

### Wynne Godley's short CV

I was in the Economic Section **of H.M.** Treasury from 1956 to 1970, (deputy director from 1970) From 1970 to 1985 I was Director of the Department of Applied Economics, Cambridge University (**from** 1980 Professor of Applied Economics). Part time appointments since leaving the Treasury include being **Official** Adviser to the Select Committee on Public Expenditure (1971-73), Economic Consultant to H.M. Treasury (1975) and, in 1992-95, a member of the **Treasury's** Panel of Independent Forecasters ("The Six Wise Men"), I was a visiting professor at **Aalborg** University, Denmark for the academic year 1987-8 and at **Roskilde** University, Denmark in the fall of 1995. For six out of the last eight years I have been a visiting scholar at the Jerome Levy Institute of Bard College.

NOTES ON THE U.S. **TRADE &** BALANCE OF PAYMENTS DEFICIT**Wynne Godley** Jerome Levy Institute **Dec 6**

## SUMMARY

1) **The** U.S. has a balance of **payments** deficit worth nearly 4% of GDP and negative **net foreign** assets (or foreign debt) worth nearly 20% of GDP. If **U.S.** growth is sustained in the medium term, it is quite likely that the balance **of trade** in goods and services **will** not improve. The U.S **is** the only major country, or country "bloc", to have a substantial trade deficit and this is proving of great **advantage** to the rest of the world.

2) **If the** balance of trade does not improve, there is a danger that over a period of time the **U.S** **will find itself in** a "debt trap", with an accelerating deterioration both in its net foreign asset position and in its overall current balance of payments (as net income paid abroad starts to explode). Such a trap would imperatively **call** for corrective action **if it** is not at some stage to unravel chaotically.

3) The emergence of a debt trap is put forward as a possibility that must be taken seriously rather than as a forecast **of what** is most likely to happen. Policy makers are advised to ensure that adequate instruments are available should things start getting out of hand.

4) Whether or not the outflow of property income starts to accelerate depends critically on the rate of return **earned on internationally** owned assets and liabilities. The well known condition for exploding payments on **debt** is that the rate of interest exceeds the growth rate. At present the U.S. 's negative position is worth about **\$** 1500 billion while **the** net foreign income outflow is **only** about \$10 billion, so it might be supposed that there is nothing to **worry** about.

5) But this is deceptive **The** low rate of **return** overall, measured **ex post**, is the consequence of the extremely low return so far **earned** on foreign direct investments in the U.S. However the bulk of any change in the **net** asset position, in the **future** as in the past, is likely to take the form of

financial investment which has been earning a much higher rate of return and one which, even now, slightly exceeds the growth rate. **Also** the return on foreign **direct** investment may improve.

6) There have recently been extremely **heavy** direct investments by foreign firms in **the U.S.**, but a very high proportion of these have been financed by exchange of shares and, to that extent, make no contribution at **all** to the financing of the deficit. The analysis of capital account flows and rates of return would be **greatly** facilitated if acquisitions financed by share exchange **were identified** separately in the accounts

7) **Policy** responses in principle come down to:

- a) Reducing domestic demand
- b) Raising foreign demand
- c) Reducing imports and increasing exports relative to GDP, **preferably** by changing relative prices

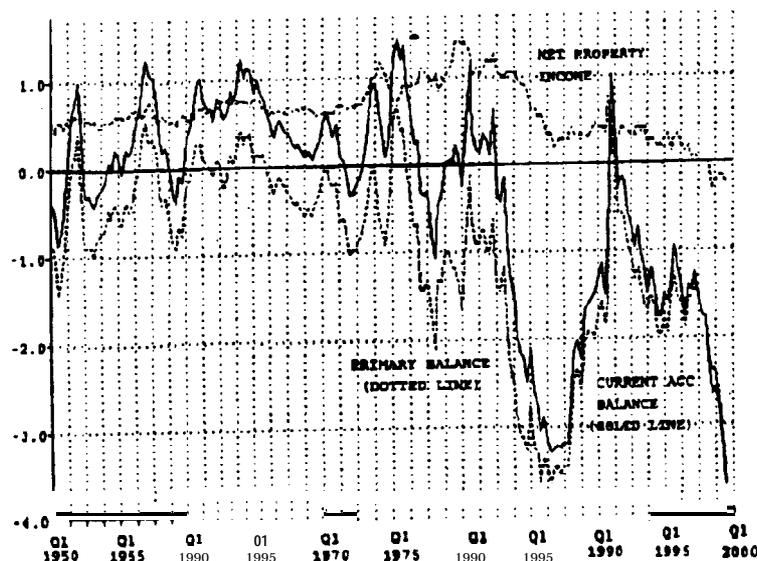
8) The **danger** is that **resort** (perhaps by default) will be had to a) - in other words that chronic and growing imbalances **between** the U.S. and the rest of the world come to impart a deflationary bias to the entire system, with **harmful** implications for activity and unemployment. Remedy b) reads hollow when neither appropriate institutions nor agreed principles **exist**, but should not be dismissed out of hand. As for c), currency depreciation is the classic remedy. But in view of the way global capital markets work, depreciation has ceased to be a policy **instrument** in any ordinary **sense**; and "floating" cannot be counted on to do the trick. Policy makers should be aware of the possibility of using **non-selective** control of imports **in extremis in** accordance with the principles set out in Article 12 of the **WTO**. Such a policy is to be sharply distinguished from "protectionism" **as** commonly **understood**.

