this leads me to believe is that every function of the Government, of the administrative branch of the Government, is subject to audit by the General Accounting Office, either directly or indirectly, except the Federal Reserve System.

Now, as I understand it, there is no GAO audit of the Federal Reserve System.

Mr. MARTIN. That is correct.

Mr. WELTNER. And there is no audit of the \$1.3 billion that is received from interest from the Government securities held in your portfolio.

Mr. MARTIN. The Board is audited by Haskins & Sells, an outside auditor of some competence. We have had other auditors. We have had Price Waterhouse and Arthur Anderson previously. We have changed them about every 5 years—we have had two outstanding auditors.

The history of this goes back, Mr. Weltner, to the Banking Act of 1933 when the Congress decided that the Federal Reserve would be an independent agency in this sense, and the record is quite clear. You can, of course, at any time change this. I have not at any time questioned the authority or the ability of the Congress to change that.

Mr. WELTNER. Well, to whom is the report of your outside auditor made? To whom is that delivered?

Mr. MARTIN. It is delivered to us. We deliver the report of their audit of the Board's affairs to this committee.

Mr. WELTNER. I just wonder if there is any reason why this one tremendously important function of Government should be beyond the audit functions of the General Accounting Office.

Mr. MARTIN. Well, in my judgment there is. This has been a controversial matter for many years, but the Federal Reserve System is a unique organization. Its auditing and work is a specialized work. We send out—we have a specialized group of people that go into the individual Reserve banks periodically. The General Accounting Office would have to get an entirely new staff to do this job appropriately and effectively, and I think there are advantages in doing it this way.

I might point out that when the Bank of France and the Bank of England were nationalized, this is one thing that they did not change with respect to the operations of those institutions.

I do think that the guardianship of the currency of the country is in a little different character than, for example, my work as President of the Export-Import Bank. I think that there is a difference between the agencies. I am not saying that—

Mr. WELTNER. Well, there is a lot of difference between the State Department and the Defense Department.

Mr. MARTIN. No.

Mr. WELTNER. But both are subject to audit.

Mr. MARTIN. No, I do not think that is a legitimate distinction. The currency is something that to me is quite sacred and important in a way that differs from the duties of these other agencies. Now, this was the concept. As I pointed out yesterday, if you go back to the struggle of Mr. Jefferson and Mr. Hamilton to establish the credit of this country in the Assumption Act, you can see all of the threads that lead into establishing confidence in currency. We have been fortunate in this country that we have maintained it, and I hope that we can always maintain it.

Mr. WELTNER. I do too, Mr. Chairman, and—

Mr. MARTIN. This is a safeguard in my judgment, and you may take a different position, but in my judgment this is one of the safeguards.

Mr. WELTNER. But it seems to me that there would be an additional safeguard in having a public audit agency examining the activities of another public agency, the Federal Reserve System—unless there is some countervailing reason why that should not be done—which I hope you can give me if there is such a reason—

Mr. MARTIN. I can give you no reason other than that what I have and it was done this way up until the Banking Act of 1933. The Board is a public agency. The Reserve banks are quasi-public.

Mr. WELTNER. Is the Federal Reserve Board audited by the General Accounting Office?

Mr. MARTIN. It was prior to 1933, but it was taken out.

Mr. WELTNER. That has been 30 years, has it not?

Mr. MARTIN. That is right.

Mr. WELTNER. So there has been no audit by a Government department for 30 years.

Mr. MARTIN. There has been no audit by the General Accounting Office for that time; that is correct.

Mr. WELTNER. And it is accurate to say, is it not, that this is the only function of government that is beyond the auditing of—

Mr. MARTIN. I could not say, because I do not know the relationship. You are talking about the indirect relationships of these other agencies?

Mr. WELTNER. Yes.

Mr. MARTIN. There has always been some question as to the role of the Comptroller in the Treasury Department, whether he is subordinate or not. I could not pass on that. There are some very difficult problems in that.

Mr. WELTNER. Well now, last year we had, I believe, Mr. Kelly appearing before this committee, and he voiced some question as to whether or not the General Accounting Office would undertake to make policy for the Federal Reserve System if there were a GAO audit. Do you harbor such fears as that, Mr. Martin?

Mr. MARTIN. I do indeed.

Mr. WELTNER. Do you think the Comptroller General would be able to work his will and thereby affect the monetary policy of the United States through the simple function of an audit?

Mr. MARTIN. I think that the tendency might be in that direction; yes.

Mr. WELTNER. Well, would it be any different in the case of the Federal Reserve System than it would be of the Comptroller General

attempting to make military policy or diplomatic policy or any other kind of policy through audits of other branches of the Government?

Mr. MARTIN. I can only stand on my conviction, Mr. Weltner, which I cannot prove, that safeguarding the currency is different from the work of other agencies.

Mr. WELTNER. And the other agencies are different from the currency, too.

Mr. MARTIN. That is correct.

Mr. WELTNER. And the same argument would hold for them as against an audit of those agencies.

Mr. MARTIN. Well, I do not think so, but this is a matter of judgment.

Mr. WELTNER. Thank you very much, Mr. Chairman.

Thank you, Mr. Martin.

The CHAIRMAN. Mrs. Dwyer.

Mrs. DWYER. No questions, Mr. Chairman.

The CHAIRMAN. Mr. Gettys.

Mr. GETTYS. Mr. Martin, following up Mr. Weltner's line of thought, would you oppose a legislative proposal designed to bring the operational funds of the Fed within the annual appropriations considerations of the Congress?

Mr. MARTIN. I would indeed, very vigorously.

Mr. GETTYS. And for the reason that you think it is a separate type of operation.

Mr. MARTIN. I do indeed.

Mr. GETTYS. You stated a little while ago that you have testified against tax-exempt securities. Would you elaborate just a little bit on that, your thinking on that subject?

Mr. MARTIN. I will give you my thinking on it, Mr. Gettys, very gladly.

Mr. GETTYS. Incidentally, I admire and respect your thinking.

Mr. MARTIN. Well, my thinking has always run this way. My experience with people has been that the rank and file never complain about a man getting a large salary in a corporation, for example, when he is working for it. They all hope that they can get that large salary some day themselves. But I think they have a little bit of a beef when a man just lies on the beach and derives income without paying taxes on it.

Now, I know all the reasons why we got into this position and how difficult it is for the States to borrow. But I still personally——

Mr. GETTYS. The depositors——

Mr. MARTIN. Yes; I still question that. It seems to me that everybody should pay something in the way of taxes. I have a friend who does no work at all and pays no taxes at all on a large block of securities. To me that is not fair.

Mr. GETTYS. You think the rule then is designed to help the individual who purchases these securities or the rule is designed to help the municipalities and the——

Mr. MARTIN. I think it has become a part of helping the municipalities. I realize it would be very difficult today to reverse it. But I still do not——

Mr. GETTYS. That is the thought I have in what effect would it have upon the local and State governments.

Mr. MARTIN. It would have a serious effect on the issuance of their securities at the present time.

Mr. GETTYS. And I am one of those that believe that the local and State governments should do more in financing their various projects instead of coming to Washington.

Mr. MARTIN. So do I.

Mr. GETTYS. And I think maybe the elimination of the tax-exempt features might tend more to bring us to Washington. What do you think of that?

Mr. MARTIN. That is possible; that is very possible.

Mr. GETTYS. Mr. Chairman, if I have time for one more question, does the Fed actually operate in such a manner as to require American taxpayers to pay bond obligations more than once?

Mr. MARTIN. Absolutely not. There is no—

Mr. GETTYS. I am confused on that subject, Mr. Chairman. I would like to—

The CHAIRMAN. We brought it out here this this morning, Mr. Gettys, that Mr. Martin admitted that when they bought the bonds they paid for them in the normal way just like we all pay debts. They were paid for absolutely no question about that.

Mr. MULTER. Let us get this straight, Mr. Chairman.

The CHAIRMAN. It has been brought out before by interrogating Mr. Eccles and Mr. Martin. It has been brought out by Mr. Martin a number of times, including yesterday. They were paid for once. There is no question of this.

Mr. MULTER. Let us get that straight on the record, Mr. Chairman. Mr. Martin said they were paid for when the Federal Reserve banks acquired them, they paid for them, of course, they did.

Mr. MARTIN. They were issued in the open market.

Mr. MULTER. The obligation that is due has never been paid, is that correct? Mr. Martin never said the obligation has been satisfied.

The CHAIRMAN. He is a trustee.

Mr. MULTER. Let us draw the distinction between paying for something when you buy it and satisfying the obligation by a payment so the obligation ceases to exist. These obligations have never been paid off and satisfied so they cease to exist. The banks could not acquire them unless they paid for them.

The CHAIRMAN. May I invite your attention to the fact that when the Federal Open Market Committee buys a Government bond, the fact that it comes into their possession; is put in their lockbox in the Federal Reserve Bank of New York; how else can they get it without paying for it? That is the only way they can get it. They paid for it.

Mr. MIZE. Will the gentleman yield for just a brief clarifying question, I hope?

Mr. GETTYS. I yield.

Mr. MIZE. Mr. Martin, would you as a hypothetical matter please trace the movement of one of these typical bonds with a face value of say \$1 million at the time the Government first issued until it was purchased by the Federal Reserve and ends up in the vaults Mr. Patman was talking about, in the vaults of New York when it becomes a part of this \$38 billion portfolio? Maybe this will clear the whole thing up.

Mr. MARTIN. The Treasury issues a security. It is issued in the open market. We do not buy it at that time.

Mr. MIZE. Who buys it? The Chase Manhattan Bank for example?

Mr. MARTIN. Yes, the Chase Manhattan Bank, or you might buy it.

Mr. MIZE. Yes.

The CHAIRMAN. Will you yield just for a suggestion?

Mr. MIZE. Yes, sir.

The CHAIRMAN. They can only be bought through certain dealers. There are, I believe, 20 of them now. They have a monopoly on this market. You see, all Government bonds bought and sold by the Open Market Committee—these 20 dealers get a cut on these transactions.

Mr. MARTIN. Oh, Mr. Patman—

The CHAIRMAN. I mean the dealers get a cut on Federal open market transactions.

Mr. MARTIN. No, no, Mr. Patman, anybody can subscribe.

The CHAIRMAN. All bonds bought or sold by the Open Market Committee go through these dealers.

Mr. GETTYS. Mr. Chairman, I did not yield my entire time to—

The CHAIRMAN. Excuse me; Mr. Gettys has the floor.

Mr. MIZE. I never did get my bond traced.

Mr. GETTYS. I believe my time has expired, but I would be glad to yield, if I have time left, for Mr. Mize to proceed with his question.

Mr. MARTIN. May I put into the record an illustration?

Mr. MIZE. Please. That I think would help clarify the whole thing.

Mr. MARTIN. Yes, we will put into the record an illustration of the purchase of a bond and the sale of a bond and where it goes and how it gets into our \$38.5 billion.

The CHAIRMAN. To clarify it, Mr. Martin, you buy the bonds through the—

Mr. MARTIN. That is not the original sale, Mr. Patman.

The CHAIRMAN. He is representing the Open Market Committee—the Federal Open Market Committee; it is really a closed market, but we will call it an open market. You buy all your bonds through the dealers, do you not? Now you ought to be able to answer that without these fellows helping you.

Mr. MARTIN. I find your questions very difficult to answer. I never know whether I am going or coming. We will buy the bonds—

The CHAIRMAN. Through the open dealers.

Mr. MULTER. Let him answer.

Mr. MARTIN. There is a difference between the issuance of bonds by the Treasury and their subsequent purchase by the Federal Reserve. We go out into the open market and buy those bonds, and, as you say, we buy them through the dealers.

The CHAIRMAN. And when you sell them, you sell them through the dealers.

Mr. MARTIN. We sell them—

The CHAIRMAN. The dealer has two toll gates.

Mr. MARTIN. Where else would we go?

The CHAIRMAN. One going in and one going out. The dealer gets a cut both ways. These are the 20 exclusive dealers in Government bonds. There are no other dealers in this market.

Mr. MARTIN. This is all the dealers there are.

The CHAIRMAN. That is right.

Mr. MARTIN. If we can get some more, if you would like to deal—

The CHAIRMAN. Every one of them is located within a rock's throw of the Federal Reserve Bank of New York.

Mr. MARTIN. I would like to deal with you if you would set up an organization, Patman & Co.

The CHAIRMAN. I will find out if I can get a license and see if the banks will extend me a line of credit.

Mr. GETTYS. Mr. Chairman, I yield back the balance of my time with the statement that my confusion has been compounded.

Mr. MULTER. I think it might be well at this point, Mr. Chairman, to let Mr. Martin make a full and complete statement about these bonds without any interruption, from the time they are issued by the Treasury until they are finally paid by the Treasury.

The CHAIRMAN. There is no question about that. But if he wants to do it, Mr. Martin, you may elaborate on it.

Mr. MARTIN. I would much rather put it in the record.

The CHAIRMAN. All right, sir.

(This information was previously supplied; see p. 22.)

The CHAIRMAN. Mr. Todd.

Mr. TODD. Thank you, Mr. Chairman.

The CHAIRMAN. Wait, I believe Mr. Stanton is next.

Excuse me, Mr. Stanton. Mr. Johnson I mean. Seniority prevails here, you know.

Mr. JOHNSON. I am only senior by the toss of a coin. Thank you, Mr. Chairman.

Let us see, we are considering a question here whether we shall, let us say, emasculate the Federal Reserve System by taking \$30 billion worth of bonds out of your portfolio, giving them to the Treasury Department, and then they will, on their books, put a direct liability for \$30 billion worth of currency issued, and you, correspondingly, will be relieved of a \$30 billion direct liability on currency, as I understand it.

Now, if this were to become law, what kind of an entry would you make on the books of the System? I notice in your balance sheet here, as of April 28, in the entire System your main assets are gold certificate reserves of \$14 billion; U.S. Government securities, \$37 billion roughly; loans, \$439 million; and cash items, \$6 billion, or a total of \$59 billion in your assets.

Now, here are your liabilities. Federal Reserve notes issued, \$34 billion; member bank deposits, \$17 billion, and your capital stock issued is \$538 million.

Now, if this law were to become law, what entry would you make on the books of the Federal Reserve System? First of all you would credit the asset of the bonds being taken out of your portfolio; is that not right?

Mr. MARTIN. That is right.

Mr. JOHNSON. And your offsetting debit would be against Federal Reserve notes issued.

Mr. MARTIN. Right.

Mr. JOHNSON. In other words, then we will have a split situation wherein the Treasury Department on their books will have an obligation for \$30 billion worth of currency issued, and you will only have \$4 billion left, is that correct?

Mr. MARTIN. That is correct.

Mr. JOHNSON. Now, this other asset on the books of \$14 billion in gold, I take it that our gold out at Fort Knox is carried as an asset of the Federal Reserve System, is that right?

Mr. MARTIN. In gold certificate form, right.

The CHAIRMAN. Oh, no, no.

Mr. JOHNSON. That is, the first item on the balance sheet of the Federal Reserve System is \$14 billion in gold.

The CHAIRMAN. No, no, the Federal Reserve does not own the gold.

Mr. MARTIN. I did not say we owned the gold, but the gold certificates are assets of the System.

