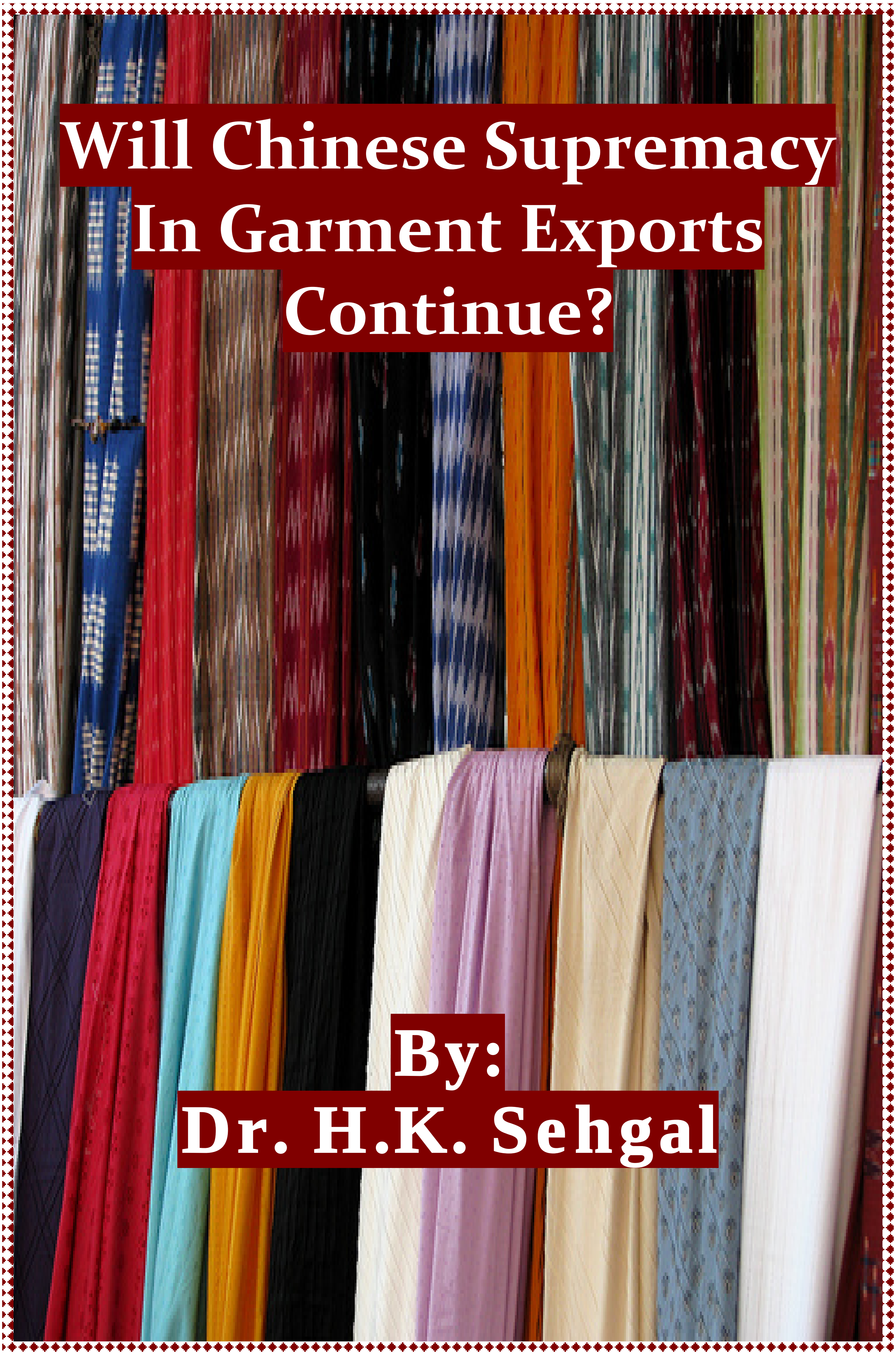

Will Chinese Supremacy In Garment Exports Continue?

By:
Dr. H.K. Sehgal

Will Chinese Supremacy In Garment Exports Continue?

