Statement of

William McChesney Martin, Jr.,

Chairman, Board of Governors of the Federal Reserve System,

before the

Senate Committee on Banking and Currency,

on S. 743, S. 797, and S. 814

February 2, 1965

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You have asked for comment on three bills relating to the requirement of present law that each Federal Reserve Bank maintain a gold certificate reserve of at least 25 per cent against its Federal Reserve notes in actual circulation, plus a further gold certificate reserve of at least 25 per cent against the deposits it holds. S. 743, introduced by Senator Douglas, would repeal both requirements. S. 797, introduced by your Chairman at the request of the President, would drop the requirement against Federal Reserve Bank deposits, but retain that against Federal Reserve notes. S. 814, introduced by Senator Javits, would keep both requirements, reducing that against deposits to 10 per cent and that against notes to 15 per cent.

That conditions now call for some change in these requirements seems clear. By the end of 1964, the ratio of the Federal Reserve Banks' gold certificate holdings to their deposits and notes combined was 27.5 per cent, down 2 points from a year earlier and only 2-1/2 points above the legal minimum now prescribed in Section 16 of the Federal Reserve Act. If developments well within the range of possibilities should be realized, the legal minimum could be penetrated soon, possibly within a year.

Nevertheless the dollar is strong, and so is our economy. We are enjoying vigorous economic growth, and have been reasonably successful in maintaining a relatively stable average of prices. American goods and services are doing well in competition in world markets, as indicated by the substantial surplus in our trade balance. Therefore action on this legislation can be taken now, not to deal with a dollar crisis but to maintain the dollar's current strength.

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Gold certificate reserves of the Federal Reserve Banks reached their peak of $23.4 billion in September 1949 when the total U. S. gold stock amounted to about 70 per cent of the free world's monetary gold. Over the period from 1949 through 1964, net sales of U. S. gold to foreign monetary authorities reduced our gold certificate reserve by $8.4 billion, as shown by the table attached to this statement. In the same period, growth in Federal Reserve deposit liabilities and notes in circulation absorbed in required reserves $3.5 billion. Over these 15 years, therefore, Federal Reserve Bank holdings of gold certificates in excess of the minimum required by statute have on balance declined by $11.9 billion.

In substantial part United States' sales of gold to foreign monetary authorities since 1949 have reflected postwar recovery of the free world from the monetary chaos created by the Second World War, and the desire of the major foreign industrial countries to re-establish convertibility of their currencies. These countries sought to accomplish this by accumulating monetary reserves partly in the form of gold and partly in the form of dollar balances. Between the end of 1949 and the end of 1964, the dollar component of monetary reserves of foreign countries rose by $10 billion (from $3 billion to $13 billion) while their monetary gold stocks rose by $16 billion (from $9 billion to $25 billion). Foreign private holdings of dollars also increased by $8 billion, from about $3 billion to nearly $11 billion.

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In the half century since the enactment of the Federal Reserve Act, the function of gold in our monetary system has undergone fundamental change. More than three decades ago, coinage of gold, redemption of bank notes and deposits in gold, and private acquisition and holding of monetary gold were discontinued in this country. Domestically, these actions in effect ended the private use of gold as a store of value. Internationally, they enlarged the availability of U. S. gold for official settlements with other governments in response to the needs of our foreign commerce and investment.

Today, throughout the free world, when a citizen of one country does business with a citizen of another--whether or not either of them is an American--the chances are that they will settle their accounts in U. S. dollars. When foreign bankers, merchants, and investors acquire in their transactions more dollars than they wish to hold for working balance or investment purposes, they usually sell them to their central bank. The central bank may keep the dollars as part of its monetary reserves or use them, if it desires, to purchase gold from the U. S. Treasury. On the other hand, if a country's international settlements should use up its dollar balances, its central bank may acquire dollars by selling gold to the U. S. Treasury.

In short, the readiness of the U. S. Treasury to buy and sell gold at the fixed price of $35 an ounce in transactions with foreign monetary authorities has greatly contributed to the willingness of

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foreign monetary authorities and private foreign residents to hold a growing total of dollar reserves and working balances. Consequently, the U. S. gold stock has come to play the dual role of supporting the international convertibility of the dollar and of facilitating the inter-convertibility of other currencies among themselves and into the dollar.

This dual role of the U. S. monetary gold has helped the dollar to attain a unique position in international commerce and finance. And the universal acceptability of dollars has greatly facilitated the record expansion of international trade over the past 15 years, with world trade rising from less than $60 billion to nearly $160 billion. For this reason, the availability of U. S. monetary gold holdings to meet international convertibility needs is a matter of vital importance not only to the United States but to the entire present system of international payments on which the free world relies.

