China's growth engine remains strong in 2012

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Henry V's marriage to Catherine of Valois took place in London just three weeks after the inauguration of the Forbidden City. Twenty-six thousand guests were entertained in Beijing, where they ate a ten-course banquet served on dishes of the finest porcelain; a mere 600 guests attended Henry's nuptials and were served stockfish (salted cod) on rounds of stale bread that acted as plates.

An excerpt from *1421: The Year China Discovered the World* by Gavin Menzies

This quote plainly shows that the national power and wealth of China overwhelmed that of Europe in the past. China maintained its global status as the strongest economy up until the early 19th Century, but the Chinese economy contracted following invasion by Western Powers, abrupt power shifts, and internal wars. However, China has emerged as one of the G2 since its accession to the WTO in 2001, and hosting the 2008 Summer Olympics. China's status in the global economy is undeniable. The world already seems to have changed from a world of Pax Americana to a world of Pax Chimerica.

China's growth engine remains strong

The European sovereign debt crisis shows no signs of settling down. The American economy, the world's largest consumer market, has failed to recover from the downturn that followed the US-led financial crisis. The black cloud cast over the global economy is not disappearing quickly. Perhaps because of these circumstances, the world is paying attention to the path of the Chinese economy, which has continuously achieved an economic growth rate of over 9% and has the world's largest foreign exchange reserves, despite the rapidly changing global environment. The world is watching closely, with worry and anticipation, at how well China will play its role as a lifesaver of the global economy.

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In short, despite many uncertainties, the Chinese economy is expected to maintain its robust economic growth in 2012 and perform its duty relatively well as an axis of the world economy. So far, the Chinese economy has suffered many ill effects accumulated in the process of rapid growth, but its foundations and potential are strong enough to overcome these effects and move forward.

First, China continues to enjoy relatively good export growth. China's overall export growth is slowing down due to the economic uncertainties of the EU, China's largest export destination, and the USA, but its export growth rate of 2011 was 20.3%, due to continuously growing exports to emerging economies. This figure is lower than the 2010 figure of 31.3%, but higher than negative numbers in 2009, and the 2008 figure of 17.2%. While growth rates of exports to the EU and the USA stood at only 14.4% and

14.5%, respectively, growth rates of exports to emerging countries were relatively high at 23.1% for ASEAN, 23.5% for India, 31.4% for Russia, and 30.2% for Brazil. China's export growth is expected to fall from its current rate of above 20% to below 20% in 2012, but China's efforts to expand exports to emerging economies are expected to complement sluggish exports to advanced countries.

Second, China's financial condition is relatively sound. China's debt-to-GDP ratio was 43.5% in 2010, much lower than that of other countries: the USA at 94%, Japan at 199%, France at 94%, the UK at 82%, Brazil at 61%, and India at 56%. This means that China has enough economic power for any unexpected event. The Chinese government, which has been leading China's economic growth, has the power to respond to downside risks at any time, in case the downside risks become so great that China is unable to achieve its target growth rate.

Third, China's demographic, with its record high working-age population (15-64 years), is favorable to economic growth. The dependency rate, a ratio of the number of dependents (aged 0-14 and over the age of 65) to the working population, is expected to rise in China by around 2015. Up until then, China is expected to enjoy an ample supply of workers.

Finally, China's efforts for structural reform for qualitative growth and its strategy to bolster domestic demand by empowering the middle class are expected to have gradual effects. The Chinese government has already established the policy foundation in the 12th Five-Year Plan to promote consumption over investments. China has implemented various policies to boost consumption. In September of 2011, China raised the monthly personal income tax threshold from RMB 2,000 to RMB 3,500; China has cut import tariffs for 730 types of products, including household and medical products, from January of 2012. This year, in the second year of the 12th Five-Year Plan, a wide range of policies promoting consumption are expected to be implemented. Subsequent domestic demand expansion is expected to sufficiently offset the effects of export reductions.

Sufficient capacity for risk management

Despite robust growth prospects, the Chinese economy has some risk factors to consider, particularly early this year.

