

Welcome to the Oct-Nov 2007 edition of Pragma's China Newsletter, prepared by Jesa Consulting

➔ FOCUS ON: Human Resources current and future situation and how to face it



In a recent research conducted by "The Economist", 600 Chief Executives of multinational enterprises with business across Asia, consider the **shortage of qualified staff** in all sectors and industries their biggest concern, especially in

China. Consequently, some businesses are being forced to reconsider their growth perspectives.

Recent growth in many parts of Asia has been so great that it has rapidly transformed the type of skills needed by businesses. Schools and universities have been unable to keep up. Moreover, it is also to be considered that universities were closed during the Cultural Revolution. This has resulted in a lost of generation of business people between the age of 50 and 60, exactly the age group from where many China's corporate leaders should be drawn today.

Some facts can clarify the dimension of the problem. Because of the great recent growth of air transport, China will need to find an average of 2,200 new pilots a year, which means it will need more than 40,000 new pilots by 2025. In the meantime, big international airlines train only a few hundred pilots a year.

Similar problems are bedeviling the legal profession. According to the China Lawyer Association, in China there are **only 122,000 lawyers, 70,000 less than California** where the population is only 37 million (against China's 1.3 billion).

Another problem is the shortage of doctors. There are only 4,000 general practitioners in China, while 160,000 are needed. Equally severe is the shortage of nursing staff. That is the reason why the Chinese health system mainly relies on specialist hospitals and doctors, which not ever come up to expectations.

The **scarcity of accountants** is already having a regional impact. During the Communist era, which never paid heed to capitalist ideas like profits and assets, accountants did not play a role. Most of CFOs (*Chief Financial Officers*) and accounting revisers are being lured to the mainland from Hong Kong and the rest of the region. This fact has as direct consequence on the increase in salary of skilled resources.

In the next ten years, according to a study conducted by McKinsey, **75,000 business leaders will be needed in China. Currently they are only about 3,000 to 5,000.** The same study reports that, among the interviewed HR managers, only 10%, on average, were suitable for work in a foreign company. The available pool of engineering talent in China is no larger than that in Britain and, thus, it does not meet the country's needs.

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What is Jesa?



Jesa is a service company headquartered in Shanghai specialising in facilitating start-up of new

industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia).

Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 technicians following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on every single commercial and technical issue.

Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources.

Jesa is currently expanding its services to provide support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia.

We also perform HR audit and investment analysis (trouble-shot analysis) to check performances in support to companies already established in China.

Not less worrying, is the brain drain phenomenon. According to the Chinese Academy of Social Science, between 1978 and 2006, more than 1 million Chinese went to study overseas and some 70% of them did not go back.

The skill shortage comes in two forms: **higher staff turnover and rising wages costs.**

To explode the myth that in China staff is at a low price, against a relative low cost of unskilled labour, is to be taken into consideration the scarcity of skilled staff and its cost. Pay rates for senior staff in many parts of Asia already exceed those for similar staff in much of Europe. The yearly salary of a Chinese HR director based in Shanghai is about USD 250,000 (EUR 177,46¹), while for a CFO is about USD 194,000 (EUR 137,713). Even salaries of lower positions are increasing rapidly; the last year registered salary increase was about 8%, much greater than inflation.

In the half of 2007, in the urban areas, the average yearly salary of a worker reached RMB10,990 (about EUR 1,033²), with a 18,5% increase from 2006 (National Bureau of Statistics of China). According to 'Mercer Investment Con.' researches, remuneration in China have been growing on average with a annual rate of 7,5% between 2001 and 2005; almost all Chinese provinces saw an increase of minimum wages in 2006.

It is interesting to point out that cities located in the costal areas are those with the highest average monthly salary. In order to gain advantages from low salary conditions, which still exist in China, and to avoid the phenomenon which involved our companies in Romania where, after ten years of investments, many are living the country because of the inconvenience in production, Jesa suggest to evaluate, for the location of new production activities, **the option of going to Western China**, instead of to the over-exploited costal cities where costs and prices are inescapably set to increase. It is time, indeed, to look for other solutions. It will be more and more difficult to compete with Chinese firms if foreign factories do not locate their activities in strategic areas in the next 20 years.

The salaries of second tire cities are increasing more rapidly of those of first tier cities, because they start from a lower salary level.

In 2005, the turnover rate among professionals between 25 and 35 years old was about 87%. According to a study conducted by 'Mercer' among more than 100 local firms and MNC, the respondents reported that the average substitution cost of employee, at any level, is between 25% and 50% of her annual salary.

In middle management, the **average retention period of an employee in Shanghai is just 1.8 years**, with HR managers among the most difficult to keep. As well as excessive wage inflation there is also the responsibility inflation. Relatively inexperienced local managers are sometimes given great responsibilities because employers think that constant promotions every 18 months are the only way to keep them on the payroll.

The strategy a company should adopt in these cases is to try to render its workforce more loyal with the aim to obtain, in the long period, an advantage on competitors in coping with the qualified staff shortage. On the contrary, the actual objective of foreign companies is to obtain qualified profiles with the lowest economic contribution, without the awareness of how dangerous these decisions could be.

The shortage of high qualified and reliable Chinese managerial staff has as a consequence an increase in the number of expatriates. Among foreign companies, non Chinese passport holders detain most of the highest positions, even if among other senior position we can start to see a mild nationality differentiation. This phenomenon is directly linked to the still unfilled gap in the local workforce pool.

Western expatriates have higher salaries than other expatriates in position as managers and professionals, while Hong Kong and Taiwan staff have an advantage as general managers and top executives.

