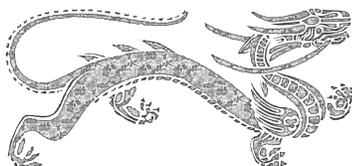


APRIL 2004

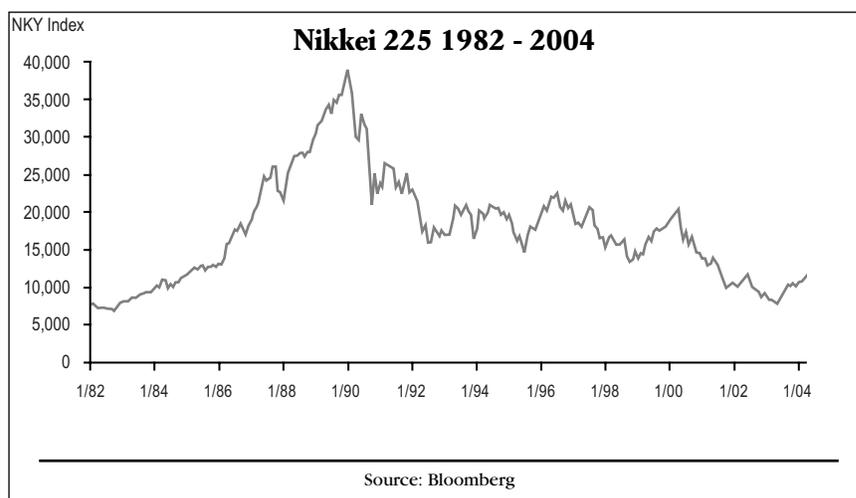
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Is Japan For Real This Time?

Japan has been the land of disappointment for investors for a very long time. Since the Nikkei 225 hit a peak of 38,915 in December 1989, thirteen years of falling markets brought the index to 7,603 in April 2003, a twenty-year low. The property market has fallen for nine straight years. Domestic consumption has been anemic at best. For six years the country has been mired in deflation that has undermined many companies and threatened the financial system with collapse. The government appeared helpless with little action beyond pork barrel spending on construction projects. Zero interest rates seemed to have little effect.

The reasons for Japan's decline have been endlessly discussed. The country experienced an enormous financial bubble in the 1980s. When the bubble popped, Japan was left with an aging, arthritic society that rejected foreign influences. Corporations made only half-hearted efforts at reform, when they tried at all. Lifetime employment remained in effect. Foreign workers



were kept out, denying Japan's economy much needed skills and ruling out the development of its own "Silicon Valley" potentially filled with Indian and Chinese programmers. The domestic economy remained wrapped like a mummy in regulations and tax systems that discouraged change.

How much of this has changed? The country continues to age rapidly. There is still a great deal of corporate

debt and a major mountain of public debt. Corporate Japan has made many efforts at reform, but usually at a slow pace. Workers are "retired" rather than fired. Still, a decade of gradual activity has, perhaps, achieved a tipping point. Most notable is corporate Japan's move into China. The logic of moving low cost manufacturing to China was ignored by Japan for a very long time for historical reasons. That resistance has ended and Japan's trade with

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CHINA

The key concern at this year's National People's Congress (NPC) related to the strains caused by the rapid and geographically unevenly distributed economic growth. In 2003, the economy experienced 9.1% growth, causing a further widening of the gap between the rural west and the urban coastal regions. Currently, the average disposable income in the rural areas is 2,620 yuan (\$315), while it is 8,500 yuan (\$1,025) in urban areas. In an attempt to redistribute some of the urban wealth the farm taxes will be gradually reduced and eventually phased out by 2009. Further, in an effort to slow down growth, the government has started to impose restrictions on lending to certain sectors. However, China needs to create 12 to 15 million new jobs every year just to keep pace with population growth. This is not counting the influx of workers from rural areas as well as the negative employment impact of the restructuring of the state-run enterprises. The lack of employment opportunities could lead to social unrest, which could undermine the Communist party. This leaves the Communist party with the tricky balancing act of delivering strong sustainable economic growth while promoting a greater degree of social equality.

HONG KONG

People in Hong Kong and China followed the election in Taiwan with particular interest as the "Basic Law", Hong Kong's mini-constitution drafted in 1997, is up for review. Currently, Beijing appoints the chief executive of Hong Kong without having to first consult the people of Hong Kong. Democracy activists in Hong Kong have called for general elections from 2007 onwards, based on what they believe are some of the rights laid out in the "Basic Law". However, Beijing is concerned that direct elections could threaten the "one country, two systems" principle and has responded by drafting two revisions to the constitution, which could push back direct elections past 2007, while ensuring that Beijing has the final word in any reform changes. Meanwhile, the mainland media has been quick to portray the demonstrations and general uncertainty in the aftermath of the election in Taiwan as an example of what Hong Kong has in store, if it was to hold premature elections.

INDIA

The Indian government is taking advantage of the recent strong stock market performance and the general "feel good feeling" in an effort to raise \$3.5 billion from the sale of stakes in largely state-owned firms before March 31st and the general election starting in April. The timing of these offerings is not coincidental and their success is crucial for the Bharatiya Janata Party's (BJP) attempt to alleviate the combined deficits of the central and state

governments, which stand at about 10% of GDP. Furthermore, the main Indian stock market index, SENSEX, has risen more than 85% in 2003 as the economy posted around 8% economic growth. The sale of shares has been a success, with the country's largest gas firm, Oil and Natural Gas Commission¹ (ONGC) \$2 billion public offering being oversubscribed within the first 30 minutes. However, the question is whether the sale was motivated by an underlying political support for privatization of the state-run sector, or whether it was a political move to avoid facing difficult budgetary decisions in an election year.

