US Downgrade Adds to Challenges for Chinese Garment Exporters

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There was a bloodbath in the financial markets all over the world, when Standard and Poors announced the downgrade of US from AAA to AA+. Though it was well known that US President was fighting a running battle for authorization for securing more loans to bail out the US economy, which was inching towards sovereign default, but it would actually come to the stage of downgrade was something which many institutions and countries did not believe.

China claims it had indeed anticipated that the US economy would stand downgraded quite sometime back, but it is only now that it has been recognized and announced. It was apparent for some time that the US economy was heading towards the dumps, and the world fretted about it. Three days before the S&P downgrade, China's largest state-approved rating agency Dagong had slashed US credit rating from A+ to A-, citing the deteriorating debt repayment capability. Last November, Dagong had downgraded the US after the Federal Reserve decided to continue its ultra-loose monetary policy.

Chinese state media have savaged the United States over what they call its "addiction to debt," in a series of unusually critical articles. An analyst writing in one newspaper went so far as to compare US debt to a "Ponzi scheme", in the wake of an unprecedented US downgrade.

The head of China's largest domestic rating agency said that although the U.S. Congress has approved a resolution to raise the U.S. Government's debt ceiling, it does not mean the end of its sovereign debt crisis. The lifted debt ceiling indicates that the U.S. Government is legally allowed to continue operating by taking on new debts to repay the old ones, allowing it to temporarily avoid default, Guan Jianzhong, Chairman of the Dagong Global Credit Rating Company, said.

I agree that the US President has wrested the raise in US Government debt ceiling; however, this does not mean that the U.S.'s actual solvency has improved, as its sovereign debt crisis still lingers. It will only be a matter of time for the sovereign debt crisis to break out, unless the U.S. introduces drastic economic and social reforms, said Guan, adding that "we should not be optimistic about it." Guan said the excessive debt of the United States is tightly connected with its credit rating. "The United States transformed from a creditor country to a debtor country in 1985, then to a net debtor country with a larger scale of debt that reduced its debt solvency," Guan said. "However, rating agencies can never disclose changes in credit risks in time. Incorrect ratings contribute to the inflow of global capital to America, which is conducive to debt growth," he added.

Zhau Baoliang, Chief Economist at the State Information Centre, a top Government think tank said, "Once the alarm of debt default is removed, China will not suffer an immediate effect. However, the effect from the United States will eventually be seen in the long term." He said that the $1 trillion reduction of the US fiscal deficit over the next 10 years wouldn't be enough; so the debt crisis, though narrowly averted this time, might be repeated. The US debt is too large to be resolved through normal measures such as tax increases and deficit reductions, while effective choices such as reducing entitlements and withdrawing overseas troops are impracticable, considering the US political landscape, Zhu said.

I can quite see that China is indeed worried about challenges implicit and explicit in the US downgrade. "The United States should hold down government debt, said China's Trade Minister Chen Deming, while addressing the meeting of Southeast Asian trade ministers. He called on the United States, China's top trading partner, to act responsibly and get their fiscal houses in order. "We support stabilising measures taken by the US, but we hope they will take measures to control their government debt proportion and take bigger responsibilities," Chen said. His remarks echo recent comments from Beijing, which has invested much of its $1.2 trillion foreign exchange reserves, the world's largest, in dollars and would loathe to see the US dollar plummet on economic problems.

Stronger Yuan and its implications

Lu Zhengwei, Chief Economist with Industrial Bank Co Ltd, said a major effect China will have to face is a possible third round of quantitative easing, which will be a certain choice if the performance of the US economy remains poor in the second half. "If the unemployment rate continues to rise, it will further damage investor confidence and force them to move away from US Treasury securities, leaving the US Government no choice but to print money and depreciate its currency," Lu said.

According to Chen Kexin, Chief Analyst at the Distribution Productivity Promotion Center of China Commerce, no matter how the US debt crisis is resolved, it will push up commodity prices and increase China's imported inflation. An agreement to raise the debt ceiling helps avoid a sudden collapse of US economy but does not get to the root of the problem. With the huge debt remaining, dollar depreciation will occur in the long term, Chen said.

This, in my view would, lead inevitably to appreciation of Yuan, which has serious implications for China. In the **first** instance, Chinese goods would become costlier for Americans to the extent that the US dollar depreciates which can impact adversely the import of Chinese goods, which have all along (and at present) enjoying the price edge over others leading to massive US imports of Chinese goods in the US and elsewhere. This position would change drastically. As the US is a major export destination for Chinese goods, the consequences of depreciation of US dollar or appreciation of Yuan are expected to be substantial. China should be mentally prepared for meeting that kind of eventually.

