Cover Story

China's New Normal: 7% Growth

How would the transitioning of the Chinese economy from high growth to stable growth impact China and the rest of the world, and what changes will it bring for Korea? Might some of the answers lie in looking back on Korea's own experience with a downshifting economy? How can we prepare for the future in the face of China's determination to reinvent itself with a view toward the long term?

"The Only Way is to Reform. Achieving 7% Growth is No Problem."

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Outside an electronics store in central Nanning, capital of the Guangxi Zhuang Autonomous Region in southern China. Urbanization helps China maintain economic growth by promoting consumption and investment.

China's Economy Still Has High Growth Potential

China's economy is now in transition. While it may have achieved rapid growth of 10% over the past 30 years, the period of high growth has now passed. A close look at internal factors influencing China's economic development suggests that the country has undergone significant changes in demographics and labor supply. Both the proportion of China's working population between the ages of 15 and 59 and the size of the overall population have declined, indicating an end to the era of population growth. China's total factor productivity (TFP) growth, which was made possible by reallocating resources in the agricultural and industrial sectors, has also declined due to a decrease in the agricultural sector's share of GDP to less than 10%. In terms of external factors, the global economy has not yet recovered as debt and deleveraging pressure continue to grow along with a rise in trade disputes. In other words, the external environment cannot support further Chinese economic growth.

Many investors focus on the aforementioned negative aspects of the Chinese economy, but they seem to have overlooked its positive aspects. Even though a social consensus on the future of China's economy has not been formed, a number of research studies suggest that China will have no difficulty achieving 7% growth in the near future because the country has growth potential in three areas.

First, China can upgrade its industrial structure. It is not a manufacturing power but a country with a large manufacturing industry, which means it still has room for further industrialization. In 2007, the added value ratios of the manufacturing sector in advanced countries such as the United States, Britain, and Japan were 44.8%, 33.9%, and 33.1%, respectively, while that of China stood at only 26.4% in 2010. In order for China to reach a similar level of industrialization as the U.S. or Japan, its added value ratio in the manufacturing industry must increase 30 to 70%.

Second, China can accelerate the urbanization process. Currently, China's urbanization rate is 52.6% when counting all those living in urban areas, but the rate would fall to 35% if counting only those with urban household registration. This means that China has much room for urbanization. If the country can resolve its migrant worker issues, it is likely to achieve high-quality urbanization, promoting consumption and investment.

Third, China can enhance its ability to innovate. For now, a clear gap separates it from more technologically-advanced countries, and China has been slow in catching up with their technologies. However, China's capacity to innovate has been enhanced significantly with increased investment in technological innovation. The number of international journal citations, which represents a country's capability in basic science, has increased while new businesses in the biotech and IT sectors have made great progress.

Multi-layered Structural Challenges Facing the Chinese Economy

With the rapid growth of the Chinese economy, a number of multi-layered problems have accumulated. If China fails to solve these problems, its economy will fail to maintain growth and fall into the middle-income trap.

First, the growth windfall has not been distributed equally. According to the Chinese National Bureau of Statistics, the country's Gini coefficient was 0.491 in 2008 and remains around 0.47, even though some organizations insist that it has surpassed 0.6.

Second, China's economic development has given rise to serious environmental problems such as acid rain and desertification. Third, the country's rigid system has prevented social mobility. As a result, a number of people who migrated to the cities have failed to become full urban residents, leading to a dualistic system within the cities that has given rise to public discontent.

