Conference Report:

Economic Crisis in Asia: Challenges and Opportunities for San Diego/Tijuana

Conference Held on
June 2, 1998

Report Prepared

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for:

San Diego Dialogue's Working Group on Asia

Prepared by:
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County of San Diego

Consejo de Desarrollo Economico de Tijuana

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First National Bank

J.P. Morgan

Merrill Lynch

Morgan Stanley Dean Witter

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REPORT SUMMARY

On June 2, 1998, San Diego Dialogue, in cooperation with several partner organizations, held a conference to illuminate the impact of the Asian economic crisis on the San Diego-Tijuana cross-border region. This event was an outgrowth of a research and community education project initiated by the Dialogue's Working Group on Asia in the winter of 1997/98. One of the objectives of the Working Group's project was to assess the cross-border region's commercial and institutional ties with Asia. To this end, a white paper was completed in the spring of 1998 that summarized regional linkages to Asia. As the crisis in Asia unfolded, the working group broadened the scope of the project to examine the impact of the crisis on the cross-border region.

This report summarizes the ideas and insights that were presented at the conference, *Economic Crisis in Asia: Challenges and Opportunities for San Diego/Tijuana*. In the first section, Robert Larkins, Principal of Morgan Stanley, provides an overview of the crisis, from its origin to future implications. Overall, the conclusion is that the crisis will be confined primarily to Asia and that the impact on the U.S. will be somewhat mild due to limited direct trade linkages with Asia. China will most likely assume post-crisis economic leadership in Asia.

The next section deals with the impact of the crisis on local companies and their strategic planning responses. William Boyle, Chief Financial Officer of Cubic Corporation, Anthony Thornley, Vice President and CFO of QUALCOMM, Inc., and Andrew Wrobel, President and CEO of Microelectronic Packaging share the ramifications of the crisis for their companies. The effects range from cancellations and delays of contracts to shifting of production out of Asia. Some of their strategic responses to the crisis include turning to markets in Latin America and renegotiating financing terms for customers. The speakers all agree that the crisis is only temporary and that they need to take a long-term approach to the markets in Asia.

The third section covers the views of Asian manufacturers operating in the San Diego-Tijuana cross-border region. Motoharu Iue, Chairman and CEO of SANYO North America Corporation, and Young M. Kwon, President of Samsung Electro-Mechanics America, Inc. speak about how their companies have adjusted to the crisis. Major issues in their remarks include regional investment delays, component localization efforts, and threat of competition from cheaper Asian exports. Both speakers emphasized their companies' continuing commitment to the cross-border region and their desire increasingly to localize production.

In the final section, Jackson Tai, Western Region Managing Director of J.P. Morgan, Philip J. Fischer, Vice President of Fixed Income Research at Merrill Lynch., and Robert Larkins, Principal of Morgan Stanley Dean Witter, give their perspective on the crisis and its effects on investment capital flows. During the luncheon address, Jackson Tai states that Asia will rebound, but in fits and starts, and that in its attempt to export its way out of misery it will contribute to a wider U.S. trade deficit and a slowdown in U.S. GDP growth. He points out that Japan's insecurity may only worsen the situation. He offers ten predictions about the implications of the crisis on the cross-border region, and claims that while it is not a pretty picture, the crisis will not be disastrous for San Diego.

Philip Fischer remarks that California is heavily exposed to Asia and therefore vulnerable, especially the agriculture, industrial equipment and computer industries. However, with the exception of the electrical devices and computer industries, he does not believe that the crisis will pose a major problem for San Diego's economy. All the bankers agree that Latin America is a good prospect for diversifying business interests in the wake of the crisis.

CONFERENCE AGENDA

7:30 a.m.	**Registration**
8:00 a.m.	**Continental Breakfast**
8:20 a.m.	**Welcome and Introductions** R. BARRY MCCOMIC Chairman and CEO, McComic Consolidated LEON H. REINHART President and CEO, First National Bank Of America
8:30 a.m.	***Economic Downturn in Asia: Setting the Context*** ROBERT LARKINS Principal, Morgan Stanley Dean Witter
9:00 a.m.	***Strategic Planning and the Asian Economic Crisis: The Perspective of San Diego Firms*** WILLIAM BOYLE Chief Financial Officer, Cubic Corporation ANTHONY THORNLEY Vice President and CFO, QUALCOMM, Inc. ANDREW WROBEL President and CEO, Microelectronic Packaging **Moderator:** JULIE MEIER WRIGHT President, San Diego Regional Economic Development Corporation Questions and Answers
10:15 a.m.	**Break**

10:30 a.m.	***The Effects of the Crisis on Asian Manufacturing in the Cross-Border Region***
	MOTOHARU IUE Chairman and CEO, SANYO North America Corporation
	YOUNG M. KWON President, Samsung Electro-Mechanics America, Inc.
	Moderator:
	RICHARD FEINBERG Director, APEC Study Center, UCSD
	Questions and Answers
11:30 a.m.	**Break**
11:45 a.m.	**Luncheon**
12:00 p.m.	***The Asian Economic Crisis and Investment Capital Flows***
	Luncheon Address: JACKSON TAI Managing Director, Western Region, J.P. Morgan
	Discussants: PHILIP J. FISCHER Vice President, Fixed Income Research, Merrill Lynch
	ROBERT LARKINS Principal, Morgan Stanley Dean Witter
	Moderator: LARRY PRIOR Chief Administrative Officer, County of San Diego
	Questions and Answers
12:55 p.m.	**Closing Remarks**

PART I: *Economic Downturn in Asia: Setting the Context*

Speaker: ROBERT LARKINS, Principal, Morgan Stanley Dean Witter

Asian Crisis Background

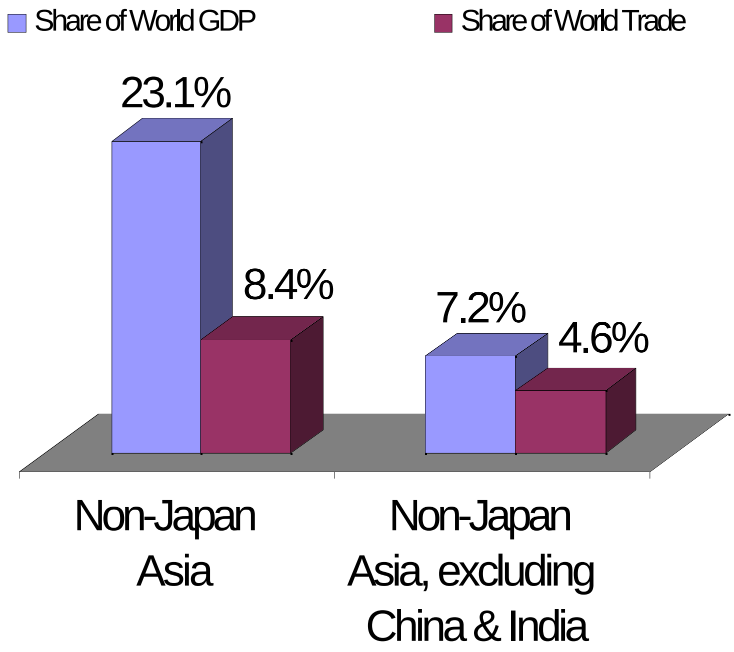
According to Robert Larkins, Principal of Morgan Stanley Dean Witter, the consensus is that the Asian economic crisis was triggered on July 2, 1997 with the sudden 17 percent fall of the Thai Baht versus the U.S. Dollar. For nearly six months speculators had been putting significant pressure on the currency and the Thai Central Bank finally gave up defending the Baht against the global currency traders. The Philippine Peso was the next perceived weak currency and, despite a valiant effort by the Philippine Central Bank to defend the currency, the Peso fell by over 10 percent when it was de-linked from the U.S. Dollar. The next currencies in line were the Indonesian Rupiah and the Malaysian Ringgit and, by December of 1997, both the Rupiah and Ringgit were down over 60 percent while the Peso was down approximately 35 percent.

