

WORLD ECONOMY

UPDATE

December 31, 2015 | Vol.5 No. 25

The China Risk and Korea's Response

ISSN 2233-9140

LIM Hyeol Vice President, Department of Northeast Asian Economies (hylim@kiep.go.kr)

LEE Hyuntai Research Fellow, China Team, Department of Northeast Asian Economies (htlee@kiep.go.kr)

CHO Koun Researcher, China Team, Department of Northeast Asian Economies (kucho@kiep.go.kr)

LEE JungEun Researcher, China Team, Department of Northeast Asian Economies (leeje@kiep.go.kr)

1. Real Economy: The Beginning of a "New Normal"

A. Current Macroeconomic Situation

After opening up its economy in 1978, the Chinese economy grew at an average annual rate of 9.7%; this slowed down to 7.3~7.7% during 2012~2014, and plunged to 7.0% in the first half of 2015, entering the so-called "era of a new normal."

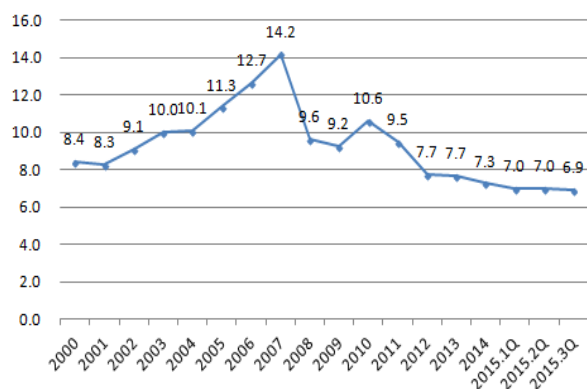
- Retail sales have slowed down from 13.1% in 2013 → 10.6% in Jan.~Nov. 2015 due to continuing anti-corruption policy, weak consumption in real estate, etc.

- Fixed asset investment, as the growth

engine of the Chinese economy, expanded by more than 30% until 2009, but slowed down from 19.8% in 2013 → 10.2% in Jan.~Nov. 2015, due to factors such as shrinking investment in manufacturing (9.7% in the first half of 2015) and real estate (46%).

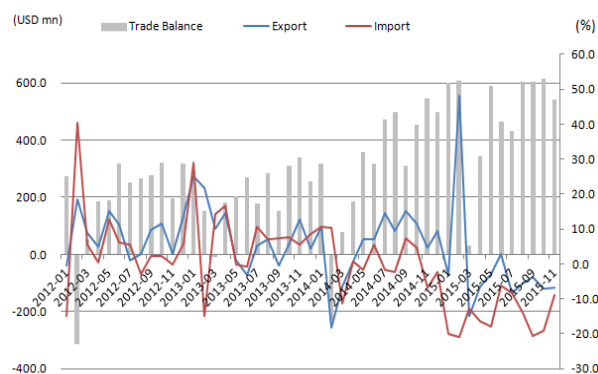
- Exports have dropped from 6.5% in 2013 → -2.95% in Jan.~Nov. 2015 (-6.8% in Nov. 2015) due to factors such as falling demand from the global economic recession, a weaker competitive edge in exports due to rising domestic wage levels, etc.

Graph 1. Chinese GDP Growth Rate



Source: CEIC (2015. 12. 10).

Graph 2. China's Foreign Transactions



Source: CEIC (2015. 12. 10).

Table 1. Key Chinese Economic Indices

(%)										
		2013	2014					2015		
			1/4	2/4	3/4	4/4	Yearly	1/4	2/4	3/4
GDP		7.7	7.3	7.4	7.2	7.2	7.3	7.0	7.0	6.9
Industrial Production		9.7	8.7	8.9	8.0	7.6	8.3	6.3	6.3	5.9
Retail Sales		13.1	12.0	12.3	11.9	11.7	12.0	10.6	10.3	10.7
Fixed Asset Investment		19.8	17.6	17.3	15.7	15.0	15.2	13.5	11.4	10.3
Export		6.5	-3.5	4.9	12.9	8.5	6.1	4.6	-2.2	-5.9
Import		8.8	2.0	1.3	1.2	-1.6	0.5	-17.8	-13.6	-14.4
CPI		2.6	2.3	2.2	2.0	1.5	2.0	1.2	1.4	1.7
PMI	Mfg	50.8	50.3	50.7	51.3	50.4	50.7	49.9	50.2	49.8
	Non-Mfg	54.9	54.3	55.1	54.2	53.9	54.4	53.8	53.5	53.6
Total Social Financing		17,317	5,631	4,895	2,367	3,531	16,413	4,644	4,125	3,157
Real Estate Price Index		105.9	108.2	105.3	100.6	96.5	102.7	94.4	94.1	96.8

Quarter-on-quarter growth. Fixed asset investment is a cumulative total. The figures for CIP/PMI/real estate index in major 70 cities are quarterly averages.

Source: National Bureau of Statistics of China, CEIC, Global Insight.

B. Chinese Economic Risk

Factors such as excessive production facilities, local government debt, adjustments in the real estate market, and intensifying financial risk are hindering the nation's economic development; the future of the Chinese economy will depend on how well these risks are managed.

1) Excessive Production Facilities

China's investment-led growth model has caused an excess of production facilities, a declining operation rate of facilities, the abnormal development of capital-intensive industries and consequent economic inefficiency.

cies, increasing company and bank insolvencies, etc.

- The National Development and Reform Commission (NDRC) estimated that half of total domestic investment in 2009~2013 (6.8 trillion USD) was wasted on excessive investment in fields like aluminum, shipbuilding, cement, plate glass, solar energy, etc., which was the result of economic stimulus, speculations in real estate markets, and excessive competition among local governments.

- Bank lending to the manufacturing sector, wholesale and retail trade account for 30~36% of total bank loans, but bad loans for the same sectors take up 80~90% of the total value of bad loans in Chinese banks.

