

October 2005

China's March to Modernity

Long Live the Great Leap Forward! Everybody, Make Steel!
Chairman Mao Zedong, 1958

It doesn't matter whether the cat is white or black, as long as it catches mice.
Deng Xiaoping, 1961

If one is in the investment business, or almost any other business, one needs to know what is happening in China. China now has the second largest GDP in the world at \$7.3 trillion (measured in purchasing power parity) and accounts for more than 10% of global GDP. Whether the topic is the price of oil, global manufacturing prices, inflation or deflation, trade deficits or the direction of the U.S. dollar, it is important to develop an informed view about China and its impact on the world.

At Bradley, Foster & Sargent, Inc., China has been of great interest to us for some time. In fact, three of our investment professionals have visited China over the recent past, and one of our principals was even in Hong Kong during the Cultural Revolution when Communist China cut off the water supply to Hong Kong. In May, 2005, a principal and a research analyst from Bradley, Foster & Sargent, Inc. flew to Japan, Hong Kong and China, visiting a number of businesses including retail establishments, cosmetic outlets, and insurance and banking operations. They were accompanied in China by Zhihong Sun, who interned at Bradley, Foster & Sargent, Inc. while she was a graduate student at the University of Connecticut and is now with Dell in Xiamen.

China's history and culture are enormously rich and varied, and a commentary such as this must necessarily be limited to reviewing events of the more recent past as well as outlining the current state of China in economic and political terms. Finally it is important to identify some key issues that merit watching and how China fits into the world of investments. As this is a topic of such vital importance, we plan to re-visit it from time to time in future quarterly commentaries.

China under Mao

In 1949, the Chinese People's Liberation Army (PLA), after almost thirty years of continuous warfare against the Nationalist and later the Japanese armies, took control of Beijing. The Communist Party under the leadership of Chairman Mao shortly thereafter established the People's Republic of China (PRC). In 1958, Mao launched a campaign which came to be known as The Great Leap Forward. With the stroke of his ink brush, Mao ordered the vast peasant population of China into a commune system. In essence, all peasants were required to give up ownership of their land and move into collectivized farms, where all produce belonged to the state. The peasants were all dressed in similar blue tunics and trousers and ate from a common rice bowl. Mao's other great effort during The Great Leap Forward was a nationwide campaign to produce more steel. Every university, hospital, school, and commune was ordered to create backyard steel mills. Into the smelting pots went every piece of iron that the people could gather, picking China clean of iron implements in a few years.

The result of The Great Leap Forward was famine. Man-made famine. Estimates vary, but most historians agree that between thirty and fifty million people starved to death. Nobody dared to tell Mao that his plans would not work – not even Zhou Enlai or Deng Xiaoping. And when the disaster had run its course, several of the more pragmatic leaders took over the reins of the economy from Mao. It was during this period that

Deng Xiaoping first made his famous remark about not caring whether the cat was white or black as long as it could catch mice. In other words, fidelity to Mao and Marx was not as important as the actual production of food and goods.

In 1965, Mao unleashed the Cultural Revolution. Historians now view the monstrous upheaval which took place as Mao's campaign to take back power and crush his enemies. It was a decade of madness. In *Wild Swans*, Jung Chang, the daughter of a high Party functionary, chronicles how she and her classmates were instructed to remove the grass on the school's lawn because grass was "bourgeois." Others write that the only book which could be bought in China's bookstores during this period was Mao's little red book. Hundreds of millions of people were uprooted. Millions were persecuted by "Red Guards," and untold numbers died.

