

# TRANSCRIPT

## FEDERAL OPEN MARKET COMMITTEE CONFERENCE CALL

May 27, 1977

### Prefatory Note

This transcript has been produced from the original raw transcript in the FOMC Secretariat's files. The Secretariat has lightly edited the original to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcript was not fully edited for accuracy at the time it was produced because it was intended only as an aid to the Secretariat in preparing the record of the Committee's policy actions. The edited transcript has not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

**FEDERAL OPEN MARKET COMMITTEE**

**MAY 27, 1977**

PRESENT: Mr. Burns, Chairman  
Mr. Volcker, Vice Chairman  
Mr. Coldwell  
Mr. Gardner  
Mr. Guffey  
Mr. Jackson  
Mr. Lilly  
Mr. Mayo  
Mr. Morris  
Mr. Roos  
Mr. Wallich

Mr. Broida, Secretary  
Messrs. Balbach and T. Davis, Associate Economists

Mr. Sternlight, Deputy Manager for Domestic Operations

Mr. Oltman, Deputy General Counsel, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee  
Telephone Consultation of  
May 27, 1977

OPERATOR. Okay, I'll call the list. Hello, President Volcker, President Morris, President Mayo, President Guffey, and President Roos. You may begin.

MR. BROIDA. President Volcker, could you tell us who is with you?

VICE CHAIRMAN VOLCKER. Who is with me? Jim Oltman and Peter Sternlight.

MR. BROIDA. President Morris, by himself?

MR. MORRIS. I'm by myself.

MR. BROIDA. President Mayo?

MR. MAYO. Dan [unintelligible].

MR. BROIDA. President Guffey?

MR. GUFFEY. Tom Davis.

MR. BROIDA. And President Roos?

MR. GUFFEY. Ted Balbach.

MR. BROIDA. Very good. All Board members--

VICE CHAIRMAN VOLCKER. Paul Meek is with me, too, Art.

MR. BROIDA. All Board members are present except Governor Partee, and there are a number of members of the staff. This is an informal discussion among FOMC members. It is not an FOMC meeting.

SPEAKER(?). Could you speak a little louder, Art?

MR. BROIDA. I say, this is an informal discussion among FOMC members of a matter of mutual interest. It is not an FOMC--

MR. MAYO. We can't hear you in Chicago.

MR. BROIDA. This is an informal discussion among FOMC members; it is not an FOMC meeting.

CHAIRMAN BURNS. Good morning, gentlemen. This is Arthur Burns speaking. Can you all hear me?

SEVERAL. Yes, indeed.

CHAIRMAN BURNS. Good. A technical problem has arisen from the ruling handed down by the IRS. It relates to certain types of transactions conducted by our New York [Federal Reserve] Bank. The matter is rather technical; it's been gone into rather carefully by President Volcker, by [Federal Reserve Board] Vice Chairman Gardner, and by Tom O'Connell, as well as by other members of our staff here in Washington.

The essential issue, I take it, can be stated rather simply by Mr. Volcker, and I think it would be well if we got this meeting under way with a statement by Mr. Volcker. I'll not be present at this entire meeting. I think I know the kind of issue this is and the suggestion that will be made by Mr. Volcker. I don't profess to understand the technicalities of this problem and can't be at all helpful to the group on it. But I will be here for the opening part.

And now, if this is satisfactory to all those who are participating in this conference call, let's proceed with your statement, Paul, if you are ready.

VICE CHAIRMAN VOLCKER. Okay. I'll try to cut through as many of the complications as I can, but the essential background is that for about four years [the New York Federal Reserve] Bank has, as agent, provided a repurchase facility to foreign central banks wanting to invest money from day to day. And about 71 foreign central banks, at one time or another, have used this. On a day-to-day basis, the average is about 35 [foreign central banks]. Something between a billion and a billion and a half dollars is invested through this facility on a daily basis.

One other bit of background information: As a matter of convenience to the [Federal Reserve] System account, about two-thirds to three-quarters of these transactions with foreign accounts, RPs [repurchase agreements], daily RPs, have been provided with the System account [acting as principal] on the other side of the transaction. The other one-quarter to one-third has been done in the market [with the New York Bank acting as agent].