First, there are some worries about the possibility that China's real estate prices are going to fall dramatically. Its real estate prices surged thanks to rapid economic growth, but in 2011 they exhibited signs of falling following a variety of tightened investment restraint policies. In January of 2011, second-hand house prices fell compared to the previous month in 3 out of 70 cities, but in February of 2012, the figure reached 45. Meanwhile, the surge in housing supply and burdensome stocks for real estate developers in 2012-2013 are likely to drag real estate prices down. Given that the real estate sector and related sectors account for about a quarter of China's GDP, a sudden fall in real estate prices could result in a hard landing for the Chinese economy.

Fortunately, however, China's real estate prices are not likely to decline suddenly. Demand for new houses continues to rise because of rapid urbanization and the trend toward nuclear families; the increasing demand is expected to prevent real estate prices from falling dramatically. For example, China's urbanization rate at the end of 2010 was 49.7%, lower than the world average of 55%. China's urbanization rate, which increases by 1 percentage point each year, will create a continuous demand for real estate for the next several years. Moreover, if real estate prices sag due to unexpected internal or external shocks, the danger of the price fall leading to financial instability and economic slump is limited. Chinese banks' bad-debt allowance increased from 155% at the end of 2009 to 278% at the end of 2011, showing that Chinese banks have enough capacity to handle losses. In addition, derivatives in China are not mortgage-backed;

therefore, real estate slowdown is less likely to spread to the financial market—another factor that makes a hard landing for the Chinese economy an unfounded fear.

Moreover, being aware of the risk of a plunge in real estate prices, the Chinese government is highly likely to adjust the strength of stability policies for the real estate market, depending on the downside risk of the economy. However, the Chinese government needs to maintain related regulations in order to ensure reasonable housing prices and prevent speculation. The Chinese government seems to think it can handle the situation.

The second risk is the possibility that local government debt, accumulated in the process of rapid growth, could lead to insolvencies of local governments and the financial sector. At the end of 2010, China's local government debt was at 26.7% of the GDP, RMB 10.7 trillion. Of this, 79.5%, RMB 8.5 trillion, was borrowed from banks, meaning local government debt could easily result in bank insolvencies. According to an estimate, non-performing bank loans account for as much as 20-30% of total

2012 China economic forecast

Economic forecast institution	Economic growth rate (%)
IMF (Mar. 2012)	8.2
Global Insight (Mar. 2012)	8.2
World Bank (Jan. 2012)	8.4
The average for 8 IB's (Mar. 2012)	8.4
CASS (Mar. 2012)	8.5
State Council of the PRC (Mar. 2012)	8.5

Note: Dates inside parentheses refer to forecast months local government debt. Moreover, the income structures of local governments are weak, evidenced by the fact that 30-40% of their revenues come from the sale of land use rights. As the real estate market condition is directly related to local governments' budget balances, a real estate market freeze could be a deadly blow to local government finances.

Fortunately, local government debts are not likely to suddenly drag down China's robust economic growth or cause bank insolvencies. As stated earlier, China's real estate market has little chance of freezing, and the central government has economic power. Moreover, the Chinese government is actively trying to address the local government debt issue using various microeconomic policies. The Chinese government also tries to secure revenue in a transparent and legal manner—for example, by the introduction of the property tax and resource tax, and through approvals for the issuance of local bonds.

Above 8% economic growth rate expected

Despite various internal and external risk factors, the Chinese economy is expected to continue to grow above 8% in 2012 by focusing on domestic demand over exports as its growth strategy, and by enhancing swift macro control capacity based on sound finances. This figure is much lower than China's average economic growth rate (10.6%) for the last decade (2002-2011), but it is in the range of 8-9%, which the Chinese government considers the necessary economic growth rate for employment and social stability.

In 2012, China is expected to focus its efforts on offsetting contracting overseas demand with expanding domestic demand. The Chinese government will actively continue to implement financial policies to benefit high-consuming, middle-to-low income classes in order to reduce dependency on exports and promote domestic consumption. These policies will include raising minimum wage requirements, providing more affordable housing units, and expanding social security benefits, such as medical and pension benefits.

Given that the capacity of China's monetary policies to respond to downside risks has increased thanks to the slowdown in inflation, China is highly likely to adopt easy monetary policies. After having cut banks' reserve requirement ratio by 0.5 percentage points in February of 2012, China's central bank is expected to cut the ratio several times again this year. Given that the Chinese economy still has the characteristics of a state-led and planned economy, China's potential for continuous growth depends on the direction of government policies.