Robert Larkins claimed that the impact of the crisis on the broader U.S. economy would be limited due to the characteristics of U.S. trade flows. While the affected Asian countries rely heavily on exports to the U.S., and therefore attempted to maintain a stable exchange rate, those same countries absorb a relatively small quantity of U.S. exports. Specifically, the aforementioned countries had been taking in about 5 to 10 percent of U.S. imports, while China on the other hand, had been growing up to approximately 30 percent during 1996.

Asian Flu Will Have Varied Impact Across Nations

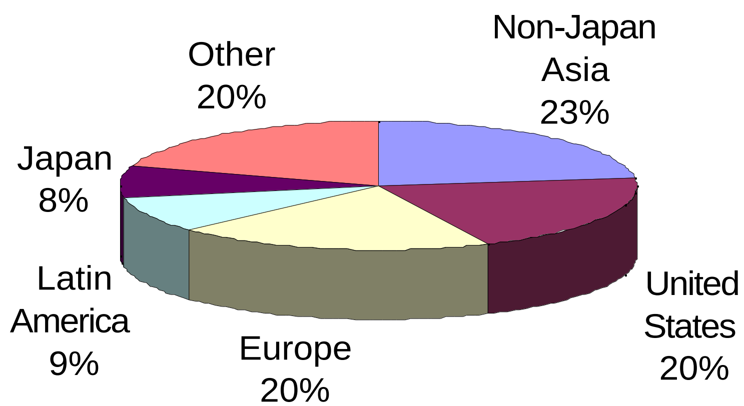
On behalf of Morgan Stanley Dean Witter, Robert Larkins anticipated that there would be a slowdown in global GDP, but that the impact would vary across nations. In particular, he predicted, “The G7 industrial nations will likely fare reasonably well as direct linkages as manifested in cross-border trade are surprisingly small.” The charts below illustrate this point. Non-Japan Asia accounts for a little over 8 percent of world trade. Since trade accounts for only 20 percent of global GDP, Asian trade equals only about 1.6 percent of global GDP. In addition, excluding China and India, non-Japan Asia accounts for only 7.2 percent of global GDP. The bright lining is that the U.S., Europe and Latin America make up 50 percent of global GPD.

Asian Share of World GDP and Trade: 1997



Source: Morgan Stanley Dean Witter

Shares of Global GDP: 1997



Source: Morgan Stanley Dean Witter

Due to the limited trade linkages, Robert Larkins claimed that there has been no near-term impact on employment or GDP in the U.S. From his perspective, the Asian crisis has largely been confined to Asia, and the main casualties have been the banks in the affected countries. Statistics provided by Morgan Stanley Dean Witter's bank and equity research group reveal a severe impact in Asia. Referring to levels of unrecoverable loans and the impact on GDP in Indonesia, a 20 percent unrecoverable loan translates into a 14 percent cut in GDP. The same 20 percent brings South Korea's GDP down by 36 percent and Thailand's GDP down by 29 percent. In the U.S., the longer-term impact may come from substantial trade imbalances, which ultimately hurt the dollar and drive interest rates higher.

Asian Crisis Has Not Provoked Global Deflation

Referring again to the realities of limited trade linkages with non-Japan Asia, Robert Larkins reiterated that the contagion would be restricted. In addition, he forecasted that the weakened exports problem of major industrial economies would be offset in the near-term by lower interest rates and cheaper imports. Longer term, however, if Asia has to export its way out of the slump, the growing trade imbalance with the U.S. could boomerang and weaken the dollar. In the view of Morgan Stanley Dean Witter, the ultimate cost of the Asian bailout could show up in the form of a sharp widening in the U.S. balance of payments deficit.

"Asian Fix" Has Three Phases

Robert Larkins offered the following commentary on the phases that affected Asian countries will go through as solutions to the financial problems are found:

Phase One: Tactics of crisis containment

The crisis containment phase is underway and the bailouts in Korea, Thailand and Indonesia are in place. The objective of phase one is to build firewalls around battered currency markets. One very important factor in this equation is China's resolve to forego devaluation and defend the currency. China has been steadfast in this regard, while the Japanese Yen has been hammered and it remains to be seen if stimulative policies in Japan will work. China's vulnerability is the threat of export competitiveness brought on by neighbors' devalued currencies, particularly the South Korean Won. Additionally, the ongoing restructuring of Chinese state enterprises is putting substantial strain on employment.

Phase Two: Test of Political Feedback

Phase Two, where the theoretical remedies confront the reality of the cost of that restructuring, is more uncertain. The results are bankruptcies, unemployment and declining standards of living. Recent social unrest in Korea and Indonesia threatens to test the resolve of leaders with a backlash against policies of austerity.

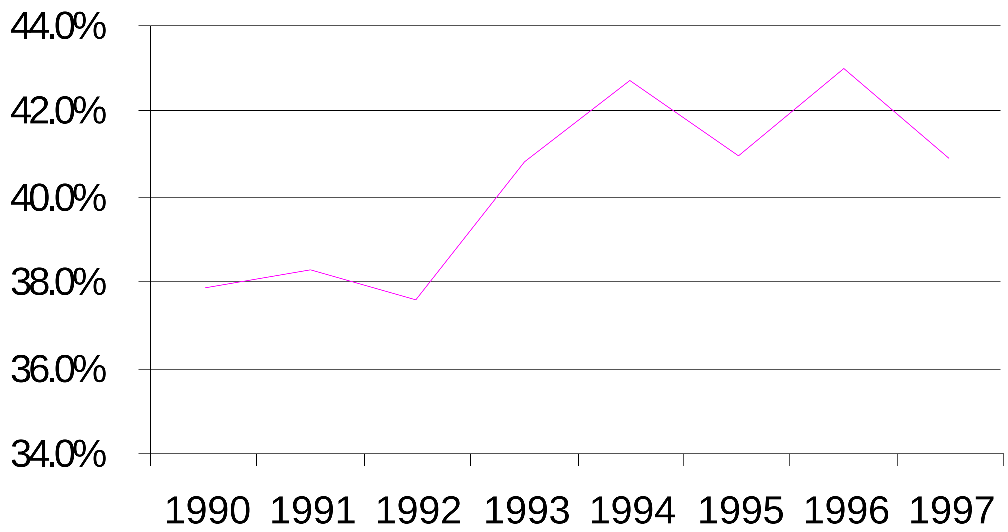
Phase Three: Ultimate Economic Workout

The last phase involves initiating discipline to the banking system and liberalizing financial markets. Loans have to be made on the fundamentals and banks will have to compete with western financial institutions and products. Part of this transition will include the adoption of modern accounting and disclosure standards so that global investors can actually compare companies and countries on an even basis.

