

THE MANIPULATION
OF OUR FEDERAL RESERVE
BANK NOTES

*

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THE MANIPULATION OF OUR FEDERAL RESERVE BANK NOTES

THE GIST OF THIS REMARKABLE TRANSACTION

THE FEDERAL RESERVE AND TREASURY AUTHORITIES embarked, on December 12, 1942, upon a manipulation of our currency without precedent in the history of this nation. This remarkable and surprising episode has largely escaped the attention of the general public, probably because the transaction involved many technicalities which, up to date, have served successfully to obscure its basic elements. The essentials of the manipulation are of such a nature, however, that any mature and interested person should be able to understand them.

The essence of the matter is this: By a sleight-of-hand performance, in which Federal Reserve bank notes were "retired" before they were issued, the Federal Reserve banks converted what should have been a liability into an asset and got \$660,000,000 additional cash reserves to which they were not entitled. The Treasury began the issuance of \$660,000,000 Federal Reserve bank notes in violation of law. It got a deposit credit of this amount on the books of the Federal Reserve banks in an unauthorized manner. It violated its legal and moral responsibilities as a custodial trustee by

using for its own purposes \$660,000,000 of Federal Reserve bank notes which it was supposed to hold in trust for the Federal Reserve banks. It and the Reserve authorities, acting together, converted these notes into a fiat money. Both authorities illegally and arbitrarily set aside a tax law of Congress.

When the question of the nature of the transaction came before Congress, the administrators were able to explain away this piece of legerdemain in ways that apparently left most members of Congress in such confusion that they felt unable to follow through and to take the proper corrective action that should have resulted from an understanding of what had been done.

Had a sufficient number of Congressmen kept their eyes on the main features of the transaction, the proffered explanations, saturated as they were with contradictions and inadvertent or forced admissions, should have revealed the existence of a manipulation. But the explanations apparently sounded plausible. In any event, most Congressmen accepted them.

Since the transaction was a sleight-of-hand performance, involving a currency whose issuance is normally surrounded by several technicalities, it was easy for the performers to divert the attention of Congress from the essentials.

Had the Treasury issued \$660,000,000 of unsecured greenbacks in violation of law, Congress doubtless would have understood the transaction and probably would have taken appropriate action. Nevertheless, in this Federal Reserve bank note manipulation, the issuance of fiat money was accomplished; but, because it was done by an unexpected use of various technicalities, the great majority of Congressmen missed the point completely.

This case is a striking illustration of what administrative bodies can do if they can operate behind technicalities sufficient in number and complexity to baffle and thwart a very busy Congress whose members normally attempt to pass judgment upon a multitude of issues regarding which even a minority often cannot find the time to inform themselves adequately. A handful of administrators,

steeped in the technicalities of a transaction, and well aware of the various side doors through which they can dodge when Congressmen question them, can circumvent most Congressmen unless the latter can and will take the time to study the practices of such administrators.

Had members of Congress not been diverted from the main features of the manipulation, the truth should have emerged. Congress really needed to do little more than to ask and to get the correct answers to the following questions:

1. Does the law authorize the Treasury to issue Federal Reserve bank notes?
2. Did not the Treasury issue these notes?
3. Were they ever a liability of the Federal Reserve banks as required by law?
4. Did they not immediately become reserves instead of liabilities of the Federal Reserve banks?
5. Did not the Treasury violate its responsibilities as custodial trustee and use for its own ends what could only be used legally by the Federal Reserve banks?
6. Were not Federal Reserve bank notes, by this transaction, illegally converted into a fiat money?
7. Did not the Reserve and Treasury authorities set aside a tax law of Congress?

The administrators who were queried about the matter escaped through all sorts of side doors. Their explanations, obviously intended to be in agreement, contained many inconsistencies, admissions, and contradictions. One Congressman succeeded in getting an admission from a Treasury official that these bank notes had been converted into fiat money. But he either did not understand the significance of the admission or he was so confused by the contradictory explanations that, in a speech on the floor of Congress, he actually supported the manipulators.

NO LAW AUTHORIZES THE TREASURY TO ISSUE
FEDERAL RESERVE BANK NOTES

THE FEDERAL RESERVE ACT, in Sections 4 and 18, provides that such notes may be issued by Federal Reserve banks. No law authorizes the Treasury to issue them. Up to December 12, 1942, no agency, other than the Federal Reserve banks, ever issued Federal Reserve bank notes, and doubtless no one ever supposed, for an instant, that any other agency would ever assume that it could do so.

Section 4, paragraph 4, of the Federal Reserve Act, provides that a Federal Reserve bank shall have power "upon deposit with the Treasurer of the United States of any bonds of the United States in the manner provided by existing law relating to national banks, to receive from the Comptroller of the Currency [a bureau of the Treasury Department] circulating notes in blank, registered and countersigned as provided by law, equal in amount to the par value of the bonds so deposited, such notes to be issued under the same conditions and provisions of law as relate to the issue of circulating notes of national banks secured by bonds of the United States bearing the circulating privilege, except that the issue of such notes shall not be limited to the capital stock of such Federal reserve bank."

The conditions under which national banks may issue national bank notes, as provided in the National Bank Act, are, in brief, that these banks must deposit with the Treasurer of the United States an amount of United States bonds, specified as security for these notes, equal in value to the notes issued and, in addition, a redemption fund in lawful money equal to 5 per cent of the notes in circulation.

Section 18 of the Federal Reserve Act carries an amendment of March 9, 1933, which enables the Federal Reserve banks, under certain (emergency) conditions, to deposit various kinds of securities and paper, in lieu of United States bonds, with the Treasurer

of the United States as security for Federal Reserve bank notes. Paragraph 6 of Section 18 continues: "Such notes shall be the obligations of the Federal reserve bank procuring the same. . . ." This quoted sentence should be noted particularly, since it is an important part of the law violated by both the Treasury and the Federal Reserve banks.

