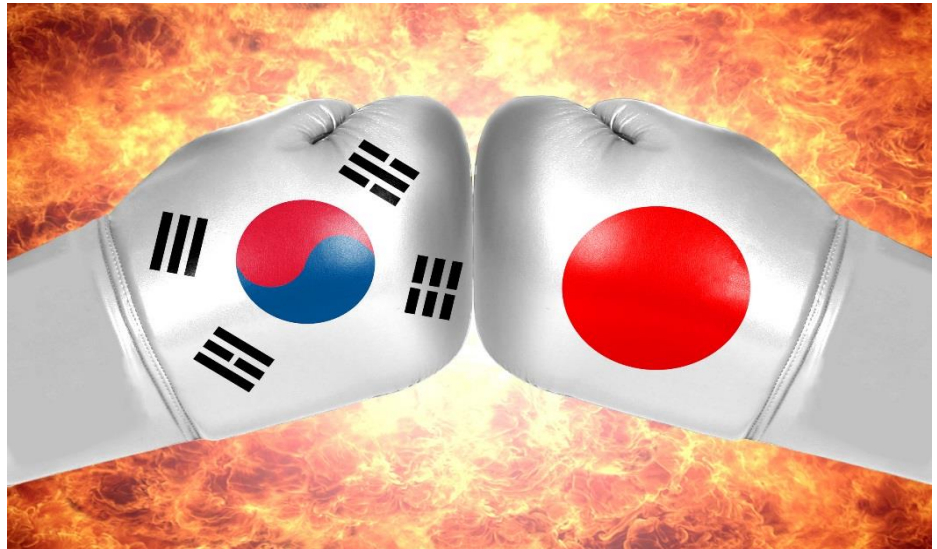


A trade war below the radar

Japan and South Korea take up battle

While global attention is on the US-China trade conflict, the escalating trade dispute between Japan and South Korea is important and needs to be seen through a historical lens that dates back to at least early last century. Supply chains may be severely impacted in the short term, and while a resolution still seems likely, the latest trade tension comes at a bad time for global growth.



Source: iStock

“ We have to work towards free trade because otherwise we will miss out on many opportunities for cooperation, and relations amongst countries will become much more difficult.

Lee Hsien Loong (Singapore's Prime Minister)

While everybody is focussing on the trade war between the US and China, the latest tensions between Japan and South Korea have not

made it to the front pages of most newspapers. Nevertheless, the trade dispute between both countries may have far reaching consequences, and will ultimately become a hot topic if the latest South Korean high tech gadgets cannot be delivered. Japan has made it more complicated for South Korea to access important Japanese materials within the supply chain to produce semiconductors and OLED screens. Japan claims that it had to make principal changes to its export control regime because of

national security concerns, however, the flare-up in escalating tensions between both countries appears to stem from unresolved issues that date back to early last century.

What happened?

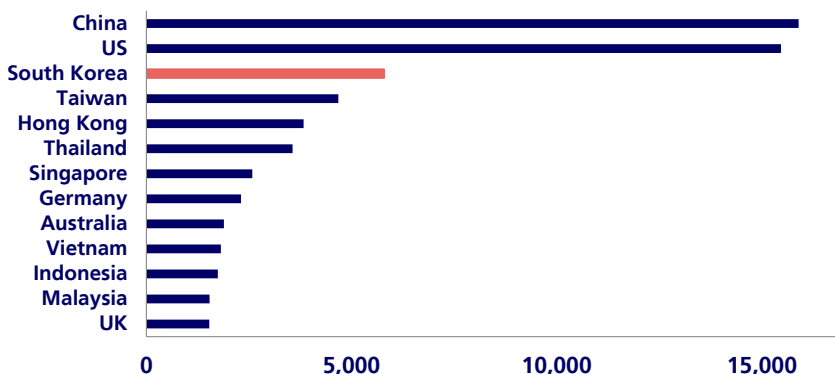
Just one day after the G20 Summit in Osaka, at which the forum's communique called for a free, predictable and stable trade environment, Japan's government launched export control measures against South Korea. New regulations were imposed for three types of electronic materials bound for South Korea that are core ingredients in the production of semiconductor and OLED screens, some of Korea's major export goods. Even shipping of PCs, smartphones and cars might be impacted.

Furthermore, on August 7th Japan removed South Korea from its 'white list' of 27 countries benefitting from trusted partner status without individual trade restrictions and subject only to simplified arms control procedures. These measures are scheduled to become effective August 28th. Korea had been added to this list in 2004 and was the only Asian country on it. 21 European countries, the US, Canada, Australia, New Zealand and Argentina remain on Japan's 'white list'.