NOTES ON THE U.S. TRADE & BALANCE OF PAYMENTS DEFICITS ..  
RECENT DEVELOPMENTS

WYNNE GODLEY

DEC.3. 1999

CHART 1 THE US CURRENT ACCOUNT AND RELATED SERIES  
PERCENTAGES OF GDP



SOURCE: CITIBASE

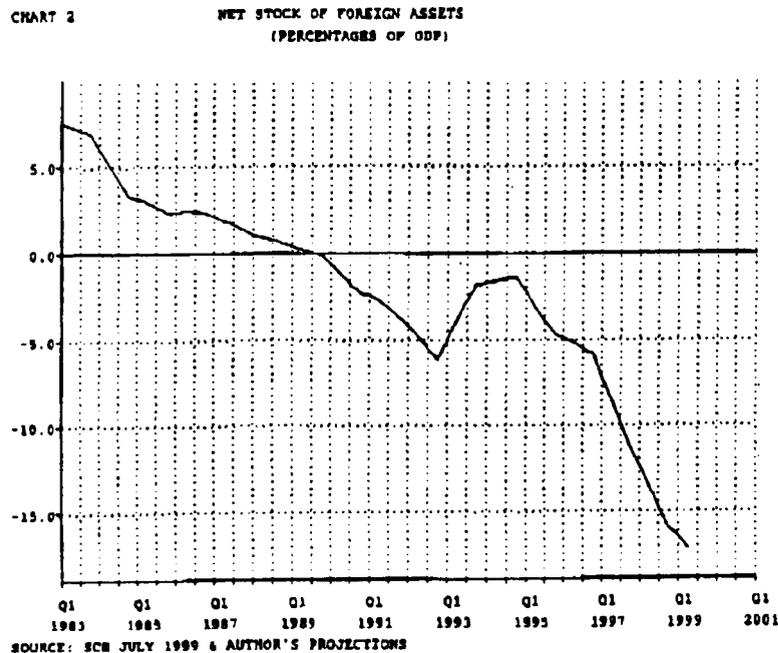
Chart 1 shows the U.S.'s current balance of payments (expressed as a percent of GDP) since 1950. In the early post war years there was generally a surplus; but since 1982<sup>1</sup> there has been a deficit which has trended upwards, albeit with large fluctuations, reaching a post-war record of 3.7% of GDP in the third quarter of 1999. Net property income' from abroad has fallen from about 1% of GDP (positive) in the early eighties to a small, negative in 1999. The chart also shows the "primary" balance of payments, that is. the current balance less net property income (the difference between the other two lines on

<sup>1</sup> Ignoring the "Gulf war" blip in 1991.

<sup>2</sup> These figures now contain a small amount of employment income - but "property income" remains a convenient term of art.

the chart)'. ..

The current account deficit has generated a large and growing debt owed by the U.S. to foreigners, which some people prefer to call the U.S.'s negative net asset position (NNAP). As Chart 2 shows, the NNAP reached about 17% of GDP in the middle of 1999. With the current account deficit running at nearly 4% of GDP and a further rise in stock prices, the NNAP will probably reach 20% of GDP by the end of this year.



The U.S.'s economic expansion and its high and rising external deficit have been of enormous benefit to the rest of the world large parts of which, even so, have been depressed or stagnating. The U.S. has for some time been the only country (or country "bloc") to have a significant trade deficit: any serious attempt

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'The primary balance may alternatively be defined as the balance of trade in goods and services (which makes up the bulk of it) plus net personal, government and business transfers.

to eliminate the U.S. deficit. could, accordingly have **serious** implications for the world economy.

#### REVISIONS TO THE STATISTICS

The following table shows the main indicators as they appear now and as they appeared three years ago.

