

ARE WE WILLING TO SHARE THE COSTS?

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Report of the Fourth Round of Labour Inspection in China for



by **CHEN WEI**¹

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1. BACKGROUND

STORMBERG[®] is a Norwegian Company in the garment and sportswear sector. The company has been trading with suppliers in China since 1998 and they seek to form long-term business partnerships with companies and factories who share its commitment to quality and values. This also includes requirement that suppliers are compliant with labour and environmental laws.

Stormberg has set up a Code of Conduct covering labour rights and environmental issues because it believes that high workplace standards, good health and safety, fair pay and conditions and care for the environment can help strengthen their business and to compete effectively in the global market. Managing these standards can improve productivity and quality and therefore the profitability.

Stormberg is a corporate member of [Ethical Trading Initiative - Norway](#). With the assistance of the ETI, the first unannounced labour inspection among two of Stormberg's suppliers was carried out by Mr. Chen Wei and Ms. Ding Ling in September 2004. The second and third inspection round took place respectively in October 2005 and November 2006.



Upon request of Stormberg, Mr. Chen Wei carried out the fourth round of unannounced labour inspection in March 2008. Three factories were inspected in this round.

	Factory 1	Factory 2	Factory 3
Located area	Nanjing	Ningbo	Ningbo
Main product	Stormberg clothing	Stormberg clothing	Gloves
Production share to Stormberg	< 1 %	50 %	< 1 %
Inspection history	1 st time	3 rd time	1 st time

This is the inspection report from the fourth inspection round. I would like to refer further information on the background of this action, inspection planning and methods, main findings, conclusion and recommendations from the previous inspection rounds. Furthermore, I would like to take this opportunity to thank Stormberg (Christina and Steinar), Chris, Steve, Zhao Jing and Li Hai from respectively those three export companies which the inspected factories are connected to, and not least all the inspected factories for their excellent cooperation and assistance.

2. MAIN CHALLENGES FOR THE INDUSTRY

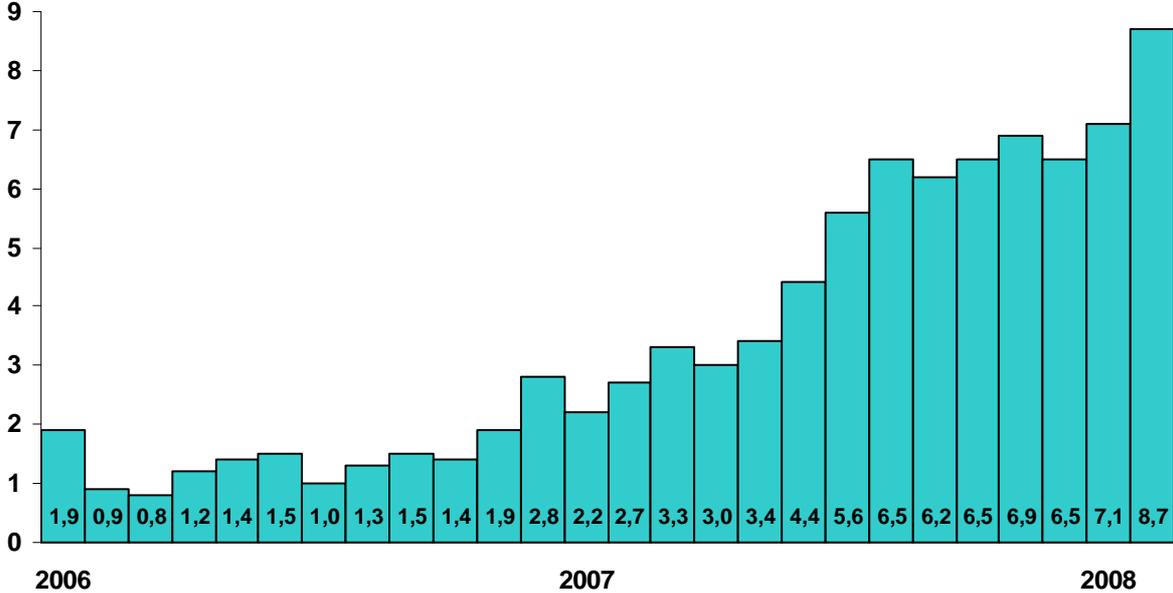
The main challenges the three inspected factories and nevertheless the whole textile and garment industry in China are facing, are sharp increase of production costs and worsening of competition conditions at macro level. The situation is so serious that it calls for deep concern.