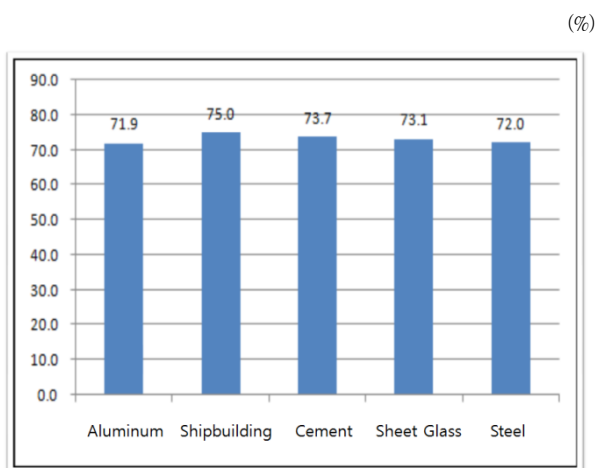
[Government Response] Liquidating companies with excessive facilities or with a high level of energy use, through industrial restructuring;

supporting domestic companies' overseas expansion and overseas relocation of production facilities; fostering new industries, etc.

- The State Council of the People's Republic of China (State Council) designated five major sectors—electrolytic aluminum, shipbuilding, cement, sheet glass and steel—as sectors excessively invested in (Oct. 2013), announcing measures to adjust them through restructuring within five years; at the same time, the State Council consistently pushed to reduce the role of State-Owned Enterprises (SOEs) and expand that of private companies.

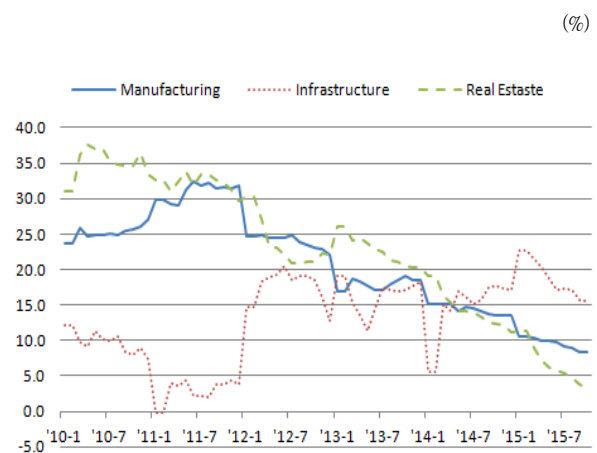
- In addition, the State Council also actively encouraged R&D investment (ranking 2nd worldwide) in the fields of new energy, environment-friendly cars, and low carbon technology, in order to acquire new growth engines and induce technological revolution.

Graph 3. Operation Rate of Facilities per Industry



Source: The Global Wire and Cable Portal
(<http://news.cableabc.com/domestic/20131216006513.html>).

Graph 4. Fluctuations in Fixed Asset Investment



Source: CEIC (2015. 12. 10).

2) Local Government Debt

The Chinese government estimates local government debt to stand at 18 trillion yuan (according to the announcement of the National Audit Office of the People's Republic of China in 2013, end of June), but the IMF (July 2014) estimates it to have been 21 trillion yuan as of the end of 2013, and to reach 30 trillion yuan (42% of China's GDP) in 2015.

- After the current tax-sharing system (分税制, fenshuizhi) was introduced in 1994, a considerable portion of local tax was switched to national tax; thus, while the ratio of central to local tax revenue stands at 5:5, local governments are responsible for more than 80% of national government expenditures. The establishment of this new regime led to an annual increase of 29% in budget surplus for the central government and, at the same time, an annual increase of 22% in budget deficit for local governments.

[Liabilities of Local Governments] Local government debt is estimated to stand at 3~5 trillion yuan, which is mostly spent on fields such as construction, transportation, and land purchase; 39% of local government debt is obtained through local government financing platforms (LGFP), which are paper companies; a considerable portion of these LGFPs is of bad quality.

- Local government debt can increase banks' bad loans, which may hinder local government growth by increasing vulnerability in the financial system or discouraging local governments' public investment.

- However, the Chinese government is still capable of managing the debt (McKinsey & Company 2015), since its debt-to-GDP ratio stands at 55% (2nd quarter 2014), a figure considerably lower than that of most developed countries (US 89%, Japan 234%, Korea 44%), and its net assets amount to 80 trillion yuan (CASS 2014).

[Government Response] The Chinese government is focusing on the fact that while China's total public debt is still lower than that of most developed countries, it is growing at a considerably fast pace. The government is closely managing the risks through measures such as debt reduction and conversion to low-interest municipal bonds.

- Local governments are reducing the total debt stock by selling government assets, while moving away from overdependence on bank loans (57% of total debt) and diversifying fund sources by expanding bond issuance (around 10% at present), operating a debt swap program for local governments (地方債置換計劃, 2015. 5), attracting private capital, etc.

- Especially, among the debts maturing in 2015, the government has swapped 2.7 trillion yuan to municipal bonds, seeking to re-finance risk and decrease the interest burden.

- At the same time, it has made improvements in local government debt management by implementing measures such as liability risk assessment and an early warning system.

Table 2. Measures to Resolve China's Local Government Debt

Type	Policy Measures
Financing	- Issue municipal bonds, attract private capital inflow and prohibit LGFP's lending activities

Debt liabilities	- Require local governments to assess liability risk as well as implement an early warning system - Make banks responsible for carrying problem loans on their books
Debt repayment	- Lower the interest burden for local governments by allowing them to convert debts into municipal bonds (2.7 trillion yuan during 2015) - Repay by importing projects, selling government assets, and attracting private capital

Source: Compilation of various media reports.