#### THINGS AS THEY APPEARED IN 1995 AND NOW

(All figures are percentages of GDP)

	CURRENT BALANCE		NET FOREIGN ASSETS ("NNAP")		NET PROPERTY INCOME	
	1 THEN	2 NOW	3 THEN	4 NOW	5 THEN	6 NOW
1993	-1.3	-1.1	-10.0	-2.7	0.16	0.37
1994	-2.0	-1.5	-10.3	-2.5	-0.05	0.24
1995	-1.9	-1.3	-12.5	-5.7	-0.10	0.27
1996		-1.4		-7.0		0.23
1997		-1.5		<b>-12.8</b>		0.05
1998		-2.3		-17.5		-0.11

The revisions to the stock data (shown in columns 3 and 4) have been spectacular, with the NNAP for 1995 revised down by about 60%; but revisions to the current account have also been substantial. I note these revisions with some feeling because three years ago (Godley 1995) I wrote a paper which drew alarming conclusions from the figures in columns 1, 3 and 5, supposing them to be accurate. However we do now seem to be faced with a situation similar to, but if anything worse than, that which I

wrongly supposed we were facing three years ago. I shall continue this submission on the assumption that the new figures are correct, while keeping a very **large** reservation concerning their reliability in the back of my mind.

#### BASIC CONCEPTS

I find myself provoked by some of the-submissions which the Commission has received into making a few observntions about elementary concepts.

The current balance of payments is defined as

A) Exports less Imports plus Net Property Income from Abroad = National Income (GNP) less Private Expenditure less Public Expenditure.

This expression can be enriched by deducting taxes (defined to include government transfers) from income and then including a new expression (the budget **balance**) in which taxes and transfers are added back again. So we now have

**B) Exports** less Imports plus Net Property Income = [National Income less Taxes less Private Expenditure] plus [Taxes less Public Expenditure]

This expression implies that a balance of payments deficit is always equal by definition to the excess of private spending over private disposable income plus any budget deficit (or less any budget surplus).

While **B)** is, in itself, nothing more than an accounting identity, it **provides** a useful framework for making a causal analysis because so much can be organised around the concept of aggregate income. Thus imports are related to income (as well as to the

price of imported relative to domestically produced goods) : "taxes are functionally related to income; and private expenditure is functionally related to income less taxes. At the same time income itself is always equal to the total of all expenditures less imports. As soon as these relationships are articulated and exports seen as a function of world activity and relative prices, we get a sense of the main individual lines of causality as well as a sense of the complex **interdependence** of the system as a whole. The outcome for GDP and the primary balance of payments may be thought of as the solution to a set of simultaneous equations which have, as exogenous variables, world output, the government's fiscal **and** monetary policy, and domestic relative to foreign **prices**'. Net property income is determined by the net wealth or debt generated by the current account flows together with the rate of **return** which this earns. The analysis presented here uses an econometric model based on these ideas which simulates past history fairly accurately.

The model outlined above suggests some of the reasons why the trade deficit has been growing - namely that the U.S., with its relatively fast growth rate, has had a greater appetite for imports (given their relative price in domestic markets) than foreigners have had for U.S. exports (given their relative price in foreign markets). The readiness of foreigners to invest in U.S. assets has kept the exchange rate from falling to a level which would correct the adverse trends in trade. This model is also suggesttlve of remedies if they are needed. If the **deficit** is to be reduced without resort to protectionism, either domestic activity must be reduced, or foreign activity must be raised, or relative prices must changed, by hook or by crook, in a way which causes the U.S. to sell a higher proportion **of its** output abroad or reduce its dependence on imports.

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'This paragraph obviously draws on the work which James Meade **did** fifty years ago.

Regrettably, it is common **practise** to modify the identity called B) above by deducting private consumption both from disposable income and from **private** expenditure, and also by deducting public consumption from the budget balance. This leaves a familiar expression which says

C) The Balance of Payments = The **Surplus** of Private Saving over Private Investment plus the Surplus of Public Saving over Public Investment.

There is nothing formally wrong with C). It is an accounting identity, true by definition. But it has abolished the concept of aggregate income without which a causal analysis of the system as a whole is impossible. And because this organising principle has been lost, the expression seems to have encouraged people to suppose, because the deficit is equal by definition to an excess of investment over saving, that it could be cured, quite simply, if the American people were to save more or invest less. But this is misleading, to the point of being incorrect, if the conclusion is then drawn that a rise in saving could, by itself, cure the deficit by any means which did not also cause a first class recession in the economy.

THE BALANCE OF PAYMENTS DEFICIT AS NET INVESTMENT IN THE U.S.