➤ Double strikes of the currency – internally and externally

The Chinese currency has been experiencing strong depreciation internally (inflation), but strong appreciation (against US dollar) externally.

After a long period with low inflation but strong GDP growth, the inflation picture has changed dramatically since summer 2007. With a CPI growth rate at nearly 9 per cent in February of 2008, the Chinese currency is clearly experiencing a strong depreciation domestically. It is foreseen that China will run high inflation in this year, which puts strong pressure on production costs (raw material costs, wages, etc.).

Percentage month to month change in Consumer Price Index (CPI), China, January 2006 - February 2008

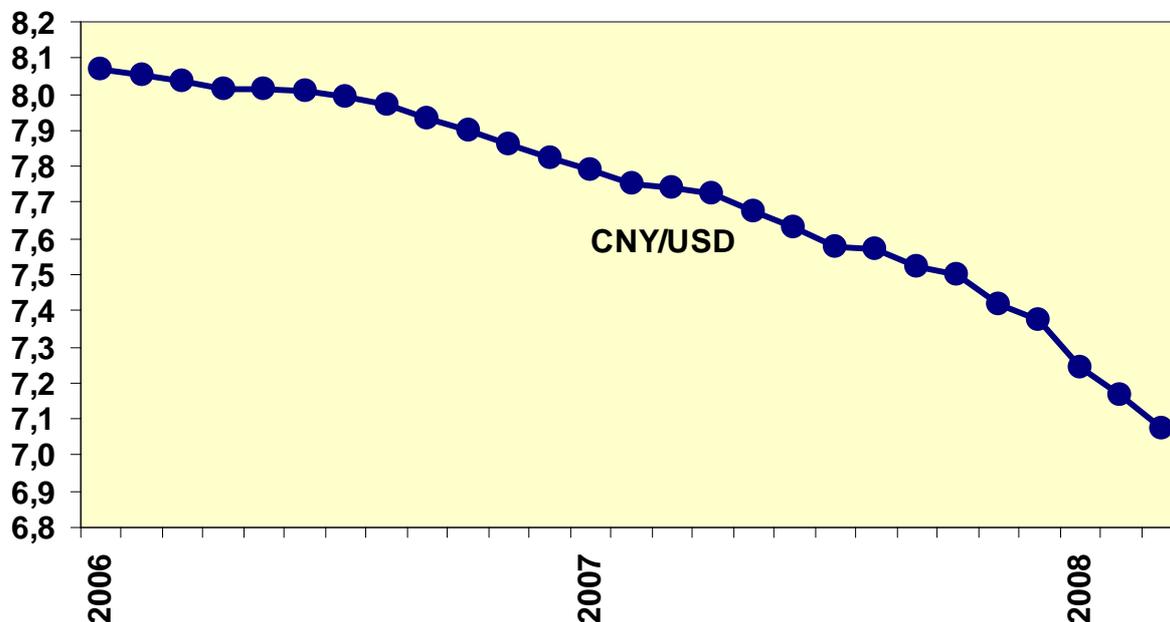


Sources: Chines Central Bureau of Statistics

Externally the Chinese currency (CNY) has experienced strong appreciation, especially in exchange to US dollar (USD). The CNY has appreciated by 12 per cent against USD over the last two years (March 2006 – March 2008). It is only a question of time (probably in the coming days), the exchange rate between CNY and USD will break the magic boundary at 7 CNY/USD. Since most of the export products from China are priced in US dollar, the appreciation of Chinese currency

against USD directly presses down the profit margin for a large scale of export producers.

