



Survey Results of 100 Japanese Companies on Economic Security 2023

**US-China
Conflicts**

**Russia
Sanctions**

**Taiwan
Contingency**

**Security
Clearance**

**Supply
Chain**

**Friend
Shoring**

**Japan-US
Alliance**

**Active Cyber
Defense**

**Regulations
on Foreign
Investment**

**Economic
Security
Promotion
Act**

Survey Results of 100 Japanese Companies on Economic Security 2023





Foreword

Kazuto Suzuki

Director, Institute of Geoeconomics, Group Head of Economic Security

This year marks our third round of the Survey of 100 Japanese Companies on Economic Security. Amidst the storm of changes surrounding our nation's international environment such as the Russian invasion of Ukraine and tensions in the Middle East, research for this survey was made possible by the various firms that were able to respond to the enquiries. We sincerely thank you for your contributions.

In light of Russia's invasion of Ukraine, our previous survey (2022) focused on the effects of sanctions against Russia and security clearance policies. We inquired about the effects of the absence of security clearance policies, as well as deepening discourse in the previous year "Booklet 2022" columns. I myself participated in the advisory committee for security clearance policies in the arena of economic security, and was involved in establishing policy creation and policy recommendations that were based off of the results of the Survey. Based on the final report by the advisory committee, the Security Clearance Bill was approved and enacted at the plenary session of the House of Representatives on May 10, 2024.

This year, we received responses from 83 firms. Reflecting the increasingly opaque nature of the international state of affairs compared to the previous year, there has been prominent US-Japan reshoring, while the enforcement of the Economic Security Promotion Act has been strengthened amongst 4 policy fields. There has been a notable divide between firms that have successfully adjusted to the new developments and fields that are still struggling to adjust. Regarding the market in China, for the first time more firms responded with "Strengthening technological research and development (R&D)" instead of "Strengthening the management of intellectual property rights and patents," signaling that the competition with the Chinese market has entered a new frontier.

In addition, through our co-hosted event with JBIC (Japan Bank for International Cooperation), which conducts annual survey on Japanese foreign direct investments, analysis from a different angle than our survey, we were able to further expand on our survey results and disseminate insights on supply chain resilience to a wider audience. In particular, JBIC's survey also mentioned India and Vietnam as China's potential relocation sites, deepening both surveys' analysis of the current status quo regarding the strengthening of supply chains. Additionally, on April 25th, Hitoshi Suzuki, the project manager of the Survey, introduced our four-year project at the London Business School's "Geopolitics & Business Conference. World in Flux: Geopolitical Uncertainty and the Future of Business." We plan to continue our outreach efforts from the next year onwards.

For this survey, we continued utilizing questions from previous years as reference points, while creating new questions/response options to accommodate for the development in US-China tensions, among other factors. We thank you for all contributions and support, and look forward to cooperation for our future research efforts.



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Executive Summary

1 | Concerns of Rising Costs from US Restrictions Amidst US-China Conflicts

Although firms that cited the unpredictability of US-China relations as a concern of economic security have decreased, the percentage of firms that are being affected by tense US-China relations have increased. In terms of possible future prospects, many firms are concerned of an increase in costs due to the US tightening restrictions. Regarding China, in light of the growth in China's technological field, most firms are focusing on the "strengthening of R&D" to compete against Chinese firms.

2 | More Specific Measures are Being Taken for Economic Security

Almost half of the firms started strengthening economic security measures after the invasion of Ukraine by Russia (February 2022), and a quarter of them have already received support measures from the Economic Security Promotion Act (May 2022). When looking at specific measures taken for economic security, there was a notable increase in the categories of "Changing or diversifying suppliers" and "Establishment of specialised departments." Firms that answered in these categories also have increased compared to research conducted in 2021. On the other hand, there are only around 20% of firms that plan to change the location of their manufacturing site or change their investment plans.

3 | Progress in Initiatives for Simulations on Taiwan Contingency

In terms of possible responses to a Taiwan Contingency, more than 30% of firms have completed simulations, around 40% are in the planning phases, and 70% of firms are engaged in development. In regards to business in China, while most firms answered that they will maintain the current business relations, there was an increase in responses that expressed concerns over geopolitical risks and business continuity risks in business operations, and more firms are preparing against these potential risk factors.



4

The US and India are the Most Friend-shored Nations, while Japan Experiences the Most Re-shoring

Japan was the most prioritized nation when Japanese firms considered a change in suppliers/sales channels, a transfer of manufacturing sites, or a change in destination for investment plans. The US, which is initiating domestic investments such as to the Inflation Reduction Act, and India, which was the chairing country for the G20 where it led the Global South, also garnered attention.

5

The Regularization of a System Management Structure for the Security Clearance System

There were concerns over organizational and structural development within firms for implementing the Security Clearance System. For the extraterritorial application of American or Chinese regulations, as well as compliance structures in the event of secondary sanctions, an increased number of firms answered “compliance system is in place” and a decrease in firms that answered “currently working towards putting such compliance system in place.”

6

Rising Expectation for the Maintenance/ Strengthening of US-Japan Relations when Advancing Japan’s Economic Security Strategies

For the category of how to advance Japan’s economic security, Japanese firms selected “Maintain and strengthen the Japan-US alliance” marginally above “Japan's leadership and trust within the Asia-Pacific region.” This indicates an increase in interest over Japan-US relations amidst the US presidential elections.

100 Company Survey on Economic Security 2023

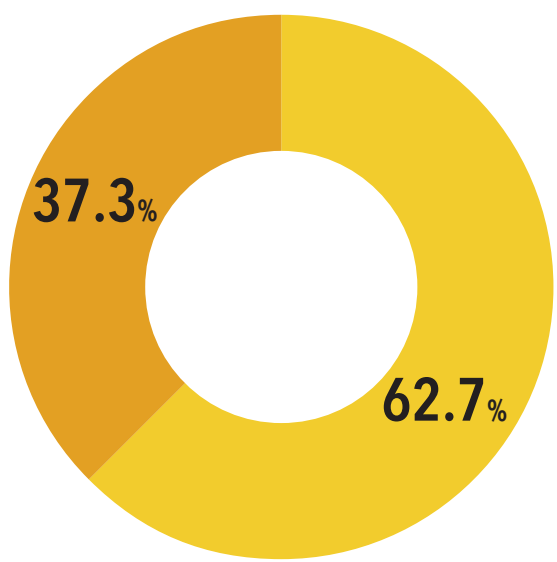
Survey Results

Total number of respondents: 83 companies (inclusive of research institutions)
Survey period: November 2023- January 2024

Industry-sector classification of surveyed companies and institutions [83 responses]

Industry-sector classification

- manufacturing sector
- non-manufacturing sectors



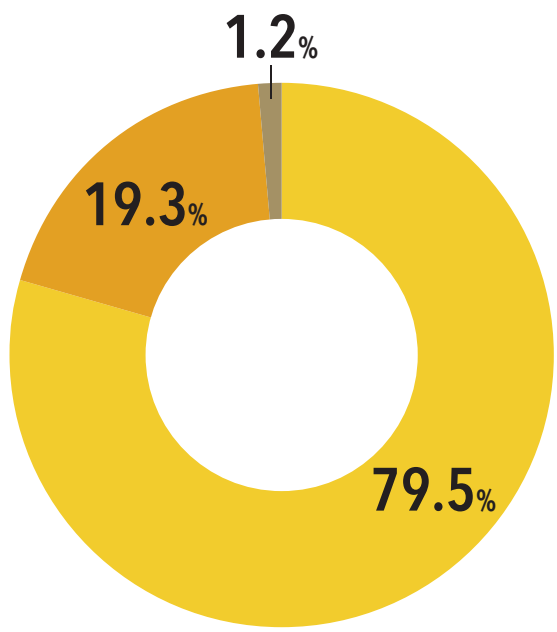
Industry classifications

- High-precision machines (11)
- Petroleum and petrochemistry (9)
- Semiconductors (7)
- Transportation equipment and machinery (7)
- Finance (7)
- Information and telecommunications (6)
- Industry and manufacturing production machinery (5)
- Iron, steel, and non-ferrous metals (5)
- Trading (5)
- Transport and storage (4)
- Information Technology (IT) (3)
- Other service industries (3)
- Heavy industry (2)
- Construction and real estate (2)
- Public service, education, fisheries, agriculture, forestry etc. (2)
- Electricity and gas (1)
- Food and beverages (1)
- Building materials, textiles, and paper (1)
- Medicine and pharmaceuticals (2)
- Retail (1)

1

To what degree are you aware/ mindful of economic security? [83 responses]

- Strongly aware
- To a degree
- Not very
- Not at all

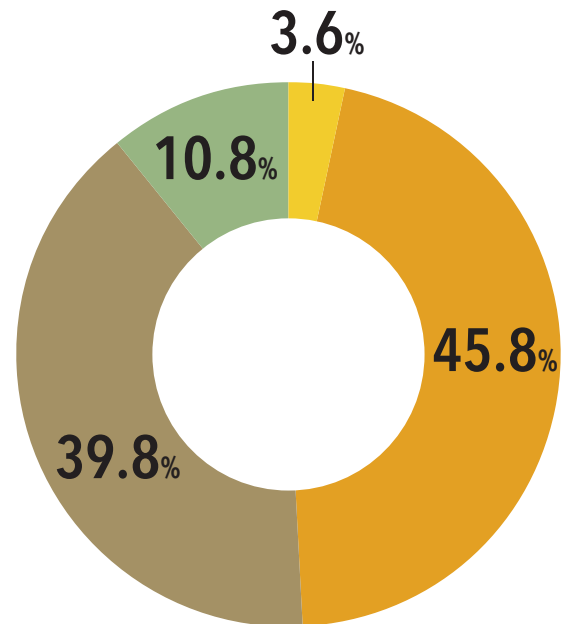
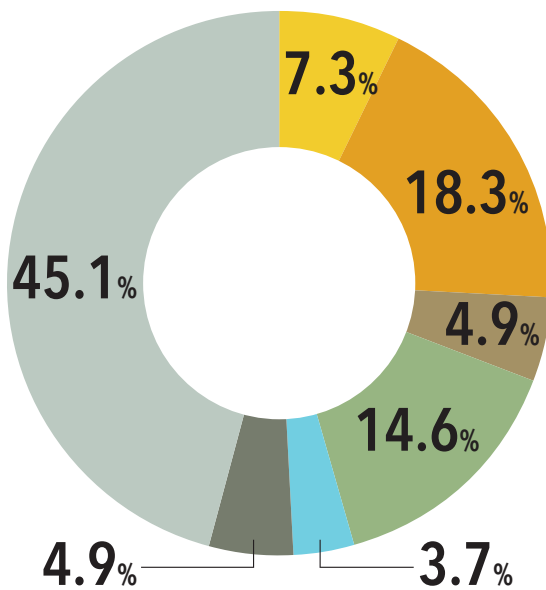


2

Is economic security ever on the agenda when discussing management policies (such as at board of directors and executive meetings)?

[83 responses]

- Every time
- Often
- Sometimes
- Rarely
- Not at all



3

When did you start your economic security initiatives?

[82 responses]

- Export regulation by China regarding rare earth elements (2010)
- The National Security Service (NSS) established an “Economy Group” specializing in the economic field (Apr, 2020)
- Russia’s invasion of Ukraine (Feb, 2022)
- Economic security promotion act passed into law (May, 2022)
- Tighter U.S. restrictions on semiconductors to China (October 2022)
- Have not started
- Others

Qualitative Responses

- Since the 1970s when we have been performing operations abroad, we always considered about dealing with economic security.
- Regarding trade management, since the 1990s we established a supervisory group dealing with it.
- In the event of economic sanctions towards certain countries (Iran or others).
- We began incorporating a technology to prevent unauthorised transfer of products since 2006.
- Since the establishment of our current company during the millennium years.
- We implemented supplier diversification since before 2010.
- Since August 2018, in response to American tightened export and investment regulations.
- After the worsening of US-China trade friction in 2018.
- In 2018 (Japanese-Korean semiconductor materials export restriction, American export restriction towards Huawei).
- Following impetus from: the American National Defense Authorisation Act of 2019 (NDAA2019), US’s Investment Control and Export Control Enhancement Act, US-China hegemonic rivalry. The American National Defense Authorisation Act of 2019
- Against the backdrop of the Export Control Reform Act (ECRA), Foreign Investment Risk Review Modernization Act (FIRRMA) and Article 889 included in the American National Defense Authorization Act of 2019 (NDAA2019) (established in August 2019), we began dealing with it.
- Since around 2019 our company started dealing with it.
- Since around 2019 we started gathering information about it.(2)
- We are not expressly dealing with it, however, since around 2020 we have been offering advice to our clients.
- August 2020.
- We have been motivated as a result of other companies creating special

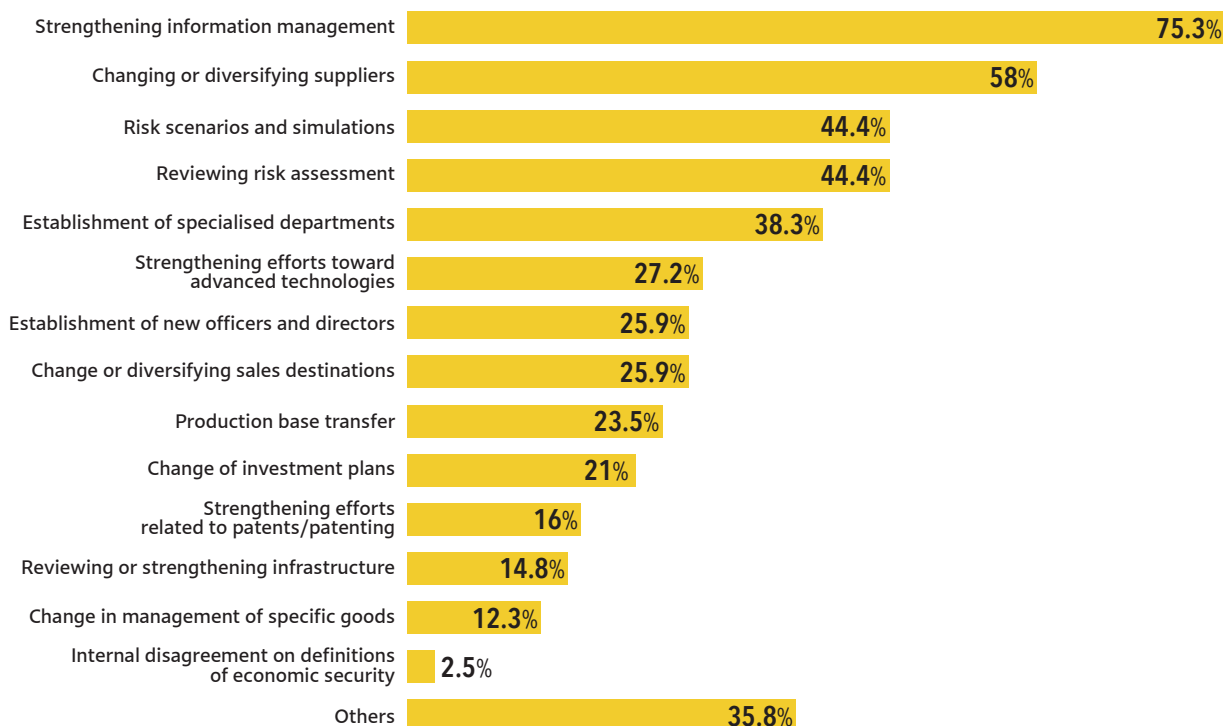
divisions dealing with economic security (in 2020).