The current balance of payments, as it appears in Table 4.1 of the **NIPA**, is described as "net foreign investment". "Investment" in this context means nothing more than that foreigners are net lenders of the funds which the US must borrow to cover the excess its spending over its Income. It is clear from evidence presented to the Commission that there exists an influential line of argument which would equate this "investment" with fixed capital formation in the US which would not otherwise have happened. Hence. the argument continues. the deficit is benign

because it leads to an enlargement of the capital stock, **raises productivity**, the US growth rate etc. etc.

This argument was made clearly, explicitly (and influentially) by Herbert Stein in an article published in the Wall Street Journal on 16 May 1989 ("Don't worry about the trade deficit"). According to Stein, if foreigners had not been buying government bonds, U.S. residents would have had to buy them instead - so that there would have been correspondingly fewer funds available for domestic investment.

It is certainly true that if there were no deficit, total domestic expenditure would have to be lower absolutely. by the amount of the deficit, than it actually now is; some items of domestic expenditure would have had to be replaced by net exports. But there is no reason to suppose that any of this reduction in domestic expenditure - let alone the whole of it - would take the form of fixed investment. Aggregate demand could be the same in each case, so the general **incentive** to invest need not be lower. At the same time, **in** order to generate a switch of demand in favour of net exports, the exchange rate and interest rates would probably both have had to be lower than they have actually been - but these are both factors which would have tended to increase investment.

In the "alternative" position in which there is no deficit, which is to be compared with the present, actual, situation, it has to be **the** case, by the balance of payments identity **B)** above, that the financial surplus of the private and public sectors combined would be higher (by the full amount of the deficit) than at present. There would therefore be additional financial funds available from domestic sources (including the government) on exactly the scale needed to replace funds from foreign investors; foreign funds would no longer be forthcoming but they would also no longer be needed.

Herbert stein makes no mention of the fact that, since U.S." domestic expenditure has for years exceeded GNP by large and growing amounts, the U.S. has become "the world's largest debtor". Yet it is the cost of servicing this debt which is now the 'main cause for concern.

#### SOME SUBSTANTIAL ISSUES

##### A) Prospects for the trade deficit'

To bring some focus to the discussion, I first derive a "base case" projection of the primary deficit which is consistent the projections published by the Congressional Budget Office together with "consensus" forecasts of developments in the rest of the world. The base case projects an average GDP growth rate of 2 1/2 % over the next 5 years following a 3 3/4 % expansion this year. The average annual growth in the rest of the world is projected to rise from the depressed 2% rate seen in the last couple of years to 4% a year (using LMF definitions).

A moderate fall in the dollar is assumed to provide some uplift to competitiveness even given the consensus expectation that American inflation modestly exceeds the average in trading partners. Inflation adjusted, the real value of the dollar is asumed to fall cumulatively by 4 1/2 % over the next five years.

The price of oil is projected close to \$20 per barrel, which is well below today's spot price. Other commodity prices are assumed to stay roughly constant-in nominal terms.

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<sup>3</sup>The projections described below are all based on simple econometric models of the U.S. and world economies, briefly described in the appendix to Godley (1999)

A key implication of all these assumptions is that there will soon be a sharp revival in U.S. export volume growth. Hit by competitiveness losses and the depressive effects of the collapse in Asian and other emerging economies, American export volumes rose a meagre 2.2% in 1998 and might grow by 3.5 - 4% this year. This performance is transformed in the projection, which envisages a rapid acceleration, **pushing** annual growth to above 7% after the turn of the decade.

But even this sharp revival will not, on the face of it, prevent some further worsening of the trade deficit. Several considerations act to offset the export volume uplift:

a) It is well attested from many studies that the United States has a relatively **high** propensity to import, implying a tendency for imports to grow in volume more quickly than exports even when American GDP growth only matches that overseas.

b) In recent years, commodity price weakness has improved America's terms of trade - and, to that extent, flattered trade performance. Prospectively, commodity price stabilization and higher oil prices will have the opposite effect.

c) The large excess of imports over exports is itself a source of trade drag. Even if exports and imports grew at the same rate, the absolute trade gap would get larger. In the base case, this effect widens the primary deficit by **1/2%** of GDP.

Taken together these projections imply that the primary deficit, will rise slightly from 3.6% of GDP in the middle of 1999 to about 4% in 2004. After 2004 the primary deficit is arbitrarily assumed to remain constant.

## B) Prospects for debt and property income

Whether or not, and for how long, a primary deficit can be tolerated depends critically on the **rate of** interest which has to be paid on the debt (**NNAP**) which the deficit generates.