Asian Crisis may be Catalyst for Chinese Economic Leadership

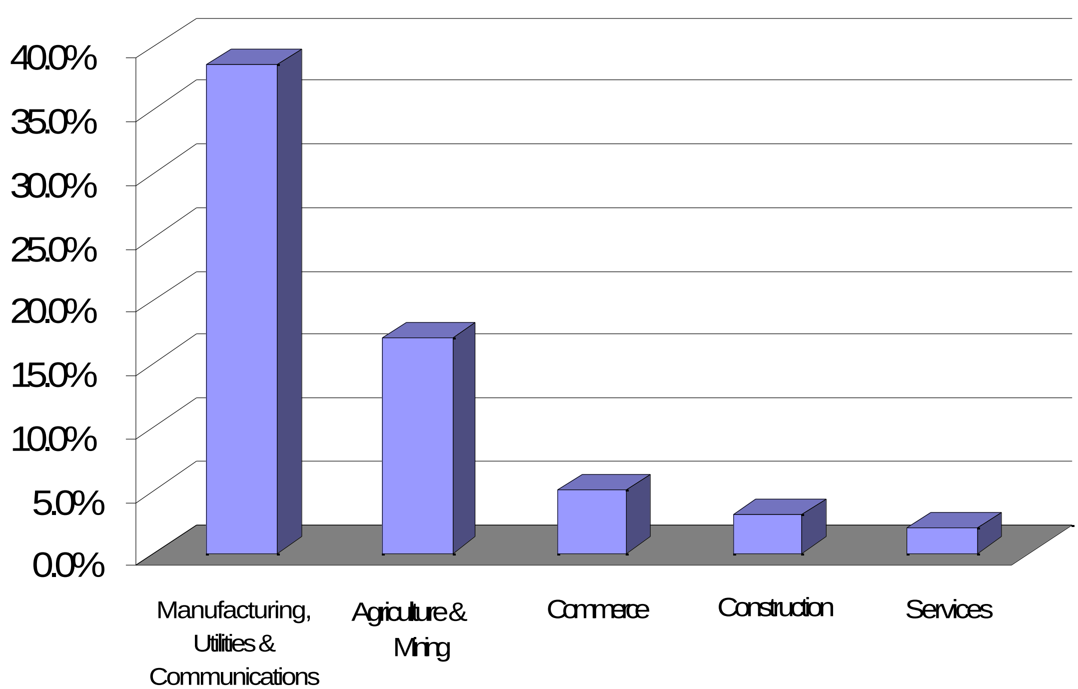
While Japan has experienced seven years of economic stagnation, China has enjoyed a 10 percent average GDP growth over the 1992-98 period. In support of the idea that China seem poised to assume economic leadership in Asia, Robert Larkins pointed out that China has steadfastly embraced an outward-looking economic perspective. In fact, the Chinese leadership has shown that it cares about what multinational financial institutions, investment banks and commercial banks actually think about Chinese policies. While China does face daunting competitive pressures and a subdued pace of job creation, Robert Larkins remarked that China has “two things in its favor – it has avoided external short-term debt and it has massive foreign reserves which can be helpful in defending the currency. China’s share of GDP of savings is in the 40 percent range, more than ten times the U.S. domestic savings rate.” Robert Larkins also commented on the fact that China’s economy offers some built-in insulation from Asian-related difficulties because so much of what is being produced in its top sectors can be consumed internally. In addition, China’s export mix is concentrated in low-value-added products, where foreign demand is relatively inelastic. The charts below highlight these three points:

China's Domestic Saving Share of GDP

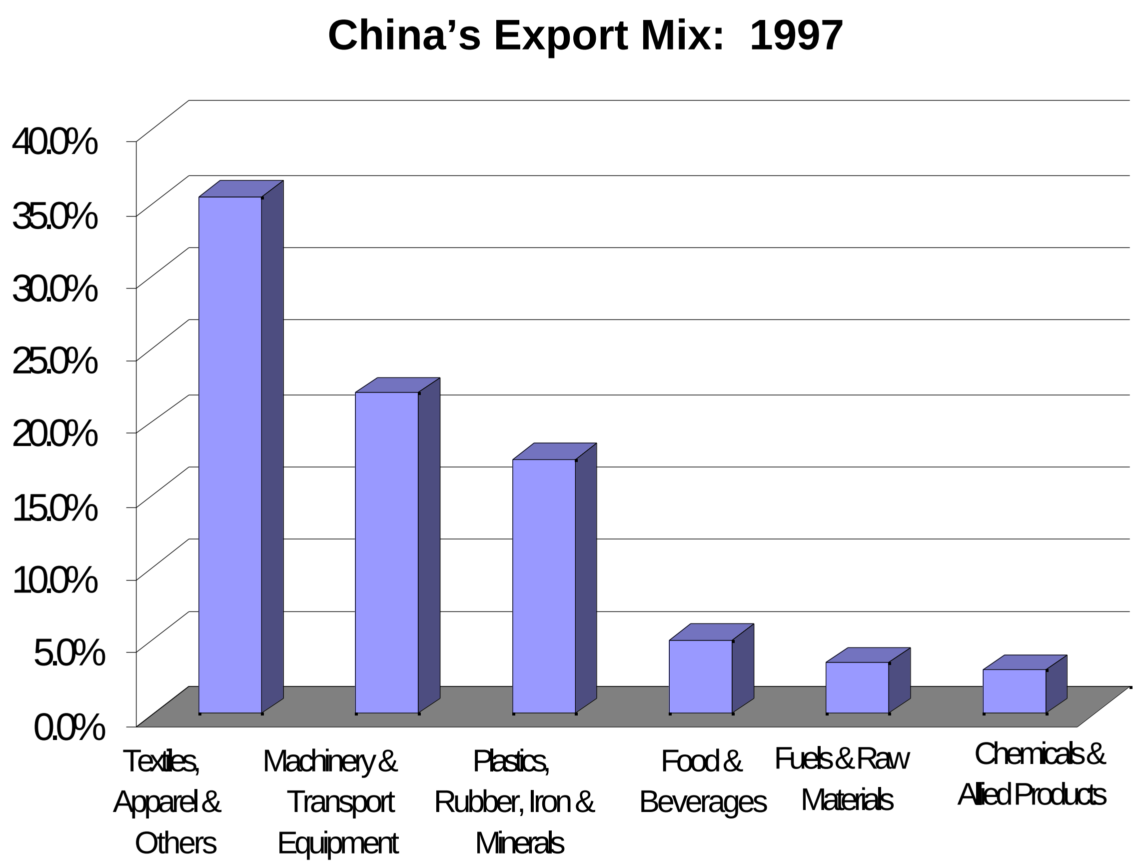


Source: Morgan Stanley Dean Witter

China's GDP by Industry: 1996



Source: Morgan Stanley Dean Witter



Source: Morgan Stanley Dean Witter

After the Asian Crisis: Where is the Global Economy Headed?

According to Robert Larkins, Morgan Stanley, largely in response to the Asian crisis, has pared its 1998 forecast of global GDP growth to 2.7 percent, a downward revision of 1.4 percent from a pre-crisis forecast of 4.1 percent. Although the aftershocks of the crisis will linger for several years, Robert Larkins expressed belief that "the worst of the Asian crisis is over." Backing this idea, he mentioned that there is good reason to believe the austerity programs resulting from the IMF bailouts in Thailand, Indonesia and South Korea will succeed in building firewalls around the three crisis economies.

Expanding on Morgan Stanley's view of the future, Robert Larkins affirmed that post-crisis Asia seems likely to be dominated by China. In addition, positive growth surprises should be expected in the U.S., Europe and Latin America. In fact, Latin America may be a real winner in terms of the Asian turmoil, with growth running at 3.5 percent in 1998 versus (1.7) percent in non-Japan Asia (excluding China and India). Furthermore, Larkins emphasized, "Latin America is well ahead of Asia on the path of financial sector reform and corporate restructuring."

After the Asian Crisis: Embedded Risks in the Rosy Scenario

While Robert Larkins painted a fairly mild picture of the Asian flu's impact on the world economy, he also admitted that there were caveats. He commented, "The world's major central banks have responded to the Asian crisis by abandoning their traditional role as inflation fighters and taking on the role of liquidity providers. As a result, money supply growth is now surging around the world, fueling the rallies in financial markets for the moment, but ultimately raising questions about the medium-to longer-term inflation."

With words of warning for investors, he added, "the U.S. remains the most likely candidate for a monetary tightening and a financial market correction, as a late-cycle build-up of cost pressures could stir inflation and squeeze margins. To the extent that frothy stock and bond markets in the U.S. could be vulnerable in the second half of 1998, investor caution in world financial markets is also in order."

Conclusion

Robert Larkins concluded his presentation with the following remarks:

> In many important respects, the Asian crisis is a wake-up call to the global economy and world financial markets. It raises deep questions about systemic perils in emerging markets. It also brings the critical issue of pan-regional leadership to a head, with China posing its first serious challenge to Japan. Moreover, a weakened Asian economy now makes Latin America look good by comparison. Throughout all this, we continue to believe that the industrial world will emerge largely unscathed; however, relatively limited GDP effects could well be swamped by widening current-account deficits that could take a surprising toll on the U.S. Dollar, thereby sowing the seeds for an important and long overdue correction in bond and equity markets.

PART II: *Strategic Planning and the Asian Economic Crisis: The Perspective of San Diego Firms*

Panelists: William Boyle, Chief Financial Officer, Cubic Corporation
Anthony Thornley, Vice President and CFO, QUALCOMM, Inc.
Andrew Wrobel, President and CEO, Microelectronic Packaging

Moderator: Julie Meier Wright, President, San Diego Regional Economic Development Corp.