- Given US-China confrontation, global disasters’ frequent occurrence and similar events, we have been speeding up our efforts since around 3 years ago.
- Since May 2021 we set up a task force.
- Since around July 2021.
- In December 2021 we set up a designated executive as well as a division dealing with economic security.
- Around the time when the Economic Security Promotion Law has been formulated.
- Since before the entry into force of the Economic Security Promotion Law. (3)
- Around July 2023.
- Since around 2022 when we became conscious of growing anxiety towards a possible Taiwan contingency.
- July 2023, since receiving explanations from the Ministry of Land, Infrastructure, Transport and Tourism.
- Since long before, we have been dealing with it from the standpoint of supplier risk management, client management including responses to catch-all regulations, information management, intellectual property management and others.
- On export control and similar, we dealt with responding to issues accordingly on a case-by-case basis.
- Because the commercial activity with China is relatively large, we are currently dealing with supply chain diversification.
- On matters of business promotion, we respond accordingly whenever necessary.
- We always follow trends and we do not get triggered by specific events.
- During discussions with management, we have been responding according to necessities but a clear beginning of our efforts is difficult to identify.

4

What specific initiative have you taken in your firm? Select all that apply.

[81 responses]



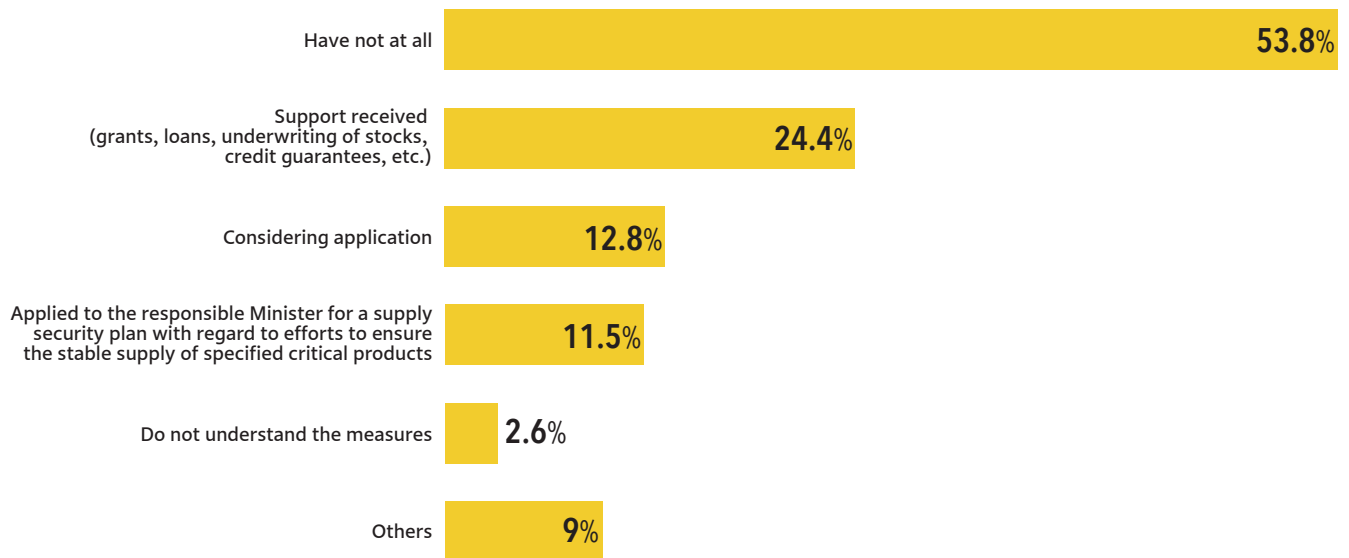
Qualitative Responses

- We performed employee awareness increase measures through training offered to all employees, held regular internal information exchange meetings, established risk assessment criteria, shared information with internal and external stakeholders, etc.
- Gathering information on economic sanctions towards foreign countries.
- Reliably applying economic security export controls.
- Focused on preparations for the entry into force of competent ministries' ordinances.
- Transferred our system development base.
- Revised current business exchanges.
- Information gathering and analysis of countries' economic security policies, creation of a framework for strengthening our supply chain, creation of a framework for prevention of sensitive technologies leakages, etc.
- Confirmation of company-wide matters which needed to be addressed, information gathering, responses related to the Economic Security Promotion Law (response to public comments, negotiation with relevant authorities, post-entry into force system development, etc.)
- Because we have been designated as Essential Infrastructure Services Operator, when discussing enactment and revision of government/ministerial ordinances we base decisions on information obtained from government agencies (National Security Strategy – NSS, Ministry of Land, Infrastructure, Transport and Tourism) and economic organisations (Keidanren). Also, we are continuing preparations for necessary measures to be implemented.
- Establishment of a task force-based information gathering and reporting system, and establishment of a system in which relevant departments coordinate and respond in case of necessity of key infrastructures' function maintenance.
- Strengthening of comprehensive compliance towards internal and external relevant authorities' export restrictions and sanctions, strengthening of management reporting on the matter, promotion of related risks to all-company management, strengthening cooperation with Japanese government, business partners and business associations.
- Appointment of an internal special advisor, thorough evaluation of supply chain.
- Strengthening of the existing export control system, internal sensitive technologies stocktaking.
- Incorporation of technology to avoid products' unauthorised circulation, strict control of design information and visitors.
- Upgrading of the export control system's functional additions, etc.
- Creation of a trade management system.
- Preparation for relevant regulations, tightening of business partners' advance checks.
- Dealing with guaranteeing Essential Infrastructure Services' stable supply.
- Under the Risk Management Commission, examining responses to information gathered and risks management.
- All-company resource management process and risk management process.
- Investment awareness activities, such as the creation of videos and related materials dealing with selection of countries and companies for investment, as well as asset creation from the perspective of economic security personnel.
- Communication with relevant authorities regarding exports towards China.
- Coordination with government agencies.
- Information gathering as well as sharing between departments and corporate.
- Holding study groups for management executives.
- Individual consideration towards each business project, launch of internal study groups, etc.
- Depending on the situation, relevant departments respond.

5

How does your company utilize the support measures under the Economic Security Promotion Act? Select all that apply.

[78 responses]



Qualitative Responses

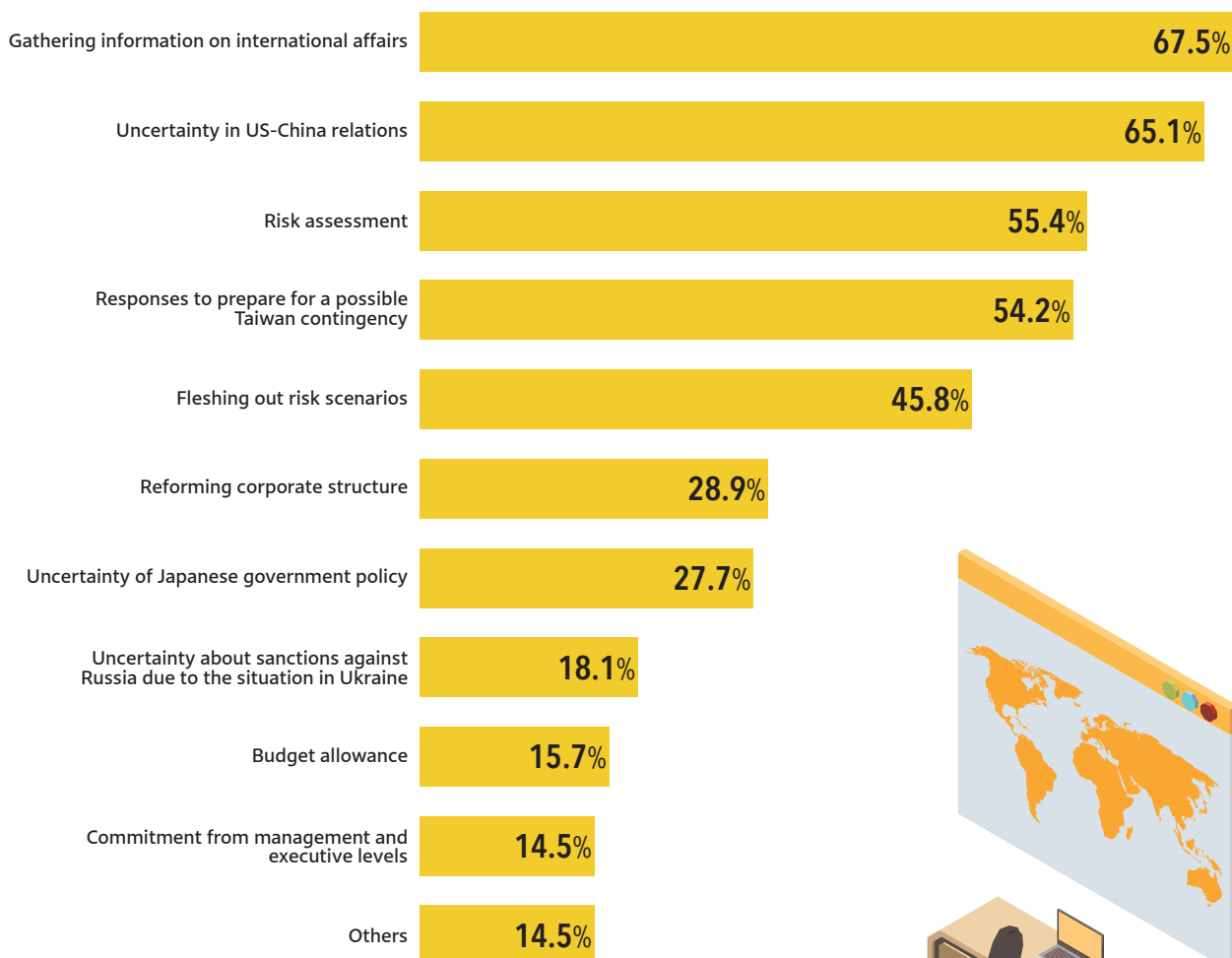
- Regarding the Enhancing Development of Specified Critical Technologies (R&D support), we have applied and have been selected for joint development between corporation and university.
- We are considering applying for the Enhancing Development of Specified Critical Technologies.
- We participate in an industry-university cooperation programme with a university receiving the Supply Chain Grant.
- There are no applicable support targets for us at the moment.
- We will consider it when the possibility arises. (2)
- We are currently undertaking activities related to the Economic Security Promotion Law.



6

What are the biggest challenges in addressing economic security? Select all that apply.

[83 responses]



Qualitative Responses

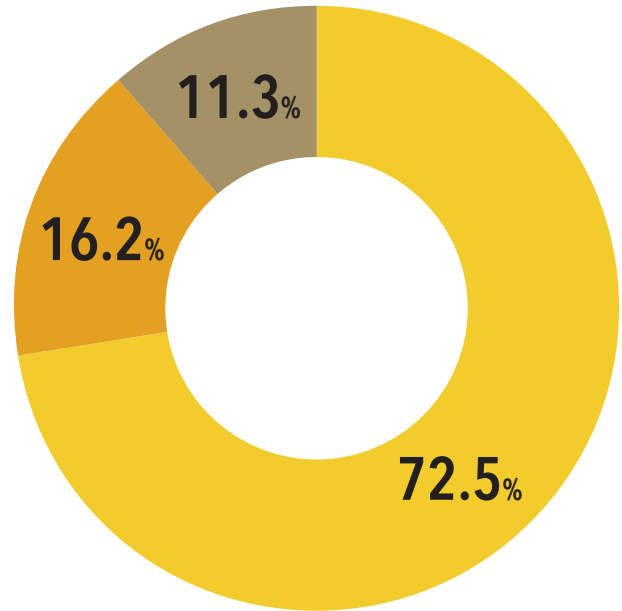
- Being required to comply with every countries' and regions' conflicting laws and rules, the lack of standards in how thoroughly concrete measures should be implemented, including on supply chain preservation.
- It is complicated to secure alternative supplies of raw materials and equipment concentrated in specific regions.
- Careful consideration of supply chain risks, securing specialised human resources, cooperation and exchanges with business counterparts.
- Enacting policies directed towards visualising and strengthening supply chains.
- Judging reputational risks.
- Risk evaluation.
- The strengthening of information analysis and intelligence capability during risk assessment.
- Interest coordination in global business.
- Obtaining appropriate information and personnel in charge.
- Foresight capability regarding Infrastructure regulations, regulations' scope limit. If in order to comply with regulations a certain country's company supply (where the price is moderate) has to be avoided, and if supply costs increase as a result of this, would it be possible to request subsidies and compensation to the government?
- Obtaining appropriate information, including on the Japanese governments' plans of action.
- There are no particular areas requiring specific efforts.

7

Has the current conflict between the US and China had an impact on your business in any way?

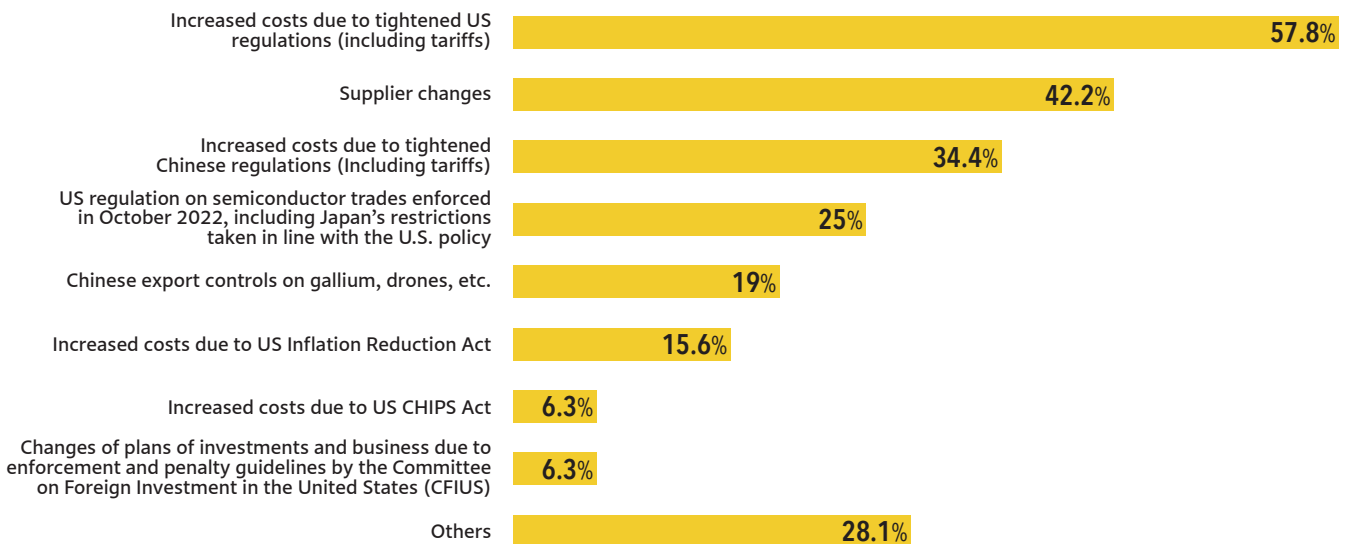
[80 responses]

- Yes, impacted
- No, not impacted
- Can't say either



For those who answered that there were impacts, what were the specific impacts? For those who have had no impact, are there any expected impacts in the future? Select all that apply.

