MATTHEWS INTERNATIONAL CAPITAL MANAGEMENT

ASIA REPORT

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Regional Overview:

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The third quarter of 1997 proved to be a tumultuous period for Asian economies, currencies and stockmarkets. What started as a crisis of confidence in the value of the Thai Baht snowballed to the point that almost all Asian currencies have come under pressure, and in many cases declined by 10-30% relative to the US Dollar.

While the roots of this crisis lie in poor macro-economic management by a number of ASEAN countries, the order of magnitude of the recent market declines has over-discounted a slowdown in regional growth. The largest economies and countries in Asia, namely Korea, Japan and China, are individually as large or larger than all of the ASEAN countries combined, comprising over a third of the world's total GNP. Although Korea is suffering some of the same problems as the ASEAN four, Japan, and in particular China, should provide support to local economies through increased consumer demand. China is at a point in its business cycle where it can and should expand credit and stimulate domestic demand, as evidenced by the government's recent 1.5% reduction in interest rates.

> *"The recent indiscriminate selling in Asian markets has created a highly favorable environment for research driven security selection."*

Hong Kong's dramatic market decline has raised concerns that foreign portfolio and direct investment flows to Asia may start leaving the region. Having recently returned from a visit to Asia, it is clear that while foreign direct capital flows may slow this year, many multi-nationals will consider this an opportunity to make additional commitments in the region. This trend will only be enhanced by the competitive manufacturing gains garnered through the recent currency devaluations. By contrast, portfolio flows may slow during the short term, as investors test market and currency bottoms.

While any prediction regarding currencies is perilous, we believe the Hong Kong dollar peg to the US dollar will be maintained. Hong Kong's currency board system is defensible as long as the government is willing to tolerate the pain of higher interest rates. A significant property correction is a likely result of this environment, but such a correction will benefit Hong Kong's competitiveness as well as the government's stated goal of providing more affordable housing.

We are confident that while Asia's "miracle economy" status has been tarnished, the region, particularly China, remains highly attractive for the long term. As a result of the recent market declines, P/E multiples in the region are at their lowest levels in many years. In addition to attractive valuations, the long term earnings outlook for many companies is not significantly different from six months ago. The recent indiscriminate selling in Asian markets has created a highly favorable environment for research driven security selection.

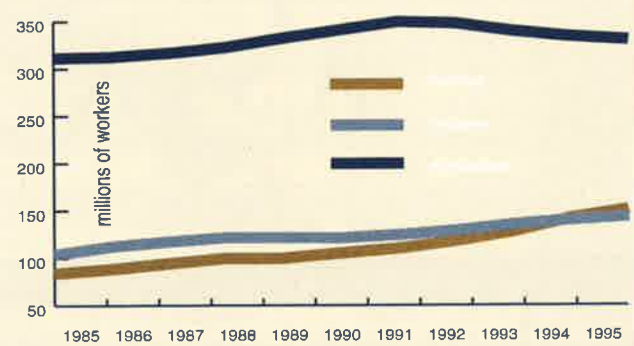
Dynamic Markets and Economic Reforms Create Dramatic Changes in China

by Jesse Soto, Research Analyst

China, the world's most populous nation, has also been one of the most dynamic, with GDP growth averaging 10.5% over the last ten years. China's development has been so dynamic that per capita income has doubled over the past 9 years, a feat that took 47 years to accomplish in the US and 34 years in Japan. Sweeping economic reforms have enabled China to dramatically increase the quality of life for its citizens. From 1978 to 1995, China was able to reduce the number of people living in absolute poverty by over 200 million, nearly the entire population of the US. China's reforms have also effected mortality and longevity. In 1995, China's infant mortality rate fell to nearly half the level in 1970. During this same time period, the average life expectancy increased by 7 years for men and 8 years for women. In addition, China's emphasis on education has led to an impressive 95% literacy rate among 10-24 year olds, a level comparable to more developed nations.

Agricultural reforms of the late 1970's were the beginning of the economic transformation of the last twenty years. During this time, rural economic conditions were poor and social unrest high. Tightly controlled production quotas and prices resulted in unmotivated rural workers producing below capacity. The situation changed dramatically with the introduction of the household responsibility system. Under this system, households were assigned land for up to fifteen years. This transfer of property encouraged workers to invest time and effort in developing the capabilities of the land they were tending. Increased agricultural productivity spurred the government to relax pricing. Under a dual-track pricing system, farmers were allowed to sell production in excess of quotas at market prices. Since the production quotas rarely changed, the amount of goods sold at market prices increased; according to the World Bank, today more than 95% of industrial output sells at market prices. The combination of these two reforms resulted in increases in agricultural productivity and rural incomes, both freeing up workers for industrial jobs and spurring a market for rural industry.