HOW THE TREASURY GOT \$660,000,000 BY VIOLATING THE LAW

IT WILL BE NOTICED that in these laws, which are supposed to control the issuance of these notes, the United States Treasury is custodial trustee for the notes until they are issued by the Federal Reserve banks. If these banks wish to issue them, they must deposit the proper security and a 5 per cent redemption fund with the Treasurer of the United States (or their Federal Reserve agent acting for him) after which the proper amount of notes is turned over to the issuing Reserve banks. When issued by these banks, the notes become their obligations—that is, they appear as liabilities on their balance sheets.

In the manipulation, beginning December 12, 1942, and still continuing, the Treasury in effect decided that it could use for itself the purchasing power which the \$660,000,000 of unissued notes in its possession would give it if it violated its obligations as custodial trustee. Therefore it deposited these notes in the Federal Reserve banks and received in exchange a deposit to its credit which it began to use at once. It also declared these notes to be a liability of the Treasury (technically known as Treasury currency). The notes were received by the Federal Reserve banks just as any Treasury currency is received—for example, as silver or gold certificates or United States notes are received. Since all Treasury currency serves as lawful money for reserves against Reserve bank deposits, these Federal Reserve bank notes ap-

peared on the asset side of the banks' balance sheets, rather than on the liability side as required by law. The Treasury got \$660,000,000 of deposits, and the Reserve banks got \$660,000,000 of so-called lawful money to add to their reserves.

What would have taken place, had these notes been issued according to law, was this: The Treasury, as trustee, would have received from the Reserve banks \$660,000,000 in bonds and a redemption fund of 5 per cent, but no deposit credit. The Reserve banks would have received in return for what they gave up \$660,000,000 in Federal Reserve bank notes which would have become a liability when issued. They would not have been lawful money for reserves; nor could they have been counted as reserves.

NO LAW AUTHORIZES THE TREASURY TO PROFIT FROM THE ISSUANCE OF FEDERAL RESERVE BANK NOTES

THE TREASURY MAY NOT LEGALLY PROFIT beyond a tax from the issuance of Federal Reserve bank notes. Yet the Treasury did profit from this manipulation. It got a purchasing power of \$660,000,000 without interest, whereas it can get its money legally only by taxation or borrowing, except as otherwise specifically authorized by act of Congress. It got this purchasing power by violating its legal and moral obligations as custodial trustee for unissued Reserve bank currency.

The laws which relate to the question of whether the Treasury shall gain or lose anything when Federal Reserve banks issue Federal Reserve bank notes deal with two matters: (1) That the Treasury shall be reimbursed by the Federal Reserve banks for the expenses involved in the paper, printing, etc.; and (2) that the Treasury shall collect a specified tax from the Reserve banks as long as these Federal Reserve bank notes are in circulation.

To be more specific, Section 18 of the Federal Reserve Act provides: (1) "Appropriations available for distinctive paper and

printing United States currency or national bank currency are hereby made available for the production of the circulating notes of Federal reserve banks herein provided; but the United States shall be reimbursed by the Federal reserve bank to which such notes are issued for all expenses necessarily incurred in connection with the procuring of such notes and all other expenses incidental to their issue, redemption, replacement, retirement and destruction."

As to (2), Section 18 provides: "Such circulating notes shall be subject to the same tax as is provided by law for the circulating notes of national banks secured by 2 per cent bonds of the United States." This means that the Reserve banks are supposed to pay "a tax of one-fourth of one per centum each half year upon the average amount of such of its notes in circulation. . . ." When the notes are in process of retirement, and have been written off as a bank liability, the banks are no longer liable for the payment of the tax.

In the Federal Reserve-Treasury manipulation of December 12, 1942, the Treasury, according to Chairman Eccles of the Reserve Board, had already been reimbursed by the Federal Reserve banks for the paper in, and printing of, these notes which the Treasury held in trust for the Reserve banks. But, because the Treasury, rather than the Reserve banks, issued them, it did not collect the legally-prescribed tax from the banks for the notes put into circulation.

In one of the Reserve Board staff documents sent by Chairman Eccles to Senator Taft on January 26, 1943, it was said that "The method followed has the effect of relieving the Federal Reserve banks of the payment of the tax. . . ." It also improperly freed these notes from the pressure for retirement which the tax normally exerts.

The Federal Reserve Act should make it abundantly clear that there is no provision in law authorizing the Treasury to profit by the issuance of these notes except in the collection of the prescribed tax—a tax that was not collected.

THE LAW PROVIDES THAT THESE NOTES SHALL BE
OBLIGATIONS OF THE ISSUING FEDERAL RESERVE BANKS

SECTION 18 of the Federal Reserve Act is perfectly clear on this matter. It says: "Such notes shall be obligations of the Federal reserve bank procuring the same. . . ."

Now when the Treasury began on December 12, 1942, to deposit the Federal Reserve bank notes, which it held as custodial trustee, with the Reserve banks in exchange for a deposit credit, these notes became liabilities of the Treasury at once. They were never a liability on the books of the Reserve banks. They never appeared in the weekly statements of the Reserve banks as liabilities—neither then nor since. But they did appear immediately in Treasury statements as liabilities—in the item "Treasury Currency Outstanding"—, and they have appeared there as Treasury liabilities ever since, mounting month by month until now they are near the maximum which the Treasury has been able, through this manipulation, to put into circulation through the Reserve banks.

One would suppose that these easily-ascertainable facts and such a flagrant violation of law would evoke immediate protest and decisive action by Congress, but, although a bill introduced by Senator Taft to prevent a future occurrence of this kind passed the Senate on May 12, 1943, no action has been taken by the House.