Managing "China's variables" is key to the Korean economy

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Currently, the business world seems more uncertain than at any time in the past. This year, with presidential elections scheduled in major advanced countries, including South Korea, global power dynamics are expected to change dramatically, as they did last year during the Arab Spring, a democratic wave that swept through the Middle East. In addition, increased risks related to North Korea, the ongoing European sovereign debt crisis, and the possibility of a hard landing for the Chinese economy are deepening uncertainty about the global economy. South Korea in particular cannot help but pay keen attention to China, its largest trade partner and largest export destination.

South Korea under the direct influence of the course of the Chinese economy

For all of 2011, Korea listened attentively to news of rising inflation rates in China. China's inflation rate increased to 4% from the end of 2010, and remained above 5% in the first half of 2011. It exceeded 6% during June and September. The problem is that inflation in China directly led to inflation in Korea, and tight monetary policies enacted by the Chinese government to curb inflation directly influenced Korea's exports along with economic slowdown. Korea's inflation rate increases by 0.64 percentage points for every 1 percentage point increase of the Chinese inflation rate. Given that Korea imports more than 52% of all imported household products and 67% of all imported vegetables from China, China's rising inflation has a significant impact on commodity prices in Korea. A 1 percentage point reduction in China's economic growth translates into a 2 percentage point reduction in Korea's exports to China, and a reduction of Korea's GDP of between 0.22 and 0.37 percentage points, according to the Bank of Korea and the Korea Institute for International Economic Policy (KIEP). In particular, capital goods (intermediate goods) account for a high percentage of Korea's exports to China; therefore, if the Chinese economy, in which investment contributes significantly to growth, slows down, Korea's exports are directly influenced.

The policies of the Chinese government, which strongly influence the course of the Chinese economy, also have a direct impact on Korea's exports to China. After China passed all-out stimulus packages in 2009, Korea's exports of construction and mining equipment increased by as much as 109% in 2010. However, after China tightened monetary policies last year, Korea's exports of construction and mining equipment increased by only 14.8%, as of November of 2011. Korea's exports of auto parts increased by about 40% in both 2009 and 2010, but the increase rate fell by 18.7% last year. This slowdown in Korea's exports to China reflects the decrease in the rate of increase in car sales in China, from 40% to 5%, following the phasing out of subsidies and tax breaks for car buyers in 2011.

An opportunity to increase domestic demand and fierce competition for exports to emerging markets

It is widely agreed that China's economy will enjoy a soft landing in 2012, with an economic growth rate of mid-8%; however, a slowdown of 1 percentage point or more in economic growth compared to 2010 seems inevitable. Investment is expected to slow down slightly in every economic sector, but consumption will continue to increase with the implementation of new supportive government policies. As large-scale investment in infrastructure has ceased for the time being, and policies continue to curb real estate prices, investment in construction, especially the construction of housing units for low income households, will continue. This year, in the construction equipment and construction materials sectors, Korea's exports to China and the sales of Korean companies having a presence in China are expected to fall, as they did in 2011. However, China is expected to continue empowering the middle class to increase consumption, and to continue policies that allow wage rises and tax breaks. Under these circumstances, Korea's consumer product exporters, and Korean companies located in China that produce final goods for local consumers, will enjoy relatively stable operation, while seeking to expand their presence in the Chinese market. However, companies whose business model is based on the assumption of low wages in China, producing and processing in China and exporting to a third country, will face challenges such as slowing exports and falling profitability, in line with the trend of a rising yuan. The trend of wage increases seen last year in China has continued this year.

The course of the Korean economy must correspond to China' s long-term policies, including the expansion of consumption, and the nurturing of the service industry and new strategic industries.

With the economies of European countries and other advanced countries tumbling, China's export increase rate is very likely to fall, from 21.1% last year to about 10% this year. Because the yuan appreciated by 5.1% in 2011, and is expected to appreciate by more than 3% in 2012, China's export competitiveness will diminish, while price competitiveness will decrease due to wage rises. This could be a favorable situation for Korean products competing with Chinese products in the global market, but the problem is that Chinese companies are targeting emerging markets, including ASEAN, India, Russia, and Brazil, in response to stagnation in the markets of advanced nations. In limited emerging markets, Korean and Chinese companies are expected to have price and non-price competition.