These developments underscore the need for speedy correction of the deficit in our international payments, which for all too many years has been eroding our gold reserves. The President, in his Economic Report, has stressed the seriousness of the problem, and has unequivocally stated that "we must and will reduce and eliminate" the deficit.

In consequence of the large and persistent deficit in the U. S. balance of payments after 1957, many foreign countries accumulated dollar balances in excess of their needs for working

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balances, reserves, and investments. Their monetary authorities used such excess dollar balances to purchase gold from the U. S. Treasury and the resulting decline in the U. S. gold stock has contributed to the sharp reduction in the System's reserve ratio.

In order to avoid any deflationary impact from this outflow, the Federal Reserve offset the effects of the decline in its gold certificate holdings by expanding its holdings of U. S. Government securities. In addition, the Federal Reserve further increased its Government security holdings in order to sustain an expansion of bank credit consistent with a growing economy and a relatively stable average of prices.

Over the years ahead, the continued growth of U. S. economic activity will require continuing monetary expansion consistent with a stable dollar. Under prospective conditions, it appears all but certain that the gold certificate reserve ratio of Federal Reserve Banks, for domestic monetary reasons alone, will steadily decline, even if gold sales to foreign monetary authorities are small. Of course, any substantial further outflow of gold would accentuate the decline.

Accordingly, the time is ripe for legislative action that will, as President Johnson said in his Economic Report last week,

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> ". . . place beyond any doubt the ability of the Federal Reserve to meet its responsibility for providing an adequate but not excessive volume of bank reserves,"

and

> ". . . place beyond any doubt our ability to use our gold to make good our pledge to maintain the gold value of the dollar at $35 an ounce with every resource at our command."

As you know, the President himself expressly requested that Congress "eliminate the arbitrary requirement that the Federal Reserve Banks maintain a gold certificate reserve against their deposit liabilities." The specific provisions to accomplish this are encompassed in S.797, introduced by your Chairman.

To me, the question before us is a practical one. S.797 offers a pragmatic response, proportioned to the present circumstances. By removing the reserve requirement against deposits, it would free approximately $4.8 billion in gold now earmarked for cover purposes and raise the total free gold certificate holdings to about $6.2 billion.

Moreover, by retaining the traditional gold "backing" for Federal Reserve notes, the proposal would be reassuring to those who, in their continuing concern for the stability of the dollar, see in a gold cover requirement an important element of strength. The value of any currency is so much a product of confidence that one should not disregard this advantage of S.797.

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The removal of the reserve requirement against deposits would seem to me fully adequate to meet our present and foreseeable needs and sufficiently ample to remove any doubt anywhere about our ability to defend the dollar abroad, and to further advance the progress of our domestic economy.

I might note here that, on an earlier occasion, Congress reduced the gold reserve requirements by lowering the percentage of reserves required against Federal Reserve notes as well as deposits in the Federal Reserve Banks. Specifically, in 1945, Congress reduced the gold cover requirements from 40 per cent against notes and 35 per cent against deposits to the present figure of 25 per cent for both. That action was taken after the amount of free gold certificates had dropped from $12.4 billion at the beginning of the war to $3.2 billion by mid-1945. If an across-the-board reduction of the present 25 per cent requirement were to be made now--say to 15 per cent--it would release about $5.5 billion of the earmarked gold, as compared to the $4.8 billion released by S. 797. Or the requirement against deposits could be reduced further, as in S. 814, to 10 per cent, coupled with a reduction in the note cover to 15 per cent; this would release an additional $1 billion in gold.

From a technical viewpoint this approach may be just as sound as that taken by S. 797. What counts, in my judgment, is which approach would be more acceptable to the public. And from that standpoint, I believe it is preferable to preserve the 25 per cent requirement for Federal Reserve notes and thus to keep intact the symbolic tie between our circulating currency and gold.

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The Congress could, on the other hand, take a more all-out approach and repeal the gold cover requirements altogether. This would release our entire gold certificate holdings of $15 billion by severing the last statutory link between the volume of our Federal Reserve notes in circulation and gold. The theory here is that, since neither Federal Reserve notes nor deposits in Federal Reserve Banks can be redeemed in gold, there is no need to have any gold "backing" against either of them. Further, it is suggested that outright repeal of both gold reserve requirements would eliminate the possibility that Congress might be called upon to take further action later. Those who would keep the "discipline" of gold, however, answer that this very possibility offers added protection against irresponsible public policies.

While judgments differ as to the value of this kind of statutory protection, we need not attempt at this time to resolve forever the problem of whether or not a gold cover requirement serves a useful end. We need only to adapt our traditional cover requirements so that we can better meet present and foreseeable needs. If we keep the gold cover requirement for our currency, our free gold certificate holdings of more than $6 billion will be enough to accommodate normal growth in circulating Federal Reserve notes for some time to come.

