

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Whither the Japanese Defense Industry

by Norihisa Fukuyama and Douglas F. Ramsey, Jane Information Group

For decades now, most of the major Japanese corporations have relegated their defense activities to dark, unfrequented corners of their corporate machines. Defense production in Japan has been a domain reserved for the few, who were willing to bid and produce products and systems for a single user in a single market. Japan's tight legal controls and prohibitions against arms exports or the export of technology and equipment designed for military applications meant that companies venturing into defense production had to accept a stove-piped marketplace, which funneled all of their products and equipment to the Japan Defense Agency (JDA).

While the profit margins may be thin, the opportunities are impressive for the major manufacturers involved. Similar in scale to its

commercial market stature, Japan represents one of the world's largest defense markets after the United States, Russia and China, with over \$42 billion spent annually by the JDA. In fact, Japanese defense contractors have a surprisingly consistent and stable market for their goods and services. The JDA looks to its domestic industries first when procuring and acquiring defense equipment. Japanese defense industries will frequently partner with foreign partners, usually from the US. But these arrangement usually benefit domestic Japanese firms far more by enhancing their product offerings with new or more robust technologies and strengthen their position for future related bids.

This stable environment may soon get a large influx of cash, which will send domestic defense manufactures in new directions and further bolster the market. The 2004 defense budget calls for significant new spending on the Japanese components of missile defense, new GPS enabled air-to-surface missiles, and a major new destroyer. These new requests have been anxiously awaited by numerous Japanese companies and their potential US partners for

several years and now the opportunities seem to be at hand.

Longer-term changes, however, are all tied into the domestic debate about how Japanese armed forces will redefine their role at home and abroad in the near term and in years to come. Several of the big questions emerging now are how and to what extent will Japan assist the US in its ongoing "war on global terrorism." Japan and the Koizumi administration have already demonstrated a willingness to play a larger role – the question now becomes how the Japanese build or adjust the legal framework to accommodate this increased willingness to act. These decisions seem sure to have important repercussions on future Japanese defense requirements and may draw Japanese industry out of its domestic market and into the international domain.

Political Shifts

Talk of changing the way that leading defense companies operate and even of how they may operate or partner overseas is now gradually emerging, even if only behind closed doors. A special delegation of Diet members specializing in US-Japan security issues have paid spring visits to Washington DC for the past dozen years. This dele-

Currently No.36 September 2003

**U.S. and Japanese Business Support
New and Improved Tax Treaty** 6
*by Jim Fatheree,
US-Japan Business Council*

**'Heads Up on Hot Topics Affecting
the US and Japan'** 8
*by Christopher Roberts,
Report from Cancun:
The WTO Ministerial*

Whither the Japanese Defense Industry

gation is usually led by one or more former JDA ministers. Over the past several years this delegation has become increasingly diverse, with representatives from opposition parties also participating. For the first time, this year's delegation, composed of two former JDA ministers and a host of opposition diet members, was accompanied by the president of Mitsubishi Heavy Industries (MHI). The message, while not explicit, seemed clear: there are major domestic commercial interests at play in the upcoming round of Japanese defense procurements.

Since the end of the first Gulf War, Japan has quietly set about sloughing off the charge of "checkbook diplomacy," or the idea that Japan could contribute to international security operations through financial assistance alone. Since then the US and Japan have gradually expanded their security dialogue and Japan has enacted a series of legislation which has appreciably strengthened Japan's ability to participate overseas and in cooperation with US forces. Today Japan participates in peacekeeping operations around the globe and has played an important support role in the war on terrorism and provides logistical support to US forces as far away as the Indian Ocean.

Japan now faces a number of difficult political challenges which maybe increasingly driven by a growing domestic sense of threat from North Korea and pressures to play a more active role in international security affairs. In addition to political factors that affect change, emerging commercial interests are moving to the forefront as more Japanese companies recognize the value of their defense operations and seek ways to increase their return on investments.

"Japan represents one of the world's largest defense markets after the United States, Russia and China, with over \$42 billion spent annually by the Japan Defense Agency (JDA)."

Since 1967, Japanese companies have been barred from exporting overseas under the so-called 'three principles of weapons exports.' These principle ban arms exports to 1) communist countries; 2) countries subject to UN resolutions banning arms sales; and 3) countries which may potentially be involved in international disputes.

