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What's in store for China in 2012?

Despite food price inflation and a stagnant housing market, China should maintain a rapid rate of growth.

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Gordon Orr, a director in McKinsey's Shanghai office, offers a forecast for growth in China this year. Read his ten predictions, then let us know what you think.

1. Government policies will spur consumption and investment. These moves will compensate for declining exports and a slumping housing market. To boost consumption, policy makers could pull a number of short-term levers, including tax breaks and rebates, and are likely to raise the minimum wage further. The 12th five-year plan calls for raising household disposable income by 7 percent a year; thus the government may urge large state-owned enterprises to increase wages across the board, which would pressure other companies to follow suit. Policy makers are also likely to extend a popular program offering rebates on purchases of electronics and appliances. (It fueled the sale of 200 million units, generating 450 billion renminbi—about $71 billion—in revenues from 2009 to 2011.) In addition, the government will invest heavily in manufacturing, particularly in the central and western regions, offering incentives to attract industrial companies inland. The manufacturing sector will continue to fuel China's growth, thanks in part to the lower cost of labor and the improving infrastructure in the country's interior.

2. Dominant models will emerge for reforming rural land ownership. China must consolidate its farms to increase agricultural output and reduce the income gap between rural and urban populations. Land reform could help it achieve these and other objectives, and regions across the country are testing different pilots to identify the best approaches. One in the city of Chongqing, for example, helps farmers move to cities and thus gain access to education, health care, and pensions, which may be unavailable in rural areas. Participants have the option of keeping or giving up their land use rights in the process. A pilot in Chengdu, aiming to bring jobs and development to the countryside, gives rural populations rights typical of those urban residents enjoy. Thanks in part to this initiative, more than 90 percent of Chengdu's rural residents now have medical insurance.

3. Real estate will stagnate. In an effort to further cool prices, the authorities will maintain purchase and credit restrictions that contributed to the deterioration of property markets in the second half of 2011. According to the China Index Academy, local-government revenues fell as a result of declining land sales—by 13 percent in Shanghai, 14 percent in Beijing, and 29 percent in Nanjing from January to November 2011, compared with the same period in 2010. Fear of local-government defaults and a general property rout may induce the central authorities to ease restrictions. Nonetheless, Beijing will continue to prioritize the construction of affordable housing for the poor in an attempt to prevent a hard landing in the construction sector.

4. The fundamentals will cause further inflation in food prices. Broader inflation in consumer prices appears to have peaked, but those of food rose at twice the rate of the consumer price index in the closing months of 2011. Inflation is highest for meats—the price of pork and beef rose by 27 and 14 percent, respectively, over the 12 months ending in November 2011, compared with the same period in 2010. The trend reflects changing consumption patterns among urban consumers and the growing middle class, who eat more meat, thereby increasing demand for cereals to feed animals. The availability of food imports is limited, and the rate of productivity improvement in domestic agriculture remains low. Moreover, price volatility is high, since even minor disruptions can affect supply dramatically.

5. Chinese investment in green tech will spike upward. Thanks to manufacturing at scale, China is already well established as a leader in the solar and wind industries. In 2012, the country will expand its efforts to deliver products and services directly to end users in international markets, raising barriers to entry for others. It will also boost investment in manufacturing and other upstream segments of the value chain, perhaps by acquiring (or striking partnerships with) struggling Japanese firms to gain access to intellectual property. As green-tech matures, the government may let subsidy programs lapse to prevent unmanageable growth and oversupply. Investors are interested. In 2011, 28 of the world's 51 clean-tech IPOs came out of China.

6. Accounting scandals will continue. China's reputation among regulators and investors was tarnished in 2011. According to the *Financial Times*, the total value of Chinese companies delisted from US exchanges exceeded what Chinese companies raised through IPOs in the United States last year. The trend will probably continue in 2012, since more than 400 "reverse merger" companies are still listed in the United States; the fact that they were not subjected to the rigors of the typical IPO process suggests that markets are in for more surprises. International investors will become increasingly selective about purchasing shares of Chinese companies.

7. Private-equity and venture capital funds may go 'walkabout.' Some venture capital and many private-equity funds in China used an aggressive short-term strategy that essentially involved buying companies shortly before they went public and then listing them at high multiples. But as asset prices decline and the stock market drifts, the potential for quick, IPO-driven returns falls greatly. If the assets these funds hold were marked to market, a significant portion would be out of the money. Some funds will probably get into trouble with impatient investors, raising the possibility that certain fund managers may walk away from investments.

8. Chinese acquirers will be bolder. As prices drop, Chinese companies will seek international buying opportunities. A recent example is Shandong Heavy Industry Group's recently announced acquisition of Ferretti Group, the Italian luxury yacht builder. Companies in some countries seem wary of the trend. Indeed, a South Korean consortium may be assembling to preempt Chinese companies from acquiring a French firm that has

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critical technology for liquefied-natural-gas tankers. The Chinese will continue to purchase property in the United States, but opportunities to acquire businesses there will be scant in 2012, an election year.

9. The automobile segment will be slow. The auto market will probably grow by around 8 percent, much slower than the 32 percent jump in 2010 but higher than last year's 2.5 percent. In particular, the market for small cars and microvans will grow significantly in 2012, although the budget segment (cars that cost less than $10,000) will become a key battleground between multinational joint ventures and local companies. The National Development and Reform Commission has required joint ventures to develop and sell vehicles under "indigenous" (that is, local) brands, and most offer budget models under them. This development puts joint ventures in head-to-head competition with domestic automobile producers, such as BYD, Chery, and Geely. Meanwhile, several local Chinese producers suffer from declining share. Stagnant real-estate prices will dampen demand for luxury cars, and the debate about how aggressively to encourage electric models has led to some adjustments in policy—such as a push behind range-extended electric vehicles—that might at last help to ignite the market. One certainty is that local companies are not ready to commercialize electric-battery vehicles at scale in 2012.

10. Hospital reform will accelerate. Two developments will drive the reform of hospitals. First, the emergence of clearer policies governing the payment mechanism between payers and providers will dramatically reduce excessive levels of prescriptions for expensive drugs. Second, local and overseas funds will lead a wave of hospital privatization, including both existing and new assets. In the pharmaceutical and medical-device segments, new provincial tendering policies will further erode prices. Nimble locals will fare best in this climate; multinationals will wait and see.

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