The problem arises because the IRS [Internal Revenue Service] recently had a ruling specifically on the point--the circumstances were very different--but the point was whether an RP on government securities is a purchase and sale, or is it a loan. And they came down very definitely on the side of it being a loan. Now, that is significant [because] a loan does not qualify for the exemption of foreign central banks from withholding tax. And we have not been withholding [taxes] on these transactions on the presumption that they're government securities transactions and not loans. Now, among other questions, this could conceivably raise the question of past tax liabilities.

But the important question is what we do in the future? And [with] this ruling coming to our knowledge, it seems to me that we had to cut this off, at least until it was clarified. Which would be quite disturbing in terms of our relationships with foreign central banks. We have had discussions with the Treasury, and they confirm the nature of this IRS ruling.

At the time I reached the conclusion that we had to cut this off, the Treasury came back and pointed out to us--and our lawyers agree, and I think they agree in Washington--that the

exemption for foreign central banks includes obligations of the U.S. government--the exemption we thought we were operating under--and obligations of U.S. government agencies and its instrumentalities. And the Treasury pointed out that since we are an instrumentality of the U.S. government, if we were to be involved in these transactions not as agent but as principal, it would be our obligation and therefore exempt in their opinion. And they offered to go to the IRS and present that view to the IRS and see whether the IRS agreed, and they think the grounds are very strong, as I understand it.

Upon receiving that information, we took some interim action. We have made no further repurchase agreements in the market. I said--for these past few days--if, in the ordinary course of the System's business, we would have made [these RP transactions with foreign central banks] with the System account anyway, therefore the System account being the principal, go ahead and do it. Now it so happens that, for the last few days, the System account found it convenient to do it. They have followed the general policy during these years and reported to the Committee regularly that, when the System account is operating in the market anyway, they would do these transactions directly [as principal] with the foreign accounts. That's the procedure that has been followed since this arrangement started.

Now the problem arises potentially on this interim basis: Sooner or later--although we expect in the next few days that the System account will be active--but sooner or later, the day will arrive when the System account would not otherwise be active, and therefore we are, under the decisions taken so far, estopped from doing these transactions [in the market, as agent]. We'd have to notify all the foreign central banks and create a certain amount of uncertainty and disturbance in those relationships.

Now the essential proposal that I have here for a course of action is that we do go to the Treasury, tell them we are prepared to act as principal in the future, and see whether that is acceptable to the IRS. If that course of action is acceptable to the IRS, [then we would] take what actions would be specifically necessary at the next [Federal] Open Market [Committee] meeting to authorize us to proceed on that basis. We as a [Federal Reserve] Bank cannot proceed as principal without the authorization of the [Federal] Open Market Committee. And the Committee itself, [if] it deviated from past practices, I'm sure would want to recognize that the System account [is] the principal on the other side. So some action, in my opinion, is necessary sooner or later by the Committee if we take this course.

And the point, I think, of this conversation is, if there is that understanding, should we go now, as I would propose, to the Treasury, and ask them to clarify this with the IRS? If the IRS is agreeable, take the necessary actions at the next meeting. If the IRS is not agreeable and raises some question, then I see no alternative to stopping these transactions at this time when they raise the question. I can't speak for the Treasury, [but] they obviously don't think the IRS will [object]; they think that the case is quite clear [and that] the IRS will not raise the question. [But] they obviously cannot speak for the IRS, and that leaves us in this dilemma.

MR. MAYO. Is this a new ruling, Paul, with regard to the IRS coming down hard that RPs are loans?

VICE CHAIRMAN VOLCKER. It is the first ruling we are aware of on government securities. There have been rulings in the past, and there's a long [history]--starting out somewhat cloudy but getting less cloudy over time--on municipal securities, where they have ruled you cannot pass through, in effect, the tax exemption on municipal securities because these are loans. This is the first case on U.S. governments.

MR. MAYO. And this is within recent weeks?

VICE CHAIRMAN VOLCKER. The ruling was in March, and I think it came to our attention in April, at which point we initiated conversations with the Treasury. We didn't really get to the right person in the Treasury until approximately a week ago.

MR. MAYO. Thank you.

CHAIRMAN BURNS. May I, at this point, suggest that Governor Wallich, who has an urgent appointment, might speak at this time and indicate his views. But just before I turn the microphone over to Governor Wallich, let me ask the participants of this conference a question. Have you all received a letter from Senator Proxmire with regard to income velocity?

SEVERAL. Yes, I have.