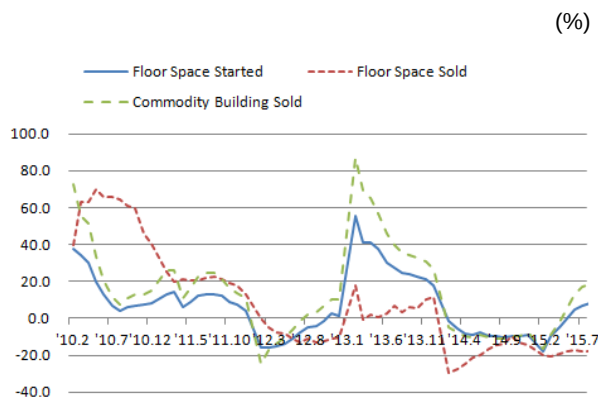
3) Adjustments in the Real Estate Market

After increasing by an average of 10% each year since 2006 (35 major cities), housing prices in China's major 70 cities have fallen since the end of 2013, with house sales also contracting. Recently, however, due to the government's various policy implementations,

housing prices and sales have rebounded by a small margin in and around first and second tier cities.

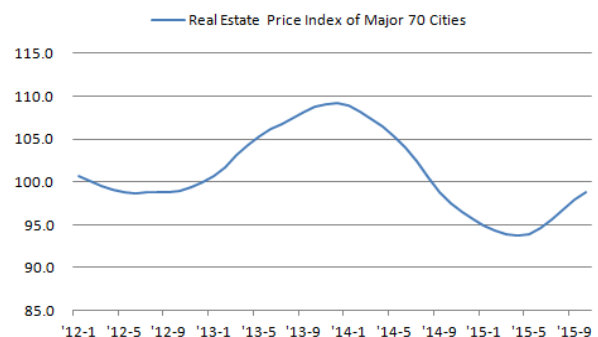
- When investment in real estate decreases by 10%, real GDP slows down by 1%p (People's Bank of China, IMF), which indirectly causes an additional 1%p of slow-down.

Graph 5. Floor Space Under Construction and Commodity Building Sold



Source: CEIC (2015. 12. 10).

Graph 6. Real Estate Price Index of Major 70 Cities



Source: CEIC (2015. 12. 10).

The real estate market is influenced by various structural, cyclical, and institutional factors, and is expected to have an influence over the real economy for a considerable length of time.

- The housing supply rate exceeded 100% (2013), and the prime home-buying age group (25~49) is expected to reach a peak in

2015, before turning downward; but purchase demand for housing will persist as "one household multi-housing owners" prevail in large cities, demand still exists for newly constructed, high-class housings (world average living floor area per person: 40m², China's average: approx. 30m²), and the ratio of one and two-person households (25% in 2000 → approx. 40% in 2010) is continuing on an upward trend.

- On the demand side, the Chinese government has been building subsidized housing (5.9 million in 2010, 10.43 million in 2011, 7 million in 2012 → 7.5 million in 2015), or so-called "indemnity housing" (保障性住房, *baozhang xing zhufang*), which has improved housing conditions for the low-income bracket.

The Chinese government has decided it is critical to stabilize real estate price, which has been escalating since the post-2008 expansive monetary policy, and to this end, has been practicing intensive real estate stabilization policy since 2013.

- But as the impact of real estate contraction extends to the real economy, the government is retreating somewhat on its real estate stabilization policy, abolishing housing purchase limits in regions, lowering the interest rate for its Housing Provident Fund, lowering the standard for receiving a mortgage loan (by the central government), reducing transaction tax on real estate, raising the

loan-to-value ratio (LTV), etc.

- On the other hand, China's new real estate registration system, which is subject to a test run until the end of 2015 before becoming fully operational nationwide in 2017, will contribute to stabilizing the real estate market.

4) Intensified Financial Risk

The scale of shadow banking (including off-balance sheet transactions, non-bank financial trading, and private financing) is estimated to amount to about 15~36 trillion yuan (25~63% of GDP).

- Shadow banking is subject to various risks, including liquidity risks; it is difficult to mitigate liquidity pressure due to factors including maturity mismatch arising from short-term liabilities and long-term investment, lack of transparency, risk contagion to other projects through funds, refinancing and extending the term of payment in the case of hard landings.

Table 3. Estimated Scale of China's Shadow Banking

Organization	Date of Release	Scale	Note
CASS	End of 2013	14.6 trillion yuan	According to government statistics, 25% of GDP, 11% of total assets of the banking sector
		20.5 trillion yuan	According to market statistics, 36% of GDP, 16% of total assets of the banking sector
Morgan Stanley	End of 2013	36 trillion yuan	63% of GDP
eastmoney.com	End of 2013	32.7 trillion yuan	Year-on-year increase of 20%
IMF	End of 2012	21 trillion yuan	40% of GDP
DRC Research Institute of Finance	End of 2012	15 trillion yuan	29% of GDP: within the financial system (9 trillion yuan), quasi-financial organizations (2 trillion yuan), and loans to the private sector (4 trillion yuan)

The banking industry's bad loans expanded for the 14th straight quarter, reaching 1.8 trillion yuan as of June 2015 (36% YoY increase); commercial bank's bad loans (sub-standard loans) have also increased to 1.5% of total loans (CBRC, 0.42%p YoY increase). The net profit growth rate (in the case of ICBC and Agricultural Bank of China), on the other hand, has decreased to around 0.3~0.6%.

[Evaluation of the Risk] However, the government's assessment is that the estimated loss from shadow banking can be absorbed by bank funds.

- In the case of bad loans, however, although its scale or ratio is still low compared to the international standard, it is expected to rise in the following years due to slumping growth and exports.

[Government Response] The government has accelerated financial reform, allowing the creation of private banks and implementing the

deposit insurance system (released the draft ordinance of its execution in Nov. 2014, enforced in May 2015); it also relaxed regulations on foreign banks, promoting a series of measures to increase financial stability.