We face the prospect of some additional gold losses this year. But if we persevere in efforts to correct our balance of payments deficit, we can look forward to a cessation of gold outflow

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and, over the longer-run, a gradual growth of our gold stock from world supplies, at times in consequence of international settlements and at times by sharing in new production.

In considering these proposals, I think we must be careful to keep in mind that, regardless of what is done about legal requirements, there is an inescapable practical requirement that we maintain an adequate gold stock to back up the role of the dollar as a key currency in world trade. Hence the need to conserve our gold stock will continue to exert a disciplinary influence on monetary and other policies, and a statutory gold reserve requirement for notes will serve to emphasize this need.

All of us need to be mindful that sound money is not established by statute alone. In the end, our nation cannot have sound money unless its monetary and fiscal affairs are well managed. The fundamental elements in keeping our financial house in order are thus sound and equitable fiscal and monetary policies.

It may be helpful to your consideration of legislation for me to say at this point a few words about the present provisions of the law respecting the suspension of gold reserve requirements. The Board's authority in this regard is contained in Section 11(c) of the Federal Reserve Act. It provides that we can suspend the gold reserve requirements for a period of 30 days, and renew such suspensions for 15-day periods thereafter.

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Upon action to suspend the requirements, the Board would have to establish a tax on the Reserve Banks graduated upward with the size of their reserve deficiencies. The tax could be very small so long as the reserve deficiencies were confined to the reserves against deposits and the first five percentage points of any deficiencies against Federal Reserve notes. But if the reserve deficiencies should penetrate below 20 per cent of the Federal Reserve notes outstanding, the tax would undergo a fairly steep graduation in accordance with statutory specifications.

The Federal Reserve Act further specifies that, should the reserve deficiencies fall below the 25 per cent requirement against notes, the amount of the tax must be added to Reserve Bank discount rates. But if the deficiencies were confined to reserves against Reserve Bank deposits, the required penalty tax could be nominal and no addition to Reserve Bank discount rates would be necessary.

From a technical point of view, it might be possible under existing law for the Board to suspend gold reserve requirements indefinitely, since there is no limit on the number of times the Board might renew suspensions for periods of 15 days each. Yet it seems clear that the purpose of the provisions for suspension was to facilitate adjustments by those Reserve Banks whose reserves fall temporarily below required levels, and not to provide a solution to a national problem of more than temporary import.

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In a world in which the role of the dollar as an international means of payment and a reserve asset has been under criticism, it is important for the Congress to assure the world of the availability of U. S. monetary gold for legitimate monetary uses in international commerce, to reaffirm the relationship between the dollar and gold, and to reassert the intention of the U. S. to maintain an adequate gold reserve for the dollar. Enactment of S. 797 would accomplish this triple purpose.

In conclusion, I would re-emphasize that we do not need now to resolve this question of gold cover for all time, for monetary arrangements and institutions are constantly evolving in accordance with domestic and international needs, and these changes call for adaptation from time to time in monetary legislation. The all-important need for legislation at this juncture is to assure the world that U. S. monetary gold is always available to maintain the convertibility of the dollar and that the United States will honor its debts and liabilities in the form of foreign dollar holdings--as I have said many times before--down through the last bar of gold, if that be necessary.

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CONSOLIDATED RESERVE POSITION OF THE FEDERAL RESERVE BANKS

(Dollars in millions)

| Item | September 21, 1949 | December 31, 1963 | December 31, 1964 |
|---|---|---|---|
| Reserve Bank deposits | $17,523 | $18,392 | $19,454 |
| Federal Reserve notes | 23,248 | 32,878 | 35,342 |
| Liabilities requiring reserves | $40,771 | $51,270 | $54,796 |
| Required reserves against deposits | $ 4,381 | $ 4,598 | $ 4,864 2/ |
| Required reserves against notes | 5,812 | 8,220 | 8,835 |
| Total required reserves | $10,193 | $12,818 | $13,699 |
| Free gold certificate holdings | 13,247 | 2,419 | 1,376 2/ |
| Gold certificate reserves | $23,440 | $15,237 | $15,075 |
| Ratio of gold certificate reserves to deposit and note liabilities | 57.5% 1/ | 29.7% | 27.5% |

1/ Postwar peak.

2/ Elimination of required reserves against deposits, as recommended in the President's Economic Report, would raise free gold certificate holdings to $6,240. "Free gold" includes some additional gold held by the Treasury (amounting to $240 million on December 31, 1964) that is not pledged as cover for gold certificates or U. S. notes.

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