Statement of

William McChesney Martin, Jr.,

Chairman, Board of Governors of the Federal Reserve System,

before the

House Committee on Banking and Currency,

on H. R. 7601

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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 cancelled and retired." Section 2 of the bill would relieve each Reserve Bank "of its liability upon an amount of (its) Federal Reserve notes . . . 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

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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 per cent 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 cancelled. Presumably, therefore, the intent would be to relieve the Reserve Banks of their present duty to maintain 100 per cent collateral and 25 per cent 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 in circulation. Thus, it would appear that of the $35 billion of identical Federal Reserve

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notes that would continue in the hands of the public, one-seventh would be secured and six-sevenths would not.

A second effect of H. R. 7601 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 cancelled 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, cancelling $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,

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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 ensure 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. Government 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

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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 or the people can be deceived nor can they wishfully deceive themselves as to the financial status of their Government. I 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 cancelled 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 per cent, 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.

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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.

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