DISTINCTION BETWEEN "ISSUING" AND
"PAYING OUT" A CURRENCY

UNDER OUR LAWS, certain currency is issued by the Treasury; and other currency—for instance, Federal Reserve notes and Federal Reserve bank notes—may be issued by the Federal Reserve banks. National banks are no longer issuing national bank notes, and the Reserve banks are issuing only Federal Reserve notes. The

manipulation involved Federal Reserve bank notes, not Federal Reserve notes. If the reader finds a Federal Reserve bank note in his purse it will bear the name, "National Currency," for reasons described below.

Among the cash which a Reserve bank may pay out, but which it does not issue, is such Treasury currency as silver dollars, silver certificates, subsidiary silver coin, minor coin, and United States notes. Among the Treasury currency that cannot be paid out by Reserve banks today are gold and gold certificates (because of the suspension of gold payments domestically), Treasury notes of 1890 and national bank notes (in process of retirement), and, when they are *actually* being retired, Federal Reserve bank notes. A Reserve bank may pay out its own Federal Reserve notes, which are not Treasury currency, but it cannot pay out the Federal Reserve notes issued by another Reserve bank. Since the Reserve banks are paying out the Federal Reserve bank notes, "retired" before they were issued, one contradictory aspect of this irregular transaction is revealed.

Never, until some of the administrators responsible for this manipulation of Federal Reserve bank notes were queried, had any supposedly responsible authority ever asserted, so far as this author knows, that the mere paying out of a currency meant that the paying-out institution was also the issuing authority. Yet, in this case, some of the Reserve authorities insisted that these notes were being issued by the Reserve banks, merely because they were being paid out by these banks. It would have been just as logical to insist that the Reserve banks were issuing silver certificates or United States notes or silver coins because they were paying them out. At the same time that these officials were contending that the Reserve banks were issuing these notes, they were also insisting that the notes had been retired by these banks. If the "retirement" had been real, the Reserve banks would not have paid them out but would have sent them to the Treasury for cancellation.

When the Board of Governors of the Federal Reserve System announced on December 12, 1942, the issuance of these notes, held as a stock by the Treasury, they did not state who was issuing them. The Reserve Board's press release was adroit in the matter. Had the issuance been in legal form, the release would naturally have stated that the Reserve banks were issuing \$660,000,000 additional Federal Reserve bank notes. But the release did not say that. Instead, it said this: "As a part of the program of the Government to conserve both labor and materials during the war period, the Board of Governors, after consultation with the Treasury Department, has authorized the Federal Reserve Banks to utilize at this time the existing stock of currency printed in the early Thirties known as 'Federal Reserve bank notes'."

It will be noticed that the Reserve Board used the word "utilize," not "issue." Since they should have mentioned their issuance by the Reserve banks, had these banks planned to issue them, all that the Board could have said accurately, under the circumstances, was that the notes were being issued by the Treasury. They did not say that; instead, they employed the word "utilize." And, if their intention was to mislead the public and the great majority of Congress, they were highly successful.

Despite the fact that the Treasury, not the Reserve banks, issued these notes, Chairman Eccles of the Board of Governors of the Federal Reserve System, sent to Senator Taft, January 26, 1943, a statement which said that "The notes were issued by the Reserve banks. . . ." It appears from Mr. Eccles' letter that this was a statement supplied him by Mr. E. A. Goldenweiser, Director of the Division of Research and Statistics of the Board; but, regardless of its authorship, it was part of the Eccles reply to Senator Taft.

In another document, included by Chairman Eccles in his letter to Senator Taft, the authorship of which is not clear, this statement appears: "In December 1942 the Board of Governors of the Federal Reserve System, with the approval of the Treasury Department, authorized the Federal Reserve banks to pay out the existing

stock, approximately \$660,000,000, of Federal bank notes which were printed in 1933." Here the words "pay out" were used. But later on in this same document it was stated that: "The Federal Reserve bank notes now being put into circulation are issued by the Federal Reserve banks. . . ."

In a letter of February 1, 1943, to Senator Taft, Under Secretary of the Treasury Daniel W. Bell said that "These notes, as you know, are being issued by the Federal Reserve banks at the direction of the Board of Governors of the Federal Reserve System. The Board of Governors consulted the Treasury prior to directing their issuance and the Treasury approved this action."

**BY THIS ILLEGAL ISSUANCE THESE NOTES BECAME ASSETS
INSTEAD OF LIABILITIES OF THE FEDERAL RESERVE BANKS**

WHEN FEDERAL RESERVE BANK NOTES are issued in accordance with the law, they are liabilities of the Federal Reserve banks; they cannot possibly be assets of the issuing banks.

As a consequence of this Federal Reserve-Treasury manipulation, however, these notes became assets and part of the reserve of the Federal Reserve banks.

The only way in which such notes can ever legally become assets of the Reserve banks is when these banks have decided to retire them and have made the proper arrangements to do so, after which the notes become Treasury liabilities.

But when such a retirement procedure is operating, the Reserve banks do not pay out the Federal Reserve bank notes being retired. Instead, they receive them as they come in, and prepare to forward them to the Treasury for cancellation. As the Reserve banks receive them, they count them as reserve—apparently unwisely, since they cannot be paid out.

In the present case, however, the Reserve banks received these Federal Reserve bank notes from the Treasury to pay out, and

they have been paying them out ever since. Month by month, since December 12, 1942, the amount of Federal Reserve bank notes being put into circulation by the Reserve banks has been steadily increasing as the table given on page 27 will show.

**THE KEY TO THIS MANIPULATION WAS
"RETIREMENT" BEFORE ISSUANCE**

IN JUSTIFICATION of this manipulation, the Reserve authorities contended that the notes were "retired" before they were issued. It was in this "retirement" before issuance performance that the key to the manipulation is found.

The Reserve and Treasury authorities insisted, under questioning, that the Reserve banks first put up the required securities, then took out the Federal Reserve bank notes, then put up lawful money with the Treasurer of the United States and took back their securities, and thereby retired the Federal Reserve bank notes as liabilities, at which time the notes became liabilities of the Treasury.