- Shadow banking, meanwhile, is showing signs of improvement, as government measures enforced in Jan. 2014 have decreased the shadow banking ratio to total social financing from 30% in 2013 → 18% in 2014.

C. The Future of the Chinese Economy

Amid a GDP growth rate slowdown, China is expected to move toward technology-led growth on the supply side, consumption-led growth on the demand side, and service sector-oriented growth in terms of the industry.

[Economic Growth Rate] The Chinese economy's long-term growth rate is estimated to fall to around 6% during 2016~2020, and around 5% during 2021~2030.

Table 4. Long-term Prospect for the Chinese Economy

Organization	Release Date	Forecast Period		
		2016~2020	2021~2030	
			2021~25	2026~30
Chinese Academy of Social Science (Li, Yang)	OCT 2014	5.7~6.6	5.4~6.3	
The State Council, DRC (Li, Shantong)	MAR 2014	7.0	6.2	
National Bureau of Statistics, China	FEB 2012	7.0	5.9	5.0
Goldman Sachs	DEC 2014	6.5	-	

[Supply Side] China is promoting a structural change from factor-based growth based on abundant labor supply and resources to

productivity-based growth through technological innovations.

- China entered into an aging society in

2001, the ratio of the working population to total population beginning to decrease in 2010; the dependency ratio, after reaching a trough, took an upturn in 2015, resulting in a swift ongoing disappearance of China's "population bonus".

- But a gain in education enrollment (college enrollment rate for those aged between 18~22: 27% → 40% in 2020) has led to an increase in human capital and productivity (TFP's contribution to growth 10 years ago:

30% → 40% at present), which in turn has mitigated the slump in the growth rate by compensating for the decrease in the labor force.

[Demand Side] In order to lower investment's contribution to growth and encourage consumption, the Chinese government is pursuing various measures to increase disposable income and the household consumption rate, promote urbanization, increase consumer finance, etc.

Table 5. Changes in China's Education Level

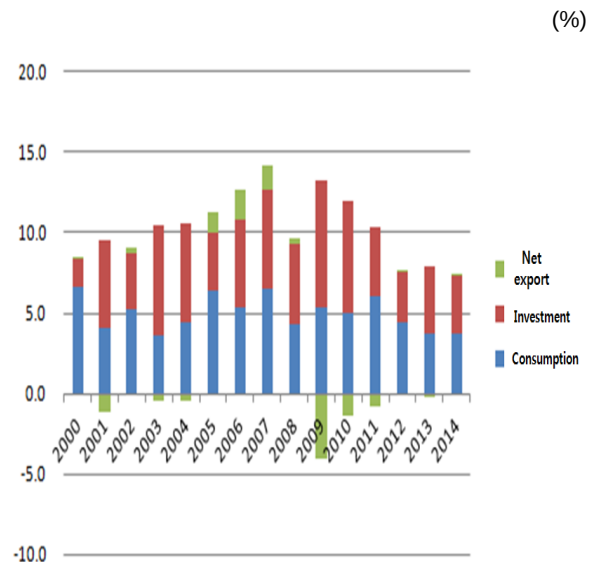
	2000~10	2010~20	2020~30
Changes in the working population (by million)	115	20	-15
Bachelor's degree or higher	33	58	57
High school diploma or lower	82	-38	-72

Source: Jun Zhang (2013. 9).

[Industry Sector] After 2000, an increase in real wages, intensified international competition and delayed technological innovation contributed to a growth decline in the manufacturing sector; at the same time it accelerated development in the service sector¹⁾ which con-

¹⁾ The Chinese manufacturing sector's added value and scale of export grew rapidly to 2.74 trillion USD (world ranking 1st place in 2013) and 2.08 trillion USD (world ranking 2nd place), respectively, but according to the World Economic Forum's (WEF) assessment, it lacks

Graph 7. Consumption and Investment's Contribution to Economic Growth



Source: CEIC (2015. 9. 7).

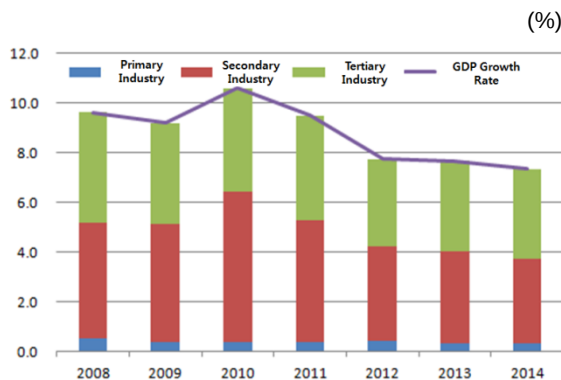
tributes the most to employment growth; the service sector's contribution to economic growth (4.0%p in the first half of 2015) surpassed that of the secondary sector (2.8%p), and the service sector's share of economy (49.5% in the first half of 2015) also overwhelmed that of the secondary sector (43.7%).

competitiveness, with its standards in fields of technology, information, and innovation ranking 70th~90th among 144 countries.

- In the manufacturing sector, wage levels (on average) increased 14% each year (2008~2014), which amounts to three times more than that in Indonesia and four times more than Vietnam's; the manufacturing sector's external dependence in high technology has increased and its level of value added is lower than that of other countries (21%, while the US stands at 35%); China's manufacturing sector also suffers from poor brand image and a dominance of low-quality, low-margin products.²⁾

- By promoting national strategies like "China Manufacturing 2025" and "Internet+," the Chinese government has focused on fostering new growth industries that create high added value.

