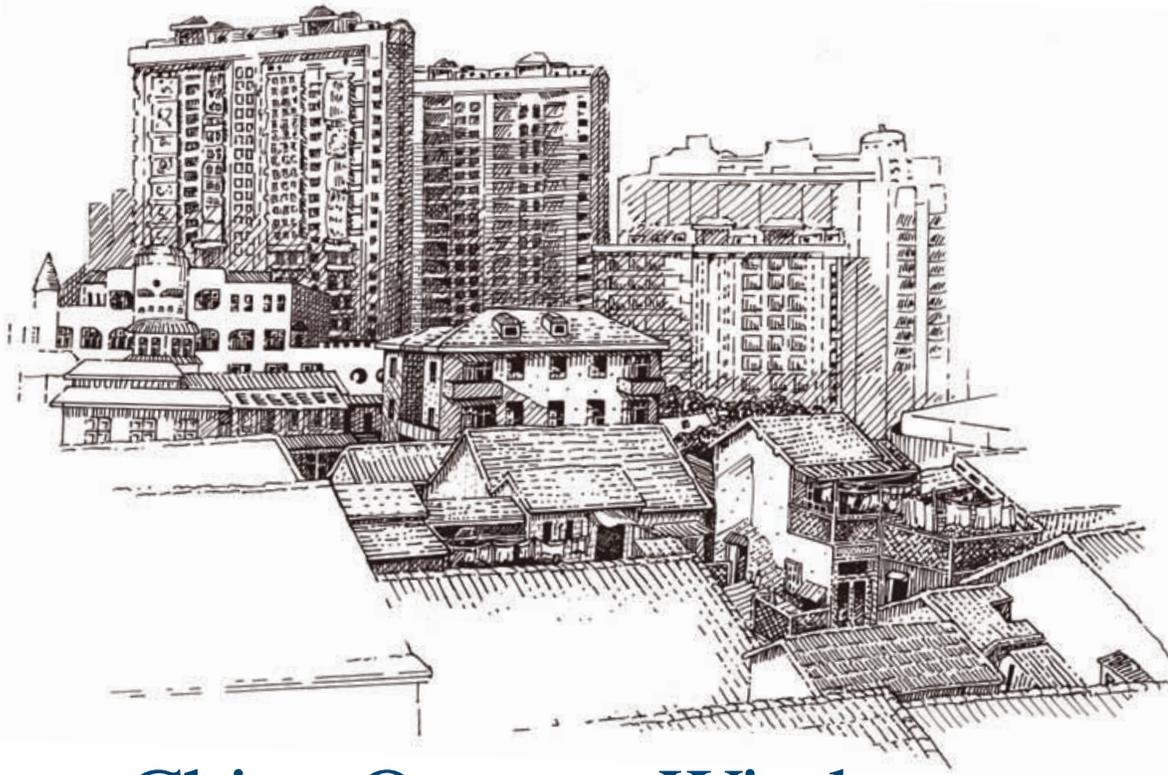




AsiaNow

A Series of Special Reports from Matthews International Capital Management



*A changing
Shanghai:
New apartments
dwarf the old city as
housing becomes
China's most desired
commodity.*

HOUSING REFORM IN CHINA

China Opens a Window— and a Door—of Opportunity

China's housing reform is turning its population into homeowners and empowering a new middle class. China specialists Richard H. Gao and G. Paul Matthews take us behind the scenes.

It's an age-old story in an unexpected setting. But the dream of homeownership is having the same profound effect on the Chinese economy as it has had in the United States and Great Britain, driving retail sales and domestic consumption to record levels.

Since 1996, when China's government first announced the privatization of public housing, Chinese families have taken advantage of state subsidies to become homeowners.

In fact, by some estimates as many as 50% of urban households are owned by their residents. Newly house-proud, the Chinese are now transforming formerly minor industries like remodeling, furnishings and appliances into instruments of China's impressive economic expansion. Housing-related industries now account for 1.5% to 2% of China's gross domestic product (GDP) growth.