Second, the real value of huge reserves of US securities, built up by China over the years-and it is a huge, huge amount-would stand depleted to the extent of depreciation of US dollar, as the same set of securities would carry the same face value of the US dollar, which has now depreciated. Personally, I do not foresee any possibility, at least in a near future, of a stable US dollar. In fact, for quite some time, the doubts have been raised about the universal acceptance of US dollar as the international reserve currency and some nations including India; have been shifting their reserves from the US dollar or to even Euro, which, of late, too, has fallen from the high pedestal of reliability as international reserve currency-and now to gold.

Third, it is very likely that that investors all over the globe would now have to tendency to move away from the US treasury market to commodities, whose prices would certain go up. In fact, this tendency can be seen even today. Look at the prices of gold, which has reached the record level of $ 1894.80 an ounce. And this is not all. Gold for immediate delivery may reach $ 2000 an ounce by the year-end, say experts. Then, there is the case of crude oil, which too can attract investors, who can move away from US treasury bills.

Four, the US demand for Chinese products are likely to decline. The US economy, which is a major Chinese export destination, has still not got over the ill-effect of last recession. According to newly revised data from the US Commerce Department, the economy is smaller today than it was when the recession began, despite (or rather, because of) the feeble growth in the last couple of years. Adjusted for inflation, personal income is down 4 percent, not counting payments from the government for things like unemployment benefits. Income levels are low, and moving in the wrong direction: private wage and salary income actually fell in June, the last month for which data was available. Consumer spending, along with housing, usually drives a recovery. But with incomes so weak, spending is only barely where it was when the recession began. The decline in demand for Chinese goods in the US could as well adversely affect the Chinese imports into US.

Five, a weak US dollar is likely to fuel inflation in China. Though US Administration has secured necessary approval for raising loan limits, but this would not be able to remove concerns over a weaker dollar, which will increase imported inflation in China in the long term. According to Chen Kexin, Chief Analyst at the Distribution Productivity Promotion Center of China Commerce, no matter how the US debt crisis is resolved, it will push up commodity prices and increase China's imported inflation. An agreement to raise the debt ceiling helps avoid a sudden collapse of US economy but does not get to the root of the problem. With the huge debt remaining, dollar depreciation will occur in the long term, Chen said. "But the US government will try to bring the tempo and speed of the depreciation well under control," added Chen.

US Downgrade to help China on acquisitions in US?

While there are a number of adverse effects of US downgrade, as referred to above, but one advantage that China can usefully leverage to its advantage is larger number of Chinese acquisitions of US industry, since with appreciated value of Yuan, it can buy (or acquire) more in the US or elsewhere with the same amount of Yuan. This is certainly an advantage that appreciation of Yuan vis-à-vis US dollar would confer on China. But this is a poor compensation particularly in view of the fact that the US economy itself is unsure of the way, it would move.

China's Lack of Options

While China launched a barrage of criticism at the United States over the debt crisis and its Central bank said it would diversify its foreign currency investments, warning of "large fluctuations and uncertainty in the US Treasury bond market," even as it welcomed a deal to raise the US debt ceiling but analysts say the world's largest foreign holder of US debt has no choice but to maintain its Treasury holdings.

But despite the rhetoric, analysts said shifting out of the US dollar can only be a long-term aspiration, with Beijing's hands tied for several reasons in the short run. China has the world's largest foreign exchange reserves at more than $3 trillion, and experts said it would be difficult for it to find alternative investment options able to absorb such volume. With around $1.2 trillion in US Treasuries, Beijing also cannot conduct large-scale selling of dollar assets without diminishing the value of its remaining holdings, they said.

"Any significant selling by China of US dollar assets would be noticed by global markets and could spark panic selling of dollar reserves on a grand scale," Ma Jun, Hong Kong-based economist with Deutsche Bank, said. With sovereign debt worries in European countries such as Italy and Spain threatening the entire eurozone, investment in US debt might still be attractive, said Liu Hongke, Economist at CCB International Securities.

With sovereign debt worries in European countries such as Italy and Spain threatening the entire eurozone, investment in US debt might still be attractive, said Liu Hongke, Economist at CCB International Securities. "It is very difficult to cut the holdings of US Treasuries. With such huge foreign exchange reserves, if you don't invest in US debt, it is hardly possible to diversify them," Liu said and added "Despite the downgrade (in the US credit rating); the United States is still safer than Europe.