The CHAIRMAN. Only the gold certificates.

Mr. MARTIN. Yes, that is what I said.

The CHAIRMAN. Not the gold.

Mr. MARTIN. Well, I said the gold certificates.

Mr. MULTER. The gold certificates represent the gold, do they not?

Mr. MARTIN. They do.

Mr. MULTER. Instead of transferring the gold physically in bullion from one place to another, you have certificates showing you own it.

Mr. MARTIN. That is right.

Mr. MULTER. By you I mean the Federal Reserve banks.

The CHAIRMAN. But they cannot get the gold.

Mr. MARTIN. The whole history of credit is gold, goldsmith certificates, Government paper, and bank deposits.

The CHAIRMAN. Here in the United States you cannot transfer gold around.

Mr. MARTIN. It is against the law in the United States.

The CHAIRMAN. Sure it is. The Government owns the gold.

Mr. JOHNSON. You have these gold certificates, and for this \$30 billion worth of currency that you issue, under the law you are holding \$7.5 billion worth of these gold certificates as a currency reserve which represents gold at Fort Knox. You are holding that gold as a reserve against \$30 billion worth of currency, are you not?

Mr. MARTIN. Yes.

Mr. JOHNSON. \$7.5 billion.

Mr. MARTIN. That is right.

Mr. JOHNSON. Would you make an entry on your books transferring \$7.5 billion worth of gold to the Treasury Department as a security against this currency?

Mr. MARTIN. No, we would not. But what actually happens here is—as I point out in my statement—is that you increase the debt limit by \$30 billion and you reduce—instead of the 25 percent backing against these notes that are outstanding, you just remove that amount of notes from the Reserve Bank's liabilities.

Mr. JOHNSON. Is it not true that the bill does not require a transfer of gold to the Treasury Department?

Mr. MARTIN. That is right.

Mr. JOHNSON. So that the Treasury will not hold the gold as security for the \$30 billion worth of currency that they have issued.

Mr. MARTIN. That is not clear.

Mr. JOHNSON. Here we now have the Treasury Department directly liable on \$30 billion worth of currency. Will it not be necessary to set up an entirely new type of currency and call it U.S. Treasury notes

instead of Federal Reserve notes, because this \$30 billion worth of notes will no longer be Federal Reserve notes?

Mr. MARTIN. You would have to make a new setup entirely; that is the point you are making, Mr. Johnson. I agree.

Mr. JOHNSON. How broad are your open market operations? What is the function of your open market operations? Is it to, let us say, peg the price of Government bonds from day to day so that there is not a crash in the Federal bond market?

Mr. MARTIN. We operate in the Government securities market for the purpose of supplying reserves or absorbing reserves, but we have attempted to maintain orderly conditions in the Government securities market to prevent difficulties—

Mr. JOHNSON. If we take \$30 billion worth of bonds away from you people and we just leave you \$3 or \$4 billion worth, would you not be seriously hampered in your ability to carry out open market operations and thereby peg the bond market on Federal bonds?

Mr. MARTIN. We would not want to peg, but I do not know what the right amount is. Mr. Moorhead asked me a question yesterday, and I said I really do not know what the amount would be. Under certain circumstances and conditions that might be inadequate. Under other circumstances and conditions it might be adequate. We cannot say.

Mr. JOHNSON. This \$1,323 million worth of interest that you get from these obligations, I grant you that you have to pay your expenses out of it and pay the member banks a 6-percent dividend. Do you know how much money last year you turned over to the U.S. Treasury over and above your operating expenses and the dividends you paid to member banks?

Mr. MARTIN. We do. We can give you that figure exactly. In 1964 it was \$1,582 million.

Mr. JOHNSON. In other words, you paid back to the Treasury Department more money than they paid you on interest on the bonds that you held, according to that figure.

Mr. MARTIN. Well, it just happened that last year part of this came out of our surplus, but actually about \$1.1 billion was paid out of current earnings of \$1.3 billion.

Mr. JOHNSON. Thank you, Mr. Chairman. I would like to make a brief statement if I have time.

The CHAIRMAN. Mr. Todd.

Mr. JOHNSON. Would the gentleman yield for a brief statement?

I cannot help but feel, Mr. Chairman, that we are probably tampering with a very vital asset in this country and something that has made for outstanding and tremendous business ability, and if we force the Federal Reserve System to disgorge \$30 billion worth of these bonds and tamper further with our currency, I would say that you are going to see one of the worst crises in this Nation that you have ever seen. It will not be just a little speech by the chairman that you blamed for causing the last flurry. I think there are a lot of other things causing it such as tampering with our currency, tampering with the silver in our coins, taking the 25-percent gold away from Federal Reserve deposits and cutting taxes one day and raising the national debt \$4 billion the next.

The CHAIRMAN. Mr. Todd, would you yield to me on something that I consider to be very appropriate at this time?

Mr. TODD. I will be pleased to yield.

The CHAIRMAN. You see, the point is that these bonds have been paid for once. The taxpayers are being compelled to pay interest on bonds that should be liquidated, and this interest is taking \$1.3 billion out of the taxpayer's pocket. It is actually picking the pockets of the taxpayers of this country for a debt they do not owe. Mr. Eccles, former Chairman of the Federal Reserve Board, stated this very fact in 1941 when I interrogated him:

Mr. PATMAN. Those Federal Reserve notes that we have often discussed are obligations of the United States Government?

Mr. ECCLES. That is right.

Mr. PATMAN. Did you use these Government obligations to buy interest-bearing obligations and you place them with the Federal Reserve banks?

Mr. ECCLES. That is right.

It can't be clearer, Mr. Eccles says the Fed uses Federal Reserve notes to buy Government bonds. So when the Fed buys bonds with Federal Reserve notes, the bonds should be canceled. The members of the Board of Governors are trustees. They should be honest with the people, with the taxpayers, and with everyone, as I am sure they want to be. Therefore when they buy these bonds, pay for them with another Government obligation, Federal Reserve notes, the bonds should be canceled.

Now I quote Mr. Martin.

This is 1957, July 15:

Mr. PATMAN. Now those statements of the Federal Reserve Board covering the 12 Federal Reserve banks shows that 96 to 97 percent of all the earnings of the Federal Reserve banks come from interest on Government bonds. Now, Mr. Martin, in acquiring those bonds of the 12 Federal Reserve banks, isn't it a fact you don't use in banking of the money which you exchange for those bonds—for instance \$23 million worth for the Dallas bank—you didn't use the reserve of the member banks, did you?

Mr. MARTIN. That is correct.

Mr. PATMAN. Did you not use the capital stock of the member banks, did you?

Mr. MARTIN. That is correct.

Mr. PATMAN. You did not use the reserve in the surplus funds of the member banks?

Mr. MARTIN. That is correct.

Mr. PATMAN. Isn't it a fact that the only thing you used was money that you created, which of course you have a right to do under the law? You created \$23 billion in Federal Reserve notes whether you actually transfer them physically or not. The result was that you created that much in Federal Reserve notes and traded them for United States Government bonds. That is correct, isn't it?

Mr. MARTIN. That is one way of stating it.

So here are the best experts in the country—Mr. Eccles and Mr. Martin—who have served as Chairmen of the Federal Reserve Board for a combination of 27 years, more than half of the time of the existence of the Federal Reserve System, and they confirm exactly what I say on this.

They have confirmed my position in the past, not one time, but several times. Thank you, Mr. Todd.

Mr. MULTER. Will you yield for a moment?

Mr. TODD. I will be pleased to, Mr. Multer.

Mr. MULTER. We have heard this so many times I think I am beginning to see what the chairman is driving at. Apparently he means—correct me, Mr. Chairman, if I am wrong—when the Federal Reserve bank issues the Federal Reserve notes to the U.S. Treasury, in payment of a new Treasury obligation, that immediately that Treasury obligation should be canceled.

The CHAIRMAN. The Fed does not buy new Treasury obligations. They have the power up to the extent of \$5 billion, but they never use it.

Mr. MULTER. Wait a minute, let us see what we are talking about. We are not talking about what the Open Market Committee buys in securities or sells in securities in the marketplace. These statements—and correct me if I am wrong, Mr. Martin—by Mr. Eccles and by yourself that were read, refer to the original payment to the U.S. Treasury for original issue of U.S. securities, is that not so?

The CHAIRMAN. Oh, you are entirely wrong.

Mr. MULTER. Let us see if I am wrong.

Am I right or wrong, Mr. Martin?

The CHAIRMAN. They do not buy—

Mr. MULTER. When the U.S. security is issued by the Treasury Department to the Federal Reserve bank, the bank takes that security, is that right, the Federal Reserve bank gets the security?

Mr. MARTIN. We have done very little that way. We have this direct borrowing authority which we occasionally have gone through—

The CHAIRMAN. You have not used it in 3 years, have you?

Mr. MARTIN. We have not used it for some time. I hope we will never—

The CHAIRMAN. You never did use—

Mr. MARTIN. Oh yes, we used it, and it is a very valuable safeguard, but our purchases normally have been made in the open market through these dealers that Mr. Patman mentions, and I hope Mr. Patman will go into that business when he retires.

The CHAIRMAN. I do not think any bank, though, would give me credit.

Mr. MARTIN. Now we buy the bond in the open market. I think what Mr. Patman's confusion is, is with collateralization, with the collateral for the Federal Reserve notes, not with the purchase of bonds by the Federal Reserve.

I have tried to spell out in this statement here that we do maintain reserves of gold certificates. When a member bank wants some currency, it can come to a Federal Reserve bank, the Federal Reserve bank, to get the currency. The Federal Reserve bank in issuing the currency pledges against this currency—when it is issued from Washington here—Government securities and these gold certificates, and I think this is where the confusion comes. It is in the collateral and the purchase of the bonds.

When we purchase bonds—as distinct from the issuance of notes—we are supplying reserves to the community. When we sell bonds, we are absorbing reserves from the community.

The CHAIRMAN. Mr. Todd, will you yield to me on that?

Mr. TODD. I will be pleased to.

The CHAIRMAN. You state that I am confused. Now, on this testimony here in 1959, you were going to transfer bonds to the member banks so they would have the earning power. How were you going to change the collateralization there?

Mr. MARTIN. We did not propose to transfer any securities in 1959.

The CHAIRMAN. Oh, yes, you did. Here is the testimony, Mr. Martin.

Mr. MULTER. That is not his statement; that is a staff statement, Mr. Chairman.

The CHAIRMAN. I will show you how good a statement it is.

Mr. MARTIN. We said we could sell the securities. We did not say we would transfer them.

The CHAIRMAN. Just a moment. After Mr. Balderston finished his testimony, Mr. Brown, chairman of the subcommittee, said:

Mr. Balderston, I want to congratulate you on a splendid statement. I understand the staff of the Federal Reserve Board has prepared a helpful memorandum of background material for each member of the committee. Without objection the memorandum will be inserted in the record at this point.

You see, this was prepared by the staff of the Federal Reserve Board for the information of the Banking and Currency Committee before whom Mr. Balderston was testifying. Now, in that staff statement it says:

To the extent necessary to avoid undue credit expansion, reserves released by any reduction in requirements could be absorbed by the Federal Reserve sales of securities in the market. This would, in effect, shift earning assets from Federal Reserve banks to member banks.

You see, that was one of the intentions of this. You had more bonds on your hands than you needed. You had \$24 billion worth. They did not cost you a penny. Public credit created the money to do it.

Now, then, you wanted to transfer them to the banks.

Mr. MULTER. Mr. Chairman, that is not so. That staff statement is merely a statement of what could be done.

Mr. MARTIN. What could be done, that is the emphasis, right.

Mr. MULTER. What could be done. They were merely telling the committee this was one of the powers that they did have, not that they were going to exercise it, but that the power existed.

Mr. MARTIN. We had no intention of—

The CHAIRMAN. If I wanted to be an apologist for the System, I would use that language. Let me finish reading here:

“The present System portfolio is adequate to permit a substantial reduction.” You see, there is the Federal Reserve saying “We have so many bonds that we can permit a substantial reduction,” and \$15 billion was considered, “and still leave enough to provide sufficient earnings to cover expenses as well as for current purposes or policy.”

In other words, after giving \$15 billion in bonds to the banks, you would still have enough for expenses and for your open market operations. So now if you were going to shift bonds from the Federal Reserve, how would you change the collateralization any different from changing it there? The point is that this is all the same Government. It is the same public servants, obligated to look after the interests of all the people, and in doing that, we should not pay our debts twice, and we should not require taxpayers to pay interest on bonds that have been paid for once. That is my point.

Mr. MARTIN. Well, we do not. There is no twice in it. When we buy a bond, we pay for it. When we sell a bond, we get paid for it.

The CHAIRMAN. Well, when you buy a bond you pay for it, do you not?

Mr. MARTIN. And when we sell a bond we get paid for it.

The CHAIRMAN. Now then, you represent the Government. You reach over into the Bureau of Engraving and Printing and you get Government obligations. That is, Federal Reserve notes. They say on their face "This is an obligation of the U.S. Government." It is the same thing as a Government bond except the notes do not have interest. The bonds provide for interest. In one hand you reach over here and you get \$1 billion in Federal Reserve notes. You give it to a person for \$1 billion in U.S. Government bonds. Why should those Government bonds not be canceled because you represent the people of the United States and the Government of the United States? You are using the Government's money. You are just changing one form of Government obligation for another; just like if you had a mortgage on your home and the person wanted a short-term obligation, instead of 40 years you give him a new mortgage, you would make darn sure that that old mortgage was torn up immediately. You would not want both in existence. Here you are insisting on both remaining in existence. The Federal Reserve notes that are Government obligations, also the bonds.

Mr. JOHNSON. Will the chairman yield on that point?

Mr. TODD. I hate to have all this control over the committee's time.

The CHAIRMAN. Just one last minute, Mr. Todd.

Now here is another thing. This is in that same testimony of 1957:

Mr. PATMAN. Now then, Mr. Martin, isn't it a fact that these Federal Reserve notes that you issue in exchange for these bonds are obligations of the United States Government just as are the bonds?

Mr. MARTIN. That is right.

You see, you are trading one form of Government obligation for another and letting them both remain in circulation.

Mr. JOHNSON. Mr. Chairman, will you yield on that point?

The CHAIRMAN. Yes.

Mr. JOHNSON. In my remarks, Mr. Chairman, I pointed out that the capital stock of the Federal Reserve System is \$538 million. As I understand it, every share of that stock is held by member banks, and in order to understand the Federal Reserve System, we have to realize that it is an independent, central bank of this Nation where the capital stock is owned by member banks, and we are dealing with an entity separate and distinct, away from the Treasury Department, and I do not see how we can—with the independence in our System to have and enjoy—how we can just rip away from them \$30 billion worth of bonds and tamper with our currency, and in doing so, you are going to destroy the independence of the Federal Reserve System. The first thing you have got to do is amend the whole act. If that is the way you are going to do it, take away the member banks, the \$538 million in stock.

The CHAIRMAN. We have got to unlearn you before we can teach you anything. This is not being owned by member banks. It is not that kind of stock. It is not a proprietorship, that is right, is it not, Mr. Martin?

Mr. MARTIN. That is correct.