There exist **theorems**<sup>6</sup>, well known to students of debt processes, that precisely describe the dynamics of debt accumulation. One of the most important of these states that if the real rate of interest exceeds the economy's growth rate, an indebted country with a primary deficit, however small, find its debt-to-GDP ratio growing for ever - a process that obviously could not in reality go on for very long and that would, by the laws of logic rather than economics, **imperatively** require correction before things got out of hand. The theorem implies that if the interest rate exceeds the growth rate, an indebted country must achieve a surplus in its primary if the debt is not to explode.

The fact that escalating debt must eventually to be corrected can be proved by **reductio ad absurdum**; for instance, the foreign debt could not be allowed to grow to the point at which the entire GDP is pre-empted by the need to make interest payments abroad thereby reducing the GNP to zero. Escalating growth in the NNAP would simply have to be checked at some stage; the only questions being how and when. It is not valid to assume that deficits are painlessly self correcting if only because instances abound of

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<sup>6</sup>For instance, using discrete time, the growth in the debt-to-GDP ratio is given by the formula

$$\Delta(d_t/q_t) = -pb_t/q_t + [(r_t - g_t)/(1 + g_t)] \cdot d_{t-1}/q_{t-1}$$

where  $\Delta$  is a first difference operator,  $d$  is foreign debt,  $q$  is GDP,  $pb$  is the primary balance,  $r$  is the real rate of interest on foreign debt, and  $g$  is the growth rate. The formula may be very simply rearranged to yield the primary surplus necessary to **stabilise** the debt-to-GDP ratio

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**emergent** debt traps in other countries (Denmark, Australia, Ireland) which inexorably led to painful periods of **retrenchment** following which the primary balance was moved into surplus. The U.S. is fortunate in that, unlike other debtor countries, its debts **are denominated in** dollars and this **means** that devaluation does not involve a capital loss. But neither this advantage, nor the enormously preponderant wealth and power of the U.S., exempts the country from the laws of compound interest.

Although the NNAP in 1999 had grown to around \$1,500 billion, the net outflow of property income has recently only been running at \$10 billion per annum. If the U.S. could continue to borrow on **any scale** whatever and for any length of time without, in effect, paying interest at all there would be little to **worry** about.

The main reason why **the net** outflow of property income has been so small is that the rate of return on **foreign direct investment in the U.S.** has been very **much lower than the return on U.S direct investment abroad.** The stocks of inward and outward investment (measured in dollars and at market prices) are now about equal to one another, yet the inflow of direct investment income is about **\$60 billion** larger than the outflow.

CHART 3 RATES OF RETURN ON DIRECT INVESTMENT MEASURED EX POST

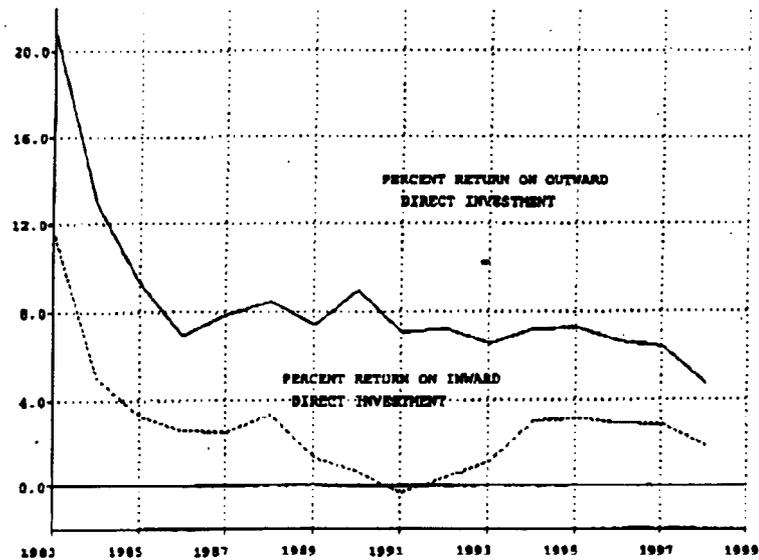


Chart 3 shows the gross flows of income from direct investment into and out of the country, expressed as a proportion of each capital stock (measured at market prices). It is noteworthy that in 1991 foreign direct investors in the U.S., taken together as a group, actually made a loss. Neither of the two attempts to explain this phenomenon of which I know (Laster and McCauley (1994) and Grubert (1997)) are very conclusive. Laster and McCauley reached the tentative conclusion (to some extent confirmed by Grubert), that foreigners earned low returns because they were newcomers and that they would probably do better as they learned American ways. But while there has been some improvement, certainly compared with 1991, this explanation is wearing thin after six more years of relatively poor profit performance.