Introduction

While the impact of the Asian economic crisis on the cross-border region may be characterized as mild relative to the rest of California and the U.S., those regional companies that have been relying on Asian markets have acutely felt the effects of the crisis. The three companies that were represented during this portion of the conference, Cubic Corporation, Qualcomm, Inc. and Microelectronic Packaging, have experienced varying degrees of influence from the crisis in Asia. In many cases, the results have been delays and cancellations of contracts, declines in sales or slowing of growth in sales, renegotiations of financing for customers in Asia, or even shifting of production out of Asia to the cross-border region.

Regardless of the varied scenarios, all of the company representatives agreed that each country in Asia has a distinct set of issues and that each market needs to be approached differently. Further, they agreed that the Asian crisis is only temporary, though the recovery will be slow. In the interim, the companies are relying on other markets in Europe, North America and Latin America to propel growth.

Regional Company Descriptions

Cubic Corporation has two principal areas of business – 1) defense electronics in ground and air training ranges, and 2) automatic fare collection (AFC) for the mass transit industry. On the defense electronics side, most of Cubic's current business in Asia comes through the U.S. Department of Defense, though the company does have some direct defense work in Asia and anticipates more. On the mass transit side, Cubic has a considerable amount of business throughout Asia, and expects Asia to be a large market for AFC in the future. Most of Cubic's work is contract specific, thereby precluding the need for inventory or long-term assets in Asia. However, as a result of the Asian crisis, Cubic suffered the first quarterly loss in 12 years. Cubic clearly expects the situation in Asia to continue to slow the growth of its defense business.

Qualcomm, Inc., a wireless telecommunications company, has four revenue sources: 1) licensing of technology, 2) sales of application-specific integrated circuits (ASIC), 3) manufacturing and sales of telephones, and 4) development and sales of manufacturing base stations. About 25 percent of Qualcomm's sales in 1997 were to Asian markets, and Qualcomm has been aggressive in building relationships with companies in Asia, particularly in Japan and South Korea. In fact, the South Korean government adopted Qualcomm's technology as a national policy. Since Qualcomm also sources components from Asia, the company has a complex set of relationships with Asian markets. Frequently, Qualcomm competes with and sells to the same companies. The first impact of the crisis felt by Qualcomm was a halving of previously fast-growing royalty and sales revenue in Asia. However, the cost of components sourced from Asia has dropped.

Microelectronic Packaging (MPI) designs, manufactures and tests high-density multi-chip modules for the mounting of silicon chips. The company specializes in designs for commercial and military markets, and most of its customers are U.S. high-tech companies such as IBM. MPI began manufacturing in Singapore in 1979 and established a San Diego manufacturing facility in 1993. As issues such as rising costs, currency fluctuation and lengthy shipping times became more problematic for cash flow and customer service, MPI reduced its production in Singapore. The Singapore operation was low-tech, while the San Diego facility focuses on high-tech products for which technical skill and customer responsiveness are critical. MPI largely avoided the negative effects of the Asian crisis by closing its Singaporean manufacturing operation in 1997.

The Effect of the Crisis on Regional Companies

The Impact Has Varied by Country

Generally speaking, the countries of Taiwan, China (including Hong Kong) and Singapore have faired reasonably well in the crisis, while the most turbulence has been felt in Japan, South Korea, Thailand, Indonesia, Malaysia and the Philippines. For example, the crisis has had relatively little impact on Cubic in its core AFC markets of Singapore and China, while the company has been hurt by contract cancellations and deferrals in Thailand, Malaysia and Indonesia. In the same way, Qualcomm was severely impacted in Thailand, Indonesia and South Korea, but continues to pursue business in China and India largely unhindered by the Asian crisis. Interestingly, MPI was negatively affected only because the company was manufacturing in Singapore, and because Singapore's economy remained healthy, the cost structure was higher than that in neighboring countries.

Drop in Royalty and Sales Revenue

For Qualcomm, the first negative ramification of the Asian crisis was a 50 percent reduction in Asian royalties. Anthony Thornley, Vice President and CFO of Qualcomm, explained that the Korean Won's devaluation from 950 to 1,700 to the dollar between September and December 1997 essentially resulted in a halving of royalty revenues. Another 50 percent reduction occurred in the company's ASIC business. Quarterly demand had doubled prior to the onset of the crisis, but it then fell back to its original level. Reflecting on the effects of the dramatic halving of demand, Anthony Thornley commented, "We were able to deal with this from an operational perspective, although it had a significant financial impact."

Contract Cancellations

Perhaps the hardest initial hits that companies took at the hands of the Asia crisis were cancelled contracts. William Boyle, CFO of Cubic Corporation, disclosed that Cubic was "to have received a sole source contract for $40 million on a Bangkok elevated system, but that was cancelled late last year when the prime contractor could not come up with the financing." Similarly, Qualcomm had developed a new phone product just prior to the Asia crisis, which the company expected to perform well in the Korean market. Anthony Thornley recounted that after signing a contract in October, the phone business fell away to nothing due to the currency devaluation's impact on the product's price.

Contract Delays

One of the most cited effects of the Asian crisis was contract delays. According to William Boyle, Cubic's defense business has seen three potential contracts deferred indefinitely – one each in Thailand, Malaysia and Indonesia. With regard to Cubic's AFC business, two other projects that the company had been tendering on were also "put on the back burner because of the crisis."

Collection of Receivables

Both William Boyle and Anthony Thornley cited problems with receivables in certain Asian markets. Qualcomm's solution in South Korea has been to extend financing to customers, stretching payment terms from 30 days to 90 days.

Local Currency Contracts

Due to the massive currency devaluation, companies in struggling Asian countries have avoided signing contracts in dollars. For example, Cubic had been servicing an air range in Thailand under a dollar-denominated contract. When the contract came up for renewal, the company was forced to renegotiate it in Baht, the local currency. Fortunately, the majority of Cubic's expenses were also denominated in Baht which mitigated the problem.

Japanese Financing Cutback

Although Qualcomm believes that the situation will only be temporary, one of the consequences of the Asian crisis has been a contraction in financing from Japanese banks. Anthony Thornley explained, "In our infrastructure business, we are almost a banking business. We have been providing substantial vendor financing and we have been looking for partners in that business for some time. In fact, we have worked very closely with certain Japanese institutions and that relationship has been very good for us, but of course, as a result of this situation, the flow of funds has been somewhat limited from Japan."

Threat of Japanese Competition

With the weakness of the Yen continuing, one of Cubic's general concerns in Asia is the potential of heightened competition from Japan in the AFC business. William Boyle stated, "The Japanese have always controlled their own market as far as AFC is concerned, but they have never been successful in competing in the world market; with this new situation, that could change very rapidly."

Strategic Planning Responses to the Crisis

Focus on European and North American Contracts

According to William Boyle, Cubic has contracts coming up in Europe which will allow the company to grow significantly and strengthen itself to compete even more vigorously in Asia when a recovery takes place. Andrew Wrobel, President and CEO of Microelectronic Packaging (MPI), clearly stated that MPI is relying solely on customers in North America and Europe for the company's growth prospects. While the primary focus of MPI is the U.S. market, the company may consider manufacturing in Europe in the future. The 19 year-old company has disengaged itself from the Asian region and intends to stay that way for the foreseeable future.

Seek Latin America Opportunities

To counter the halt to business in Indonesia and Thailand, Qualcomm has redirected its efforts towards Latin America. As evidence of Qualcomm's focus on Latin America, Anthony Thornley offered, "We have just secured a national license in Mexico, and we are pretty well through with building a network in Chile."

Build and Maintain Strong Relationships with Customers and Suppliers

Anthony Thornley emphasized that the key to weathering the Asian economic storm is having solid relationships with customers and suppliers. In Qualcomm's case, ASIC components produced by INTEL and IBM in the U.S. were being supplied to Korean customers. Just prior to the onslaught of the crisis, Qualcomm and its suppliers were able to respond to a rapid rise in demand in Korea. Similarly, when the crisis hit and demand was cut in half, Qualcomm was able to work with its suppliers in the U.S. to turn down the supply of components and lessen the financial impact on Qualcomm. On the demand side, Qualcomm worked together with Korean customers to agree on reasonable financing terms. Anthony Thornley reiterated, "As a result, again, I think of our very strong relationships, those Korean customers, despite their financial difficulties, have been very good in paying under those new terms."