MR. GUFFEY. St. Louis has not.

CHAIRMAN BURNS. What's that?

MR. COLDWELL. St. Louis has not.

CHAIRMAN BURNS. Well, such a letter has been sent out. Let me merely say that the chances are that, one way or another, we will communicate with the Bank Presidents on that issue sometime next week. At this point let me turn the microphone over to Governor Wallich.

MR. WALLICH. I just wanted to say I have no difficulties at all with Paul's proposed procedure; it seems very reasonable to me. I do think that broader issues are raised here by a decision to continue or not to continue--namely, present operations seem to be in some measure a form of competition with the private sector. Banks or dealers might be able to do the same thing for foreign central banks that we do, and we should not compete unless we have a strong reason for doing so.

One conceivable strong reason for doing that is that if the Desk didn't do it, the transactions would move not only out into the New York market but they might move out of the country to London for tax reasons, or they might even move out of the dollar into other currencies, reducing the demand for dollars possibly, influencing the exchange rate.

So I suggest that the staff here undertake some work to assess these two aspects--the degree of competition and the possible repercussions on the demand for the dollar--and that eventually at some time we have a discussion of the FOMC of these matters [so that they do not] stand in the way of a resolution of the matter the way Paul is suggesting this.

MR. GARDNER. I'd like to say a word now, Paul, if I may. I think that the course of action that you suggest is a very proper course. Now, we are fully aware of a ruling of the IRS that will probably change the procedures under which you operate. I think the responsible course is for you to go through the Treasury to attempt to obtain this ruling or opinion from the IRS of the [validity of the] exemption that could be contained in the procedure where we act as principal. At that point we will have sure knowledge of what the full tax status of these transactions are, and I think we can then better deal at an FOMC meeting with the full complexities of Henry's concerns and the other concerns that may be expressed by other Governors. And most importantly, we can better understand this complex subject which you and I have been discussing for a couple of days now.

I think our colleagues should know that your summary was brilliantly concise, but there is a great deal of complexity to the issue, and I don't think we should, on the basis of an interim [decision], however concise, make a major change in procedures and policy without full Committee deliberation. So I personally would urge you to go forward to the Treasury to get the ruling, engage the Desk people and our staff here at the Board in a full exposition so that the Committee can have a broad and appropriate discussion at the earliest opportunity.

MR. COLDWELL. I've got a somewhat similar position to Governor Wallich's position. I would support President Volcker's position in terms of moving to the Treasury to get a position from them, but I think it would be highly desirable to have a full FOMC discussion of the matter at our next meeting.

MR. JACKSON. I think we have got to get our facts together before we can make a decision, and obviously the IRS's attitude toward any course of action is one of the most essential [facts] we have got to get. I think that the discussions that we would initiate are not likely to damage our alternatives, and so therefore I think we ought to go forward and have a discussion based on what facts we can develop at the next meeting.

MR. LILLY. Lilly agrees.

MR. GARDNER. Paul, you've heard from all of the Governors who have remained here. You may want to seek the counsel of your colleagues at the [Reserve] Banks.

VICE CHAIRMAN VOLCKER. I would, indeed.

MR. MAYO. Mayo agrees.

MR. GUFFEY. Guffey agrees. I would hope that, before the next FOMC, these technical aspects could be fitted inside a document, Paul.

VICE CHAIRMAN VOLCKER. No, we will do that, we will. I am sure the Board staff will be doing something, but we review the history and technical side of this and comment also on what the importance of these transactions are as we see them and what the consequences are.

MR. MORRIS. Paul, will that also include the extent of what impact it will have on the operations of the Desk?

VICE CHAIRMAN VOLCKER. Yes.

MR. ROOS. Roos agrees.

VICE CHAIRMAN VOLCKER. We'll get to work on that paper right away. Just to repeat here, we will go to the Treasury and they will either go by themselves or with us to the IRS. If the IRS raises the substantive questions, then I think we have no alternative but to back off here and stop the thing. Doesn't mean that we can't start it again, but I think you have to understand--once we stop it, it may be very difficult to get it started again on the same basis because all the foreign central banks will have some residual question in their own minds about the nature of tax consequences.