A 1976 revision to the three principles effectively imposed a total ban on all Japanese arms exports, including to the US. But

with major growth about to occur in the domestic market, minor factions have already emerged in industry and government who recognize the need to revisit these restrictions, especially as they pertain to Japanese main security partners and allies.

The Coming 'Big Bang'

In 2003, the Japanese defense budget suffered its first reduction in four years. In August 2002, the JDA submitted a request for slightly more than ¥5 trillion. This number was later adjusted in December 2002 to ¥4.95 trillion for the

Japanese fiscal year (April 2003 to April 2004). Most of the cost-cutting occurred in personnel and equipment procurement expenses.

While Japan remains the one of the largest defense markets, approximately 45 percent is tied up in recurring expenses, such as military provisions and personnel costs. This is the highest percentage of any military in the world. When placed in this context, the relatively minor adjustments made by the JDA

“For 2004, the JDA has rolled out an impressive wish list of big ticket items which will represent significant, multi-year defense programs. While overall spending levels have not changed dramatically, a major shift has occurred toward purchasing new defense systems and equipment.”

and the Ministry of Finance in 2002 seem more like a cost correction than a budget reduction.

For 2004, the JDA has rolled out an impressive wish list of big ticket items which will represent significant, multi-year defense programs. While overall spending levels have not changed dramatically, a major shift has occurred toward purchasing new defense systems and equipment.

First and foremost on this list is a ¥142.3 billion request for missile defense in FY2004. This cash infusion would be used to upgrade current air defense systems at land and on the sea. Japan's missile defense system would have two levels of protections represented by the Aegis destroyer-based Standard Missile-3 (SM-3) and the Patriot Advanced Capability (PAC-3). The SM-3 system is a sea-based capability designed to intercept incoming ballistic missile in the upper atmosphere. The PAC-3 system is a land-based capability that would intercept ballistic missile during their final descent.

The PAC-3 would replace Japan's current PAC-2 systems.

Of the ¥142.3 billion requested for missile defense in 2004, ¥54.2 billion would go to support the upgrade of the Aegis destroyers with the SM-3 capability; ¥76.6 billion would be for procuring PAC-3 capabilities; and ¥8 billion would be reserved to continue to support ongoing Japan-US joint missile defense research which has been ongoing since 1999.

JDA aims to lock-in sufficient funding to support the development of the nation's missile defense system through 2010. This would include securing funding for the maintenance of one Aegis-equipped destroyer and one PAC-3 group every year from fiscal 2004 through fiscal 2007. This would require approximately ¥500 billion for this 4-year period. The JDA aims to have the full missile defense system in place by 2010.

There will be numerous additional investments in command, control, communications, and computers to support these new systems in the out years to support the

integration of these systems. The JDA has already decided to develop improved radar with advanced early warning capabilities. JDA is planning to request approximately ¥15 billion in FY2006 for this system which is being designated FPS-XX. The JDA hopes to have four FPS-XX systems in place at radar sites on the Sea of Japan by 2011.

The JDA has also requested approximately ¥115 billion to procure GPS guidance systems for insertion into their current air-to-surface missile systems. This enhanced capability would effectively convert the JDA current air-to-surface arsenal into a Joint Direct Attack Munitions (JDAM) capability similar to the missiles used by US and UK forces in the Iraq campaign.

Another major addition this year is the request for a 13,500 ton destroyer that is being characterized as a helicopter carrier. The new ship would be the largest destroyer deployed by Japan since the Second World War and cost ¥116 billion to build and deploy by 2008.

Finally, JDA is requesting an additional ¥38 billion to strengthen border security given rising concerns about infiltration by North Korea agents and spy ships. The Japanese coast guard would receive

Continued on page 4

Whither the Japanese Defense Industry

DEFENSE COMPANY	DEFENSE PRODUCTS
1. Mitsubishi Heavy Industries, Ltd.	Ships, military vehicles, aircraft, & missiles
2. Kawasaki Heavy Industries, Ltd.	Ships & aircraft
3. Ishikawajima-Harima Heavy Industries, Co., Ltd.	Ships & engines
4. Mitsubishi Electric Corporation	Electronics & missiles
5. Toshiba Corporation	Electronics & missiles
6. NEC Corporation	Electronics
7. Fuji Heavy Industries, Ltd.	Aircraft
8. The Japan Steel Works, Ltd.	Artillery
9. Komatsu, Ltd.	Small arms, ordnance, & military vehicles
10. Hitachi, Ltd.	Electronics & military vehicles
11. Oki Electric Industry Co., Ltd.	Electronics
12. Daikin Industries, Ltd.	Small arms & ordnance