The CHAIRMAN. So you are wrong. It is not that kind of stock. It cannot be sold, it cannot be hypothecated. It cannot even be voted. So that changes your premise.

Mr. JOHNSON. These seven members of the Board——

The CHAIRMAN. That changes your premise.

Mr. MULTER. Only in part, Mr. Chairman, because the Federal Reserve banks are still the central bank of the United States of America.

The CHAIRMAN. And nowhere in the act will you find that word "independent." That word doesn't exist in the act. It was only created as part of a propaganda campaign in the last few years.

Mr. MARTIN. If you read the legislative——

The CHAIRMAN. Central bank is a good word to use after 1935 only. It was not a central bank in 1933.

Mr. MULTER. Is it now?

The CHAIRMAN. Before 1935 we had 12 regional banks. In 1935, in the depths of the depression, when everybody voted for anything they thought would get out of the depression, everything was put into that act. It then became the Federal Reserve Central bank of 1935.

Mr. MULTER. A central bank.

The CHAIRMAN. Central bank.

Mr. MULTER. And it is still a central bank.

The CHAIRMAN. Yes, it is.

Mr. MULTER. If you do not want it to be a central bank, you ought to try to amend the statute or repeal it.

The CHAIRMAN. I do not object to a central bank properly operated.

Mr. Todd, excuse me.

Mr. TODD. Thank you.

I would just like to comment that I do not know when I have provoked so much discussion without saying anything.

Mr. Martin, it seems to me there are three things this act in effect does. One, it increases the debt limit by roughly \$30 billion, as you have indicated. This could be offset by a separate bill reducing the debt limit by \$30 billion and would therefore have no effect, with compensating legislation.

It would reduce your income to the Federal Reserve System by about \$1.1 billion according to the figures submitted. This would have no practical effect upon your operations or the Treasury receipts because all this money goes into the Treasury now. If there were some objection on the part of this committee as to let us say, the manner in which the Fed spends money as an independent agency, this could be taken care of in separate legislation, and in fact this legislation would have no effect on your ability to buy thick rugs or thin rugs or fancy paintings.

Mr. MARTIN. No.

Mr. TODD. This would have to be done through separate legislation, so it seems to me the net effect then is to cause a bookkeeping transaction which reduces your obligations on your Federal Reserve notes by \$30 billion and retires \$30 billion of assets.

Now, could this not be done equally well through a scheme alluded to, I think by Mr. Stanton, in which the Federal Government would issue Federal notes. They could be the equivalent of a silver certificate without silver backing, which would be an obligation of the U.S.

Treasury. These notes could be given to the Federal Reserve System in exchange for its bonds, or in exchange for Federal Reserve notes which are now in circulation.

So this would mean a retirement of \$30 billion of Federal Reserve notes. These would come to the Treasury. These notes in turn could be paid to you and the bonds acquired by the Treasury for the Federal Reserve notes.

Is this not in effect what this bill would do, when you talk about the creation of fiat money?

Mr. MARTIN. Yes, I think so. I would not quarrel with that.

Mr. TODD. And this is, in a sense, why you would question the propriety of this type of an operation because it would be the equivalent of the creation of fiat money, which, if unrestricted, could lead to difficulty.

Mr. MARTIN. That is right.

Mr. TODD. Fine. I have no further questions.

The CHAIRMAN. Mr. McGrath?

Mr. MCGRATH. Thank you, Mr. Chairman.

Mr. MARTIN, are the audits of the Federal Reserve System which are made by private accountants sent to the GAO or to the Congress?

Mr. MARTIN. They are sent to the committee here, the House and Senate Banking and Currency Committees.

Mr. MCGRATH. Thank you. That is all.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Thank you, Mr. Chairman. I am very happy to ask a question before I too become unheard.

The CHAIRMAN. I said that respectfully.

Mr. STANTON. Mr. Martin, getting back to a question in the conversation that you had here with Mr. Fino in regard to our balance of payments, I wonder how you feel about the so-called temporary program which we now have in effect with regard to the voluntary restraint of foreign investments abroad. Do you think that this program has a possibility of becoming permanent in the near future or the future in order to allow our Government, which is faced with the problem of increased investments in foreign aid and a dangerous international situation, to increase their commitments?

Mr. MARTIN. I think there is no likelihood of it becoming permanent. I do not think it would work if it became permanent.

Mr. STANTON. I do not either, but I wanted to make sure as to how you felt on the subject.

No other questions, Mr. Chairman.

The CHAIRMAN. Yes, sir. Mr. Hansen?

Mr. HANSEN. Thank you, Mr. Chairman.

Chairman Martin, is there any limit to the number or the amount of Government bonds that the Fed can hold?

Mr. MARTIN. Well, only that our deposits and notes can never be four times our holdings of gold certificates.

The CHAIRMAN. Mr. Martin, the deposits, you are mistaken about that.

Mr. MARTIN. The deposits have been changed on that.

The CHAIRMAN. The deposits of the banks we have repealed——

Mr. MARTIN. We are talking about notes now.

The CHAIRMAN. That is all in the notes in actual circulation.

Mr. MARTIN. That is right.

Mr. HANSEN. I am asking the question: Is there not a limit as to the amount of money the Fed can invest in Government bonds or Government securities? That is what we are discussing here today, the matter of getting rid of some of these bonds. I am like Tom Gettys. I am a little confused this morning. It reminds me of when I was walking down the street a few years ago with a fellow when they had all these elephant stories going around, and he asked me, "Did you ever see an elephant with pink toenails?" and I said, "No." He said, "Do you know why they have pink toenails?" He answered by saying, "So they can hide in cherry trees." I said, "No; I have not seen them in cherry trees." He said, "That just proves my point."

Mr. MARTIN. There is no limit, Mr. Hansen, on the Government securities that we can purchase.

Mr. HANSEN. You could purchase theoretically then the whole national debt.

Mr. MARTIN. We could, but I—

Mr. HANSEN. Theoretically.

Mr. MARTIN. I think a government that finances itself by selling its securities to itself—there is a limit on how long that can go on.

Mr. HANSEN. I can see that point.

Mr. MARTIN. I am talking about the legal limit.

Mr. HANSEN. Do these securities that we are talking about include Treasury bills and Treasury notes?

Mr. MARTIN. That is right.

Mr. HANSEN. They do?

Mr. MARTIN. They do.

Mr. HANSEN. Has the accumulation of these securities been a conscious effort on the part of the Fed, or is it a byproduct incidental to your other monetary functions?

Mr. MARTIN. Well, our problem is to regulate the money supply so that there will not be too little or too much money. This is a matter of judgment that the Open Market Committee is confronted with.

The CHAIRMAN. Mr. Martin, I did not understand you. Do you say it is a matter of judgment as to how much you—

Mr. MARTIN. I said that the regulation of the money supply, as to whether there is too little or too much money in the stream, is a matter that the Open Market Committee—

The CHAIRMAN. Thank you, sir.

Mr. MARTIN (continuing). Is dealing with at each meeting, and we have, generally speaking, felt that there should be some increase in the money supply with the growth and development of the country. What the increase ought to be is a matter of judgment, but it has steadily increased, and we now have \$38.5 billion of these Government securities that we have acquired in carrying out that factor of growth.

Mr. HANSEN. Actually the accumulation has stemmed from—

Mr. MARTIN. From monetary policies.

Mr. HANSEN. From monetary functions. I am still not clear as to how the Fed operates in acquiring these bonds. I have heard several discussions about it here this morning, but it is still unclear. If you have—I am like Congressman Mize here, I would like to have a tracing

made, and I understand you are going to do this for the record. But I for the life of me cannot quite understand how you can take \$30 billion of these and cut them away. What would you do, pull in an equivalent amount of Federal Reserve notes to keep yourself in balance?

Mr. MARTIN. Well, under this bill it would be just a bookkeeping entry. You could cancel them.

Mr. HANSEN. You would just cancel them.

Mr. MARTIN. That is right. The liabilities would be transferred to the Treasury.

Mr. HANSEN. I beg your pardon?

Mr. MARTIN. The liability would be transferred to the Treasury.

Mr. HANSEN. And what would they do with it? As Congressman Todd said a bit ago, do they issue certificates again to pay for them, or what?

Mr. MARTIN. I do not know what they would do with them, Mr. Hansen. They would have to set up a new bookkeeping setup.

Mr. HANSEN. And if they did this then, could they turn around and resell these bonds?

Mr. MARTIN. Oh, the Treasury? No; these are being canceled.

Mr. HANSEN. Oh, I see.

Mr. MARTIN. By this bill.

Mr. HANSEN. Well, I will be interested to see your outline of the history of the creation of a Federal Reserve note by way of the Government bonds, as you expect to outline it to us, because this looks a little bit complicated to me, and I cannot quite figure out how you can short circuit the thing.

Mr. MARTIN. I think it would be very damaging, as I said yesterday, if we took this bill very seriously. I think a lot of our foreign creditors and others would think we were just going haywire.

The CHAIRMAN. Do you not think that we would be haywire by paying a debt twice?

Mr. MARTIN. If we pay debts twice; yes. But I do not concede that we do.

The CHAIRMAN. I think I have proven by your own statements that we have.

Mr. MULTER. Some members of the jury dissent.

Mr. HANSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Mr. Martin, from your testimony I was going to ask two questions that have been touched upon; H.R. 7601, are you against the bill?

Mr. MARTIN. Right.

Mr. ANNUNZIO. Could you further elaborate on the effect that the passage of this bill would have on the economy? You said it would be disastrous. How do you mean that?

Mr. MARTIN. Well, I think it would be damaging to the credit of the United States. This is the thesis, if we can cancel \$30 billion, why do we not cancel the whole debt? I do not see why you stop at \$30 billion. You can make some relationship to what our holdings are in this, but I think that this is putting the foot in the door or saying that when you get into a little bit more debt than you want, you just cancel it.

Mr. ANNUNZIO. How would it damage our credit? Do you mean with foreign countries?

Mr. MARTIN. Well, I think at home. You have to sell these bonds to our own citizens. I do not know. You might have a different judgment than I have on it, but I would be a little bit more skeptical about buying Government bonds if this went through than I am now.

Mr. ANNUNZIO. I am not expert on this financial business, but I do know that we have more people today than we ever had, population-wise. We have more people working. We have more safety valves in the economy that the Congress has provided, and I am not too concerned about the future. We have a lot of people who are not producing anything in our society, liabilities, and we ought to make these people assets, and when people become assets, they have money they do not hoard money or save money. They buy the very necessities of life to live on, and that is what makes the economy prosperous and will continue to make our economy grow.

I am only giving a simple explanation as to how I look at this problem. And I do not know enough about whether this \$30 billion will affect our economy to that particular extent.

I would appreciate more of an explanation, Mr. Martin, on this particular bill for the record if you can supply it.

Mr. MARTIN. I doubt if I can give you much more, but you and I have exactly the same objectives, Mr. Annunzio. I am in complete agreement with you.

Mr. ANNUNZIO. Thank you.

The CHAIRMAN. Mr. Mize.

Mr. MIZE. Thank you, Mr. Chairman.

Mr. Martin, how long a term are these Government securities, generally, that are included in this \$38 billion portfolio we are talking about which you hold?

Mr. MARTIN. I would say the average of the bonds would be about 5 years. Of course, most of our holdings are short-term bills, notes, and certificates.

Mr. MIZE. That means blocks of them mature from time to time.

Mr. MARTIN. They do.

Mr. MIZE. When they mature, how does the Treasury Department pay you?

Mr. MARTIN. How do they pay the bonds?

Mr. MIZE. Yes.

Mr. MARTIN. Well, we get a credit into our account.

Mr. MIZE. Now then, Mr. Chairman, I would like to explore one thing with you, sir, please. You seem to object to this what you call "toll gate effect" that these bond dealers enjoy, commissions on the way in, commissions on the way out. Could I explore this just a minute? Suppose there is a Chevrolet dealer in Texarkana, Tex., and he sells a new car to you, for example, and after 6 months you decide you want another new car, and you go back to that same dealer, and you trade the new car that you originally had back.

Now, he has got the same car back and has made two profits already on the one car. Now, he takes the used car and sells it to someone else. This person comes back in a year and a half with that used car and sells it back, or trades it in on another car, i.e., that same dealer may make four or five profits dealing on that same car.

Do you say that that is wrong?

The CHAIRMAN. No, I say it is right.

Mr. MIZE. Then what in heavens name is wrong with a bond dealer or stock dealer making a profit on the same situation, in bonds or securities bought and sold for various customers?

The CHAIRMAN. This is almost a put-up deal, the way I see it. The buying and selling of Government securities by the Federal Open Market Committee could be handled by the 12 Federal Reserve regional banks themselves.

Since our debt has become so large, there is no way to have an absolutely free market, experts tell us. This is almost a fake, you know, to have only a handful of dealers and say, "Now you will have an exclusive on this," and all bonds that go to and from the Open Market Committee, "they have got to go through you."

In other words, you have a toll gate here, and they get a cut. And all bonds that are sold must go through you, these certain dealers, these exclusives, and they get a cut on that.

Well, that is just charging the people for something they should not have to pay. It is unnecessary. It is useless in my book. It does not create any free market, never has, and never can.

Mr. MIZE. Are there any regulations or any laws that specifically state there are only 20 dealers in the United States of America that can deal in bonds of this size?

The CHAIRMAN. They only license a few dealers. There used to be 17.

Mr. MARTIN. There is no licensing at all, and I have offered you an opportunity to go into the business, Mr. Patman.

The CHAIRMAN. Well, if you would back me, now we might talk about it.

Mr. MIZE. Mr. Chairman, we have to admit that there are not very many people who can deal in bonds with face amounts as large as a \$1 million bond or note.

The CHAIRMAN. That is right, I admit that.

Mr. MIZE. There are large dealers——

The CHAIRMAN. Right there in Wall Street every one of them, and they have a country-type family telephone and they can all talk at the same time if they want to.

Mr. MARTIN. Anyone who has adequate capital and wants to make a market is eligible.

The CHAIRMAN. What is that?

Mr. MARTIN. Everybody who has adequate capital and wants to make a market is eligible, and I hope that you will consider going into business.

Mr. MIZE. Mr. Chairman, may I ask one more question, please, sir?

Let us assume that the Federal Government issues \$100 million worth of bonds to refinance \$100 million that are maturing to help finance the deficit that is being created by the building of our Great Society, and these bonds are not \$1 million face value but only \$10,000 face value. Now, they make an announcement that they are going to issue these bonds, and Congressman Annunzio decides he wants to buy one of those bonds. It is a 5-year maturity, let us say.

The CHAIRMAN. That is a direct issuance from the Treasury.

Mr. MIZE. That is right.

The CHAIRMAN. They come under a different category.

Mr. MIZE. The same principle is involved.

The CHAIRMAN. No, it is not because they do not have to go through these dealers.

Mr. MIZE. I am frustrated. I quit.

The CHAIRMAN. Mr. Martin, if it is all right with you, we will reserve the right of sending you written questions, and you can answer them for the record, and maybe we can shorten this some. Will that be satisfactory with you?

Mr. MARTIN. I will do my best.