**Chinese Yuan (CNY) in exchange to US dollar (USD),
monthly average from January 2006 to March 2008**



Thus, the currency has given the export industry in China a double strike: pressure on the production costs on the one hand due to inflation and one the other hand pressure on the export prices due to external appreciation.

➤ A strong price growth of raw materials

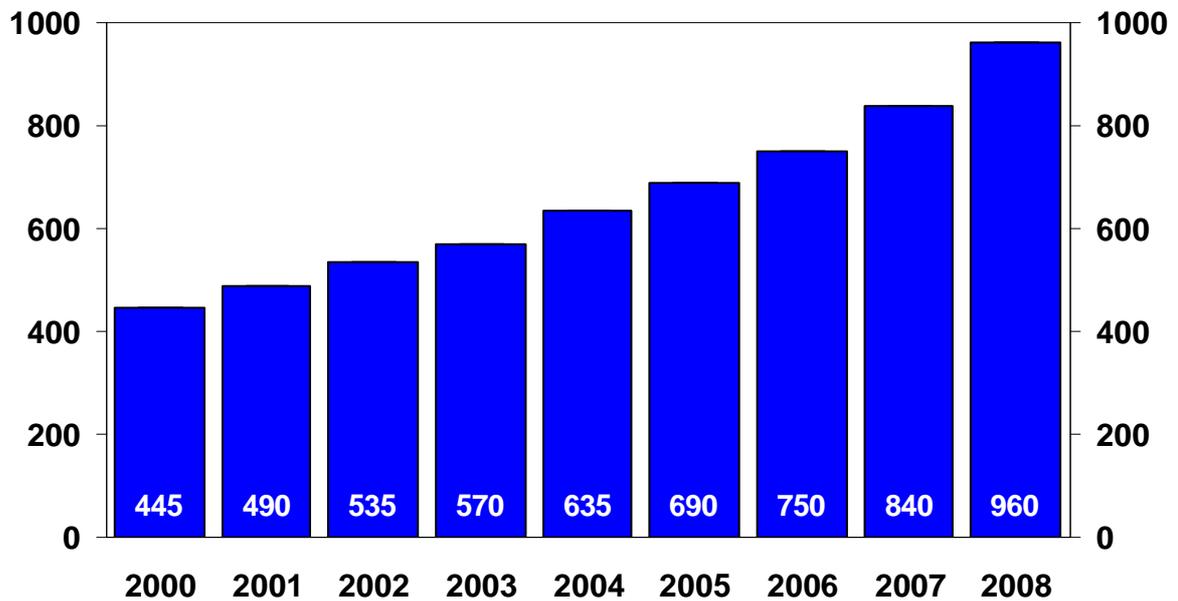
The **prices of raw materials** for the textile branch have gone up by around 20 pct. Last year. Long lasting high petroleum prices have been transferred to higher prices on petrochemical products and higher energy prices. There has also been a strong increase of general price level in China.

➤ Increase in labour costs – wage and New Labour Law

The general **wage level** has increased. Due to high inflation, the wage pressure has increased too.

The following chart illustrates the minimum wage level in Shanghai area. Since the minimum wage is under local mandatory regulation, there is regional difference among the minimum wage levels in different areas. The minimum wage level in Ningbo area is 850 yuan per month, a little bit lower than in Shanghai area. The minimum wage in Shanghai area has increased by more than 10 per cent every year over the last years, and has been doubled over an 8-year period.

Minimum wage level in Shanghai-area (regional mandatory), yuan per month



The minimum wage level reflects the general wage level. In addition, the general wage level in the textile and clothing industry is not much higher than the minimum wage level (in average around 40 % higher) in that particular area. Since the minimum wage is mandatory, it works like a bottom line (or guarantee wage) for workers in a factory. A factory can not pay a worker less than the minimum wage. Thus, the development of minimum wage level illustrates the increasing pressure on wage.