SOURCE: US DEPARTMENT OF COMMERCE, BUREAU OF INDUSTRY AND SECURITY, 1999

almost ¥10 billion of this amount to improve their abilities to track, capture, and analyze suspicious ships off the coast of Japan. The majority of these funds, however, are being channeled into improving counter-measures to guerrilla attacks at home.

Who's in the Pole Position?

The world of Japanese defense contractors is very narrow. According to the most recent statistics released by the US Department of Commerce, only 12 companies account for 95 percent

of JDA's total acquisition budget. The following table lists these companies and their major defense product lines.

As demonstrated by the table, Mitsubishi Heavy Industries (MHI) is Japan's most diversified defense company and has the most room to play in most of the major procurement programs currently emerging. However, several other companies have equally strong positions in the market, thanks in large part to their willingness to participate in the earlier research stages of efforts such as missile

defense. Equally, there are several US and other international companies who stand to gain in this market due to their existing ties with domestic Japanese partners or through their technology leadership in several key systems or applications.

First, a cursory review of past market successes should indicate who currently has the lead in upcoming contracting opportunities. In July 2003, the JDA's Central Contract Office (CCO) released data pertaining to total

fiscal 2002 procurement costs, which amounted to ¥1.279 trillion.

Not surprisingly, MHI ranked in first place as the biggest defense supplier, with contracts valuing over ¥348 billion. MHI builds several key missile defense components such as the advanced Aegis radar system and the PAC-2. Kawasaki Heavy Industries (KHI) ranked second with over ¥110 billion in contracts, followed closely by Mitsubishi Electric Corporation (MELCO) with approximately ¥73 billion in contracts. Ishikawajima-Harima Heavy Industries (IHI) received over ¥52 billion, while Toshiba Corporation fell just shy of ¥50 billion. Despite not being ranked amongst the top defense contractors, Itochu Corporation had a surprisingly good year, having received a key order from JDA to act as the trading house responsible for procuring a Boeing 767 oil-supply and transport plane worth over ¥23 billion in 2002.

Early movement already indicates that the regular lead contractors will continue to win the majority of forthcoming contract opportunities and, not surprisingly, MHI seems well positioned to receive numerous contract leads. The JDA decided in June 2003 to seek permission from the US to allow a Japanese contractor to build the PAC-3

system domestically. The JDA has already designated MHI as the most likely candidate for effort. By contrast, the SM-3 is unlikely to be developed domestically due to the highly sensitive technology used in this system.

Mitsui Engineering and Shipbuilding Co. is already competing openly with IHI for acquiring key overseas elevator technology for the new helicopter carrier. Mitsui has obtained a license for production from US-based Jered Industries while IHI has licensed similar technology from UK-based Strachan & Henshaw. Both plan to incorporate these technologies into their upcoming bids.

Conclusions

As Japan continues to 'normalize' its defense policies, it seems certain that there will be a trickle-down effect on Japan's domestic industries. Some of these industries, however, may prove to be more vocal in their desire to see changes to the export control laws that currently confine them to the domestic markets. The current 'big bang' in defense procurement may just be the impetus to drive Japanese defense companies to want to open to foreign markets. Moreover, JDA may find it attractive to lobby on behalf of these sup-

pliers in order to see their production costs lowered.

Because of the current single market environment, domestically produced Japanese defense equipment and products cost substantially more than their foreign made counterparts. Japanese defense could achieve immediate cost reducing through mass production for foreign markets. Additionally, many Japanese defense companies may start to become increasingly vocal about recouping the costs of their military R&D efforts by looking to gradually relax export restrictions. However, there remains major political and public perception hurdles to overcome before this can be achieved, yet, the dialogue seems well underway. ■

Norihisa Fukuyama is an Information Consultant with Jane, Information Group in Tokyo, Japan and can be reached at norihisa.fukuyama@janes.jp.