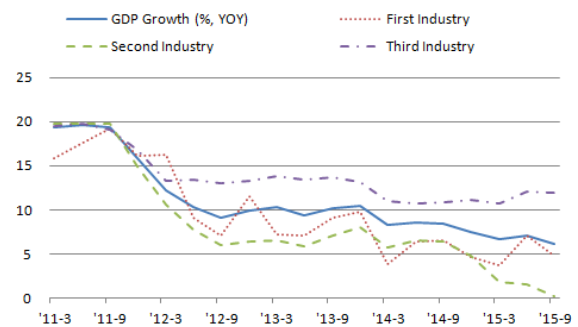
Graph 8. Industry-wise Contribution to GDP Growth



Source: National Bureau of Statistics of China (2015. 9. 7), The Bank of Korea, Beijing Representative Office (2015. 7. 20).

²⁾The Bank of Korea, Beijing Representative Office (2015. 8. 10), "The Present Condition of China's Manufacturing Industry and Chinese Government's Measures to Strengthen Its Competitive Edge," China Weekly.

Graph 9. Industry-wise Growth Rate



Source: CEIC (2015. 12. 10), The Bank of Korea, Beijing Representative Office (2015. 7. 20).

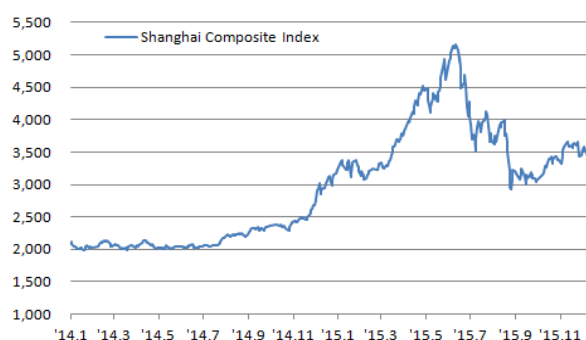
2. Financial and Foreign Exchange Market: Expanding Market Volatility

A. The Chinese Stock Market Crash: Causes and Prospects

Chinese stocks, which had skyrocketed in 2007 as enthusiastic individual investors rushed to the stock market, crashed during the Global Financial Crisis; recently, as property investors began to turn to the stock market for returns, Chinese stocks reached a new peak on 12 June (Shanghai Composite Index 5,166).

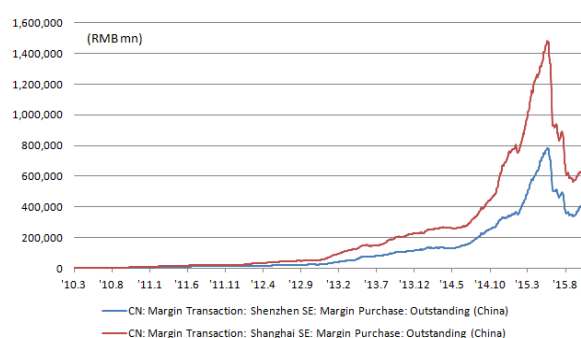
- But the declining growth rate of the Chinese economy and the consequent decrease in its credit ratings, as well as growing distrust in the government's ability to manage the market, have caused stock prices to fall, collapsing below the psychologically significant 3,000-point for a period at the end of August. There is heightened interest as to where the Chinese stock market is headed, and its potential impact on the Chinese and world economy.

Graph 10. Changes in Shanghai Composite Index



Source: CEIC (2015. 12. 10).

Graph 11. Changes in Margin Transactions in Shanghai and Shenzhen Market



Source: CEIC (2015. 12. 10).

[Reasons for the Crash] Decline in the growth of the Chinese economy and its credibility is the foremost reason for the stock market crash. Another cause was the individual investors who take up 82% of exchange volume (CEIC, end of 2013) and 99% of stock accounts (A-share analysis, CEIC, July 2015); individual investors, who are more vulnerable to rumor and herd behavior, sold their leveraged funds once prices began to dip, which further exacerbated the vicious cycle, pushing down prices.

- In addition to credit in the market, illegal, over-the-counter credit also increased by a large margin along with rising stock prices; consequently, a combination of factors including strengthened government supervision and a sudden increase in the supply of credit settlement triggered a fall in stock prices.

[Evaluation] The total value of listed stocks remains above the trend line and total trade volume also remains at a high level; the stock market is slowly becoming stabilized.

- After September, the Chinese stock market has stabilized, remaining near the 3,500-point mark.

- The Chinese government is enforcing strict measures to regulate and monitor actions such as illegal credit transactions.

[Impact] Since there is a low correlation between the Chinese stock market and the real economy, stock price fluctuation will have a limited influence on the latter.

- Previous conditions have restricted the Chinese stock market from adequately reflecting industry flow; they include: state-owned enterprises' large holdings of non-tradable shares, restrictions in foreign investment (including limits on foreign investors trading A-shares), a limited number of private companies (who function on market principles) that acquire funds through the stock market, etc.

- Also, because the number of stock investors, total market value and financial assets of households are all significantly lower than that of developed countries, falling stock prices have a limited impact on consumption.

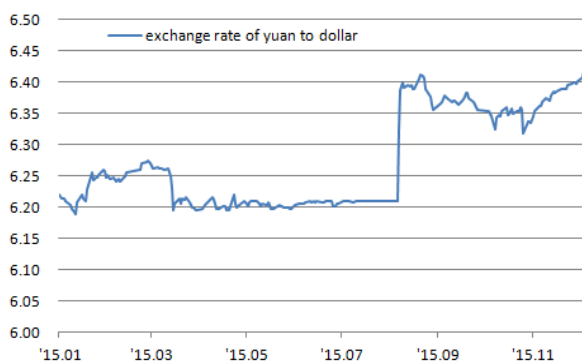
[Prospects] With the Chinese government showing a strong determination to manage the stock market, China's stock prices, while

maintaining a downward trend, are expected to gradually find a balance.

