Proposal for the National Defense Program Guidelines

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Keidanren

１．Security environment surrounding Japan

The security environment in Northeast Asia continues to become tense. North Korea launched a missile which they claimed to be a “satellite” in December 2012 and implemented the third nuclear test in this February. The tensions continue as they show signs of launching yet another missile. Drastically increasing the defense budget, China is actively promoting marine deployment while simultaneously proceeding with the development of aircraft carriers and stealth fighters.

In response to current situation including the above, U.S. is making a military transformation on a global scale and showed the stance to rebalance toward the Asia-Pacific region in the Defense Strategy in January 2012. The QDR (Quadrennial Defense Review: Review of the defense program of the United States conducted every four years) is also scheduled next year, and Japan must pay close attention to its impact.

The range of activities of the Japan Self-Defense Forces has been expanding. For example, their sincere efforts in disaster relief activities in the damaged area of the Great East Japan Earthquake as well as their participation in the international peace cooperation activities in South Sudan, etc. is noted and the importance of the Self-Defense Forces is highly recognized in Japan.

After the change of the ruling party in 2012, the government has decided to review the National Defense Program Guidelines and develop the new Mid-Term Defense Program by the end of this year. Currently, the “Committee for Discussions and Review of Defense Capabilities” in the Ministry of Defense is holding specific discussions.

Keidanren Defense Production Committee has dispatched the investigation mission on the Defense Industrial Policies in the U.S. and European countries 4 times since March 2010, including the “Fact-Finding Mission on Defense Industrial Policies to Italy and the U.K.” from January to February of this year. This time, Keidanren has newly formulated the Proposal for the National Defense Program Guidelines, taking the results of the above activities and the current state of the defense industry into consideration.

2. Significance of defense production and technological base

The defense industry plays an important role in the entire lifecycle of defense

equipment. Maintaining and strengthening of defense production and technological base are critical responsibilities of a nation. The significance of defense production and technological base includes the following 5 points;

1) Deterrent capabilities and sovereignty based on advanced technological capabilities

High-level technological capabilities enhance deterrent capabilities and diplomatic negotiation power to inhibit invasion by other countries, ensuring national sovereignty without dependence on other countries.

2) Speedy procurement, operational support and improvement of equipment

Defense industrial base makes it possible to implement speedy procurement of equipment in an emergency, quick trouble-shooting and repair, improvement of the equipment in line with technological advancement. As a result, higher operational availability[1] and safety can be ensured.

Imported equipment requires a long time for repairing overseas. Therefore a large number of additional items are necessary to operate during the repairing time, often resulting in a higher expense.

3) Development and production of equipment suited to national geographical characteristics and conditions in Japan

It is important to develop and produce equipment and provide operational support best for national defense. It must be suitable for the geographical environment of the Japanese Islands, surrounded by sea in all directions and replete with mountainous areas and isolated islands, and the nonaggressive national security policy.

4) Technological and economic ripple effects

Development and production through domestic investments by utilization of defense production and technological base will lead to the development of domestic industries and creation of new jobs. The development of advanced defense technologies will bring about new technological breakthroughs and major technological ripple effects to civilian sectors.

5) Participating in international joint development/production with advantageous tasks, and ensuring bargaining power in case of imports or licensed production

Advanced technological capabilities in defense production and technological base are necessary to acquire an advantageous position among participating countries in international joint development/production. These capabilities will facilitate Japan's bargaining power in negotiating prices and technological disclosures of foreign equipment in case of import or licensed production in Japan.

[1] The percentage of time that the equipment is being operated properly when necessary. In the case of fighter aircraft: Air capabilities (Number of operable aircraft) = Number of deployed aircraft×operational availability.

3. Current state of the defense industry

Defense capabilities are the key for national security of Japan. The role of the defense industry, leading the development and production of defense equipment and supporting the operation of the Self-Defense Forces, is becoming increasingly important in the tense security environment surrounding Japan.

As Japan's defense-related budget has continuously been reduced, new contracts of major equipment, which peaked at 1.07 trillion yen in FY1990, has gradually decreased and dropped to about 700 billion yen in FY2012, which is about 60% of the peak value. After the change of the government in December 2012, the decrease in defense-related budget was stopped, and the defense budget has increased by approximately 35 billion yen in FY2013 compared to the previous year. This is the first increase since FY2002. Appropriate amount of budget for equipment, which is necessary for Japan's national security, is expected to continue in the future.