Look to China and India

At least for Cubic Corporation, long-term prospects in China look bright. The central government in China recently announced a trillion-dollar infrastructure program, which includes a substantial investment in transportation. If the Chinese government wants to get concessionary multilateral financing, then a lot of local content is precluded. In fact, EXIM Bank's transit financing does not cover local work, which bodes well for Cubic. Qualcomm continues to pursue its infrastructure business in China and India since those countries have not been as severely impacted by the Asian crisis. While recent events in India have given Qualcomm cause for concern about future plans, the company remains on track in both markets.

Work on Projects with EXIM Bank Support

EXIM Bank-financed contracts can make a big difference in the midst of the Asian crisis. Highlighting this issue, William Boyle explained that even if China were to devalue its currency, Cubic would still be relatively unaffected. "Existing contracts are in dollars and they are being financed by the EXIM bank on very favorable terms for China."

Shift Production to the San Diego Cross-Border Region

In the case of MPI, the solution to minimizing the impact of the Asian crisis was leaving the Asian region entirely. Proximity to customers coupled with the worsening situation in Asia formed the basis for the decision to close the company's three subsidiaries in Singapore. However, the closure was a dramatic step for MPI. Andrew Wrobel noted, "In 1996, our sales out of those subsidiaries in Singapore represented approximately $40 million in revenue and employed 500 people. As of the end of 1997, we had zero employees and no revenue was derived from those operations." Since the closure of the Singaporean facilities, MPI has also been able to restructure its debt with Singaporean creditors on favorable terms for the company.

More importantly for the San Diego cross-border region, MPI's San Diego operation has grown from $5 million in sales and 20 employees in 1995 to $28 million in sales in 1997 and

150 employees at present. In fact, contrary to the experience of the other companies at the conference, MPI has experienced three consecutive growing quarters since October 1997.

In terms of MPI's outlook for the future, Andrew Wrobel stated, "if the lower labor costs are required, I think that the ideal solution is right south of the San Diego, south of the border, and that is where MPI is heading." In addition to the low labor costs found in Baja, Andrew Wrobel also mentioned that San Diego's pool of high-skilled labor and high-tech firms provide favorable conditions for growth.

Crisis Outlook

The Crisis is Temporary, but Recovery will Take Time

While hesitant to estimate the pace of recovery, the company representatives all agreed that Asia would eventually rebound and become a vibrant economic force. Anthony Thornley of Qualcomm stressed that the best stance was to take a long-term view and hold positions in order to be able to take advantage of those positions when the market improves. William Boyle predicted that the resuscitation would be slow due to the lack of transparency. Referring to the absence of open corporate reporting, he said, "in order to attract new capital, this code of secrecy will have to be broken, and that cultural change generally takes a bit of time."

PART III: *The Effects of the Crisis on Asian Manufacturing in the Cross-Border Region*

Discussants: MOTOHARU IUE, Chairman and CEO, SANYO North America Corporation

YOUNG M. KWON, President, Samsung Electro-Mechanics America, Inc.

Moderator: RICHARD FEINBERG, Director, APEC Study Center, UCSD

Introduction

One of the major concerns for the cross-border region has been the impact that the Asian crisis has had on the many Asian manufacturers operating in San Diego and Tijuana. The two companies represented at the conference, SANYO North America Corporation and Samsung Electro-Mechanics America, Inc., are among the very largest Asian manufacturers with investments in the region. Both companies have been affected by the crisis in terms of competition from cheaper Asian exports to North America. Samsung has suffered from delays to expansion plans in the region as well as corporate austerity measures. However, SANYO and Samsung remain committed to the cross-border region and have plans to increasingly localize production.

Company Descriptions

SANYO North America Corporation has been operating in the region for 19 years and has introduced the production of color televisions, home appliances, factories, components, and personal computers. SANYO moved its North American headquarters to San Diego in 1996. While most of SANYO's products go to the North American market, SANYO does export a small quantity back to Japan depending on exchange rates and consumer preferences. SANYO is being impacted by the crisis in terms of competition from cheaper products made in Asia. SANYO's answer to the current crisis, as with past currency swings in Japan, has been to further localize production in the cross-border region.

Samsung Electro-Mechanics America, Inc., as part of the Samsung consumer electronics conglomerate, benefited from the rapid growth that the company experienced throughout the early 1990s. The two table below displays Samsung's expansion success through 1996:

Samsung, 1992-96

	1992	1993	1994	1995	1996
Sales (Exports)	$49 billion ($17 billion)	$51 billion ($21 billion)	$64 billion ($29 billion)	$84 billion ($40 billion)	$93 billion ($36 billion)
Profit	$375 million	$521 million	$1,681 million	$3,802 million	$164 million
Overseas Employees	36,000	N/A	N/A	N/A	50,000
Overseas subsidiaries & offices	423 in 68 countries				

Source: Samsung Electro-Mechanics America, Inc.

In the last two years of operation, Samsung Electro-Mechanics America, Inc. has also experienced marked growth in sales and profits. Through 1997, Samsung had already invested $630 million in the cross-border region with plans to invest nearly $60 million more through the year 2000. However, these plans have been delayed by the Asian crisis. While the company expects more growth in 1998, the table below shows that a major slowdown is predicted through the year 2000:

Samsung Tijuana
(* in Million)

	1996	1997		1998F	1999F	2000F
Sales*	$470	$664		$1,014	$1,060	$1,230
Profits*	($15)	$7.7		$20.2	$26.5	$12.5
Investment*	$300	$330		$360	$505	$650
Employees	3,500	4,540		4,590	5,365	7,070

Source: Samsung Electro-Mechanics America, Inc.

Effects of Crisis on Asian Companies in Region

Threat of Competitive Exports from Asia

Like many U.S. manufacturers, Asian companies in the region fear the competition that will result from the Asian crisis. The currency devaluation in certain Asian countries has made products manufactured in those countries less expensive than locally-made goods, even after transportation costs. Mr. Iue, Chairman and CEO of SANYO North America Corporation, voiced concern that Asian companies manufacturing in the cross-border region could potentially be hurt by cheaper imports coming from Southeast Asia. He made clear his belief that Southeast Asia would try to export its way out of the crisis, thereby putting competitive pressures on products manufactured in North America.

Mr. Kwon, President of Samsung Electro-Mechanics America, Inc., mentioned that Samsung in Tijuana had already lost its competitive edge relative to manufacturers in South Korea due to the devaluation of the won. To further the problem, Mr. Kwon noted that because of the unemployment in Korea, “the Korean government wants to keep business domestically,” and does not want companies like Samsung manufacturing competitive products abroad. Both Mr. Iue and Mr. Kwon stressed that competition will become even more problematic should China devalue its currency.

Halt to or Delay of Investment

For Samsung, the problems in South Korea have meant a significant delay in investment and expansion plans for the cross-border region. Specifically, the crisis has brought a halt to construction of a microwave oven plant, the production of large picture tubes and the establishment of a research and development facility. Mr. Kwon explained that the microwave oven facility was under construction in the Tijuana Samsung Park, but that production and operation would be postponed for the moment. Similarly, the large picture tube production was postponed due to lack of financing, but Mr. Kwon was hopeful that investment would be resumed later in 1998. Referring to the R&D Center, Mr. Kwon admitted, “We sort of had a commitment to set up our research and development center in San Diego in the beginning of our investment in Tijuana; however, that project has been postponed indefinitely.”

Cancellation of Vendor Investment

Larger Asian manufacturers are not the only companies that have been forced to delay investment in the region. Mr. Kwon told conference attendees that, “Some vendors who followed us to provide us their components or the parts which are needed for us to produce our products either cancelled or reduced operations or postponed (their relocation.)”

Strategic Responses to the Crisis

Concentrate on North and Latin American Markets

Asian manufacturers in the region have not felt a direct hit to sales because very few if any of their products are sold in Asia. The vast majority of products manufactured in the region are marketed locally. Mr. Iue stated that SANYO North America's principal markets are the U.S., Canada, Mexico, Central America and South America, and those markets are providing ample opportunities for expansion and growth. SANYO has benefited from the record-setting economic growth in the United States. Mr. Kwon also noted that Samsung in Tijuana has enjoyed tremendous growth in sales and estimates a 52.7% sales increase in 1998.

