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Stable market requires stable policies

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Tremors in the stock market reflect shaky economic policies. High short-term interest rates, pending tax increases and the lapse in President Bush's fast-track-trade-negotiating authority threaten to reverse the substantial gains in equity prices since 2003.



Even after the setbacks last week, the Standard & Poor's 500 index has increased by approximately 75 percent during the past four years. The Dow Jones Industrial Average and the S&P 500 Index have reached new all-time highs this year. Much is at stake.

Many blame the turbulence in stock prices on the expanded practice in recent years of making mortgage loans to less-qualified homeowners. The unprecedented loosening in lending standards is dearly costing lenders and investors who played that game. But the losses will be contained and do not justify the turmoil in the stock market. The real risk is whether economic policy will be conducive to continued prosperity.

Federal Reserve Board Chairman Ben Bernanke has done a good job correcting monetary-policy missteps made earlier in the decade. For the past two years, the Fed has held short-term interest rates above the level consistent with normal economic growth and stable inflation. The objective is to counter the inflationary forces set in motion when the Fed pegged short-term interest rates too low for too long in 2002-2004.

What is unsettling to financial markets is that Bernanke is leaning toward raising short-term interest rates even higher. He told us so again in testimony before Congress just before the largest weekly percentage decline in the S&P 500 index in nearly five years. An increase in interest rates is unnecessary and could spell the end for the economic expansion.

The threat from fiscal policy is greater, because the fuse is burning. Massive individual and corporate tax increases are legislated to take effect in a couple of

years, and the absence of calls to avert the event is ominous.

Under current law, tax rates on individual income, capital gains and dividends will increase substantially in 2011. The estate-tax rate will jump from zero to 60 percent and exemptions will decrease. The child-tax credit will be cut by half and the so-called marriage penalty for taxpayers will return.

The result will be a higher cost of capital, lower after-tax return from investment, and a large shift of resources from the private to the public sector.

Say what you will about President Clinton's 1993 tax increases. At least they coincided with the liftoff of a tremendous economic expansion. In similar fashion, Bush's tax cuts at the beginning of the decade took effect just as the economy headed into a recession.

The 2011 tax increase is likely to be timed poorly. The economic expansion will be 10 years old, if it lasts that long, and more likely will need a boost rather than restraint.

Finally, the foreign-trade environment soured when Congress failed to renew the Bush's negotiating authority at the end of June. Fast-track authority provides for a simple up-or-down congressional vote on trade agreements, assuring foreign governments that their efforts stand a good chance of success.

As a result, any new trade deals are unlikely before 2009, when a new president will take office. And although it is early in the campaign, rhetoric from presidential hopefuls has not been favorable toward trade expansion.

Foreign trade is critical to growth of the U.S. economy. Exports increased 38 percent in just the past four years, accounting for nearly one-third of total economic growth. A commensurate share of the more than 8 million jobs created during the period is surely linked to the higher volume of trade. At a minimum, future job growth would be inhibited by limits to trade.

Volatility is an inescapable part of the stock market. Whether the recent setback is a flutter or a prelude to something serious will depend on the course of monetary, fiscal and trade policy.

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