The U.S. and European countries have been promoting mergers & acquisitions of the defense industry in response to the decrease of defense budget and proactively promoting globalization in order to maintain defense production and technological base. Furthermore, international joint development/production of equipment has been promoted in response to the enhancement of defense technologies and the rising development cost.

On the other hand, major defense companies in Japan have maintained the production/technological base by shifting resources toward civilian sectors for the time being and utilizing civilian technologies as measures in response to defense budget decrease. However, some companies, which have exceeded the limit of their streamlining efforts through business scale reduction, are being forced to reduce or withdraw from defense business.

As for mergers & acquisitions, Japan's defense business is basically limited to domestic market unlike the U.S. and European countries. Due to management risks such as the difficulty to foresee the long-term operational prospect under the long-term reduction trend of defense equipment budget etc., mergers & acquisitions has not been promoted.

As the development of defense equipment and bringing up of engineers require a long time, it would be extremely difficult to recover defense production and technological base if it were lost. Therefore, realistic measures to maintain the Japanese industrial base are required.

4. Defense Industrial Policies

(1) Formulation of strategies for defense production and technological base

The final report summarized in June 2012 by the Study Group on Defense

Production and Technological Base of the Ministry of Defense presented the basic policy of selecting the key areas that should be maintained within the country according to the criteria such as “strategies”, “confidentiality” etc. and seeking for “indigenous production,” “licensed production,” and “international joint development/production” for the key areas in order to maintain/strengthen the defense industrial base. It is necessary to actually clarify key areas and also ensure financial support to maintain/strengthen the industrial base in the future.

In addition, the ratio of research and development investment within defense budget in Japan is lower than other countries. It is necessary to increase the research and development investments in order to enhance technological capabilities. The DARPA (Defense Advanced Research Project Agency) of the U.S. Department of Defense promotes proactive investments in future technologies applicable to equipment for technical advantages. Part of these technologies has spilled over to civilian sectors, leading to drastic technical innovations like Internet and GPS etc. Such basic technical research is also necessary in Japan in order to improve the overall development capabilities for advanced technology including civilian sectors.

Dual-use technologies which are applicable to both defense and civilian products are often used in developing aircraft, such as transport aircraft and amphibious planes etc. Conversion of such equipment to civil usage is easy to apply, therefore should be promoted from the viewpoint of maintaining defense production and technological base.

(2) Promotion of international joint development/production

1) Making individual exemptions for Three Principles on Arms Exports etc.

Based on the Three Principles on Arms Exports in 1967 and the unified government view on arms exports in 1976 (hereinafter referred to as the “Three Principles on Arms Exports etc.”[2]), arms exports and arms technology transfer have essentially been banned in Japan except in certain cases, such as Japan-U.S. joint development/production of the ballistic missile defense system etc.

Based on the trend of international joint development/production for equipment, the “Guidelines for Overseas Transfer of Defense Equipment etc.” was announced in December of 2011 regarding the Three Principles on Arms Exports etc. These

[2] “The Three Principles on Arms Exports,” stated by then Prime Minister Sato at the Committee on Audit in the House of Representatives in 1967, is the government’s policy not to permit arms exports to: (1) communist bloc countries; (2) countries to which arms exports are prohibited under U.N. Resolutions; and (3) countries which are involved in or likely to be involved in international armed conflict. In 1976, then Prime Minister Miki stated at the Budget Committee in the House of Representatives “the unified government view on arms exports” to refrain from arms exports to areas other than those that are applicable to the Three Principles on Arms Exports. The above two are collectively called “the Three Principles on Arms Exports, etc.”

guidelines have stipulated that comprehensive exemption measures are to be taken in overseas transfer of defense equipment etc. for cases related to peace contribution and international cooperation as well as for cases regarding international joint development and production of defense equipment etc. that contributes to Japan's security. Furthermore, the Statement by Chief Cabinet Secretary that F-35 components produced by industries of Japan is outside the Three Principles on Arms Exports etc. was announced in this March. F-35 is being developed through international cooperation of 9 countries[3] including the U.S. This statement refers to the maintaining, cultivating, and sophisticating of Japan's defense production and technological base in addition to the necessity of F-35 in security, considering the importance of the defense industry.

The advantages of participation in international joint development/production contain the enhancement of relationships with allies and friendly countries in foreign policy, access to the latest overseas technologies, reduction of development cost, security of interoperability, and equipment improvement through feedback on operational information etc. On the other hand, production work-share becomes more complicated if the number of participating countries increases in multiple-country joint development. It is necessary to solve such issues as extra time and additional cost for adjustment and a delay of development schedule.