However, the U.S. cannot rely on foreigners making poor investments in the U.S to finance the current account deficit to more than a very limited extent. Apart from the fact that foreign direct investments may perform better in the future, the greater part of the funds needed to finance the deficit will have to come

from financial investment. where the rates of return are much higher than those earned. so far, by foreign direct investors. It is true that during the last twelve months there has been a surge in foreign direct investment. But this surge provided very little finance for the current account deficit because it was largely financed by exchange of shares. Further discussion of this important point has been banished to the appendix.

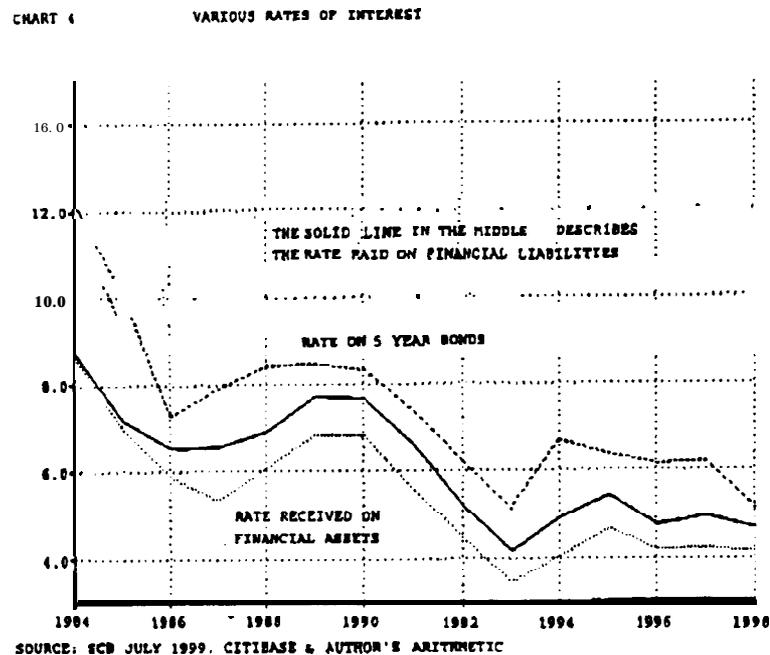


Chart 4 shows inward and outward flows of property income other than those associated with direct investment as a percent of the

financial asset and liability stocks which generated them. -  
Notwithstanding that these "interest rates" are the messy outcome of dividing very diverse aggregates into one another, they have exhibited a considerable degree of coherence, moving roughly in step with **one** another and with (say) the rate on 5 year U.S. Treasury bonds. It is not surprising that "interest rates" on internationally held financial assets should be lower than the yield on bonds, if only because very roughly a quarter (\$1 - 1.5 trillion) of all financial assets held by foreign investors take the form of equities, which carry a very low running yield.

It is perfectly proper to measure the income derived from equities by their running yield, since this harmonises with other **NIPA** conventions - besides, while any capital gain earned by foreigners adds to the U.S.'s NNAP, it does not have to be financed as regular income flows have to be financed. There exists, however, an obvious danger that large scale net sales of equities by foreigners might at some stage occur, and these would have to be financed by sales of bonds or other instruments bearing high rates of interest which would substantially change the net property income flow for the worse. Even as things stand, the average real rate of "interest" on all financial liabilities (including equities) has been slightly above the normal growth of output and, with rising interest rates within 1999, may have come to exceed it more decisively by the end of the year.

In the "base case" simulation presented below. it has been assumed that the bulk of the funds which will be needed to finance the growing current account deficit will in the future come from sale of securities with an average rate of interest equal to 4.5% - very slightly above the rate which actually obtained in 1998.

## SYNTHESIS

CHART 5 THE CURRENT & PRIMARY BALANCES: ACTUAL & PROJECTED  
(PERCENTAGES OF GDP)