The CHAIRMAN. And we will take the privilege of not only asking you about this \$40 billion but also about your June 1, 1965, speech since it has gotten into this discussion, too, if the members want to ask you about it. That will be all right with you, will it not, Mr. Martin?

Mr. MARTIN. You can ask me anything at all, Mr. Patman.

The CHAIRMAN. You always fall on your feet like a cat.

Mr. MULTER. If I heard correctly, we have certainly created a lot of inflation—that \$30 billion mentioned in the bill has now gotten to be \$40 billion.

The CHAIRMAN. And he is talking about why not cancel the whole national debt. Of course that is irrelevant. I am only talking about canceling the bonds that have been paid for once—those bonds held by the Federal Open Market Committee. I am against even the taxpayers' having to pay a debt twice.

Mr. STANTON. Mr. Chairman, are we going to hear from the Secretary of the Treasury on H.R.——

The CHAIRMAN. We will consider that. If it is important, we will do it.

Any other questions?

Mr. WELTNER. Mr. Chairman, with Mr. Martin's narrative on the creation, purchase, holding, and acquisition of these bonds, may we request that a copy be furnished to each member rather than having to await the printing of the record to read it?

The CHAIRMAN. I did not understand you.

Mr. WELTNER. I would like a copy of Mr. Martin's narrative about the course of history of these bonds without waiting.

The CHAIRMAN. The minute it comes back it will be printed right away. This whole transcript will be printed, and then you will get it, and I will get it, and the rest of us will.

Mr. WELTNER. All right, sir.

The CHAIRMAN. That is the only way we can handle it.

Any other questions?

Mr. MARTIN. We will send one to you, Mr. Weltner.

The CHAIRMAN. You can furnish him one.

Any other questions before we recess?

Mr. MULTER. I would like to suggest, Mr. Chairman, before we recess, in years gone by at the beginning of new sessions the Federal Reserve used to come up at the invitation of the chairman of the Banking and Currency Committee and give the members of the committee—particularly the new members—the A B C's of the operation of the Federal Reserve Board. That has not been done this year.

I hope, Mr. Martin, you will find the time to invite at least the new members down to the Federal Reserve Board so we can get the complete story about the operations of the Federal Reserve System.

The CHAIRMAN. And give the chairman equal time. Thank you, sir. We will stand in recess.

(Whereupon, at 12 o'clock noon, the committee adjourned subject to the call of the Chair.)

(The following material was submitted for inclusion in the record:)

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
OFFICE OF THE CHAIRMAN,
Washington, August 19, 1965.

HON. WRIGHT PATMAN,
*Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.*

DEAR MR. CHAIRMAN: This is in reply to your letter of July 15, in which you asked for responses to a number of questions, to be included in the record of your hearings on H.R. 7601. As you requested, the questions are restated below, followed by my answers.

1. *With regard to H.R. 7601, a bill to provide for the retirement of \$30 billion of interest-bearing obligations of the United States, please answer the following questions:*

A. *Does not the Federal Reserve occupy a position of agent and trustee for the Federal Government in respect to the open market portfolio?*

Answer. Not in the sense in which the word "agent" is used in question 1B. Obviously, System officials recognize an obligation to perform their duties in the public interest, if that is what is meant by the question. But question 1B seems to indicate that a much narrower meaning is intended—that the question is whether System open market purchases are made as agent for the Treasury. The answer is that, while the Reserve banks act as fiscal agents for the Treasury in several respects, as they are expressly required by statute to do, the System is not acting as an agent for the Treasury when it purchases Treasury obligations for the System Open Market Account.

1B. *As an agent of the United States, why should the Federal Reserve not be required to cancel bonds that it purchases with the public credit?*

Answer. Bonds purchased by the Federal Reserve System are paid for by the assumption on the part of a Reserve bank of a liability (credit in the reserve account of a member bank) which is separate and apart from any obligation of the Treasury. Under such circumstances, the Federal Reserve System has merely become a holder in due course of a Treasury promise to pay, and there is nothing in such a transaction that would justify canceling this promise.

1C. *What justification exists for the Federal Reserve continuing to collect interest on these obligations in its portfolio?*

Answer. As indicated in the answer to 1B, the purchase of a Government security by the Federal Reserve System does not relieve the Treasury of its obligation to make whatever payments it promised to make when it sold the security. A Federal Reserve bank holding a Government security is as much entitled to collect interest on that security as is any other holder in due course.

In a broader sense, the question seems to ask whether there is any reason to distinguish the assets and liabilities of the Federal Reserve System from those of the Treasury. Perhaps this is the basis for the assertion in question 5 that the present arrangements constitute "at least a myth, if not a deception." But there are good reasons for keeping the System's books separate from those of the Treasury. In essence, separate books help to keep the credit functions of the System separate from the borrowing functions of the Treasury.

The reverse of the question also merits attention; would any benefits flow from canceling the securities? It has been said that cancellation would lower the interest payments the Treasury must make on the debt (ignoring the fact that it would reduce the interest payments the Treasury receives from the Reserve banks by precisely the same amount). Or it is said that it would improve the Government's credit rating (lowering interest costs) to reduce the debt. Against this possibility should be weighed the risk of damaging the Government's credit rating (raising interest costs) by appearing to repudiate part of the debt.

Finally, it has been suggested, the Government could use the money that has been invested in the System's portfolio to finance the antipoverty program. This ignores the fact that H.R. 7601 would not provide the Treasury with any funds to spend for any activity, however worthy. It also seems to suggest that the motivation behind the bill is to use the credit-creating (or money-creating, if you prefer) powers of the Federal Reserve System to extend credit (or create money), in multi-billion-dollar magnitudes, over and above the amount appropriate under current economic conditions, purely for the purpose of financing the Government. The impact of such a course of action on the Government's borrowing costs would depend on many factors, but if it were steadfastly pursued long enough, the temporary financial benefits to the Government would be outweighed by the damaging effects on the economy of the ensuing inflation.

1D. Isn't it true that the \$38.5 billion now held in the open market portfolio is far in excess of any amount needed to carry out the objects of the Open Market Committee?

Answer. Yes.

1E. In your opinion, what is the minimum necessary size of the portfolio that the Federal Reserve would need for its own functions?

Answer. As I indicated in my testimony, there is no practicable way of estimating the minimum necessary portfolio to meet all contingencies, but it should suffice to say that if \$30 billion of the System's securities were canceled, the remainder in the System's portfolio would be sufficient for monetary policy purposes. Whether it would be sufficient to meet collateral requirements on Federal Reserve notes depends on whether the intent is to remove these requirements for the \$30 billion of Federal Reserve notes on which liability would be transferred to the Treasury under section 2 of the bill.

1F. What legal basis is there, if any, for permitting the portfolio bonds to continue drawing interest while in the hands of the Federal Reserve? What basis is there for any agency of the United States to retain the bonds of the United States and collect interest on such bonds from the United States? In other words, Mr. Martin, if I were in business, could I, as a matter of good accounting procedure, purchase an outstanding note of the business and then continue to have the business pay interest on its own unretired notes? Wouldn't I have to retire the note?

Answer. See answers to questions 1B and 1C. The legal basis for making payments on Treasury securities (in the hands of the Federal Reserve System or in the hands of Government trust funds such as those established under the social security program, or indeed in the hands of any other purchaser, public or private) is that the Government has contracted to make the payment, and this contractual obligation is not satisfied until payment is made. The accounting basis is that good accounting practice requires that assets and liabilities of separate entities not be commingled. Answering the third part of this question and applying the principles just mentioned, it would seem that if an individual invested his own funds in an outstanding note of a business firm with which he was connected, the business firm should still be required to meet its contractual obligation on the note.

1G. Isn't it true that any attempt to reduce the portfolio substantially through selling the bonds would cause a severe contraction in the whole credit structure, and trigger off a depression—unless, of course, the commercial bank reserve requirements are sharply reduced, as was proposed in 1959 in what I refer to as the vault cash giveaway proposal?

Answer. A substantial reduction in the portfolio through sales of securities would reduce bank reserves and therefore the lending potential of banks unless a compensating reduction in reserve requirements were made; this could in some circumstances cause a recession or depression. The System did not propose a sharp reduction in reserve requirements in 1959.

1H. Doesn't the retention of these bonds in the portfolio under present practices result in a double counting and therefore an exaggeration of the public debt and an inflation of interest charges for the American taxpayer?

Answer. No. As more fully explained in my other comments furnished for this record, there is no double counting, and therefore no exaggeration of the public debt; cancellation of \$30 billion of the System's portfolio would reduce the System's payments to the Treasury by precisely the same amount as the Treasury's payments to the System; there would, therefore, be no saving to taxpayers.

11. Isn't it a fact that when the Federal Reserve purchases U.S. bonds, it is actually exchanging one Government obligation—a non-interest-bearing one—for another Government obligation that bears interest?

Answer. No. As correctly stated in question 1J, the Federal Reserve System pays for the bonds it buys by increasing its deposit liabilities to member banks. Such a transaction is not an exchange of one Government obligation for another because a deposit in a Reserve bank is not a Government obligation.

1J. Isn't it a fact that the Federal Reserve System creates money to pay for these bonds merely by increasing the deposits of the selling banks? Isn't it a fact that it has free access to the Treasury for obtaining such supply? Looking at it another way, does not the Federal Reserve have the free exercise of the credit of the United States, i.e., the sovereign power to create money?

Answer. The System pays for Government securities it acquires by crediting the account of a member bank (which may be the seller or the seller's bank), thereby increasing the deposit liabilities of the Reserve banks.

The Federal Reserve banks do not use or need access to the Treasury to obtain a supply of money to increase reserve balances of member banks. This is a characteristic of any central banking system that controls the clearing accounts of commercial banks. In this respect a central bank differs from a commercial bank because the central bank cannot lose deposits through the settlement of interbank clearings, as happens in the case of commercial banks.

For instance, when a commercial bank makes a loan to a customer, the following transactions are likely to occur:

- (1) The bank will increase the customer's balance.
- (2) The customer will spend the loan funds by drawing a check against his balance and giving the check to a third party.
- (3) The third party will deposit the check in another bank, which in turn will present it for payment to the original lending bank.
- (4) The lending bank will then have to transfer funds to the second bank in payment for the check.

In contrast, when a member bank draws a check against its deposit account at its Reserve bank, the check will wind up as a deposit in the account of another member bank at its Reserve bank.

1K. Will you give us the benefit of your recommendations and guidance as to any improvements or revisions that should be made in H.R. 7601?

Answer. The Board's basic objections to H.R. 7601 cannot be overcome by amending the bill. Any effort, as a service to the committee, to assist in perfecting the measure in spite of the Board's opposition to it, would be ineffective without some clearer understanding of what it is intended to accomplish.

2. Mr. Martin, on page 3 of your testimony, you state that the enactment of H.R. 7601 would repeal the gold certificate reserve requirements for about six-sevenths of the Federal Reserve notes now in circulation. That statement is clearly without factual support. If H.R. 7601 were enacted today, the gold certificate requirements on outstanding or new Federal Reserve notes would not change in the slightest extent.

A. Isn't it true, Mr. Martin, that your statement to this effect is predicated on two assumptions that you have failed to state: The first is that Congress would enact, and the President approve, an amendment of the Federal Reserve Act reducing the gold certificate requirement; and, secondly, assuming such unlikely legislation, you further assume that the entire \$30 billion would be converted into Federal Reserve notes and that existing gold reserves would remain completely static?

Answer. My statement was that the bill does not expressly repeal the gold certificate reserve and collateral requirements, but that since section 2 would cancel the Reserve bank's liability on \$30 billion of Federal Reserve notes presumably the intent would be to do away with these requirements for the \$30 billion (p. 2 of my statement). I then added that "If this analysis is correct * * * H.R. 7601 would repeal (these requirements) for about six-sevenths of the notes now in circulation."

Your question indicates that you intend, on the contrary, to require the Federal Reserve banks to hold gold certificate reserves equal to 25 percent of all of their Federal Reserve notes, including the \$30 billion on which their liability would be extinguished. There would seem to be no rational basis for continuing that requirement and not continuing the collateral requirement. But if the collateral requirement were continued, the Federal Reserve System would be

forced to buy Government securities in such large amounts to meet the collateral requirement that it would be unable, under existing law, to absorb the resulting increase in bank reserves, even by raising reserve requirements to the maximum permitted under existing law. The result would be, in my judgment, not only an unwarranted burden on member banks but also an economically disastrous increase in bank credit.

I considered pointing this out in my testimony on H.R. 7601 but concluded, in all fairness (I thought), that you did not intend this result.

2B. Since Federal Reserve notes presently consist of slightly less than 10 percent of the existing national debt, on what possible basis do you assume that 100 percent of the \$30 billion would be converted into Federal Reserve notes?

Answer. Answering questions 2A and 2B, my statement was not predicated on either assumption that you state, but on the assumption that a fair reading of section 2 of H.R. 7601, itself, would probably (although not clearly) lead to the conclusion that it impliedly repealed the gold certificate reserve and collateral requirements for the \$30 billion of Federal Reserve notes mentioned in the section.

*3. In your statement you state that " * * the provisions of existing law with respect to the issuance and collateralization of our currency are well designed to avoid misunderstanding and mistrust." You state further that the existing system is designed "to assure people" of the continuing value of the dollar.*

A. Do you intend to suggest that the soundness of the dollar is dependent on the collateral against it? Isn't the soundness of the dollar really dependent on the viability of the economy generally and the relative levels of employment and production specifically?

Answer. As pointed out in my prepared statement on H.R. 7601, the answer to your first question is "Not necessarily." The answer to the second question is that the same policies that produce a sound dollar will produce a healthy, growing economy; policies that undermine the soundness of the dollar will also undermine the soundness of the economy.

*3B. As your remarks in this regard seem to infer psychological considerations, wouldn't there be great psychological advantage in the cancellation of \$30 billion of the existing national debt because the Government securities representing that debt have been paid in full? In other words, as you say, " * * the credit of the U.S. Government in the eyes of our own citizens is continuously put to the test * * " by market borrowings, wouldn't marking "PAID IN FULL" on \$30 billion of the national debt greatly enhance the credit of the United States in the eyes of our own citizens and the rest of the world?*

Answer. If they really were paid off, that would enhance the credit of the United States. But if they were not really paid off, but simply marked "PAID IN FULL" the credit of the United States would be damaged.

4. In your testimony on H.R. 7601 you express a dichotomy between "maintaining the supply of currency needed to meet the needs of commerce, industry, and agriculture" and the "the function of financing such deficits as may arise as a result of Government expenditures in excess of current receipts."

A. Aren't deficit expenditures by the Government part of the general pattern of our economic boom since the end of World War II? Are you opposed to such expenditures? Are you suggesting that the pattern or nature of Government expenditures be changed? If so, what do you suggest?

