OPINION

China's Restructuring Is Underway

By Andrew Batson

China is grappling with an economic downturn, but there is more than the usual amount of disagreement about how fast it's slowing down and what its future prospects are. The battle is not between the usual bulls and bears. The most interesting split this time is between those who focus on a "macro," or top-down, picture of an economy, and those who zoom in on a "micro," or bottom-up, picture of companies.

The macro crowd says that China is slowing, but not collapsing. They point to broad-based economic indicators like industrial output, which grew 9.6% year-on-year in May. Granted, this is much slower than the 13-14% gains recorded last year. But those searching for a real economic disaster story, they argue, would find more to work with in countries like Spain, where industrial output fell 6.1% the same month.

Those who point to falling corporate profits and sales as bearish cues miss the bigger, more bullish, picture.

Those of a micro persuasion don't believe these statistics, and instead prefer to look at more detailed corporate reports, many of which show falling profits and sales. They've seized on the fact that makers of construction equipment, which grew enormously during the building boom of the last couple of years, are now seeing a 30-40% fall in sales volumes and a rise in unpaid bills.

Another favored example comes from the port of Qinhuangdao, which handles much of China's coal imports, and which is now reporting falling prices for and rising stockpiles of the fuel—just when the summer rush to turn on air conditioners usually leads utilities to buy more coal. This negative picture is backed up by the large industrial companies surveyed monthly by the National Bureau of Statistics, whose combined profits were down 5.3% from a year earlier in May, with the profits of chemicals firms plunging 23%.

The continued lack of transparency around China's official data makes it necessary to check the numbers against experience. Yet the micro crowd's rush to condemn these statistics risks missing a more important story. Parts of China's economy that did very well over the last few years are indeed not doing so well now, and the companies that depend on those sectors are struggling. But it's a fallacy to mistake the part for the whole.

While construction equipment, coal and chemicals have been important to China's economic growth up to now, the economy is hardly so narrow today. Consumer spending is growing steadily. Car sales have picked up. Wages are rising. Even exports to some markets, outside struggling Europe, are not doing so badly.

Reuters

Consumer spending is rising, and forcing companies to change tack.

The clash between the micro and macro views is then less evidence of terminal economic decline than it is of a necessary economic restructuring. Companies are adapting to the end of China's investment boom and its transition to slower overall growth.

This structural change will be stressful for many companies. Both the World Bank and Chinese government scholars estimate that China's potential economic growth rate will be closer to 7% over the next several years than the 10% of recent years—in other words, the pace of growth will be cut nearly in half. This would still count as fast growth by most countries' standards, but it is a significant change from what Chinese companies are used to. A business strategy of rapidly expanding capacity and ignoring costs could have worked well in the past decade of high growth, but will face problems in the coming decade of slower growth.

Moreover, China will not grow in the same way over the next decade as it has over the past decade. Growth in fixed capital formation, the broadest measure of investment, averaged 16% a year over the past decade, after accounting for inflation. In 2011, real growth in fixed capital formation dropped to 10%, and will likely slow further this year.

With investment cooling, consumer spending will start playing a bigger role in China's economy. This is not a bad thing, but will mean tough times for those companies—like makers of construction equipment—that have grown by supplying the investment boom.

So rather than take the current signs of corporate distress as a signal that it needs to stimulate the economy more, China's government needs to embrace this turmoil. For China to achieve its macroeconomic potential in coming years will require a lot of microeconomic disruption, as uncompetitive companies close down and capital and labor flow to new, more productive uses.

There are some signs government leaders understand this. When Premier Wen Jiabao visited the eastern province of Jiangsu last weekend, he told business leaders that to survive they need to come up with new products and pay attention to market signals, and not just "tinker" with existing products or invest in fashionable sectors with a glut of capacity. If Mr. Wen can put in place policies to help this transition, such as improving funding for new companies and opening more markets to private-sector competition, China's economy can keep changing, and thereby keep growing.

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What's Wrong With the Federal Reserve?

By Allan H. Meltzer

By allowing its monetary policy to be influenced by elected politicians and market speculators, the Federal Reserve is putting its independence at risk. It is also neglecting basic economics, which was a great strength of its current chairman, Ben Bernanke.