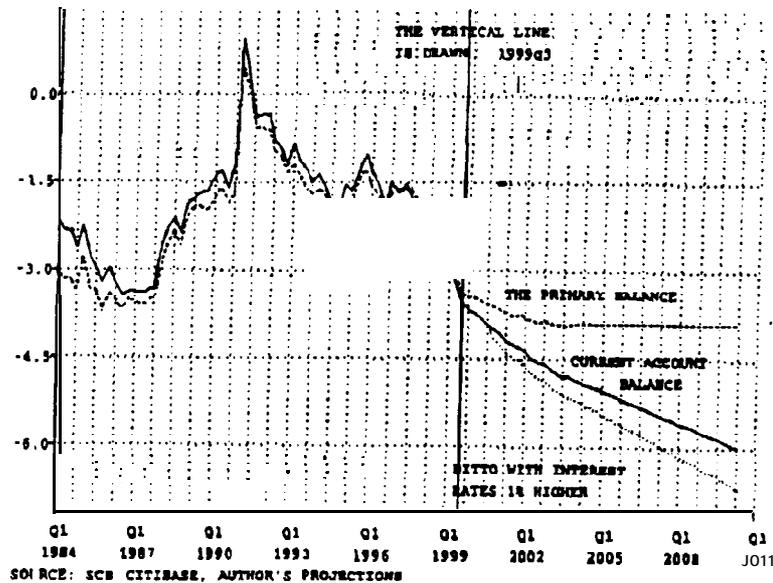
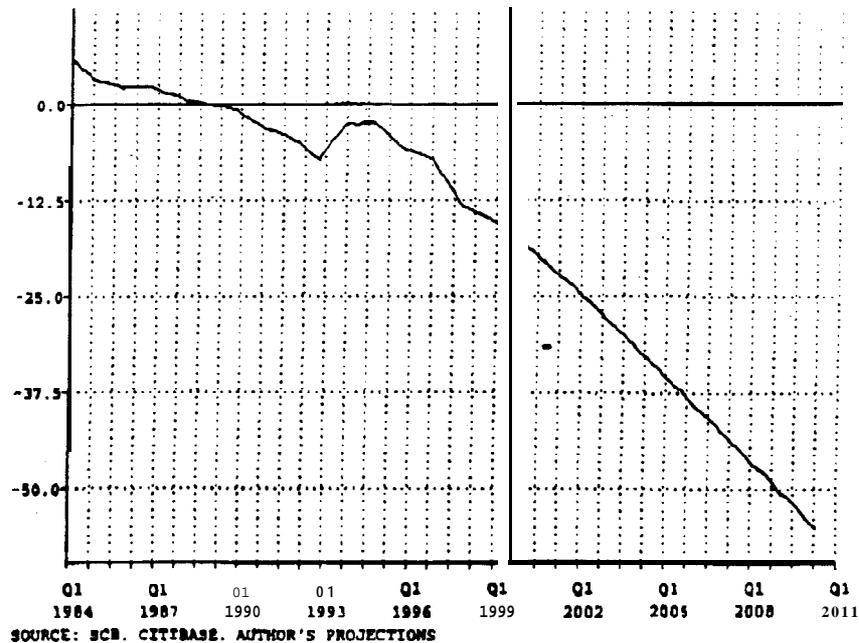


Chart 5 puts together the assumptions and conditional predictions discussed in the preceding sections. The striking feature of the chart is that, while the primary balance does not deteriorate very much from now on, the net outflow of **property** income takes up the running, making the current account deficit as whole continue to increase almost **as** fast in the future **as** during the last five years. After ten years the current account deficit **is** about 6% of GDP - nearly double its present level, **while** the NNAP (see Chart 6 below) continues to rise rapidly, reaching 50 - 60% of GDP in ten years time. Chart 5 also shows a projection of the current balance of payments on the assumption that the **average** rates of interest on financial assets and liabilities are both 1% higher than in the base case. As is to be expected, the deficit rises faster and the increase in the **outflow** of net property income show clear signs of acceleration.

CHART 6

NET ASSET POSITION  
(PERCENTAGES OF GDP)

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Charts 5 and 6 describe situations which, for a number of reasons could not really happen, or be allowed to happen. The interest cost (around 2% of GDP) would not **be extremely** large even after ten years. But the U.S. would, by then, be having to generate foreign capital inflows every year worth 6% of GDP and high **and** rising interest rates would probably be needed to bring this **about**, so making the outflows of property income even larger than those in the projections. Next, recalling the identity called "B" on page 4, It would necessary for the government to run a high and rising deficit **as** a counterpart of the external deficit; for it seems inconceivable that the private sector deficit, which is already at a record level, could rise further by enough to match the whole of the external deficit. But above all, it would have become clear, at some point during the first decade of the new millennium, that the **U.S.** was indeed **in** a debt trap which would be calling absolutely for countervailing measures - if **it had** not already caused a disorderly collapse in the dollar with inflationary and other implications which cannot clearly be foreseen..

## POLICY CONSIDERATIONS [PROVISIONAL]

The projections I have presented in this paper do not have the status of forecasts. I particularly emphasize this because it happens to be my opinion that the U. S. will undergo a period of recession or severe stagnation in the first decade of the new millennium, in which **case** the balance **of** payments deficit will greatly improve and any plans to improve it could be shelved. My aim, having made a fairly careful analysis of the recent past, is simply to display what seems reasonably likely to happen if world output recovers but otherwise past trends, policies and relationships continue for a few more years. To inform policy it is not necessary to establish that this particular projection is extremely likely to come to pass, only that it must seriously be reckoned to be on the cards. The potential usefulness of the exercise is to warn policy makers of grave dangers which may exist and help them think out what policy instruments are, or should be made, available to deal with worst cases, should they arise.