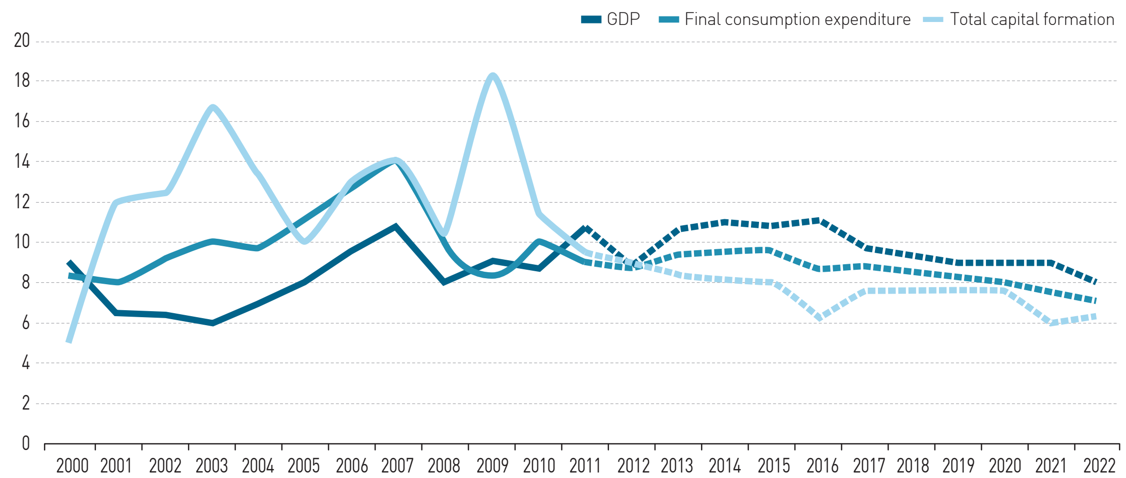
A slowdown of China's economic growth will reveal certain problems that were not taken seriously during the era of rapid growth. The most serious issue is excess industrial capacity, particularly in the steel, coal, chemicals, building materials and nonferrous metals sectors. The excess capacity issue has come to the fore several times but had been solved previously with the help of high growth. China has no experience in solving such problems without such high growth.

In addition, the asset bubble, especially the property bubble in China, is likely to cause economic instability. Changes in the property market will affect investment as well as people's income and consumption, ultimately having a negative impact on the financial market and financial institutions. There is no need to argue over the bubble. What matters most is reducing possible shocks to the economy caused by changes in the real estate market.

Another problem is associated with the reduced role of local government. Even though China's local governments had long been key players in economic development, they now have only limited tools to contribute to the country's economic growth due to reduced income and problems related to local government loans. In the meantime, companies have been losing growth momentum. A number of newly emerging large

China can maintain growth by industrializing, urbanizing and enhancing its capacity to innovate. However, it must also solve problems such as asset bubbles and the wealth gap.

China's Long-term Economic Growth Prospects (Unit :%)



companies have management that is ineffective, recklessly diversifying without enhancing their capacity to innovate.

Carry Out Restructuring While Preventing Risks

As the Chinese economy undergoes transition, government policies are at the center of attention. During a transition period, it is difficult to form a consensus on what is a growth engine for the economy, resulting in different interpretations of economic statistics and policies. Investors are also confused. What is clear, though, is that China's existing development model is not sustainable, and the country can continue to grow only when it invigorates all economic players through reform.

China's current economic policies are focused on stabilizing growth, promoting reforms, restructuring the economy and guarding against risks. Stabilizing growth means maintaining economic growth at the same rate as potential growth through sound currency policies and active financial policies. This means China will seek to achieve 7.5% growth, a goal set early this year. Maintaining growth at a certain level is important for effective economic management because reform, restructuring, and avoiding risk would be impossible without growth. Promoting reform means improving relations between government and market, expanding a market-based system, and establishing a sound market economy. Restructuring is correcting irrational aspects of industrial structure, demand structure and income distribution. Guarding against risks means controlling and preventing financial risk, liability risk, and asset-bubble risk.

Learning from Korea
How to Escape the Middle-income Trap

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China's economic reforms include the liberalization of financial and capital markets. However, it may take time for the country to improve its financial structure, which has been distorted by excessive government intervention.

