

Japan-South Korea trade fight a lose-lose scenario

Economics/Growth/Korea/Japan

Group Research

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- *Japan-South Korea tensions are escalating as the two countries removed each other from the list of countries that enjoy preferential trade treatment.*
- *South Korea will feel the supply-chain disruption impact, given its relatively high import dependency on Japan.*
- *Japan will see negative impact on its exports, as South Koreans boycott Japanese goods and tourism.*
- *Tensions between Asia's 2nd and 4th largest economies cloud the region's near-term export outlook, as well as the longer-term prospect of trade liberalisation.*
- **Implication for our forecasts:** *We maintain the 2019 GDP growth forecasts for South Korea (2.1%) and Japan (0.7%), but see downside risks to the both.*
- **Implication for investors:** *One more 25bps rate cut from the Bank of Korea is likely for the rest of this year. The odds of Bank of Japan easing in 2H19 are on the rise.*

Japan-Korea trade tensions are escalating. The Japanese government approved last Friday to remove South Korea from the list of countries that enjoy preferential treatment in trade (the so-called white list), effective from August 28. This means that Japanese firms will need to take additional administrative procedures to obtain licenses when exporting to South Korea, to ensure that the products shipped are not diverted to military use. This is a further measure taken by the Japanese government after beginning to curb the exports of three high-tech materials to South Korea on July 4. In response, South Korean government also said last Friday that it will remove Japan from the white list of trusted trading partners.

South Korea: supply-chain disruption impact

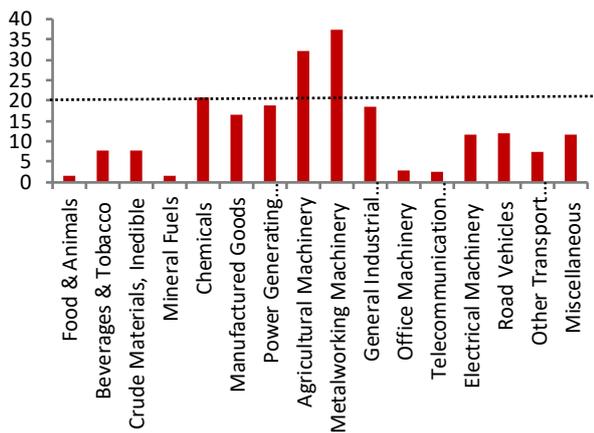
South Korea will likely feel the supply-chain disruption impact from Japan's export controls, to be reflected in a slowdown (not a halt) in its manufacturing production activities. Statistics show that Japan is South Korea's third largest source of imports (after China and the US), accounting for a significant share of 10%. In contrast, only 4% of Japan's total imports are sourced from South Korea.

South Korea's import dependency on Japan is especially high in the segments of chemicals (21%), iron & steel (28%), agricultural machinery (32%), metalworking machinery (38%), and photo/optical equipment (30%). In particular, South Korea relies on the chemical materials imported from Japan for the

production of key electronics components like semiconductors and display screens. Owing to the concerns about Japan’s export curbs disrupting South Korea’s semiconductor output, global DRAM spot prices soared about 25% during the two weeks after July 4, while prices of NAND flash memory chips rose 6%.

South Korea's import dependency on Japan

Imports from Japan/South Korea's total imports, % 2018



Source: CEIC, DBS

Japan: exports will take a hit

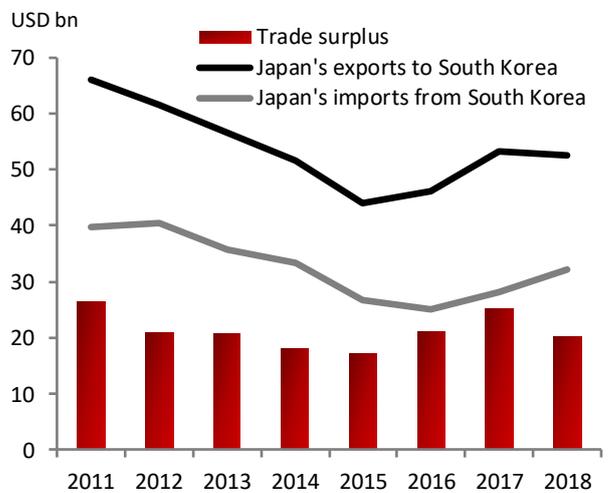
To Japan, negative impact will be mainly on its exports. The self-induced export controls will cause inconvenience and increase costs for the Japanese firms selling products to South Korea. More importantly, South Koreans have started to boycott Japanese travel and consumer products on a voluntary basis. The Korea Mart Association said that more than 200 local supermarkets and grocery stores have halted the sales of Japanese products. Korean Air also said that it is considering cutting the number of flights between the two countries.

South Korea is currently Japan’s third largest export destination (after China and the US), accounting for 7% of its total exports. In 2018, Japan’s exports to South Korea amounted to

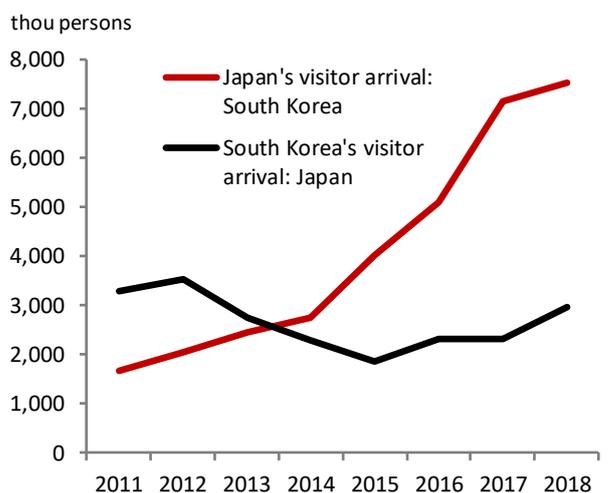
USD 52.5bn, well outweighing imports of USD 32.2bn. South Korea is also Japan’s second largest tourism market (after China), contributing 24% of its total visitor arrivals. The number of South Koreans visiting Japan stood at 7.5mn in 2018, far exceeding the number of Japanese visiting South Korea (2.9mn).

Assuming a 10% decline in exports to South Korea and a 20% decline in the number of South Koreans visiting Japan, Japan’s GDP growth will be cut by a circa 0.15ppt. This is not insignificant, given that the country’s growth is low to begin with (DBS forecast: 0.7% in 2019).

Japan's trade with South Korea



Japan's tourism trade with South Korea



Source: CEIC, DBS

Implications for the region

The rise in Japan-South Korea trade tensions carries the risk of disrupting the regional supply chains especially the electronics supply chains. This adds uncertainties to Asia's short-term exports outlook, which is already clouded by the escalation of China-US trade war, global slowdown and tech sector weakness. On the other hand, some degree of trade diversion could be expected as a result of Japan-South Korea trade tensions, which should mainly benefit the two countries' export competitors in the region, like Taiwan and China.

From a longer-term perspective, deteriorating relations between Asia's 2nd and 4th largest economies would dampen the outlook for regional trade liberalisation. This could delay the ongoing negotiation process of China-Japan-South Korea free trade agreement, and the Regional Comprehensive Economic Partnership.

Recent publications

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[Japan-Korea tensions pose new risks to electronics supply chains](#)

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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