

# Jesa Investment & Management Co. Ltd.

## NEWSLETTER

November 2008



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## NEWS FROM JESA !

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Starting from this Newsletter, I will write every month a short note about different topics and answering to the many questions that we receive from all of you. We would like also to thank all of you for the support and suggestions about new topics that you would like we develop in our monthly Newsletter.

On October 26<sup>th</sup>, Jesa moved its offices in a new location, inside the "Former French Concession", in the heart of Shanghai.

Our location is a famous Shanghai Villa built in 1947, about 1000 m<sup>2</sup> ready to continue to support and follow our Customers and Partners in their projects in China.

In this difficult moment of global economy, we do believe that we are entering in a new phase, where industry and real market will overtake the fake economy and the virtual economy. Despite the slow down of the markets, China is driving at more than 9% of the GDP, and this thanks also to the internal market. This is an important factor that everybody has to take into consideration; China has a growing internal market that sustains the development and the local industry.

More than 600.000 foreign enterprises are in China (less than 2.000 are Italian, including representative offices) and most of them are now getting advantage of the Chinese market.

Jesa has always believed that China is not only a low cost production base, but also an interesting market.

Jesa is currently expanding its services providing HR audit, investment analysis and accounting and professional tax advisor services in China.

## Impact of China's 2008 Labor Contract Law

In October 2007, JESA wrote an article on the upcoming new employment contract law (later officially named Labor Contract Law and hereafter called "LCL") in China. It has now been almost ten months since the implementation of this 98 article long groundbreaking law – enough time to preliminarily assess its impact.



Picture by Edward Burtynsky

### Excerpt of components of the LCL

#### Commencement of employment

- | Employer must enter into a *labor contract* within one month of employment. If, after one month a contract is still not signed, the employer must pay double salary for every non-contracted month. Exceeding of the one year limit in addition results in automatic permanent employment.
- | Maximum *probationary period* for contracts lasting one to three years has been reduced from three to two months.

#### Continuance of employment

- | From having no obligation regarding *renewal of a fixed-term contract*, an employer must now pay severance to the employee if he fails to renew the contract after expiration.
- | *Permanent employment* is no longer reached after 10 years of continuous employment, but rather after two fixed-term contracts. The same terms must apply, or the employer will have to pay severance.
- | *Social insurance* must be paid by the employer.

- | *Company rules and regulations* are not binding unless negotiated and agreed by the labour union (or if there is no labor union, by employee representatives), and clearly communicated..

#### Termination of employment

- | The employer must notify and, in reality, get approval from the labor union in case of *termination* of an employee. In essence the company needs to argue bankruptcy, operational difficulties or prove employee incompetence.
- | Employees can *leave the firm* with only 30 days' notice.
- | Maximum *non-compete period* is reduced from three to two years, and compensation must be paid monthly after termination.
- | Employees may now *sue their employers* directly, without the aid of the state

#### Perspective and opinions on the new labor law

In almost every other area, Chinese law has adjusted in order to reflect the speed and breadth of economic change in the country. Concerning labor rights and obligations however, no legislative alterations have been made since China's first codified labor law, effective in 1995. Opinions on the 2008 law are many. Some believe the LCL is going too far as the dynamic and fast-changing economy of China requires flexibility of the businesses. Others argue that China should have acted tougher on the labor issue years, or even decades, ago. Nevertheless, since the LCL became effective on 1<sup>st</sup> January 2008 it has had major factual impact on employers as well as employees in China

#### Employee power has increased significantly...

Fundamentally, the employer-employee power balance has clearly shifted in the employee's favor. The enhanced clarity that the LCL represents has also made employees less dependant on state aid in resolving employment disputes. Chinese workers have evidently become

aware of these new rights as the number of labor disputes, since last year only, have increased by 106% in Beijing's Chaoyang District People's Court, 231% in Nanjing's Qinhuai District People's Court, 126% in Shenzhen, 132% in Dongguan and 92% in Guangzhou. As always there is a second side to the coin. The LCL for instance leaves part-time employment rather untouched, which may influence the ability to attain full-time contracts.

#### ...whilst impact on companies is ambiguous

For the corporations active in China, most feel an impact of the LCL in terms of changed business routines including written contracts, policy manuals etc. Profitability related impact on the employer however depends on the characteristics of the company.

Most *state-owned enterprises* and *large foreign firms* already provide good worker protection and benefits, and the law hence has limited impact here. In fact, companies that already at the time of the LCL enforcement met or exceeded the requirements are now in a better competitive situation as less employee-friendly competitors are now spending new money to meet the LCL standards.

Some *smaller foreign labor-intensive companies* are however reported to have gone out of business due to increased labor costs (which LCL is only partly liable for though), or have left China for other countries less protective of their workers. It has nonetheless been argued that many of these companies were not very profitable to begin with. Also, few of these companies have been based in either North America or Western Europe; but rather been low level manufacturers from Hong Kong, Taiwan or South Korea.

#### "China Plus One" vs. "Status Quo" prevails

The LCL and other elements slowly increase the cost of, or impose constraints on, production in China. Therefore maintaining current operations in China, but in addition expanding into the neighborhood - having a "China Plus One Strategy" - has become popular with some

profitable Western companies. Most companies however simply remain in China as the country is still better equipped than most neighbors when it comes to manufacturing all but the least sophisticated products. In fact, foreign direct investment (FDI) in China continues to increase, also since the enactment of the LCL: during the first eight months of this year China attracted US\$67.73 in actual FDI, up 41.6% from same period of the previous year. A very recent Ernst & Young survey also showed that 44% of world business leaders still consider China to be the best destination for FDI.