Yet it is somewhat awkward to discuss policy responses to the hypothetical situations which have been outlined in this paper at a **time** when the whole concept of active macroeconomic policy has gone out of fashion. Active fiscal policy 'seems for the time being to have been ruled out of court and there **is** a widespread belief that "market forces", working both nationally and on a global **scale**, can and must be counted on to correct any imbalances that turn up. Macroeconomic policy seems nowadays to mean nothing more than the small changes which the Fed and other central banks make in response to expectations about inflation.

My diffidence is increased by the fact that there is no **compelling** cause for immediate concern. Even ignoring that the problem may be at least temporarily eased if the U.S. enters a

period of stagnation or recession, it could well be, as my "simulations indicate, quite a long time before the alarm bells ring in earnest.

Nothing can alter the fact that an emergent foreign debt trap could at some stage place the U.S authorities under the obligation to bring about a substantial improvement in the primary balance. By the standard **theorem** of debt dynamics, to stabilise the debt/GDP ratio the primary balance would have to move into surplus on whatever scale is needed to pay for the property income outflow.

As indicated in my introductory section (on page 5) the range of possible policy responses comes, **in principle**, down to three categories: policies which reduce domestic output, policies which raise foreign demand and policies which change relative prices so that a higher proportion of output is exported or a lower proportion imported.

Of these alternatives, the easiest, technically, to operate is the first. Faced with an intractable external crisis, the easiest and (probably) commonest response is to deflate demand, using some **combination** of fiscal and monetary policy. But this **is** a solution to be deplored. It would allow the U.S.'s external imbalance to impart a disinflationary bias to world, as well as U.S., production and trade.

"Policies to raise foreign demand" sounds distinctly 'hollow at a time when any form of demand management. or policy intervention of any kind, seems to be ruled out of court in the public discussion - and when appropriate international arrangements do not exist. **Yet** if the **argument** of this paper has any merit there **must** be a danger, at the very least, that endemic trade and payments imbalances come to impart a severe deflationary bias to whole system of world production and trade. If the means are

obscure the ends at least are clear - to achieve high levels-of growth in output and employment in the U.S. and in the world at large.

So far as improving matters by changing relative prices goes currency depreciation is the classic remedy. But in today's world of completely unrestricted capital flows, depreciation is not in any simple sense a policy instrument any more and it cannot be counted on to do the trick automatically or in any orderly way.

Policy makers should not forget that under Article 12 the WTO sponsors the use of non-discriminatory import controls if there is a conflict between the objectives of full employment and balance of payments equilibrium. Article 12 insists that the methods used to control imports should be non discriminatory with regard both to the countries and to the products affected and is therefore to be sharply distinguished from "protectionism" - which I understand to mean the use of selective controls to protect individually failing enterprises. The provisions of **Article 12** after revision as part of the Uruguay Round in 1994 expressed a preference for "price based" measures such as "import surcharges. import deposit requirements or other equivalent trade measures with an impact on the price of imported goods"

Notwithstanding the deplorable advertisement, and the awful danger that the principle of non-discrimination might be breached by powerful special interests, non-discriminatory control of imports must stand as a realistic policy in **extremis**. The great advantage of import controls, as Keynes once said, is that they do stop imports from coming into the country.

## APPENDIX ON DIRECT INVESTMENT FINANCED FOR BY EXCHANGE OF SHARES

A new measurement problem has arisen because during the last twelve months some extremely large takeovers of U.S. by foreign firms took place which count as "foreign direct investment", but which were financed entirely (or nearly entirely) by exchange of shares. When this happens, the direct investment in question makes (virtually) no contribution at all to the financing of the balance of **payments** deficit, precisely because no money changes hands. Corresponding to the positive figure for direct investment there has to be an offsetting entry in the line describing transactions in securities. Ownership of the firms in question has indeed, in these cases, **passed** from U.S. to foreign hands with the result that the holders of shares in what had been a U.S. firm now find themselves holding shares in a foreign firm. But in the statistics, a transaction in equities is considered to have taken place although not a cent has changed hands. So the jump in direct investment by foreigners has generated an equivalent but spurious reduction in net inward financial investment. In my projections I have assumed that inward financial investment continues to be the main means by which the current account deficit is financed with all the implications that this **has** for debt service.

It would be extremely helpful if the statistical tables were to include a memorandum item describing that proportion of direct investment which is financed by shares - which also describes a fictitious "purchase" of foreign securities by U.S residents.

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