The so-called migrant workers, those who come from the rural areas and take upon work in the cities, constitute the major labour force supply for the textile and clothing industry. On the country base, there are nearly 200 million migrant workers in different sectors and industries countrywide. Although there is still a large labour force surplus of migrant workers in the country as a whole, regional labour force shortage, especially shortage of skilled and experienced workers, does occur. In Ningbo area, there is 74 pct. shortage of skilled workers at advanced level, 68 pct. shortage of skilled workers at intermediate level and 45 pct. shortage of skilled workers at lower level. Some of the clothing factories in Ningbo area had few migrant workers returning to their workplaces after the Chinese New Year vacation, and factories had serious difficulties in recruiting new migrant workers to fill out the vacancies. However, this situation didn't occur to the inspected factories. Because of the increasing competition on the labour supply, payroll is becoming a utmost import factor in labour recruitment, in stable employment and in production.

A New Labour Law – the Labour Contract Law took into effect from 1.1.2008. The Labour Contract Law has significant impact on the employment and labour conditions in many ways, for instance, the labour contract condition (time-limited contract vs. permanent contract), compensation at termination of contract and lack of contract, and mandatory social expenses.

The Chinese Labour Law from 1995 contains stipulations on the employer's obligation on social security expenses for employees such as health insurance, unemployment insurance, pension insurance, maternity insurance and occupational disease and damage insurance. In reality, these stipulations have never been actually enforced. In the textile and clothing industry, it has been a common practice that employers pay social security contribution only for those local employees (thus most of the migrant workers were excluded), for employees in the administration and for employees who have worked there for many years (loyalty reward).

The Labour Contract Law enforces employers' social security contribution from day 1. Employers have to pay social security contribution for all employees. For those enterprises which have never or partially done that before, this enforcement means a strong increase of the total labour costs.

In a large enterprise in Shanghai area, the employer pays almost 40 pct. of employee's payroll as employer's social security contribution. Employees pay around 10 pct. of payroll as employee's share. The contribution rate is however not harmonized all over the country, and is much lower in other places other than Shanghai. In Ningbo area, taking the labour intensive (especially migrant workers concentrated) industries into consideration, the authorities issue "social security package" which most of the textile and clothing factories use. Employers pay a certain fixed amount for each employee as social security contribution (180 yuan per month in Ningbo). In average, it constitutes 10 – 20 pct. of payroll.

A new regulation on paid vacation will take into force from 1.5.2008. Every employee is entitled to 1 – 2 weeks paid vacation depending on how many years he/she has worked. For the textile and clothing factories, the new regulation means that employers may have to pay salaries to their employees in vacation (for instance in connection to the Chinese New Year).

In sum, the labour costs have significantly increased due to the labour market situation and enforcement of new legislations.

➤ Favourable tax rules for export are vanishing

Companies have for a while enjoyed favourable tax rules for export. The company tax can be deducted for export. The tax deduction rate has been

significantly reduced for textile and garment products. It is foreseeable that the favourable tax rules for textile and garment export are on their way out.

A general overview is that the labour intensive export industries in China are facing tremendous challenges. The competition condition has been worsened as results of currency appreciation externally, domestic inflation and labour cost increase. The earning margin is heavily pressed. In the short run, we have already seen the close-down of a number of labour intensive but low value-added production factories in for example textile and clothing branch and toy branch. In the long run, the labour intensive export industries can not survive without better prices for their products or self innovation.

3. FINDINGS AND COMMENTS IN THE INSPECTED FACTORIES

√ With regard to the general industrial situation

During the inspection, all the inspected factories and their respectively connected export companies have come with the same overview and concern for the industrial situation at macro level (elaborated in the previous chapter). The competition condition has been worsened and the production costs have increased sharply. The profit margin has been pushed down.