[64 responses]



Qualitative Responses

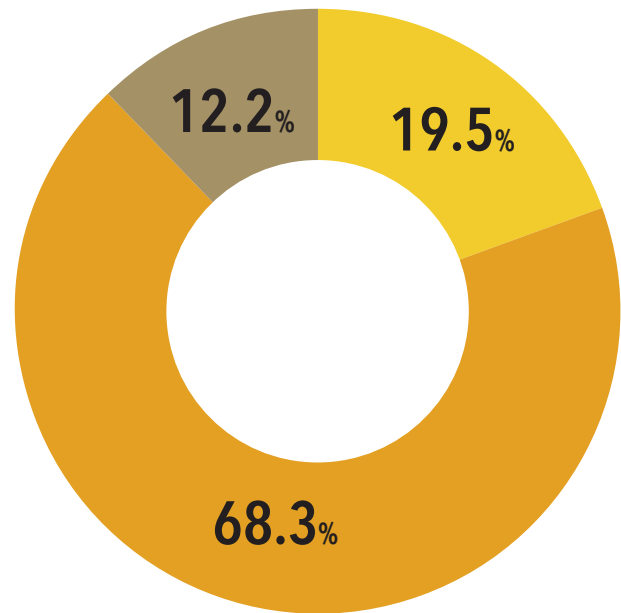
- Complying with the US entity lists.
- Depends on the possibility and content of sanctions towards China.
- Dealing with every kind of sanctions.
- The transfer of production base of specific items.
- Supply chain distribution.
- In case of investment recipients (including candidates) being affected, the impact on investment decisions and performances.
- Considering risk scenarios, etc.
- Obstacles to new business development's investments and similar matters.
- Strengthening both the information management posture and the pre-screening of outsourced companies.
- Dealing with clients and investment decisions relating to Chinese companies being targeted by stricter US regulations.
- Examining the impact of China's revised anti-espionage law and similar.
- The decline of investment projects in China.
- Sales reduction resulting from our clients' reduced activity.
- Currently, because of the insufficient supply of direct flights between the US and China, US-Japan routes' demand remains strong. However, there is anxiety about the fact that in the medium and long term the stagnation of the global economy resulting from US-China confrontation will indirectly reduce flight demands. Also, because China bears a large portion of the demand for semiconductors, trading companies are increasingly aware that US-China confrontation brings potential business risks.
- Rise in compliance costs.
- Complying with the US' Uyghur Forced Labor Prevention Act (UFLPA).(2)
- Foreign investors' capitals increased inflows towards Japan.

8

Have you ever been caught between the US and China, where you had to choose between them in some way?

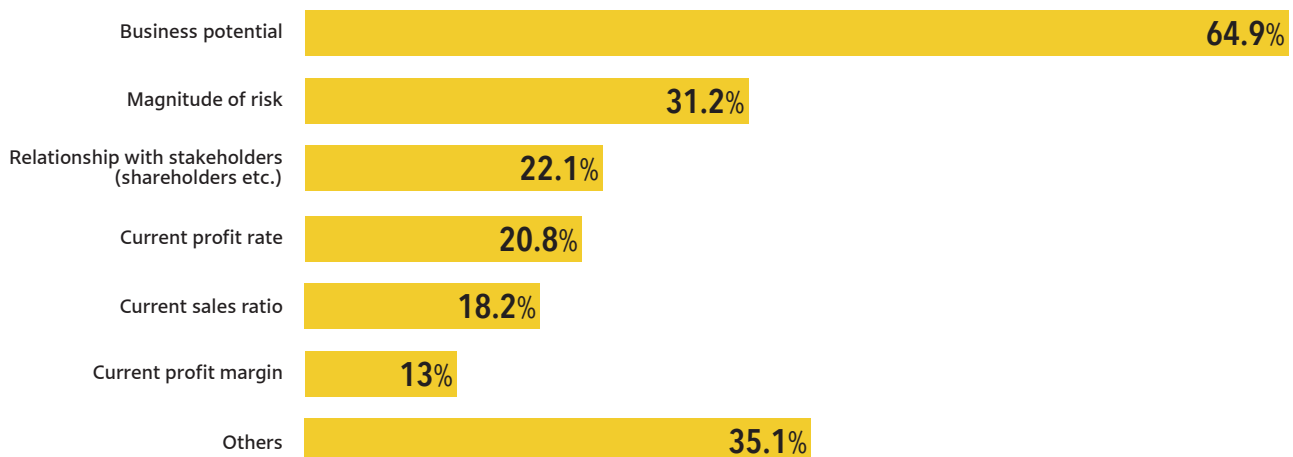
[82 responses]

- Yes
- No
- Can't say either



If you had to choose between US and Chinese business, what would be the criteria to make that decision?

[77 responses]



Qualitative Responses

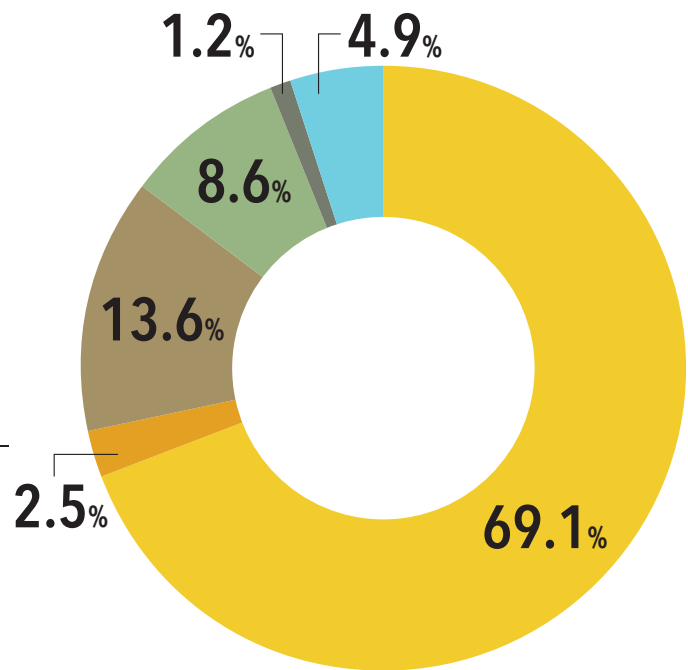
- We do not expect to choose between the two countries.
- Impossible to choose either of the two.(2)
- We have large dealings with both and we cannot choose.
- Both markets are important and choosing one among them is not an easy task.
- Chinese business is incomparably larger than the US', so for us there is no choice.
- Because most raw materials are sourced from China and most of the manufacturing equipment are assembled in the US, it is impossible to choose one.
- It is not a financial decision, but rather a primarily geopolitical decision (legislation, government's policy, and so on).
- As a healthcare related company, decisions will be made according with the number of patients who need our products.
- Depending on country risks.
- Clearance with respect to compliance (due diligence issues).
- Corporate reputation.
- The future prospects of business, keeping into consideration Japan's national interests and its impact on customers.
- Future business viability in fields that are not involved in political disputes between the US and China.
- In order not to fall into such situation, we perform decision-making based on geopolitical risks when participating and promoting projects.
- Whether common democratic values are shared with Japan.
- We don't have much business with China.
- Compatibility with the government's policy.
- We will decide in accordance with the situation at the time.
- Because every case is different, decisions will be made by each business unit/project.
- We will only make comprehensive decisions.
- Japanese government's policy.(2)
- Regulatory compliance.
- Judgement criteria depend on the content of the matter, target customers, etc.
- Comprehensive judgement based on all of the above, internal and external political circumstances, etc.(2)

9

Has Russia's invasion of Ukraine and the resulting sanctions against Russia impacted your business in any way?

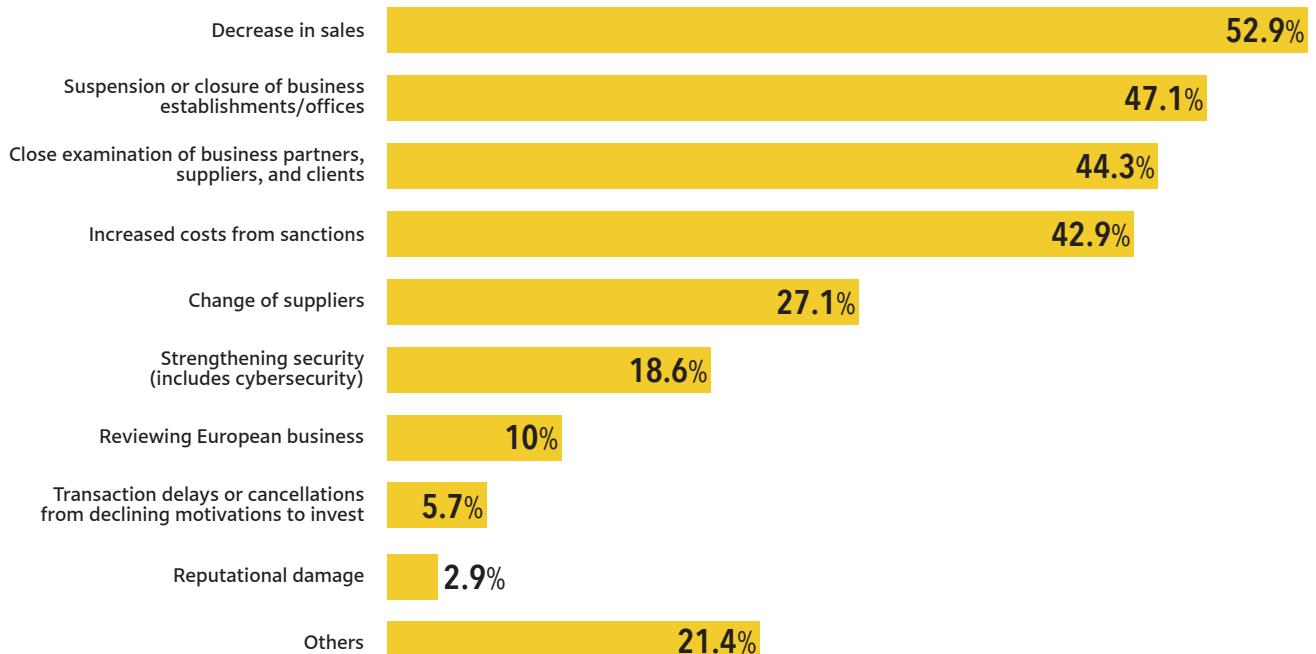
[81 responses]

- Impacted
- Impacted, and increased
- Impacted, but diminished
- Not impacted
- Not impacted yet, but expected
- Can't say either



For those "impacted", how have you specifically been impacted? For those who were "not impacted", are there any specific impacts expected for the future? Select all that apply.

[70 responses]



Qualitative Responses

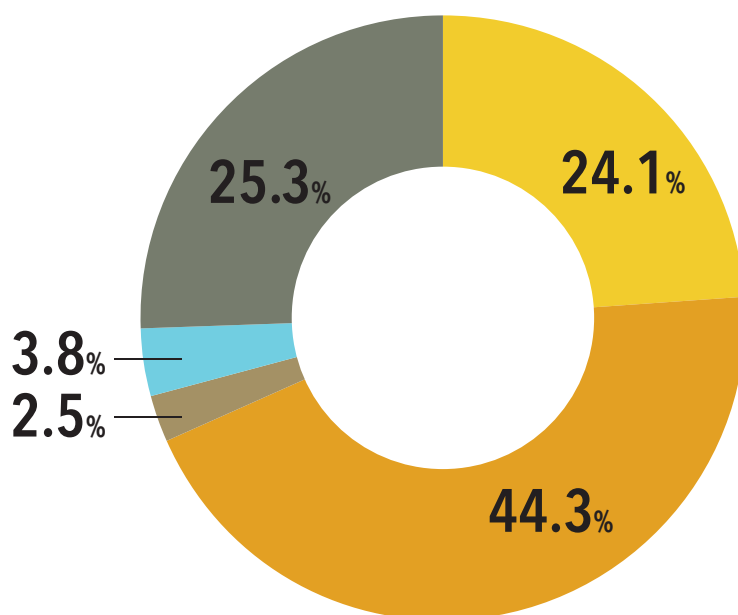
- Ceased local production and sales, and change of after-sale operation.
- Soaring raw material prices.
- Some gases' such as helium's (HE) supply delays and price increase.
- Rising utility and fuel costs.
- Rising energy costs.
- Oil prices and similar, market prices' fluctuation.
- The rise of energy costs in Europe negatively affects the economy.
- Impacts of monetary policy resulting in price increases, the impact of price index fluctuations.
- Impact on the stock, foreign exchange, bond and other markets.
- The increased cost of credit, reviewing risk evaluation in other regions.
- Reviewing risk evaluation in other regions.
- Increase in operational variable costs, primarily fuel costs, due to detour operations of Japan-Europe flights, which are not based on sanctions-related airspace flight restriction, but for risk aversion of halted remittances and absence of flight insurance. Impact on equipment and crew member's operation, reduction in the number of flight operations. Freeze of preparations for new services to and from Moscow. Self-restriction of services for Russian aviation companies and pilot training.
- Changes in the business structure.
- Review of risk evaluation.
- Securing appropriate human resources.

10

To what extent have overall costs increased due to the cost required to handle economic security?

[79 responses]

- No increase
- Increased by under 5%
- Increased by 5% to less than 10%
- Increased by at least 10%
- Decreased
- Not clear



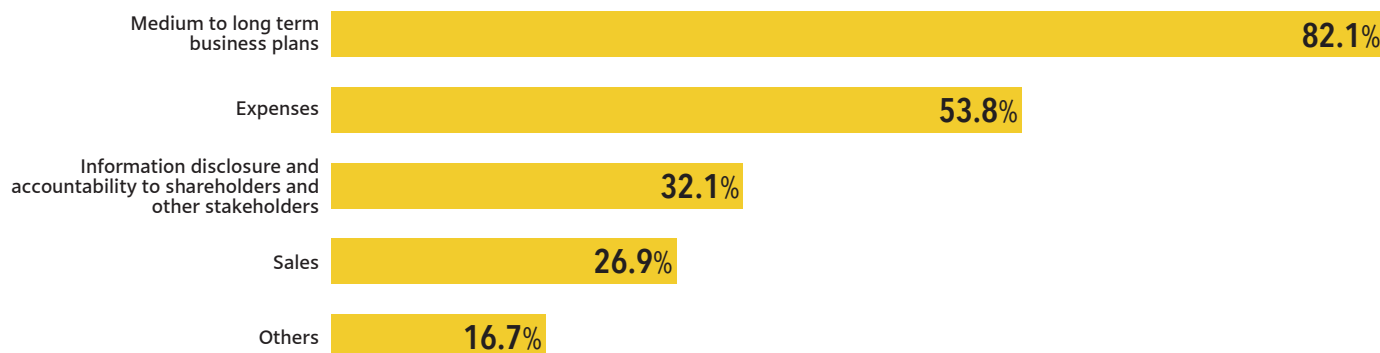
Qualitative Responses

- Maintenance of Essential Infrastructure Services and development-related limitations.
- Regarding stable supply systems of Essential Infrastructure Services, the administrative burden placed on the operators and its suppliers.
- Being subject to regulations as Essential Infrastructure Services operator might obstruct the smooth operation of equipment and systems. The transportation of important goods - especially semiconductors' manufacturing equipment, engine and similar main components for aircraft, ships and similar - play a large part in the transportation of goods and is central in supply chain resilience. This is also true for transportation of life-related products such as pharmaceuticals and regenerative medicine as well as exports of agricultural and fishery products, which the Ministry of Agriculture, Forestry and Fisheries aims to strengthen exports.
- Possibility of changes to the supply chain and the trend of tightening sanctions.
- Ensuring supply chain due diligence, including the risk of human rights violations.
- Reduced appetite for investment, investment restrictions on Chinese companies, restrictions on data acquisition from Chinese companies, and restrictions on remittances to and from China.
- If business risks increase to the point where business in China can no longer continue, extremely hard choices will have to be made and the impact on the entire company will be extremely large.
- The impact on customers, regulatory risks, risks of sanctions, constraints on human resources, etc.
- Securing the necessary human resources and budget to implement policies.
- If tax breaks and similar are implemented, we expect an increase in net profits.
- Impact depends on the content of the regulations.
- No specific matters of concern.
- No unusual impact felt.

