

Abenomics *on the* Ropes

*Are military exports
Japan's last hope?*

BY YOSHIHIRO SAKAI

At the end of last year, the Abe Administration triumphed in a general election of members of the House of Representatives. At issue were the policies of Abenomics—raising the consumption tax again, extending its period for a year and half from October, and giving priority to an exit from deflation and toward reflation.

Abenomics is comprised of three arrows, but in actuality only two of the three have been shot. The first arrow was quantitative and qualitative easing, which resulted in a 50 percent depreciation of the yen on the market and an expansion in earnings for export-oriented companies. But although the Nikkei Stock Average value has more than doubled, Japan's GDP has been lower than the previous year as of the second quarter of 2014. The downward trend of the price of oil has been good for pushing down the cost of energy, but it has also had a negative impact on exiting from deflation. The Bank of Japan has lowered its consumer price index forecast for 2015 from a 1.7 percent increase to a 1 percent increase. Given the present financial conditions in Japan, the second arrow—public works—is problematic in that it is unlikely that large-scale economic stimulation measures may be sustained.

The third arrow—structural reform—is meant to surmount this situation and enhance the continued growth of the Japanese economy. Following the House of Representatives election, the Abe Administration announced anew the three pillars of its structural reforms, namely reforms of bedrock regulations for agriculture, employment, medical care, energy, and the like; reforms for the business environment, such as reducing corporate taxes; and reforms of employment practices, such

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as hiring women and foreigners. Assuming the usual winding course of the system reforms process in Japan, however, it will take at least two years for any economic effects to appear. Based on the failure of past reforms, it is also unknown if Japan can accomplish these on its own. The consumption tax increase extension expires in April 2017, which may be too early to confirm an expansion of the economy.

These three could be fairly well achieved through the proposed Trans-Pacific Partnership, as could Prime Minister Abe's aim to reinvent Japan as "the easiest country in the world for companies to start doing business." The TPP might even push Japan to privatize its own state entities, a structural reform that former Prime Minister Junichiro Koizumi was not able to accomplish, in order to create "equal footing" with foreign companies in terms of fair competition. According to a government survey of forty-eight industry groups, however, the TPP has only about a 30 percent approval rating, so it is not known if this can be realized in the short term.

The only ways to buy time until the third arrow takes effect are to once again step up quantitative and qualitative easing—the first arrow—or come up with measures that will increase GDP and exports in the short term. Considering that the second round of quantitative and qualitative easing was approved only by a one-vote margin at the end of October last year, it would be unrealistic to

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expect a third round. That being the case, any short-term positive economic effect we could expect will come from the relaxation, in April of last year, of export controls for military weapons and their components.

Last April, Japan relaxed its "Three Principles on Arms Exports" and their related policy conditions, which until

The Case for Arms Exports

Because the price of these weapons and weapons-related products is high, the value of exports will be high and the profitability of the companies will soar. And since much of the defense industry is covered under state secrecy regulations, it will be imperative that the entire production process, from parts to the finished goods, be done basically within Japan. This will have a large and positive effect on the Japanese economy. Bringing manufacturing back to Japan is an embodiment of the "third arrow" that Abenomics is truly aiming for.

—Y. Sakai



Shinzo Abe

then had been maintained for approximately half a century, and introduced the "Implementation Guidelines for the Three Principles on Transfer of Defense Equipment and Technology." As a result, it has become permissible, with some restrictions, for Japan to export military weapons and their components to allies of the United States, Japan's counterpart in the Japan-U.S. alliance. The Japan Association of Defense Industry, a support organization, has 130 member companies. Because that number includes leading companies such as Toyota, Hitachi, and Mitsubishi Heavy Industries—the developers of mid-range small commercial jets (MRJ)—its membership is wide-ranging, especially if subcontractors are taken into account. These would include Toray Industries and other basic materials companies. For example, harness technology such as carbon fiber made by Toray Industries is used for commercial airplanes such as the Boeing 787 Dreamliner, but it is also valuable for military use.