Answer. Obviously, the Government has been running a deficit in most years since World War II. My statement was that the function of maintaining the supply of currency at appropriate levels should be kept separate from the function of borrowing to meet budget deficits. This has nothing to do with whether budget deficits are a good thing or a bad thing. The point is that the powers of the System (whether they are described as extending credit or creating money) should be geared to the economic needs of the Nation, not the borrowing needs of the Government. One of the objections to H.R. 7601 is that it seems to be aimed at using Federal Reserve credit to pay the Government's bills without any regard to its consequences for the economy. In your opening statement at the hearing, for example, you said that "\$38.5 billion would go a long way toward building schoolhouses and training the poverty-stricken for jobs and making skilled people out of them, providing hospitalization, and so forth." This seems to say that the Federal Reserve System should endeavor to supply \$38.5 billion to the Treasury so that the Treasury would not have to borrow it in the marketplace. While H.R. 7601 would not do that (and would not in fact provide the

Treasury with one cent it does not now have), apparently you view the bill as a preliminary step toward meeting the Government's expenses with Federal Reserve credit. That is precisely why I feel it is wrong in principle.

4B. How do deficit expenditures affect the money supply?

4C. In order to insure continued growth of our economy, isn't it necessary to insure a concomitant rate of growth of the money supply?

Answer. Deficit expenditures have no direct effect on the money supply. The money supply must grow if the economy is to continue to grow. The rate at which it should grow is a matter of judgment, but the point is that that judgment should be reached solely on the basis of how much is needed for the economy; we must not use the Federal Reserve System to expand credit faster than is good for the economy simply because it will help meet Government deficits.

5. In your statement you strongly support our system of collateralization of our currency and our system of market borrowing by the Government as assuring that "neither the Congress, the administration, the Federal Reserve or the people can be deceived nor can they wishfully deceive themselves as to the financial status of the Government." However, the system whereby the Fed through the Open Market Committee, purchases obligations of the United States with other obligations of the United States, say U.S. bonds with Federal Reserve notes, is at least a myth, if not a deception, isn't it?

Answer. No.

6. On page 4 of your testimony you state:

*"Interest-bearing U.S. Government bonds, which were sold in the first instance to interested buyers in the open market, make up over three-fourths of this collateral * * *."*

When you state that such bonds were sold "in the first instance," aren't you in effect admitting that such bonds have been repurchased and paid for, otherwise they could not be held as collateral?

Answer. I cheerfully admit that when the System buys a bond, the System pays for it. This is not, however, a repurchase unless you consider a purchase payment by the System as being a redemption payment by the Treasury.

7. In your speech of June 1 at Columbia University, you stated " * * we find disquieting similarities between our present prosperity and the fabulous 1920's." Following this statement you list a series of purported comparisons between that period and today. The following series of questions is directed to these comparisons. I shall restate the comparison and follow it by a series of questions:*

*A. "Then, as now, there had been virtually uninterrupted progress for 7 years. And if we disregard some relatively short though severe fluctuations, expansion had been underway for more than a generation * * *."*

(1) How many other virtually uninterrupted 7 years of progress have there been in our history?

(2) Do you consider the recession of 1960-61 to be part of this 7 years of progress?

(3) When you refer to a generation of expansion, what specific periods do you have reference to?

(4) In what year did the inflationary boom associated with World War I end, and in what year did the boom associated with World War II end? Isn't it true that the World War I boom ended in 1920, while the World War II boom is still in progress?

Answer to 7A (1). On the basis of the Pearson index of manufacturing production, which starts with 1863 (Historical Atlas for the United States, 1789-1945, Washington, D.C., 1949, p. 179), the only 7-year stretch without a dip in the annual average of manufacturing production prior to the First World War was the period from 1885 to 1892, which was immediately followed by the panic of 1893 and the serious depression of the mid-nineties. On the basis of the national income index compiled by the National Industrial Conference Board, which starts with 1899 (ibid., p. 14), there also was such a stretch in the period 1899-1907, which was immediately followed by the panic of that year; but manufacturing production dropped between 1903 and 1904.

Answer to 7A (2). The recession of 1960-61 was a temporary pause in growth rather than a contraction of the economy: the annual figures for real gross national product (Economic Report of the President, January 1965, p. 190), for real per-capita disposable income (ibid., p. 209), and for industrial production (ibid., p. 228) all show increases for 1960 and 1961, in contrast to the behavior of these indexes for 1953-54 and 1957-58.

Answer to 7A (3). In speaking of a generation of expansion I referred to the periods 1896-1929 and 1933-65, respectively.

Answer to 7A (4). The boom caused by the First World War may indeed have ended in 1920; but, in my judgment, the boom caused by the Second World War ended, at the very latest, with the end of the Korean war in 1953. Any boom conditions that may have arisen since that year should, in my judgment, be attributed to postwar events and policies rather than to the effects of the war.

7B. *"Then, as now, prosperity had been concentrated in the fully developed countries * * *"*

(1) *How many underdeveloped countries can be called prosperous?*

(2) *In fact, isn't prosperity associated almost exclusively with developed countries?*

Answer to 7B (1). An underdeveloped country is—almost by definition—likely to be less prosperous than a developed one; nevertheless, there are quite a few relatively prosperous underdeveloped countries (e.g., Mexico) and some actually wealthy ones (e.g., Kuwait). Since national income statistics of most underdeveloped countries are unreliable, an enumeration of absolutely or relatively prosperous underdeveloped countries would be too arbitrary to be of value.

Answer to 7B (2). While prosperity, in absolute terms, tends to be higher in fully developed than in underdeveloped countries, there is no inherent reason why underdeveloped countries should not make relatively as much progress as fully developed ones. The widely held view of informed observers that this is presently not the case contributes, in my judgment, to the uncertainties of the current situation.

7C. *"Then, as now, there was a large increase in private domestic debt; in fact, the expansion in consumer debt arising out of both residential mortgages and installment purchases has recently been much faster than in the twenties."*

(1) *Is the ratio of consumer debt to national debt higher today than it was in the 1920's.*

(2) *Doesn't the rise in personal income permit people to carry greater personal debt?*

(3) *In view of the fact that we are rapidly becoming a suburban and exurban Nation, is it really surprising that residential mortgages have been rising faster than in the 1920's?*

(4) *Isn't it a fact that the rise in consumer debt, residential mortgages, and installment purchases generally, reflect our great wealth and general affluence, representing a testament to the strength of our economy?*

Answer to 7C (1). Since the debt of the Federal Government was very small (only \$17 billion) in 1929, the ratio of total consumer debt to national debt was higher in 1929 than it is today.

Answer to 7C (2). A rise in personal income indeed permits people, in absolute terms, to carry greater personal debt. But the ratio of consumer debt to personal income was in 1964 nearly twice as high as in 1929 (15½ percent, as against 8 percent).

Answer to 7C (3). It is not surprising that, in absolute terms, mortgage debt has recently been rising faster than in the twenties; but the ratio of mortgage debt to personal income in 1964 was higher by two-thirds than in 1929 (40 percent, as against 24 percent).

Answer to 7C (4). A rise in consumer debt, mortgages, and installment purchases can be explained by the rise in income and wealth; but consumer debt and mortgage debt have recently been rising faster than the output of goods and services, as measured by the national product. The expansion of output of goods and services, rather than the rise in indebtedness, represents the strength of our economy.

7D. *"Then, as now, the supply of money and bank credit and the turnover of demand deposits had been continuously growing; and while in the late twenties this growth had occurred with little overall change in gold reserves, this time monetary expansion has been superimposed upon a dwindling gold reserve."*

(1) *Precisely what was the annual percentage increase in the stock of money in each of the years ending in July 1926 through 1929?*

(2) *Didn't the insignificant growth of the money stock in the 1920's undermine the economy and create great inflationary pressures?*

(3) *What is the significance of the fact that today our gold reserves are dwindling, whereas in the 1920's there was little overall change in our gold reserves?*

(4) *Is it your view that value of the dollar depends upon gold collateral behind it, rather than on the goods and services that may be purchased with the dollar and, therefore, on the prosperity and stability of the domestic economy and domestic prices?*

Answer to 7D(1). The narrowly defined money supply (currency in circulation plus demand deposits) rose 3 percent between mid-1925 and mid-1926 but did not show any significant changes between mid-1926 and mid-1929. The broadly defined money supply (currency in circulation plus demand, time, and savings deposits) rose 4.6 percent between mid-1925 and mid-1926, 2.6 percent between mid-1926 and mid-1927, 3.9 percent between mid-1927 and mid-1928, and 0.7 percent between mid-1928 and mid-1929 (Friedman and Schwartz, "A Monetary History of the United States," pp. 711-712). Bank debits to deposit accounts in 141 centers, however, rose 7 percent from 1925 to 1926, 11 percent from 1926 to 1927, 20 percent from 1927 to 1928, and 16 percent from 1928 to 1929 ("Banking and Monetary Statistics," Washington, D.C., 1943, p. 234).

Answer to 7D(2). The increases in the broadly defined money supply and in bank debits (i.e., in the use of money) indicate that the failure of the narrowly defined money supply to rise between 1926 and 1929 did not undermine the economy; and there is no reason why that failure should have created inflationary pressures.

Answer to 7D(3). The recent dwindling of our gold reserves, both in absolute terms and in relation to liquid dollar claims of foreigners, has made our monetary system more vulnerable to a possible run of foreigners on the dollar than it was in the twenties.

Answer to 7D(4). The strength of the dollar depends basically on the prosperity and stability of our economy. But the volume of, and especially the changes in, our gold stock influence confidence in the strength of the dollar and hence influence the value of the dollar in exchange markets.

7E. *"Then, as now, the Federal Reserve had been accused of lack of flexibility in its monetary policy * * *"*

(1) *Since you regard this as a disquieting similarity between the present and the period immediately preceding the great depression, what do you propose to do about it?*

Answer. I intend to help keep monetary policy flexible by avoiding, to the best of my ability, any dogmatic adherence of monetary policy to preconceived ideas of either permanent ease or permanent tightness.

7F. *"Then, as now * * * convertibility of the major world currencies at fixed par values had been restored for a number of years."*

(1) *Why is this a disquieting similarity?*

(2) *Was the price of the English pound in the 1920's an appropriate one, particularly in view of the fact that the British economy failed to expand?*

(3) *How does the state of the American economy today compare with that of Great Britain in the 1920's?*

Answer to 7F(1). In itself, the restoration of convertibility of major currencies is not disquieting; but it seems disquieting that both in the twenties and in recent years restoration of convertibility has been associated with a rise in speculative international movements of volatile funds.

Answer to 7F(2). According to most experts, the exchange value of the British pound turned out not to be appropriate in the twenties.

Answer to 7F(3). The American economy today is in a much better state than the British economy was in the twenties.

7G. *"Then, as now, international indebtedness had risen as fast as domestic debt; recently, in fact, American bank credits to foreigners and foreign holdings of short-term dollar assets have increased faster than in the closing years of the earlier period."*

(1) *If we raise short-term interest rates in the United States, won't this increase foreign holdings of short-term dollar assets? If so, why do we want to raise short-term rates? What effect does raising short-term rates have on our domestic economy? Is there conclusive proof that raising short-term rates assists in solving our balance-of-payments problems?*

Answer. An increase in U.S. short-term rates in relation to those in foreign financial centers would result in a preference of some holders of liquid funds at home and abroad for dollar assets over foreign currencies and perhaps also over gold; hence, while it would increase foreign dollar holdings, it also would increase the gold and foreign-exchange reserves of the United States. Within limits, a parallel increase in monetary reserves and foreign dollar holdings

would have a beneficial influence on confidence in the stable value of the dollar (see question 7D(4), above). Actually, the Federal Reserve has not tried to increase short-term rates sufficiently to provoke an *inflow* of short-term funds but merely sufficiently to curb an *outflow*. Since an outflow of American funds increases our payments deficit, curbing such an outflow assists in solving our payments problem. The increase in short-term rates that has occurred does not appear to have had any adverse effect on the domestic economy. In fact, it may have helped to avert speculative excesses and overrapid inventory accumulation.

7H. *"Then, as now, the payments position of the main reserve center—Britain then and the United States now—was uneasy, to say the least; but again, our recent cumulative payments deficits have far exceeded Britain's deficits of the late twenties."*

(1) *Weren't Britain's balance-of-payments deficits of the later 1920's current account deficits, and in particular trade deficits?*

(2) *Is this truly comparable with the balance-of-payments deficits of the United States at the present time? What specifically is the nature of the U.S. current balance-of-payments deficits?*

Answer to 7H(1). Britain's payments difficulties in the twenties were attributable to a deterioration in its current-account position, not just in its trade position: Britain had a trade deficit even prior to the First World War but the deficit was then covered by its net receipts from services and capital income; Britain would not have been in difficulties in the twenties if these receipts had continued to be sufficient to cover its trade deficit.

Answer to 7H(2). According to many experts, the main factors accounting for the recent U.S. payments deficits were the magnitude of the outflow of private capital and the magnitude of Government expenditures abroad for military purposes and for assistance to foreign countries. But it is difficult to make one or two factors responsible for a deficit to the exclusion of all others: if our trade surplus last year, for instance, had been larger by one-half than it actually was, with all other items remaining unchanged, our overall payments balance would have been in surplus rather than in deficit. Hence, it could be contended just as well that our trade surplus was too small as that our capital outflows and Government expenditures abroad were too large. Insofar as Britain had an overall payments deficit in the late twenties and the United States had such a deficit in the early sixties, the international payments positions of the two countries were comparable.

7I. *"Then, as now, some countries had large and persistent payments surpluses and used their net receipts to increase their short-term reserves rather than to invest in foreign countries."*

(1) *Do you intend to imply that the United States did not make substantial investment of its 1920 surpluses in foreign countries? If not, then what is the relevance of this point?*

Answer. The United States made large investments abroad both in the twenties and in the forties and fifties. But some Continental European countries that became creditor countries in the sixties have failed to follow that example. If these countries were to invest their payments surplus abroad, through long-term credits or through assistance to less developed countries, they would not only solve their own payments problems; they would also, by reducing foreign demands for U.S. capital and assistance, help us to solve our payments problem.

7J. *"Then, as now, the most important surplus country, France, had just decided to convert its official holdings of foreign exchange into gold * * *"*

(1) *Will France run a surplus in 1965?*

(2) *What financial sense does it make for the French to take gold rather than dollars? Isn't it true that by converting dollars to gold France is foregoing interest payment on U.S. Treasury notes and is bearing the additional cost of gold storage?*

(3) *Isn't it a fact that the current action taken by France is essentially motivated by political, rather than economic criteria? If this is so, what then is the validity of the comparison you pose?*

Answer to 7J(1). France is expected to run a large payments surplus in 1965.

Answer to 7J(2). It does not make financial sense for a country to convert its dollar reserves into gold.

Answer to 7J(3). I feel that it would not be appropriate for me to pass judgment on recent actions of individual foreign countries. Generally speaking, however, it is difficult to decide how far a country's conversions of dollars into

gold are motivated by political criteria or by a traditional preference for gold or by distrust in the stable value of the dollar. Some foreign countries (of which France was one) suffered severe losses in 1931 on their remaining sterling holdings; memory of those losses has probably been an important factor in their present policies. This is again a point in which the "confidence factor" (see question 7D(4), above) may be decisive.