11

In the event that further enforcement of Japan's economic security policies proceed, where do you expect to find the biggest impact on your business? Select all that apply.

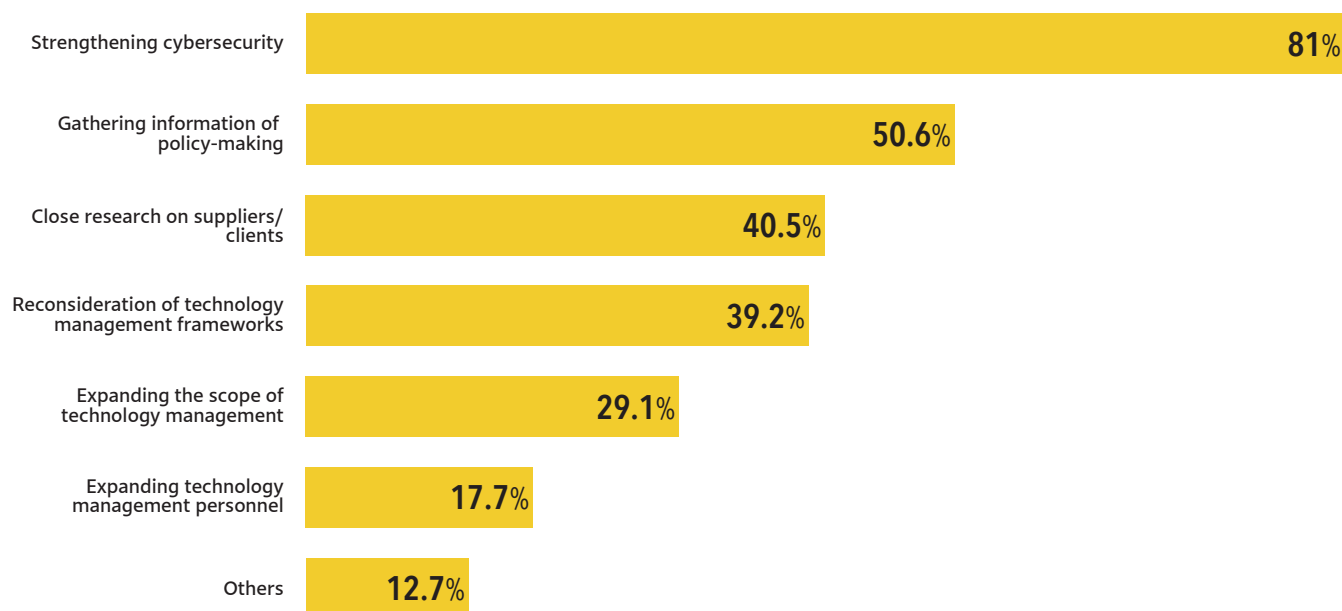
[73 responses]



12

In addition to conventional technology management and export control, what efforts have you made to prevent technology leaks?

[79 responses]



Qualitative Responses

- Cure the vulnerabilities discovered during penetration tests and review of security applications, etc.
- Protection of intellectual property rights and its promotion through business associations.
- Strengthening monitors of information access and external data transfers.
- Established an internal management system in line with the 'review of deemed export regulations' of the Foreign Exchange and Foreign Trade Act revision.
- Strengthening efforts in trading companies' trade management committees. In order to prevent technology leaks, we are implementing measures to control exports of technology information. Continue reviewing relevant laws and regulations and respond accordingly.
- Close scrutiny of the System for Non-Disclosure of Selected Patent Applications.
- Advancing employees' literacy through training.
- Thorough management of confidential information.
- Nothing in particular.(2)

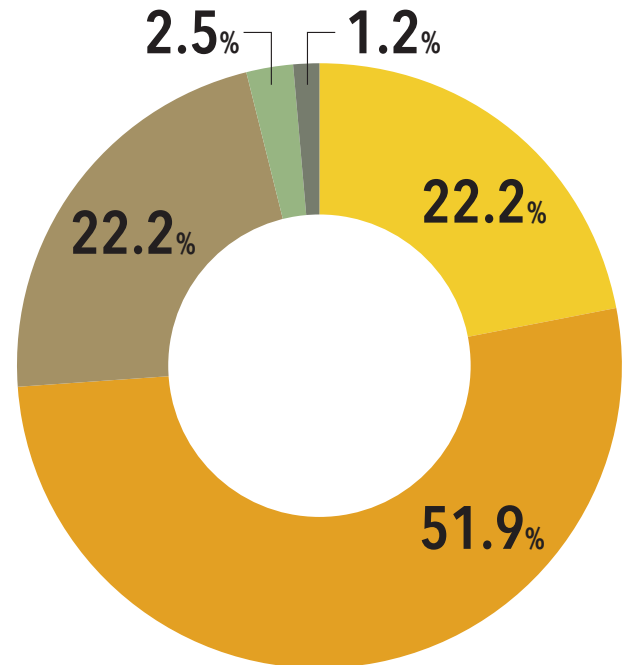


13

Do you think Japan needs a security clearance system (other than in existing area such as defense)?

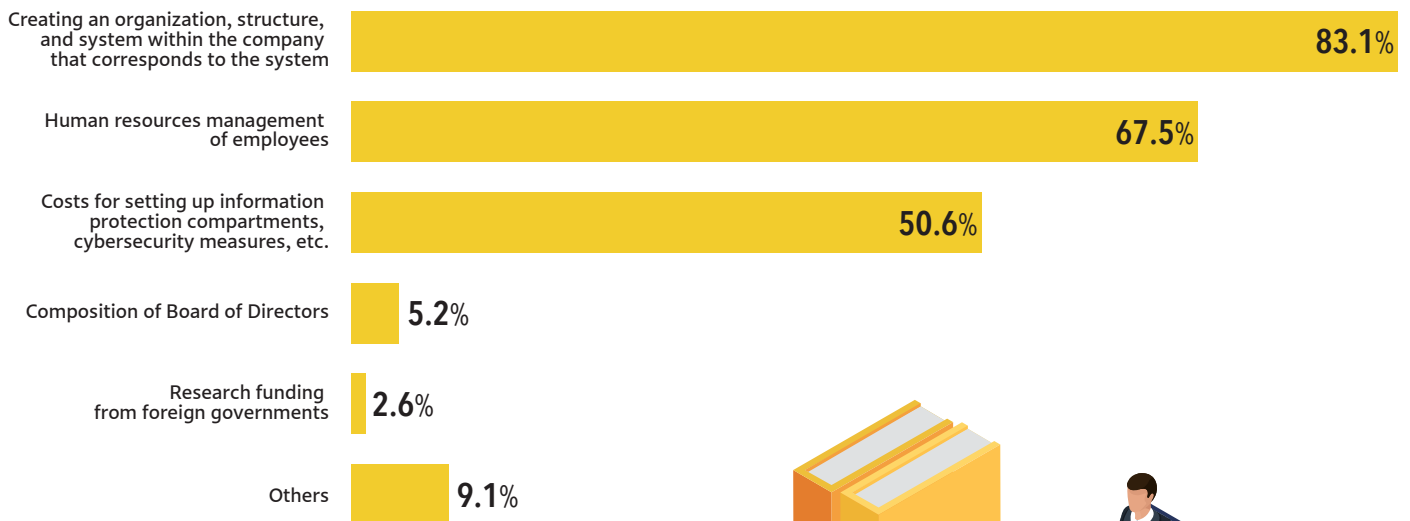
[81 responses]

- Yes, immediately necessary
- Yes, in the future
- Not necessary
- Couldn't say either way
- Unsure what kind of system it is
- Others



What are your concerns if a security clearance system were established. Select all that apply.

[77 responses]



Qualitative Responses

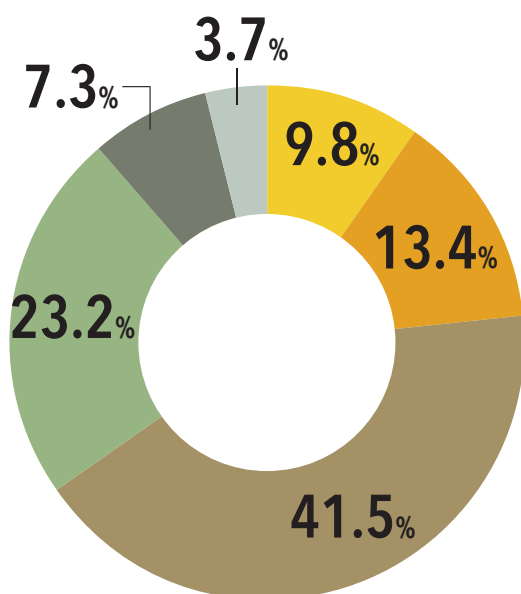
- Difference between the Act on the Protection of Specially Designated Secrets and the new security clearance law is unclear.(2)
- Whether the system under discussion is applicable to our company is unclear, refrain from answering.
- We do not expect to take part in this system.
- How the system is applied to the company is undecided.
- Not applicable.(2)



14

Regarding sensitive information and technology in your company, to what extent do you manage such information, employees who handle such information, and personnel who have access to highly technical information (e.g., manage such information as trade secrets, limit and control employees who have access to such information)?

[82 responses]



- Manages and identifies personnel who are exposed to advanced technical information, including retirees
- Centralised understanding and management of in-house personnel who handle advanced technical information
- Each department understands and manages personnel handling advanced technical information
- Each department is responsible for the management
- No special measures taken
- Others

Qualitative Responses

- In order to unitarily control personnel and technologies, we purchased an AI tool and currently applying the system. Due to the nature of our business, we do not hold much sensitive technology information.
- Not applicable.

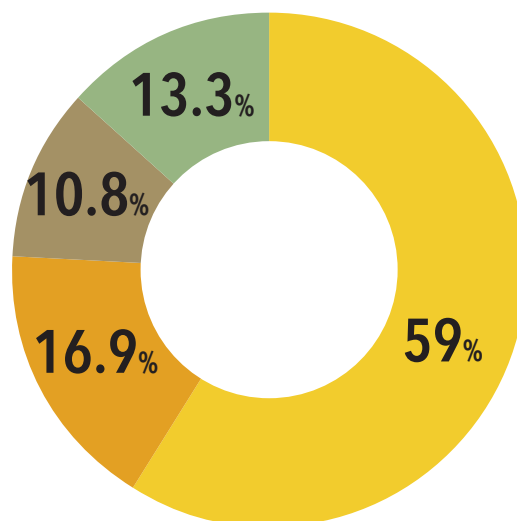


15

Is there a compliance system in place in anticipation of extraterritorial applications of US and Chinese economic sanctions or secondary sanctions?

[83 responses]

- Yes, such compliance system is in place
- Currently working towards putting such compliance system in place
- No plans to start
- others



Qualitative Responses

- We are prepared for US' regulations, but its extraterritorial application in China is not clear and therefore we will comply whenever it is made clear.(2)
- We have already dealt with the US, while we cannot make decisions on China because its extraterritorial application is unclear.
- Preparations for the compliance system on American economic sanctions' extraterritorial application are completed, but those for Chinese economic sanctions' extraterritorial application are currently handled.
- Expected economic sanctions are dealt with case by case.
- Preparation is to some extent completed but further improvement is needed.

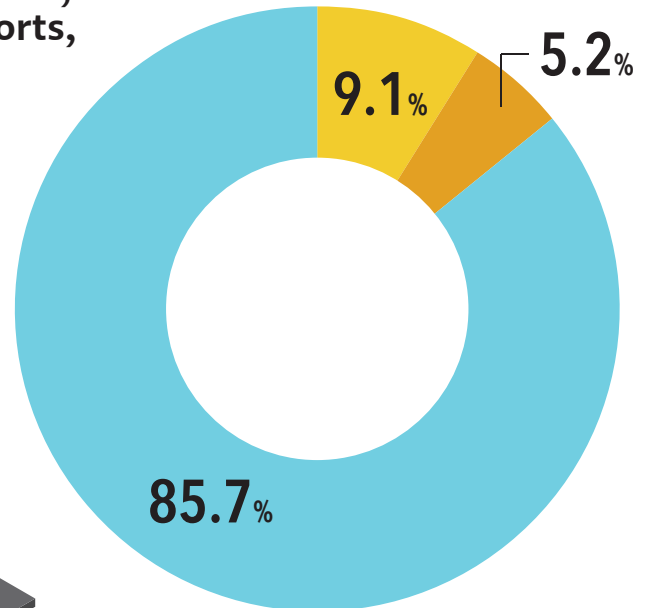
- Not prepared for the moment but considering for the future.
- No particular preparations in place for a compliance system specific to extraterritorial application and secondary sanctions. We have in mind a system coherent with policies of the Japanese authorities.
- In response to the development of sanctions and regulatory provisions, our current system will be revised.
- If necessary such systems shall be considered.
- Case by case response.
- Refrain from disclosing information.

16

In the past, have you ever received signals or attestations by Japanese, US, Chinese, or other governments regarding imports, exports, or transactions with sanctioned companies?

[77 responses]

- Have received indications from the Japanese government
- Have received indications from the US government
- Have received indications from the Chinese government
- Have received indications from other governments
- Never received any such indications

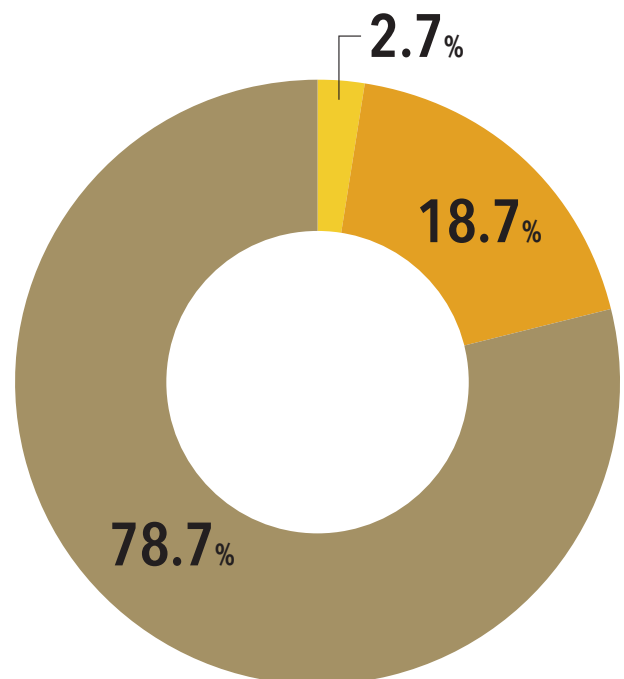


17

Have you ever been subject to fines, transaction suspensions, or import/export suspensions in your business?