Adopt Lean Management Practices

Although Samsung's sales continue to grow, the company has been negatively impacted in other ways. In particular, the crisis has imposed new management practices on Samsung. Mr. Kwon described the change as a move to "a very slim type of organization and lean manufacturing style." For example, the number of Korean staff has been reduced as expatriates have been sent back to Korea. In addition, Mr. Kwon stated that all of the remaining staff members have been encouraged to adopt austerity measures.

Take Opportunity to Localize Components

According to Mr. Iue, the crisis has provided the perfect opportunity for SANYO to further localize raw material and components. He added, "It is also an opportunity for locally-based firms to sell to supporting companies and it is a good chance to work towards reaching the level of the local content indicated by NAFTA." One example of SANYO's component localization program is a compressor joint venture that the company has in Mexico. Mr. Iue clarified, "A portion of the compressors which are part of the refrigerators were imported from Indonesia. Due to the recent instability of which you are all aware we have switched to obtaining those compressors from our mixed country joint venture."

In response to a question, Mr. Kwon explained that because of the NAFTA 2001 requirements, Samsung has been working hard to localize components since the inception of its operations in the region. He claimed that while the Asian crisis would probably put a financial burden on Samsung's commitment to localize, the company would proceed as required.

Both speakers mentioned that the Asian crisis and NAFTA laws are not the only forces driving localization. Because just-in-time manufacturing is a competitive weapon, manufacturers must be close to their suppliers. Mr. Iue remarked, "My opinion is that right now economically it is important to get products quickly and inexpensively to consumers, and no matter how inexpensive products may become coming from Southeast Asia, they still will not be as readily available as locally available products."

Lobby Mexican Government for Advantageous Policies

While both SANYO and Samsung are making efforts to localize production, they will nevertheless need to continue importing some components. Since import duties are slated to return to normal levels after 2001 under the NAFTA agreement, Asian manufacturers in the region are worried that they will become even less competitive vis-a-vis manufacturers located in Asia. Both Mr. Iue and Mr. Kwon alluded to their company's efforts to persuade the Mexican government to adopt a more favorable policy stance, and expressed their hope that the government would quickly announce a decision.

Crisis Outlook

Asian Manufacturers will Remain Committed to Region

Mr. Iue made it clear that SANYO North America views the San Diego cross-border region as instrumental in his company's strategic planning. In addition to affirming SANYO's commitment to localization in the cross-border region, Mr. Iue confirmed, "with the San Diego/Tijuana region as our hub, we intend to expand not only to the North and the South, we are also in an extremely advantageous location for dealing with countries of the APEC and Pacific Rim."

In response to a question from the moderator about commitment to the cross-border region, Mr. Kwon replied that Samsung's plan to internationalize remains unchanged. He added that Samsung has ambitious plans and has worked hard to achieve them. Unless an adverse situation arises, which the company does not expect, the initial plans for investing in the region will remain the same, though they may be delayed.

Crisis is Temporary, So Look for Investment Opportunities in Asia

With advice for U.S. investors, Mr. Kwon stressed that it is a good time to shop for bargains in Asia, particularly in South Korea. In his view, the economies of Asia will no doubt rebound and when they do, those that invested during this time of devaluation will profit. Mr. Kwon highlighted the fact that Korea was once a closed market, but that the government has made great strides in opening up the economy to foreign investment and is trying to push forward the market corrections necessary to overcome the crisis.

PART IV: *The Asian Economic Crisis and Investment Capital Flows*

Luncheon Address: JACKSON TAI, Managing Director, Western Region, J.P. Morgan

Discussants: PHILIP J. FISCHER, Vice President, Fixed Income Research, Merrill Lynch
ROBERT LARKINS, Principal, Morgan Stanley

Moderator: LARRY PRIOR, Chief Administrative Officer, County of San Diego

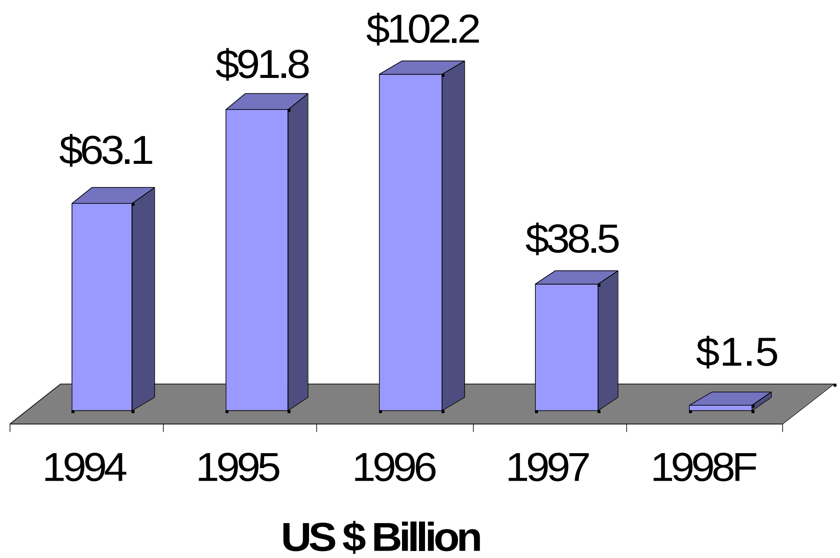
Luncheon Address

Revisionist View of the Asian Flu Origin

Unlike his counterparts, who pointed to the lax policies of banks and rampant corruption in many Asian countries, Jackson Tai, Western Region Managing Director of J.P. Morgan, provided another theory for the force behind the Asian crisis. His version traced the origin of the crisis back to the post-Cold War spread of western capitalism and the immersion of free markets and investment flows. According to Jackson Tai, bankers in Asia became addicted to massive inflows of overseas capital and this capital was very speculative. As a result, property speculation soared and assets became overvalued, which in turn led to inflated stock markets. Jackson Tai claimed that bankers were so caught up in the promise of the Asian miracle that they "neglected some very obvious warning signals, and those of course would be overheated economies, negative trade balances, and huge amounts of short-term external borrowings." More importantly, he added, "these are indeed still command economies, not demand economies." As such, Jackson Tai concluded, the disconnect between western capitalism and state-directed economic activity was bound to cause the economic engine to stall and interrupt investment flows. When this happened, it triggered exaggerated market corrections, sparking, in a vicious cycle, a serious loss of confidence by international investors.

Due to the slowdown, Jackson Tai noted that bankers and economists are pessimistic about GDP forecasts in Asia over the next year. The charts below display the dramatic drop in capital inflows to Asia and the downward revisions in GDP growth for many Asian countries:

Net Private Capital Inflows to Asia



Source: International Monetary Fund World Economic Outlook, May 1998

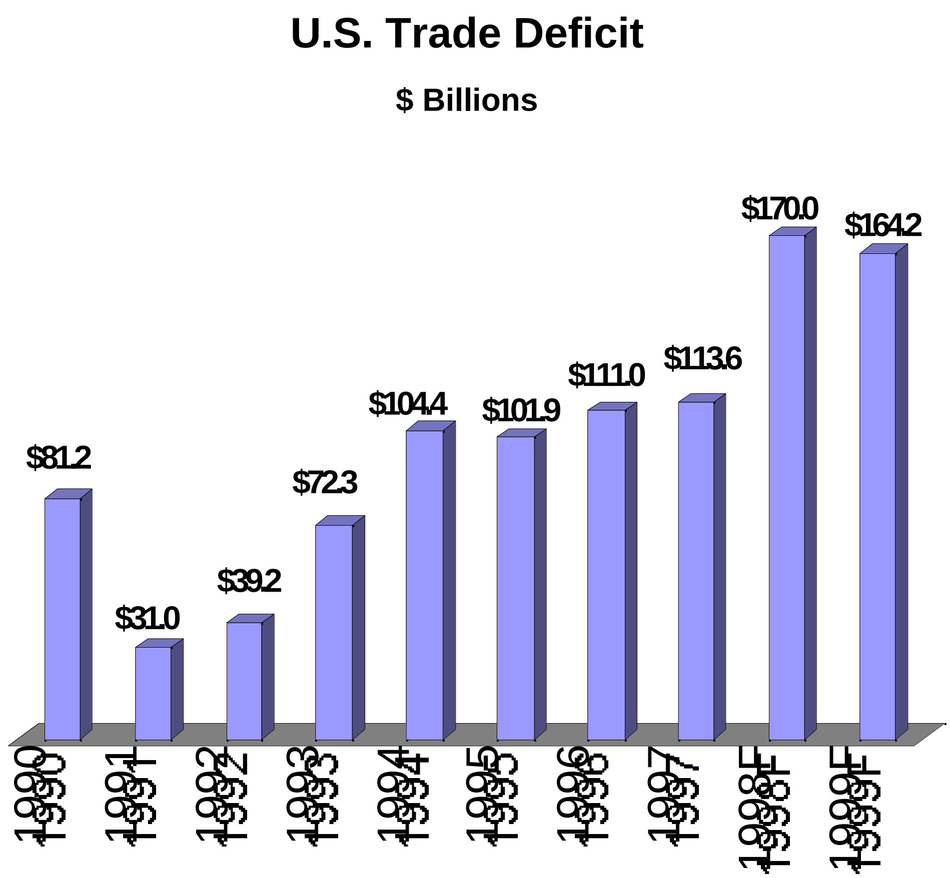
Downward Revisions in GDP Growth

	December 1997	April 1998	Change
South Korea	1.8%	(3.6)%	(5.4)%
Indonesia	3.0	(10.0)	(13.0)
Malaysia	3.9	(0.5)	(4.4)
Philippines	4.9	1.0	(3.9)
Thailand	(1.3)	(4.2)	(2.9)
China	9.0	6.5	(2.5)
Hong Kong	3.7	(0.6)	(4.3)
Taiwan	6.3	5.5	(0.8)
Singapore	5.1	2.0	(3.1)
Japan	1.1	(0.2)	(1.3)

Source: J.P. Morgan Economic Research

Asia's Economy Will Rebound, but with Fits and Starts

Jackson Tai agreed with everyone at the conference that Asia's economies would rebound. However, he qualified his remarks by saying, "Not all the countries in Asia will come back with the same intensity and pace. Some members will fall to the back of the class." Eventually, he said, investment capital in Asia would moderate and become more rational and more commercial. On the negative side, Jackson Tai predicted that Asian countries "will have no choice, but to slow imports and return to the outside world to export their way out of their current miseries." He noted that this correction was already underway in Korea and Thailand, and that it would lead to serious parts competition for manufacturers. More importantly, the correction will translate into an upsurge in the U.S. trade deficit with Asia. Overall, Jackson Tai felt that a larger U.S. trade deficit would lead to the resurfacing of Asia bashing by protectionist politicians, especially in this election year. The following chart illustrates the forecasted increase in the U.S. trade deficit:



Source: International Monetary Fund World Economic Outlook, May 1998

Asia Downturn Will Lead to Social Unrest

Jackson Tai expressed his concern about the social implications of the Asian crisis. He presented a Misery Index (below), which combines unemployment and inflation, in order to quantify and rank the social unrest in varying Asian countries. Not surprisingly, Indonesia had the highest index rating. Jackson Tai explained that having endured corruption, and perhaps repression, the average person in Indonesia would take to the streets in protest and violence after the dream of a higher standard of living collapsed. Moreover, the shattering of investor confidence would mean delays in infrastructure projects in Asia, which will also have negative social ramifications. He noted, “Governments in Asia risk losing control, something that may have larger implications for our already reduced ability to export goods to Asia, and the governments in Asia losing control will also have implications for U.S. defense spending in the region.”

Misery Index

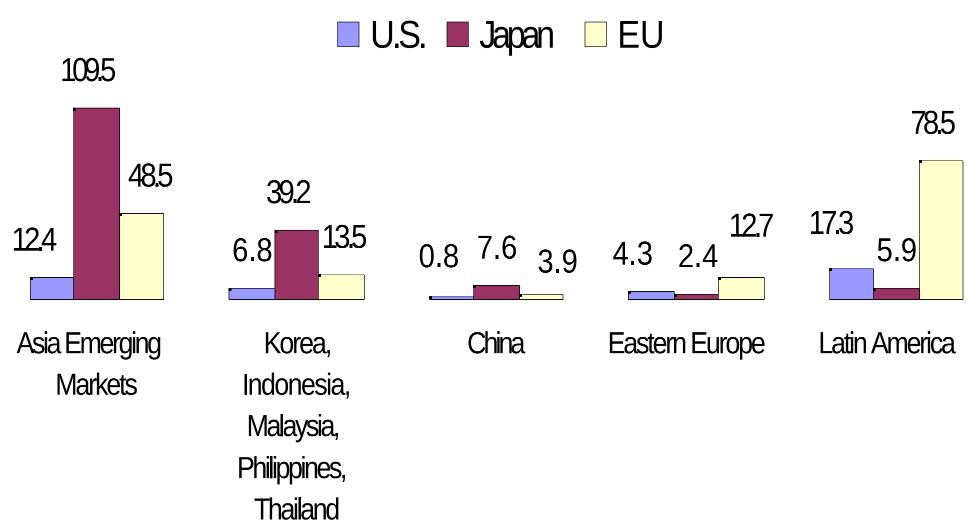
	Real GDP (%oya)		Unemployment (% Labor Force)		Inflation (%oya)		Misery Index (Unemp+Infl)	
	1997	1998	1997	1998	1997	1998	1997	1998
South Korea	**5.5**	**-3.6**	**2.6**	**6.7**	**4.4**	**12.5**	**7.0**	**19.2**
Indonesia	**7.0**	**-10.0**	**2.2**	**10.0**	**6.6**	**60.0**	**8.8**	**70.0**
Malaysia	**7.5**	**-1.2**	**2.5**	**3.0**	**2.7**	**10.0**	**5.2**	**13.0**
Philippines	**5.1**	**1.0**	**8.0**	**9.5**	**5.1**	**15.0**	**13.1**	**24.5**
Thailand	**0.5**	**-4.2**	**2.7**	**5.5**	**5.6**	**15.0**	**8.3**	**20.5**
China	**8.8**	**6.5**	**3.2**	**4.5**	**2.8**	**0.8**	**6.0**	**5.3**
Hong Kong	**5.2**	**-0.6**	**2.4**	**3.8**	**5.7**	**3.4**	**8.1**	**7.2**
Taiwan	**6.8**	**5.5**	**2.7**	**2.5**	**0.9**	**3.0**	**3.6**	**5.5**
Singapore	**7.5**	**2.0**	**3.0**	**3.8**	**2.0**	**3.0**	**5.0**	**6.8**

Source: J.P. Morgan Economic Research

Japan's Insecurity Could Trigger a Relapse and Prolong Asia's Woes

If the script for the Asian meltdown had been written ten years ago, Jackson Tai commented, the ending would have featured Japanese banks and a strong Japanese economic machine coming to the rescue. Instead many are worried that the continuing Japanese banking problems, the lingering Japanese recession, and overall Japanese insecurity may prolong Asia's woes. He explained that Japanese banks are paralyzed with about a trillion dollars in bad debt and because they are unable to restructure the capital, they rely on the gains of the Nikkei-225 to meet adequacy ratios. The banks are hoping for a recovery in property markets so that non-performing assets will not worsen, but property values are questionable because demand is stagnant. Additionally, the Nikkei-225 is tied to property devaluations and corporate profits, which are in turn linked to consumer spending and Japanese exports. Unfortunately, the "salarymen" are paranoid about layoffs, so they are not spending their tax cuts, and the politicians, paranoid about voters, are not leading. Jackson Tai continued, "Despite Japan's huge stake in the rest of emerging Asia, the Japanese have failed to take the lead in organizing a global restructuring of bad debts, leaving that task to American banks." The chart below clearly shows that Japan's exposure to the "IMF Five" (South Korea, Indonesia, Malaysia, Philippines and Thailand) is significantly greater than that of European or U.S. banks.