√ With regard to the ethical requirements from Stormberg

- All the factories – management and workers in interview – know about the ethical requirements from Stormberg. Stormberg's Codes of Conduct is clearly hanged on the board.

- Two of three inspected factories have been inspected in a more formal way by consulting companies on behalf of other Western customers (social auditing). The factories are of the view that the labour inspection from Stormberg is more practical and easy to cooperate and comply. The formal social auditing leads to red tapes, more time consuming, irrelevance and even lies which doesn't serve its purpose. A practical and constructive inspection like Stormberg's is better preferred.

- In spite of better awareness of Stormberg's ethical requirements, the purpose of this action with keywords like long-term partnership, cooperation, joint efforts, follow-ups, should be further emphasized and highlighted in the business relationship.

√ With regard to the general labour conditions

- Employment situation in the inspected factories is stable in spite of a more difficult labour market. Unlike those two factories in Ningbo area, the factory in Nanjing area has all employees from the local community. Several handicapped workers have been observed at the workplaces. The average age among the workers is much higher than other similar factories. This employment practice should be appreciated and welcomed with regard to social inclusion.
- The wage level is increased, partly because the minimum wage level in area is increased, and partly because of the general wage pressure.
- No child labour and no forced labour discovered.
- All factories have implemented major requirements from the Labour Contract Law. Standard written labour contracts are signed between the employers and the employees. Social security contribution is provided by the employers as the law requires (full coverage from 1.1.2008)
- Overtime use is still comprehensive. Extra overtime pay is either limited or doesn't exist at all.
- The general working time is long. Workers get only 1 to 3 days off from work per month. The workers in interview consider the long working time as the biggest problem. When they were asked to choose between higher wage and shorter working time, the answer was shorter working time.

√ With regard to the trade union

- All the inspected factories are organised on the employee's side. They have either trade union inside the factories or as part of a trade union organisation for local community. The trade union officers are still not elected by the employees, rather being appointed by the administration. They come from the administration as well. To our knowledge, there are limited trade union activities at these enterprises. The general overview is that the factories are organised, but the trade unions are not functioning as they suppose to be.
- A phenomenon has come to surface lately. After the Chinese New Year vacation, some migrant workers organised themselves and put forward a spokesman (representative). The spokesman negotiated with the factories on behalf of a group of migrant workers concerning wage and other welfare arrangements. These migrant workers came to work for those factories they managed to reach agreement with. This phenomenon illustrates that migrant

workers are fully aware of their market position as a result of regional shortage of labour supply. They explore the possibilities and conduct a “genuine” wage negotiation. This “infant and immature” form of organisation and collective bargaining carries the trade union characteristics. It creates both challenges and possibilities for the Chinese trade union.

√ In relationship with Stormberg

- All the inspected factories came with positive views on the relationship and communication with Stormberg.
- Extensive use of overtime and long working hours in the factories is not caused by Stormberg’s level time requirements, since the proportion of production which goes to Stormberg is not big. On the other side, Stormberg’s contribution, such as better planning, timing of order placement, level time requirements, communication, technical support, which can help the suppliers to ease the situation of overtime, will be very much appreciated.
- The factories are satisfied with in-time payment from Stormberg.

4. GENERAL ASSESSMENTS AND RECOMMENDATIONS

We recall that the objectives of Stormberg’s action are to seek to form long-term business partnerships with companies and factories who share its commitment to quality and values. This also includes requirement that suppliers are compliant with labour and environmental laws. Stormberg’s Codes of Conduct covering labour rights and environmental issues, because we believe that high workplace standards, good health and safety, fair pay and conditions and care for the environment can help strengthen their business and to compete effectively in the global market. Managing these standards can improve productivity and quality and therefore the profitability.

There have been developments in the general labour standard in China, and we have learned improvements in pay and welfare for the workers among Stormberg’s suppliers in China. The driven forces behind that are as following:

- External ethical requirements (customer relationship), to some extent.
- General economic and labour market development, to some extent
- New labour legislations, to a large extent.