[75 responses]

- Yes
- No but can foresee a possibility of being subject in the future
- No and not expecting to be subject in the future

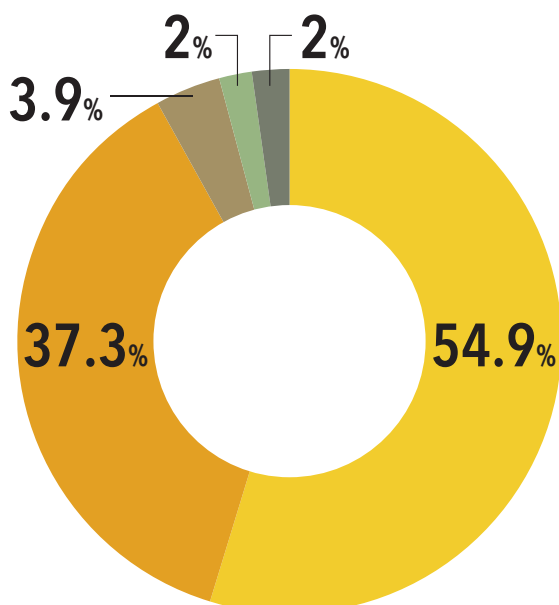
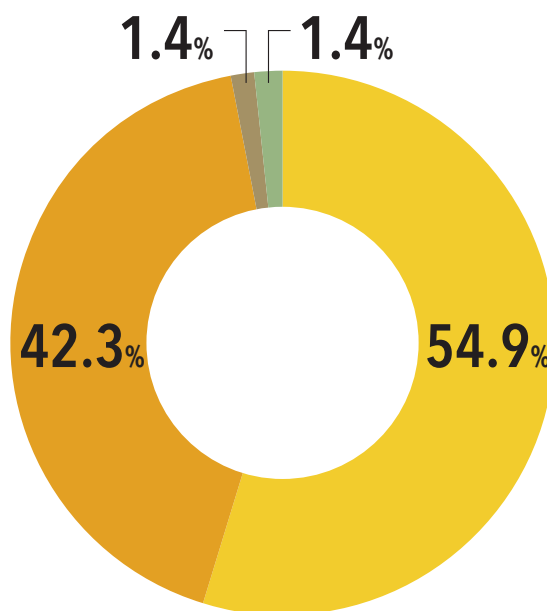


18

What ratio of your sales are in China?

[71 responses]

- Under 10%
- 10% to 30%
- 30% to 50%
- 50% and over



If your business includes production processes, what ratio does this take?

[51 responses]

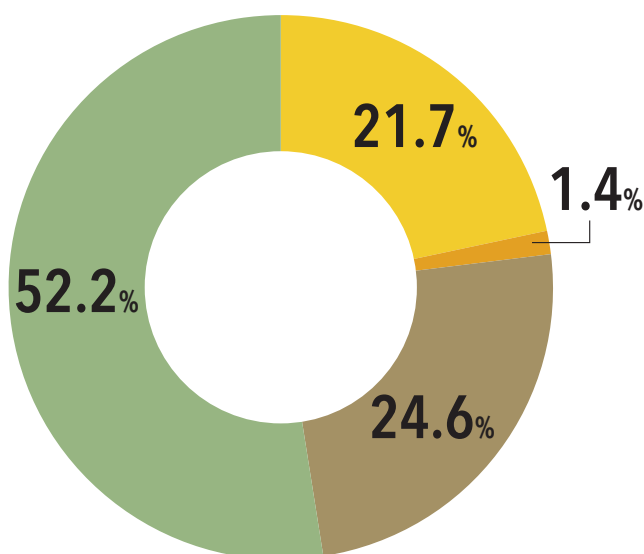
- Under 10%
- 10% to 30%
- 30% to 50%
- 50% and over
- others

19

Do you have any medium to long term aims to change the sales ratio in China?

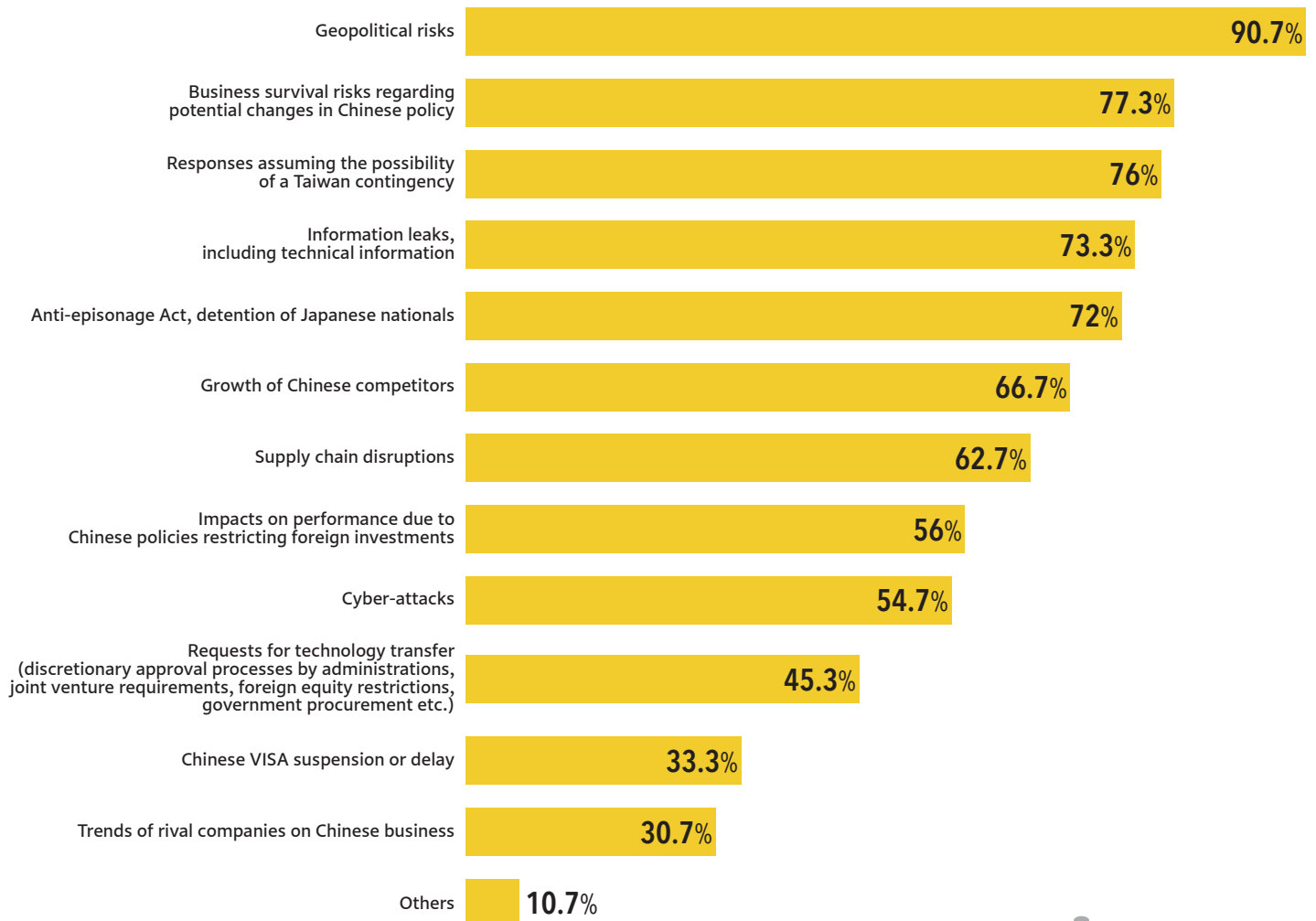
[69 responses]

- Aiming to increase the sales ratio in China
- Aiming to reduce the sales ratio in China
- Maintaining the current ratio
- Not especially



What are important topics to be attentive to for developing business in China? Select all that apply.

[75 responses]



Qualitative Responses

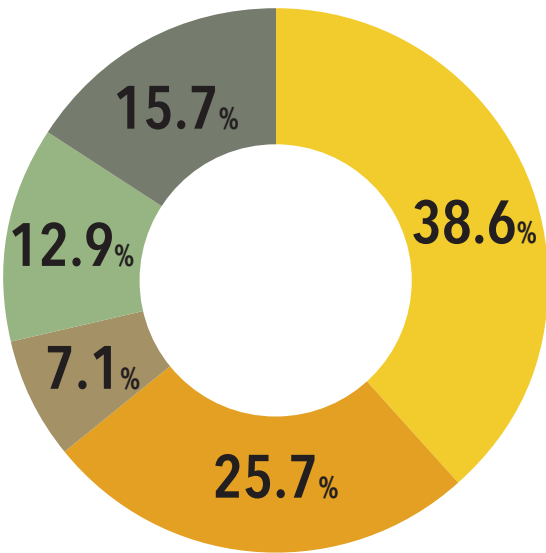
- Currently no support operation for Japanese companies in China, but all items should matter when involved in the future.
- Misappropriately filed Intellectual Property Rights and similar, such as Innovation Patent Rights and Patent Rights, etc. by Chinese companies are an obstacle.
- Restrictions by American policies and regulations on operations in China.
- Diversion to military use of products.
- Strengthening of export regulations.
- Delayed production due to restrictions on electricity.
- Sales boycott activities resulting from worsened sentiments towards Japan.
- No operations in China.



Is your company prepared for a possible Taiwan contingency, and how far?

[70 responses]

- Planning Taiwan contingency simulation drills
- Finished simulations and preparing a BCP (Business Continuity Plan)
- Finished simulations and prepared a BCP
- No simulations planned
- Others



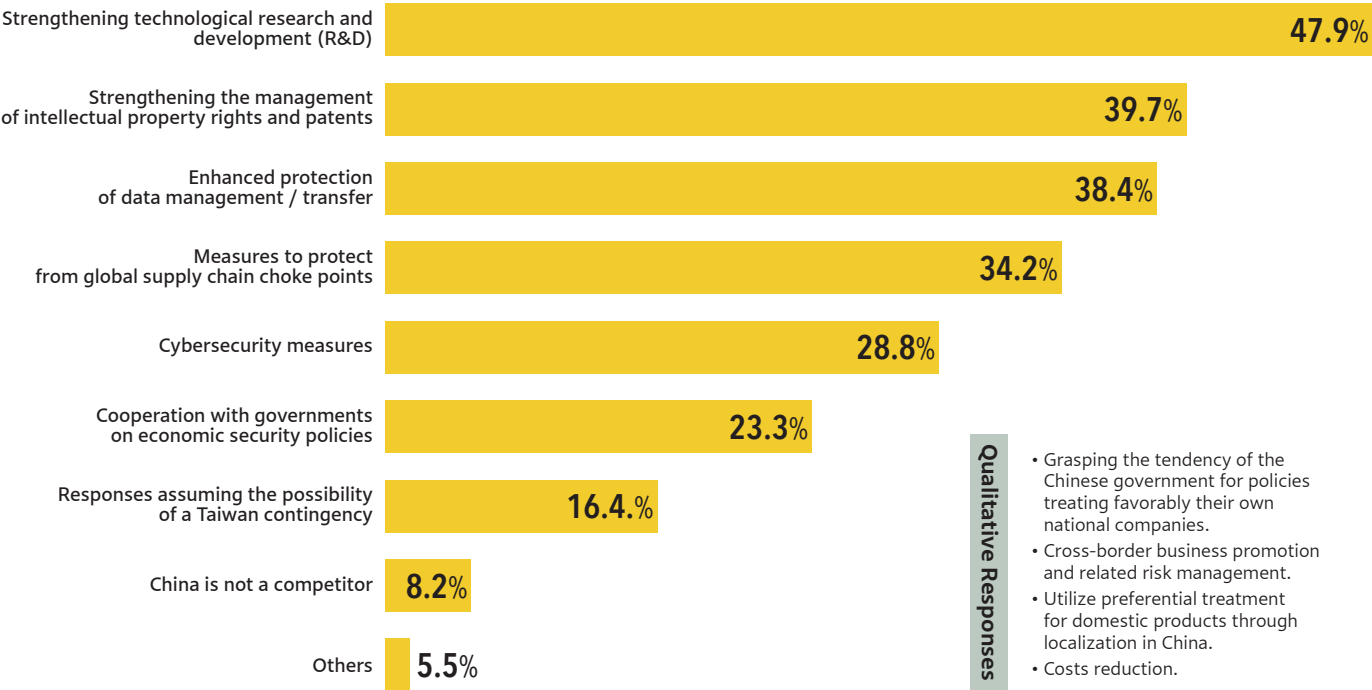
Qualitative Responses

- We completed some partial simulations and we are now preparing a plan of response.
- Review of Business Continuity Plan's (BCP) risk items and update of the whole BCP.
- We are preparing a plan of response, including a Business Continuity Plan (BCP).
- In addition to creating backup plans and Business Continuity Plans (BCP), we are verifying IT-related backup systems.
- We are preparing expected responses to a number of issues, including a Taiwan contingency. From now on, we will plan for the necessary realization of these responses in accordance to specific situations.
- We are in the process of formulating response plans for times of emergency.
- We are preparing response plans mostly assuming gray zone situations.
- Currently, we are considering all possible issues. Future response is still undecided.
- Not yet considered.
- We would like to refrain from disclosing information.

21

To maintain a competitive edge in regard to China, where do you place the most value?

[73 responses]



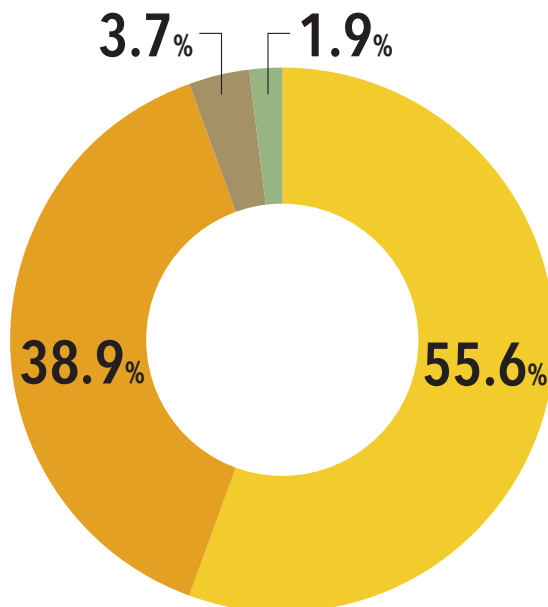
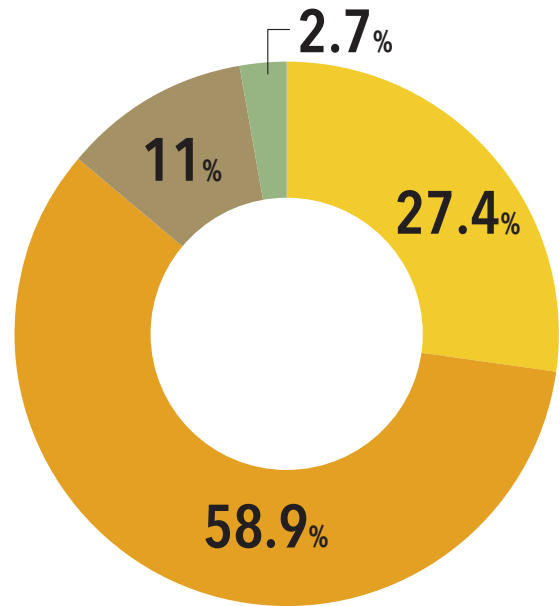
Qualitative Responses

- Grasping the tendency of the Chinese government for policies treating favorably their own national companies.
- Cross-border business promotion and related risk management.
- Utilize preferential treatment for domestic products through localization in China.
- Costs reduction.