Consider the response to last week's employment report for June—a meager 80,000 net new jobs created, and an unemployment rate stuck at 8.2%. Day traders and speculators immediately clamored for additional monetary easing. Even the president of the Federal Reserve Bank of Chicago joined in.

To his credit, Mr. Bernanke did not immediately agree. But he failed utterly to state the obvious: The country's sluggish growth and stubbornly high unemployment rate was not caused by, nor could it be cured by, monetary policy. Market interest rates on all maturities of government bonds are the lowest since the founding of the republic. Banks have $1.5 trillion in cash on their balance sheet in excess of their legally required reserves—far more than enough to meet any unsatisfied demand for loans that bankers regard as prudent.

Consider also how, in the summer of 2010, the Fed allowed itself to be spooked by cries about a double-dip recession and deflation. It added $600 billion to banks' reserves by buying up federal Treasurys and mortgage-backed securities. Today, $500 billion of those reserves remain on bank balance sheets, and most of the rest of the dollars are held by foreign central banks. Not much help to the U.S. economy. By early autumn 2010, it had become clear that fears of a double-dip recession and deflation were just short-term hysteria.

One of the Fed's big mistakes is excessive attention to the short term, over which it has little influence. As I researched the central bank for my "History of the Federal Reserve," I was dismayed to find hardly any discussions in the minutes of its policy arm, the Federal Open Market Committee, about what members expect to happen a year from now as a result of whatever actions it is taking today.

True, the staff provides forecasts about the future, but these are made before policy action is decided. Former Fed Chairmen Paul Volcker and Alan Greenspan told the staff several times that its inflation forecasts based on the Phillips Curve—which theorizes a trade-off between inflation and employment levels—were not useful. But the Phillips Curve is still central to the inflation forecasts that Messrs. Volcker and Greenspan found useless.

The problem with the short term is that data reported today are subject to revision, or reflect only transitory changes. The better economic data last winter are one of many examples. Would the reported improvement in the economy persist? We didn't learn the answer until weaker data reported this spring. Is the slowdown persistent or temporary? We can only guess.

Business investment is held back by uncertainty about taxes and regulation. Printing dollars won't help.

Executing monetary-policy changes in response to transitory data is a mistake. The late Nobel laureate economist Milton Friedman taught that monetary policy operates with long lags. Actions today have their main effects much later. By then the data often support a very different story.

The other big problem at the Fed is staying mum about the real cause of the high current unemployment rate—fiscal policy.

Today's economic problems are serious, but the Fed can't do much about them if these problems are not monetary. Very expansive monetary policies did help during the crisis of 2008-09, but they're not what is needed now. To get out of our bad economic situation, we need coherent long-term fiscal policy, especially entitlement reform.

With mortgage rates lower than ever and housing showing very sluggish recovery, what can be gained by dropping the mortgage rate another small fraction? Business investment is held back by uncertainty. No one can reliably calculate tax rates, health-care costs, and the regulatory burden until after the election, if then. How can corporate officers calculate expected return when they cannot know these future costs? How is more monetary stimulus today supposed to help?

From about 1985 to 2003, the Fed achieved relatively stable growth, short, mild recessions, and low inflation by more or less following the Taylor Rule, which specifies (to simplify) what interest rate the Fed should establish in response to the expected inflation rate and the unemployment rate. Rule-based monetary policy brought us a far better economic outcome than discretionary ups and downs. The Fed should commit to that rule and follow it.

The policies that are really needed are on the fiscal side. Instead of more short-term stimulus, we need a government that puts us on a path toward a balanced budget over time, mainly by reducing spending. Instead of denigrating and then ignoring House Budget Chairman Paul Ryan's courageous effort at entitlement reform, the administration should put a program on the table to control our deficits.

Evidence is growing that many think higher inflation is in our future. One sign is the premium that investors pay to hold index-linked Treasury bonds that protect against inflation. Another is the shift by asset owners from holding money to holding equities and real assets, or claims to real assets. What many call "bubbles" cannot occur without this shift occurring.

One of the many costs of the Fed's excessive attention to the near term is that it will wait until after the inflation is upon us before it does anything to stop it. The Fed's view is that by raising interest rates enough, it can stop any inflation. True, but not entirely relevant. Will the politicians, the public, business and labor accept the necessary level of interest rates? Much history says: "Don't count on it." Better to adopt something like the Taylor Rule and begin gradually reducing the banking system's excess reserves now.

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