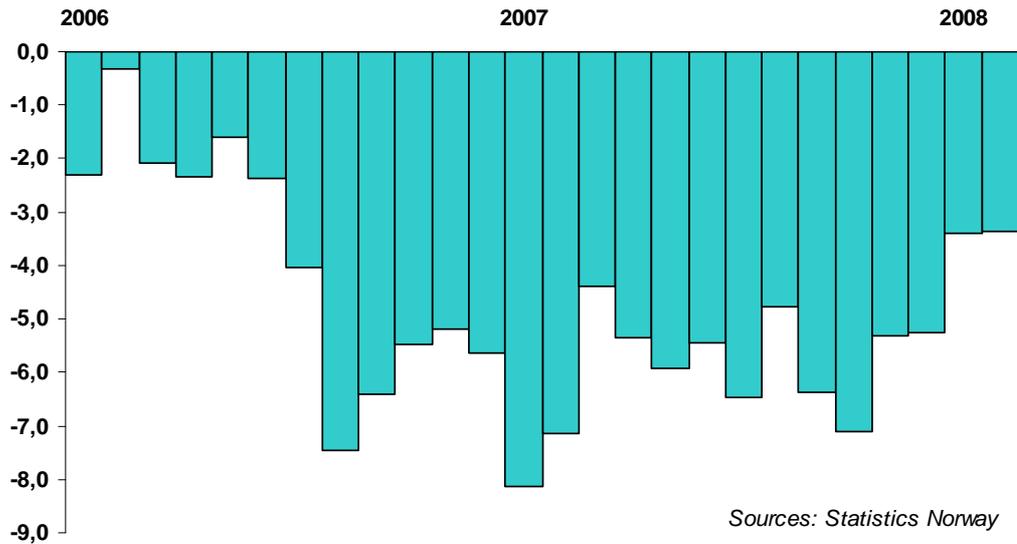
There is no doubt that it costs to raise the labour standard. The question is: are we willing to share the costs.

Example: Have the Norwegian market shared exchange rate burden of Chinese clothing products?

Fact 1: Around 40 pct. of clothing products on the Norwegian market are imported from China (made in China).

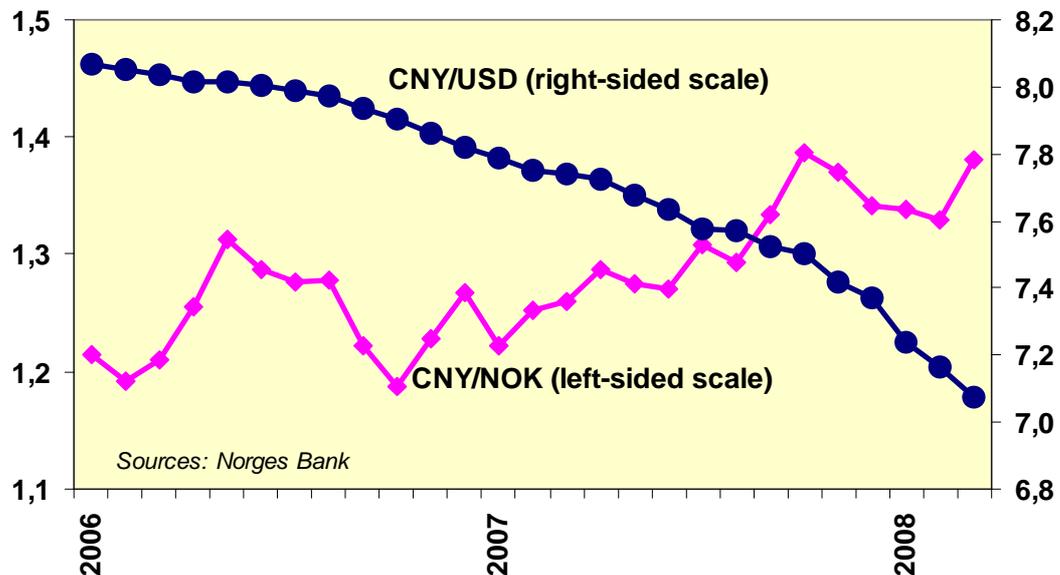
Fact 2: There has been a continuous fall in clothing prices in Norway