7K. *"Then, as now, there were serious doubts about the appropriate levels of some existing exchange rate relationships * * *"*

(1) *Would it be fair to say that the exchange rates of today are more in line with true equilibrium rates than they were in the 1920's, with the possible exception of France, which may have depreciated its currency too much in 1958?*

(2) *Isn't it true that some scholars were saying in the 1920's that if the Federal Reserve continued its tight money policies, beginning in late 1927, we were going to have a depression?*

(3) *Isn't the damage of tight money one of the main real dangers of another great depression? Have we ever had a depression or even a recession which was not preceded and accompanied by a fall in the growth of the money supply and a rise in interest rates?*

(4) *In this connection, please explain the great fluctuations in the money supply in the months of May and June of this year.*

Answer to 7K(1). I trust that exchange relations today are more in line with equilibrium rates than they were in the twenties; but periodic disturbances in exchange markets show that doubts exist about the adequacy of some present relations. I feel that it would not be appropriate for me to comment on individual foreign currencies in this connection.

Answer to 7K(2). While some scholars may have accused the Federal Reserve in the twenties of having followed too restrictive policies, other scholars accused the Federal Reserve of having followed policies that were too easy and did not effectively avert the speculative excesses of 1929.

Answer to 7K(3). Virtually every depression or recession is preceded by an upswing. During an upswing, interest rates generally tend to rise as higher business profits and rising consumer optimism contribute to the expansion of demand for credit and capital. Moreover, a depression or recession tends to be the more severe the more inflationary pressure has been built up in the preceding upswing. It is appropriate for a central bank to try to stem that inflationary pressure by firming its monetary policy and thus inhibiting an excessive rise in bank credit and hence in the money supply. For these reasons, any depression or serious recession tends to be preceded by both a rise in interest rates and as shown in the growth in the money supply. But it would be a mistake to interpret this time sequence as a casual relation (according to classical logic: a confusion between "post hoc" and "propter hoc"). Actually, it would be more proper to state that in many if not most cases the depression or recession occurred in part because the central bank had not been sufficiently restrictive in the last phases of the upswing to prevent the upswing from turning into an unsustainable boom. Hence, a firm monetary policy, if applied at the right time and in the right dosage, does not cause, but on the contrary helps to avert, a depression or recession.

As soon as the danger of an inflationary boom passes, it is appropriate for a central bank promptly and decisively to reverse measures that would inhibit an excessive growth of bank credit and hence of money and put or permit upward pressure on interest rates. Hence, a depression or recession need not be accompanied by a fall in money supply and will rarely if ever be accompanied by a rise in interest rates. In fact, during the recessions of 1953-54 and 1957-58 both the narrowly and the broadly defined money supply continued to expand (Friedman and Schwartz, pp. 593 and 720-721) and both short- and long-term interest rates dropped (Federal Reserve Historical Chart Book, 1964, p. 23).

Answer to 7K(4). The seasonally adjusted money supply statistics show an \$1,100 million drop in the public's holdings from April to May, followed by an \$1,800 million increase in June and a further rise of \$800 million in July. These are unusually large variations, and reflect the interaction of a variety of factors, both technical and more fundamental. The decline in the May average resulted in large part from heavy tax payments in mid-April, which produced a larger than seasonal buildup in the Treasury cash balance—not included in the money supply—that persisted through most of May. The subsequent increase in the money stock reflected a desire on the part of holders to rebuild depleted balances,

as well as further growth in transactions needs and expansionary effects of the continued vigorous growth in bank lending.

Changes in the money supply over short periods have typically been rather volatile. A new series of seasonably adjusted weekly money supply figures is presented in the July issue of the Federal Reserve Bulletin; these data show that, despite substantial and persistent expansion in the stock of money (by \$7.7 billion or 5 percent) over the 1½ years to the end of June 1965, there were 23 weeks (out of a total of 78) when the stock declined and 10 in which it showed no change. But these variations, reflecting a multiplicity of demand and supply developments, evened out markedly with the passage of time. Thus, in the 8 months since the November 1964 discount rate increase, the money supply has risen at a 3.3 percent annual rate; this rate is virtually the same as that for the whole period since the end of 1963.

8. *In your June 1 speech you state, " * * a country may be justified in voiding or at least modifying a tightening of monetary policy even though its gold reserves are declining, if otherwise it were to risk precipitating or magnifying a business recession." Later in this speech, you stated, " * * if indeed an occasion arose when we could preserve the international role of the dollar only at the sacrifice of modifying our favorite domestic policies—even then we would need to pay attention to the international repercussions of our acts." There appears to be a distinct conflict between these two statements: The first seems to suggest that priority be given to achieving domestic prosperity, while the latter seems to suggest that we should sacrifice domestic prosperity in order to balance payments. Which position do you recommend, and how do you reconcile these two statements?*

Answer. The main purpose of monetary policy—as well as of all other economic policies—is to help achieve and maintain domestic prosperity. But this goal cannot be reached unless we achieve and maintain international payments equilibrium. Hence, there is no question of sacrificing domestic prosperity to the balance of payments; it is a question of choosing those policy methods that advance domestic prosperity in a way compatible with international equilibrium, and rejecting those that only seem temporarily to advance domestic prosperity but, by not taking account of their international implications, actually harm domestic prosperity in the longer run. I do not see any conflict between my opposition to policies that would impair domestic prosperity for the sake of dogmatic adherence to the alleged rules of the classical gold standard, and my opposition to policies that would impair domestic prosperity by failing to maintain the international role of the dollar and more generally by failing to maintain a viable international payments system.

9. *In your speech you apparently recognize that the restrictive policies pursued by the Federal Reserve in the fall of 1931 to stem the outflow of gold greatly aggravated the depression and led to the devaluation of the dollar. How was this deflationary action of the Fed in 1931 substantially different from the Fed's deflationary actions in the 1950's?*

Answer. In 1931, the Federal Reserve raised the discount rate by an unprecedented 2 percent in the midst of a serious depression. In the fifties, firming actions were taken by the Federal Reserve only when the Federal Reserve—rightly or wrongly—believed that they were either required to avert a subsequent recession by stemming domestic inflationary pressures, or to insure a continuing upswing by averting excessive outflow of short-term funds. No such action was taken during a downswing, and no such action was so severe as to deserve to be called deflationary. In these respects, the recent actions of the Federal Reserve were substantially different from the action taken in 1931.

10. *When you speak of " * * the courage to * * advocate necessary remedies" by the prompt application of antirecession measures, what specific suggestions do you have to offer?*

Answer. Specific remedies immediately to be applied at the downturn of economic activity must depend upon the specific circumstances of the case. It would be impossible within a reasonably brief answer to present an exhaustive list of the various possibilities. Remedies will need to differ, for example, dependent upon the question whether the factors responsible for the downturn appear to be structural or financial: whether the downturn appears to affect the economy as a whole or to be clearly confined to specific sectors; whether the country's payments balance appears to be in substantial deficit, in substantial surplus, or in reasonable equilibrium; or whether prices tend to rise sharply, to fall, or to remain reasonably stable.

11. Since the simple statement of a comparison does not establish causation, state specifically what you consider to be the factors that convert a boom economy into a depressed one.

Answer. It would be impossible within the limits of a reasonably brief answer to present a complete theory of the factors responsible for turning a boom into a depression. Of particular interest to those concerned with monetary policies are the dangers of inflationary price rises, which may lead (a) to excessive cost increases that may hamper production; (b) to an excessive accumulation of inventories that may also provoke a cutback in production; (c) to an over-rapid rise in consumption that may prove unsustainable; (d) to unsound investment projects; and (e) to a rise in business and personal indebtedness that may prove impossible to carry once the rise in prices and money incomes is stopped. In a country such as the United States in which equity financing and thus the behavior of stock exchange markets influences investment decisions, highly speculative and hence unsustainable increases in stock prices may have some of the same adverse consequences as inflationary increases in commodity prices; this factor was largely responsible for the depression of 1929-33.

Sincerely yours,

Wm. McC. Martin, Jr.

STATEMENT OF PROF. JOHN M. CULBERTSON, UNIVERSITY OF WISCONSIN

I appreciate the opportunity to submit a statement dealing with the issues raised by H.R. 7601. I interpret this bill as relevant to several constructive purposes, to several areas in which some kind of future action seems desirable. I should like to characterize these areas and the relevance of the action proposed by H.R. 7601, to propose an alternative action, and then to discuss the issues involved at somewhat greater length. Unfortunately that common ground of understanding that is required for effective discussion and action on these matters seems to require a good deal of cultivation.

The principal constructive purposes to which I see this bill as relevant are three: (1) to reduce the costs of and simplify Federal Reserve and the Treasury operations in Government securities, (2) to contribute to clarifying the nature and meaning of the Nation's monetary system and the role of the Federal Reserve System, (3) to contribute to establishing a basis for a justifiable policy with reference to the level of required reserve ratios of member banks of the Federal Reserve System.

As I understand the matter, the proposal of H.R. 7601 is to consolidate the position of the Federal Reserve System and the Treasury with respect to a part, \$30 billion, of outstanding Federal Reserve notes and U.S. Government securities held by the Federal Reserve banks. With respect to these items, the Treasury now shows a liability on the Government securities, a contingent liability on the Federal Reserve notes; the Federal Reserve banks show the Government securities as assets and the Federal Reserve notes as liabilities. The consolidation would transfer the liability on the Federal Reserve notes (perhaps to be renamed and reidentified) to the Treasury. All the other entries then would be redundant and could simply be eliminated.

This action, I take it, would not be radical or inherently unsound, and would not basically alter the nature of our monetary system. With reference to current operations, it seems to leave quite unaltered the prerogatives and the procedures of the Federal Reserve System in conducting open market operations in pursuance of monetary policy. The proposed changes do not affect current operations, but only that portion of the Federal Reserve holdings of Government securities for which the expectation is that they will never be sold but will simply be held in perpetuity. The proposed changes seemingly would eliminate the gold reserve requirement behind \$30 billion of Federal Reserve notes. This is a desirable thing to do in any case. For a substantial part of the world's stock of monetary gold to be tied up as collateral behind the domestic money of the United States is an archaic arrangement that is harmful to both our domestic monetary system and the international monetary system.

The relevance of the action proposed by H.R. 7601 to the constructive purposes mentioned above can be briefly characterized in this way: First, the issues of cost and simplicity of the present arrangements arise with reference to the continued management of that very large portfolio of Government securities of the Federal Reserve System that is not relevant to actions to effectuate monetary policies. With reference to this, the Federal Reserve engages in huge operations

in replacing its maturing securities. It also collects a large amount of interest income beyond what is required to cover its operating expenses, which it then repays to the Treasury. The proposed consolidation would eliminate both the redundant portfolio operations and the redundant interest payments with reference to \$30 billion of Government securities. This—if \$30 billion is, indeed, the appropriate figure—would reduce Federal Reserve operations in the Government securities market to those bearing some relation to the needs of open market operations to effectuate monetary policy. It would also reduce its interest receipts to a figure somewhat closer to what is required to meet the System's operating expenses.

Second, the proposed change—if it could itself be made understandable to those who initially seem to find it confusing—could be a step toward understanding the nature of our monetary system and the steps that can be taken in the future to modernize and rationalize it. In our changing world, it will be necessary in the future not only to manage monetary policy reasonably in each day and month, but also to revise and rationalize our institutions to bring them into line with the needs of the times. The idea that the institutions and the practices of 50 years ago are not necessarily the ideal ones for today—this is not an idea that Americans find shocking with regard to other areas of endeavor. If they were given some constructive leadership in this area I believe that they could accept it with reference to our monetary system as well. Reforms in our monetary institutions will have to be made. The only protection against changes that are too long delayed or are misconceived and damaging is widespread understanding of what our monetary system is all about. If—which is perhaps a large “if”—the action here proposed could be understood, it would begin to put into proper perspective the duplicating entries of the Treasury and the Federal Reserve with regard to the monetary system, the limited meaning of the backing of money by gold and by duplicating bookkeeping entries involving Government securities, the ultimate foundation of the Nation's money in firm usage, Government powers with regard to the payments system, and effective management of the amount of money.

Third, with reference to member bank required reserve ratios, the action proposed by H.R. 7601 would contribute to establishing a reasonable policy by making clear that the large portfolio of Government securities that the Federal Reserve System has acquired in providing reserves for monetary growth to the banking and monetary system do not constitute any argument for further reducing required reserve ratios of member banks. Such reductions in reserve ratios seem to be contrary to the public interest. In the absence of a fuller clarification of policy in this area, the proposed action would help to guard against further ill-advised reductions in required reserve ratios.

When considering specific actions of Government policy, it is necessary to ask not only whether the proposed actions make matters better than they are without action, but also to ask whether they make matters better than they would be with any other possible policy action. While the action proposed by H.R. 7601 can be interpreted as having constructive effects, it seems to me subject to criticism on two grounds: (1) In the present state of prevalent nonunderstanding of our monetary system this may be too large a step to try to take at one time. The step might be very difficult to take and widely misunderstood if taken. If it strengthened emotional reactions, it might make the state of understanding of our monetary system worse rather than better. (2) Its constructive effects could be substantially achieved by an action that is easier to understand—and thus of greater educational value—more likely to gain wide assent and less of a departure from existing arrangements.

In view of this, I should like to propose for discussion an alternative action. Even though it were judged desirable to take now the action proposed by H.R. 7601, I suggest that it would clarify matters and reduce misunderstanding to think of this as involving two separable steps. I suggest, also, that since the first step is a smaller step and an easier one to understand and since it seems to accomplish the immediate purposes that are relevant, it may be appropriate to consider taking only the first step, leaving the second one for possible action at some future time. The two steps are: (1) replace the redundant portion of Federal Reserve holdings of Government securities by a special issue of non-interest-bearing securities of no fixed maturity date, and (2) consolidate the liabilities of the Federal Reserve and the Treasury with regard to these Government securities and Federal Reserve notes. More specifically, the suggestion is this: New legislation should direct the Treasury to offer for sale to the Federal Reserve banks in unlimited quantities a non-interest-bearing (and nonmarket-

able) Government security (or certificate) of no fixed maturity date, this to be convertible at the option of the Federal Reserve banks into some specified marketable Government security. The legislation should also instruct the Federal Reserve System to exchange for these non-interest-bearing securities all of its holdings of Government securities except such as can be justified as required for conceivable open market sales of Government securities in connection with actions of monetary policy, or for meeting the operating expenses of the Federal Reserve System.¹

I believe that this action would substantially substitute for that proposed by H.R. 7601 in meeting the purposes discussed above. I should like to suggest as a related action to go further than H.R. 7601 in reforming existing arrangements with regard to the required reserve ratios of member banks. It seems appropriate to clarify the grant of authority by Congress to the Federal Reserve System in connection with required reserve ratios of member banks and to limit it to that required for actions of monetary policy. Any further reductions in member bank required reserve ratios designed to increase the profits of member banks or to reduce service charges of such banks should be authorized by Congress, rather than taken administratively by the Federal Reserve System. Consistent with this, legislation should make clear that the normal means of Federal Reserve provision of additional reserve to the banking system for monetary growth is through open market purchases of Government securities, these subsequently to be replaced as appropriate by the non-interest-bearing securities proposed above. Required reserve ratios, thus, would be changed only when unusual circumstances justified the use of an unusual tool of monetary policy, and the presumption is that the average level of such required reserve ratios would remain unchanged, except as revised by legislation.