Douglas Ramsey is Jane, Consultancy, Manager for North America and the Asia-Pacific in Washington DC and can be reached at douglas.ramsey@janes.com.

US and Japanese Business Support New and Improved Tax Treaty

by Jim Fatheree, US-Japan Business Council

After three years of formal negotiations and a good many more of informal discussions, the US Treasury Department and Japan's Ministry of Finance announced on June 10, 2003, an "agreement in principle" to revise the 32-year-old US-Japan Tax Treaty. The existing treaty has been in effect since 1971 and, as such, no longer reflects the realities of the bilateral economic relationship.

In particular, foreign investment flows between the United States and Japan have grown exponentially since the original treaty was signed, as multinationals from each country have established major operations in the other. Many US and Japanese companies now earn a substantial portion of their income from their operations in Japan or the United States, so a new treaty offering better tax treatment is essential to further growth in the bilateral business relationship.

Work on the proposed revisions is still underway. Legal and tax experts from Treasury, the US State Department, Japan's Ministry of Foreign Affairs, and Ministry of Finance are still going through the treaty text line-by-line and translating the necessary documents. Details will not be released publicly until this process is complete, likely in October 2003, at the earliest.

It is clear from US Treasury officials' statements that the broad objective is to bring this important treaty more in line with other bilateral income tax treaties that offer lower withholding rates. The existing treaty contains withholding rates of 10 percent on interest, dividends, and royalties — levels which exceed both the US and OECD Model Rates.

The Treasury Department generally supports lower withholding rates due to the globalization of the US economy, and as a way to facilitate the free flow of investment across borders. Thus, while the exact rates agreed to in the revised treaty are not yet known, it is likely that they will offer significant improvements over current levels. Improvements in dispute settlement procedures (arbitration and transfer pricing provisions) were also an important part of the negotiations. MOF also hopes to use this treaty as a model for tax treaty revisions with other countries.

Treasury Secretary John Snow was enthusiastic in his June 10, 2003 announcement of the "agreement in principle" when he spoke to the Japan Society of New York:

"The proposed treaty reflects both the deepening economic ties between the United States and Japan and the globalization of our

two economies. The proposed treaty reduces barriers to trade and investment between the United States and Japan through substantial reductions in source-country withholding taxes on royalties, on certain interest, and on certain inter-company dividends. Achieving a new and improved tax treaty with Japan has been a priority. We are pleased to have worked together with our Japanese partners to achieve an agreement that will benefit the economies of both of our countries, and I look forward to signing this important agreement without delay."

Diverse US companies with significant business operations in Japan have been working toward treaty revision for a number of years through the National Foreign Trade Council, the US Council for International Business, and the US-Japan Business Council (USJBC).

The USJBC, which is comprised of many of the leading US companies operating in Japan, and its Japanese counterpart, the Japan-US Business Council, proposed in 2000 that the governments advance negotiations to the "formal" stage. Since then, the Councils have continued to stress the need for a revised treaty that would provide lower withholding rates on dividends, royalties, and interest as well as improved dispute settlement and

“An improved bilateral tax treaty offers significant benefits to US and Japanese companies, as well as to both economies.”

other procedures. USJBC member companies are, of course, pleased that negotiators have reached an agreement in principle, and commend Treasury and MOF negotiators for their diligence and responsiveness.

The goal at this point is for US and Japanese negotiators to finalize the treaty as soon as possible so that it may be taken up immediately in the US Senate and Japanese Diet. The rough timetable calls for the proper authorities in both countries (Secretary of State or the US Ambassador to Japan; Japan's Minister of Foreign Affairs) to sign the Treaty, probably sometime in October. Once signed, the Treaty is subject to ratification in the US Senate and Japanese Diet.

Ideally, the Senate Foreign Relations Committee could “receive” the Treaty before year end, but much depends on other legislative priorities. The Foreign Relations Committee is constitutionally obligated to review the treaty explanations provided by the Treasury Department, as well as statements offered by other parties. It may report the treaty to the full Senate with a recommendation for approval as is, or with certain

amendments, reservations, or understandings. As with all treaties, a two-thirds Senate vote is required for ratification.

But given the Japanese elections and other pressing business this fall, the Diet is unlikely to consider the treaty until January 2004. From there, it is not clear how soon ratification can occur, although some experts think it could be early in the second quarter.