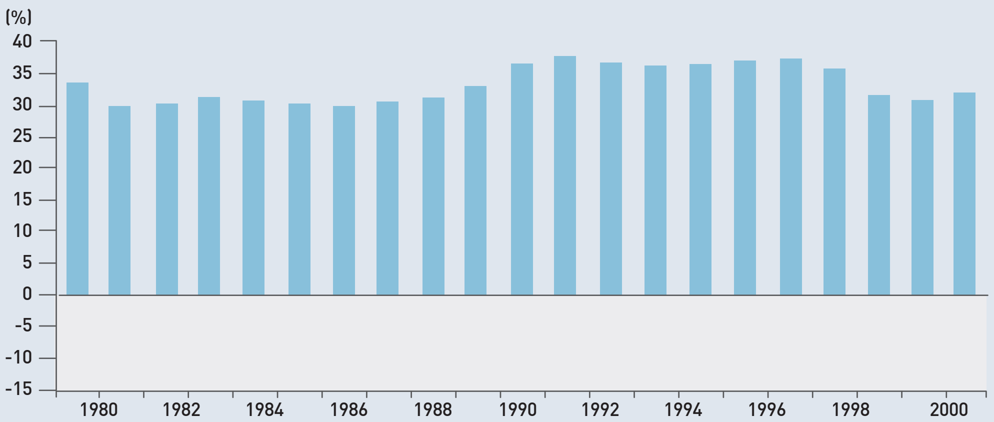
Will China escape the middle-income trap? This is one of the biggest concerns for Chinese economists. Not surprisingly, their attention has been drawn to those countries that have successfully avoided the middle-income trap. Among this group, Korea might be the best subject of research. Can Korea become a good "model" for China? What can China learn from the Korean economic experience?

Three Lows Drove 9.8% Annual Growth in the 1980s

The 1980s was the golden age of the Korean economy. Aggressive economic stabilization policies carried out by the Korean military government in the early 1980s coupled with the so-called "three lows" (low dollar, low oil prices, low interest rates) paved the way for rapid growth. Korea's annual economic growth for the decade averaged 9.8%, greatly surpassing its potential growth of 8%, while per capita GDP rose 14% per year on average, indicating that people's living standards improved significantly. However, the country's low wage-driven industrialization strategies have not worked since 1990. In the 1990s, Korea's annual economic growth fell to 7.1% and its potential growth declined to around 6%. In short, the Korean economy

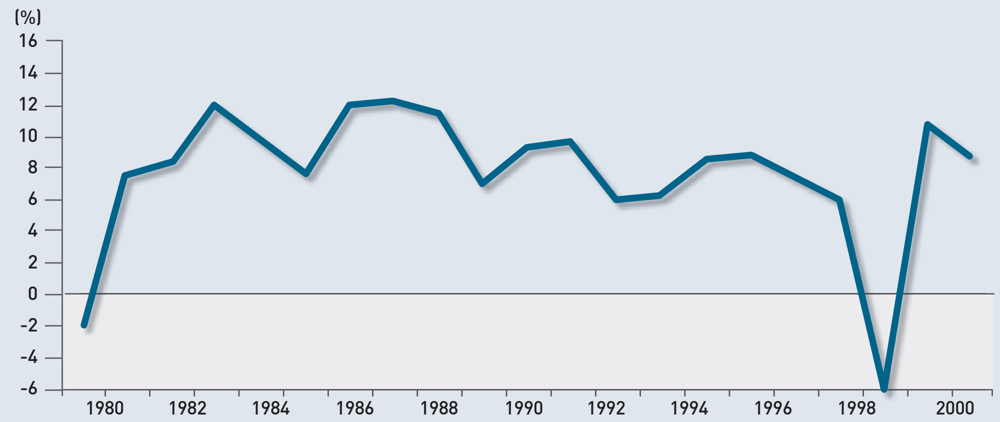
Korea's GDP Growth

(Share of Gross Fixed Capital Formation in GDP)



Korea's GDP Growth

(Economic Growth)



entered a period of steady growth due to the end of the three lows, limits to capital injection-fueled growth, and a rapid increase in production costs.

