THE WALL STREET JOURNAL.
WSJ.com

OPINION | OCTOBER 4, 2010

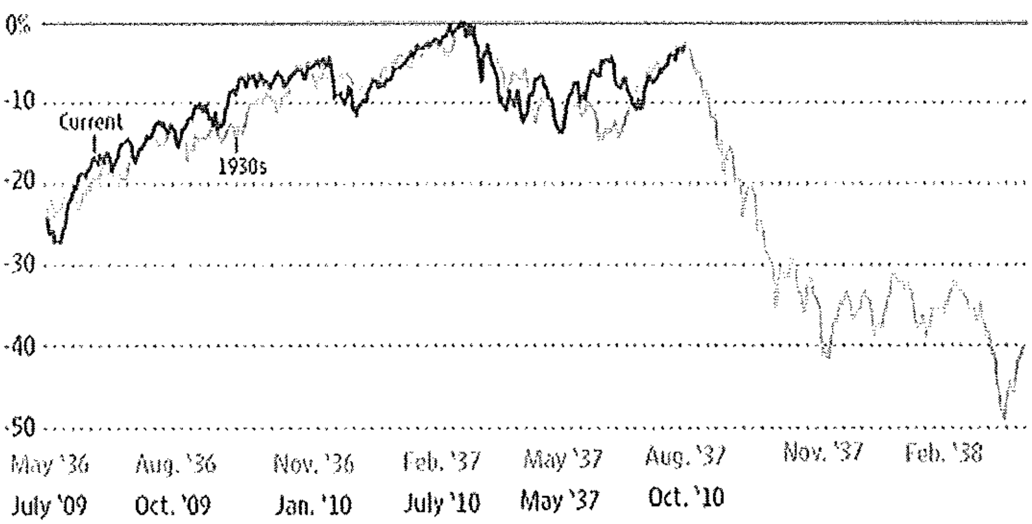
The Trade and Tax Doomsday Clocks

By DONALD L. LUSKIN

The nearby chart is an update of one I showed on this page in early July. It depicts how the stock market over the last year and a half has followed a path eerily similar to that of 1937. This week corresponds on the chart to mid-August 1937, when the cumulative effects of massive hikes in personal and corporate tax rates, severe monetary tightening, and aggressive business-bashing by the Roosevelt administration tipped the economy into the "depression inside the Depression." From there, stocks were in for the longest and second-deepest bear market in history.

Headed for a Fall?

Dow Jones Industrial average before and after recovery highs on March 10, 1937 and April 26, 2010 (percentage change)



Source: Donald L. Luskin

Thankfully, we're not repeating all the mistakes of 1937. But Congress and the Obama administration are flirting dangerously with one of them by failing to extend the expiring low tax rates for all Americans. What's worse, we're close to repeating the mother of all policy errors, the one made not in 1937 but in 1930—the one that started the Great Depression. We're on track to resurrect the 1930 Smoot-Hawley Tariff Act.

Let's start with taxes. If today's low rates expire at year-end per current law, that would at a stroke reduce after-tax income for every working American, the average reduction being 3.3% according to the Tax Policy Center. Do the math: 94% of income goes to consumption, and consumption is 70% of gross domestic product. All else being equal, if the Bush tax cuts don't get extended, that's a 2.3% hit to 2011 GDP. That means instant double-dip recession, starting at midnight, Dec. 31.

Why won't the Democrats who control both houses of Congress switch off this doomsday clock? It's because Democratic leaders and the Obama administration want to roll the dice for the sake of ideology, by giving tax relief only to the middle class while letting rates rise for higher earners. A growing number of Democratic dissidents have joined with Republicans in insisting that, in this weak economy, it's more prudent that relief be given to all Americans.

Some have even undergone a supply-side conversion. Forty-seven Democrats have sent a letter to House Speaker Nancy Pelosi citing the urgency of preserving low tax rates on dividends and capital gains for the sake of more job-creating capital formation.

Democratic leaders blocked Congress from taking up the matter before the October recess, fearing a humiliating defeat. Last Wednesday a resolution permitting the House to adjourn without dealing with the doomsday clock passed by a single vote, over unanimous Republican opposition and nays from 39 Democrats.

When a bill comes before the House in the lame-duck session later this year, the games will really begin. House rules allow Mrs. Pelosi, as speaker, to offer legislation under what's known as "suspension of the rules," which limits time for debate but requires a two-thirds majority to pass, rather than a simple majority. If Mrs. Pelosi offers a bill under suspension that excludes the highest earners, there's little chance she'll get enough GOP votes for the supermajority she needs. That way she can blame Republicans for the defeat of an already doomed bill many Democrats oppose, shaming the GOP for "voting against middle-class tax cuts."

Meanwhile, as we await New Year's Day when today's low tax rates expire, American taxpayers, already beset by crippling uncertainty, have no choice but to keep listening as the ticking of the doomsday clock gets louder and louder.

Associated Press

Unemployment line in Newark, 1935

Now to protectionism. Last week the House passed the Currency Reform for Fair Trade Act. It's an amendment that gives dangerous new protectionist powers to the notorious Smoot-Hawley Tariff Act, the proximate cause of the global Great Depression, which after all these years is still on the books. Democrats—all but five of whom voted in favor of the bill last week—would do well to remember that in 1932 Franklin Delano Roosevelt ran as a free-trader, pledging to lower Smoot-Hawley's tariff walls. The 99 Republicans who voted aye should know that Herbert Hoover's name lives in infamy for erecting them. Instead, Wednesday's vote was a bipartisan move to build those walls higher using currencies as the bricks and mortar.

The bill, if passed by the Senate and signed by the president, would mandate that the Department of Commerce take a foreign country's currency interventions into account in determining whether its trading practices are unfair. In the case of China—the target at which this bill is aimed—Commerce would determine that the amount by which the yuan is allegedly undervalued. The number being thrown around now by supporters of the bill, such as the AFL-CIO and the United Auto Workers, is as much as 40%. The cost basis of Chinese-made goods exported to the U.S. would then be adjusted upward by that amount to determine whether they are being sold below cost, an unfair trade practice known as "dumping." Not a single Chinese export good could survive such a test—virtually the entire volume of China's exports to the U.S. suddenly would become subject to countervailing duties.

Surely China would retaliate. That makes the bill a nuclear threat of mutual assured economic destruction. If carried out, it would crush trade between China and the United States, which are huge export markets for each other.

Suppose China blinks and revalues the yuan to avert the nuclear threat. Even if this creates some American jobs, which is doubtful, it would do so by making all Chinese goods more expensive in the U.S.—an immediate inflationary tax on American consumers.

At the same time, it would make goods priced in dollars cheaper for China to import, supposedly a boon to U.S. exports. But an unintended consequence is that it will make China an even more voracious competitor for oil. That's because oil is priced in dollars, so a revaluation would make it cheaper in yuan terms. Remember, during the period from 2005 to 2008 when the yuan was revalued under similar political pressures from the U.S., the price of oil rose, not coincidentally, to $147 per barrel from $60. That could happen again—and it would be another inflationary tax on U.S. consumers.

Both issues—extending today's low tax rates, and protectionism against China—are animated by the coming election. Once that has passed, presumably cooler heads on both sides of the aisle will prevail, and these twin threats to our fragile economic recovery will fade away.

But sometimes such things can take on lives of their own. And sometimes in the heat of politics cooler heads do not prevail. If that happens now with issues as critical as these, then the economy and the stock market will be doomed to repeat the tragedies of the 1930s.

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