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What might happen in China this year?

Despite inflation, bankruptcies, and other problems, industrial enterprises should remain highly profitable.

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Gordon Orr, a director in McKinsey's Shanghai office, peers into 2011 and finds ways China may once again surprise the world. Read his six predictions, then let us know what you would add.

Inflation in food prices will take longer than expected to control. The drivers of inflation are much more structural than cyclical. Indeed, the entire system is now so highly stressed that one snowstorm brings large spikes in food and energy prices as coal runs short. When ice shuts down the roads, as it does today in much of southwestern China, agricultural products simply cannot get to market.

Chinese consumption patterns are shifting as people become wealthier—more meat eating requires more cereals to feed the animals. The food supply chain, running at the limit, is close to breaking, and the pressures this problem creates will lead to further food quality crises. What's more, price caps won't be effective in creating a better balance between supply and demand. Rising food prices are a pan-Asian issue: inflation has recently surged in Indonesia (chilies), India (onions), and South Korea (cabbage and now beef as a result of foot-and-mouth disease). China, given its large absolute demand for so many agricultural products, will shape food prices across Asia.

A major second- or third-tier Chinese city will see demonstrations over food price rises, unemployment, or both, on a much larger scale than anything that has occurred in recent years. The demonstrators will probably be satisfied quickly by local action to increase financial support for them and to replace local-government leaders. Yet concerns over copycat actions elsewhere will lead to a nationwide preemptive program to support the urban unemployed.

Middle-class bankruptcies will expand dramatically. Buyers have aggressively bought multiple properties with every penny of free cash flow. All that is needed for a wave of bankruptcies is further interest rate rises (targeting inflation) that result in a blip down in house prices just as mortgage payments rise. We have seen this before across major cities in Asia. The government will probably decide that it cannot bail such people out, as that would be seen as rewarding recklessness among the haves at the expense of the have-nots. There is already significant noise on the Internet to the effect that government leaders are completely out of touch with the true cost of urban housing. These leaders must take material action to show that they are aligned with the hopes of people just getting on the real-estate ladder.

Minimum wages will rise, but productivity gains will outstrip labor costs. The profitability of industrial enterprises remained high at the end of 2010—indeed, higher, in many cases, than it had been a year earlier, despite the minimum-wage increases rolled out in 2010—and will probably remain high. Yet a government seeking to enhance its stature with lower-income workers will find that increasing minimum wages, perhaps

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by 15 to 20 percent, is an easy lever to pull. Once again, multinationals, especially Asian multinationals, will find themselves being monitored first for compliance. More broadly, 2011 is likely to see further increases in the number of complaints that blue-collar workers bring in the legal system against employers for failure to pay overtime and to give employees the required time off from work.

China's economic growth will be lower than expected. The rollback of subsidies to consumers will, in 2011, lead to a slow start for consumption, which will never quite catch up during the year. In recent months, for example, automotive purchases accounted for 20 percent of consumption. With the rollback of subsidies, the imposition of quotas in Beijing (and probably other cities), and increased prices for license plates and parking, car sales are likely to plateau if not fall in 2011. This problem will be exacerbated by food price inflation, which will cause lower-income workers to cut back on nonfood and other discretionary expenditures.

China will step up its "invest out" program in the new five-year plan. The government may well seek to double the country's cumulative outbound investment within the next five years. There will be resistance by governments in some countries (probably in Africa, Eastern Europe, and Latin America) where public opinion is not yet convinced that so much Chinese ownership of key assets is really attractive. This opposition will visibly upset China's leaders, who may decide to sell the bonds of the reluctant governments and to increase the challenges that enterprises from these nations face in selling to Chinese state entities.

The state will again try to reduce its ownership role in business. If the government relaunches its program to sell off more of its stake in companies, domestic share prices will probably decline or at least remain flat. The program will also soak up much of the liquidity currently supporting Chinese IPOs, thus reducing the ability of entrepreneurs to cash out quickly through them. Also, private-equity firms that have been investing in pre-IPO growth stocks in China may hold on to these investments longer than planned.

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