A more fundamental risk for Korean companies is that China is rapidly losing its charm as "the factory of the world," and its potential to emerge as "the market of the world" is being delayed, as China tries to shift its growth method to focus more on domestic demand –the main objective of its 12th Five-Year Plan. If China's rapid economic growth rate were to suddenly slow, and China became caught in the middle-income trap, the Korean economy and companies would be at great risk. Korea should continuously monitor China's economy and expand its efforts to diversify the countries it invests in and cooperates with.

○ ● Opportunities in the service industry and consumer goods exports

What is the appropriate strategy for success in the Chinese market? According to cumulative statistics on trade between Korea and China, as of November of 2011 intermediate capital goods accounted for 57% of Korea's exports to China, and raw materials accounted for 30%, while consumer goods accounted for only 6%. In particular, as the China's economy started to show signs of slowdown in 2011, the increase in Korea's capital goods exports was less than half of the increase in Korea's

South Korea's exports to China (Jan.-Nov. 2011)

(Unit: USD 100 Mil.)

	Total	Raw materials	Capital goods	Consumer goods	Immediate consumer goods	Durable goods	Non-durable goods
Exports (YoY)	1,225.5 (15.9%)	460.3 (29.8%)	694.4 (7.4%)	70.6 (24.8%)	8.0 (63.8%)	52.2 (22%)	10.4 (16.5%)
Share	100.0%	37.6%	56.7%	5.6%	0.7%	4.3%	0.8%
Imports (YoY)	795.8 (22.4%)	283.2 (30.5%)	351.4 (16.5%)	161.2 (22.3%)	30.3 (19.7%)	70.8 (21.5%)	60.1 (24.7%)
Share	100.0%	35.6%	44.2%	20.3%	3.8%	8.9%	7.6%

Source: Trade statistics of the Korea International Trade Association (KITA) (www.kita.net)

total exports. On the other hand, exports of raw materials rose by 24.4% in 2010, and by 30% as of November of 2011. These figures can be interpreted to mean that exports of intermediate goods to Korean and global companies with a presence in China decreased, while exports of raw materials to Chinese companies increased. Therefore, it is necessary to acknowledge the strategic limitations of using China as a base for production, processing, and export.

Korean companies should expand consumer goods exports, aiming at China's domestic market. The immediate consumer goods market, including food and beverages, will likely expand in line with the trend of high-income Chinese consumers seeking safe, high-quality foods. In addition, durable goods, such as cars, furniture, and high-end home appliances, and non-durable goods, such as high-end clothing and toys, should be considered strategic products with potential for increased export to China.

The course of the Korean economy must correspond to China's long-term policies, including the expansion of consumption, and the nurturing of the service industry and new strategic industries. According to statistics on non-residential consumption in Korea for the third quarter of 2011, released at the end of last year by the Bank of Korea, the surge in the number of Chinese and Japanese tourists, and their increasing expenditures in Korea, contributed to the country's gross domestic product (GDP) growing by 0.3 percentage points. In 2011, the number of Chinese visitors to Korea rose by 74.1% from the previous year, and in the third quarter of 2011, the number rose by 38% year-on-year. Chinese tourists have superior purchasing power overseas, as evidenced by the fact that Chinese tourists have the world's third largest overseas consumption. The Korean economy would benefit from strategically developing infrastructure, services, and cultural content related to the tourism industry in order to attract Chinese tourists and increase their consumption in Korea.

Korean companies must manage paradoxes

A trade-off is when one thing is gained at the cost of another. There are many trade-offs in business management. In this hyper-competitive era, choosing appropriate trade-offs is not enough to secure a competitive edge. We have entered the paradox management era: companies must create alternative options that unravel contradictions by effectively synthesizing all trade-offs. In order to achieve conflicting goals, for example preserving the value of a design or brand while maintaining a reasonable price, it is imperative to think outside the box in all areas of management. In explaining paradox management, Taoist philosophy often comes into play. The world is composed of *yin* and *yang*; the balance of *yin* and *yang* is not static, but ever-changing. When this idea is applied to management, there is no one solution to a problem, and one should overcome the changing environment by combining various factors in a creative way. The concept of paradox is deeply rooted in the minds of the Chinese people, and they excel at managing paradoxes. The Chinese word for paradox is *maodun* (矛盾), which refers to the coexistence of a spear that can pierce any shield and a shield that can block any spear. In order to succeed in the Chinese market, Korean companies must manage paradoxes, including high-quality at reasonable prices, and global standards with local responsiveness.