

## ASIEN AKTUELL

### Do Rising Labour Costs Spell the End of China as the 'World's Factory'?

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Labour shortages and worker unrest have afflicted foreign factories on China's coast in recent months, drawing international attention to the conditions of Chinese workers. Foxconn, an assembler of Apple products, and Japanese car makers Honda and Toyota recently increased their workers' wages by as much as 24% to 65% (Jin 2010). In Foxconn's case, this may have been in response to a spate of suicides, while Honda and Toyota were hit by strikes. Implications of these developments could be far-reaching.

For decades, a constant flow of migrant workers moving from rural areas to the cities has provided the pool of labour China employed to become the 'workshop of the world'. Now, multinational companies are wondering if these wage increases could signal the end of China as a cheap manufacturing location. Will wages continue to rise? We argue that this is likely for at least three reasons: First, wages of urban workers, particularly those of migrants, have lagged behind productivity gains for many years and are due to increase; second, migrant workers have become increasingly aware of their value and are more likely to negotiate higher wages; and third, the political leadership supports these wage increases to narrow the urban-rural divide, raise domestic consumption and preserve social stability. We will elaborate on these factors below.

#### 1 Wages are due to catch up

China's workers, be it migrants or locals, are due a pay increase. As a result of a 'low wage growth strategy' the share of wages in national income has fallen in the past decade and a half – from 52% in 1995 to 40% in 2007, with capital's increasing correspondingly (Zhou, et al. 2010). This development has constrained domestic consumption. Moreover, uneven development has led to an increasingly skewed income distribution. Addressing the growing income gap between rich/poor and

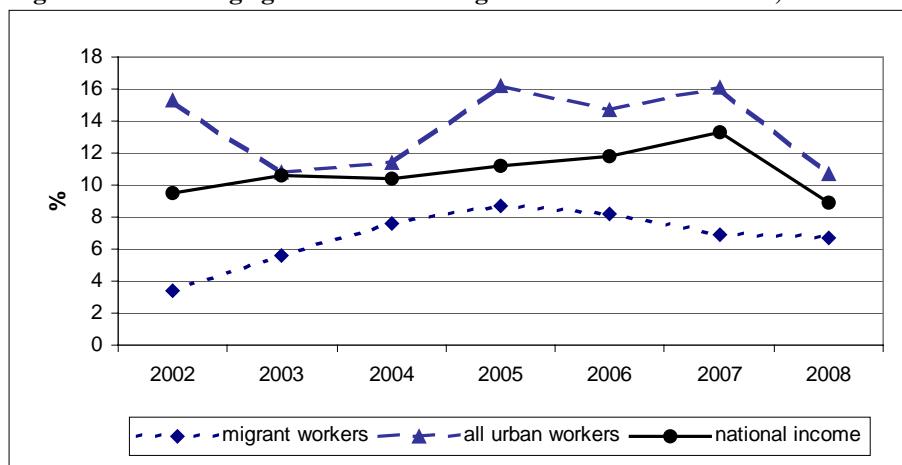
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urban/rural labourers was a prominent theme in Premier Wen Jiabao's "Report on the Work of the Government", which he presented on March 5, 2010. Policies to reverse this trend have been hotly debated in recent meetings of China's Communist Party and the Chinese Parliament, and they may well be a key focus of the coming 12<sup>th</sup> Five-Year Plan (2011-2015). Experts have specifically called for eliminating the status of 'migrant workers'. While this would be 'a breaking point in dismantling the dual urban-rural system' (Li Xing 2010) and promote greater equality, it would end of the supply of cheap workers with rural *hukou*.

In the last few years, we have seen workers' real wages rise. In the period 1998-2007, the average real annual wage for 'formal employment' (staff and workers, *zhigong*) grew by 13.2%, compared to 3.9% in the period 1986-1997 and 4.9% before 1985 (Yang, et al. 2010: 8). We believe that this trend will likely continue, in part, because the government is keen to reform the distribution of income, help rural areas catch up and reverse China's low rate of consumption. This, however, will not lead to equal compensation for urban local workers and migrant workers in the short run.

**Figure 1: Real wage growth of rural migrants and urban workers, 2002-2008**



Source: ZTN and Rural Survey (various years) acc. to Herd et al. 2010, 22; ZTN 2009.

