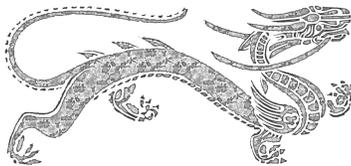


JULY 2005

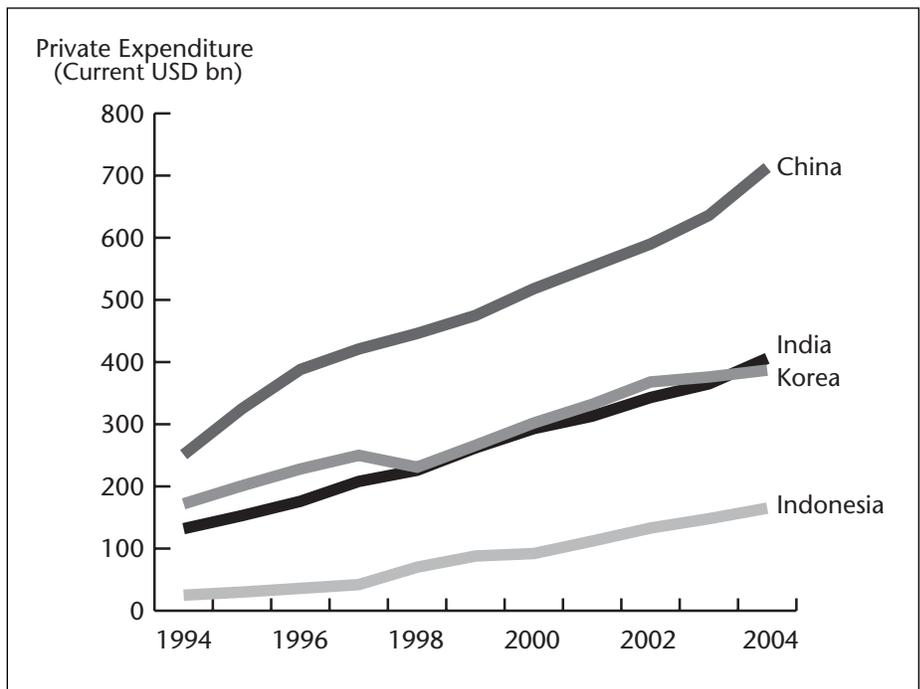
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A Decade of Consumption in Asia

There are at least two factors which must be in place for U.S. investors to derive the full benefits of international diversification from investing in Asia. First, since correlation between U.S. and Asian markets can remain high on a day-to-day basis, it is important for investors to have a long-term investment horizon, as touched upon in June's *Asia Insight*. Second, Asian companies must increasingly generate their incomes from sources that are not directly tied to the U.S. economy. One way for this to occur is for domestic consumption in Asia to become a larger slice of the pie in the regional economy, thereby reducing the region's dependency on exports for growth. While private consumption in the region has indeed increased, fueled in part by the strong economic growth over the last decade, its share of GDP still remains below that of the levels seen in developed countries. Therefore, while the absolute growth in Asian consumption looks encouraging from an international diversification stand-point we would like to see Asian households play an even greater role in the future economies of the region.

Over the last decade, growth in consumption across Asia was largely



Source: CEIC, World Bank

underpinned by the strong economic expansion across the region. The average annual real economic growth rate in Asia Pacific ex-Japan was 6.2% during 1994-2004, while growth rates during the same

period in the U.S. and EU were 3.3% and 2.2% respectively. Economic growth has also been reflected at the household level where rising wages increased the individual's ability to spend, thereby

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CHINA

Economic numbers released in May indicated that China maintained its growth momentum after recording real GDP growth of 9.5% in the quarter year-on-year. The growth rate for fixed asset investments (FAI) and industrial production (IP) remained firm, which rose by 28.2% and 16.6%, respectively on a year-on-year basis. Retail sales growth picked up 12.8%, after expanding 12.2% in April, on the back of rising wages and employment. Continuous growth in domestic consumption on the margin should help keep China's economy more balanced and relatively less investment-driven. Inflation, however, remained relatively mild in May; the consumer price index (CPI) rose 1.8% year-on-year. Meanwhile, China's exports remained robust and rose 30.3%, although the exports to other Asian economies softened in recent months. In the first five months of the year, the country's trade surplus has reached US \$30.1 billion, compared with a US \$9.2 billion deficit recorded in the same period last year.

HONG KONG

Following Hong Kong's former chief executive Tung Chee-hwa's resignation in March, Donald Tsang, the chief secretary and acting chief executive, had been elected uncontested in the 2005 chief executive election. Under the current chief executive nomination process, the support of 100 Election Committee members is required to be a legal nominee. Donald Tsang won support from 714 members of the 796-member Election Committee, making him the only valid nominee. The newly-elected Chief Executive will serve the remaining two years of former Chief Executive Tung Chee-hwa's second term. In the meantime, the Hong Kong Census and Statistics Department (HKCSD) released payroll figures for the first quarter of 2005. The payroll in real terms increased by 3.6% quarter-on-quarter, in line with anecdotal evidences seen in recent months.