There were several variations to this story, some of them definitely contradictory. But the important points to remember about this business, quite apart from the various and differing stories told as to the steps taken, are these: (1) When Federal Reserve banks are really retiring their Federal Reserve bank notes, they are not subsequently paid out, as these notes have been since December 12, 1942; and (2) when these notes are put into circulation in a legal manner they are liabilities of the Reserve banks while they are being issued; they are not, as in this case, liabilities of the Treasury and reserve assets of the Reserve banks.

Up to December 12, 1942, no administrators of the Federal Reserve System ever engaged in any such transaction as this in the various issuances and retirements of Federal Reserve bank notes. One would hardly assume that any Reserve official would ever suppose that he could tell Congress that he was having the

Federal Reserve banks "retire" their Federal Reserve bank notes before they were issued. Yet that is what these Reserve administrators told Congress.

While these are the essentials of this particular aspect of the manipulation, the reader may wish to peruse a sample of the explanations made by Reserve authorities regarding this "retirement" before issuance.

The following is the statement made by Chairman Eccles in his letter to Senator Taft on January 26, 1943—a statement apparently prepared by Mr. E. A. Goldenweiser:

"The law and regulations thereunder authorize the Federal Reserve banks to issue Federal Reserve bank notes against Government securities pledged for the purpose and to extinguish their liability on these notes by depositing lawful money with the Treasurer of the United States. When the Reserve banks' liability has been extinguished in this manner, they are at liberty to withdraw the Government securities that were pledged against the notes. What was done is precisely that. The notes were issued by the Reserve banks and government securities were pledged against them. Lawful money was deposited with the Treasurer of the United States by giving the Treasury a deposit account at the Federal Reserve banks [*note this sentence*], which is withdrawable at any time in gold certificates, silver certificates, or any other lawful money. In this way the liability on the notes was extinguished, and the securities back of the notes were then withdrawn."

This remarkable explanation calls for comment. First of all, the Federal Reserve Act provides for retirement of Federal Reserve bank notes after the Reserve banks have issued them, not before they are issued.

Next, the statement says: "The notes were issued by the Reserve banks and Government securities were pledged against

them." The answer to that is that the Reserve banks did not issue these notes. Then there is the question as to why the Reserve banks should make the gesture involved in the useless process of first putting up securities, then immediately retiring them by putting up lawful money. Proof of the procedure actually followed by the various Reserve banks in going through this "retirement" before issuance performance was never submitted to Congress; nor was there any revelation of the official instructions that were issued by the Board to the Reserve banks in respect to the steps to be followed. Furthermore, if the banks put up lawful money, there was no reason why they should give the Treasury a deposit credit. And if all this alleged putting up and taking back led in the end to the granting of a deposit credit to the Treasury in exchange for the Reserve bank notes, why should it not have been done directly?

In any event, the Federal Reserve Act did not contemplate any such hocus-pocus. The idea of making "retirement" precede issuance is merely a piece of modern, 1942, administrative manipulation and a willful distortion of the clear wording of an act of Congress.

The statement says further that "Lawful money was deposited with the Treasurer of the United States by giving the Treasury a deposit account at the Federal Reserve banks. . . ."

Now depositing lawful money with the Treasury is one thing; giving the Treasury a deposit credit is something else. If a Reserve bank deposits lawful money with the Treasury, it reduces its reserve by that amount. If it gives the Treasury a deposit credit, it writes up its deposit liabilities but does not reduce its cash reserve; it merely reduces the reserve-to-deposits ratio by a small percentage. The fact that the Treasury can draw out lawful money as a consequence of getting a deposit credit on the books of the Reserve banks does not alter this important distinction. Anyone having a deposit in a bank can get lawful money.

The observations made by other staff members of the Board and by Under Secretary of the Treasury Bell contained similar

confusions. They can be read in the *Congressional Record* of February 4, 1943, pp. 621-623, and in the report of the hearings on "Wartime Suspension of Certain Provisions of Federal Reserve Act" held by the Senate Committee on Banking and Currency, February 17, 1943, pp. 24-37. In one breath the Reserve and Treasury authorities asserted that the Reserve banks put up lawful money; in the next they said that the Treasury got a deposit credit. But all of them attempted these explanations for one purpose: to prove that the Reserve banks had retired these notes before they paid them out—a totally unwarranted procedure that was never contemplated by the authors of the Federal Reserve Act.

A CHANGED TECHNIQUE IN THE RETIREMENT OF FEDERAL RESERVE BANK NOTES PROVIDED THE MACHINERY FOR THIS MANIPULATION

UP TO MARCH 9, 1933, when Section 18 of the Federal Reserve Act was amended, Federal Reserve banks, like national banks, retired their bank notes by depositing lawful money with the Treasurer of the United States in order to get back the bonds which they had posted as security against these notes at the time they were received for issuance.

The pre-1933 provision of Section 18 was: "They [Federal Reserve bank notes] shall be issued and redeemed under the same terms and conditions as national bank notes. . . ." The National Bank Act provides that any national bank "desiring to withdraw its circulating notes, in whole or part, may, upon the deposit of lawful money with the Treasurer of the United States in sums of not less than nine thousand dollars, take up the bonds which said association [bank] has on deposit with the Treasurer for the security of such circulating notes; which bonds shall be assigned to the bank in the manner specified in the nineteenth section of the National Bank Act; and the outstanding notes of said association,

to an amount equal to the legal-tender notes deposited, shall be redeemed at the Treasury of the United States, and destroyed as now provided by law.”

A National Bank Redemption Agency was responsible for the redemption of both national bank notes and Federal Reserve bank notes. In its account it carried the cash received for the redemption of these notes and a record of the notes redeemed and received for redemption.