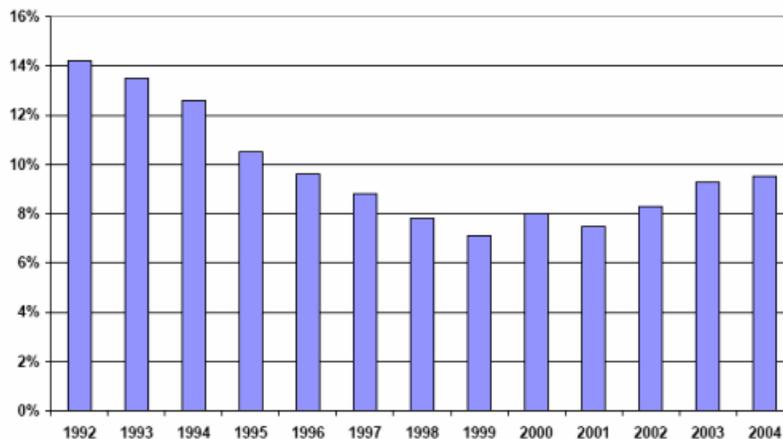
Deng Xiaoping's Revolution

Upon Mao's death and the fall of the "Gang of Four," China slowly retreated from the irrationality of the Cultural Revolution. By the early 1980's, Deng was back in control, and he launched China into its period of remarkable growth. Unlike the Soviet Union where the Communist Party lost political control and democracy was attempted, China has been kept under the political control of the Chinese Communist Party, which, however, allowed an increasing amount of free market enterprise to flourish. Peasants were permitted to divide up and lease the communal land, and they could reap the fruits of their own rewards. Trucks and tractors could be privately owned. Individuals could go into business and hire a dozen or more people; small farms and businesses prospered. Each province, city and village was allowed leeway to do it their own way. It was with this backdrop of rising prosperity that the tragedy of Tiananmen Square occurred in 1989. History has shown that political revolutions often take place when expectations and desires are raised by improving conditions. In the confrontation between the students and political bosses of China, the elder statesmen of the Communist Party made it clear that they were determined to maintain rigid political control of China. And this has been the continuing story for the last fifteen years. There is increased personal freedom and economic opportunity, but any move which poses a political challenge to the Party is ruthlessly suppressed.

China – Economic Powerhouse

In the years since Tiananmen Square, China has shown economic growth unrivalled throughout the world. While statistics are generally unreliable in a Communist country, there is no doubt that China is being transformed. Its GDP, on a purchasing parity basis, is currently measured at \$7.3 trillion – compared with the U.S.'s \$11.7 trillion. One of the reasons for this amazing growth rate is the very high Chinese savings rate of 40%+ which allows for tremendous investment in the infrastructure and factories. As the chart below shows, GDP growth over the past decade has been remarkable, increasing at an average annual rate of 9%. During this same period, the GDP of the U.S. grew at 3.5% annually.

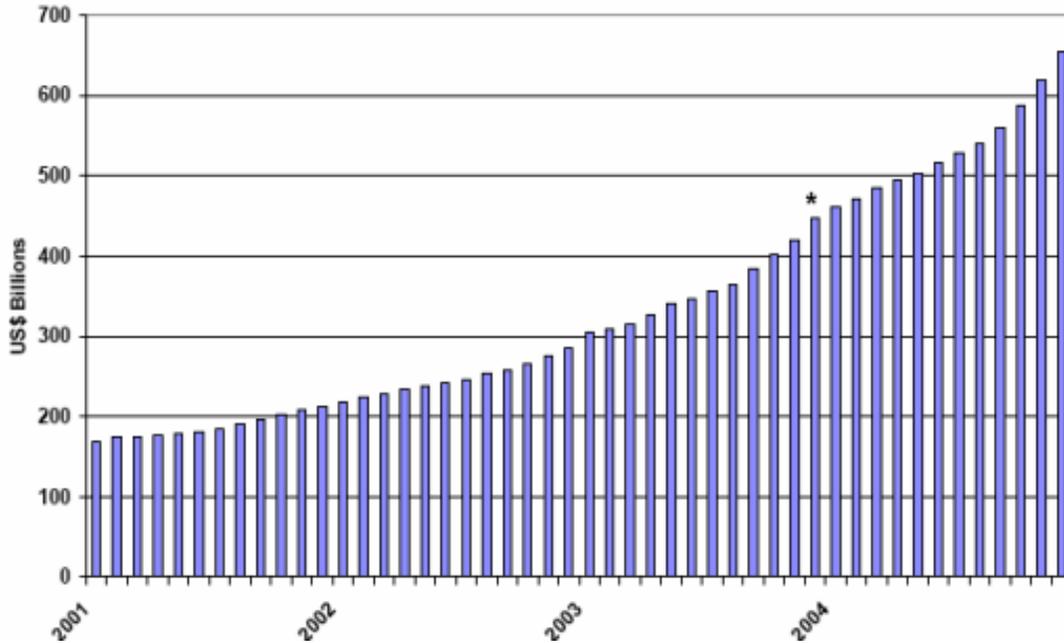
China's Real GDP Growth, 1992 – 2004



Morris Goldstein, Institute for International Economics

While the size of China's GDP in absolute terms is large, so is the population. There are approximately 1.3 billion people in China. This translates to a per capita GDP of roughly \$5,600 which is lower than that of the Dominican Republic. The per capita GDP of the U.S. is seven times greater. China's literate work force combined with low wages and political stability has made it a manufacturing base for the world. This, combined with an undervalued currency, has allowed for a large trade surplus with the U.S. (and other countries as well) and the build-up of large foreign currency reserves as shown below:

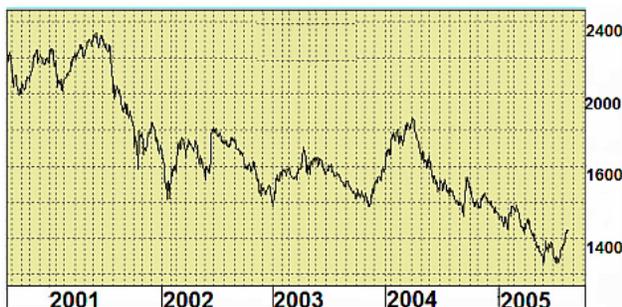
International Reserves, 2001-2004



Morris Goldstein, Institute for International Economics

One would imagine that such remarkable GDP growth over the past two decades would create a very positive investment environment – both for Chinese and foreign investors. However, over the past five years, the U.S. consumer has benefited the most (by buying everything from sneakers to computers made in China). The stock market investors have had a challenging time as the charts below show. Chinese investors have lost 37% from the market top in 2001, while foreign investors appear to have lost more than 65% over the same period.

Chinese Investors Only
Shanghai A-Shares Index (Aug 2000 – Aug 2005)



Jonathan Bernstein, ETFzone.com

Foreign Investors Only
Shanghai B-Shares Index (Aug 2000 – Aug 2005)



Jonathan Bernstein, ETFzone.com

The table below outlines some of the positive and negative aspects of the current situation in China (from the perspective of a foreign investor):

Pros

Reliable labor force with strong work ethic
Literate, low cost workers
Major investment in improving infrastructure
Strong export-led economic growth
Very high savings rate
High level of foreign direct investment
Large international monetary reserves
Huge ramp-up of internet and mobile phones
Large investment in education
Entrepreneurial enterprises encouraged
Wealthy overseas Chinese

Cons

Communist Party control
Chinese military buildup
Risk of conflict over Taiwan
Poor record on human rights
Intellectual property at risk
100 million+ surplus rural workers adrift
Disparities between coastal and rural areas
Exchange control
Large amount of bad loans in state-owned banks
Nepotism and corruption
Uncertain courts and property rights
Damage to the environment

Summary

It is clear that China is on the march to becoming one of the world's most powerful nations. There is, of course, great risk to the international community when another major world power emerges. One need only look at Germany and Japan in the 20th century to see how badly it can turn out. If nations feel threatened, anxiety and fear can prevail. An example of this is Major General Zhu Chenghu's remarks on July 14, 2005 in a session with foreign journalists regarding U.S. interference in a possible war between Communist China and Taiwan: "We [the Chinese] will prepare ourselves for the destruction of all Chinese cities east of Xian. Of course, the Americans will also have to be prepared that hundreds ... of their cities will be destroyed by the Chinese nuclear weapons." In the past, comments such as these by a highly placed military figure were only made if they represented the views of key Chinese military officers and members of the Central Committee. Zhu's remarks were not repudiated by senior Chinese politicians or officers. From the U.S. perspective, a key tenet of its foreign policy – ever since its recognition of the PRC in the 1970's – has been that the resolution of the dispute between China and Taiwan must be accomplished through peaceful means. Moreover, both Democratic and Republican administrations for decades have committed to assist Taiwan in maintaining democracy free of coercion – whether by invasion, missile attack or blockade. Clearly this is a situation of great risk with huge stakes, and great care must be exercised by all parties to avoid unintended consequences.

On the positive side, the U.S. and China have developed an enormous amount of mutually beneficial trade and economic activity. In a very real sense, both nations are dependent on each other for some of their economic success. Furthermore, capitalism, as practiced in China, can often lead over time to genuine democracy. It is clearly the hope of people of good will that the constructive forces of progress and peaceful relations will outweigh the all-too-real problems in the geo-political sphere. In regard to Bradley, Foster & Sargent, Inc.'s approach to investing in China, we will continue to identify and invest in leading U.S. and foreign multinational companies that are well positioned to take advantage of the economic growth of China but refrain from the direct investment approach until some of the risks above have been mitigated.