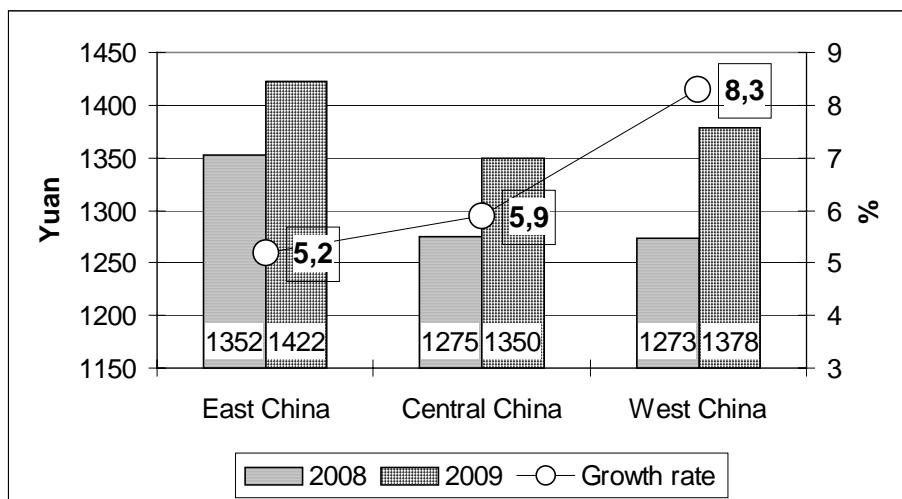
According to Zhou et al. (2010), the huge amount of rural surplus labour, which is able to make an economic contribution far beyond the wages it is paid, is the key to understanding the weak labour share in GDP. Unofficial rural migrant workers account for around 23% of total urban employment (Herd et al. 2010: 17).<sup>1</sup> For dec-

<sup>1</sup> There were 145.33 million migrant workers that moved across the border of their home county (*waichuwugong*) in 2009, compared to 140.41 million in 2008. The National Bureau of Statistics (NBS) estimates that there are currently 229.78 million migrant workers (GTJ 2010).

ades prior to 2003, the basic wages of migrant workers saw little change. Indeed, migrants often had to bear significant wage arrears (Cai, et al. 2009b). During the 2000s, migrant workers' real wages rose by 6% per year, on average, which was markedly less than the growth of wages of formal urban workers and well below growth rates of national income (Figure 1). In 2001, migrant workers earned 71% as much as formally employed workers. By 2007, this ratio had dropped to 49% (Herd et al. 2010: 22). Cai, et al. (2009b: 15) calculate that mean hourly wages of migrants in 2001 and 2005 were only 52% and 56% that of local workforce. They estimate that, between 41% and 56% of this gap is caused by discriminatory factors with regard to household registration status (*hukou*).

In 2009, monthly wages of migrant workers rose by 5.7% from 1340 Yuan to 1417 Yuan, a slower increase than in previous years. There are, however, important regional differences. In the last five years, wage differentials between the coastal and interior areas have fallen (Herd et al. 2010: 13). Between 2008 and 2009, wages in Western China experienced the most rapid increase (Figure 2), as a result of the demand for labour stemming from the stimulus programme and the relatively large investments made in Western China. With many Chinese firms relocating inland in search of lower labour costs, we believe that the regional wage differentials will continue to narrow.

**Figure 2: Growth of average monthly earnings of migrant workers by region, 2008-2009**



Source: GTJ 2010.

Higher minimum wages reflect the governments' policy of raising compensation for migrant workers. According to the Ministry of Human Resources and Social Security (MOHRSS), a total of 27 provinces, regions and municipalities raised their local

minimum wages in the first half of 2010, some by more than 20% (GT 2010b; see Table 1).<sup>2</sup>