By: Dr. H.K. Sehgal

According to recent information, put out by China's Ministry of Commerce, the profit margins in the export sector (for all industries) in China fell to 1.44% in February 2011 from 1.47% in 2010. In Guangdong, the major southern industries province, local media has reported that the profit margins in some clothing exporting companies are as low as 2%. There have been a number of problems that the Chinese garment exporters have been facing for quite some time. The major problems confronting the Chinese exporters are appreciation of Yuan, high and volatile material costs and soaring labour costs. These accretions in costs have outpaced the subsidy that the Chinese Government has been offering from time to time. And the competition for pie in the world garment export trade is become fiercer by the day. Will China, which has been the world leader in garment export, be able to maintain in supremacy in the global garment trade?

A recent Chinese report speaks of "the clothing factories of Shenzhen have been hit by a "perfect storm", battered by rising labour costs, unstable prices for raw materials, currency appreciation and dipping demand. By year's end, more than half of the once bustling businesses could be shuttered." The report goes on to add that "One by one, the garment factories of Shenzhen are shutting down. Industry analysts say that by Christmas, 60% will be gone. A business that was once worth 150 billion RMB (23 billion dollars) per year has been battered on all sides: rising costs of labor and raw materials, an appreciating currency, inflation, and a slump in demand."

"Wang, an exporter in Shenzhen, who used to receive massive orders to supply brand-name retailers, invited me onto his empty factory floor. He said the greatest difficulty the business faces is the continuing appreciation of the Chinese currency, RMB, which intimidates factories from taking orders. He now accepts only urgent and short-term contracts. Wang pointed to the hundreds of automatic sewing machines sitting idle, noting that his garment production capacity used to be hundreds of thousands of pieces annually. Since January this year, production volume has not even reached 5,000 pieces. The factories used to hire thousands of workers. Now they employ just a few dozen. And even with these workers, the factory is only in operation for less than 10 days a month. Wang told me that if the situation does not improve, his factory will eventually collapse altogether. For now, he is one of the luckier ones, able to maintain a skeletal operation; large numbers of smaller enterprises are already doomed no matter what happens.

Another factory boss, Liu Quande, confirmed the predicament of the business. He said that, since last year, the zone's once prosperous industry has been reduced to sporadic operations for a few surviving factories. Liu says that in addition currency woes and growing labour costs, there is also the problem of sharp price fluctuations for raw materials. Last year, the price of cotton shot up from 20,000 RMB per ton to 30,000 RMB per ton. Many garment factories then opted for synthetic fabrics to reduce costs. But the inferior garment quality was thought to be responsible for sluggish sales. Others hoarded cotton stock, but then the price of cotton dropped so much these businessmen went broke.

Liu says the Chinese garment industry is at a crucial point, and he is not particularly optimistic. The small enterprises are badly positioned in a competitive global environment, while the bigger ones will be difficult to restructure. He reckons that maybe 10% to 20% have a chance to survive. The secretary-general of the Apparel Industry of Shenzhen, Shen Yongfang, said the region's garment export industry used to sell more than 100 billion dollars worth of goods per year. Now, at the best, it can generate just a few billion. Shen said that most of the entrepreneurs are eager to rebuild their businesses, except they don't know how.

Let us have a closer look at the situation on the ground.

Appreciation of Yuan

Though the American and Europeans are not at all happy with the slow rate of appreciation of Yuan, the fact of the matter is that Yuan has actually appreciated though it may not be at the satisfaction level of the Americans and the Europeans. Officially, the Yuan moved to a managed floating exchange rate based on market forces with reference to a basket of currencies dominated by four currencies: the U.S. dollar, the Euro, the Yen and the South Korean won. Despite the managed float, the Yuan's trajectory from 2005 to 2008 was one of a gradual but stable appreciation vis-à-vis the U.S. dollar. The Yuan appreciated twenty-one percent compared to the U.S. dollar in this time period but was then pegged again at a more or less fixed rate to the U.S. dollar in July 2008. RMB/CNY Exchange rate on 13 July 2010 was CNY6.7802 to a US dollar.

Liu Yuhui, a researcher with the Financial Research Center of the Chinese Academy of Social Sciences (CASS), said the U.S. dollar depreciated almost 10 percent in the past year, but the Yuan strengthened only 5 percent against it, and actually weakened against other strong currencies in the past year.