Korea's capital injection-fueled growth seems to have reached its limit in the late 1980s. In the manufacturing sector, the annual average total factor productivity growth dropped from 5.0% during 1986-1988 to 2.2% during 1989-1993, even raising concerns of a crisis in manufacturing. The share of gross fixed capital formation in GDP reached a peak of 38% in 1991, but continued to decrease to 29% in 1999. As a result, the contribution of gross fixed capital formation to GDP growth plunged from 3.7 percentage point to 2.3 percentage point. Second, wage increases following a series of massive labor strikes in 1987 put a damper on Korea's economic growth. The annual average growth rate in real wages rose from 6.3% during 1985-1987 to 10.6% during 1988-1990. At that time, the labor productivity growth rate was lower than the real wage growth rate, thus increasing the burden of production costs for companies. Meanwhile, a sharp expansion of the middle class turned the country into a mass consumer society in the early 1990s. An increase in private consumption has been linked to lowering the total savings rate from 40.7% in 1988 to 34.6% in 1996, reducing long-term growth rates.

Advancement of Industrial Structures, Deregulation, and Open-door Policies

The most striking feature of the Korean economy's transition from rapid growth to steady growth was the significantly increasing role of private companies in the national economy. During the boom period of the three lows, private companies, particularly large companies, could secure investment resources with relative ease. With this capital, companies could push forward with their investment strategies in response to economic slowdowns. On the basis of these sizable investment resources, a growth system began to be formed that was focused on high value-added heavy chemical industry products such as semiconductors, automobiles, home appliances, steel, and shipbuilding, and was complemented by an export-oriented industrial structure anchored by large companies. As a result, the proportion of heavy chemical products to total exports rose to 72.7% in 1995. In the 1990s, companies also began to advance into foreign markets due to the limited expansion potential of the domestic market, high production costs and land prices.

Meanwhile, with the globalization of Korean companies and market liberalization, direct government intervention decreased and economic development programs were, in effect, abandoned. In particular, the liberalization of capital movements initiated by the government in the early 1990s marked an important turning point. The need for large companies to enter the financial sector, along with the national goal to join the Organization for Economic Cooperation and Development (OECD), led the government to begin active liberalization of regulations on foreign currency and capital transactions in 1993. As a result, financial institutions could borrow large

China should pursue privatization, deregulation, advancement of industrial structures, and improvement of income distribution.
It must learn from Korea, which had to deal with real estate bubbles, low financial competitiveness, and external growth of insolvent large companies.

amounts of foreign currency at low interest rates and meet business demand during the economic upturn of the mid-1990s. In addition, as the government worked to relax import controls, Korea's degree of import liberalization reached that of OECD member countries in the mid-1990s. In fact, the Korean government intended to promote competition, thus improving industrial competitiveness through open-door policies.

Efforts to Improve Income Distribution and Reduce Asset Bubbles

As the Korean economy transitioned to stable growth, two other characteristics seen during this process were the improvement of income distribution and the reduction of asset bubbles. Income distribution improved gradually from 1980 to the mid-1990s. The Gini coefficient, which represents income inequality (values closer to zero express lower inequality), declined from 0.34 in 1985 to 0.27 in 1994 while R/P 10% (the ratio of the average income of the richest 10% to the poorest 10%) also decreased sharply from 4.6 to 3.6 during the same period. In addition, social welfare improved with the National Health Service expanding to cover the entire nation in 1989 and the National Pension Scheme and Employment Insurance System being adopted in 1988 and 1995, respectively.

In the meantime, asset bubbles that had formed during the economic boom of the late 1980s decreased in the 1990s due to economic slowdowns thus causing many challenges. In the housing market, imbalance between supply and demand intensified because a rise in household income and the urban population drove up demand for housing. As a result, apartment prices skyrocketed by 20.7% during 1988-1991. When the housing market showed signs of excess demand, the Korean government announced a plan in 1988 to construct two million new units, which brought about structural changes in Korea's housing market. In 1992 when people began to move into new towns, the number of unsold apartments rose, leading apartment prices to plunge by 11.5%. They would continue to fall by an annual average of 2.7% until 1996.