- In the long term, as the government proceeds with the liberalization of the capital market, Renminbi (RMB) internationalization and privatization of SOEs, stock prices will be dependent on how the government deals with a number of tasks including boosting company efficiency, streamlining its excessive investment and successfully completing industry restructuring.

- Therefore, it is important to closely monitor fundamental changes in the Chinese real economy and changes in its economic structure, rather than focusing on short-term changes in stock prices.

Graph 12. Changes in RMB Exchange Rate



Source: CEIC (2015. 12. 10).

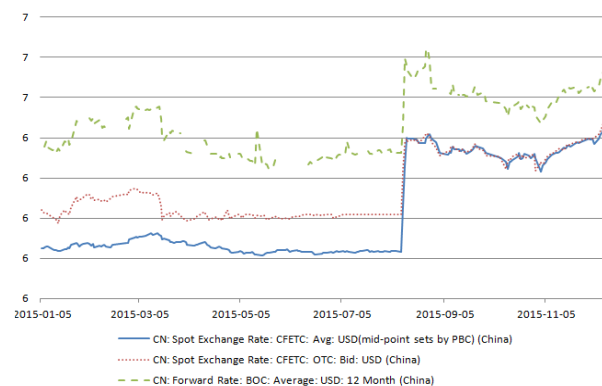
[Prospects] The recent devaluation indicates that the Chinese government has realized the need to decrease the gap between the market exchange rate and the daily fix that is published by the central bank each day; thus, the present policy is expected to be sustained for the time being.

B. RMB Devaluation: Background and Prospects

The People's Bank of China devaluated the RMB to 4.7% during Aug. 11th~13th, as part of a drive to make its exchange rate more market-friendly, reflecting the changes in major foreign currencies.

[Background] RMB devaluation was maneuvered in order to prepare for the inclusion of RMB in the IMF SDR basket by allowing the market to exert more influence in determining RMB value; it was also carried out in a response to downward pressure that came from the recent upturn in capital outflow.

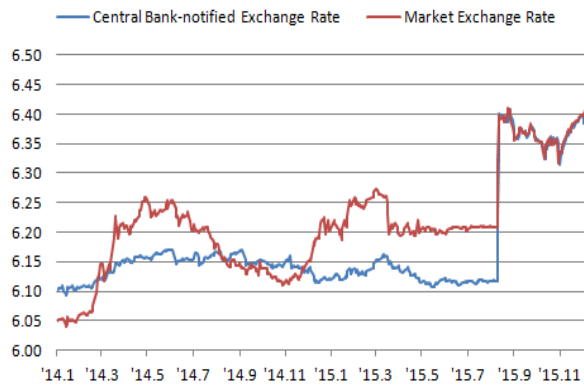
Graph 13. RMB Spot Exchange Rate and Forward Exchange Rate



Source: CEIC (2015. 12. 10).

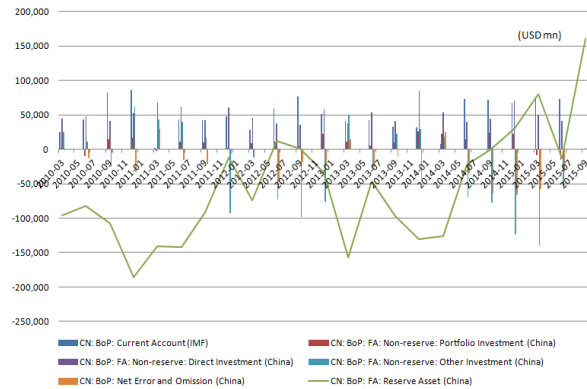
But since the Chinese government (Premier Li Keqiang, Aug. 2015) has announced there will be no further devaluation in the near future, it will consider various factors such as economic conditions, forward and spot exchange rates in the FX market, etc., in deciding its future moves.

Graph 14. Changes in the Gap Between the Market Exchange Rate and Central Bank-notified Exchange Rate



Source: CEIC (2015. 12. 10).

Graph 15. Recent Decline in Foreign Exchange Reserves



Source: CEIC (2015. 12. 10).

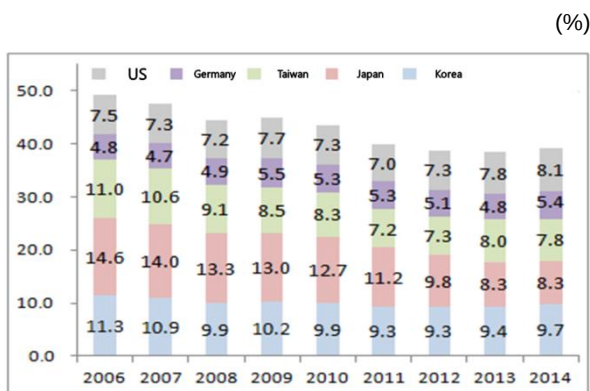
3. Korea's Response

A. Changes in Korea-China Economic Relations and Korea's Response

1) Korea's Exports to China

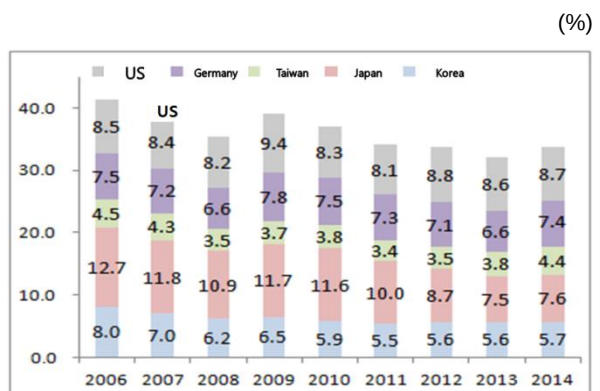
[Market Share] Korea's share in the Chinese market has recently been declining, as the increase rate for Korea-China trade and Korea's exports to China turned negative for the years 2014~2015.