Commercial Bank Loan Exposure as a Percentage of Bank Capital



Source: J.P. Morgan Economic Research

Overall, Jackson Tai was not optimistic about Japan or Asia's abilities to quickly solve the region's problems. He said, "The inefficiencies in the Japanese and Asian economic models have been masked, covered over, by poor financial disclosure which was neither timely, transparent, or complete." He also cited corporate adventurism as a problem, telling the conference participants that "corporate adventurism has been unwillingly funded by shareholders who have not been paid at proper return. These shareholders do not have a real voice in corporate governance. Corporate adventurism, particularly in Japan, has also been funded by cross-shareholding agreements and this adventurism has also been funded by consumers who have no competitive choices at the supermarkets or at the department stores."

Implications of the Asian Meltdown for the Homefront

Since the San Diego's economy is not dependent on Asia, Jackson Tai doubted that the implications of the crisis north of the border would be disastrous. However, that is not to say that the region as a whole would not be negatively affected. He offered ten deliberately provocative predictions:

1. **Japanese and Korean Adventurism is Over**

   Japanese and Korean banks, security houses, property companies, construction companies and even the large industrial complexes are too weak to have an interest in expanding to the U.S., particularly to projects with inflated valuations. Investment capital flows will more likely come from overseas Chinese havens, and be attracted to leading technology.

2. **Some Asian Investors will be Unable to Support Their Commitments**

3. **Expensive Asian Expatriates will be Brought Back to Asia**

   As Asian currencies continue to fall and languish, Asian expatriates are becoming very expensive and will have to return to Asia.

4. **Overexposed South Korean Chaebols Will Sell off Billions in U.S. Assets**

   Companies such as Hyundai, Samsung, L.G., and Daiwoo are being forced to scale back their operations and some may have to bail out of U.S. subsidiaries altogether.

5. Reduced Technological Research Competition from Asia

Asian countries will emphasize the export of cheap labor and the pace of technological advances will be slowed.

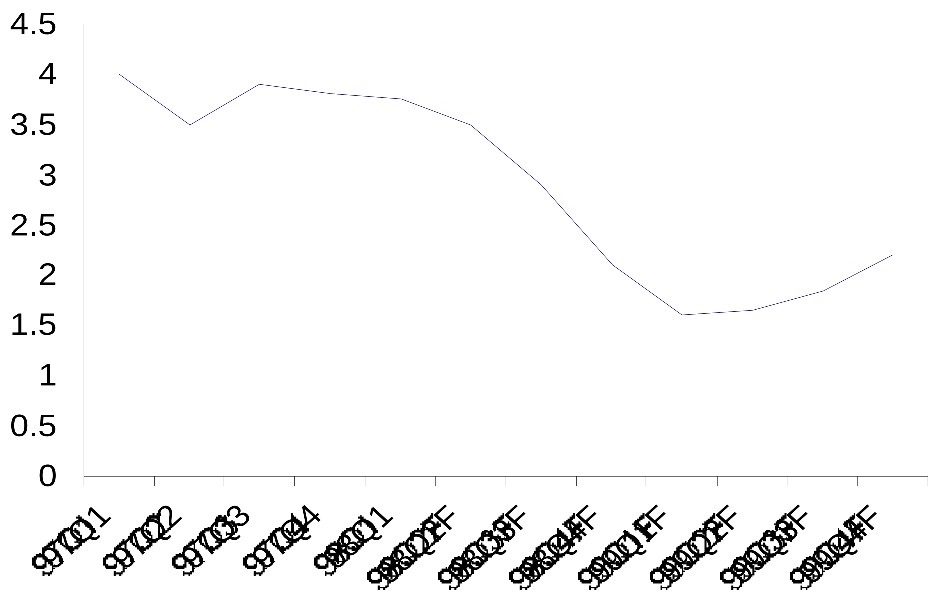
6. Look Before you Invest

With the devaluation of currencies and the deflation of values, there will be a strong temptation to put up investment capital, which carries extreme risks. On top of operating risks, there will be foreign exchange risks. One development to watch is the compounding of this problem potentially brought on by devaluation of the Japanese Yen. Additionally, there are still strong cartels throughout Asia, some sanctioned by regulators. As mentioned before, the lack of timely, transparent, and complete financial disclosure means that what you see is certainly not what you get. However, for those that still want to invest in Asia, multinational, or multi-flag operations are the safest.

7. Asia Bashing will Increase with a Flood of Cheap Asian Exports

Trade deficits resulting from a flood of cheap Asian exports will increase the chance of a significant slowdown in overall U.S. economic growth. The chart below shows that GDP forecasts have been adjusted downward to reflect the impact of the Asian crisis:

U.S. GDP (% Change over Previous Year)



Source: J.P. Morgan Economic Research

8. Maquiladora Investments will be Protected by NAFTA's Rule of Origin

For the time being, the NAFTA rule of origin will mean that many of the investments will stay in operation. Even if the currency devaluations and more competitive labor terms allow Asian countries to export parts more inexpensively to the U.S., they will try to avoid triggering the rule of origin penalties.

9. As U.S. Security Blanket Becomes More Essential to Asia's Stability, San Diego Will be the Recipient of Increased Military Spending

The likelihood of continuing social unrest will tax the U.S. security blanket, sparking renewed U.S. military commitment, which will benefit San Diego.

10. Dollar Will Be Almighty Again, At Least for Awhile

The theory is that smart money will gravitate to the U.S. Dollar until there is some stability restored to the Asian financial markets.

Discussant Comments

U.S. Trade with Asia

Citing recent trade figures, Philip J. Fischer, Vice President of Fixed Income Research at Merrill Lynch, noted that U.S. exports to Asia comprised about 30 percent of all exports prior to the crisis. Agricultural exports were even higher, with 40 percent of all exports going to Asia. The most recent trade data at the time of the conference indicated that the export figures were falling fast, with U.S. exports to Asia at about 22 percent of total exports. Philip Fischer added, “year to date, exports to Asia are down 17 percent, exports to Korea collapsed 48 percent.” He concluded that the Asia crisis is undoubtedly going to cost the U.S. in terms of GDP growth.

California Trade with Asia

Addressing California's commercial exposure to the crisis, Philip Fischer observed that the state is heavily integrated with Asia and is the leading exporter to Asia. He specified that California exports to Asia in 1997 were about $51 billion, or about half of all California exports. Furthermore, Asia accounted for approximately 5 percent of state domestic product. According to Philip Fischer, such large exposure makes California industries vulnerable, particularly the computer, industrial equipment and agricultural industries. Another concern that he brought up is the potential for the repatriation of Japanese assets from California. However, Robert Larkins disagreed, stating that the instability in Asia should keep money in the U.S.

San Diego's Exposure to Asia

In the opinion of Philip Fischer, San Diego is in a relatively nice posture. He estimated that "the impact on San Diego should be modest, but material; perhaps 0.5 percent or 1 percent in growth, but that is the direct impact." His prognosis was based on the fact that the largest employers in San Diego are the U.S. military, the University of California and biotech companies. Furthermore, area growth is rapid, with growth projections at about 4 percent, while the population is growing at a little less than 2 percent. On the downside, 22 percent of San Diego's exports go to Asia, and they are concentrated in the electrical devices and computer industries. However, Philip Fischer pointed out, other countries are more important to San Diego. For example, 44 percent of San Diego's exports are sent to Mexico.

Mexico and Latin America

Like others at the conference, Philip Fischer mentioned that Latin America stood to benefit from the Asian Crisis. In fact, Merrill Lynch views Mexico as the best Latin American prospect and predicted that Mexican GDP would increase 4 to 4.5 percent in 1998. Supporting this idea, he explained, "they have little direct exposure to Asia and only about 10 percent of their exports are in fact water-based, so they are removed from the direct impact. Inflation in the country is moderated and current account deficits appear manageable." The other discussants agreed that Latin America is expected to perform better than Asia over the next couple of years. Robert Larkins commented that it would be a good strategy to deploy to Latin America in order to take advantage of the population base and the wealth that has been built up there.

ABOUT THE RAPPORTEUR:

Tamara Richardson is an alumnus of the Graduate School of International Relations and Pacific Studies at the University of California, San Diego. Ms. Richardson is a business analysts who consults for various organizations and companies focusing on international management issues, with particular emphasis on Asia and emerging markets.

APPENDIX I: BIOGRAPHIES

To be inserted.