When deciding to hire foreign staff, Jesa suggests considering the following supplementary and relevant costs:

- **emigration bonus**, higher when the activity is located in an isolated and short in infrastructure area;
- necessity to increase the salary when the person hired has to **pay her children's education**. It must be remembered, in fact, that the average cost for an international school in Shanghai is about USD10,000/11,000 per year for elementary education, USD21,000 for junior high school, USD 24,000/27,000 for high school, while a year of university costs about USD30,000 to USD50,000.

Generally, it is difficult to set precise remuneration categories for Western expatriates in China. It must be considered that working conditions in China are harder and more stressful than in Europe, due not only to social and cultural

¹ 1 USD = 0.70986 EUR, cambio al 4 ottobre 2007.

² 1 RMB = 0,0939904 €, cambio al 3 ottobre 2007.

differences but also to environmental conditions (pollution, security, risks, etc.). Retributions are, indeed, proportional to the managerial position, responsibility and expectations. To invest in human resources in China, especially in the most critical staff, will protect and maximize the industrial investment.

In the last few years, many companies already present in China asked Jesa to analyse problems and performance of HR, through sales force audit, supply chain and purchases performance analysis, corporate governance analysis, etc.

Jesa and Pragma put at the Client disposal their direct experience in China starting also from greenfield situations.

EU and China decide on textile import monitoring system for 2008

Following the final stage of global liberalization on January 1 2005, textile and clothing exports to Europe from China experienced a very rapid surge accompanied by very rapid drops in unit prices. This surge caused serious damage to many EU producers and **precluded any realistic possibility of EU producers adapting to new levels of competition**. The EU and China negotiated a Memorandum of Understanding that would cap imports from China at agreed levels each year until 2008.

The EU invoked the Textile Specific Safeguard Clause in China's 2001 WTO Accession Agreement to launch consultations with China on responses to the problem. The Textile Specific Safeguard Clause allows WTO Member countries to unilaterally impose temporary safeguard quotas on Chinese textile and garment exports until 2008 where a sudden rise in Chinese textile or garment exports threatens irreparable damage to domestic industry. However, rather than using the Textile Specific Safeguard Clause, the EU and China negotiated an agreement that would cap imports from China at agreed levels each year until 2008. These annual allowances would be subject to an annual increase of up to 12.5%. This would allow Chinese exports to continue to grow, but at a rate that would allow EU producers to adjust to new levels of competition. Other countries, including the US, did impose quotas under the terms of the Textile Specific Safeguard Clause.

Since the liberalization of textile trade on 1 January 2005, total EU textile imports have increased at a moderate rate - about 10% in volume 2006 over 2004, with the increase concentrated in the categories liberalized on 1 January, for which the average increase is 23% in volume 2006 over 2004. Obviously those products covered by the agreement with China have increased more slowly. Total Chinese textile imports to the EU have risen by 42% in volume 2006 over 2004; approximately 150% 2006 over 2004 for the products liberalized in 2005. Turkey, India and Bangladesh have also increased their share of the EU import market, accounting together for the same import share as China. Past liberalizations under the ATC showed a similar pattern, a steep initial rise in exports that then decreases as the market stabilizes.

The fact that Chinese imports to Europe have grown quickly while overall textile imports to Europe have grown at only a moderate rate is evidence that textile liberalization has resulted in a shift in the main exporters of textiles to Europe - from other countries in Asia to China. So countries that have traditionally supplied textiles to the EU such as Taiwan and Macao have been displaced by China. This shift to a producer with the productive capabilities and economies of scale of China has resulted in **serious new competition at the level of unit price**.

Following from their 2005 Memorandum of Understanding on cooperation in managing the transition to free trade in textiles, the European Commission and the Chinese Ministry of Foreign Trade have decided on a system of joint import surveillance that will operate for one year in 2008 following the end of the import growth caps on ten categories of textiles and clothing from China. The **'double checking system'** will track the issuing of licenses for export in China and the importation of goods into the EU. The arrangement covers the eight most sensitive of the ten product categories covered by the levels agreed in 2005 and that will expire at the end of the year. Although imports of these goods will be closely monitored their **level of import will not be restricted quantitatively** by this arrangement.

The product categories subject to double-checking will be categories 4 (T-shirts), 5 (pullovers), 6 (trousers), 7 (blouses), 26 (dresses), 31 (bras), 20 (bed linen) and 115 (flax yarn). The system will be formally adopted by the European Commission in the days ahead. It will be administered by EU Member State licensing offices.

The criteria, which has set a threshold for Chinese enterprises specialized in exporting textile products to the European market, was just issued jointly by the China Chamber of Commerce for Import and Export of Textiles, China National Textile and Apparel Council and China Association of Enterprises with Foreign Investment. The criteria will allow roughly 10 thousand manufacturers to obtain export licenses.

According to the criteria, qualified enterprises in particular should be registered in China's mainland with over 500,000 Yuan (about EUR 46,995) of registered capital and more than two year's export history.

In addition, eligible players are required to export over US\$10,000 worth of textile products to the EU in 2007 and should be clear of law violations in the last three years, especially on intellectual property rights and environment protection.

In theory the Textile Specific Safeguard clause allows for the use of import caps until the end of 2008. However, the EU has an agreement with China that runs until 2008. While the agreement contains no quantity import restrictions for 2008, it does commit both the EU and China to show joint responsibility for managing developments in 2008. The goal remains a swift but smooth transition to global free trade in textiles and clothing.

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