22

What ratio of your sales are in the US? [73 responses]

- Under 10%
- 10% to 30%
- 30% to 50%
- 50% and over



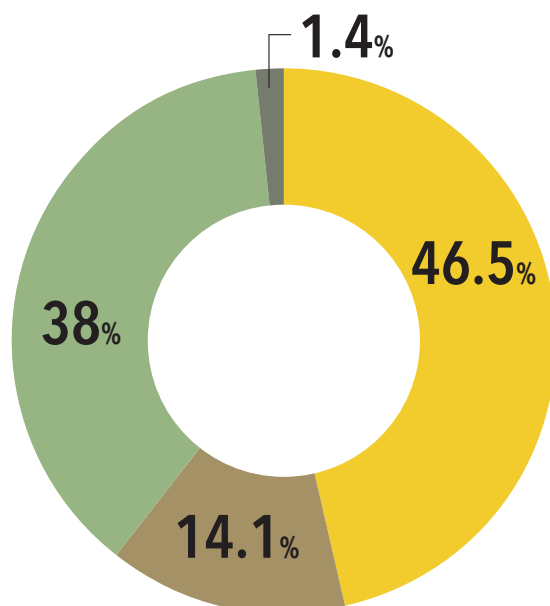
Additionally if your business includes production processes, what ratio does this take? [54 responses]

- Under 10%
- 10% to 30%
- 30% to 50%
- 50% and over
- others

23

Do you have any medium to long term aims to change the sales ratio in the US? [71 responses]

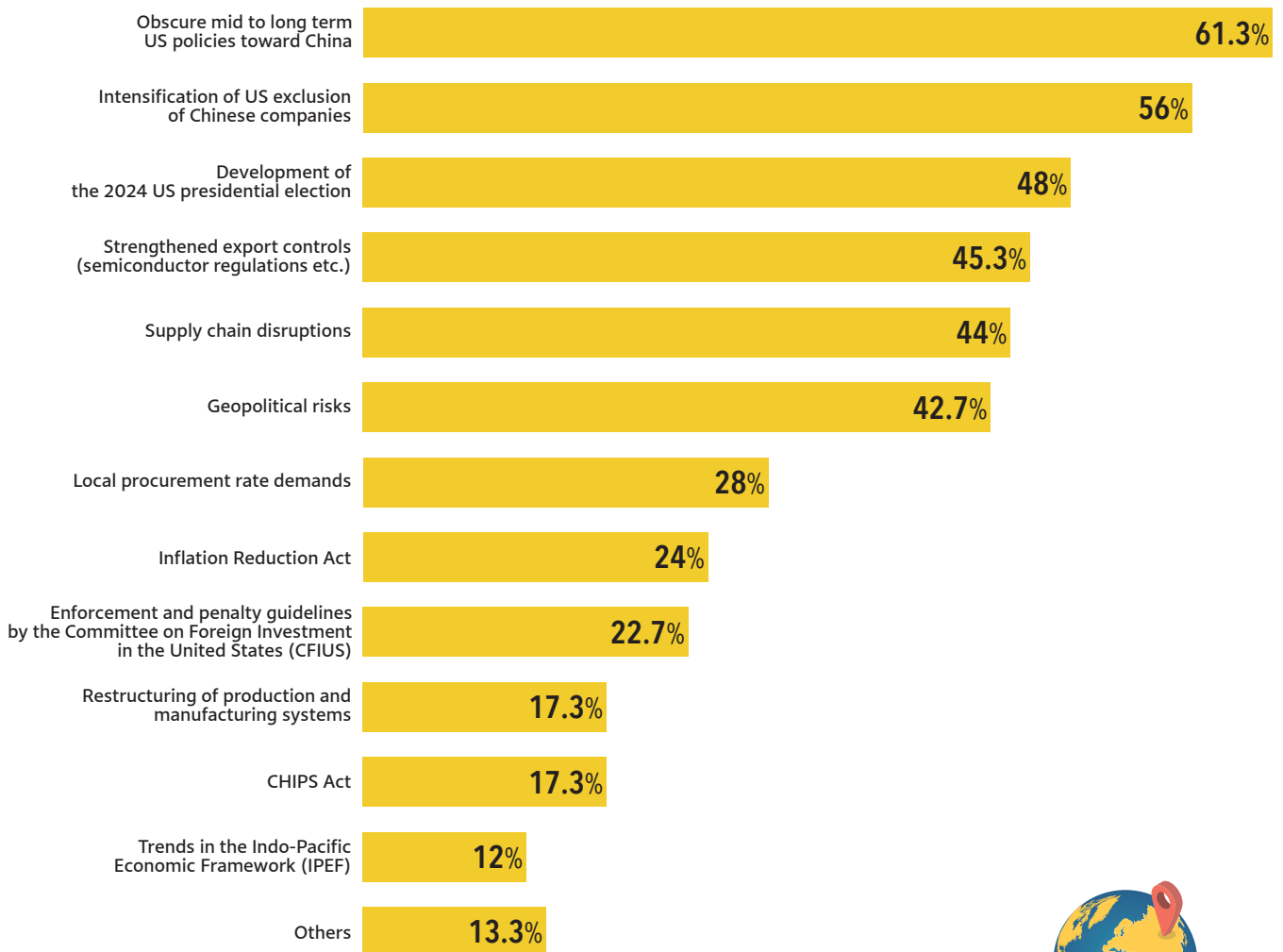
- Aiming to increase the sales ratio in the US
- Aiming to reduce the sales ratio in the US
- Maintaining the current ratio
- Not especially
- Others



24

What are important topics to be attentive to for developing business in the US? Select all that apply.

[75 responses]



Qualitative Responses

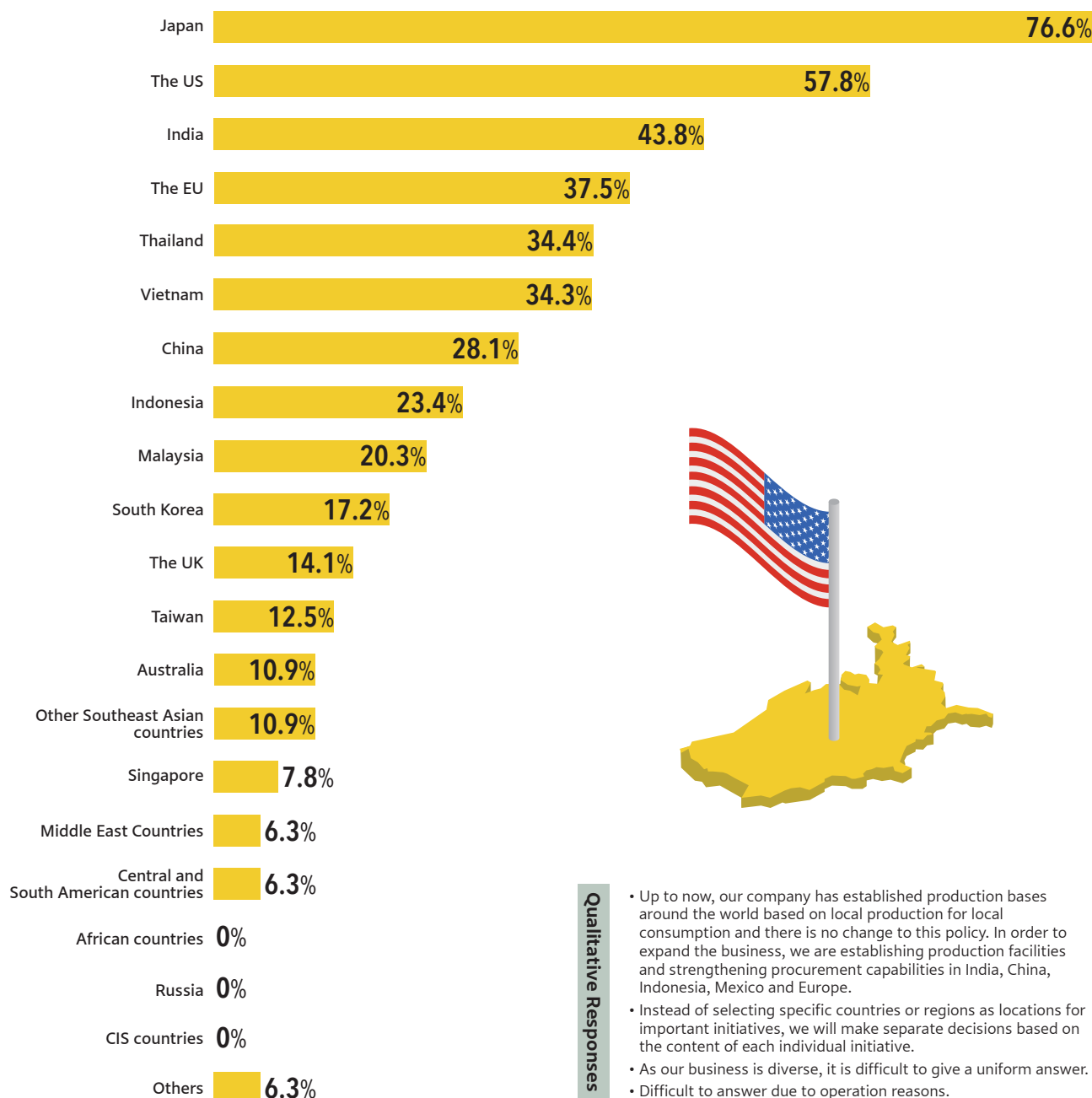
- Trends in Carbon Neutrality (CN) policies including industrial reinforcement policies. Also, issues of political divisions and social unrest.
- Change of direction in responses towards the environment and similar issues stemming from changes in government.
- Trends in US' national regulations.
- US government's environmental policies, US' financial institutions' financial regulations for the resource sector, product market conditions (not limited to the US), etc.
- Complying with US government procurement, International Traffic in Arms Regulations (ITAR), etc.
- The National Defense Authorization Act 2023 (NDAA 2023) and similar semiconductor regulations aimed at China.
- Compliance with the Uyghur Forced Labor Prevention Act.
- The American economic situation as well as market trends.
- Economic situation, tightening regulations, etc.
- Nothing in particular.



25

Select a country/region planned or designated for diversifying suppliers, changing or diversifying sales destinations, transferring production sites, or changing investment plans. Select all that apply.

[64 responses]



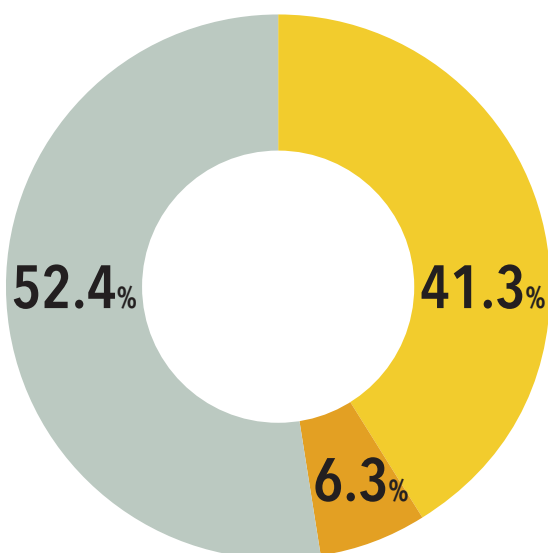
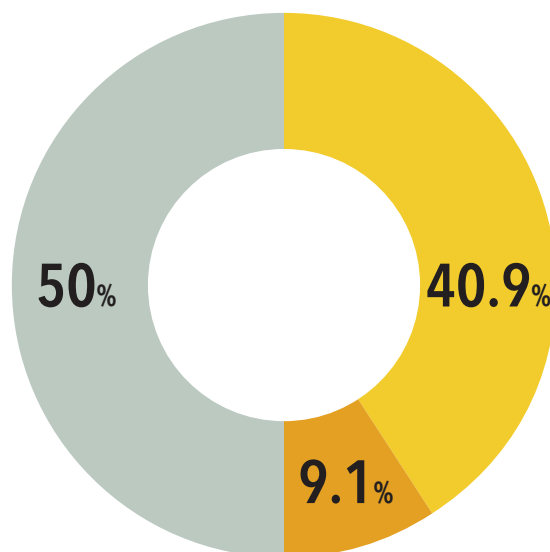
26

Regarding the future economic security policy, please indicate your satisfaction with the Japanese Government's efforts in each of the following topics below. Of the items related, please put “○” to satisfied topics, “×” to unsatisfied topics, and “△” to neither topic.

Supporting supply chain resilience and transfer of production bases, including reshoring

[66 responses]

- Satisfied
- × Unsatisfied
- △ Neither



Support for ensuring stable supply of specified critical products.

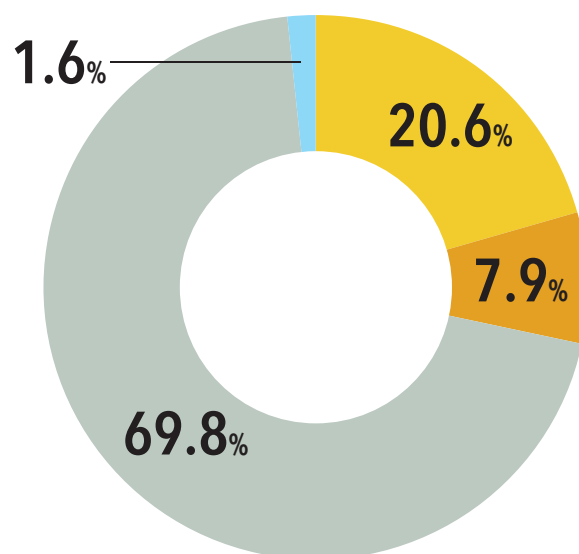
[63 responses]

- Satisfied
- × Unsatisfied
- △ Neither

Supporting to ensure stable provision of essential infrastructure services, including screenings

[63 responses]

- Satisfied
- × Unsatisfied
- △ Neither
- other



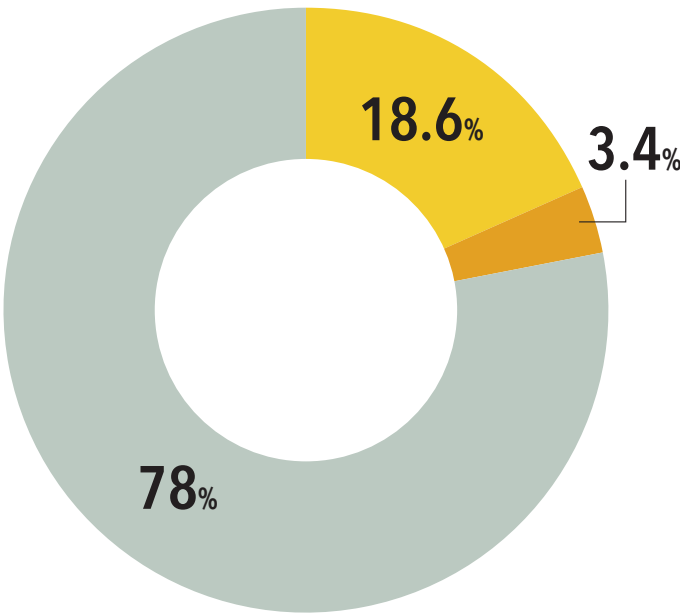
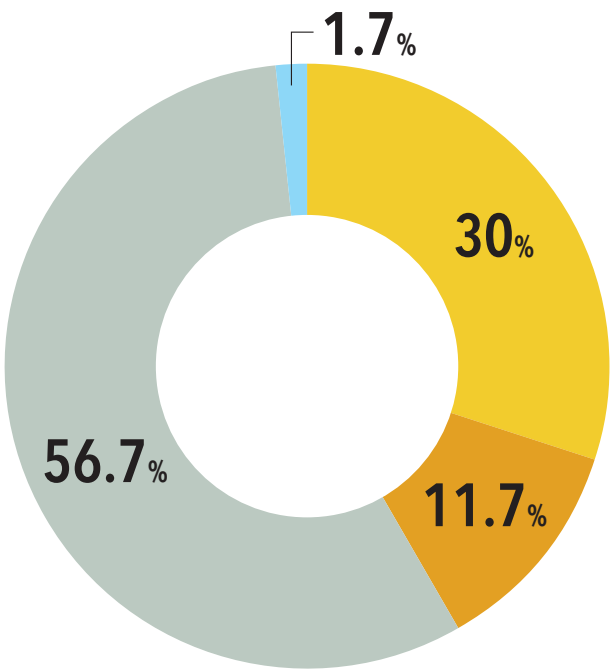
Support for enhancing development of specified critical technologies through public-private cooperation

[60 responses]

- Satisfied
- × Unsatisfied
- △ Neither
- other

Qualitative Responses

• There is no demand for public-private partnerships but support towards the development of critical cutting-edge technologies is more and more necessary.



