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US Current Account Adjustment May Not Be So Smooth -Fed Paper

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WASHINGTON (Dow Jones)--There is no difference between returns foreign investors earn on U.S. assets and those U.S. investors earn abroad, according to a Federal Reserve paper. This finding could mean trouble for those hoping for an orderly adjustment of the large U.S. current account deficit absent a large dollar adjustment.

"Our finding of no return differential between U.S. claims and liabilities means that one stabilizing aspect of the current international economic system is on shaky footing," said the authors of the paper, which was co-written by a Fed economist and posted on the Fed's Web site Wednesday.

"In theoretical models, relative to the presumption of a positive returns differential, a zero returns differential would increase the likelihood of a disorderly adjustment in the U.S. current account and the dollar," they said.

The paper was written by Fed economist Stephanie Curcuru, Tomas Dvorak of Union College and Francis Warnock of the University of Virginia.

Chances of a "benign" evolution of global imbalances rest on the ability of U.S. investors to earn "substantially" more on their foreign investments than foreign investors earn here, the authors said.

However, "over the period from 1994 to 2005 - a period of increasing financial globalization - there is no evidence that U.S. portfolio claims provided substantially higher returns than U.S. portfolio liabilities," they added.

"A positive returns differential, and the stabilizing influence that it would lend to the

global economic system absent a sustained dollar depreciation, is not apparent when one examines actual bond and equity portfolios," the authors of the paper said.

The U.S. ran a massive current account deficit last year of over $850 billion, or about 6.5% of gross domestic product. Fed officials want to see that deficit come down, but have said it should do so in a gradual way.

The current account has two components - trade in goods and services and income from international investments - and most of the U.S. gap comes from trade.

If the U.S. earns more on its foreign investments than it pays out, that would cushion some of the current account deficit. If there's no differential, then the adjustment would more likely have to come through a weaker dollar, which would depress imports and boost exports.

The paper's key finding of no return differential is somewhat counterintuitive. After all, U.S. investors are more heavily weighted in foreign equities that tend to have higher returns than debt, which is where foreign holdings of U.S. assets are typically concentrated. And, contrary to the findings of the Fed paper, other academic studies have found a positive return differential in favor of U.S. holdings of foreign assets.

"Indeed, we find a positive composition effect, as all over the world equities had higher returns than bonds," the authors of the Fed paper stated.

Yet that favorable edge from the "venture capitalist" structure of U.S. investments overseas was "neutralized" by the fact that U.S. stocks performed particularly well over the 12-year period examined by the authors, while bond returns were roughly equal among developed economies, according to the paper.

"The returns that foreigners achieved in the United States would have been even higher if not for their poor timing in reallocating between stocks and bonds," which trimmed their returns in the U.S. by 70 basis points a year, the authors of the paper said.

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