The important point to notice here is that when Federal Reserve banks wished to retire their Federal Reserve bank notes they were required to deposit lawful money with the Treasurer of the United States. This transaction affected the asset side of the banks' balance sheets; they gave up lawful money, which reduced their reserves correspondingly, and got back their bonds. On the liability side of their balance sheets they wrote off Federal Reserve bank notes as liabilities. But nothing in this transaction affected deposits on the liability side of their balance sheets, and this is an important fact to bear in mind considering the new technique introduced in 1933.

As Section 18 of the Federal Reserve Act stands after being amended on March 9, 1933, “The Secretary of the Treasury is authorized and empowered to prescribe regulations governing the issuance, redemption, replacement, retirement and destruction of such circulating notes and the release and substitution of security therefor.”

Of course this amendment does not mean that the Secretary could authorize the issuance of Federal Reserve bank notes by the Treasury; it merely authorizes him to prescribe regulations governing their issuance and retirement by the Reserve banks. This part of Section 18 follows those parts of the section dealing with the issuance of these notes by the Reserve banks, and it follows that part of the law which provides that “such notes shall be the obligations of the Federal reserve bank procuring the same. . . .”

On March 11, 1933, Secretary of the Treasury Woodin issued a regulation authorizing the Reserve banks to issue new Federal Reserve bank notes under the emergency provisions of Section 18 as enacted on March 9. At the same time he designated the twelve Federal Reserve agents of the Reserve banks as agents for the Treasurer of the United States and the Comptroller of the Currency in the holding of the collateral and the release of the notes to the Reserve banks.

But the important change, which provided the machinery for the manipulation of December 12, 1942, was introduced by Acting Secretary of the Treasury Arthur A. Ballantine in a regulation issued on March 31, 1933. It provided that "Deposits by Federal Reserve banks for credit in the redemption fund provided for under paragraph 10 of the regulations approved March 11, 1933, or deposits to retire Federal Reserve bank notes as hereinafter provided may be made by credits in the Treasurer's general account or by payment through the Gold Settlement Fund."

This was held by General Attorney Dreibelbis of the Board of Governors of the Federal Reserve System to mean that the Reserve banks could retire their Federal Reserve bank notes by the simple device of giving the Treasury not lawful money but a deposit credit on their books. In other words, the Reserve banks did not need to reduce their reserves by depositing lawful money with the Treasurer of the United States; all they needed to do was to write up their deposits—the deposits of the United States Treasury in the Reserve banks.

But another part of the regulation adds confusion to the picture because it says that "Any Federal Reserve bank may at any time retire its Federal Reserve bank notes by the deposit of such notes with its Federal Reserve agent [who acts for the Treasurer of the United States], or may reduce its liability for outstanding Federal Reserve bank notes by the deposit of lawful money with the Treasurer of the United States. . . ."

What the regulation says, literally, is that the Reserve banks can retire their Federal Reserve bank notes in any of three ways: (1) by crediting the Treasurer's account, (2) by depositing the Reserve bank notes with their respective Federal Reserve agents, and (3) by depositing lawful money with the Treasurer of the United States—if "reduce" means "retire."

All the officials who, in January and February, 1943, offered explanations of the retirement process seemed to take it for granted that the Reserve banks could retire their Reserve bank notes by crediting the account of the Treasury even though they generally confused this with the deposit of lawful money with the Treasurer of the United States. In his interpretation of the Treasury regulation, General Attorney Dreibelbis of the Reserve Board said (January 23, 1943) that "... it has been the practice of the Federal Reserve banks to reduce or extinguish their liability on such notes by establishing credits in the Treasurer's general account."

The results flowing from the use of these three possible methods—if, indeed, there are three—are not the same.

If, for instance, the Reserve banks should reclaim their bond security by the presentation of their Federal Reserve bank notes, the security would remain with the Treasury until the notes were presented for cancellation, the Treasury would receive no deposit credit, and it would receive no lawful money which it could deposit in the Reserve banks in exchange for a deposit credit. The Reserve banks would write off their liability for these notes as they came in and would use them to get back their bonds. This would be a sound procedure.

If, however, Reserve banks deposit lawful money with the Treasurer of the United States for the retirement of their bank notes, the situation becomes very different unless the Treasury holds this money as a trust or special fund for the redemption of the bank notes as they come in. But the Treasury does not hold this lawful money in a special fund. It either spends it directly or deposits it in the Reserve banks in exchange for a deposit credit.

When this latter practice is followed, the end result is that Reserve banks have retired their bank notes by giving the Treasury a deposit credit. But when the Reserve banks deposit lawful money instead of giving the Treasury a deposit credit at once, they at least reduce their cash reserves for a time, particularly if the Treasury does not deposit the cash with the Reserve banks but spends it and it remains in circulation for some time.

Because the Treasury does not hold funds in trust for the retirement of bank notes sent in for cancellation, it opens the way to an unsound practice in the retirement procedure: Both the notes still in circulation and the funds deposited with the Treasury for their retirement are circulating at the same time. And, when the notes come in for redemption, the Treasury must redeem the notes out of its general funds, since it will have spent the money posted by the Reserve banks for their redemption.

The most unsound procedure of all is followed when the Reserve banks credit the accounts of the Treasury, since the Reserve banks do not reduce their reserves but merely write up the deposits of the Treasury which can be used as part of the currency in circulation before any of the Federal Reserve bank notes are retired. It was this device that was employed in the end, if not used directly, by the Treasury and Reserve banks in December, 1942, when "retirement" before issuance was introduced.

In a document, by a staff member of the Reserve Board, which was included in Chairman Eccles' letter to Senator Taft, it is stated that when arrangements were made by the Reserve banks, between February 28, 1934, and March 1, 1935, to retire the Federal Reserve bank notes issued in 1933, the banks "extinguished their liability for Federal Reserve bank notes then outstanding by depositing an equal amount of lawful money with the Treasurer of the United States for their redemption, as provided in the Treasury Department's regulations of March 31, 1933." He says further: "The national banks deposited lawful money with the Treasurer

of the United States for the redemption of their bank notes then outstanding [in 1935]. . . .”