System for non-disclosure of selected patent applications

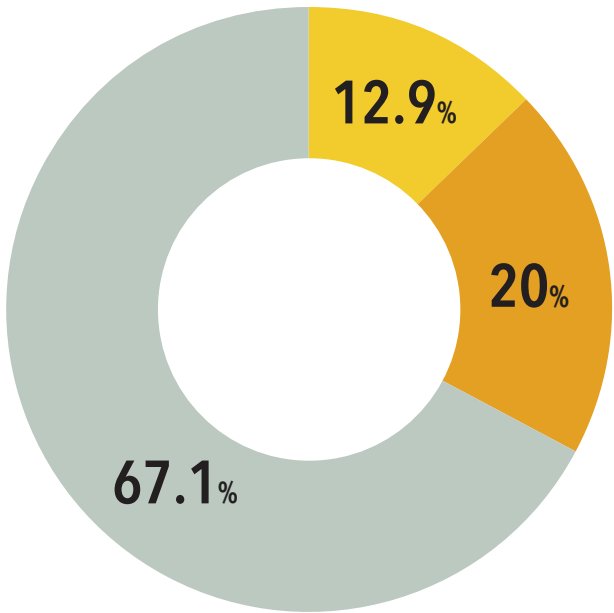
[59 responses]

- Satisfied
- × Unsatisfied
- △ Neither

Clarication of the direction in future legislations and information disclosure

[70 responses]

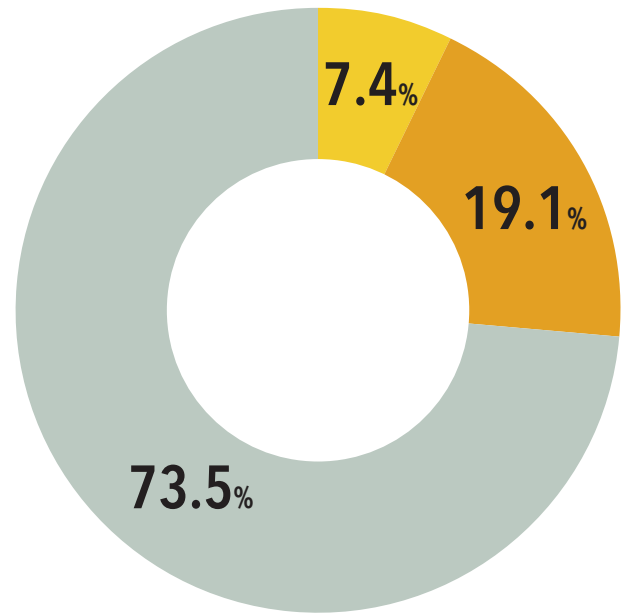
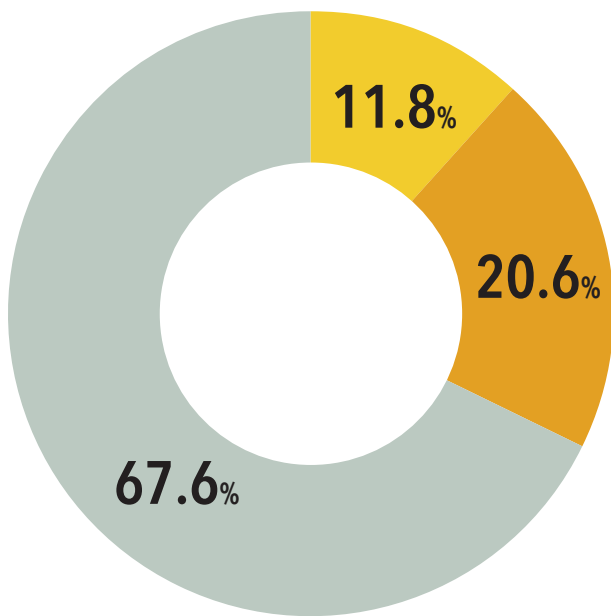
- Satisfied
- × Unsatisfied
- △ Neither



Policy making with the protection of corporate profits in mind

[68 responses]

- Satisfied
- × Unsatisfied
- △ Neither



Provision of Information on US-China relations, the situation in Ukraine and Taiwan

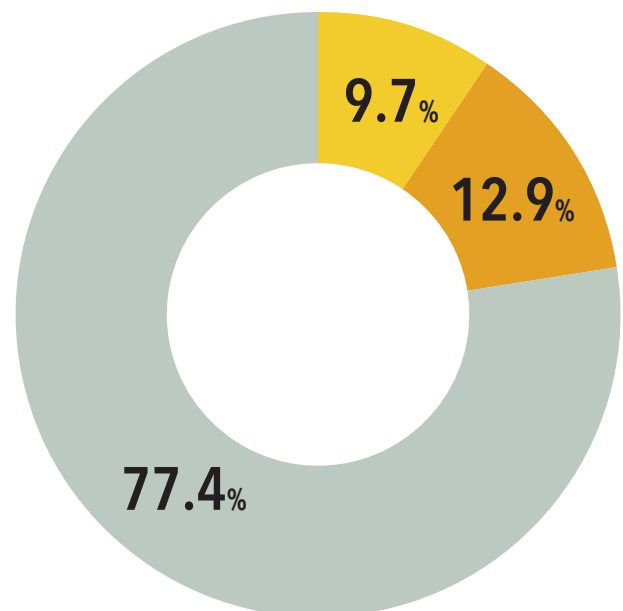
[68 responses]

- Satisfied
- × Unsatisfied
- △ Neither

Establishment of public-private joint meetings/councils to discuss economic security

[62 responses]

- Satisfied
- × Unsatisfied
- △ Neither



Qualitative Responses

- Strengthening defense power (Satisfied).
- Promoting effective initiatives in collaboration with the business community, including economic organizations.
- Can't say either (Satisfied or dissatisfied) regarding: support for small-scale capital investment, special secrets' protection law and security clearance law system classification.
- Protection of companies from retaliatory measures from China (Unsatisfied).
- Unfairness of subsidies' adoption for semiconductors (Unsatisfied).
- We refrain from policy evaluation at this time.
- We refrain from answering.

What do you expect most from the Minister for Economic Security? Please answer freely.

[62 responses]

Qualitative Responses

- Regarding the 'Ensuring the safety and reliability of core infrastructure through preliminary screening and so on.', article 5 of the law stipulates that regulatory measures shall take into account the impact on economic activities and in order to guarantee security, they should be carried out considering reasonable necessity and within recognised limits. In addition, the basic guidelines also pay attention to the balance between citizens' and country's safety and free economic activity. The system and its operation are to be developed based on the specific circumstances of each business etc. following adequate enquiries and similar methods conducted with economic operators, all the while limiting target restrictions to the absolute necessary. According to the recently promulgated ministerial ordinance and public announcement, this regulation targets specified social infrastructure operators (210 in total). Because it imposes on these operators and their suppliers a heavy burden, Keidanren, the Japan Electronics and IT Industries Association (JEITA) and the specified social infrastructure operators themselves expressed great concerns over the regulations' application through public comments. Furthermore, although the basic guidelines state that constant communication shall be established with related business operators (including specified social infrastructure operators), despite the stated aim to foster trust relationships, we find that the government has not provided sufficient information. In particular, regarding making the system known for hypothetical foreign suppliers, we feel that efforts are not sufficient.
- In order to maintain the profitability and competitiveness of Japanese companies, we would like (the government) to always be knowledgeable of the latest state of affairs in the US, China, and other foreign countries, sharing this information with the business world and formulate policies giving importance to their point of view.
- Policy support for strengthening core Research and Development (R&D) and clarifying the policy direction.
- At the time of putting the Economic Security Promotion Law into effect, cooperation and coordination efforts between the new leaders National Security Secretariat (NSS), the Economic Security Promotion Office on the one hand and relevant authorities on the other. When introducing the security clearance system, the establishment of a governmental leading organization to centrally handle defense and nondefense matters.
- To make public clear government responses and messages to the outside so as to avoid that a worsening security environment in East Asia or elsewhere will affect economic and business activities.
- We would like to ask for the submission of the very best policies directed at Japanese businesses' and industries' growth and development.
- Carefully select the target areas for applying restrictions and to provide detailed information on target areas as early as possible.
- Establishment of a fair competitive environment with foreign competitors and the contribution of proposals aimed at developing a healthy global market.
- Measures to limit the leak of next-generation technologies' Intellectual Property (IP); support for investment in alternative domestic production as a response to the supply crisis of core components procured overseas; support for investment to reduce overseas' energy dependence (promotion of renewable energy); support and negotiation for securing Japan's competitiveness regarding legislation represented in the Inflation Reduction Act (IRA).
- Establishment of meetings and systems to jointly discuss economic security in the public and private sectors.
- Enacting policies based on businesses' actual status.
- On the one hand, Japanese companies are taking measures to not be at a cost disadvantage to Chinese companies and Western governments are requesting the application of human rights due diligence. On the other hand, China is treating human rights investigations as interference in its internal affairs and it's applying retaliatory measures because of it. We would like to see the strengthening of multilateral cooperation, etc. in order for Japanese companies not to worry about how to respond to the above issues.
- Steady enforcement of the Promotion Law, including the development of the remaining legal systems (security clearance system and others). Continuation of reciprocal communications with the business community to promote efforts regarding economic security policies that Japan is required to apply.
- To grasp a comprehensive view of supply chains in Japan, US, China, Germany, France and UK. To present the ideal scenarios for the years 2030 and 2050.
- Clarification of dealings that should not be carried out. At the moment, we understand that decisions on potentially risky transactions in line with economic security are left to the company to decide upon. However, there are cases where transactions do not damage the companies but Japan itself. We are concerned that unless the government does not clarify which transactions should be prohibited, as it happens to some extent in the US, Japanese companies will practice excessive self-restraint and lose international competitiveness. (Loss when self-restraining) Example: Cases when, a company possesses a technology that is no longer needed because it is no longer operating in a certain field, but the technology is a core one so that Japan could be in trouble if it leaked to China. It is hoped that by spreading a system in which the country decides which transactions should be avoided, there will be no need to give excessive consideration to reputational risks, like the case of the so-called 'self-restraint police' during the coronavirus pandemic.
- In order for Japan to obtain leading technologies such as carbon neutral ones ahead of other countries, we wish for proactive industrial support policies including subsidies and similar. Moreover, in order to obtain and maintain competitiveness in such high-level technologies, we wish for the government to actively engage in, and work on, maintaining a fair international order and rule-making.
- Support for dealing with supply chain risks to prevent technologies' loss from small and medium enterprises.
- We would like to convey the information that given the uneven distribution towards China on raw materials and towards the US on production and assessment equipment, companies dealing with semiconductors cannot materialize business in case the US-China confrontation deepens further.
- Establishment of policies that will strengthen measures to prevent information leaks through people and laws cracking down on industrial espionage.
- We wish for the formulation of policies which attach importance to ensuring the competitiveness of domestic production.
- We would like to entertain early discussions with the US government regarding their new rules and regulations. In addition, we would like to sufficiently contribute to what will be said to the US government.
- Smooth implementation of the four measures of the Promotion Law which reflect corporate activities.
- When developing new legislation, it is necessary to ensure the predictability of policies and to take a long-term perspective that focuses on the characteristics of each industry, while at the same time paying attention to not make excessive regulations impede business. From this perspective, we would like to ask for consideration regarding: the direction of the development of the system, information disclosure, maintaining fairness in the international competitive environment and finally, refraining from sudden environmental changes (like industrial protection or the tightening of regulations).
- We would like (the government) to proactively work on the economic security of medical care. Based on the Covid-19 experience, we would like to deal in a coordinated manner

with relevant ministries for the protection of citizens' lives and for ensuring a safe and secure lifestyle through initiatives and measures of medical security, including a stable supply of drugs and medical equipment.

- We would like (the government) to grasp the situation facing private companies, gather practical opinions from the field and use these to improve not only our company but the Japanese economy as a whole.
- Ability to create and implement regulations for cybersecurity measures regarding specific fields, companies and their relative supply chains. In order to avoid being left out of global supply chains, policy planning based on mutual information exchange with the business community.
- Equipment of intelligence capacity to support the whole country.
- Disclosure of government offices' direction and public-private exchange of information.
- Support for small-scale capital investments, clarification of the Special Secret Protection Law and clarification of the security clearance law system classification.
- We would like initiatives that truly put Japan's national interest at the forefront.
- The formulation of administrative guidelines regarding the implementation of the legal system.
- Ensuring economic security with consideration for freedom of economic activity.
- We would like information disclosure and distribution of easy-to-understand information to the public.
- Ensuring policy transparency and predictability.
- Proactively disclose information on the direction of the legal system and its implementation from now on.
- Clarification of the future direction and understanding/supporting energy security.
- In the case that limits to the market and normal trading exchanges will be imposed in accordance with the country's national security issues, we would like (the government) to understand the ideas of related private businesses beforehand and provide public information.
- Strengthening channels and fostering common understanding at various levels between the US and Japanese government in order to ensure both, that US security legislation is not unreasonably applied to Japanese companies and that the Japanese government could provide appropriate advice to companies regarding the compatibility of economic security and business. Similarly, we would like (the government) to carry out related measures to ensure that Japanese companies, as third-country businesses, do not suffer disadvantages (caught in the US-China confrontation) as a result of the Chinese government's national security law/competition legislation and similar.
- Enacting economic security policies based on actual private businesses' management operations. This information is to be gathered by engaging in dialogue with the business community when enacting and enforcing laws as well as ministerial ordinances. In order to avoid situations where Japanese businesses' are in the position of being forced to choose between the US and China (on their own responsibility and judgment) or being pushed to take up costs until now not present, the government should be standing in front and enact policies aimed at minimizing companies' business risks. While the essential condition remains that regulations should be kept at a minimum to ensure freedom of business activities, based on the fact that regulations are a national policy, (the government) might have to think about giving compensation/support to companies affected by it. Especially in response to expected 'economic coercion' from the Chinese government, we would hope for collaborative private-public sector efforts also in the US-Japan and G7 frameworks.
- Strengthening the supply chain for high-overseas-dependent