According to most of the Chinese garment exporters, the rising Yuan is the top reason for declining profits. Says Lin Yan, Sales Manager with Hangzhou Light Industrial Products, Arts & Crafts, Textiles Import and Export Co., "We have used different financial tools like forward rate agreement and dollar loans to minimize our loss caused by the currency appreciation, but we still have to raise prices by at least 5%, which is high enough to turn away new clients", adding that old clients are somewhat more willing to share the cost.

Yuan appreciation is like is a double edged sword. "Any degree of further appreciation of Yuan is likely to make exporters bankrupt, which is unaffordable." Department of Commerce Deputy Long Zhong Allard says, "If the water is heated to 99 degree and is not boiling; but if it continues to rise 1 degree, the water will boil." This shows that China's textile and garment exporters face the fragile situation.

Tan Yaling, an analyst with China Forex Investment Research Institute, warned of the Yuan's depreciation. Yuan exchange rate reforms have been moving in a single direction in the past seven years-appreciation-which is against market rules, Tan said. China abandoned a decade-old peg to the U.S. dollar by allowing its currency to fluctuate against a basket of currencies on July 21, 2005. The reforms were suspended in a bid to fight the global downturn in 2008. The Yuan exchange rate again was pegged to the dollar at a ratio around 6.83 from September 2008.

Volatile and High Cost of Materials

Another major contributor for the sharp fall in profits of Chinese garment exporters is the rising and volatile cost of materials. Says Luo Weiming, President of Shanghai Dragon business Textile, which makes jackets and coats for clients in Europe and the US, "Down, for example, is now priced at CNY 300 (US$46.2 per) per kilogram almost tripled from

2009". In so far cotton is concerned, even a recent price fall of 30% to CNY 25,410 (US$3,918) per ton from CNY 34,800 (US$ 5,367.9) in February has not helped much.

Textile raw material costs more this year over the previous year by about 30%, of which the cost of raw materials such as cotton or up to more than double the increase of the big hit 15 years high. However, raw material prices are not an end. Cotton and other raw materials price surge is the result of superposition of many factors. First, the world's cotton acreage and production in the shrinking year by year, resulting in tight supply and demand. Second, the U.S. excess liquidity pushed up cotton and other commodities futures. In addition, although the textile manufacturing industry is the first of China's market, the largest production capacity of the industry, but the factors like the flow of cotton, chemical fiber raw materials are keeping the costs of raw materials components still high.

Soaring Labour Costs

However, the real piece of villain is the soaring labour cost alongside shortage of labour. Labour costs have indeed shot up. For example, wages for sewing a down jacket have risen to CNY 45 (US$ 6.9) from CNY 28 (US$4.3). Luo Weiming says "But we cannot just raise our prices accordingly, because we do not want to scare away our clients." He explains that the company now only earns US$ 1 per down jacket from US$ 3 two years ago. Even with this reduced level of profit, Luo cannot please his price-conscious foreign clients, who threaten to transfer orders to low-cost countries like Vietnam and Bangladesh. Luo has thoughtfully considered the options for reducing the wage bills. One way could be shifting to interior areas like Anhul province, where the average wage in about CNY 1800 (US$ 277.7) compared to CNY 3000 (US$ 462.7) in coastal cities. But then again, the cost of transport from the hinterland to coastal areas for shipping in terms of time and money and costs, it may not fulfill the objective of reducing the unit price of his products for his foreign clients.

The continuing rise in cost of labour has been predicted by Boston Consulting Group (BCG), who went as far as stating, "We expect net labour costs for manufacturing in China and the US to converge". While the claim is being made by BCG may look like going a bit too far, but the fact remains that substantial increase in wages of Chinese workers is entirely in consonance with the Chinese Government policy. Leaked extracts from its next Five Year Plan, as available in public domain, predict that "wages will rise at least 80%" by 2015. Working backwards, the estimate of Chinese Government works out to some 20% every year.

However, BCG appears to be quite right to emphasize that higher labour costs in China are not an uncomfortable side-effect of China's recently economic growth; these are in fact absolutely central to the Chinese policy. This is natural because the Chinese communist Party believes that only under its constant control, can China escape the centuries of disorder and that constantly increasing wages are essential to ensure political stability and the Party's survival in power.

Chinese Advantage

Having discussed some of the disadvantages of Chinese garment export scenario, we may as well turn our attention to the advantages that China enjoys; more important among them being: reliability and quality, potential for increase of productivity and the Chinese Government's ever-ready assistance to support the garment exports.