However, it is important to note that both measures are not a ban, but rather make

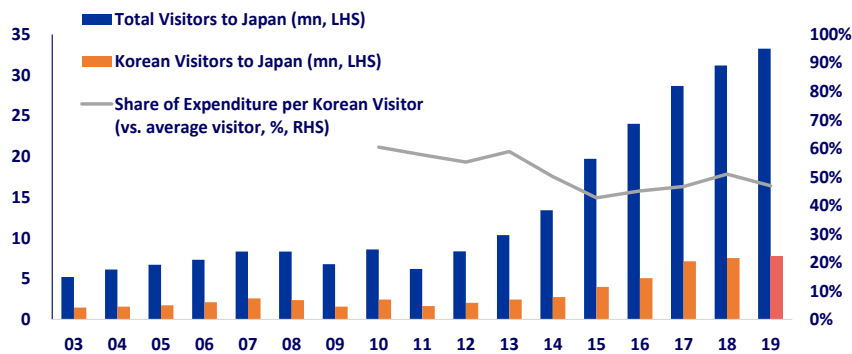
South Korea is Japan's third biggest export market

Japan's Exports by Countries 2018 (JPY bn)



Source: Bloomberg

Koreans rank second behind Chinese, but spend far less



Source: Japan Tourist Association (2019 H1 annualised)

exports more complicated and slower, as an individual instead of a bulk licence review and approval process is required that may take up to 90 days or even longer. Even for countries not on the 'white list' of trusted trade partners most goods exports do not require an export license under normal circumstances. If, however, goods may be used by the importer to produce weapons of mass destruction, or the importing company is on a black list, the exporter needs to apply for an export licence. So far no South Korean company has been included on this black list (the so called 'Foreign End User List'). However, restrictions continue to apply for technology exports via a 'white' country to a 'non-white' country, or if Japan's Ministry of Economy, Trade and Industry (METI) decides so, which is not publicly disclosed.

On August 12th South Korea retaliated, dropping Japan as a favoured trading partner, which will extend the approval process for exporting certain goods to Japan.

A difficult and deteriorating relationship between the two neighbours based on war-time issues

The Japanese government claims that the core reason behind its latest trade restrictions towards South Korea are based on national security concerns that urge principal changes to its export control regime, and are not intended as retaliatory measures for the latest diplomatic issues between the countries.

However, Chief Cabinet Secretary Suga also acknowledged that the relationship and trust between both countries has been severely damaged, and that South Korea has not come up with a satisfactory solution to end the latest row.

What lies at the heart of the latest dispute? Several South Korean court rulings ordered two major Japanese steel firms to compensate for forced labour during Japan's 1910-1945 colonisation of the Korean Peninsula. The court also approved the seizure and disposal of assets, including trademarks, patents and shares in joint ventures. Japan argues that the issue of compensation had been "completely and finally" settled under a 1965 treaty between both countries that restored diplomatic relations. While South Korea's proposal of a joint corporate compensation fund has been rebuffed by Japan, Japan's proposal of an arbitration panel has remained deadlocked as South Korea did not meet the

deadline for selecting members. There is also the longstanding dispute concerning the issue of so called 'comfort women' during the occupation. Numerous apologies by Japanese prime ministers and the Emperor over the years as well as an agreement between both countries to set up a support fund did not draw a line under the matter.

What impact are these export restrictions having on South Korea?

So far there is little evidence of any negative economic impact on either country, but it is too early to tell.

As far as the restrictions of electronic materials are concerned, they account for a negligible 0.05% of South Korea's total imports. However, they are key inputs for semiconductors and screens. Without these, the whole supply chain could collapse, resulting in significant downside risks and a loss of up to 8% of South Korea's overall exports, while a 10% decline in South Korea's chip production could result in a reduction in GDP growth by 0.4 percentage points and also hit South Korea's current account surplus.

South Korea's major 'chaebols' in the semiconductor space, Samsung Electronics and SK Hynix, are believed to have 20-30 days of inventory to overcome an administratively induced delay of imports of these three key materials. It was reported recently that Samsung Electronics bought extreme ultraviolet photoresist from a Belgian company in an attempt to secure enough stock.

In the first five months of this year, South Korea imported 92% of resist for semiconductors from Japan, as well as 94% of fluorinated polyimide for flexible OLED displays and 46% of hydrogen fluoride used as a semiconductor etching gas. South Korea will find it difficult to find substitutes as Japan commands a 70%-90% of the global market share. While South Korea has increased its market share for finished semiconductors over the last few years, Japan has moved towards becoming a major supplier of key inputs as well as semiconductor production equipment and has made itself indispensable in the semiconductor supply chain.