**Table 1: Minimum wages, mid 2010**

	new monthly standard (highest-lowest) (Yuan)	old monthly standard (highest) (Yuan)	average growth rate (%)	new hourly standard (highest-lowest) (Yuan)	average monthly earning of employed persons in urban units (2008)
Shanghai	1120	960	16.7	9.0	4344
Beijing	960	800	20	11	4654
Tianjin	920	820	12.2	8.8	3333
Guangdong			21.1		2774
- Guangzhou	1030-660		27.9	9.9-6.4	
- Dongguan	900-1000	770	19.5	8.8	
- Shenzhen	1100		10		
Fujian			24.5	9.60-6.50	2130
- Xiamen	900				
Zhejiang			15.3		2802
Jiangsu	960-670	850	12	7.8-5.4	2608
- Nanjing	960	850			
Shandong	920-600		21.2		2186
Hainan	830-680	630	31.7	7.2-5.9	1814
Jilin	820-730		22.9	6.3-5.6	1941
Liaoning	650		29		2265
- Shenyang	900-750	700			
Hunan	850-600		27.8	8.5-6.0	2012
Hubei			28.9		1865
Henan			20		2037
Anhui			25.9-28.6		2142
Jiangxi	580-420				1716
Sichuan	~750-550	650			2060
Shaanxi	760-580	600	26.6	7.6-5.8	2123
Yunnan	830-630			8-6	1942

Source: Minimum wages compiled from Yang 2010; GT 2010b; „2010 nian quanguo gedi zuidi gongzi biaozhun“, <http://wenku.baidu.com> (6.8.2010); „2010 nian quanguo zuidi gongzi biaozhun“, <http://www.lawtime.cn/info/laodong/gongzi/2010050435412.html> (6.8.2010). Average monthly earnings acc. to ZTN 2009 (own calculation).

Minimum monthly wages were first introduced in 1993 and set on the assumption of a standard workweek. In 2004, the minimum wage system was implemented and hourly rates were set to cover part-time workers. The prefecture usually defines the wage levels. Regulations specify that the minimum wage should be changed at least every two years and a growing number of cities adjusted wage rates after 2004. This indicates that governments have responded to the changing labour market situation

<sup>2</sup> Only Gansu, Guizhou, Chongqing, and the Guangxi Zhuang Autonomous Region have not announced minimum wage adjustment plans.

and the first appearance of labour shortages in 2004. However, the increase in minimum wages has lagged behind average wage growth. Minimum wages fell from 44% to 28% of average local wages between 1995 and 2006 (Du and Pan 2009: 84 f.).

According to Du and Pan (2009), there is little evidence that minimum wages are enforced on the ground. While more than 85% of workers, both migrants and local, are paid as least as much as the minimum monthly wage, coverage is lower on an hourly basis, reflecting working hours that exceed the standard work week. In addition, the situation appears to have deteriorated over time. In 2001, approximately 48% of migrants and 79% of local workers were paid at least as much as the minimum hourly wage in the five major cities surveyed. By 2005, these rates dropped even further – to 21% and 45%. These data also reveal that migrant workers typically work much longer hours than locals (Ibid.: 87 f.).

In the longer run, labour costs might further be pushed up by social security contributions. When the crisis hit China, the government underlined its intention to construct a comprehensive social welfare system by 2020 (CD 2009). Coverage will be enlarged incrementally and the plan is to include migrant workers. Currently, only 7.6% of migrant workers receive pension insurance, 12.2% receive health insurance and 3.9% receive unemployment insurance (GTJ 2010). But instead of bringing them into the established social security schemes, new schemes will be developed (see, e.g., Watson 2009). It will take some time until the various schemes for urban workers, migrant workers and rural labourers are integrated into a unified national system. It is not yet clear whether the system will be funded by the government or by employee/employer contributions.

## 2 Migrants' growing inclination to collective action

Western media reports were taken aback by Chinese workers' protests against poor labour conditions – Guangdong suffered at least 36 strikes between May 25 and July 12, 2010 (Li Wenfang 2010) – and wondered if this portended increased social instability. In fact, labour disputes and protests are not a new phenomenon at all and they have been on the rise for many years. What makes recent strikes unusual is the attention they received in Chinese media – at least until coverage was banned.<sup>3</sup> Beijing may be tolerating workers' demands for increased wages as part of its attempt to restructure economy.

Between 1993 and 2008 so-called 'mass incidents' increased tenfold from 8.700 to around 90.000 per year. Most of these were led by peasants and workers (Schucher

<sup>3</sup> Some observers hold that media coverage was encouraged to fan anti-foreign sentiment and that workers specifically targeted Japanese, South Korean and Taiwanese employers (Stratfor 2010). This might be true for English-language papers like *China Daily*. Chinese-language papers have reported protests in Chinese factories in the past (CLB 2009).