According to publicly available information, at the current stage—only one year since the relaxation of controls—there have been many negotiations, one of which is close to resulting in an agreement between the Japanese and Indian governments to export fifteen air-sea rescue flying boats to India for ¥198 billion (\$1.65 billion). Also if, as has been reported, the export of twelve submarines to Australia—which Australia is said to be studying—becomes a reality, it could be a ¥7.2 trillion (\$60 billion) deal. Japan has also signed a letter of agreement with France to codevelop and export defense equipment such as unmanned underwater vehicles.

There are two important, positive points to be made about the commencement of arms exports. First, because the price of these weapons and weapons-related products is high, the value of exports will be high and the profitability

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of the companies will soar. Second, since much of the defense industry is covered under state secrecy regulations, it will be imperative that the entire production process, from parts to the finished goods, be done basically within Japan. We can expect this will have a large and positive effect on the Japanese economy. Bringing manufacturing back to Japan is an embodiment of the “third arrow” that Abenomics is truly aiming for.

In connection with this, the price of an MRJ passenger aircraft is said to be ¥4.3 billion (\$36 million). The aircraft industry is typically labor-intensive, and there is a rule of thumb that with the learning curve, when cumulative production doubles, the cost declines a little more than 10 percent. Similarly, because an economy of scale can be expected for other weapons products as well, profitability can be expected to go up with each sale in the future.

There would also be ripple effect from entering into the military market, the result of which will likely be an increase in sales of a great many products that are currently being produced as consumer products, such as four-wheel drive vehicles or engines that supply power for outdoor encampments, including supply lines for armed forces use.

The defense industry is an area that has essentially not been able to expand due to Japan’s post-World War II “Three Principles on Arms Exports.” For that reason alone, if this is taken on in earnest, it will have the profound effect of adding a new industry to Japan. Furthermore, this could be an area of great promise and expectation because Japan’s technology is already held in high esteem overseas. Despite the “lost decades” that started in Japan soon after the Plaza Accord in 1985, Japan’s reputation as a premier exporter of highly advanced technological goods and services has been sustained intact.

There will certainly be issues for Japan’s defense industry in the future, however. When the Japanese public becomes more clearly aware of these arms exports through the ordinary media channels, there is a possibility that, due to the abhorrence of war that has been a part of the Japanese national character since World War II, there will be a backlash against the “merchants-of-death” image that arms exports might create, and that this will spark a domestic debate along the lines of “the economy or peace?” Furthermore, when arms produced by Japan come to hold a larger share of the market, there may be a recurrence of the kind of trade friction that occurred in the 1980s over automobiles and consumer electronics, and it will be necessary for Japan to export with a conscious awareness of the United States and other close allies, and to introduce the concept of joint development of products.

Japan could also be in a position to maintain peace after it expands its export of weapons. During the war

between Iran and Iraq, the Iranian Air Force flew U.S.-made F-14 fighters, but after the revolution in Iran, the United States stopped supplying parts and missiles for these planes to the new regime, and they became *hors de combat*. Hypothetically, many Japanese-manufactured weapons, such as aircraft fighters, tanks, submarines and battleships, would not be operable if Japan were to simply stop supplying the parts necessary for their maintenance. In other words, the countries using these weapons would not be able to continue using them without Japan’s contributions. This means that with an exclusively defense-oriented policy, Japan could deter aggression from the countries it supplies. In other words, to the extent that Japan’s share in supplying

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a given country’s weapons increases, so would its ability to influence that country’s war policy. This would also help the strategy of the United States, as Japan is one of the closest U.S. allies, and such a contribution to peace by Japan would be consistent with U.S. strategy.

As the recent ransoming and killing of Japanese nationals in the conflict zones of Syria and Iraq has illustrated, the entrance of Japan into the military contracting field could create new dangers for Japan. An action by Japan to begin exporting weapons could put the lives of Japanese nationals working overseas at risk, and it could also expose the Japanese homeland to terror attacks. I doubt that ordinary Japanese people would accept these risks.

With monetary policy, there is usually a one-year time lag for it to take effect. Last year’s stagnation in the GDP has the effect of appearing to be high in comparison to this year’s GDP. However, we must understand that until structural reform—the third arrow—can take effect, it will not be easy to grow out of deflation and realize any full-scale expansion unless the actual Japanese economy relies, as stopgap measures, on another round of quantitative and qualitative easing or the expectations for arms exports. ◆