Social Labor Force



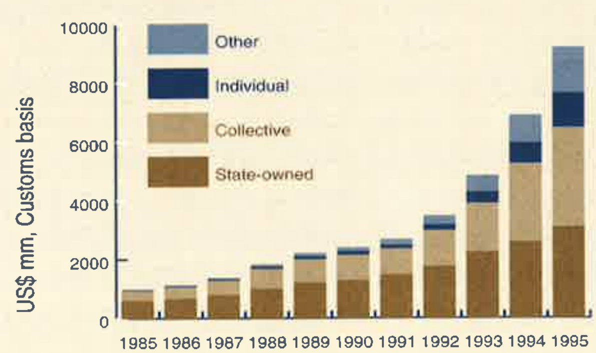
Source: China Statistical Yearbook, 1996

By 1978, importing goods to support agricultural reform had become a necessity. The government quickly depleted its foreign exchange reserves, bringing the government close to a foreign exchange crisis. To increase reserves, China further opened its economy to the outside world. Reform began by easing restrictions on international trade. Tariffs on imports were lowered and exports were stimulated by allowing exporters to retain a portion of their foreign exchange receipts.

Today, China's imports and exports have increased to more than 30% of GDP, versus 13% in the late 1970's. In addition, the government altered its exchange rate policy, nearly halving the exchange rate and devaluing the currency on four later occasions. China also relaxed regulations on direct foreign investment (DFI). Prior to 1979, China attracted nearly no DFI, versus its currrent status as the world's second largest recipient after the US.

Several initiatives to continue economic and political

Merchandise Exports & Imports



Source: China Statistical Yearbook, 1996 reforms are outlined in China's Fifteen-Year Perspective Plan and Ninth Five-Year Plan. The plans call for a transition from a planned economy to a "socialist market economy". Integral to the process is the transformation of the 118,000 industrial state-owned enterprises (SOEs). As a percentage of GDP, SOEs profits over recent years have declined from 6% to below 1%. In 1996, nearly half of all industrial SOEs posted losses totaling approximately 1.3% of GDP.

While the profitability and contribution to total production of SOEs has decreased, the amount of resources they consume have not. According to the World Bank, SOEs account for nearly three-quarters of total investment and represent approximately 60% of non-financial public sector borrowing. These huge demands on resources have served to crowd out investment in non-state firms, which are driving China's growth.

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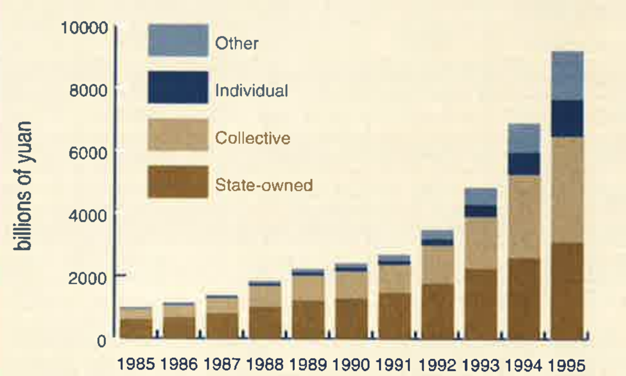
The Chinese government plans to maintain state ownership of 1,000 key industrial enterprises, but improve their performance by establishing market oriented incentives. The 1,000 key companies will originate from five industries: machinery, electronics, petrochemicals, construction and automobiles. The revitalization process includes debt forgiveness, interest payment exemptions, technical renovation and payments for idle workers. The remaining 117,000 industrial SOEs will be restructured, with the government providing a special fund for bankruptcies, reorganizations, debt write-offs and other financial considerations. In addition to reforming the industrial sector, the plans also call for social reforms, including the elimination of poverty by the year 2000 and expanding the number of years of compulsory education. The government ultimately projects growth to run at 6-7% a year for the next 25 years, a level that would expand the Chinese economy sevenfold.

As promising as the Chinese economy appears, achieving these hefty goals will not be easy. There are many costs associated with reform, both economic and social. The banking sector requires substantial reform; China must begin separating the banking system from government dictated projects. At the bequest of government, banks have provided loans to SOEs with little or no consideration of the enterprises' credit worthiness. A critical component for easing corporate dependency on bank loans is the development of a bond market. Going forward, companies must be encouraged to keep costs down and operate efficiently, achievable only by eliminating subsidies. The government must also address structural issues, which may jeopardize socio-economic stability. Key to successful reform will be China's ability to manage monetary policy and enforce laws. The central bank's ability to control monetary policy will be a critical component for future economic stability. Better use of the courts to protect property, civil and intellectual rights is necessary for societal stability. While progress in devising and passing new laws continues, enforcing these laws is still challenging.

A recent trip to China confirmed that the political will is in place for the next stage of market reforms to commence. When discussing the challenges of reforming the enormous state sector, Chinese officials were remarkably forthcoming about the many conflicts of interest to overcome. Conflicts between central and local government, managers and shareholders, newly privatized enterprises and the remaining nationalized businesses, are all openly discussed and not underestimated. There is no longer any debate as to the role that financial markets will play in this process; it is now well accepted that capitalism is integral to China's new socialism.

Gross Output By Industry



Source: China Statistical Yearbook, 1996