An improved treaty offers significant benefits to US and Japanese companies, and to both economies. In particular, as Japan pursues its goal of doubling foreign direct investment, lower taxes on income earned by foreign corporations in Japan – a notoriously high tax environment – could help boost foreign investment there. Coupled with a separate US-Japan Social Security Agreement, the new treaty will also benefit Japanese corporations with affiliate operations in the United States.

For this reason, it is important to make the revised treaty “effective” at the earliest possible date. Under normal US procedure, tax treaties can go into effect two months from the exchange of articles of ratification from both legislative bodies.

Potentially, this could mean lower withholding rates for US companies in Japan as early as January 2004. In Japan, there are reports that the “effective date” could be January 2005, regardless of when the treaty is ratified in the Diet.

The USJBC hopes this is not the case, as it would further delay a process that has been underway for a decade. We therefore will continue to work with US and Japanese companies to see that the treaty moves through each stage as quickly as possible. It is in the interests of US and Japanese businesses, and the two economies, to do so. ■

James W. Fatheree is President and COO of the US-Japan Business Council, a Washington-based association of diverse US companies with business operations in Japan. The USJBC works independently to promote US business interests in Japan, and with a separate Japanese counterpart group, the Japan-US Business Council, on areas of mutual concern such as the US-Japan Tax Treaty. He can be reached at: www.usjbc.org

Heads Up On Hot Topics Affecting the US and Japan

KKC's monthly program featuring experts on breaking issues of importance to both countries.

Report from Cancun: The WTO Ministerial

The World Trade Organization's agenda in Cancun, Mexico was a "big meal to digest in just five days," said Christopher Roberts, a Senior Trade Analyst with the law firm Covington & Burling LLP and a former Director-General of Trade Policy with the British Government.

Speaking at the September 16 'Heads Up' program, Roberts explained that just ten years ago it was easier to get consensus within GATT. But today, with 148 WTO member countries, divergent interests between the world's industrial powerhouses and those of impoverished, agrarian-based economies understandably emerged on the ambitious Doha Development Agenda (DDA).

In the end, he said, Cancun's failure was a result of a combination of factors – profound disagreements over how far and how fast agriculture subsidies could be cut; whether and how the four "Singapore Issues" could be accommodated (trade facilitation, transparency in government procurement, investment, and competition policy); political miscalculations by inexperienced negotiators, WTO rules which allow a small bloc of countries to torpedo discussions; and possibly

Chairman Derbez's premature closing of the ministerial.

In the wake of the collapsed meeting, the unfinished issues will be sent back to Geneva where WTO officials will use the revised draft (issued on September 13) as a baseline for continued discussions. It is unclear whether a "mini ministerial" will be held in early 2004, as has been tentatively discussed, because a number of key countries – the United States included – will hold elections next year. In any case, Roberts contended, achieving the DDA's January 1, 2005, deadline is "very unlikely indeed."

The impact of Cancun on business interests is difficult to quantify. The quality of the services offers by countries are generally poor in quality and to date, only 38 of the 148 countries have tabled any proposal. An issue ripe for conclusion is trade facilitation (essentially, customs and regulatory changes that remove impediments to trade), but it is unclear whether those negotiations can be completed, given they are tied to the other three Singapore Issues. And eliminating or reducing industrial tariffs (so-called non-agricultural market access, or NAMA) is an issue of top priority to industrialized countries. Here again, given the failure of Cancun, it is unclear whether this issue can be resolved.

Sadly few, if any, "winners" walked away from the wreckage of Cancun, Roberts concluded. And it remains to be seen whether the US and EU and other industrialized countries will begin to look to bilateral and plurilateral arrangements to advance their trade and investment interests, or whether they will make a renewed commitment to the World Trade Organization. ■

Publisher, Keizai Koho Center

Director, Katsunori Nemoto
nemotok@kkc-usa.org

Editor, Valerie Ploumpis
vploumpis@kkc-usa.org

1900 K Street NW
Suite 1075
Washington DC 20006
202 293-8430

www.kkc-usa.org

Keizai Koho Center (KKC) is an independent, non-profit organization designed to promote the understanding of Japan's economy and society at home and abroad. Its financial resources are derived entirely from the private sector.

KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

The views expressed in this newsletter are of the contributors and do not necessarily represent those of the Keizai Koho Center.