

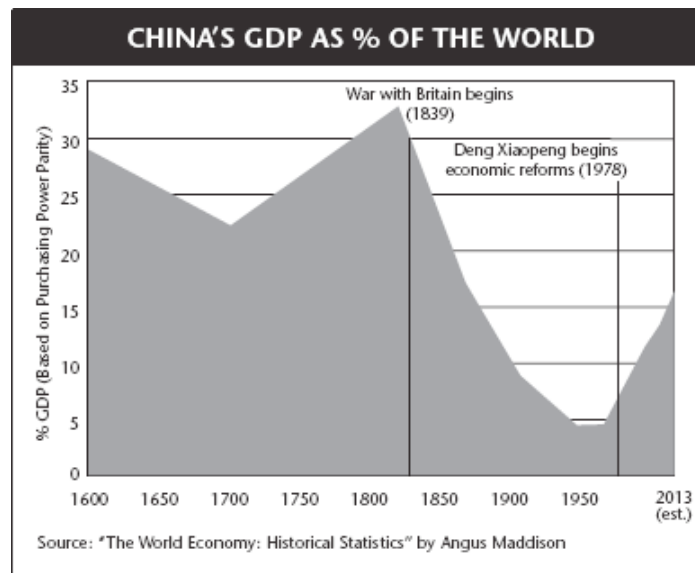
From: Arthur McKee <art@mckeeinvestments.com>  
Subject: **China Perspective**  
Date: April 23, 2010 12:11:53 PM EDT  
To: update@mckeeinvestments.com  
1 Attachment, 8.7 KB

Good Friday!!! The writing below is a little longer in length than I usually like to send out, however, I think it would be worth your time (just about 5 minutes) to read it through. In addition, this is something that I did not write. It is a piece that was written by Mark Headley from Matthews Asian Funds, a fund company that specializes in just a few Asian countries and in which we have significant investments. Here it is:

### In China's Shoes

In the evolution of global trade and finance, China's relative increase in almost every level of economic statistic over the last 30 years is one of the defining events of our times. Yet, in many ways, China is still a poor country with a per capita annual income of roughly US\$3,000 versus about US\$40,000 for the U.S. When pressured to address vital issues such as terms of trade, human rights and the environment, China constantly refers to its own internal challenges, external grievances and long road to development.

Many developed countries are increasingly frustrated with China's unwillingness to "play by the rules." China seems to want the full benefits of access and membership to the global system while maintaining unfair advantages. The currency issue is the most obvious source of friction for many developed and developing countries alike struggling to maintain jobs. China has frustrated the world a great deal in the past 30 years and generally has paid little or no price for its obstinacy. Access to China's potentially huge domestic markets is one of the obvious reasons that other countries complain but seem to do little. No one wants to be China's "least favored" trading partner.



But tensions are rising and the need for major adjustments is slowly becoming inevitable. So why does China behave the way it does and how do we, as citizens of the world's most powerful nation, work with China?

Some months ago I made a crude attempt to describe China's psychology to a large group of professional U.S. investors. I had precisely two minutes, so on a whim I decided to lay out an alternative history of the U.S. with the hope of giving the audience some understanding of China's domestic identity. So, forgive the vast revisionism and crude reductionism, and please consider what our national attitudes and debates might resemble if the U.S. had gone through something like the Chinese experience.

#### A Revisionist's History

*Imagine if the U.S. had lost the War of 1812 against the British. Instead of a messy end to a sideline for the then mighty British Empire, the U.K. established total domination in key American cities. The War ends with Manhattan transferred to the British in perpetuity. Some 50 years later, they demand and receive Long Island on a 99-year lease. Backed by British power, other European nations demand their allotted piece of our coastal cities and economy. Imagine if this outrage to a nation's sovereignty ended only 13 years ago with a formal handover ceremony—the Union Jack finally replaced by the Stars and Stripes in Times Square.*

China and Britain went to war in 1839, largely because China objected to the vast opium imports devastating its domestic population. China's forces were utterly defeated and Hong Kong was later demanded as a national territory of Britain. In a series of treaties, China was stripped of much of the ability to manage its own terms of trade. This set the tone for all future colonial depredations along China's coast with European nations, and later Japan, demanding the right to virtually run their own private states within Chinese territory for much of the next 100 years. The demise of China's 2,000-year-old imperial system can be significantly attributed to this ruthless attack on its sovereignty. Certainly, any hope of a smooth movement to democracy was greatly diminished. India did have the advantage (if it can be called that) of total British domination in forming its democracy. China, on the other hand, fell back after years of devastation on an imperial model dressed in Marxist robes.

*Imagine if the U.S. Civil War, so etched in our national psyche, had not lasted four years and cost less than 1 million lives, but rather lasted over 15 years and resulted in losses 20 times what we actually suffered. Imagine if Washington, D.C., not Richmond, Virginia was the capital of the Confederacy for almost two decades.*

China's little known Taiping Rebellion lasted from 1850 to 1864. It was launched by a Cantonese farmer who interpreted the Christian teachings he was exposed to by the new Western presence to mean that he was the younger brother of Jesus. Vast armies fought battle after battle, and at least 20 million people died. The Taiping were finally slaughtered after ruling much of central China from the southern city of Nanjing. The Qing Dynasty was left even further weakened in its ongoing battle with colonial powers. Anyone who wonders why Chinese authorities are so paranoid about Christian activity or other spiritual organizations, like the Falun Gong, should study this history.