Reliability and Quality

It is well known that cost is not the only basis on which the orders for exports are based. The sturdy infrastructure, the long tested and proven capacity to faithfully adhere to the quality standards and uncompromising fulfillment of delivery dates are all important factors. True, there are some other countries say, like Bangladesh which has lower wage rates, but the faith of the international buyers in their capacity to delivery on time has not been fully justified. It is not that Bangladeshi exporters are not keen to stick to their delivery schedule, but there are hosts of factors like power shortages, endless labour disputes and transport and port infrastructure that strike to international buyers, as medieval. Notwithstanding that, Bangladesh and Vietnam are quite successful in increasing their share of world garment export trade, yet the fact remains that these countries are far from perfect for making garments quickly and efficiently. The international buyers have always reckoned China primary because of its superior efficiency and reliability, which enables them to get even a small premium for that over others in the matter of prices.

Increase in Productivity

Now one way of Chinese retaining their supremacy is to significantly improve productivity. One must acknowledge that productivity, and not the cash cost of labour, makes a business competitive. China is known not to have the lowest wages in the world garment industry. Indeed, during the five years since 2005 during which it had become the world's largest exporter, wages have got more, rather than less, expensive compared to the rivals like Bangladesh.

In fact, key to continuing dominance by China rests on constant productivity improvements. This is one area where the Chinese people have constantly worked hard. This would be evident from the fact that between 2003 and 2010, the number of workers in Chinese apparel manufacturing rose 69%, while their output grew four-fold in value and if one were to work on the basis of prices, the increase was even five-fold. It is well known that by 2015, China National Textile and Apparel Council plans to double apparel production-again with virtually no increase in the industry's workforce. Increased productivity, it says, is going to be the sector's main priority.

I would like our readers to ponder that given that the output per worker grew two and a half times in the past seven years when productivity was not that high a priority, what results one can expect from a five-year hot and sole pursuit of productivity as a major policy thrust?

State Aid

This is an acknowledged fact that the Chinese Government has all along been highly supportive of all exports and it is even more pronounced in case of textiles and garment exports. This has been best brought out by National Council for Textile Organisation (NCTO) claims that the Chinese Government employs numerous illegal and unfair trade practices to ensure that Chinese exporters can under-price their worldwide competition in textiles and apparel. Anti-competitive actions by China's Government claimed by the US industry, include currency manipulation (estimated to provide up to 40% subsidy for Chinese exporters), illegal direct Government subsidies of its money losing state-owned textile and apparel sectors, illegal export tax rebates (13%) and the deliberate extension of billions of dollars in non-performing (free money) loans by China's central banks in order to award a competitive advantage against foreign competition. Cass Johnson, President of NCTO, claims an NCTO analysis concluded that Chinese prices in world markets for apparel products averaged 58 percent below the prices offered by other countries, including low priced suppliers as Bangladesh, India and Pakistan. NCTO has claimed that the Chinese Government has allegedly provided some US$10 billion in export subsidies to its textile sector by increasing value-added tax rebate rates provided to textile and apparel exports from 11 percent to 16 percent. NCTO claims that China continues to provide massive subsidies to domestic textile and apparel manufacturers in the form of research and technology grants, bank lending programmes, tax exemptions and preferential tax programmes, in addition to the already mentioned VAT rebates for exports. China's subsidy structure also remains opaque and is plagued by a lack of transparency, which makes it difficult to determine the subsidies that are actually being provided to domestic producers.

What has been the actual extent of subsidization by Chinese Government to their textile and garment export sector is difficult to be precisely determined and defined, primarily because of opaque system that the Chinese Government has enforced, yet one is inclined to agree that NCTO has come out with valid points, even one might differ with those estimate in terms of degree.

China emerging as one of the Super Economic Powers, wielding vast economic clout to defy world opinion apart from willful defiance of terms and conditions it had agreed to, while accession to WTO, is likely to continue with all that heavy subsidization, which would come to timely aid of their textile and garment exporters. This does ensure that the commanding heights that China has reached by being largest exporter of textiles and garments in the world is not likely to be disturbed and its supremacy unchallenged.

However, China will need to make a serious note of some of new phenomena that is emerging like slump in world demand due to economic turmoil in European Union, fast changing fashion habits of the world consumer, who want more niche products; thereby rendering the Chinese superiority of mass production out of tune of the times now and ahead.

The views presented here are that of the author