2009).<sup>4</sup> The number of labour disputes accepted for mediation or arbitration increased from 48.121 in 1996 to 693.465 in 2008. Of these, the number of collective cases rose from 3.150 to 21.880 and involved 92.203 and 502.713 labourers respectively. The number of cases nearly doubled between 2007 and 2008, collective cases grew by 71% and the number of labourers involved in collective disputes rose by 85%. In 2007, 60% of disputes were about remuneration and social insurance (Schucher 2008; ZTN 2009).

Without proper institutional means to solve their grievances, workers choose collective action. For some time, it had been presumed that migrants would 'eat bitterness' (*chiku*), rather than confront their employers. Indeed, there is no indication of migrants' increased organizational strength. Although the Party-led Chinese trade union has started to organize migrants, it does not act as the workers' representative in collective bargaining. The increase in workers' protests and labour disputes observed in recent years is taken by many researchers as a reflection of a new assertiveness based on new labour laws and improved rights awareness.

This view is supported by surveys about the implications of a generational shift among migrant workers. Currently, 42% of migrant workers are aged 16-25, while 20% are aged 26-30 (GTJ 2010). These migrants were born during the reform period and the majority has been brought up after the agricultural reforms of the early 1980s. The new generation has developed higher life expectations and dispositions, new meanings of work, an increased proclivity for urban consumer culture, and a greater pursuit of personal development. They are more likely to compare themselves with the urban population than with those they left behind in their villages (Song 2010). Although it might be disputable whether they have developed a kind of class-consciousness, their greater readiness to undertake collective action is beyond question (Knight and Gunatilaka 2010; Pun and Lu 2010).

For some time, research on labour unrest focused on workers in state-owned enterprises. Migrants were seen as unorganised group without any sense of their rights – a kind of 'guerrilla workforce' (*Lei Guang*) that only acts sporadically. In recent years, however, migrant workers have staged more strikes, which have been provoked by unpaid or substandard wages, disciplinary violence or industrial injuries (Chan and Ngai 2009).

Collective action has been facilitated by migrant workers' better education. While 26% of those over 30 have at least finished senior high school, senior high school graduates account for 31% of the young migrants aged 21 to 25 (GTJ 2010). Like urban youth, these young migrants are surprisingly tech-savvy. *The New York Times* highlighted the use of technology by striking workers: detailed accounts of strikes were posted online by the strikers hours after they began, videos were uploaded by

<sup>4</sup> There is no precise information about the location of labour protests. In 2005, an estimated 50% of mass incidents were urban (Keidel 2006).

the strikers showing confrontations between management and employees and online forums were used to share strategies and grievances (Barboza and Bradsher 2010).

### 3 Has China reached its Lewis Turning Point?

Labour shortages, which had occurred as early as 2004, reappeared in Guangdong province in late 2009. Labour shortages and rising wages have sparked a debate about whether China has reached the Lewis turning point. This is the stage of development beyond which surplus labour is exhausted and the demand for labour begins to boost real labour incomes. Some researchers, like Cai Fang (Cai 2007; Cai, et al. 2009a), have argued that China has indeed reached that point and that the agricultural labour surplus is much smaller than hitherto thought. Others have shown that despite increases, migrant wages still lag far behind urban wages, that there is still evidence of widespread surplus labour in rural China and that labour market segmentation due to *hukou* regulation accounts for most of the difference between migrants' wages and those of local workers (Knight et al. 2010; Du and Pan 2009; Kwan 2009).