If the author of that document was accurate about the procedure of retirement used in 1934 and 1935, then the retirement by the use of deposit credit began in December, 1942. If he was correct in his assertion, General Attorney Dreibelbis was in error when he asserted in a document, sent to Senator Taft at the same time, that “it has been the practice of the Federal Reserve banks to reduce or extinguish their liability on such notes by establishing credits in the Treasurer’s general account.”

THE TREASURY SPENDS THE FUNDS DEPOSITED BY THE
BANKS TO RETIRE THEIR BANK NOTES WHICH THEN
BECOME PART OF THE NON-INTEREST-BEARING DEBT

REGARDLESS OF WHETHER the Federal Reserve banks, when retiring their notes, deposit lawful money with the Treasury or give it a deposit credit on their books, the Treasury proceeds to spend the money and then to retire these bank notes, out of the general funds of the Treasury, as they come in. The notes to be retired become part of the non-interest-bearing debt of the United States government. If one turns to the *Daily Treasury Statement* for December 31, 1943, p. 8, he will find the following item under the debt bearing no interest: “National and Federal Reserve bank notes assumed by the United States on deposit of lawful money for their retirement—\$768,164,534.50.” This is, indeed, a peculiar statement if the Reserve banks in the end, or directly, credited the account of the Treasury on their books.

The significance of the Treasury’s practice of spending these retirement funds, in connection with the manipulation of December, 1942, lies in the fact that such practice gave the Treasury a special inducement to join in the “retirement” before issuance project. Since the issuance was to follow the retirement, the Treas-

ury received a deposit credit equal in value to the face value of the notes to be issued, and this deposit will run for the longest possible period—for a period equal to the circulating life of the notes, and even longer since some of them will not come in during the period of the actual circulating life of the notes.

Of the approximately \$234,000,000 of Federal Reserve bank notes issued in 1933, some \$18,000,000 were still outstanding in December, 1942, although arrangements for retirement were made between February 28, 1934, and March 1, 1935. As a consequence, there is no good reason to suppose that the Treasury will not have most or much of this deposit of \$660,000,000 to use, for several years—perhaps fifteen or twenty—unless Congress takes some special action to force the retirement of these notes.

**BY THIS MANIPULATION OF 1942, THE FEDERAL RESERVE
BANK NOTES WERE CONVERTED INTO A FIAT MONEY**

ONLY THE THOMAS INFLATION AMENDMENT to the Agricultural Adjustment Act of May 12, 1933, authorizes the Treasury to issue fiat (unsecured) paper money. But under this law, only United States notes can be issued, and even these notes, which could be issued up to three billions of dollars, would have a gold security of approximately \$156,000,000 behind them.

By the device employed in the issuance of Federal Reserve bank notes, beginning in December, 1942, arrangements were made to pump \$660,000,000 of Treasury currency into circulation without the currency having a penny of security behind it beyond the general assets of the Treasury. Unsecured or fiat money always has the assets of the nation's Treasury behind it—a specious argument advanced by those who advocate this dangerous kind of money.

Also by this manipulation, the Treasury and Reserve authorities injected \$660,000,000 of fiat money into the reserves of the

Federal Reserve System, and, at the same time, the Treasury got an equal amount in deposits which it, too, put into circulation.

Nor is this all. These \$660,000,000 of added fiat money reserves would support approximately \$1,886,000,000 in deposits in the Reserve banks, since these banks may legally maintain a reserve of 35 per cent against their deposits. These deposits, in turn, can support a much greater expansion of bank deposits in the member banks of the system. If average basic requirements of 10 per cent were used in the calculation, this \$1,886,000,000 could support \$18,860,000,000 in deposits. In short, each dollar of reserve put into the Reserve banks can support as a maximum approximately \$28.58 in deposits in the banking system as a whole. But today member banks are required to maintain higher reserve ratios—nearer 20 per cent on the average. So long as these higher requirements are maintained, the possibilities of total expansion are more restricted. A dollar of reserves in the Reserve banks probably could support fourteen or fifteen dollars in deposits in the banking system as a whole. On this basis, the \$660,000,000 of fiat reserves pumped into the Federal Reserve banks may be expected to support approximately \$9,900,000,000 additional deposits in our banking system.

Those facts are not altered because the Federal Reserve banks have paid out most of these Federal Reserve bank notes. To the extent that these notes are paid out, other lawful money serving as reserves in these banks is conserved and can continue to act as a basis for credit expansion in the manner indicated.

The fiat nature of these Federal Reserve bank notes was admitted by Under Secretary of the Treasury Bell, under questioning by Representative Frank B. Keefe of Wisconsin at hearings before the Subcommittee of the Committee on Appropriations, House of Representatives, January 18, 1943, as follows:

“MR. KEEFE. It is contended by responsible people—people no less responsible than the Federal Reserve banks—that by virtue of the method of issuing these Federal Re-

serve bank notes, the Treasury Department having no right to issue them, but having issued them in the manner indicated through the Federal Reserve System, they, therefore, became a Treasury liability, and, therefore, lawful money for reserves in the Federal Reserve banks as against their deposit; so by this transaction and the handling of these Federal Reserve bank notes in the manner indicated, which, prior to this method of putting them in the hands of the Federal Reserve Bank System, could not be issued by the Treasury Department, you have made of them lawful money that can be used by the Federal Reserve banks as reserves against their deposits.

“MR. BELL. That is right.

* * * * *

“MR. KEEFE. What is the security?

“MR. BELL. Now it is the credit of the United States Government. It is the same thing that is behind the securities of the Government. The credit of the United States is behind these notes. There is no difference between that security and the security that was put up in the first instance, because they were backed by the credit of the United States Government.

“MR. KEEFE. Of course, speaking broadly, there is no difference. It is the full faith and credit of the United States against or behind these notes and their security. There is nothing evidencing the Government credit, such as Government bonds deposited to evidence that credit.