US officials have also made the case that despite the downgrade and a political showdown that drove the United States to the edge of default, the country remains one of the world's safest investments. Michael Pettis, senior associate at the Carnegie Endowment for International Peace, saw little change in China's appetite for US Treasuries, since that would require a change in long-standing economic policy.

"They simply cannot stop and if they do, they will be doing what the US government has been trying to get them to do for several years," said Pettis, who is also professor of finance at Peking University.

Fuelling Domestic problems for Chinese garment exporters

China, like any other countries, has its own set of domestic problems that are assuming larger proportions and the US downgrade would only add fuel to them. While the implications of US downgrade has a much wider implications than our limited area of relating it to the Chinese garment export trade, I need to restrict myself to the following points.

High inflation

China's inflation rate hit a three-year high in July, posing challenges to policymakers amid turmoil in the global financial markets. Inflation reached 3-yr high at 6.5%. The consumer price index (CPI), a key gauge of inflation, rose 6.5 percent in July year-on-year, driven mainly by soaring food prices which climbed 14.8 percent from a year earlier, the National Bureau of Statistics (NBS) said. Analysts said that the higher-than-expected inflation figure poses serious challenges to policymakers as escalating global financial turmoil complicates efforts to tackle domestic inflation.

Economists forecast that the CPI will stay above 6 percent in the third quarter. "This means that inflation, instead of an economic slowdown, remains the major risk," Qu Hongbin, Chief Economist for China and co-head of Asian economic research at HSBC, said. The US may be poised to launch a third round of quantitative easing in an attempt to stimulate the economy. Two previous rounds lifted commodity prices, saw a surge of speculative capital inflow into China and increased inflationary pressure.

Other Major Problems

Other major problems, particularly those confronting Chinese textiles and garment exports, have been discussed in great detail in my article published as the Cover Story on Chinese Supremacy in Garment Exports in August issue of The Stitch Times. I would briefly mention important factors for the benefit of our readers.

Appreciation of Yuan

The Yuan appreciated 21% compared to the U.S. dollar at one point of time. RMB/CNY Exchange rate on 13 July 2010 was CNY6.7802 to a US dollar. 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."

Yuan exchange rate reforms have been moving in a single direction in the past seven years –appreciation-which is against market rules. 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. Any appreciation of Yuan is not to the liking of China, which has been resisting it, despite the world opinion being in favour of it.

Volatile and High Cost of Materials

Another major contributor for the sharp fall in profits of Chinese garment exporters has been the rising and volatile cost of materials. Says Luo Weiming, President of Shanghai Dragonbusiness 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%, which has blunted the price edge that Chinese garments had had over others.

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. 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" even if many people do not subscribe to this statement.

No Risk of "Double-Dip" for Chinese Economy

A Chinese official has claimed that the Chinese economy faces no risk of "double-dip" nor big fluctuations and that the Government is capable and confident of keeping steady and relatively fast growth in the long run. According to Li Pumin, spokesperson with National Development and Reform Commission (NDRC) said that China's potential growth rate will remain at a high level in the future on the back of the deepening process of industrialization and urbanization, as well as accelerated economic restructuring, which will release huge domestic demand.

Li, however, admitted that the country does face many challenges such as the weakening global economic recovery and unbalanced, uncoordinated and unsustainable domestic development. Many new problems emerging in the first half this year have complicated the macro-regulation.

My View

Chinese exposure of investment of around $ 1.2 trillion in US Treasury is the biggest one for any country. This decision must have been taken by the Chinese Government after taking into account all factors, though their placement of such enormous faith in the US currency was a clear case of over-reach even in the best of times. Any depreciation of US dollar, which is inevitable sooner or later-or rather sooner than later-would certainly impair the Chinese interests as discussed in details above. As we discover, the world economic order is not as stable now, as it used to be, but any wise Government would have calculated the risk involved in any economic decision of such critical importance. This, to my mind, is the most serious, even though least expected, infliction to China on financial ground.

In so far as Chinese garment exports are concerned, there were already a number of problems, as was discussed in the last issue of The Stitch Times. This new unexpected phenomenon has certainly added new dimension and gravity to not-a-very-happy position, in which China stands today, exacerbating and accelerating a slow, but sure decline in forecast of its role in the world garment trade.

Here 'I' refers to the author of the article