Some of the labour shortage appears to be cyclical. The Information Monitoring Centre collects data from 103 major cities on the numbers of job vacancies and job seekers. It then creates a jobs-to-applicants ratio, where a number greater than 1 indicates that there are more vacancies than job seekers and that there is excess demand in the labour market. This indicator shows that Chinese labour markets have rebounded quickly from the crisis and that labour market pressure reached a new high in early 2010 (Figure 3).<sup>5</sup>

The cyclical labour market pressures in major cities have been exacerbated by a shift in the supply of migrant labour. When the economic crisis broke, many of these workers returned to their homes in central and western China. At the same time, the government's stimulus program created economic opportunities in these regions. According to an investigation released by the Ministry of Human Resource and Social Security, while the demand for migrant workers was flat in eastern China in 2009, the amount of migrants in inland areas increased by 16% from 2008.<sup>6</sup>

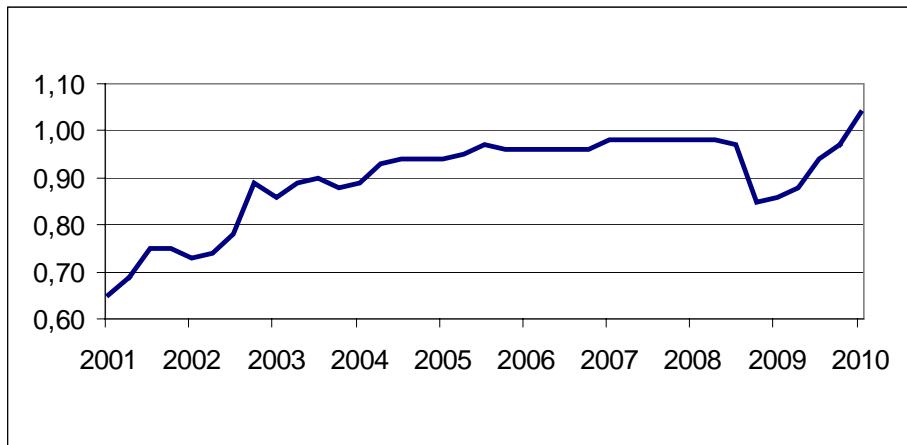
We have not yet seen a significant fall in the supply of new workers. In 2009, the number of new arrivals on the labour market was 11.02 million, compared to 11.13 million in 2008 (MOHRSS 2010). In the future, however, fewer children will lead to a decline in the labour force. The 2008 sample census shows that the number of

<sup>5</sup> The very low reading at the beginning of the sample likely indicates the aftermath of the restructuring of state-owned enterprises in the late 1990s, which resulted in a significant amount of labour shedding.

<sup>6</sup> See Ministry of Human Resources and Social Securities, "Analysis of the Employment Situation Facing Migrant Workers in 2009" (Chinese), February 25, 2010.

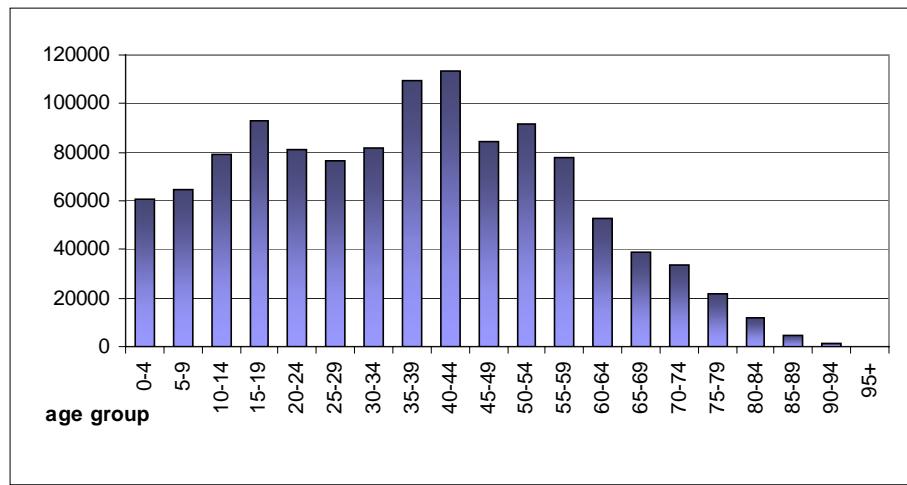
young Chinese, those now aged 10 to 14, is smaller than the cohort aged 15-19. The succeeding cohorts are even smaller (Figure 4).<sup>7</sup>

**Figure 3: Jobs to applicants ratio**



Source: Ministry of Human Resources and Social Security.

**Figure 4: Population in 2008 by age groups**



Source: 2008 Sample Census, ZTN 2009.