Flawed Financial System Invites the Asian Financial Crisis

As Korea transitioned from rapid growth to steady growth in the 1990s, the Korean government implemented a wide range of reform policies including those aimed at the advancement of industrial structures, deregulation and open-door policies while companies grew substantially based on the strength of the heavy chemical industry. However, the government's ability to ensure the soundness of financial institutions did not keep up with changes in the structure of the economy. In addition, the companies' external growth, which relied on debt and foreign capital, exposed a variety of problems such as overinvestment. Ultimately, the Korean economy was hit hard by the 1997 Asian financial crisis.

The Chinese economy is also preparing for a soft landing to steady growth. China is different from Korea in many aspects: physical characteristics such as population and land size; economic system (China has its own brand of socialist market economy); values; and culture. Therefore, one must be careful to analyze changes in the Chinese economy based on the experience of the Korean economy. Nonetheless, Korea's experiences could have significant implications for China: After it accumulated industrial capital and achieved export-oriented growth with support of the planned economy led by the government and low wages, Korea made its growth sustainable through the private sector-led market economy and distributive justice. China is likely to face the same challenges Korea dealt with: collapse of real estate bubbles, weak financial system and competitiveness, market-opening and bankruptcy of insolvent large companies. In that sense, studying the Korean economy would be useful for Chinese economists.

The "China Cycle" Overturned

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Any recent news from Brazil is cause for concern. The Brazilian economy has sunk into recession and violent protests continue to take place around the country. Its GDP growth, which reached 7.5% in 2010, plunged to 2.7% in 2011 before dropping to 0.9% in 2012. It dropped even further to 0.6% in the first half of this year and shows no sign of recovery. Some even say that Brazil should waive the right to hold the 2014 World Cup. What happened to Brazil, which only a few years ago had been described as a "top student of the world economy" along with China? China is a factor that has led to the current conditions in Brazil.

In 2010 when the Brazilian economy was booming, the country recorded a trade surplus of USD 5.2 billion with China. At that time, Brazil's total trade volume was USD 54.6 billion and the country mainly sold natural resources to China. Excluding resources, Brazil's trade deficit with China reached USD 23.5 billion, meaning that Brazil imported products from China with the dollars it earned from natural resources. However, this situation did not last long. China's construction industry began to shrink in 2011 and demand for raw materials declined, resulting in a sharp decrease in Brazilian exports to China.

The term "Dutch Disease" refers to a mechanism in which a resource-rich nation exports natural resources and enjoys a temporary boom thanks to inflows of foreign capital, but falls into economic recession because price increases and a strengthened currency make its manufacturing sector less competitive. This is a vicious cycle: exports of natural resources bring in dollars, which results in currency appreciation, thus weakening the competitiveness of its manufacturing sector. It was China that offered Brazil the “Magic Moment” of rapid growth, but it was also China that put an end to that growth.

The case of Brazil clearly shows how growth and recession in the Chinese economy can affect the rest of the world. Ben Simpfendorfer, an economist at the Royal Bank of Scotland (RBS) dubbed this phenomenon the “China Cycle,” meaning economic fluctuation caused by China. The China Cycle has its origins in 1990s East Asia. As China emerged as the world’s factory, neighboring countries including Japan, Korea, and Taiwan served as parts bases, providing the factory with parts. The ratio of intermediate goods (parts or half-finished goods) in major Asian countries’ exports to China is 74% in Taiwan, 72% in Korea, and 60% in Japan. Countries with abundant natural resources such as Brazil and Australia also became involved in the China Cycle. As China began to suck up raw materials, driving up international raw material prices, resource-rich nations have received windfall gains.

Multinational companies are also relying heavily on the Chinese market. With China’s emergence as the world’s department store, the Chinese market can now determine the fate of those companies. In short, many countries across the world have benefited from China’s growth, or the China Cycle.

China Cycle vs China Stress

However, too much dependence on China and changes in China’s economic structure have caused stress as well. Since the Chinese economy passed its rapid growth period and has entered a period of 7% growth, it does not always provide benefits to other nations.

