By hand

June 24, 1959.

The Honorable Wilbur D. Mills,
Chairman,
Committee on Ways and Means,
House of Representatives,
Washington 25, D. C.

Dear Mr. Chairman:

This is in response to your request that I supply you and Mr. Simpson a statement on the effects of the proposal by Representative Patman to cancel $15 billion of United States Government obligations presently held by the Federal Reserve Banks.

Up to the present time, the details of Representative Patman's proposal are not available to us. As you will recall, in the statement that he made to your Committee, he merely indicated that he would introduce an amendment to S. 1120, which would provide for the cancellation of $15 billion of such securities.

The Government obligations owned by the Federal Reserve Banks have been purchased over the course of time in the process of supplying banks with sufficient currency to meet the public's demands and of maintaining the reserve balances that the banks are required to hold against their deposit liabilities. Broadly speaking, ignoring items of lesser importance, the Federal Reserve Banks' assets consist of $26 billion of Government securities and about $20 billion of gold certificate reserves. Their liabilities comprise $27 billion of Federal Reserve notes and $20 billion of deposits, mostly member bank reserve balances. The law provides that the Reserve Banks must set aside as collateral against Federal Reserve notes an equivalent aggregate amount of gold, eligible paper, and U. S. Government securities, and must maintain gold certificate reserves of at least 25 per cent against note and deposit liabilities.

Cancellation of $15 billion of the System's holdings of Government securities would require a balancing reduction in its liabilities. As pointed out above, it was not clear in his statement to your Committee how Mr. Patman proposed to accomplish this second step. If no parallel provision were made simultaneously in the law, the net result would, of course, be to place the Federal Reserve System in bankruptcy.

There is no practical way by which $15 billion of Federal Reserve notes could be taken out of circulation "immediately"; the amount in circulation is determined by the public's demands. One possible adjustment would be to simultaneously reduce the reserve balances of the member banks by $15 billion through some form of assessment or tax. This in turn would create similar problems for member banks. As I pointed out, it would be highly deflationary, since it would require a drastic curtailment of credit to pull the banks' deposit structure down to the level permitted by their reduced reserve balances, even if reserve requirements were reduced to the present statutory minimum.

Subsequent to his appearance before your Committee, Mr. Patman has provided some further information as to the nature of his proposal. In his statement on the floor of the House, on the Public Debt Act of 1959 (H.R. 7749), Mr. Patman stated:

> "I have proposed legislation which would cancel $15 billion of these bonds. And the amendment I have proposed could also take care of the bookkeeping in a nice, tidy, orthodox way. It would transfer the $15 billion of assets to the Treasury for cancellation, and at the same time it would transfer to the Treasury $15 billion of liabilities for the outstanding Federal Reserve notes. This will keep the books in balance. And certainly the Treasury can have no objection to assuming the $15 billion of liabilities for these Federal Reserve notes, because the fact is, as I have pointed out, these notes are already liabilities of the Treasury, all $27 billion of them. And they are a convenient sort of liability to have because, as I have said, no one will ever try to redeem them, and if a holder of these notes should try to redeem them, the only thing he could demand in exchange would be another Federal Reserve note just like the one he wants to redeem. So this method of transfer would take care of the matter very nicely.

"Unfortunately, the Members of the House are meeting here under a gag rule. The Rules Committee has not seen fit to give Members of the House an opportunity to propose amendments to this debt-increase bill, otherwise I would offer an amendment which would substitute a figure permitting the $12 billion increase in the debt limit for a figure which would bring about a net reduction of $3 billion in the debt limit. And it would, furthermore, require the Federal Reserve Board to transfer to the Treasury for immediate cancellation $15 billion of its unneeded debt obligations.

"I hope, however, to be able to offer this as an amendment to the bond give-away bill S. 1120 when we take that up. So that the Members may be informed, I will insert at the conclusions of my remarks a copy of the amendment I propose to make at that time, assuming that the House should make the unfortunate decision to approve this debt-increase bill."

So far as we are aware, the amendment has not been published in the Record, nor has any specific legislation been introduced. However, the substance of Mr. Patman's proposal now appears to involve the monetization of $15 billion of the Government's outstanding debt. In essence, it would mean financing the Government through the issuance of fiat money. This raises the basic question of whether the United States Government should finance either past or current deficits by the issuance of currency; or whether it should, as it now does, finance its debt by borrowing on interest-bearing obligations, in order to minimize the inflationary impact of deficits by financing them with real savings.

Many years ago the Congress made the basic decision that it was not desirable for the Government to finance itself by the issuance of "greenbacks", or some other form of unsecured paper currency. Even in the direst periods of national emergency, we have not resorted to this expedient. While this option is always open to the Congress, and it would have the effect of reducing the nominal amount of the Government debt, the repercussions with respect to the soundness of the Government's credit would be far-reaching and possibly devastating.

It appears that Mr. Patman would not propose, for the moment, to increase or decrease the total amount of money in circulation in the United States, but, rather, to substitute $15 billion of currency, which would be an unsecured obligation of the Treasury, for $15 billion of Federal Reserve notes, which are backed by interest-bearing obligations and a gold reserve of at least 25 per cent. In accordance with the Federal Reserve Act, Federal Reserve notes are only supplied in an amount sufficient to meet the public's needs for currency and in exchange for assets of equal value. They may not be issued to finance the expenditures of the Government.

Over the long span of history, the issuance of currency to finance government has invariably been associated with depreciation and devaluation of the currency, and there can be no doubt that such an action by the United States at this time would be so interpreted, both by our own citizens and by the world at large.

Sincerely yours,

Wm. McC. Martin, Jr.

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