“MR. BELL. No, sir; there is no bond behind them.

* * * * *

“MR. KEEFE. The situation simmers down to this, as I understand it, that the Treasury is simply issuing some

unissued Federal Reserve bank notes, which are not different, in the last analysis, from unsecured greenbacks. That is, they simply have behind them the full faith and credit of the United States Government.

“MR. BELL. That is right. They are like United States notes particularly that part of the outstanding amount in excess of the \$150,000,000 gold reserve.”

When Representative Keefe discussed the matter on the floor of the House on February 3, 1943, his speech indicated that he was not impressed by the above confirmation of the fact that the Reserve authorities and Treasury, acting together, had turned Federal Reserve bank notes into fiat money. He contended that the people of the country had no grounds on which to be disturbed or to lose faith in the currency of this country. He insisted (incorrectly) that, by the Thomas Inflation Act of May 12, 1933, “Congress wiped out all distinctions between the various types of circulating medium,” and he said he wanted “the people of this country to know that the currency which they have is as sound as the credit of the United States.”

Precisely so! When a government issues money against nothing but the general credit of that government, the money is just as good as that credit, but no better. All fiat money is like that. But paper money properly issued, for example that issued against gold or silver, is better than that. The holders of such paper money do not have to worry so much about the credit of the government—not when they can get gold and silver. Government credit is merely promises of men, and they may be violated. Payment of gold and silver for paper issued against them constitutes fulfillment of the promises.

For the remainder of his speech, Representative Keefe merely repeated and accepted the Treasury and Reserve explanations at their face value.

**THE TREASURY ISSUED A CURRENCY BEARING
A FALSE LEGEND**

IT HAD BEEN POINTED OUT to Representative Keefe and to other Congressmen that these notes, called "National Currency" because they were an emergency composite printed from national bank note plates in 1933 though designed to pass as Federal Reserve bank notes, carried upon their face a statement as to security that was completely false. The legend on the notes read, and reads, while they were and are being issued: "National Currency secured by United States bonds deposited with the Treasurer of the United States of America or by like deposit of other securities." Despite the fact that Mr. Keefe had himself obtained the admission from Under Secretary of the Treasury Bell that there was not a bond behind these notes, he, like most other Congressmen, offered no objection to the issuance of a currency bearing a false legend.

**THE EXCUSE GIVEN FOR THE MANIPULATION
WAS IRRELEVANT**

IN ITS PRESS RELEASE of December 12, 1942, the Reserve authorities, after pointing out that a stock of approximately \$660,000,000 of notes "known as 'Federal Reserve Bank notes'" was in existence, said: "By making available for use, as needed, this stock of unissued paper currency, which is identical with Federal Reserve Bank notes now in circulation [about \$18,000,000], it is estimated that more than \$300,000 will be saved in the cost of printing new currency. In terms of labor and materials, there would be a saving of 225,000 man hours in printing alone, and of 45 tons of paper in addition to a substantial saving of nylon and ink."

Now the simple fact of the matter is that this saving would have been made just the same if the notes had been issued by the

Reserve banks in accordance with the law. The excuse given was therefore no justification whatever for the manipulation. It was quite irrelevant.

Furthermore, according to Chairman Eccles, the Treasury had already been reimbursed for the expenses of printing, paper, etc., and, had the notes been issued properly, the Treasury, in addition, would have collected taxes from the Reserve banks while the notes were in circulation.

What the Treasury would have been deprived of by the legal issuance of these notes was the \$660,000,000 deposit in the Reserve banks which it took with the help of the Reserve authorities who got the same amount in assets, instead of liabilities, out of the transaction.

RESORT TO THE DEVICE OF "RETIREMENT" BEFORE
ISSUANCE HAS LED TO A SUBSEQUENT REPORTING
OF CONTRADICTIONARY DATA

THE CONTENTION of the Reserve authorities that they had "retired" the notes before they were issued has led them into an awkward situation from which, apparently, they have not yet been able to escape.

Since they insisted that these notes were being retired, they have carried regularly in the monthly *Federal Reserve Bulletin* a footnote on both national bank notes and Federal Reserve bank notes which reads: "Federal Reserve Bank notes and National bank notes are in process of retirement."

But if the reader will look at the table on "Kinds of Money in Circulation," in any *Bulletin* from March, 1943, to January, 1944, inclusive, he will find a steady month by month increase in the amount of Federal Reserve bank notes entering circulation—that is, outside the Treasury and Federal Reserve banks. In short, the footnote says that the notes are being retired while the table proves that they are being issued.

For the convenience of the reader, the figures on the steady increase of these notes in circulation will be taken from the table, "Kinds of Money in Circulation," as it appeared in the *Bulletin* for January, 1944, p. 67. This table has not appeared in any subsequent *Bulletin*. It was a valuable and historic table, and it was the only one giving a continuous series of figures since the Treasury began to issue these notes. The *Bulletin* for February and subsequently substitutes other methods of reporting which are much less revealing and much less useful.

That part of the January, 1944, table dealing with Federal Reserve bank notes and national bank notes in circulation is as follows (in millions of dollars):

END OF MONTH	FEDERAL RESERVE BANK NOTES	NATIONAL BANK NOTES
1942 — November	18	136
December	188	135
1943 — January	362	135
February	474	134
March	534	134
April	557	133
May	574	133
June	584	132
July	599	131
August	615	131
September	622	130
October	626	130
November	627	129

It will be noticed that national bank notes, which were not subjected to the type of manipulation applied to the Federal Reserve bank notes, have been slowly declining in accordance with the normal procedure of retirement. They declined during the year from \$136,000,000 to \$129,000,000. Federal Reserve bank

notes, on the contrary, increased during the year from \$18,000,000 to \$627,000,000, and every month showed an increase over the preceding one, beginning in December, 1942. The footnote which says that both kinds of bank notes "are in process of retirement" has been accurate regarding the national bank notes. But every month, since November, 1942, it has stated an untruth regarding Federal Reserve bank notes.

