



We understand why the labor market has been resilient, but we do not have full confidence it will stay so in 2016. The stable labor market reflects three factors. The labor force is shrinking, hence less pressure to supply side. The demand side has been boosted by a robust service sector, which helps to absorb labor from the weak industrial sector. Moreover, the government managed to prevent large scale layoffs so far, despite the growth slowdown. This delays job destruction.

The labor market outlook is uncertain because the delayed job shedding may occur in 2016. The government started to send signals recently that it would tolerate more bankruptcy. Premier Li Keqiang mentioned the risk imposed by "zombie companies" on the economy in a State Council meeting in November. The lack of government intervention in the recent Shanshui cement bond default may also indicate the subtle change in government's thinking. The government recently mentioned the importance of managing the supply side of the economy, which suggests it may finally address the overcapacity problem more seriously.

We believe it is the right policy to allow some "zombie companies" to go bankrupt. It will help improve the efficiency of the economy and avoid building up of bad loans down the road. The impact on the labor market in the short term is difficult to forecast. We assume as a baseline case that there will be some signs of rising unemployment in the economy. In such a scenario we believe the government will respond by cutting interest rates twice in H2 2016, and expand fiscal spending.

There is room for policy easing in 2016, but with caveats

The government has the capacity to ease policies. On the monetary front, the reserve requirement ratio is still quite high (Figure 4). We expect 4 RRR cuts in 2016. The one-year deposit rate is currently at 1.5%. With inflation relatively low, the PBoC can cut the benchmark interest rates if downward pressure on growth intensifies. On the fiscal front, total government debt is around 39.6% of GDP, not including the RMB8.6 trillion debt of local government financing vehicles, which has been recognized by the central government. This is lower than the level in major developed economies.

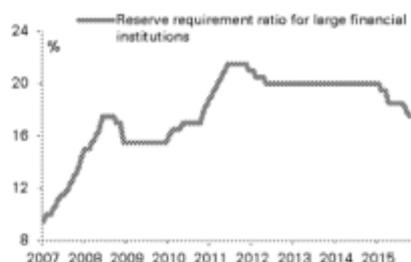
Further policy easing clearly has its costs. The leverage ratio of the economy will likely rise further and imposes higher financial risks. Loosening of monetary policy may delay the resolution of "zombie companies" and overcapacity problem further. The benefit of short-term growth stabilization will come with pains in the longer term, and the tradeoff is becoming increasingly unfavorable. There is room for easing in 2016, but this may come with a hefty price.

SDR inclusion is structurally positive

The SDR inclusion of the RMB on November 30 is a structurally positive development for China (Figure 5). The most significant macro implication is on reform outlook. The progress of structural reforms has been slow. There is doubt among investors about whether China is truly committed to market-oriented reforms. Such doubt heightened in the summer after what happened in the equity market. The SDR inclusion may work as a catalyst to boost the momentum of reforms in China. It indicates that the authorities are keen to integrate China's economy further with the global economy, which may help better align China's domestic market operations with international best practices.

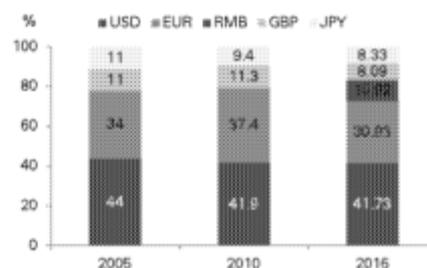
The size of capital inflows in the short term may not be high, as the SDR inclusion itself will only begin effective Oct 1 2016. But China has opened its fixed income and foreign exchange markets to foreign central banks and

Figure 4: Reserve requirement ratio



Source: PBoC, Deutsche Bank Research

Figure 5: SDR basket



Source: IMF, Deutsche Bank Research

Figure 6: Deutsche Bank forecasts:

	2014	2015F	2016F	2017F
05-yr, unless stated				
Real GDP growth	7.3	7.0	6.7	6.7
CPI inflation, pavg.	2.0	1.4	1.8	1.8
Current account balance, % of GDP	3.1	3.3	2.8	2.5
USD/CNY, eop	6.1	6.4	6.7	6.7
Fiscal balance, % of GDP	-1.8	-3.2	-3.5	-3.5
Government debt, % of GDP	37.1	39.6	40.0	40.5
1-year deposit rate, %	2.75	1.50	1.00	1.00
M2 growth	12.3	13.6	12.7	12.4

Source: National authorities, Deutsche Bank Research