Based on shocks to the demographic structure, Herd et al. (2010) dispute that the Chinese economy has reached a turning point. As Figure 4 shows, the shortage of

<sup>7</sup> Data for the rural population only show the same trend, see Herd, et al. 2010:15.

migrant labour may have been driven by the small size of the 20-34 age cohorts, people born between 1974 and 1988. The dip in the demographic structure comes from the small number of children born to those aged 45-49, reflecting the effects of the famines during the socialist experiments in the late 1950s and early 1960s.

Using data from the China Household Income Project for the years of 2002 and 2007 Knight et al. (2010) conclude that labour market forces were indeed responsible for wage increases, although migrant wages rose less rapidly than the wages of urban workers. Estimating the probability of migrating, they calculate that there is still a substantial pool of potential migrant workers available in rural China – and a very strong demand for workers in urban China. Their interpretation for simultaneous surplus labour and rising rural migrant wages is that there is segmentation, i.e. constraints on rural-urban labour migration.

He and Zhang (He and Zhang 2009) point to a mismatch in the age structure of migrant worker supply and demand. Their calculations, based on 2005 figures, show that there is still a surplus of 100 to 130 million migrant workers. Of these, more than 82% are 31 or older. Only 11% are between 16 to 20 years old. However, employers want young workers, 62% of the workers demanded are below 25 years old. The average age of migrants is increasing. Between 2001 and 2004 the average age rose from 27.8 to 28.6 years and it appears that employers do not take advantage of the whole pool of employable migrants.

China's population, like those of many other countries, is aging rapidly. This is due to the combined effects of the one child policy and increased longevity. According to UN population projections, the working age population, aged 15-59, is expected to peak at 67.8 percent of the total population shortly and the absolute amount of people in this cohort will peak in 2015 (Figure 5). In our view, with the working age population as a percent of the total population reaching a maximum now, it is premature to attribute current labour shortages to demographic change.

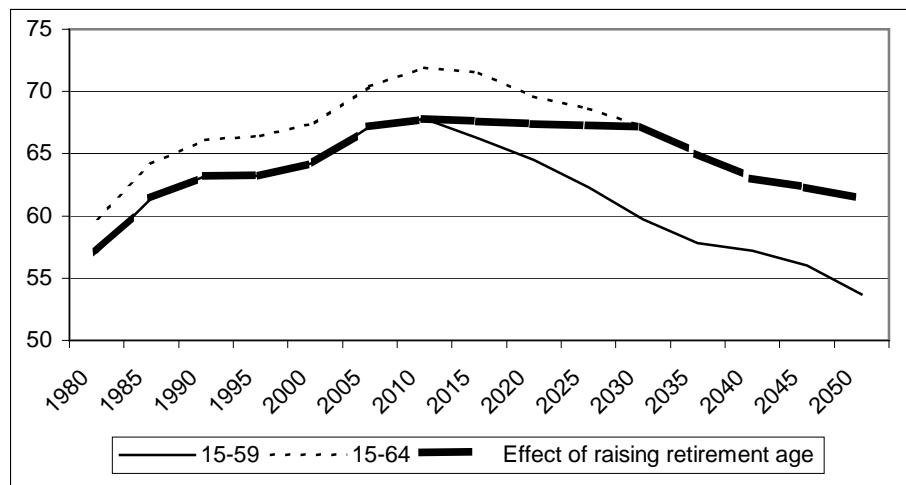
Looking forward, however, demographic change does present a challenge to the Chinese economy. All things being equal, a smaller working age population will result in higher wages, less savings and higher interest rates. Therefore, this demographic change will reverse many of the advantages that China has enjoyed over the last 30 years. However, policies can be implemented to mitigate the effects of this change.

First, the retirement age can be increased. The official retirement age is 60 for men and 55 for women. Moreover, people in manual jobs are allowed to retire five years earlier and there appears to be a tolerance for even earlier retirement. Figure 5 shows the effect of moving the retirement age up 5 years. Note that, depending on how the increase is phased in, the working age population's share in the total population could be maintained until 2030.

Second, the *hukou* system, which links workers to their place of origin, could be relaxed. The system was designed to prevent the type of urban drift and crime-

ridden shantytowns that are endemic to many developing countries. However, as noted above, the *hukou* system imposes costs on migrant workers, which, at the margin, keep them in lower productivity activities. Allowing migrant workers the right to access social services where they work would lower the cost of migration and increase labour supply where it is needed most.

