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Japan and South Korea risk scrambling supply chains further

By: Angelo Katsoras

Relations between South Korea and Japan have always been complicated. The two countries share a bitter history owing to Japan's colonization of Korea from 1910 to 1945.

The latest flare-up occurred when South Korea's top court ruled late last year that Japanese companies using forced Korean labour during World War II could be sued by their victims for compensation. Assets of major Japanese companies, such as Nippon Steel and Mitsubishi Heavy Industries, have been seized. Japan protested the ruling and claimed the matter had been resolved under a 1965 treaty, whereby South Korea agreed to settle all claims in exchange for \$500 million in financial aid and loans.¹

Denying any connection to the court ruling, Japan placed controls on three specialized chemicals in what is widely perceived as a retaliatory move. These chemicals are crucial to memory chip manufacturers (see illustration below). Japan cited national security reasons and fear that strategic information was leaking to North Korea, though no proof was presented.

While Japan dominates the global production of these chemicals, South Korea is a leader in the global production of memory chips. In 2018, for example, two South Korean companies—Samsung and SK Hynix—accounted for 61% of the global market for components used in memory chips.² The controls, which went into effect in early July, mean that Japanese companies must now seek permission each time before shipping any of these chemicals to South Korea. The process can take as long as 90 days.

Three key manufacturing chemicals

	Use	S. Korea's reliance on Japanese firms	
Photoresists	Photosensitive coating agent for semiconductor boards	92.3%	
Fluorinated polyimides	Material for organic EL panels	94.0%	
Hydrogen fluoride	Cleansing of semiconductors	44.6%	

Data from Korean International Trade Association for Jan.-June 2019.

Source: "S. Korean firms suddenly scrambling," Japan News, August 13, 2019

In addition to these controls on exports, Tokyo took South Korea off a list of countries granted preferential trade status. This will allow Japan to impose tighter controls on a wider list of strategic components. Not surprisingly, South Korea responded in kind by removing Japan from a list of trusted trading partners that qualify for accelerated imports of South Korean products (effective early September).

Taking a harder line is politically popular on both sides. Opinion polls show that well over 70% Koreans and Japanese don't trust each other.³ Boycotts of Japanese consumer goods have been organized in South Korea.

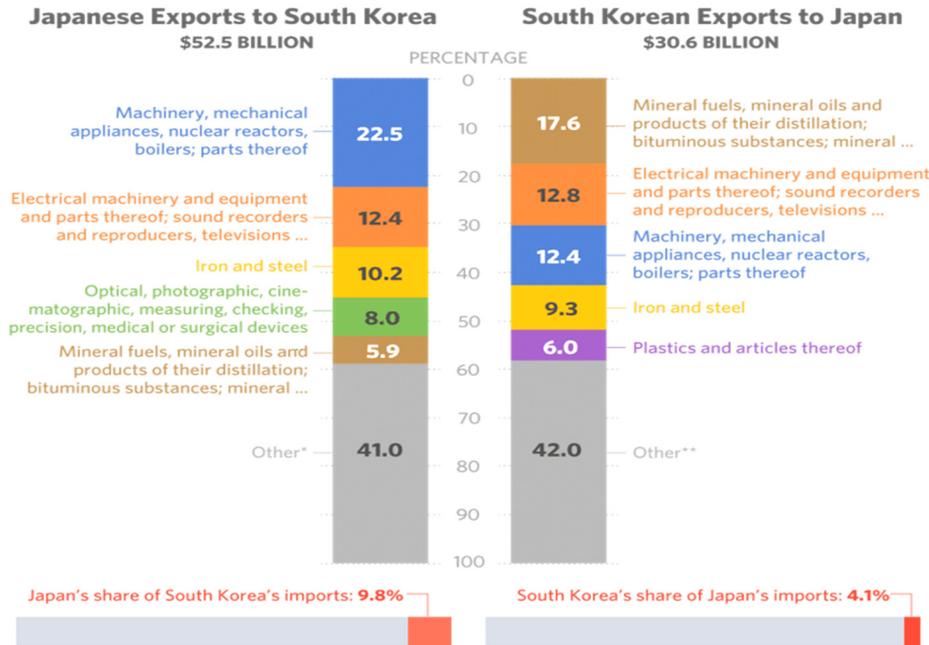
¹ "Where the Cold War Never Ended," The New York Times, August 12, 2019

² "A trade dispute between Japan and South Korea has Trumpian echoes," The Economist, July 18, 2019

³ "3 in 4 Japanese distrust South Koreans – and the feeling's mutual," South China Morning Post, June 12, 2019

South Korea's and Japan's significant trade relationship

South Korean high-tech industries are highly dependent on Japanese materials, components and manufacturing equipment to make chips and other IT products.



Source: "Seoul and Tokyo Stare Each Other Down," Stratfor, July 18, 2019

Conclusion: the potential long-term impact

So far, the actions of both countries have not halted trade, but only slowed it down. However, the repercussions of this breakdown in trust will be difficult to reverse for the reasons listed below. The announcement of negotiations, while welcome, would do little to change this dynamic in the near future.

- The potential to scramble supply chains further. Even before these recent tensions, South Korean and Japanese companies looking to avoid U.S. tariffs and rising labour costs were struggling to find alternatives to China as a manufacturing base.
- South Korea announced that it would strive to end its high-tech electronics industry's reliance on key Japanese materials. The undertaking is being backed up by \$6.5 billion in new government funding. Some argue that instead of investing heavily in areas dominated by Japan, South Korea would do better to invest in sectors where it has a competitive advantage.
- The growing global trend of using punitive trade measures to advance geopolitical objectives. Japan's claim that it imposed exports restrictions on South Korea for reasons of national security is similar to the justification given by the United States for imposing tariffs on steel and aluminum. Japan and the United States have another thing in common in this regard: They both argue that the WTO lacks the authority to challenge decisions taken for reasons of national security. Ultimately, all this means that companies must increasingly analyze whether their business models and supply chains are compatible with the geopolitical objectives of their main export markets. This in turn will force many companies to build back-up supply chains, thus raising costs and reducing efficiencies.
- China, which is focused on building its zone of influence in Asia, would be the real winner of a long-term fallout between Japan and South Korea. The middle kingdom could also benefit from these tensions by becoming a major alternative supplier for both countries in certain sectors. Finally, the split will also make it more difficult for the United States to maintain a united front with its Asian allies against North Korea.

Bottom Line: Geopolitical-driven events continue to reconfigure supply chains.



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