The impact of South Korea's removal from Japan's 'white list' of trusted trade partners

As the removal from Japan's 'white list' is concerned, South Korea will now have to apply for individual export licenses for a bigger range of products and technologies. JP Morgan estimates that 583 out of 1,795 items will be subject to tighter controls. Out of these, South Korea is highly dependent on Japan for 138 imported products. More importantly, based on a trade input-output table, nearly half of South Korea's imports from Japan are intermediate inputs for final demand in other countries, which may have consequences for the global supply chain.

South Korea may be able to find substitutes, but this will be a difficult and long-lasting process, particularly for small- and medium sized South Korean companies. Even if certain input products were to be replaced quickly, there may be a quality issue as Japanese products often have a comparative advantage to other foreign peers in terms of quality.

South Korea will try to diversify its supply

In the meantime South Korea's government has marked one hundred key input materials that have a high dependency on imports from Japan, including minerals, fuels, plastic, rubber, glass, transportation, optical instruments and textiles.

South Korea has passed an extra budget bill of KRW 5.8tn, which includes KRW 273bn to support companies suffering from Japan's export curbs. This public spending is targeted to promote the development of components, to build test facilities and to expand domestic capacity.

In terms of foreign direct investment, South Korea's dependency on Japan has shrunk. Ten years ago, Japan's share of overall FDI to South Korea was higher than 15%, and had spiked to even 27% in 2012. Last year it had fallen to only 5%.

Japanese still make up one fifth of all tourists visiting South Korea, but this share has fallen from 35% earlier this decade. In terms of revenue per capita, the Japanese only spend about one third of what Chinese tourists do and half that of Singapore travellers, for example. This is the result of short-stay tourists making use of numerous one-hour flights between Haneda and Gimpo or a short ferry trip between Fukuoka and Pusan.

How will Japan be impacted?

South Korea is Japan's third largest export destination behind China and the US, with a share of 7% of Japan's exports (see chart on the front page).

There has been a broad based public outcry in South Korea calling for a boycott of Japanese goods. For example, Japanese beer has been spilled publicly, some retail shops have cleared their stock of Japanese products, gas stations have refused to fill Japanese cars with fuel, and there were calls to avoid purchases at a major Japanese clothing retail chain. While this may make headlines and could have negative consequences for specific companies in the cosmetics, fashion and food & drink industries, we believe the overall impact

should be manageable. Consumer goods make up only 13% of Japan's exports to South Korea, compared to 63% intermediate goods and 24% capital goods. Cars account for less than 2%, with Lexus being the most affected brand. South Korea's second hand car market may be impacted as well, as owners of Japanese brands may feel they need to switch to domestic or German brands to avoid any backlash. We also note that some business leaders, parliamentarians, shop owners and ordinary people on the streets have urged for calm and dialog on both sides.

Looking at the other side of the coin, Japanese imports from South Korea make up only 4% of total imports, led by mineral oils and integrated circuits. There are only a few categories where Japan substantially depends on South Korean imports, with South Korea making up more than half of Japan's overall imports, including flat-rolled steel, silver and special chemicals. We believe that potential export controls by South Korea might have a more significant impact on individual companies in the semiconductor industry should South Korea put restrictions on these goods as a retaliatory measure, but would not affect the Japanese economy overall.

Tourism may get hit, as South Koreans are the second biggest tourist bracket behind China

If hostilities between both countries were to persist, Japan's inbound tourism from South Korea could suffer. Tour operators are already scaling back their services to Japan. In 2018, South Korean tourist consumption amounted to JPY 588bn, which is equivalent to about 10% of income from exports to South Korea. Over the last five years the number of South Korean tourists has nearly doubled to 7.5 million, in line with the general surge of inbound tourism in Japan. South Korean tourists account for nearly a quarter of all tourist arrivals, second only to the Chinese. However, it is interesting to note that South Korean tourists spend only half as much as the average tourist in Japan. This is most likely the impact of short weekend trips due to the proximity of both nations, and due to the fact that the age bracket of 20-29 year old makes up the bulk of South Korean tourists in Japan. Koreans in this age bracket spend less than the average older tourist.

Apart from the overall impact of retaliatory measures from South Korea, several Japanese firms are directly impacted. Those supplying the critical materials for South Korea's semiconductor industry said that the announcement of the restrictive export measures had come 'out of the blue' without any warning. However, looking at the share prices of some of the most affected companies does not show any evidence that investors are too concerned. Only one company has seen its share price tumble, but that was not due to the restrictions, but rather due to a disappointing Q2 earnings report.