The enormity of these figures literally hits home with Matthews Asian Funds. Richard Gao, co-manager of the Matthews China Fund and a native of Guangzhou, not only has experienced these changes firsthand, but has also seen his family and friends become part of the burgeoning middle class that is creating a brand-new—consumer-friendly—China.

ing reform and began to sell houses at a very cheap price. My mother was able to buy her home for about US\$2,000—well below its current market price of close to \$40,000.”

Richard’s mother wasn’t alone. Since the reforms were first implemented, homeownership rates have skyrocketed throughout China. A recent survey in Guangzhou showed that approximately 74% of residents now own their own apartments. “Wherever you go in China, people are talking about housing-related issues. I just got back from visiting Guangzhou, Beijing and Shanghai, and everyone was discussing their home renovations or mortgage interest rates. It’s very exciting, not just because it means good things for the Chinese economy, but because it’s such a good opportunity for the Chinese people.”

The new housing policy has even affected the physical look of China, particularly in the

Richard H. Gao

Co-manager of the Matthews China Fund

Background

AGE: 33
HOMETOWN: Guangzhou, China

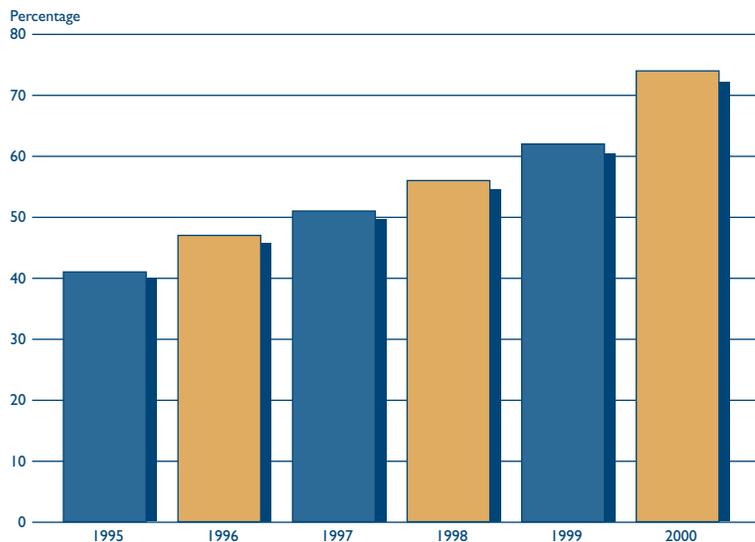
EDUCATION: BA, Literature, Guangdong University of Foreign Studies; MBA, Dominican College, San Rafael, California

PROFESSIONAL EXPERIENCE: Assistant manager in charge of foreign exchange trading, Bank of China; joined Matthews International Capital Management as an analyst in 1997, named co-manager in 1999.

A Home-Buying Spree

“Six or seven years ago, all property in China was owned by the state and leased back to you at a very low rate,” explains Richard. “For example, my mother rented her apartment for just \$8 to \$10 a month. Then the government implemented a program of hous-

Homeownership Soars in China’s Coastal Cities



Source: Guangzhou Statistical Yearbook

More than 70% of the residents of Guangzhou now own their own homes, with average private housing ownership rates nearly doubling since 1995 (based on surveys from 500 Guangzhou families).

A new housing complex in suburban Guangzhou reflects the market’s demand for modern design.



coastal areas. The multistory concrete block buildings of old are now giving way to more diversified styles. With new incentive to construct attractive alternatives, real estate developers are creating American-style suburbs and building residential communities complete with convenience stores, schools and shuttle buses. Richard describes community living as “a new concept in China. Building different types of houses to meet people’s different needs is also a new phenomenon. In the past the government allocated housing, and you had no choice. These changes have introduced a new feeling of flexibility.”

Unleashing China’s Greatest Asset

To the casual observer, privatizing property would seem to be the last thing a famously socialist country like China would attempt to do. But G. Paul Matthews, co-manager of Matthews China Fund and a veteran investor

in Asia, believes that the new housing policy was simply the next logical step in China’s wide-ranging program of reforms.