JAPAN

The question on everybody's mind seems to be whether or not Japan's latest recovery is here to stay this time around. Economic data during March seemed to support the view that Japan might be in a sustainable recovery for the first time in more than a decade. Business confidence was positive for the second straight quarter, a level of optimism not seen for the past three years as exporters saw overseas demand increase. Revised numbers for GDP growth were 6.4% for the fourth quarter of 2003, the fastest pace in 13 years. Retail sales rose for the second consecutive month in February boosted by falling unemployment rates and strengthening consumer confidence. However, the strength in the retail data is tempered by the fact that February included an additional shopping day compared to last year, and wage growth, which is traditionally a key driver for consumer spending, remains stagnant.

KOREA

March tested the strength of the democratic institutions in South Korea as President Roh Moo Hyun was impeached for election-law violations after only one year in office. The National Election Commission found Roh to have been supporting the Uri Party in the upcoming parliamentary election campaign, thereby violating a law requiring the executive branch officials to remain neutral. The ruling led to more than 40,000 people taking to the streets, with some opinion polls indicating that three in every four Koreans oppose the impeachment. Prior to the impeachment, Roh's popularity had been on a steady decline, but the popular support against the impeachment process could result in Mr. Roh returning to office stronger than before his impeachment. On the economic front the economic data is mixed, with GDP growing at 2.7% in the fourth quarter, the fastest growth rate in two years. However, growth has mainly been driven by exports, which grew by 46% in February, the highest in 15 years. However, domestic consumer spending is still muted, as one in 13 Koreans are three months or more behind on debt payments. In response to this credit card crisis and in the hope of fueling domestic

consumption, the government plans to bail out more than 400,000 people that are unable to repay their loans.

MALAYSIA

The general election in Malaysia saw Abdullah Badawi, from the ruling National Front, score a landslide victory, marking what many observers believe is a new post-Dr. Mahathir era in Malaysian politics. The election saw a halt to the rise of the Islamic Party of Malaysia and gave Abdullah Badawi a stronger hand in his promised campaign against corruption and cronyism. The Kuala Lumpur Stock Index, with which international investors have had an ambivalent relationship since Malaysia imposed controls of capital outflows during the Asian Crisis, rose in the aftermath of the election. However, Dr. Mahathir and members of the National Front remain influential political players, opposed to some of Mr. Badawi's reform plans and the coming months will test whether Malaysia has indeed entered a new political era or if it remains business as usual.

TAIWAN

The presidential election was a clear indication of the volatile and unpredictable nature of Taiwan's relatively young democracy, which held its first general election in 1992. The contenders were, the incumbent President Chen Shui-bian of the Democratic Progressive Party, known for his confrontational stance towards mainland China, and Lien Chan of Kuomintang (KMT), an advocate of closer economic and political ties with the mainland. Mr. Chen won by 29,000 out of the close to 13 million votes cast (with 300,000 votes being invalidated) after being slightly injured by a bullet in what was believed to be an assassination attempt. The opposition responded with allegations that Mr. Chen staged the assassination attempt to attract sympathy votes and keep 200,000 servicemen from voting. One important outcome of the election, which was overlooked in the turmoil surrounding the presidential vote, was the fact that Mr. Chen did not succeed in passing a referendum concerning the future of the cross-strait relationship. The majority of the voters supports the status quo, which gives Taiwan de facto independence, and do not support a confrontational stance towards the mainland on independence issues. However, while the political situation remains murky, economic exchanges between China and Taiwan have increased substantially. China is now Taiwan's main export market and it is estimated that the mainland has attracted an estimated \$100 billion in Taiwanese investments since 1979.

¹ As of 3/31/04, Matthews Asia Funds held no positions in the Oil and Natural Gas Commission.

Is Japan For Real This Time?

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China has gone through the roof. Remarkably, Japan is still running a trade surplus with China. At home, Indian software engineers are starting to invade Tokyo and temporary workers are becoming more acceptable. All of this should feed through to the profitability of Japanese companies, but it is unlikely to be enough to create a self-sustaining economic recovery.

The buzzword on the reports written in Tokyo is "reflation". The end of years of deflation with rising asset values, especially property, may have a very powerful effect on the domestic economy. Tokyo's property market has been showing signs of life for almost a year, and that now may be spreading to other regions. Combined with more coherent government policies and more profitable corporations, the case for Japan's comeback can be compelling.

If Japanese consumer sentiment improves and there is a hint of inflation, domestic spending could remain on an up trend. More profitable corporations, sensing a better local economy, may start spending their capital. This is the essential case for a sustained economic recovery. It does face major challenges.

Japan's export sector remains the economy's most efficient and profitable area. A strong yen threatens such exports. The strength or weakness of a currency always has a combination of good and bad impacts. While dampening export profits, the stronger yen encourages investment in Japan, including the repatriation of Japan's vast overseas investments. Employment is another big issue. While investors want a flexible labor market with low value manufacturing moved offshore, the impact on Japan is higher unemployment and consumer uncertainty.

One cannot take Japan's recovery with certitude. How dependent is the recovery on the recovery in the U.S.? What trick can the Japanese bureaucrats pull out of the bag to undermine the economy? Will corporate Japan backslide at the first signs of better days? The fact that Japan is back on global investors' radar screens is all you can be sure of.

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Your comments are welcome. Please e-mail them to info@matthewsfunds.com.

The Nikkei 225 Stock Price Index is a price-weighted index of the largest Japanese companies listed in the First Section of the Tokyo Stock Exchange.