THE QUESTION OF THE VIOLATION BY THE TREASURY OF ITS FUNCTION AS CUSTODIAL TRUSTEE

THE QUESTION MAY BE RAISED as to whether there are any grounds on which the Treasury may justify violation of its moral and legal obligations as custodial trustee while individuals in their private and business relations are held by law to the observance of theirs. The answer would seem to be obvious: If there is to be any difference in the standards of conduct observed by custodial trustees, the highest standards of all should be observed by the government itself.

Commissioner Ganson Purcell of the Securities Exchange Commission, in testifying before the Committee on Interstate and Foreign Commerce, House of Representatives, January 23, 1942 (*Hearings*, Pt. IV, p. 1256), put the matter of the duty of the trustee properly when he said:

"The higher standard of conduct which the law requires of fiduciaries in order to guard against potential abuses has seldom been better stated than by Mr. Justice Cardozo's opinion in a famous New York case (*Meinhard v. Salmon*, 249 N. Y. 458, 164 N.E. 545), where he said:

"Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place.'"

In this Federal Reserve bank note case, the Purcell-Cardozo standard for trustees was, apparently, not the one employed by the Treasury.

WHO WAS RESPONSIBLE FOR THIS MANIPULATION?

AT A HEARING before the Senate Committee on Banking and Currency on March 17, 1943, Senator Tobey of New Hampshire asked Chairman Eccles, of the Board of Governors of the Federal Reserve System, who was responsible for the issuance of these notes by the Treasury, and Mr. Eccles replied:

"We not only suggested it, but initiated it."

Senator Tobey: "You suggested it?"

Mr. Eccles: "We take the responsibility for it."

Secretary of the Treasury Morgenthau appears to have had no direct connection with this transaction. He was resting in the South; part of the time he was in Cuba. Under Secretary of the Treasury Daniel Bell was Acting Secretary, and it was he who defended the Treasury's part in the manipulation.

Although the Eccles statement suggests that the Reserve authorities alone were responsible for the idea, Under Secretary of the Treasury Bell, in his letter of February 1, 1943, said: "The Board of Governors consulted the Treasury prior to directing their issuance and the Treasury approved this action." This would seem to make the responsibility a joint one.

The stimulus for the official moves in Washington, according to a statement made by Chairman Eccles, at a hearing before the Senate Committee on Banking and Currency on May 4, 1943, came from the Federal Reserve banks. He said: "The Federal Reserve banks were the ones that raised the question in the first instance; people on the outside of Washington, people who were anxious to use this currency."

But even though the Reserve banks may have needed notes to issue, that fact provided no reason why these notes should not have been issued in the usual and legal manner.

THE PROPER CORRECTIVE ACTION

ALTHOUGH IT SEEMS REASONABLY CLEAR that it was the numerous technicalities surrounding the issuance and retirement of these notes that confused and bewildered the majority of heavily-burdened Congressmen, with the consequence that no corrective action was taken in 1943, the facts are that Senator Taft took steps calculated to be effective, and that the Senate Committee on Banking and Currency gave him such support as to suggest that remedial action by Congress is still possible, perhaps probable.

On February 4, 1943, Senator Taft introduced a bill, S.658, which provided, in Section 1, that paragraph 6 of Section 18 of the Federal Reserve Act, as amended, March 9, 1933, be repealed, and, in Section 2, that "All Federal Reserve bank notes issued under the authority of Section 18 of the Federal Reserve Act, received by any national bank or by any Federal Reserve bank, shall be promptly presented to the Treasury for payment, and upon payment shall be retired."

Hearings were held by the Senate Committee on Banking and Currency on May 4, and the bill, with Section 2 eliminated, was reported favorably to the Senate which passed it on May 12. In the House, no action has thus far been taken. It is not too late for the House to take proper corrective measures. But with Section (2) omitted from Senator Taft's bill, the latter would have no bearing on the present manipulation; it would merely lock the door after this \$660,000,000 had been taken by the Treasury.

Congress should pass a law embodying the following corrective provisions, some of which go beyond those contemplated by the original Taft bill:

Each Federal Reserve bank should be required to deposit with its Federal Reserve agent, acting for the Treasury, United States bonds and a 5 per cent redemption fund against the Federal Reserve bank notes which it received from the Treasury. Each Reserve bank should be required to list these notes as a liability and to pay the presently-required tax on them as long as they are in circulation. (When these notes are free of this tax, one of the important pressures causing their retirement is missing.) As these notes come in to each Reserve bank, they should be used to repossess the bonds, and then they should be cancelled by the Treasury. This would be honest retirement, and the security, as required by present law and as promised on the face of the notes, would remain posted until the notes are retired and cancelled. The Treasury should be required to reimburse each Federal Reserve bank for the amount of deposit it received and used in connection with its deposit of these notes in the banks and to forfeit any portion of the deposit not yet used. The Reserve banks should be prohibited from counting any of these notes as reserves, even when they are passing through it on their way to the Treasury for retirement. Finally, it would be wise to provide that no more of these notes shall be issued. Bond-secured notes are not a desirable type of bank note or paper money. The Federal Reserve note is the only kind of note which the Federal Reserve banks should be authorized to issue.

With these corrective changes made, this unsound element in our currency would in due course be eliminated.

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ECONOMISTS' NATIONAL COMMITTEE
ON MONETARY POLICY

1. To enlighten the public as to the economics of the monetary issues before the country.
2. To educate the public as to the desirability of an early return to a gold standard.
3. To combat unsound monetary programs such as those of the inflationists, devaluationists, and commodity dollar advocates.
4. To issue public statements on current monetary issues as circumstances seem to warrant.
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6. To distribute its own and other literature.
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