

Research Focus

China's New Challenges after Thirty-Years of Reform

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Thirty years (1978-2008) of reform have turned China into one of the largest and most dynamic economies in the world. Currently, however, China faces three significant and profound challenges: first, to maintain continued high growth amid global financial turbulence, the slowdown of the major economies abroad, and some rising socially-destabilising tensions such as growing income inequality; second, to bring its growth path in line with environmental sustainability; and third to manage the rising demand for energy in order to moderate oil price increases and to placate heightening domestic and international concerns about the environment and global warming. How China deals with these challenges will have important implications for both China itself and the world at large.

China's task of sustaining its rapid growth and maintaining macroeconomic stability is complicated by the deceleration of the US economy, high international oil prices, and gradual increases in costs of production in China. In combination, these factors enable the Chinese economy to grow at a slower pace while facing a relatively high level of inflation. The pressure from inflation is particularly acute because the temporary flight of savings from developed countries where growth has slowed into investment in China raises China's domestic aggregate demand to offset export decline, hence maintaining output level. This capital inflow

forces China's central bank to choose between appreciating the RMB more quickly or allowing faster inflation. Despite the arguably negative impact on exports, a faster pace of RMB appreciation seems desirable in the current macroeconomic environment, as it boosts imports, eases external pressure on current account imbalances, and checks domestic inflation.

Increasingly, excessive income inequality is looming as one of the most undesirable outcomes from China's thirty-year long reform. It essentially reflects the trade-off between achieving the goal of economic efficiency and maintaining social stability through improved equity and social justice under economic transition. The first thirty years of reform put efficiency above everything else which was justified by the nature of economic transition, namely moving from a centrally planned to a market economy. The challenge now is how the government alleviates income inequality while maintaining high growth. Apart from strengthening the re-distributional functions of the government and building a more comprehensive social security system, further reform to enhance rural-urban migration will be crucially important for continued growth of productivity and income.

However, success in carrying out future reform for China's long-run growth and development will be crucially dependant upon whether China is capable of building the governmental institutions which are transparent, efficient and accountable, and supported by an effective legal system.

China's present rapid economic growth goes hand in hand with increasing resource use and pressure on the environment as it relies on a large amount of factor inputs (e.g. capital and raw materials), concentration

on heavy industries that are both energy and pollution intensive such as steel, and is driven by strong pro-growth central and local governments. The combination of rapid economic growth and high carbon intensity means that in the coming years China will have an impact on greenhouse gas emissions unmatched by any other country. For example, despite its low per capita emissions, China has already passed the United States as the largest emitter of CO₂, and these emissions continue to rise rapidly.

For China, a key challenge is how to minimise the negative growth impact from limiting its greenhouse gas emissions and improving environmental quality. The political economy of emissions reduction mean there are different reactions from the central government, local governments, enterprises and households to the objective of emissions reduction. The key is to design an incentive scheme that makes relevant regulations incentive-compatible among all stakeholders. The effectiveness of emissions reduction policy eventually lies in the endogenous demands for a change in growth pattern and for a cleaner environment resulting from rising income.

China has been the world's largest destination for foreign direct investment (FDI) and the environmental consequences of FDI have attracted increasing concern as China's environment deteriorates. Empirical evidence showing an inverted-U curve relationship between FDI and pollution suggests that continued FDI inflows would eventually reduce pollution emissions. However, it also implies that FDI inflows into richer regions will reduce pollution while FDI flows into poorer regions (mostly inland) will worsen their environment. Thus, China's poorer provinces should be treated like the less developed countries in fulfilling their global

obligations to reduce emissions and provided with financial means and technological support to comply with the toughened government emissions regulations. Inland regions benefit from reducing emissions, even though pollution abatement efforts involve additional costs, because many environmental damages are irreversible.

China grows food to feed 1.3 billion people but there are growing concerns that water shortages and reduced availability of arable land would attenuate Chinese food security. Declining area of arable land due to rapid urbanisation and industrialisation, the uneven distribution of water, and lower than normal rainfall in the recent years make this issue particularly acute. Water shortages may pose an immediate environmental threat to China's continued high economic growth. While it is important for China to continue to improve its water and land management, the best hope lies in institutionalisation of water (land) pricing and water (land) use rights policies.

China's responses to environmental challenges are critically important in building a harmonious global system. In the short run, emission mitigation policies mainly seek to increase energy efficiency through technological progress, and the development

of renewable energy and nuclear energy. In the long run, China's policies will focus more on reducing greenhouse gas emissions (through measures like emission trading schemes or a carbon tax), and adapting to climate change. China is heavily dependent on coal, which provides nearly 70 per cent of China's primary energy consumption, and is the single most significant source of pollution. For example, 85 per cent of the sulphur dioxide, and 60 per cent of nitrogen dioxide emitted into the atmosphere in China come from coal burning. Coal's share in China's primary energy consumption is expected to remain unchanged in the next twenty years. It is therefore essential for China to work closely with other countries to develop a new generation of clean coal technologies, which if successful, will unleash sustainable development in China as well as in the rest of the world.

China will also readjust its economic structure towards producing goods which are less energy-intensive and resource-intensive. Success will depend upon whether China can effectively shift its pattern of economic activity from energy-intensive areas (e.g. specific forms of heavy industry) to sectors that are knowledge-intensive and rely less on energy and other resource inputs;

and whether it can stimulate the adoption of advanced technologies which are both energy efficient and more environmentally benign. Achieving such an outcome is in the interests of both China and the international community, so developed countries need strong measures in support of such policies in China.

However, it is too early for optimism. The uncomfortable reality for China remains that unless ecological balance is restored within the medium-term, environmental limits could choke further growth. Proper management of the environment has now become critical if China is to continue its industrialisation process. But China's emergence as a global economic and political player carries with it the responsibility to balance the requirements of key industries driving its development to ensure that its growth is not only efficient, but also equitable as well as sustainable.

* *Ligang Song is from Crawford School of Economics and Government, Australian National University. This article is adapted from chapter one in China's Dilemmas: Economic Growth, the Environment and Climate Change, Ligang Song and Wing Thye Woo (eds), Asia Pacific Press, the Brookings Institution Press, and Social Sciences Academic Press (China) 2008.*

Events

19–20 September, *Indonesia Update: Indonesia beyond the Water's Edge: Managing an Archipelagic State*. For more information, please visit the website: <http://rspas.anu.edu.au/economics/ip/IU08/>

22–23 September, *Comparative Experience in Competition, Policy Reform: Australia, Japan and East Asia*, conference, ANU

Crawford Seminars

2 September, *Governing the transition: the Oil Palm Boom and its policy dilemmas for Indonesia*, John McCarthy, Crawford School

4 September, *Chinese foreign direct investment in the Australian resources sector*, Peter Drysdale, Crawford School and Christopher Findlay, University of Adelaide.

9 September, *Women's political representation and the quota in Indonesia*, Sharon Bessell, Crawford School

11 September, *What Australia should expect from the next US President*, Geoffrey Garrett, CEO, United States Studies Centre

16 September, *The wheat exporter and the dictator: How a venerable institution became an international embarrassment*, Linda Botterill, Political Science Program RISS and Crawford School

**Seminars are held at 12.30pm in Seminar Room 4, Crawford Building

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Foreign Direct Investment, Emma Aisbett, Ligang Song and Chunlai Chen, No. 8 (forthcoming)

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