## Rising wages are changing the game in China

After years of being one of the cheapest and least regulated labor markets in the world, China's main competitive advantage is slowly being challenged. Over the past couple of years, attention has been drawn to labor shortages and increasing wage demands. This despite the fact that China has about 800 million laborers - by far the world's biggest labor force and almost twice that of US, EU and Japan combined.

### Virtually everyone is included

Wages in China are undoubtedly on the rise - on all labor levels. Senior managers in China are now better paid than those working in the West, after adjustment for taxes and cost of living. But



even minimum wages are going up. In 2007, the

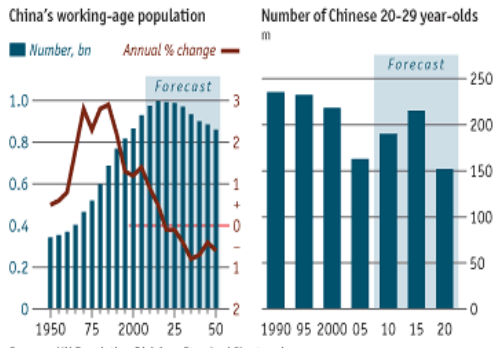
municipality of Shanghai for instance raised its minimum monthly wage to RMB 690 (US\$98). In April this year, Shanghai again increased the minimum monthly wage. This time to RMB 960 (US\$137). The minimum wage is considerably lower in most other areas of China, but also there the wages follow a steady upwards curve.

### Several reasons for the speeding wages

This increase in wages depends on several factors. The main factors, all highly interrelated, for general wages are however argued to be the evident domestic inflation, increasing world prices of commodities, domestic governmental directives concerning minimum wages as well as the actual labor supply - in general and of high-skilled labor.

- | The domestic *inflation* is rising sharply, above historical trends, and reached 8.5 percent in April 2008, up from 4.8% percent in 2007. This erodes worker purchasing power, causing workers to demand increased wages. The situation includes a paradox as the consequential wage increases also feeds inflation, when companies absorbing higher wages pass on those costs onto their customers.
- | Rising *global prices*, of food and fuel in particular, result in higher costs for all countries in the region. China is as hit as anyone and has to offset the higher prices with higher wages.
- | To react to these and other circumstances, the Chinese government has chosen to respond through the *minimum wage*. China's first minimum wage law was implemented in 1994 and has been strengthened throughout the years. Employers are now not only required to pay the minimum wage, but also to sign long-term contracts with workers, pay social security benefits and increase redundancy payments. The actual level of the minimum wage is to be set by the individual provinces, municipalities, and autonomous regions and the minimum wage therefore varies greatly throughout the country. Lately China's government has however repeatedly ordered nationwide increase of the levels.

- The main discussion around increased wages however concerns the change in *labor supply*. A seemingly unlimited supply of cheap workers has been one of the main forces behind China's rapid economic growth. The situation is however changing. The population of working age is expected to increase until 2015, but will then start to shrink as an effect of the one-child policy, introduced in 1979. In



addition, certain industries focus almost solely on young women and men aged 20 to 29, as they are thought to be more hardworking and flexible. However, the population is for the same reason ageing and the number these of workers fell from 233 million in 1990 to 165 million in 2005. Simultaneously, the migration of workers from agriculture to industry, which has been an important source of productivity gains, is projected to slow down. These circumstances imply a gap between supply and demand of labor, which would be a reason for increased wages.

- Others however, amongst them the World Bank, claim that the Chinese labor surplus will not run out for at least another decade. Experts instead refer specifically to the high level positions, and the related "war for talent" due to the gap between supply and demand of *highly-skilled labor*. Despite an increase in this segment there is still a shortage, meaning that these laborers can continue to demand higher wages. Reportedly, China today has fewer than 5,000 managers with the skills required by multinationals, and another 75,000 such positions are expected to be created over the next five years. At the same time, a political job such as governor of a province still has a higher status than running a big company. The result is

increasing wages and also high turnover of labor. The situation does not only affect this labor segment, but is also assumed to have a domino effect on lower-level wages, as these workers feel encouraged to also demand higher wages.

**China's attractiveness however remains** Regardless of the above challenges, China still possesses advantages that will ensure that the country remains competitive in the future. Chinese labor is still relatively cheap and there is considerable domestic wage variation. In addition, all countries in the Asia region are affected by increasing world prices for basic goods, and adjustments in wages follow also here. China is also unique in that its large population and abundant natural resources can offer opportunities of economies of scale that smaller countries in the region cannot. Although the majority of the population is still employed in agriculture, an increasing number are employed in more technically-skilled sectors. In 2006, 32 percent of the population was involved in the service sector and 25 percent in the industry. Highly-skilled workers constituted 6 percent of the population in 2007. The numbers are all increasing and make for a good quality base of labor. In addition, China is pursuing specific educational strategies to ensure that it can offer a highly skilled workforce in the future.

**Understanding the new game will be key** Hence, China will most certainly keep its position as one of the most attractive markets in Asia and in the world. The situation rather calls for new ways to play the game. Macro economical circumstances are difficult to influence as a corporation. Governmental policies can be hedge against via the choice of location or potential relocation of the business. In the long-term however, the most important part of the game seems to be to successfully attract and keep the talent. This is easier said than done, but is equally important for global as well as local corporations and large as well as small ones, as they are all fishing in the same small pool of talent.

For inquires and suggestions regarding this newsletter or for any other concerns, please contact us anytime at: [info@jesa.com.cn](mailto:info@jesa.com.cn)

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