Perhaps it is clear that this program would substantially accomplish the constructive purposes defined above. It would eliminate redundant Federal Reserve and Treasury operations associated with the continuing management of that portion of the Federal Reserve portfolio not related to the conduct of current monetary policy and eliminate redundant interest payments from the Treasury to the Federal Reserve and back again. It would make a contribution to understanding of the operation of our monetary system in the context of secular growth. It would clarify public policy and Federal Reserve authority with reference to changes in required reserve ratios.

Moreover, perhaps it can be said for proposed actions that they not only are *not radical*, but that any reasonable person *could scarcely misunderstand them to be radical*. The existing structure of assets and liabilities of the monetary system is preserved. It can scarcely be argued that what makes for soundness of the system is a set of obviously pointless and inefficient Federal Reserve and Treasury operations in "management" of that portion of the Federal Reserve portfolio that is likely to be held in perpetuity, or the payment of interest back and forth between the Treasury and the Federal Reserve. Similarly, the scope and ambiguity of the existing grant of power to the Federal Reserve in connection with member bank required reserve ratios seems contrary to principles of good management of Government affairs, and such as would be an embarrassment to any administrative agency.

In support of this interpretation, and in recognition of the confusion that seems to exist regarding the issues raised by H.R. 7601, I should like to discuss at somewhat greater length the public interests involved in these.

1. *Simplification and reduction of cost of operations in Government securities of the Federal Reserve and the Treasury.*—The fact that the United States is

¹The appropriate degree of independence of the Federal Reserve System from the usual fiscal procedures of Government is a separable issue. The proposed reform of the System could preserve the status quo on this point. On balance, however, it would seem a reasonable element in any such rationalization of the System to provide that the size of the Federal Reserve portfolio of marketable (and interest-bearing) securities should depend only upon anticipated possible open-market sales, that all interest received by the Federal Reserve should be returned to the Treasury, and that the operating expenses of the Federal Reserve System should be handled as are those of other Government agencies. This would further clarify and simplify the System. While I am not aware of abuses in connection with the present arrangements for financing the operating expenses of the Federal Reserve System, it does not seem arguable that the degree of independence of authority and policy now generally considered as appropriate for the Federal Reserve System requires it to have its own private income. Perhaps the major harm done by the existing arrangements is to contribute to preserving the harmful illusion that the Federal Reserve System is not a Government agency but an ordinary bank, or the creature of the member banks, or an independent and superior power subjecting the Government to its discipline of natural law or of the inherited wisdom of the financial community.

steadily growing in potential implies a normal expectation of a continuous increase in gross national product, and a normal expectation of a continuous increase in the required money supply of the Nation. Within our existing institutions, this implies a normal expectation of an increase in the Federal Reserve portfolio of Government securities, perhaps one on the average of several percent a year. In recent years, the growth in the Federal Reserve portfolio has been more rapid than this, as Federal Reserve purchases of Government securities have been used to offset the effects upon bank reserves of a large outflow of gold.

The continued increases in Federal Reserve holdings of Government securities that are required to provide normal growth in the Nation's money supply are not "needed" by the System on other accounts. Growth in the System portfolio on this scale is not needed to provide sufficient interest earnings to permit the System to meet its operating expenses. Neither is it needed to provide as large a volume of Government securities as might conceivably be needed to make open market rates for purposes of monetary policy. This situation simply reflects the fact that we have a growing economy. The U.S. economy and the U.S. monetary system are not going to be liquidated. There will never be an occasion to undo the growth of the past.

The fact that Federal Reserve purchases of Government securities to meet growth needs of the monetary system are essential in some connections but superfluous, or even anomalous, in other connections creates a situation that is subject to misinterpretation. It gives rise to a situation in which the Federal Reserve banks carry a large portfolio of Government securities for which they have no conceivable "need"—other than that they must acquire them to provide for growth needs of the monetary system—a portfolio that involves huge and continuous operations in Government securities by the Federal Reserve System, huge and continuous payments of interest by the Treasury to the Federal Reserve and repayments of interest by the Federal Reserve to the Treasury. This arrangement may be objectionable on three grounds:

First, it involves the Federal Reserve in extensive operations in Government securities in managing its portfolio of Government securities. Maturing securities must be replaced by new ones acquired in Treasury refunding operations or by a replacement purchase in the Government securities market. These operations involve costs in terms of Federal Reserve and Treasury facilities and staff as well as transactions charges. So far as this is purposeless busy work, its mere cost is a substantial argument for finding a better way of handling matters.

Second, these extensive operations in Government securities involve the Federal Reserve in the Government securities market on a larger scale than is perhaps desirable. Federal Reserve spokesmen in the past have persuasively argued the usefulness of developing a Government securities market that is broad and stable, that can accommodate without extensive fluctuations in securities prices those open market operations of the Federal Reserve System that are essential to the conduct of monetary policy. From this point of view, it would be helpful if that large volume of Federal Reserve operations in Government securities that does not serve any purpose could be eliminated.

Finally, the situation in which the Federal Reserve banks hold a large volume of Government securities that are seemingly unnecessary to its purposes—at least some of its purposes—may give rise to serious misunderstandings. To be specific, evidently it has led some to conclude that it would be desirable to transfer these securities, in effect, from the Federal Reserve banks to the private commercial banks by reducing required ratios of the commercial banks.

If it is correct to estimate the portion of the Federal Reserve portfolio that is not needed for its operating functions presently as \$30 billion, then in another 10 years it might conceivably be over \$40 billion, and in another 10 years over \$50 billion. It is scarcely credible that we shall go on forever with the Federal Reserve busily—and expensively—"managing" all of their securities as if it were a private business and not an agency of the U.S. Government. It is only a question of time until some more rational arrangements are adopted, and there is no better time to begin thinking about the matter than the present.

2. *Clarification of the nature of the Nation's monetary system and the role of the Federal Reserve.*—There are many kinds of confusion as to just what the Nation's monetary system is all about and what is the role in it of the Federal Reserve System. Is it a system for controlling banks credit, controlling the quality of credit, regulating the interest rate, stabilizing the Government securities market, providing funds to meet demands for loans, or regulating the

money market? Correspondingly, does the validity and soundness of the monetary system depend upon the quality of credit, the placidity of the money market, the price of Government securities, the quality of bank loans? Or does the soundness of the Nation's monetary system depend upon the collateral behind the money, in the form of gold or Government securities? Is the Federal Reserve System essentially a group of Government-run banks, to be governed by ordinary banking principles, or is it to be viewed the Nation's monetary system?

Most students of the subject, I believe, now agree that the Federal Reserve System must be interpreted as the governor of the Nation's monetary system, a system that was established by Congress to advance the public interest. Thus, the Federal Reserve banks are not agents of the private banks that nominally own their "stock." They are agents of the Government in disposing of the power delegated to them to create and control the Nation's money supply. The Federal Reserve banks are able to acquire Government securities because their obligations, Federal Reserve notes and deposits, are given monetary status by the Government. Commercial banks can operate as they do only because the Government permits their demand deposits to circulate as money, performing a function that is explicitly recognized in our legal framework as a Government function. By permitting demand deposits of commercial banks to be generally used as money, and by itself accepting them in payment, the Government confers upon these banks a status that they do not share with ordinary credit institutions.

In our system, we have seen fit to confer a certain independence of action upon the Federal Reserve System. This is a limited independence—"independence within the Government," as Chairman Martin aptly puts it. But this independence in decisionmaking, which continuously must justify itself on political and administrative grounds, in no way implies that the Federal Reserve System is not a part of the Government. That being the case, consolidating some part of its activities with those of the Treasury may or may not be expedient, but it is surely *not radical* nor antithetical to the idea of a free enterprise system.

Pursuing this point, there does not seem to be anything dangerous or radical in the idea of consolidating the operations of the Federal Reserve and the Treasury with reference to the issuance of circulating notes to serve as money. Under the arrangements that I propose above, the Treasury's liabilities would consist in part of non-interest-bearing securities held by the Federal Reserve System (plus a contingent liability on Federal Reserve notes), while the Federal Reserve banks would hold these securities as assets and show Federal Reserve notes as their liabilities. Obviously, nothing would be radically changed if these balance-sheet entries were consolidated, so that the only liability would be that of the Treasury for circulating U.S. notes. This is a second step that might someday be taken to clarify and simplify the monetary system. It could be so managed as to leave the operation of the system totally unaffected, merely consolidating a substantial part of the existing bookkeeping entries, while leaving Federal Reserve control over *changes in money supply* and Federal Reserve procedures for changing the money supply totally unchanged.

3. *Policy with reference to required reserve ratios of member banks.*—A change in the minimum required reserve ratio of member banks of the Federal Reserve System by the Federal Reserve authorities has two principal effects so far as concerns the public interest. These are its effect upon (a) the stability and controllability of the Nation's monetary system and (b) the cost of servicing the Government debt, the profitability of private commercial banking, and the level of service charges of commercial banks. In order to understand the relevance of changes in required reserve ratios to the package of issues with which we are here concerned, it is necessary to have a clear understanding of the nature of the public interest in these two aspects of changes in required reserve ratios.

So far as concerns the stability and controllability of the Nation's monetary system, the implications of the level of required reserve ratios seem perfectly clear—although doubtless the point is not universally appreciated. The higher are required reserve ratios, the more stable and controllable is the Nation's monetary system. The logic of this interpretation is perfectly straightforward. Consider the extreme cases. If the required reserve ratio of the member banks is 100 percent, then the creation or extinction of money occurs immediately and directly at the instance of the Federal Reserve System. When the Federal Reserve banks buy \$100 million of Government securities, the Nation's money

supply increases instantaneously and unquestionably by \$100 million. To take an example at the other extreme, if required reserve ratios are 5 percent, an increase in the money supply of \$100 million is ordinarily brought about by Federal Reserve purchases of only \$5 million of Government securities (assuming the money remains in deposit form rather than in the form of currency). The immediate and assured increase in the money supply, thus, is only \$5 million or 5 percent of the total. The other 95 percent of the monetary increase occurs at the initiative of the private commercial banks. Its timing depends upon their responses, and upon the accidents of the geographical distribution of the excess reserves. It seems perfectly clear that if we compare two situations, in the first of which change in the money supply occurs immediately at the instance of the Federal Reserve System and in the second of which it occurs only in small part in this direct manner and in major part in response to the initiative of commercial banks, the first system is the more precisely controlled.

Moreover, the fractional reserve monetary system can operate in a systematically destabilizing manner. For example, economic weakness can cause banks to want to hold more excess reserves, which—unless fully offset by Federal Reserve provision of additional reserves—causes reduction in the money supply, which causes more economic weakness, and so on. This unstable interaction-system has been a source of great mischief to the U.S. economy in the past. The lower are required reserve ratios, the greater is potential instability from this source.

We take it as not necessary to have 100 percent reserves in order to have a *sufficient* control over our monetary system. But what degree of control is *sufficient* is a difficult question. One must ask, "*Sufficient* under what conditions?" When economic and financial affairs are moving along smoothly, the behavior of private banks is stable, and the Federal Reserve leadership is knowledgeable and businesslike, it may perhaps be possible to control the Nation's monetary system with required reserve ratios of only 5 percent against member bank's demand deposits. But control systems are not usually designed to work only under the most favorable conditions. How would the system work if the economy somehow entered a period of disturbance that threatened to be cumulative, if banks unexpectedly altered their desired reserve position, and if the management of the Federal Reserve System happened to be in weak hands—a not unknown situation.

An analogy may be illuminating. Under favorable conditions, one can successfully manage an automobile that has a great deal of slack in its steering mechanism. But such a mechanism in the hands of an inept driver facing a crisis situation requiring decisive action—this may be a recipe for disaster. Thus, the motive of seeking a stable monetary system, a system that will assuredly perform well even under conditions of crisis and confusion, clearly argues that wherever a choice is made the higher reserve ratio is to be preferred to the lower one.

The hazard of a monetary system involving low required reserve ratios in the case of the United States is increased by the fact that some of the traditional ideas of the Federal Reserve lead it to magnify disturbances arising from this source, rather than offsetting them. For example, if private banks decline to play their usual role in contributing to normal growth of the money supply and elect to hold excess reserves instead, presumably the Federal Reserve ought to provide whatever additional reserves are required to offset this variation in the behavior of private banks. In the past, however, its confusion over its own role has sometimes led the Federal Reserve in such a situation to reduce bank reserves, rather than increasing them, because of fears that credit might become excessively easy, or banks might make unsound loans, or cause redundant money. Evidently the hazard of a monetary system with low required reserve ratios is greater if such responses on the part of the Federal Reserve cannot be ruled out.

As to the other principal effect upon the public interest of the level of the required reserve ratios of member banks, it is quite clear that lower required reserve ratios imply larger interest payments to the public on the Government debt and some combination of higher bank profits or lower bank service charges. For any given money supply, lower required reserve ratios of member banks imply a smaller Federal Reserve portfolio of Government securities, smaller Federal Reserve interest earnings, smaller "reserves" of non-interest-earning assets of member banks, and larger earning assets and interest earnings of member banks. With lower required reserve ratios and a smaller Federal Re-

serve portfolio of Government securities, a part of the interest that would have been paid to the Federal Reserve and thus returned to the Treasury (or simply would not have been paid at all had the Federal Reserve been holding the proposed non-interest-bearing securities) must now be paid to the public, and financed through tax receipts or other such means. With any given money supply, thus, the effect of a reduction in required reserve ratios is to increase the cost of carrying the public debt and to increase the profits of commercial banks. To the extent that commercial banking is a competitive industry, any such improvement in its earnings position in the long run ought to be reflected largely in reduction in the service charges made by commercial banks. Presumably what is mainly in question in the long run is the interest burden on the Government debt and the level of service charges on checking accounts (and thus the usual proportion of their money and liquidity that people choose to hold in this form rather than in the form of currency or liquid assets).

Insofar as it is desired to maintain low service charges on checking accounts, even though this involves an additional general tax burden, these are means available for doing this that do not involve the loss of control over the monetary system that is involved in reductions in required reserve ratios. It would be possible to subsidize commercial banking without lowering required reserve ratios simply by paying some appropriate rate of interest on the deposits of member banks at Federal Reserve banks or upon all member bank reserves. Other means of subsidizing commercial banking explicitly also could be arranged. Thus, the choice that a rational public policy would make is not only one of to what extent it is appropriate to subsidize commercial banking, but also one of the preferred instruments for doing this.

As a general rule for a policy, it seems appropriate that any transfer of funds from the public Treasury to a particular industry or line of business ought presumptively *not* to be done in the absence of some positive showing that it is in the public interest. After all, the opportunities for subsidizing industries and groups in the economy are unlimited, far exceeding available resources. To make any such transfer without a positive showing that the public interest is served is both uneconomical and politically unacceptable.

This interpretation, which I take to be a quite orthodox one, argues that in general high required reserve ratios for member banks are to be preferred to low ones, both on grounds of controllability and stability of the monetary system and on grounds of its cost of operation to the Treasury. Anyone who understands this cannot be baffled by the actions and the policy statements of the Federal Reserve on this matter in recent years, which seem to proceed from precisely the opposite belief. As the matter was put by C. Canby Balderston, Vice Chairman of the Board of Governors of the Federal Reserve System, in testimony on changes in required reserve ratios, "the desirable ultimate level of reserve requirements need be no higher than essential for purposes of monetary policy."² On the basis of the ideas developed here, it seems that this position should be paraphrased in this way: "The desirable ultimate level of reserve requirements is the one that makes the monetary system as unstable and unmanageable as we can possibly get away with." And, "The desirable ultimate level of reserve requirements is the one that makes the interest burden to the Treasury of the public debt as high as possible."