**Figure 5: Working age population as a share of total population**



Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2008 Revision, <http://esa.un.org/unpp>; authors' calculations.

Third, the government may want to phase-out the one-child policy. Introduced 30 years ago to stave off a growth in population that could outstrip the ability of the economy to provide basic needs, the one-child policy is at a cross roads. The policy already has a number of exceptions and there is a pent up demand to have more children. The productivity of the Chinese economy has surged in the last 30 years and China can easily provide universal food, shelter and clothing. Thus, the time could be ripe to allow for bigger families.

Fourth, workers need to become more productive. Since the beginning of the reform period, China's policy imperative has been to provide jobs for an ever-growing number of workers. With demographics about to change, policy must be reoriented to making relatively fewer workers more productive. There are a number of concrete steps the government can take in this regard including ensuring that China's vibrant private sector can compete on an equal footing with the less efficient state-owned enterprises, increasing access to education and supporting innovation by protecting intellectual property.

But even those who conclude that China has not yet reached its Lewis turning point concede that the end of surplus labour is approaching (Knight, et al. 2010). On the assumption that China can maintain economic growth in the future, demand for additional labour force will make rural-urban migrants increasingly important in the urban economy – and, at least in the long run, will elevate the pressure to improve their treatment.

#### **4 Political support for a new growth model**

The extensive media coverage of recent labour unrest suggests that the Chinese leadership supports higher wages (GT 2010a). Talking to construction workers, Premier Wen Jiabao noted that government officials, as well as all members of society, should treat young migrant workers as their own children. He added that the migrant workers' contribution to the growth of the country's wealth and the building of urban skyscrapers should be respected (XH 2010a). The central government is expected to approve a wage regulation by the end of this year in a major effort to improve workers' lives and narrow the income gap (Yu 2010).

For the leadership, wage growth is directly tied to boosting domestic consumption and transforming the economic growth model. This 'second transition' (Bottelier 2007) will lead to a more sustainable pattern of slower, but higher quality growth. The economic model will shift from being export-led, labour-intensive and resource-intensive to a reduced dependence on investment and external demand. This shift is central to the 'scientific development concept' of the incumbent Hu-Wen-leadership, but, so far, little progress has been achieved.

In November 2009, the Politburo introduced 'Five Points of Even-Greater Emphasis', which stress raising the quality and efficiency of economic growth, accelerating the shift of the economic model and autonomous innovation (Naughton 2010). On February 3, 2010, President Hu Jintao said that 'on the surface, the global financial crisis impacted the speed of China's economic growth, but in essence it was the economic growth pattern that was worst hit' (XH 2010b). We expect that this transformation will feature prominently in the next Five-Year Plan.

The three new labour laws that took effect in 2008 were intended to create a more equal basis in industrial relations. Most important was the new Labour Contract Law that aimed at the formalization of individual labour relations. Enforcement, however, was deferred due to the global financial crisis and the slump in exports. The fear of rising unemployment and social unrest led the Chinese leadership prioritize employment stability. With the economy back on track, enforcement might be put on the agenda again. Even though the new law turned out to be less restrictive than suggested,<sup>8</sup> it will increase firms' administrative costs for formalized treatment of workers.

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<sup>8</sup> Only 42.8% of migrant workers have signed a labour contract (GTJ 2010).

## 5 What about foreign companies?

Changing the growth model also appears to imply a different attitude toward foreign direct investment. For some time already, Western companies have complained that China's approach has changed and that it is becoming more selective towards FDI (Dyer 2010b). The government policy of promoting "indigenous" or "home-grown" innovation in information and communication technologies industries focuses on nurturing large-scale local firms in a few high-technology sectors. The goal is to increase domestic value added by exporting products based on indigenous innovation rather than continuing to pay the high cost of licensing foreign technologies (USCBC 2010).