Asian neighboring countries are starting to feel more economic stress. China’s economic slowdown directly impacts Korea, Taiwan and Malaysia, which depend on China for 20 to 40% of their exports. According to the Korea Institute for International Economic Policy (KIEP), when China’s real GDP decreases one percentage point, Korea’s real GDP will decline 0.22 to 0.38 percentage points, and its exports to China will fall two percentage points. In other words, when China has even a slight cold, Korea suffers from body aches. But the kind of stress felt by resource-abundant countries is different. A slowdown in China’s investment boom leads to decreased demand for raw materials, thus affecting the economies of resource-rich countries. This is why Brazil is now suffering.

It is a reality that no one can be strong when China is weak. Events happening in China’s financial markets can shake the world’s capital markets. For example, the sharp rise in China’s overnight call rate on June 20 shocked not only Korea and Japan but stock markets around the globe including those in the U.S. and Europe, indicating that the China Cycle has begun to operate in reverse.

Changes in the Chinese economy also increase burdens on the global economy. A case in point is inflation in China. Walmart, the world’s largest retail corporation, has approximately 7,000 suppliers, and 70% of their products are made in China. China’s labor costs have skyrocketed about 20% every year, driving up production costs. As China accounts for 10% of the world’s exports, most of which are daily necessities, consumers around the world are likely to be hit directly by any changes in China. World grain markets also have taken a direct hit from the China Stress. China consumes 17% of the world’s wheat supply and 20% of its corn production. Even the news that China will buy more corn could drive up corn prices.

China is working hard to upgrade its industries despite slowing economic growth as it seeks to avoid the middle-income trap. However, such efforts have led to a talent war. Since undertaking reform and opening, China has taken low-quality jobs from developed countries. China offered simple manufacturing jobs in the toy and shoe industries as well as simple assembly jobs in the IT industry for products such as TVs and mobile phones. However, with rapid technological advancement, China is now threatening high-quality jobs as well. Once Samsung and LG build LCD plants in China as planned, Korea may have to outsource jobs to China. Samsung Electronics even plans to construct plants in the Chinese city of Xian to produce semiconductors, the company’s core product. If they were built in Korea, jobs for vocational college graduates would be created in Korea. The world now seems to have a serious turf war with China.

The China Cycle

1 Emergence as the world’s factory
Sharp increase in exports of intermediate goods (parts) by Asian countries (Japan, Korea, Taiwan)

2 Rapid increase in demand for raw materials
Resource-rich regions (Africa, the Middle East, Central and South America, Russia, and Australia) increase exports to China and attract investment

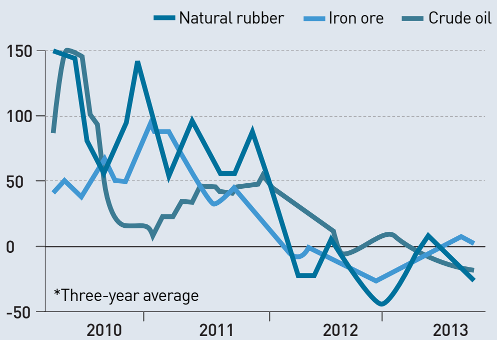
3 Increased supply of low-price industrial products
The U.S. and Europe pave the way for low prices and high growth
China and the U.S. purchase government bonds

4 Expansion of the domestic market
Multinational companies (GE, IBM, and Samsung) benefit from growing sales in China

5 Entry into M&A market
Volvo and Saab enter the Chinese market
Citigroup and AIG sell stakes to CIC
Inflows of China money to the West

6 Provision of foreign currency to troubled countries
Currency swap deals with 8 countries (Korea, Malaysia, etc.)
Purchase government bonds of Europe’s troubled countries (Greece, Portugal, etc.)