Considering the Japan-U.S. alliance, the U.S. is the most important country as a partner of international joint development/production. However, it is expected that Japan will promote its globalization of defense industry through collaboration with European countries which share the values of democracy and have an abundance of experience in international joint development/production. That will lead to the maintaining of defense production and technological base in the future.

Between Japan and European countries, intergovernmental discussions have been held regarding international joint development/production program especially with the U.K. Realization of specific joint program is expected in the near future. In addition, governments and defense-related companies of Italy, France, Germany, and Sweden, as well as EU, and NATO (North Atlantic Treaty Organization), which Keidanren Defense Production Committee visited for investigative missions, have also expressed their expectations toward cooperation. Keidanren hopes that Japanese government, on its part, will also promote cooperation with these countries etc.

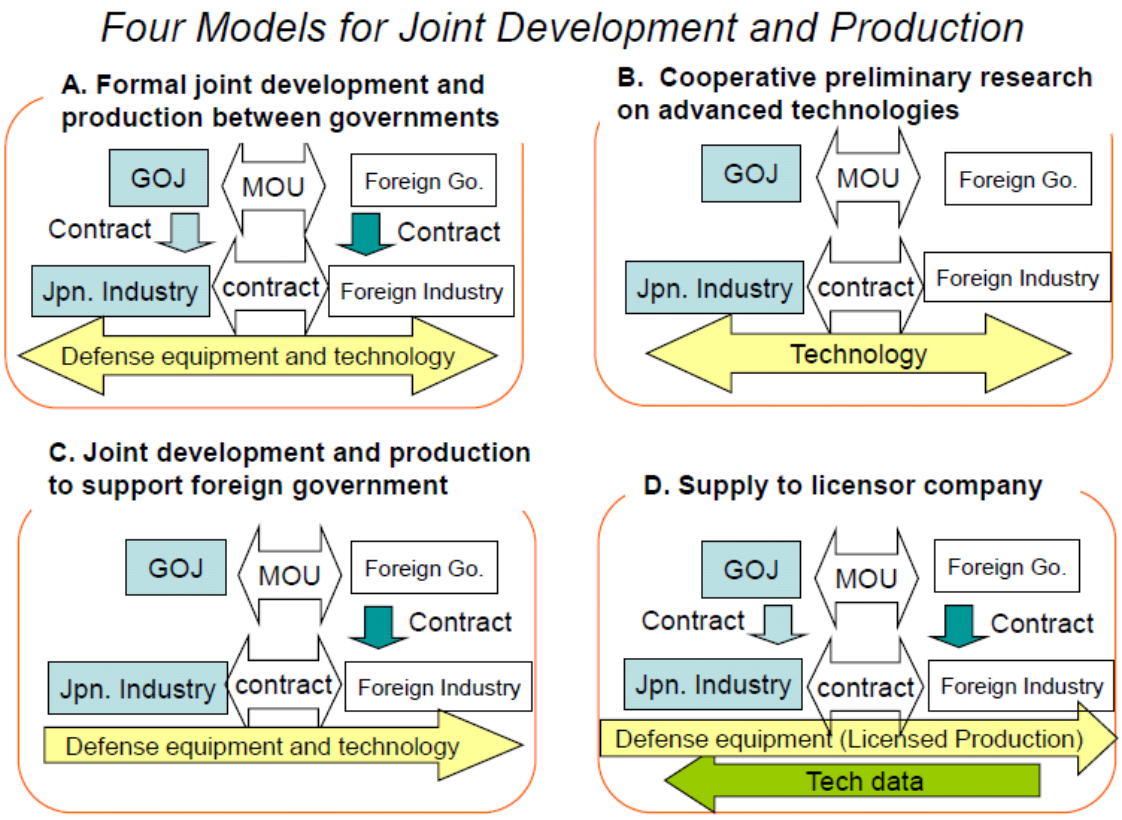
2) Three Principles on Arms Exports etc.

Keidanren Defense Production Committee and the Aerospace and Defense

[3] 9 countries, including the U.S., U.K., Italy, Netherlands, Turkey, Australia, Canada, Denmark, and Norway are the joint development countries.