Graph 16. Share of China's Import Market by Country



Source: Furong Jin and Jung Jihyun (2015), "Changes in China's Import Structure for Domestic Market and Korea's Response," KIEP.

Graph 17. China's Domestic Market Share



Source: Furong Jin and Jung Jihyun (2015), "Changes in China's Import Structure for Domestic Market and Korea's Response," KIEP.

The increase rate of Korea-China trade has declined from 27% in 2001~2008 to 6% in

2009~2014.

Korea's share in China's import market de-

creased from 11.3% in 2006 → 9.7% in 2014 (Korea ranked 1st) and its share in China's

domestic market dropped from 8% in 2006 → 5.7% in 2014 (Korea ranked 4th).

Table 6. Korea-China Trade

(million \$, %)

Years	Korea's Exports to China		Korea's Imports from China		Trade Balance
	USD	Percentage Change	USD	Percentage Change	
2000	18,455	34.9	12,799	44.3	5,656
2005	61,915	24.4	38,648	30.6	23,267
2009	86,703	-5.1	54,246	-29.5	32,457
2010	116,838	34.8	71,574	31.9	45,264
2011	134,185	14.8	86,432	20.8	47,753
2012	134,323	0.1	80,785	-6.5	53,538
2013	145,869	8.6	83,053	2.8	62,816
2014	145,288	-0.4	90,082	8.5	55,206
2015.10	12,497	-8.0	8,384	3.3	4,113
2015.1~10	114,534	-4.3	75,138	1.8	39,396

Source: Korea International Trade Association (KITA), (2015. 12. 17).

[Evaluation] China's declining growth has decreased its import volume by more than 19% between Jan.~Oct. of 2015 and China's industrial upgrading has caused the country to replace previously imported intermediate and final goods with domestic products; considering this, it is hard to say that Korea's exports to China (which decreased by 4.3% between Jan.~Oct.) is experiencing a slump.

- **P**rice factors—the drop in oil prices has dragged down the unit price of petrochemical products for exports—as well as the Tianjin explosions, and the so-called "coupling phenomenon," which refers to the downward trend of Chinese and Korean exports moving together, also need to be considered.

- **T**he problem is that Korea is unable to fully utilize the growing share of consumer

goods in the Chinese market stemming from a rise in China's consumption level, since Korea has not yet advanced well into China's domestic market.

[Prospects] Korea's exports to China will continue to decrease due to multiple factors: a decrease in China's exports will cause China's imports of intermediate goods to decrease; China will also continue to substitute the imported intermediate goods with domestically-produced products.

- **C**hina's exports and Korea's exports to China moved together when China concentrated on processing trade, because Chinese exports utilized intermediate goods from Korea. Recently, however, the two economies have clearly decoupled.

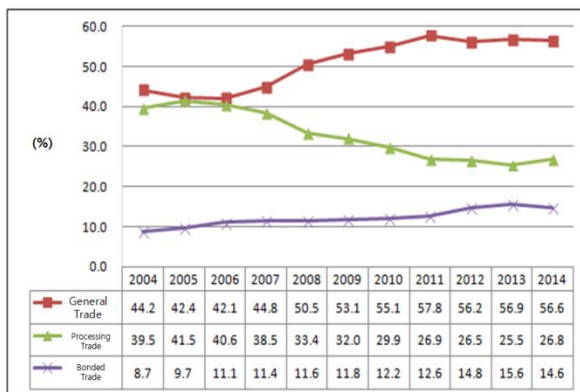
- **W**hile the share of processing trade in total imports has decreased from 41.5% in 2005

→ 26.8% in 2014, the share of general trade (for the domestic market) has increased from 42.4% in 2005 → 56.6% in 2014.

- However, Korea is not responding quickly

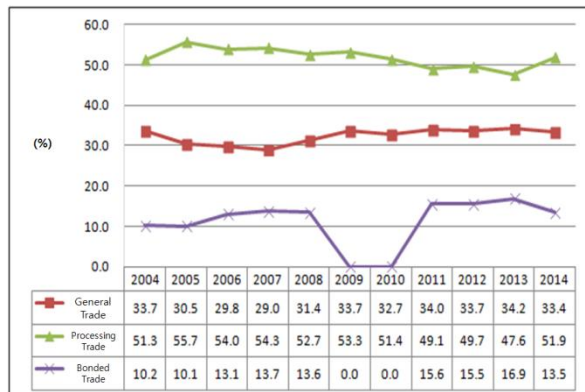
enough to the changes in China's trade structure; the share of processing trade (51.9% in 2014) still exceeds that of general trade (33.4%) in its exports to China.

Graph 18. China's Imports According to Types of Trade



Source: Furong Jin and Jung Jihyun (2015), "Changes in China's Import Structure for Domestic Market and Korea's Response," KIEP.

Graph 19. Korea's Exports to China According to Types of Trade



Source: Furong Jin and Jung Jihyun (2015), "Changes in China's Import Structure for Domestic Market and Korea's Response," KIEP.

2) How to Respond to the China Risk

As China's real economy is projected to continue experiencing a slowdown, it is important to utilize the opportunities that come from qualitative changes in the economy, and prepare for the risks that economic slowdown entails.

- [Opportunities] 6~7% of stable growth following economic restructuring, expanding domestic demand, creation of new demand arising from the urbanization and development of China's Western region, development of a new market following the conclusion of the Korea-China FTA, expansion of Chinese regional markets on the back of China's regional policies (Beijing-Tianjin-Hebei Project, Yangtze River Economic Belt, One Belt One Road)

- [Risks] Shrinking exports to China due to weakening demand, a narrowing technological gap due to China's industrial upgrading, increasing competition following China's global expansion

Sectoral Strategy for Expanding the Market and Targeting New Demands

- [Targeting the Consumer Goods Market] Consumer goods imports are increasing at an annual rate of 35% due to a rise in the Chinese people's income level. Thus, Korea should utilize the Korea-China FTA as an opportunity to expand its exports of consumer goods and intermediate goods used for consumer goods.