“When China first started down the reform road in the late 1970s, its road map was very simplistic,” he says. “First they wanted to raise productivity in the agricultural sector and introduce market pricing to industry. Then they began to focus on areas like infrastructure: Roads, bridges, telecoms, power—everything you need to run a developed economy.

“By the early 1990s, China’s leaders realized that though they were building all these nice roads and had enough power to run the country, they weren’t really generating a true middle-class consumer”—one who could spend enough to invigorate the economy and stave off deflation.

“Ordinary Chinese people—like my friends and family—are now putting the priority on their economic life. They’re not as concerned about politics as they used to be.”
—Richard Gao



Trendspotting

China and the WTO: A 1.3 Billion-Pound Gorilla?

by G. Paul Matthews, Chairman and Chief Investment Officer

China’s admission into the World Trade Organization (WTO) last November was met with understandable enthusiasm by the Chinese as well as the foreign companies who have coveted this huge market for years.

A lot of issues are raised by China’s joining the WTO, however. On the one hand, this is going to expose many Chinese industries to more severe competition than they’ve ever faced before, and that raises the risk of further unemployment in some state-sector companies.

But Chinese competition is also going to be a huge challenge for the world’s agricultural industries, which are about to be exposed to some very large scale operations. I heard an interesting story recently from an agricultural lobbyist who was representing the California walnut industry. California produces about 99% of all the walnuts consumed in the United States, so this is a very significant issue to California growers. The lobbyist went to visit a walnut nursery in China and was alarmed to learn that there were more seedlings in that one orchard

than there were trees in all of California; as he described it, there were trees from one end of the horizon to the other. Just as he was leaving, the nursery manager turned to him and said, “The next time you visit, I will take you to our larger farm.”

Of course, that doesn’t mean that there isn’t an eager market for foreign goods (even foreign walnuts). For example, KFC opens a new store in China every five days, and Proctor & Gamble sells more shampoo there than anywhere else in the world. But China’s sheer size is in many ways a double-edged sword.

Because it’s such a large market, China is becoming the price leader, which really means it’s exporting deflation to the rest of the world. For as long as China remains such a poor country, it’s going to be hard for any company to have pricing power in industries where China is a factor in the market. So as China opens up, the scale issue will bring opportunities—but also challenges—for both China and the rest of the world.



*Shoppers crowd
a commercial
strip in
Guangzhou.*

According to Paul, it was at this point that Premier Zhu Rongji and his think tank realized that they weren't utilizing what was perhaps China's greatest asset: its tremendous housing stock. "China was the world's largest landlord, but all the property was owned by the government. So it was really Zhu Rongji's masterstroke to recognize that housing privatization would lead to all the things it has indeed led to: the development of a middle class with a sense of wealth and the ability to consume."



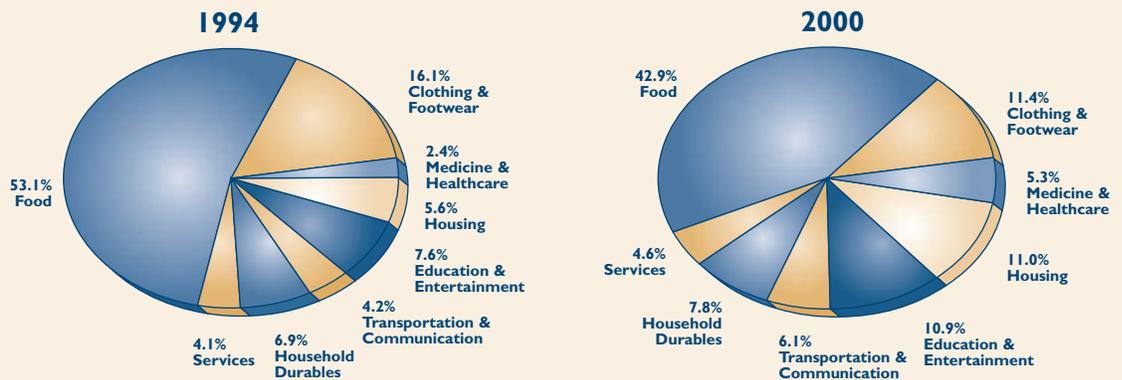
Sparking a Consumer Revolution

Although the Chinese may have come late to the idea of a market economy, they've made up for lost time by becoming avid shoppers. Property ownership, itself a major driver of economic growth, has had an even broader impact by stimulating domestic consumption. "The government figured that if people had their own apartments, they would then want

to spend money on anything related to their property, like remodeling or buying new appliances," explains Richard.

