China's Unfair Advantage

How China's Artificial Credit Rating Hurts U.S. Manufacturers – Improper Sovereign Benchmark Gives Chinese Companies Cheap Access to Foreign Capital

TUCSON, Ariz., July 25 -- It's not just low wages that gives China a major competitive advantage over U.S. manufacturing companies. U.S. manufacturers are also hurt by the assignment of an improper and artificial investment-grade sovereign credit rating to the government of China, which enables Chinese companies to raise foreign capital for expansion of operations more cheaply than would be the case if the Chinese government's credit rating reflected the existence of China's defaulted sovereign debt. According to a 2002 report issued by the U.S.-China Commission, Chinese corporations raised an estimated $20 billion over the past decade from international bond offerings denominated in U.S. dollars, including approximately $9.7 billion from U.S. markets. In an aggressive bid to set the stage for a fresh round of debt issuance by Chinese corporations and secure additional ratings business, Standard & Poor's Rating Service last week raised China's sovereign credit rating from "BBB+" to "A-."

Sovereign Advisers, a private financial research and investment analysis firm, recently filed a complaint with the U.S. Securities and Exchange Commission Division of Market Regulation and the Committee of European Securities Regulators, pertaining to the inappropriate and misleading sovereign credit ratings assigned to the People's Republic of China (http://www.globalsecuritieswatch.org/SEC.pdf). The complaint, predicated upon the existence of defaulted full faith and credit sovereign obligations of the Chinese government, was filed on behalf of U.S. bondholders and has begun to draw the attention of the U.S. Congress. The Chairman of the Congressional Joint Economic Committee has rightfully demanded that the SEC open an investigation into this very serious matter, which also has broad implications with respect to both CNOOC's financing of its unsolicited takeover bid for Unocal as well as to U.S. manufacturing companies facing competition from Chinese companies.

In commenting on the complaint and the prospect of an SEC investigation into the matter, Mr. Christopher Mahoney, Executive Vice President of Moody's Investors Service, was recently quoted as stating that a country's past default "does not preclude ... a high rating today." Mr. Mahoney's statement presupposes that the past default was cured through discharge or settlement of the debt. Such is not the case in the instance described in the complaint, wherein the defaulted debt was settled in the U.K. but neither settled nor discharged in the U.S., where it has been left outstanding and continues to be evaded by the government of China. According to Mr. John Petty, president of the Foreign Bondholders Protective Council, "Mr. Mahoney selectively disregards this discrimination against U.S. citizens. This kind of behavior by Moody's and S&P- ignoring an issuer's defaulted obligations when assigning a credit rating-hurts Americans who have been discriminated against in foreign government bond defaults."

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The "nationally recognized statistical rating organization" status enjoyed by Fitch Ratings, Moody's and Standard & Poor's entails a very high degree of responsibility to the investing public. Unfortunately, such diligence is not evident in their respective China sovereign credit ratings. Statements such as those offered by Mr. Mahoney, which dismiss an obvious fact, do nothing to enhance the overall credibility of the rating agencies. This aspect is described in detail in a letter prepared by Sovereign Advisers and delivered to Mr. David M. Walker, Comptroller General of the United States (http://www.globalsecuritieswatch.org/GAO_LETTER.pdf).

China's "Willingness to Pay" Ignored in Setting Benchmark Rating

China possesses a reported $691 billion in foreign exchange reserves, yet continues to shamefully evade payment of its defaulted sovereign debt in violation of international law. Such behavior is blatantly inconsistent with the "willingness to pay" metric implied in an investment-grade rating. As Richard Brookhiser stated in his recent article on Alexander Hamilton, entitled "Alexander the Great" (Wall Street Journal, June 30th), "Mr. Hamilton knew that if the United States started picking and choosing among its creditors, its credit would go back into the outhouse." This same standard need not apply to the government of the People's Republic of China so long as the three major rating agencies continue to aid and abet China's evasion of payment on its defaulted sovereign debt through artificially inflated credit ratings.

