China’s economy has grown quickly over the last 35 years, transforming from a controlled socialist to a market-oriented economy. During this period, however, risks and vulnerabilities have increased significantly. Now China’s economy looks like a flying jet with an overheated engine. And Korea could find itself in its wake.

Having grown 7.4 percent last year, its lowest rate since 1990, the Chinese economy is not expected to meet its official growth target of 7 percent this year. This would largely be due to the weak performance of corporate investment and the real estate market. The International Monetary Fund, in its latest World Economic Outlook, forecasts the country will grow 6.8 percent in 2015 and 6.3 percent in 2016. China’s mid- and long-term growth potential is diminishing due to structural factors. Labor input has dropped due to a decline in fertility rates and population aging. A reduced rate of return on investment has lessened physical capital accumulation. With limited innovative capability, China will struggle to maintain its strong technological progress. The country’s economic slowdown and instability could pose a serious threat to the Korean economy, especially when the side effects of China’s rapid growth signal a hard landing of the Chinese economy.

The country’s major vulnerabilities and risks include property bubbles, shadow banking and local government debt. As estimated by the McKinsey Global Institute, China’s total debt hit 282 percent of its GDP last year, which is larger than that of the United States. At 55 percent of its GDP, China’s government debt is less than the international standard, but local government borrowing has soared by 27 percent a year since 2007, accounting for more than half of the public debt.

Local governments and many enterprises are heavy borrowers in the less supervised and regulated shadow financial sector, a portentous sign of a financial crisis.

The Beijing government has been carrying out structural reforms to promote domestic industry, the privatization of state-owned enterprises and the liberalization of the financial sector. The government strives to prevent a hard landing through close monitoring and a flexible mix of fiscal and monetary policy. But uncertainty remains about whether the economy can achieve a soft-landing and sustained economic growth due to China’s declining growth potential, massive debt and financial risks.

The recent rout in the Chinese stock market has increased uncertainty about the future direction of China’s economy. The Shanghai stock index fell more than 30 percent in just three weeks from June 12 despite a series of government actions, including a cut in interest rates and reserve requirement ratio, suspension of initial public offerings and a ban on short selling. The market was finally stabilized after the government’s use of stronger measures, including the prohibiting of stock sales by controlling stakeholders and provision of unlimited central bank liquidity support to a state-run securities company for stock purchases. While authorities had to re-establish public confidence by showing their ability to maintain financial market stability, strong state intervention in the market reinforced foreign investors’ suspicions about the low transparency, heavy regulations and high political risks of China’s economy.

Chinese policy makers will try to muddle through imminent risks, but China’s economy will inevitably face headwinds due to given uncertainties. Government attempts at a soft landing, deleveraging and structural reforms could be further threatened by external shocks, policy mistakes and political risks.

For Korea, all this could mean a threat to our economy. China imports a fourth of Korea’s exports, which make up 56 percent of Korea’s gross domestic product. Chinese tourists have become Korea’s biggest foreign customer group, and our portfolio investment in China continues to rise.

Korea has not yet prepared for the rapid slowdown of China’s economy. Korea should start by examining the domestic weaknesses of its economy and rebalancing sources of growth. While maintaining the responsiveness of macroeconomic and foreign exchange policies, the Korean government should be aware of the vulnerabilities of large household and corporate debt. Korea must strengthen domestic demand by supporting small- and medium-sized enterprises and the service sector. In short, the Korean economy will have to turn to a balanced growth engine of manufacturing exports and domestic demand backed by the services sector.

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