Richard's mother is typical of most Chinese homeowners: "After my mother bought her home, she did a complete renovation. She installed hardwood floors; changed to much fancier, energy-saving windows; and redid her bathroom and kitchen. The money she spent

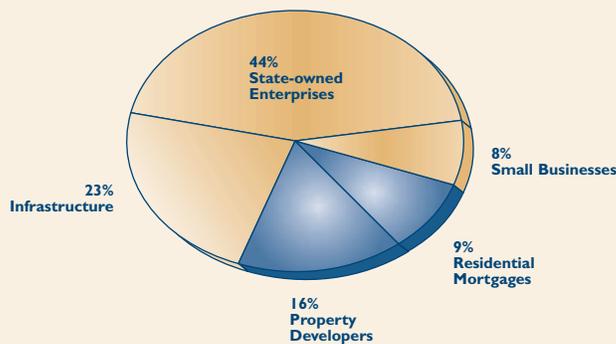
A New Emphasis on Home and Lifestyle
Changes in the distribution of household consumption
(as a percentage of total expenditures)



Source: Urban and Rural Socio-Economic Survey Organization/National Bureau of Statistics

In just six years, spending on housing, household goods and entertainment has assumed greater importance in the lives of China's growing middle class.

Mortgages Account for a Significant—and Growing—Percentage of Chinese Bank Loans



Source: UBS Warburg

The chart above shows the breakdown of the loan portfolio of China Construction Bank, one of the country's top five financial institutions.

on renovations was actually much higher than the price she paid for her apartment—and that's exactly what the government wants to see."

The biggest beneficiaries of this new spending have been the home furnishings, electronics and remodeling industries. During his most recent visit to China this past January, Richard saw crowds flocking to decorating materials and painting supplies, as well as to textile, furniture and electronics stores.

"The housing reform has resulted in hundreds of thousands of new businesses," he says. "For example, there are now a half-million home improvement companies." But Richard cautions potential investors about the fragmentation of the Chinese market. "There are just too many players now, and there will need to be consolidation."

Mortgages: China's Next Growth Industry

One industry that shows no sign of slowing is residential mortgage financing—a business that didn't exist for individual consumers before the 1996 reforms.

Paul credits China's housing boom to a parallel growth in mortgage origination. "If I really wanted to pick a growth industry in China, I think it would be mortgages. Foreigners can't invest in it yet—all the banks are still owned by the government or by quasi-government institutions—but it would be a great investment if you could."

According to research done by Matthews International Capital Management, home mortgage loans in China have been growing by 200% year-on-year since 1998, and now

He also warns that, "although demand is currently very strong, housing-related growth rates have probably reached their peak. Remember, the reforms have been going on for five or six years now, and the housing market has become much more mature in the coastal regions."

"As a foundation for a broader sustainable period of long-term economic growth [housing is] a tremendous engine."

—G. Paul Matthews



account for more than 40% of new loans made by banks.

In addition to becoming a key source of bank profit, mortgages are having the secondary effect of upgrading the balance sheets of some troubled banks. “A lot of Chinese bank loans are bad or non-performing, because they’re related to state enterprises,” says Paul. “But mortgages are widely regarded as one of the better credits globally.”

A New Acceptance of Debt

More astounding than the growth of the mortgage business is the acceptance of the concept itself. With exceedingly high savings rates of as much as 40% of income in past years, many Chinese people preferred to simply pay for their homes or their purchases outright. Paul explains that “most consumers, if they went into debt, borrowed from their families or through the black market, so personal consumption was also held back by the lack

of finance. But now, outside of mortgage origination, one of the region’s fastest-growing industries is credit cards—not just in China, but throughout Asia.”