Potential spillover to other Asian countries is not negligible

We see a direct impact on other countries mainly due to a shortage in memory chips, which make up 72% of South Korea's chip exports. China does not have any domestic mass producer of DRAM and NAND. Last year, nearly half of China's memory-chip imports came from South Korea, while, vice-versa, 81% of all South Korean memory chips were exported to China and Hong Kong. If China was forced to switch from the two big South Korean DRAM producers, in principle only one major US-company could step in as an alternative supplier. However, given the current atmosphere, we believe that China would find it difficult to rely too much on direct US imports or those channelled via ASEAN countries amid the ongoing trade war and the Huawei issue with the US.

Vietnam may suffer most

Vietnam is even more dependent on South Korean semiconductor imports than China or Taiwan. At 42%, the dependency ratio is double as high as that of China, as Vietnam imports nearly two thirds of all memory chips from South Korea. Any shortage would significantly impact Vietnam's exports overall, as electronics exports make up 37% of all Vietnamese exports. Interestingly, one quarter of all exports from Vietnam are produced by Samsung Electronics' local subsidiary, with more than half of the company's global smartphone supply produced in Vietnam.

Sabre rattling likely to continue for now

While the impact of the latest turbulence on trade between Japan and South Korea is not

yet visible, we believe that disruptions will play out over the next few months. We do not believe that a quick solution is imminent. It is unlikely that Japan will withdraw its decisions to remove South Korea from its white list, nor will it back off from implementing stricter export controls for the three important semiconductor-related materials. However, we do not believe that Japan will escalate pressures. There are some signs that could be interpreted as Japan not playing hard ball. Indeed, on August 8th Japan allowed the export of photoresist for the first time since the new regulations started. No South Korean companies have been put on the 'black list', and no new materials have been added to the list requiring an individual export licence. Concerns about the negative impact of direct or indirect South Korean retaliatory measures, as well as international criticism in the media might have played a role.

Global and internal pressure on both countries should help to alleviate tensions

We believe a medium- to longer-term solution will require third-party mediation. South Korea brought up the issue at a meeting of the WTO Council for Trade in Goods and the General Council meeting in Geneva, while Japan claims that its measures are fully in line with WTO rules. However, an official complaint brought to the WTO will take years to be settled. Any mediation attempt by a neutral party, be it a supranational organisation or a neutral country, will probably be done behind closed doors, but may help to end the political deadlock.

The US has already called for a resolution to the conflict, as it is not helpful in the current difficult geopolitical environment that involves both global players and other Asian nations.

Pressure may also come from inside Japan and South Korea, as companies may urge the government not to escalate tensions, similar to the pressure US companies have put on the US government concerning the Huawei issue.

Once companies get accustomed to the bureaucratic procedures, the approval period may get shortened to a month or so, while South Korea will get used to having the same status as other major Asian importers including China, Taiwan and Singapore.

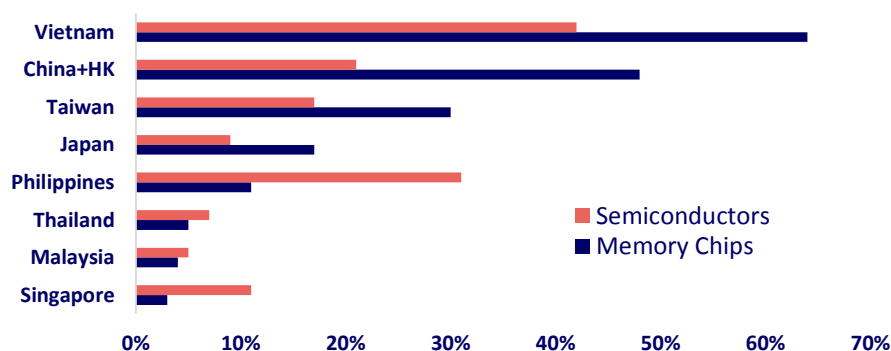
Currently we believe it is rather unlikely that tensions will escalate further. Such a scenario would likely end in a 'lose-lose' trap for both countries and harm other countries dependent on the semiconductor supply chain.

We applaud the latest statement by South Korean President Moon made on Liberation Day, August 15th, calling for cooperation with Japan. Moon said, "We will strive with Japan to create an East Asia that engages in fair trade and cooperation".

What is clear, is that this latest trade friction could not have come at a worse time for global growth and in particular the ailing APAC region.

Vietnam and China are most vulnerable to potential disruptions

Asian Semiconductor Imports from South Korea
(% of total semiconductor imports 201)



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