The effect of rising wages on foreign companies' China operations depends on many aspects, including the labour intensity of production, productivity, and location. As we have suggested, there is little reason to believe that China will run out of cheap labour in the near term. Labour productivity in agriculture is still low and rural labourers can multiply their income by moving to cities. Migrant workers have flexible work arrangements as the minority have formal labour contracts. Studies on urbanization show that rural migrants will continue be the largest source of increase in the urban population in the next decade. And the elimination of the *hukou* system could further increase labour mobility.

Compared to other developing countries in Asia, China's workforce is still cheap, even though not as cheap as it used to be.<sup>9</sup> There are differences between the skilled and unskilled sectors. Data for migrant workers in Guangdong suggest that between 2000 and 2004 much of the real wage gains stemmed from the improving educational endowment. Real wages hardly changed for the very lowest skilled workers (Herd et al. 2010: 21). Though the returns to unskilled labour have risen recently, wage growth for this group will remain moderate due to potentially large supply and rather modest demand.<sup>10</sup> Thus, China will likely maintain its competitive edge in low labour cost in the near future (Yang, et al. 2010).

In labour-intensive and export-oriented sectors like textiles, shoes or toys, however, profit margins are often extremely thin. Thus, many companies have moved production to lower wage countries like Vietnam. Skill-intensive and technology-intensive economic activities are better placed to offset higher wage through increased productivity. Wage increases may, for example, not have a big impact on petrochemical

<sup>9</sup> China's wage level in manufacturing is still only about 7 to 21% of economies such as Japan, Korea, Taiwan or Hong Kong. It is below that of Malaysia and comparable to the levels of the Philippines and Thailand (Yang, et al. 2010: 17). 'At \$1.98 per hour in 2010, Chinese hourly compensation in manufacturing would still be less than 15% of that elsewhere in East Asia (ex Japan) and only about half the pay rate in Mexico' (Roach 2010). China's minimum annual income is said to be less than 15% of the world's average (GT 2010).

<sup>10</sup> Total employment in manufacturing has only increased at an annual rate of about 3% in recent years (Yang, et al. 2010: 20).

industry as labour costs only make up 2-3% of its overall production costs (Suratman 2010).

Things may, however, look different for Chinese contract manufacturers. Consider the new Apple iPhone 4. Only 7% of its costs are incurred in Shenzhen. Apple's profit margin of as much as 60% gives a lot of leeway to absorb cost increases. But contract firms operate on slim profit margins. For them soaring labour costs could pose a serious problem (see [www.isuppli.com](http://www.isuppli.com) and Barboza 2010). Foxconn Technology Group, which makes iPhones and other gadgets, said it will cover the wage increases by speeding up factory automation programs and by charging its customers more. The shifting of some of its operations to inland China might also help to mitigate rising labour costs in southern China's factory belt (CD 2010a, 2010b).

Relocation to inland regions, where wages are lower, is one of the strategies companies employ to cope with increasing labour costs. Anhui, for example, could be quite attractive as Geoff Dyer explained (Dyer 2010a). Compared to Western provinces like Sichuan or the city of Chongqing that provided even cheaper labour production, Anhui is closer to the coast and does not have costly logistical problems.

Much depends on productivity. For example, from 1995 to 2004 labour costs in China's bigger firms tripled, but labour productivity more than quintupled, resulting in a decline of unit labour costs by 43% (according to n.A. 2010). Even if this amazing productivity performance cannot be repeated, finding efficiency gains is the best option for companies to offset wage increases. While growth is slowing, the position of Chinese industry remains strong, profit margins and profit levels for the first five months of 2010 compare favourably with those of previous years. Profit data does not indicate that firms are suffering from the rise in wage costs. Our view is that recent wage increases are broadly in line with gains in productivity.

There are also measures policy-makers can take to meet changes in labour force development as we have mentioned above. The retirement age can be increased, the *hukou* system could be further relaxed or even abolished, or the one-child policy could be phased out, as advocated by many experts. By further reforming the education system, the government could also help to make relatively fewer workers more productive.

The outsourcing of the low-end industries will force the coastal area to upgrade its industry, which suits the leadership's intention to transform China's economic growth mode. In the long term, higher labour costs would help China to change the country's manufacturing mix, upgrade its economy, and reduce the income disparities. Rising wages and higher consumption in China could also lead to higher Western exports, thus creating jobs in Europe and USA, reducing the trade deficit, and making up for falling sales at home.

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