China’s Imports of Raw Materials (y-o-y, Unit :%)



Source: CEIC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A Shift to Strategies Aimed at Domestic Market: We Should Know it Inside and Out

During a recent visit to Korea, Rich Lesser, CEO of the Boston Consulting Group, advised Korean companies to focus on Asia if they want to grow. His advice may have come from the assessment that Korean companies, which have grown based on exports, do not know much about the Asian market despite claiming to have a global mindset. Lesser added that Korean businesses should take note of how global firms are responding to the Chinese and other Asian markets. For example, Schneider Electric, a France-based IT company, has headquarters in both France and Hong Kong.

How should we interpret a westerner's advice that Korea, an Asian country, must know more about and concentrate on China and the rest of Asia? In fact, he has a solid basis for this advice. Global companies have already entered the medical supply and device markets in China where both income and the elderly population have been increasing. In July 2011, General Electric (GE)'s health-care unit moved the headquarters of its X-ray business to Beijing. Around the same time, Germany's leading pharmaceutical company Bayer also moved its general medicine headquarters to the Chinese capital. Why are these firms moving to China?

Global Companies Run, Korean Companies Watch

The number of diabetics in China was 93 million as of 2011. In addition, there are 140 million people at risk of developing diabetes in the country. To tap this market, global blood glucose meter manufacturers such as the U.S.-based Johnson & Johnson and Germany's Roche founded local subsidiaries in China in the mid-1990s. As a result, global companies now hold a combined market share in the Chinese industry of approximately 70%. Multinational companies well known for excellent marketing skills did not miss out on "golden opportunities" in China.

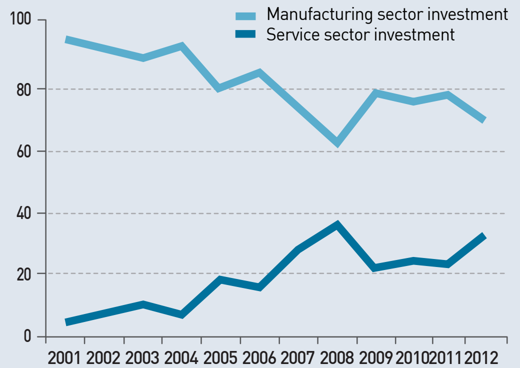
But what about Korea? In 2009, a Chinese consumer wanted to buy a new lightweight, better-performing insulin pump as his was too old. The insulin pump he had was made by a Korean company, which had the world's No. 2 technology. So he searched for the price of a new product launched by the Korean company and found that

A large billboard for the Korean cosmetics brand Laneige on the wall of Hong Kong's SOGO Department Store, the bridgehead of AmorePacific Cosmetics to China. (JoongAng Photo)

it was being sold for CNY 70,000 (KRW 13 million). However, the same product was being sold for less than KRW 3 million in Korea. As the Korean company did not have a local factory in China, Chinese consumers had to buy imported products, and the profits went to Chinese retailers.

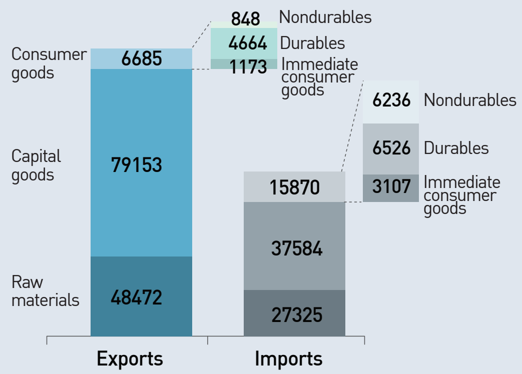
Products made by the Korean insulin pump manufacturer are more expensive because its technology is much more advanced than that of other companies. However, the Korean company gave up on advancing into the Chinese market due to a vague sense of anxiety. If only it had recognized China's potential four years ago and entered that market, we would have seen a Korean medical device manufacturer develop into a global company while benefiting from rapid growth in China.