Richard agrees that the negative attitude toward credit is definitely changing. “More and more people are willing to buy on credit cards. But the spending culture is comparatively quite conservative. If Chinese people have money, they still prefer to pay off debt.”

That is, unless they have another big-ticket item in mind. Richard predicts that now that most coastal Chinese own their own homes, they’ll soon be looking for the next big consumer item. “After a house, the people I know in China would like to buy a car or a new computer, upgrade their mobile phone handsets or even take an overseas vacation. Those are the new growth areas in terms of consumption.”

Computers and Mobile Phones Top Consumers’ Wish Lists

Number of major durable goods owned per 100 urban households

	Refrigerators	Color TVs	Automobiles	Computers	Mobile Phones
1985	6.6	17.2	-	-	-
1990	42.3	59.0	-	-	-
1995	66.2	89.8	-	-	-
1997	73.0	100.5	-	-	-
1998	76.1	105.4	0.3	3.8	3.3
1999	77.7	111.6	0.3	5.9	7.1
2000	80.5	116.7	0.6	9.4	18.3
2001	82.2	119.9	0.6	12.5	30.6

Source: Lehman Brothers

Housing reform has stimulated demand for consumer goods such as refrigerators, TVs and computers. Dramatic growth is expected for the mobile phone and automobile industries as well.

A Downside to Privatization?

Housing privatization, like any other reform in China, has also had its downside. Success has tended to breed excess, leading to a glut of property developers and a concern that certain areas will be overbuilt once again.

Paul recalls the early 1990s, when overbuilding in a number of Chinese centers left commercial space empty for long periods of time. “Housing is a notoriously cyclical industry, prone to problems. But I do think that as a foundation for a broader sustainable period of long-term economic growth, it’s a tremendous engine.”

“Suddenly, people are seeing more and more opportunities—especially inside the country—now that China has opened itself up to the outside.”

—Richard Gao

For Paul it’s urbanization that poses the potentially greater problem, as thousands of people migrate from the poorer Chinese countryside to the booming coast. “We already have more than 25 cities in China with over 10 million people, and that’s only going to grow,” he says. “Such a big population shift creates its own set of tensions and unrest. So

far, though, it has been far more peaceful than anyone would have anticipated.”

Richard—just back from a trip around the country—points out that a substantial income gap is already widening between the coastal haves and the rural have-nots: “While there are many wealthy Chinese in the major cities,



800 million people still live on US\$25 a month. We’re seeing rural people trying to move to the coastal areas, and that’s causing problems, like a rise in the urban crime rate.”

Ushering In a New Era of Social Change

Overall, however, the housing reforms are considered an overwhelming success—and a stunning break from decades of often-stifling government control. “In the past the Chinese government took care of everything: housing, employment, even family planning,” says Richard. “Now life is no longer controlled by the state or the company you work for. Your apartment is your own, and you can change your job easily without worrying about not getting a place to live.”

Richard believes that this new financial flexibility has brought about a sense of social satisfaction as well: “Ordinary Chinese people like my friends and family are now putting the priority on their economic life. They’re not as concerned about politics as they used to be.”

Today, McDonald’s operates more than 40 restaurants in Shanghai alone.

What's Next for China?

As exciting as the past few years have been, the next few promise even more possibilities. China's recent entry into the World Trade Organization (WTO)—an international body designed to facilitate free trade among its 140 member countries (see “Trendspotting”)—is only the most obvious sign of the enormous changes that lie ahead.

“The WTO is already having a profound impact on people's lives,” notes Richard. “Books about the WTO are best-sellers, and English classes have become very popular.” He says that his friends now feel a growing connection between China and the world. “Suddenly, people are seeing more and more opportunities—especially inside the country—now that China has opened itself up to the outside.”

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Redemption as a percentage of amount redeemed within 90 days of purchase: 2.0%

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