As your team’s newly hired Asia strategist, your two responsibilities are to follow the performances of two Asian economies, China and Japan. You are to predict China’s 2017 Real GDP performance. You will also forecast the value for the currency relationship between the U.S. and Japan. You have inherited your firm’s old forecast, and they shared the consensus expectation. Thus as of today you are predicting that China’s 2017 Real GDP will be up 6.5%, year-on-year. You also are in print forecasting that, year-end 2017, it will require 118 yen to buy one dollar.

You must always be ready to participate in class discussions, and be ready to answer questions about current developments relating to the future direction for Japan and China.

**Barometer #1: China’s Real Gross Domestic Product**

Consider the chart, above, depicting Chinese real GDP change, year-on-year. We can identify four phases.

1. Leading into the Great Recession China boomed, with real GDP gains of 10% to 14%. These advances were propelled, in large part, via surging exports to the USA and to Continental Europe, coupled with massive investment in infrastructure (factories, roads, living quarters) justified by the great export boom.
2. The Great Recession slammed China exports. Year-on-year growth slowed sharply.
3. Chinese authorities, to rescue China growth from the swoon experienced in the rest of the world, used public funds to finance an infrastructure investment boom. This resulted in a rise in investment as a share of GDP, from 35% to 55%.
4. Surging Chinese debt levels, coupled with wild excess capacity in many investment sectors, has led to a slowing of GDP growth.

Critics of China’s recent performance, (read Michael Pettis materials) point out that they must sharply curtail dependence on exports and investment, and enfranchise their consumers. This is
difficult to engineer, given the fact that China’s export and investment industries are largely owned by relatives of members of the Chinese Communist party. Xi Jinping’s anti-corruption campaign, is ostensibly aimed at shutting down government subsidies that keep the old order in charge. He has had only mixed results.

https://www.ft.com/content/3f1938d6-d1cf-11e6-b06b-680c49b4b4c0

the FT article, cited above, put it this way:

“The mountains are high and the emperor is far away” is an ancient saying that remains popular to this day. Through millennia of dynastic cycles, central control over the Chinese empire has often been weak. The emperor’s mandarins, with the help of the garrison, were supposed to impose order and uphold the laws in the provinces — but more often than not they served as corrupt symbols of the predatory state, bending the laws and tax codes to suit their own interests”.

President Donald Trump now adds a big additional unknown. He has, on many occasions, declared China a major drain on the U.S. economy. He has threatened to impose a large tax on Chinese imports.

In sum, China’s internal dynamics demand that they cultivate new growth engines. And Trump suggests the sooner the better. Where does that leave real GDP growth going forward???

The Yen/$ Bilateral Exchange Rate

![Graph showing the Yen/$ Bilateral Exchange Rate](image)

How does one forecast bilateral exchange rate? The honest answer is that no models do particularly well. We do know that a central bank, if it wants to, can announce a plan to drive its currency lower. If the central bank declares they will print however many yen are needed to keep the price of the yen equal to 120 dollars, they will succeed. They must accept that flooding their markets with yen will collapse their interest rates. But if zero interest rates are not a problem, they can proceed.

That is a very rare event. Related, however, is the effect of interest rate differences on currencies. Although finance theory has difficulties with the notion, it turns out that a jump for a Nation’s expected interest rate path, relative to another nation, tend to lift the bilateral exchange rate.