So it's going to be very hard to get it started again, which is why, when we got this reassurance from the Treasury, we didn't cut it off completely. But I think we have to [cut it off] if we don't get the reassurance from the IRS. If we do get the reassurance from the IRS, we will continue on this limping fashion until the next FOMC meeting, and I would think--and I just want to clarify this point, I'd like to get your opinion on this: Do we try to avoid [doing the transactions on] a day or days when we don't do any transactions, [or do] we just do them in the System account assuming we have the IRS reassurance?

MR. GUFFEY. Paul, a question. Are you suggesting that, without IRS assurance, we would not continue these transactions with the System account when we can accommodate them?

VICE CHAIRMAN VOLCKER. Yes. If we go to the IRS and say, "We plan to continue these with the System account as principal during this interim period"--that's the substance of it--"We think that that is correct, and there is clearly an exemption," [and] they come back and say, "We don't think there's clearly an exemption," then we stop.

MR. GARDNER. I think that would be not only wise but the only practical course in that eventuality. Now you've had the best abilities of our counsel, both in New York and here, telling us, and the Treasury telling us, we think the IRS won't give us that [objection]. But if they do give us that [objection], I would think one of two things would eventuate: One, you would have to stop; and two, you might want to call an official meeting. This is an exchange of views, as you know, in a conference call, but absent that result, the whole matter will be fully discussed under your suggestion at the FOMC, and with appropriate background material.

VICE CHAIRMAN VOLCKER. I would presume we would discuss it at the FOMC anyway but would just be doing it from a different background--a quite different background of having cut them off.

SPEAKER(?). Yep.

MR. JACKSON. I would not want us to stop doing the transactions without a meeting of the FOMC to make that decision.



VICE CHAIRMAN VOLCKER. Just technically, Phil, I have no problem with that, but as it now is, with us an agent, it has not been an FOMC decision. We are just acting, as I understand it, in an agency capacity by the New York Bank, and there's no question of our legal ability, in a sense, to cut it off, and our responsibility, I think, to cut it off. I don't mind at all discussing it with the Committee. I don't mean to imply that, but I don't think it's necessary either.

MR. JACKSON. Paul, I'd hate to stop acting as principal without a meeting of the Committee.

VICE CHAIRMAN VOLCKER. We have now stopped, as I indicated, doing anything in the market. That action has already been taken.

MR. GARDNER. In other words, you've stopped acting as agent.

VICE CHAIRMAN VOLCKER. Right. Well, the Bank, I think, actually is still acting as agent; the System account is acting as principal.

MR. GARDNER. Then your plan is to limp along, as you characterize it, until we get some clarification of this IRS ruling and it's applicability to our operations with central banks. And I think we should remember, as Paul said initially, that the ruling was taken by the IRS in a totally different context, applicable to transactions in the commercial area, but it does affect our operations [with] the central banks.

VICE CHAIRMAN VOLCKER. There is one question I raised. I'm just talking entirely now [regarding the period] before the next meeting. [The question of] whether the System account operates [on any given day], as you know, is always a matter of judgment. Should that judgment be shaded in favor of [having the System account act] on these [foreign central bank RPs] when, in past circumstances, the judgment might have gone the other way and we would have done them in the market [as agent]?

MR. MORRIS. I think that you ought to [have the System account act]. One thing is, it would give us some concrete experience with operating difficulties if there are some. It will be helpful to this Committee when we have the meeting.

VICE CHAIRMAN VOLCKER. Right.

MR. GARDNER. I agree with that because you're prejudging the whole conclusion if you don't continue it, with great prudence of course.

VICE CHAIRMAN VOLCKER. Is that agreed?

MR. GARDNER. Bob Mayo, were you coming on? I'm sorry.

MR. MAYO. Just said that I agreed, Steve.

MR. GARDNER. I'm persisting in believing this is an exchange of views.

VICE CHAIRMAN VOLCKER. Right. I understand.

MR. GARDNER. Paul, I think we're finished here in Washington. If our [Reserve Bank] colleagues have more, fine, but I think you certainly got an expression of the views from all of the members of the FOMC.

VICE CHAIRMAN VOLCKER. Well, we will go ahead and prepare the necessary background information. I'm sure the Board staff will be supplementing that, and we will keep you informed as [we get] the result of the contact with the Treasury and the IRS.

MR. GARDNER. Very good. Have a nice Memorial Day.

VICE CHAIRMAN VOLCKER. Thank you.

END OF TELEPHONE CONSULTATION