Korea's FDI in China by Industry (Unit:%)



Source: Export-Import Bank of Korea (Korea Eximbank)

Korea's Trade with China (2012) (Unit: USD million)



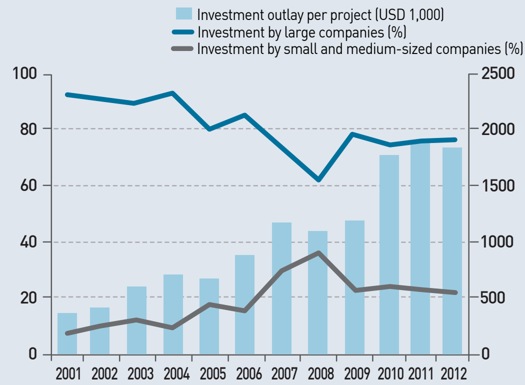
Source: Korea International Trade Association

China's Business Environment Will be Different in the Future

The Chinese economy over the past ten years may be characterized as one driven by rapid growth based on investment and exports, supported by the three lows and aided by the government – low wages, low interest rates, and the low value of the Chinese currency. In the past, Korean companies, which could not compete with high domestic factor prices on the global market, used cheap factors of production in China to extend their product life cycles. The Korean companies manufactured products in China and sold them to the global market, enjoying the benefits of China's three lows. China accounts for the largest portion of Korean small enterprises' foreign investment and exports of intermediate capital goods, which reflects the Korean business strategy to use China as a processing and manufacturing base.

However, after a decade, the Chinese economy shifted to relatively high wages, high interest rates, and a high currency value. With decreasing investment and exports, China now has no choice but to shift its strategy toward the domestic market. China's macroeconomic conditions, which were controlled by the central government, are likely to be exposed to more frequent fluctuations so that the Chinese market can automatically respond to and insulate itself from changes. Over the past ten years, China's capital goods businesses have caught up with Korean companies, thus increasing the intensity of competition between Korea and China. If high wages and the strong yuan persist, Korean companies' strategy of exporting intermediate goods to China, and then processing and re-exporting the products may not work anymore. If Korean companies sell and export intermediate goods such as petrochemicals and steel through processing plants in China, they must compete with Chinese companies, which now have high production capacity and competitiveness. Given the high wages and strong yuan, Korean companies might face challenges in the Chinese market.

Korea's FDI in China by Company Size



Source: Export-Import Bank of Korea (Korea Eximbank)

Time to Devise Sales Strategies

Korean companies' recent China strategies reflect the changing local business environment. The proportion of intermediate goods in Korean exports to China increased from 35% in 2002 to 61% in 2010 in tandem with an increase in Korea's direct investment in China. However, the ratio has remained at 59% from 2011 to the first half of this year. In addition, as investment by large companies, aimed at China's domestic market has grown, large companies have accounted for an ever greater share of Korean investment in China, rising from 56% in 2006 to 76% last year. In terms of direct investment in China, the manufacturing sector accounted for a decreasing proportion of FDI by Korean firms, dropping from 85% in 2007 to 70% last year. At the same time, direct investment in the service sector rose last year, accounting for 30% of total direct investment in China by Korean firms, implying a desirable shift is under way.

Nonetheless, Korean companies must heed the advice of Boston Consulting Group's CEO. When the goal of Korean companies was to produce goods in China, they could just combine the effective Korean production system with China's low-price factors of production. At that time, what mattered most was what they had to produce. However, if their goal is to sell products in China, they must know more about China. Korean companies must understand the characteristics and preference of Chinese consumers, the strengths and weaknesses of Chinese companies, and the Chinese government's policies and social changes taking place in China. Korean garment and shoe makers, which moved their production bases to Southeast Asia from China, also need to consider the Chinese market's potential in order to leap forward. During the manufacturing period, what was critical to operating business in China was the ability to manufacture products at cheap prices. As Korea was well accustomed to this paradigm, China was a blessing for the Korean economy. Now that China has entered the period of consumption, what matters now is deciding what to sell. This is what Korean companies have to do in order to survive in China, which has been moving toward 7% growth. Korean companies should work hard to ensure that China remains a blessing for them.