**Percentage month to month change in prices, clothes, Norway
CPI (Consumer Price Index), January 2006 - February 2008**

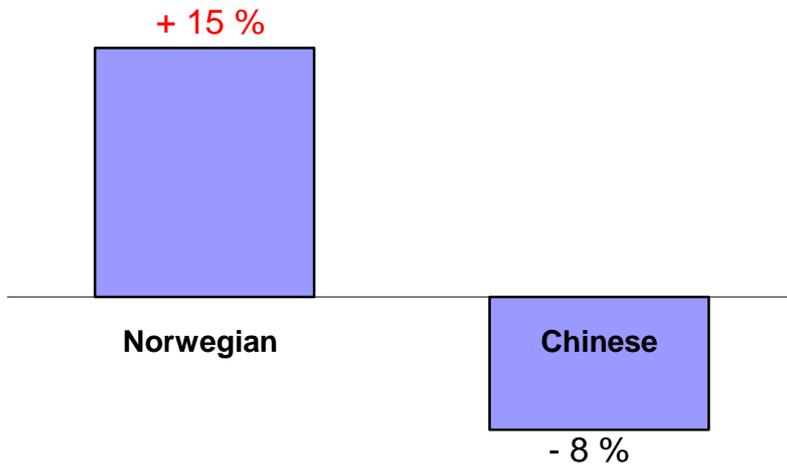


Fact 3: Chinese currency appreciated against US dollar, but depreciated against Norwegian krone

**Chinese Yuan (CNY) in exchange to
US dollar (USD) and Norwegian Krone (NOK)**



Fact 4: If a Norwegian customer paid a price of 100 US dollar for products from China in March 2007, and he/she paid a same price of 100 US dollar for the same products in March 2008, the Norwegian customer got 15 pct. price gain solely from the exchange rate, but the Chinese supplier (producer) got 8 pct. loss due to the exchange rate change.



Even if the Norwegian customer fully covers the exchange rate loss of the Chinese supplier, he/she still gets a 7 pct. price gain (in Norwegian krone).

We have learned that Stormberg has annually increased its prices on products from China by 5 – 10 pct. Part of this increase was supposed to cover the exchange rate changes (products are priced in US dollar). Taking the followings into account (as we have described before), the price increase is not sufficient with regard to cost sharing in order to improve the labour conditions:

- 5 – 10 pct. exchange rate (CNY/USD) loss during one year;
- 10 – 20 pct. price increase in raw material during one year;
- 20 – 30 pct. increase in labour costs in 2008 (20 pct. one time effect due to the New Labour Law).

Based on the general assessments, we put forward the following recommendations:

- (1) The ethical requirements from Stormberg towards its Chinese suppliers play an important role in developing corporate social responsive business relationship. The practice and not the least the objectives, to develop a long term partnership, should be further emphasised. Good communication, follow-up and cooperation are key words. Only joint efforts can lead way to success.

- (2) In the short run, Stormberg should find ways, within its capacity and ability and with help of communication and dialogue, to help its suppliers getting out of the current serious cost-rising situation and help them to release the burden. By so, it contributes to build up sound and genuine mutual trust and confidence in order to develop long term partnership. It will also contribute to further improvement of labour conditions among the Chinese suppliers, to the benefits of workers.

There are several ways to do so. A new price system to share the exchange rate risks, for example pricing in a more stable currency (for example euro), or pricing in Chinese currency, can ease much of the exchange rate risks for the Chinese partners. A more direct way can be general price increase.

- (3) In the longer run, Stormberg should provide its suppliers with technical support and knowledge, and encourage them to self innovation and restructuring, in order to improve competitiveness and profitability.