China's Defaulted Sovereign Debt: Selective Default vs. Investment Grade

All ratings agencies agree that a debtor is in default when it either misses a payment beyond a grace period or seeks to renegotiate the loan – anything, says S&P's Marie Cavanaugh, that is not "timely service of debt according to the terms of issue." In fact, S&P's own "Selective Default" classification states "An obligor rated "SD" (Selective Default) has failed to pay one or more of its financial obligations (rated or unrated) when it came due. An "SD" rating is assigned when Standard & Poor's believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner." Unfortunately, S&P selectively ignores that fact that a prime example of selective default is the Chinese government's refusal to honor the series of full faith and credit sovereign obligations issued as the Chinese Government Five Per Cent Reorganization Gold Loan, scheduled to mature in 1960 and which remains in default under international law as a payment obligation of the People's Republic of China as the successor government. Failure to assign a "Selective Default" rating to the Chinese government represents a violation of S&P's own internal policy. Commenting on last week's upgrade, Sovereign Advisers president Kevin O'Brien stated "an investment-grade sovereign rating is not warranted for China, given the existence of defaulted sovereign debt of the Chinese government. Last week's upgrade by S&P is a transparent attempt to protect its China ratings franchise in the face of anticipated competition resulting from new legislation (H.R. 2990) introduced by Representative Mark Fitzpatrick (R-PA) which will open up the credit rating industry to new entrants."

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The assignment of the proper rating classification for sovereign debt of the Chinese government (i.e., "Selective Default") would effectively function to prevent bond-financed takeovers of U.S. corporations by Chinese state-owned enterprises, since a "default" rating of the Chinese sovereign benchmark (which generally acts as the international credit rating ceiling for all Chinese corporations) would no longer permit Chinese corporations to access international debt financing at an artificially-subsidized cost until such time as the sovereign default is cured. Such a ratings adjustment to reflect the existence of defaulted obligations of the Chinese government would help to level the playing field for American businesses in competition with Chinese manufacturers, which enjoy cheap access to capital as a result of the Chinese government's investment-grade sovereign rating.

Congress Takes Action on China's Defaulted Sovereign Debt

The U.S. Congress is finally taking action to remedy this inequity. In addition to Rep. Fitzpatrick's legislation, the chairmen of both the Joint Economic Committee and the House Appropriations Committee, along with influential members of several other key Congressional committees have written to the SEC calling for the agency to investigate the conduct of the credit rating agencies in setting the sovereign credit rating for China (http://www.globalsecuritieswatch.org/congress.html). Congress is also poised to take further action pending introduction of anticipated legislation intended to halt the issuance of new Chinese government securities in the U.S. capital markets until the Chinese government cures its defaulted sovereign debt.

As holders of full faith and credit sovereign obligations of the government of China, U.S. bondholders continue to suffer from both selective default and a discriminatory settlement (i.e., the 1987 settlement with British bondholders which excluded U.S. citizens). There is no excuse for the major international credit rating agencies to continue to pretend otherwise. China's credit ratings should reflect evasion of payment on the country's defaulted sovereign debt. It is unfortunate that the prospect of losing a significant share of the Asian corporate ratings business would sway S&P, Moody's and Fitch Ratings to assign an investment-grade rating to a government in default. It is also interesting to note that Goldman Sachs and JP Morgan, which have pledged $3 billion in bridge financing for CNOOC's takeover bid, would find it difficult to sell bonds to investors if China's credit rating reflected the existence of defaulted sovereign debt. In a similar vein, perhaps the Chinese government should cure its defaulted debt before allowing its state-owned enterprises to launch takeover attempts on U.S. companies.

References

Reference to Mr. Christopher Mahoney's quote:
http://www.globalsecuritieswatch.org/press.html

Reference to the Joint Economic Committee:
http://www.globalsecuritieswatch.org/chairman_saxton_demand_for_investigation.pdf