*Imagine if the Japanese Imperial Navy had successfully captured Hawaii following the attack on Pearl Harbor in December 1941. This setback allowed Axis forces to capture much of the East (or West) Coast (take your pick) and hold that territory through eight years of brutal warfare. Military and civilian casualties in the tens of millions resulted. Many of America's major coastal cities are left devastated. We are saved by the U.S.S.R's defeat of Germany and Japan.*

China, desperately weakened by its ongoing civil war between the Nationalists and Communist forces, faced direct Japanese hostilities in mid-1937. A bitterly divided country fought the Japanese in battle after battle until Japan's final collapse in 1945. China fought approximately two-fifths of all Japanese forces in World War II, perhaps keeping Japan from successfully invading Australia and holding Southeast Asia against the Allied counter-attack.

*Imagine if the radical left successfully captured power during the turmoil of the 1960s, and decided the best way to move the U.S. forward was to close virtually every school, college and university in the country for almost a decade. An entire decade's worth of students received little or no education and floated through our society, terribly handicapped, ever since. Many of our most precious national monuments and historical artifacts were destroyed in the name of the new order.*

China's Cultural Revolution was unleashed by Chairman Mao Zedong as a political move to distract the population from the horror of the Great Leap Forward, a failed economic plan that resulted in mass starvation. The Cultural Revolution inflicted such chaos and brutality on an already tortured nation that it is hard to grasp. There remains in China a generation—who are roughly 50 to 60 years old today—that received little education. Being educated in the Soviet Union saved, and indoctrinated, a handful of the elite who run China today.

#### **China's View of the World**

Each of the hypothetical examples above is flawed in any number of ways, but may give some insight into how the Chinese and its leaders view the world. The experiences in the U.S. that truly compare to what has happened to China in the last couple of centuries might resemble the genocide of Native Americans and the slavery of African Americans. Until the last 20 years, America's worst decade in the last 200 years would be far preferable to China's best decade. Imperial collapse, foreign invasion and civil war have typified China's modern experience. So when China behaves brutally, petulantly and, so often, reactively, this is largely a product of historical trauma of the highest order—a proud and ancient nation brought to its knees by both internal and external strife. Mao's final madness was a terrible gift to a nation that is searching for a new path but remains distrustful of foreign nations and obsessed with internal stability.

When we look today to solve complex issues such as China's fixed currency system, there are several implications:

1. **China, its government and its citizenry, value stability very highly.** So anything that threatens stability, whether that is a floating exchange rate (which devastated richer neighbors in the Asian Financial Crisis) or freedom for Tibet, will be treated with immense caution. China's citizens seem to have accepted Deng Xiaoping's proposal, made in the shadow of the Tiananmen Square protests, of encouraging economic freedom while not tolerating challenges to the power and ideology of the state. The Communist Party has allowed a major degree of economic freedom, unleashing a market economy, while forcefully putting off political freedom to some distant future resolution. This is a deal that the vast majority of Chinese have embraced, at least while the economy is flourishing.
2. **China will respond very negatively to harsh foreign pressure.** Threats and insults in foreign negotiations, while often playing well to any nation's domestic audience, are unlikely to do anything but encourage Chinese intransigency. China's government does not dare to appear weak before its own population and feels time is on its side in most areas of friction. China sees negotiating with the West as a 300-year continuum, and it is playing the game very seriously with a huge commitment to winning a few rounds after so many losses.
3. **China, as a nation, is a developing economy, with all the associated cultural baggage such terms imply in a post-colonial world.** But unlike most such nations, China sees itself as a resurgent great power with the tools required to meet the West and Japan on an even playing field for the first time in the modern age. No other nation is in a comparable position of returning to greatness with a very large chip on the shoulder. This will make negotiations difficult and, at times, virtually impossible.

China's industrial development, export success and rising domestic market give it a very strong hand in global negotiations. Today, we are literally in China's shoes, or at least our children are. Any trade war would devastate our economy at least as much as China's. Not to mention the many implications of China's holdings of U.S. dollars. The potential of China's market—where car sales have now exceeded those in the U.S., there are more cell phone users than European Union citizens, and more Internet connections than people in North America—keeps every nation rightfully nervous about being excluded. A fear China has used very effectively.

This is not an argument for handling China differently than other nations. Most developing countries have similar histories of colonial outrages and profound domestic trouble. But to attempt to understand China, one must recognize that a country that has been the Rome and Greece of Asia for over 2,000 years, rightfully, has great pride—just as we do. Its citizens know this history well. Sadly, we rarely know much about our own history let alone China's deep and complex story.

I write this piece to warn against the simplistic notions about China that permeate our media, and to challenge the powerful special interests that want to paint China as a nation to be attacked, not vigorously debated. We face a long and very challenging dialogue with China, and I believe knowledge is an infinitely better negotiating tool than crude propaganda and simplistic nationalism.

Am I really saying China should be handled differently? No, just intelligently.

*Mark W. Headley*

*Chairman*

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