- [Developing New Industries] Since the Chinese government is focusing on energy-

conserving, environment-friendly green growth, the Korean government should take measures to prepare for the rising demand for related facilities, materials and components; it also should vitalize online transactions between the two countries, transforming the current product-oriented market to a "total service platform".

- [Entering the Service Industry] As a response to changes such as rising income levels, aging society and changes in the industry structure, the Korean government should foster knowledge-based service industries, which include telecommunication, transportation, tourism, medical care, healthcare, the 'silver' industry, education, contents, etc.

- [Entering Small and Medium-sized Cities] It is necessary to develop a tailored expansion strategy to respond to the increasing consumption caused by government policies such as aiming to boost income in rural areas, a new urbanization model, etc.

- [Vitalizing Investment in Infrastructure] The "One Belt One Road" strategy and the establishment of the AIIB will increase opportunities for foreign companies to participate in infrastructure building and investment, for instance building public facilities like roads or airports, or the construction of smart cities; by forging strategic partnerships with Chinese companies, Korean companies should develop adequate market entry strategies.

- [Strengthening Future-Oriented Industrial Cooperation] Move away from the current cooperative system that mostly involves

processing and assembling, seeking cooperation in high value-added fields such as R&D, design, branding, etc., and redefining labor division between Korea and China.

B. Impacts of Changes in China's Financial Market on the Korean Economy

2) Impacts of China's Stock Market Crash on Korea

[Korean Stock Market Instability] Since Korea and China's economic growth are highly correlated (2009~2014, growth correlation coefficient: 0.66) and both economies are classified as emerging markets, the stock prices of the two countries tend to move together.

- After China's stock market crashed, the risk of contagion in emerging markets has increased, causing developed countries' capital in the Korean market to withdraw; KOSPI fell below the 1800-point mark after the recent crash in China's stock market as foreigners pulled out of the Korean market for 13 consecutive days.

[Limited Coupling Effect] However, the fall in Korea's stock prices in August was a mixed result of the North Korean risk and China's; the Korean stock market is also more stable than China's, signaling that the impact of the Chinese stock market is limited.

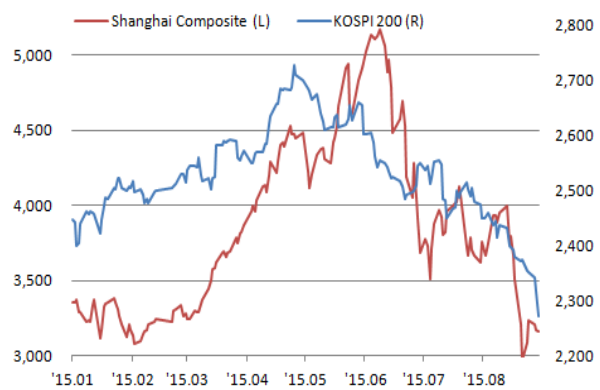
- The share of foreigners in the Korean stock market is 28.9%, and most of it is accounted for by US (39%) and European capital (England 8%, etc.), with China occupying a mere 2%. Nonetheless, active monitoring is necessary.

Graph 20. Coupling of KOSPI and Shanghai Composite Index



Source: CEIC (2015. 12. 10).

Graph 21. Changes in KOSPI and Shanghai Composite Index



Source: CEIC (2015. 12. 10).

[China's Stock Price and Korea's Real Economy] If China's stock market crash becomes protracted and its effects extend over to the real economy, Korean exports may suffer a blow, but not to a great extent.

- However, if the correlation between China's stock market and real economy heightens in the future, stock prices may come to function as a leading indicator for the economy; therefore, it is necessary to closely monitor China's stock market.

2) Impact of RMB Devaluation on Korea's Exports

[Positive Impact] RMB devaluation → increase in China's exports due to the increasing competitiveness of Chinese products → increase in Korea's exports to China (as of 2014, the share of processing trade is 52%); while such a course of events is possible, the expected impact is limited, because the two economies have recently been showing signs of decoupling.

- Because China is growing increasingly self-sufficient in terms of intermediate goods, such positive impacts from RMB devaluation are expected to decrease.

[Negative Impact] As the Korea-China export rivalry intensifies in China's and the global market, there is a possibility that Korean exports may decrease.

- While Korea's share of the world export market has remained stagnant (2.7% in 2000 → 3.0% in 2014), China's share is growing swiftly (3.9% → 12.4%); Korea's trade specialization index has also remained the same (0.04 in 2000 → 0.04) while that of China (0.05 → 0.09) has risen.

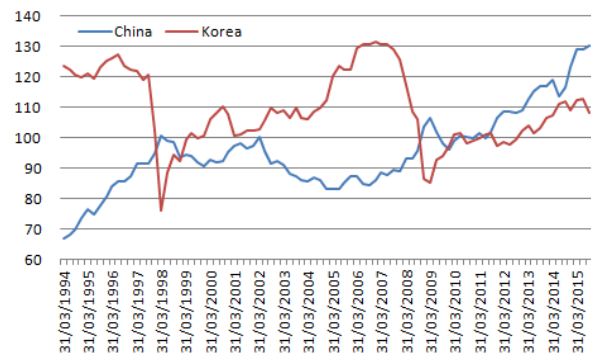
- As the prices of RMB-denominated Korean consumer goods increase, Korea's exports to China may suffer, but Korean products in the global market will not be threatened greatly by Chinese products, due to the coupling effect of RMB and the Korean won. .

Graph 22. China's Export and Korea's Export to China



Source: KITA K-stat (2015. 12. 10).

Graph 23. Changes in Korea-China Real Effective Exchange Rate



Source: BIS (2015. 12. 10).

KIEP