JAPAN

Economic data released in June indicated that the unemployment rate remained at its six-year low of 4.4% in May as the economy added 420,000 jobs. On a similar note, job advertisements increased 19.9% year-on-year during May, according to the Association of Job Journals. Wages have increased in four of the past five months and the real wage index rose 0.4% in May on a year-on-year basis. May also saw a 2.7% increase in retail sales compared to the previous year. The Tankan survey, which measures the business confidence of 10,316 companies, rose to 18 in June, up from 14 in March. The service-

related company index rose to 15, the highest level since 1992. A positive number indicates a positive short-term economic outlook and this was the first increase in the past three quarters. The Finance Ministry's data on foreign direct investment (FDI) released in June revealed an interesting fact. Japan became a net recipient of FDI for the first time since records began in 1950. Approximately 75% of the US \$36 billion invested by foreigners during fiscal year 2005 went into the finance and insurance sectors.

KOREA

The Bank of Korea maintained the benchmark interest rate at its historical low of 3.25%, while lowering its economic growth forecast for 2005 from 4.0% to 3.8%. This was in part because the central bank estimated that higher oil prices would shave 0.8% from the full-year GDP. There are early signs that Korea may be recovering from the credit card crisis of 2002-03. Credit card usage increased 16% in the first half of 2005 compared to a year earlier, according to the Korean Economic Daily. The last government figure on the level of credit card debt facing Korean households was released in December of 2004, at which point one in thirteen Koreans were three months or more behind on their debt payments. The Korean government has intervened with repayment relief for some credit card holders, and the fact that credit usage has risen could indicate that household balance sheets are on the mend. The consumer confidence index fell to 95.4 in June, its third consecutive decline according to the National Statistical Office. However, retail sales continued to expand through May, growing 2.3%, in spite of the negative consumer sentiment.

TAIWAN

The central bank of Taiwan raised benchmark interest rates by 12.5 basis points to 2% in an effort to curb inflation as oil prices surged. The consumer price index (CPI) rose 2.4% year-on-year in June, which was a continuation of an upward trend since April this year. The country's trade surplus narrowed 87% from a year earlier to US \$549 million in the first five months of 2005. Meanwhile, the Ministry of Finance (MOF) announced a plan to sell NT\$100 billion (US \$3.19 billion) of bonds in the third quarter to help fund a budget deficit that was projected to reach NT\$337.3 billion (US \$10.76 billion) up from an estimated NT\$304 billion (US \$9.7 billion) last year.

A Decade of Consumption in Asia
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Growth in Real Consumption Across Asia
 Average Annual Growth Rate 1994-2004

China*	6.4%
India	5.3%
Malaysia	5.1%
Singapore	4.8%
Taiwan	4.3%
Philippines	4.2%
Indonesia**	4.0%
U.S.	3.7%
Korea	3.5%
Thailand	3.0%
Hong Kong	1.8%

* Based on 1994-2003 period

** Based on 2000-04 period

Source: CEIC, World Bank

lifting millions of Asian households into the consuming middle class.

Because incomes in the region grew at rates faster than the rest of the world, disposable wealth also rose quickly, which in turn allowed for higher levels of consumption. Private consumption in Asia ex-Japan was roughly U.S. \$2.4 trillion at the end of 2004, up from a little less than one trillion in 1994 (based on end of 2004 exchange rates). This is still less than one third of the private consumption expenditure in the U.S., which amounted to U.S.\$ 8.2 trillion in 2004. The graph on the front page measures private consumption for some of

the most populous countries in the Asian region in current U.S. dollars. The table on the left shows the real growth rates in consumption, i.e. the growth in private expenditure after accounting for the effects of inflation. This table illustrates that while consumption in the U.S. is greater in absolute terms, Asia's consumption growth has outstripped that of the U.S. over the last decade.

However, ultimately it is the size of domestic consumption relative to GDP which will determine the impact of consumption on overall economic growth, and on this measure Asia as a whole still trails the developed economies. At one end of the spectrum is China, where private consumption, according to official figures, remains close to 43% of GDP, compared to 70% in the U.S. In Korea, where households enjoy a higher level of income, private consumption still only accounts for a little more than half of GDP. India is one example of a country which has bucked the trend with private consumption accounting for close to 65% of GDP.

While Asia has undoubtedly experienced strong growth in both GDP and private consumption over the last decade, we hope to see the region's households play an even greater role in the future of the Asian economies. This could come about as a result of several factors such as greater access to consumer credit, rising household incomes and a greater propensity to choose current spending over savings.

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INVESTOR DISCLOSURE

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Single country and sector funds may be subject to a higher degree of market risk than diversified funds because of concentration in a specific sector or geographic region.

Technology stocks may be very volatile and mutual funds that concentrate in one market sector are generally riskier than more diversified strategies.

All performance quoted in this report is past performance and is no guarantee of future results. Investment return and principal value will fluctuate with changing market conditions so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the return figures quoted. Returns are net of the Funds' management fee and other operating expenses. Returns would have been lower if certain of the Funds' fees and expenses had not been waived. For the Funds' most recent month-end performance please call 800-789-ASIA (2742) or visit www.matthewsfunds.com.

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