Committee of the American Chamber of Commerce in Japan (ACCJ) summarized the "Joint Statement on Defense Industry Cooperation between Japan and the United States" in July 2012. This statement categorized the types of international joint development/production into 4 models (A. Joint development/production of defense equipment based on intergovernmental agreement, B. Cooperative preliminary research on advanced technologies, C. Joint development/production to support foreign governmental programs, and D. Supply of licensed production items in response to requests by the licensor company). Thus, international joint developments/productions are supposed to contain not only typical intergovernmental program but also various private-level cooperation.

When applying the "Guidelines for Overseas Transfer of Defense Equipment, etc." stipulated in December 2011, however, it should be made clear which of the above 4 models is possible to be implemented as "international joint development/production of defense equipment", considering Japan's contribution and responsibility for the program etc.



Regarding international joint development/production of defense equipment, conclusion of Memorandum of Understanding (MOU), etc. between governments, establishment of an appropriate control system for extra-purpose use and transfers to third parties, and conclusion of information security agreements etc. that enables

sharing of technical information regarding equipment would be required. Therefore, Keidanren hopes that such frameworks will be swiftly established.

In addition, for those with less contribution and responsibility of Japan for the program like “Supply to licensor’s country”, the criteria of transfers to third parties etc. must be considered flexibly in accordance with international practice.

As for the areas/items/technologies of international joint development/production of equipment, even if it is on a private company level, government should stipulate for them in long-term technical strategies in the “Strategies for Defense Production and Technological Bases.”

(3) Improvement of acquisition and procurement policy

Improvement of acquisition and procurement policy is a pressing issue for the industry and government. Establishment of a system that can appropriately evaluate company’s cost and risks, improvement of a system to derive incentives for company cost reduction, and discussions and review of contract methods for adequate sustainability of defense business etc. are urgently needed.

Especially with procurement reform, current general contracts tend to have more risks, such as additional cost required to clarify specifications and additional cost from economic fluctuations aside from currencies etc., on industry side. Cost reduction efforts are only required on industry side even in incentive contracts. Currently, industry must share the results with the Ministry of Defense. Review of such unilateral characteristics and establishment of a contract system for fair risk-sharing between the industry and government are required. In addition, review of cost structure is being promoted in order to reflect actual industrial activities. Thorough implementation of the review is expected.

For the stable continuation of defense business, establishment of government-industry partnerships through utilization of long-term contracts etc. would lead to the stable and WIN-WIN relationships. Industry, on its part, hopes to work on this issues hand in hand with government.

5. Promotion of space development and utilization and cyberattack responses

(1) Promotion of space development and utilization

Space and cyber space are positioned as new areas that are as critical as land, sea, and air in security.

The Basic Space Law developed in 2008 and the Law Concerning Japan Aerospace Exploration Agency revised in June 2012 has expanded the space utilization area to security.

On the other hand, the “Basic Plan for Space Policy” stipulated by the government

in January 2012 has incorporated several programs applicable to security purpose, such as information-gathering satellites etc. However, space development and utilization focused on security is to be promoted based on the conclusion of the National Defense Program Guidelines review. Clear positioning of space development and utilization in defense area in the National Defense Program Guidelines and the Mid-Term Defense Program is required.

(2) Response to cyberattacks

Cyber space has become a key infrastructure in developed countries that depends on computer networks including the internet.

Measures should be stipulated in the National Defense Program Guidelines and the Mid-Term Defense Program, and their implementation is urgent so that national security is not threatened by cyberattacks to the government and companies that might result in major damage in key infrastructures etc. Therefore, promotion of sophisticated technical development and bringing up of special human resources to respond to cyberattacks are necessary by the cooperation between ministries and agencies concerned, such as the Ministry of Defense and the Ministry of Economy, Trade and Industry, as well as between government and industry.

6. Expectations on the National Defense Program Guidelines

The security policy is indispensable for a nation. Defense production and technological base of defense industry plays the key role in national security. The National Defense Program Guidelines should explicitly list up the roles of the defense industry and include the basic government policy for maintaining and strengthening defense production and technological base.

Further detailed “Strategies for Defense Production and Technological Base” should be formulated and implemented from a long-term perspective based on the above policy, clarifying and maintaining/strengthening the key areas, promoting international joint development/production, and achieving fair risk-sharing in contracts between government and industry. Future prospect is expected to be clearly foreseen through the implementation of various assistance measures by the government toward globalization listed above.

Keidanren, on behalf of the industry, will make efforts for maintaining and strengthening the defense production and technological base by enhancing international competitiveness in cooperation with the government.

The industry continues the companies’ own research, development and cost reduction efforts as well as the study of reform of industrial organizations for gaining international competitiveness.