In my reading of Federal Reserve statements with reference to reductions in required reserve ratios, I can find nothing approximating a showing that the public interest was served by these steps. It is argued, negatively, that "reserve requirements of member banks do not need be as high as they have been in recent years," which may or may not be true depending upon how much controllability and stability of the monetary system the future will disclose that we *need*. The principal positive justification for these steps appears to be that: "A lower level of requirements would improve the earnings position of the banks and aid them in building up their capital positions to levels commensurate with the more rapid expansion that has occurred in their liabilities during the past 30 years."³ It is surely a possible position that it is in the public interest to transfer public funds to the support of bank profits, bank capital, and to promoting low bank service charges. It is less likely, but still possible, that it is appro-

² "Member Bank Reserve Requirements," hearings before subcommittee No. 2 of the Committee on Banking and Currency, House of Representatives, 86th Cong., 1st sess. p. 10.

³ From Federal Reserve Staff Memorandum, "Proposed Legislation for Revision of Reserve Requirements," *Ibid.*, pp. 27-28, see also p. 15.

appropriate to make this subsidy in the form of a reduction in required reserve ratios. This is *possible*, but it is surely not *obvious*, and anyone who examines the justification offered for such actions by the Federal Reserve cannot but be struck by its inadequacy.

One of the objectives of policy with regard to the set of issues that concern us here is to achieve a clarification of the public interest in the level of required reserve ratios of member banks and, if that seems appropriate, to direct the Federal Reserve System to cease reducing required reserve ratios, or to otherwise discourage the System from doing so. It is not clear that this is an idle consideration. The arguments that have been used in the past by the System to justify reductions in required reserve ratios could as well be used to justify further reductions in the future. Bank liabilities and required bank capital presumably will continue to increase in the future, just as they have in the past. Chairman Martin has testified that a purpose of reduction in required reserve ratios is to make it possible for banks to lend more money—and surely we shall want them to continue to lend more money in a growing economy. It seems entirely possible that unless it is otherwise guided or instructed, the Federal Reserve will make further reductions in required reserve ratios.

It does not seem in conformity with sound procedures for the administration of public policy for the Federal Reserve System to have the power to vary required reserve ratios of member banks in response to considerations of monetary policy, bank profits, bank capital, bank loans, or other considerations that the System chooses to take into account. It seems appropriate to limit the delegation of power to the Federal Reserve to such variation of required reserve ratios as can be justified as required for the conduct of monetary policy. Delegation to the System of administrative authority, in effect, to transfer funds from the Treasury to the commercial banks on account of its interpretation of their need for larger profits, and in absence of any legislative criteria or guides in this regard—this seems to me an unusual and an unjustifiable governmental procedure. The use that has been made of this power in the past seems unjustified, contrary to the public interest, and providing no basis for continuation of this procedure.

To place an administrative agency in the position of officiating over the profits of the industry that it regulates, without guidance in the use of this power, without the necessity of justifying in detail the actions taken—this is to place it in an impossible position. Regulatory agencies always are under severe pressure from those that they regulate. It is not reasonable to place them in this position without the protection of firm guides to policy. The position of the Federal Reserve System is made more difficult by the fact it competes with State banking authorities that have less stringent requirements, since member banks have the option of withdrawing from the System to become State nonmember banks. It is possible that this competitive pressure is one of the factors that caused the System to reduce required reserve ratios. If so, this does not make the action any the less unfortunate. Such “competition in laxity,” to use an apt phrase of Marriner Eccles, has long been a distinctive and damaging characteristic of the U.S. banking and monetary system. It was prominent during the 1920's. It does not seem appropriate to follow the path marked out during that era in developing a unifiable monetary system.

If the Federal Reserve finds that the pressure of competition from State banking authorities is causing reduction in the number and importance of member banks and reduction in the System's control over the Nation's monetary system, it would be desirable that it come to the Congress with a proposal that will involve correcting that competition by raising the standards of the State banking authorities rather than by reducing the controllability and stability of the Nation's monetary system. If the Federal Reserve System believes that the public interest will be served by increasing at the public expense the earnings of the private commercial banking industry, it would be desirable that it prepare a brief to that effect and bring the matter to the Congress for its action.

4. *Basic approach to revision of the monetary system.*—There is a common response to suggestions of revision or reform of our monetary system that strikes me as strange and even dangerous. Indeed, it is, if I may say so, in a distinctive sense, *un-American*. In other areas Americans are at home with the idea of progress and continuing adaptation, of adjusting institutions to changing conditions and applying the latest advances of knowledge. American business is noted for not being satisfied with the old ways of doing things, for not being bound by the traditional ways. For a machine or a business method to be unchanged from the days of our ancestors is taken as a cause for reproach, not as evidence of soundness of management.

Why is it, then, that when suggestions of revision of our monetary system are made, these provoke such fearful vies of tampering with the institutions of our forefathers? Why is it taken that in this area—seemingly uniquely in the modern world—suggestions for change are to be regarded as heretical? In monetary institutions is there no need to adapt to new situations, no opportunity for progress? Is this an area in which the traditional practices and institutions are to be preserved through all eternity?

Look at the matter in another way. The spirit of modern science—which is being applied with great vigor and drive to the methods and institutions of business in this country—calls for an objective, unemotional analysis of alternative ways of doing things. Business thought has become bold, imaginative, creative. It involves application of new formal structures and analytical techniques to the interpretation and the building of business systems, systems that have defined and desired dynamic properties. Does not all of this have some applicability to reform of our monetary system? While business analysis rapidly becomes more precise and more advanced, why is monetary policy still discussed in terms of notions like “ease” and “tightness” that seem to defy definition? Why is it taken as a decisive criticism of a new monetary idea that it does not initially command the confidence of the superstitious and the uninformed? Does our monetary system belong to a world apart, a world to which science has no relevance, a world on which time has no impact, a world where vaporous pieties of central bankers reign immortal?

It is obviously inappropriate that suggestions to revise our monetary system should be frivolously made or lightly adopted. But it is scarcely less dangerous that such suggestions should not be made at all, or that when made they should be rejected out of hand as constituting tampering with the sacred ways of the past, as undermining the confidence of the ignorant. When the supposed makers of policy cringe before the opinions of the superstitious and the ignorant, it is the superstitious and the ignorant who are the real makers of policy.

To prepare to meet the needs of the future requires continuing revision of our monetary system. Progress in this calls for careful and tightly reasoned analysis of the effects of alternative arrangements. It also requires effective leadership, some of which ought to come from the Federal Reserve System. In this vein, it seems to me that H.R. 7601 does raise some issues that call for thought and action. It seems that objections on grounds of tampering, of destroying confidence, of destroying the credit of the United States, are not a valid reason for not pursuing the matter. If the genuine issues that it raises can be discussed carefully and unemotionally and the constructive purposes to which it is revelant can be considered in relation to alternative means of their effectuation, this bill can contribute to the making of needed improvements in our monetary system.

ZIMMERMAN, EVANS & LEOPOLD,
Atlanta, Ga., August 14, 1965.

HON. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE PATMAN: H.R. 7601 came to my attention through a transcript of Chairman Martin's related statement included in the July issue of the Federal Reserve Bulletin.

The enclosed statement reflects my analysis of the proposed statute which is being submitted for the consideration of your committee.

Sincerely yours,

JOSEPH H. LEOPOLD.

THE NATIONAL DEBT IS BEING QUIETLY RETIRED

An Analysis of H.R. 7601 and Federal Reserve Board Chairman Martin's Formal Statement Relating Thereto

H.R. 7601 is a proposed statute before the House of Representatives that should raise some eyebrows, not only among Members of Congress and students of monetary theory, but also among the general public. The bill contemplates acknowledging the cancellation of \$30 billion out of about \$40 billion worth of the so-called “public debt” that has been quietly retired by the Federal Reserve System over the years through the issuance of Government checks to citizens or banks whose bonds were cashed in. No allocation of tax remittances from citizens was used

as a basis for these bond redemptions. The money was created out of thin air by the Federal Reserve System, and then issued to the economy where it is now circulating.

The Federal Reserve System really does not like to engage in this easy money policy, because it runs counter to the traditional concept of bankers that all new money introduced into the economy should be first created and owned only by commercial banks, and then lent out to businesses or the Government at current interest rates. But the System feels compelled from time to time to relax this preferred policy because it realizes that to do otherwise would soon result in recession—producing money shortages. Such situations actually have occurred in the past, following periods during which the System failed to use this expedient with sufficient vigor. For example, all of the post-World War II recessions were induced by money shortages that could have been avoided by retiring a larger portion of the public debt than was being retired. In this connection, it is important to realize that the public debt is really not a debt in the way that is generally assumed; that is, it is not necessary for citizens to make remittances of their earnings to the Internal Revenue Service in order that the debt be retired. This debt fund actually reflects hoarded idle capital on deposit in the Treasury in the name of the bond holders. The entire amount could be returned to the citizens tomorrow. Contrary to popular belief, this would not cause inflation for the same reason that a person with a large quantity of earned money will not start spending it recklessly just because he cannot lend it at high interest rates. During the great depression the "prime" interest rate at commercial banks was in the order of only 1 percent and this certainly did not cause inflation. In fact, the Government was desperately trying without success to induce inflation to a degree, because it foolishly thought that the solution to the depression lay in lowering real wages of the citizens through the raising of prices.

To return to H.R. 7601, the fact that the debt in question no longer exists is obscured somewhat by the Treasury's continuing to pay the Federal Reserve System interest on it; the System returns the money unspent to the Treasury which then uses it for real expenditures. H.R. 7601 would end much of this juggling of numbers by officially declaring canceled \$30 billion of the \$40 billion debt previously retired by the Federal Reserve System.

Revelation that such a substantial portion of the public debt as \$40 billion has actually been paid off without corresponding tax remittances from the citizens may prove embarrassing to those directing the Nation's monetary policies, since it could well raise immediate question from taxpayers as to why more of the debt was not also retired in the same way. Such retirement obviously would spare the citizens from having their living standards reduced by the portion of their remittances to the Internal Revenue Service attributable to interest on the public debt.

Mr. McChesney Martin, Chairman of the Federal Reserve Board, testified against H.R. 7601 before the House Banking and Currency Committee July 6. His principal objection to the bill was his fear that the proposed statute might lead to removing the present requirement that deficits (the public debt) must be financed by market borrowing. Mr. Martin seems to imply that the Treasury always borrows the Federal deficit from private citizens out of their savings, as opposed to creating the money out of thin air. The implication seems to be that the latter process is unthinkable. But as a matter of fact, much of the money borrowed by the Treasury to finance deficits is created out of thin air by commercial banks through a hidden process (at present there is about \$65 billion outstanding in this category) and then lent to the Treasury at the highest basic interest rate that the Secretary of the Treasury can be persuaded by bankers to approve. (The mechanics of this operation are summarized in a report to the House Committee on Banking and Currency dated August 5, 1964, U.S. Government Printing Office Document 34-710, p. 47.)

Understandably, Mr. Martin, as a banker's banker, would like to have this very favorable arrangement perpetuated, although this basic desire is somewhat obscured through a stated concern about not wanting to deceive the people about the financial status of their Government. Mr. Martin believes that the Government should be forced to borrow at whatever interest rates lenders wish to charge, and that such interest rates would tell the people about the financial status of their Government. In other words, Mr. Martin is suggesting that it is more in the peoples' interest for banks to create deficit money out of thin air, and then lend it to the Government at substantial interest rates paid for by the people, than it would be for the Treasury to create the same money out of thin air, and let the people keep the interest payments for their own use. It is very

doubtful that the people would agree with Mr. Martin if they understood what he was talking about.

In analyzing Mr. Martin's statement, it is appropriate to recall that the noted inventor, Thomas A. Edison, who became interested in the same subject, when asked, "If the Government can issue bonds, why can't it issue money and save the interest?" replied as follows:

"If our Nation can issue a dollar bond it can issue a dollar bill. The element that makes the bond good makes the bill good also. The difference between the bond and the bill is that the bond lets money brokers collect twice the amount of the bond and an additional 20 percent, whereas the currency pays nobody but those who contribute directly in some useful way.

"It is absurd to say that our country can issue \$30 million in bonds and not \$30 million in currency. Both are promises to pay: But one promise fattens the usurers, and the other helps the people."

Mr. Edison's comments, although still correct, would be even more appropriate today if he used the term "deposit" instead of "bill" or "currency"; since most money today exists in the form of "deposits." The volume of bills or currency in circulation at any time is always determined only by the public's current desire for cash—a desire that is relatively independent of the amount of deposit money in existence.

Aside from not wanting to change the present scheme for financing deficits out of market borrowing, Mr. Martin expressed a few other objections to H.R. 7601 as discussed below:

1. Mr. Martin notes that the proposed statute would upset the present use of cashed-in Government bonds in possession of the Federal Reserve System as collateral for Federal Reserve notes engraved by the Treasury. Mr. Martin further advises that the interest received from the Treasury on the retired bonds, and which is returned to the Treasury unspent, should be thought of as interest payments to the Treasury for the Federal Reserve notes placed in circulation by member banks in response to the people's requests for cash.

The proposition that any useful purpose is served by using one type of Government-issued paper (Treasury bonds) as collateral for another type of Government-issued paper (currency notes), or that one Government agency should charge another Government agency interest for performing a Government service for the benefit of the people is very questionable to say the least. It is analogous to a person writing an I O U to himself as collateral for an I O U previously written to himself, and then writing another I O U to himself to cover interest on the second I O U. It would appear that abandonment of such incongruent activity would be a strong argument in favor of H.R. 7601. There are many ways that meaningful collateral could be put up by commercial banks for the Federal Reserve notes made available to them by the Treasury to accommodate their depositors or other creditors. The use of retired bonds for such collateral is meaningless.

2. Mr. Martin is concerned that if \$30 billion of the public debt is acknowledged to be canceled, this will automatically raise the debt ceiling by \$30 billion. The implication here seems to be that Congress would immediately pull out the stops and become reckless with authorizations to spend Federal funds, upon learning that the public debt is \$40 billion less than they were previously led to believe. This objection can be dismissed on its face without comment.

3. Mr. Martin, in reciting his objections to H.R. 7601, in effect, admitted that the interest payments on the bonds in question are imaginary; i.e., imaginary interest is paid to the Federal Reserve System which returns it unspent to the Treasury. As Mr. Martin put it: With the proposed statute the Treasury and the taxpayers would come out even. This admission would appear to be another good reason for eliminating the fiscal sleight-of-hand inherent in the present arrangement. The debt in question has been retired and there is no logical reason for attempting to obscure this fact.

H.R. 7601 should be adopted as an important first step in simplifying monetary procedures, and in unmasking the inherent unsoundness of present fiscal and monetary theory. If enacted, this statute could open up a Pandora's box of hidden natural economic secrets that have been waiting patiently for centuries to be discovered.