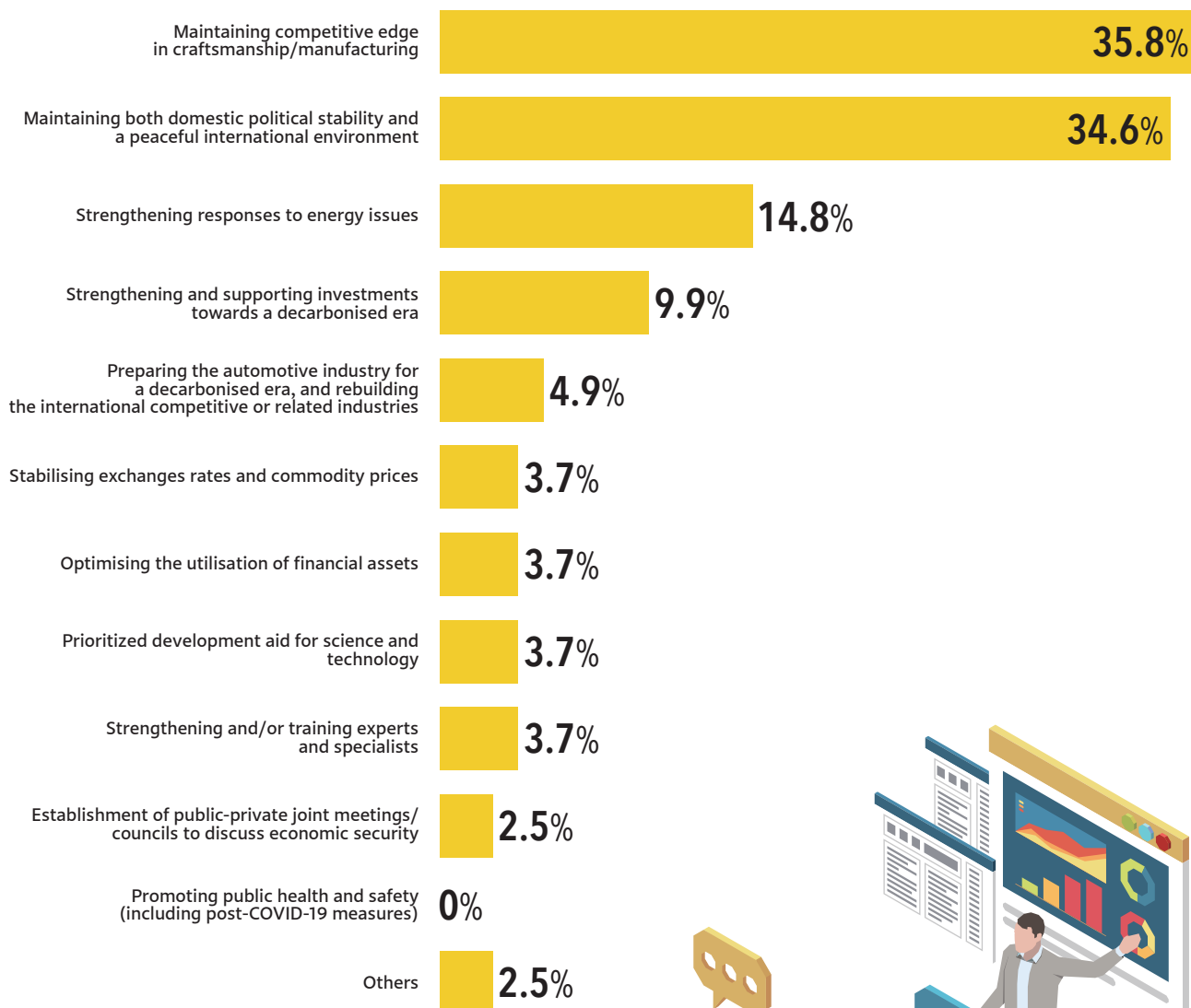
energy resources.

- Information gathering regarding designated essential supplies and appropriate responses.
- Strengthening supply chain diversification support through development support of designated essential supplies, production and rare resources, which are currently unbalanced towards certain countries.
- Flexible use of export insurance.
- As part of security, there are the strengthening of regulations aimed at risk reduction such as export control and policy promotion aimed at obtaining advantageous conditions from the standpoint of country and national industries. Especially for the latter, we hope for proactive communication and efforts to take place.
- In order to protect the autonomy of Japanese manufacturers, it is indispensable to establish technological chokepoints. We would like that effective choke point technologies will be strategically identified through close public-private discussions and based on a medium-long term perspective, we hope that effective support will advance. Also, in preparation for major changes to the current situation (such as changes in allies' policies, etc.), we would like to see the appropriate examination of risks and the strengthening of discussions on backup plans.
- Strengthening of industrial technology leak prevention and safeguard.
- Ensuring transparency of policy direction.
- Creating a mechanism for companies to receive clear answers and advice when consulting with the government.
- Policies directed towards both securing the national interest and freedom of economic activities for businesses.
- Economic security responses conforming with national energy policy.
- Proactive policy decisions directed towards securing our country's strategic autonomy, and demonstrating a leading role in shaping the international order.
- Further strengthening of dialogue and coordination between country and businesses regarding economic security.
- Creation of legislation and introductory steps for the corporate activities-related security clearance system. Structure-making for information sharing in the Five Eyes framework. We would also like assistance in developing necessary legislation for supply chain visualization of critical goods.
- Cross-border exchanges are often a strength for Japanese businesses in their business with China. (We would like to ask for) Policy guidance focusing on avoiding creating obstacles to cross-border opportunities and information exchanges between headquarters and subsidiaries, as well as focusing on maintaining business and profits.
- Impact mitigation in support of the Japanese economy and businesses through: towards the US and as a US ally, deterrence from economic security policy radicalization and excessive extremism as a result of American internal political polarization; towards Europe, encouraging joint actions as Europe is currently advancing in its own independent path while observing trends in US-Japan relations ahead of it.
- Maintaining and developing a fair competitive environment and clear judgment standards.
- Maintaining an effective structure of collaboration with business circles, including business associations.
- Clarification of regulatory limits regarding directives in matters of economic security and policy decisions aiming at American-Chinese business coexistence.
- Nothing in particular.
- N.A.

28

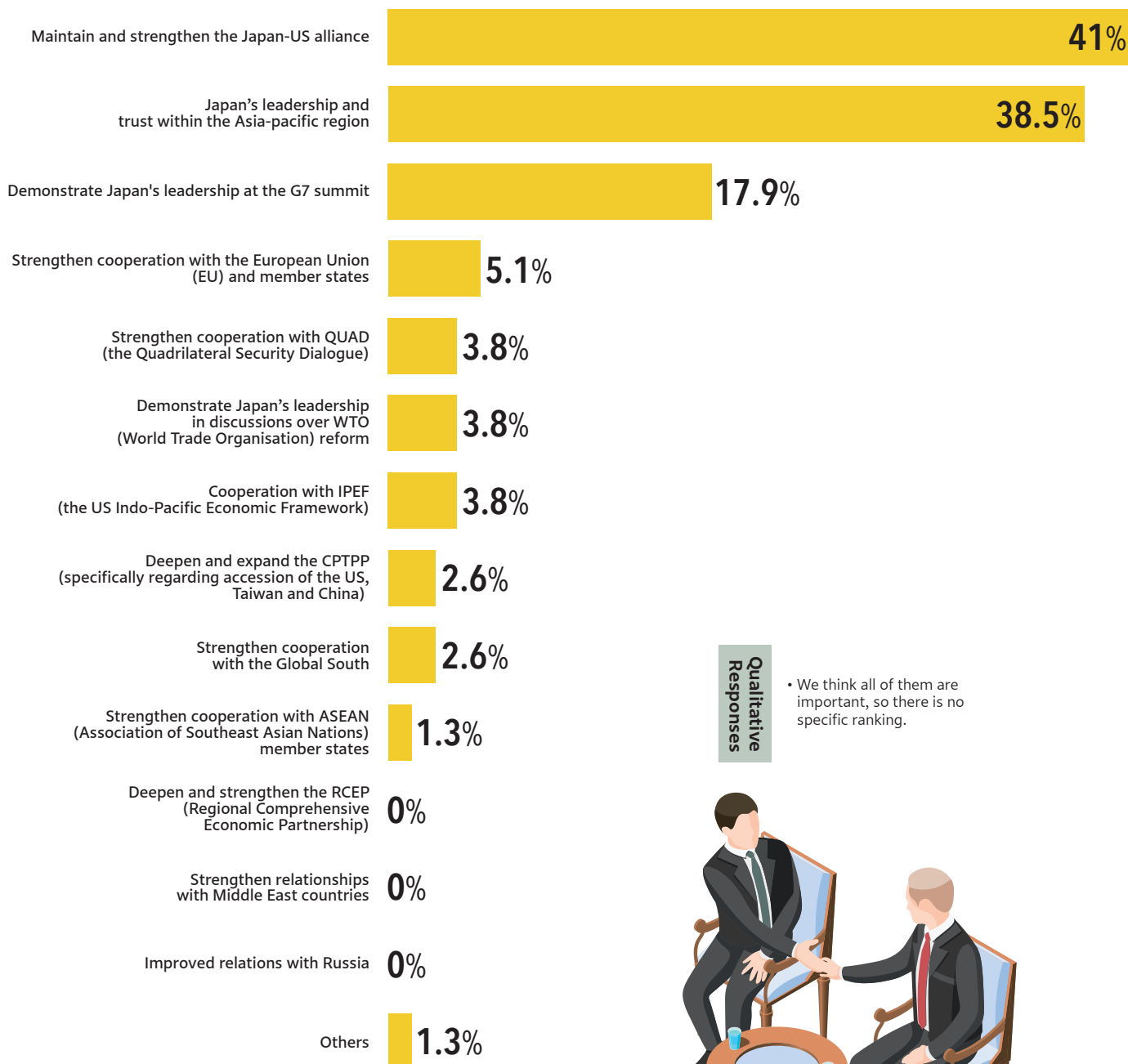
In promoting Japan's economic security strategy, what should be done to maximise and make the most of Japan's strengths? Please select which of the following you consider to be the highest priority.

[81 responses]



Which of the following frameworks/region do you think Japan should strengthen relations with in advancing economic security strategy? Please select which of the following you consider to be the highest priority.

[78 responses]



Qualitative Responses

- We think all of them are important, so there is no specific ranking.



Current status and challenges of supply chain restructuring:

the government should realize economic security together with companies by providing support in need

Mariko Togashi, Visiting Research Fellow, Economic Security Group



Against the backdrop of strategic competition driven by the US-China confrontation, the destabilization of the international order due to the two wars in Ukraine and Gaza and the extensive use of economic means for security purposes, the strengthening of supply chains has become one of the most pressing policy agendas for many countries. In Japan as well, supply chain restructuring has become a priority as one of the most important elements of achieving economic security. For instance, the Economic Security Promotion Act which came into effect in 2022, includes supply chain restructuring as one of its pillars.

Among companies, supply chain restructuring is moving forward despite the lack of sufficient information to make decisions. In the third survey of ‘100 Japanese Companies on Economic Security’ conducted by the Institute of Geoeconomics (IOG) in 2023 (hereafter referred to as the ‘100-companies survey’), to the question ‘What is in your opinion, the biggest challenge in dealing with economic security?’ (Survey Question 6), essential elements relating to supply chain restructuring such as ‘Gathering information on international affairs’, ‘Uncertainty in US-China relations’ and ‘Risk-evaluation methods’ ranked high. Nevertheless, regarding practical efforts to address economic security already being implemented by companies (Survey Question 4), 58% of respondents confirmed they ‘Changed or diversified suppliers’, 25.9% have ‘Changed or diversified sales destinations’ and 23.5% have ‘Transferred production bases’.

Essentially, supply chain restructuring requires a careful balancing of interests. The fundamental issue with government-led supply chain restructuring (also true for economic security in general), is the difficulty of striking the balance between economic interests and security. Therefore, understanding the direction of supply chain restructuring and grasping the actual situation is important to find the right balance to ensure Japan's economic security.

With the above issues in mind, this article will focus on the Japanese government's supply chain restructuring efforts and the companies' current state of supply chain restructuring, and discuss some points worth of attention. While strengthening the supply chain does not necessarily mean moving away from a specific country, this article will

focus on the activities of Japanese companies in the Chinese market, given its scale, high level of dependence towards it, and overall importance.

The Japanese government's efforts towards supply chain restructuring

For the Japanese government and Japanese companies alike, supply chain restructuring has been an issue since well before the recent spike in awareness of economic security. In fact, a trend towards a ‘China plus one strategy’, aiming at reducing and diversifying investment and production dependence on China, has emerged first, in response to China's slowing growth and rising prices due to higher labour costs, and second, in response to a deterioration of Japan-China relations following the collision incident involving Chinese fishing vessel off the Senkaku Islands in 2010 and the consequent suspension of rare earths exports.

More recently, in 2020, which was before the implementation of the Economic Security Promotion Act, the Japanese government provided subsidies to encourage the return of domestic production and to support diversification towards Southeast Asia as a direct result of the pandemic exposing supply chain vulnerabilities. In 2022, the Economic Security Promotion Act, of which one of its pillars is represented by the promotion of a stable supply of specific critical materials, came into force and the government began a fully-fledged supply chain restructuring.

International efforts for supply chain restructuring are based on mini-lateral or plurilateral frameworks. Japan, holding the presidency of the G7 in May 2023 at the Hiroshima Summit, confirmed the importance of ‘Resilient and reliable supply chains’, and in conjunction a Quad summit consisting of Japan, the United States, Australia and India was also held. To promote joint investment in critical technologies, a Quad Investors Network (QUIN) was launched. In August of the same year, at the Japan-US-Republic of Korea (ROK) summit, in order to quickly share information in the event of disruptions to the supply chain of critical materials (such as critical minerals and storage batteries), a supply chain Early Warning System (EWS) has been set up. In October, in the field of decarbonization, the launch with the World Bank of the partnership for ‘Resilient and Inclusive Supply-chain

Current status and challenges of supply chain restructuring:

the government should realize economic security together with companies by providing support in need

Enhancement (RISE)¹ and in November with the signing of the Indo-Pacific Economic Framework (IPEF) supply chain agreement, the Japanese government is rapidly developing its international efforts to strengthen supply chain resilience. Cooperation with the so-called Global South is also being strengthened, mainly focusing on strengthening supply chains for resources such as critical minerals.

No significant changes in trade volume yet, but investments volume has dropped significantly

The Japanese government has been bolstering its effort to restructure supply chains both domestically and internationally, but to what extent have companies actually restructured their supply chains? Indicators for supply chain distribution are wide-ranging, however, this article will focus on trade volume and direct investment volume. Overall Japanese exports to China in 2023 (January to December) fell 6.5% year-on-year (YoY) with the US becoming the top export destination. However, raw materials (accounting for 11.4% of total exports to China), electrical equipment (21.3%) and transportation equipment (8.1%) all fell by more than 10% YoY, which was likely driven by the current slowdown of the Chinese economy. Especially steel and auto parts fell by 24.9% and 24%, respectively, suggesting an impact from the worsening real estate market. In semi-conductors, exports of related manufacturing equipment increased by 19.7% YoY due to last-minute demand before the implementation of US export restrictions towards China. Exports of semiconductor electronic parts fell by 7.1% but considering that the global semiconductor market fell by 11% compared to the previous year¹, this is not a particularly revealing figure.

Japanese total imports from China in 2023 were down by 1.7% YoY, driven by raw materials (accounting for 11.6% of total imports from China) which fell by 7.8% and by general machinery (accounting for 17%), which fell by 4.2% YoY. Although semiconductor electronic parts fell by 22.4%, there has been an overall increase by 2.2% in electric machinery, mainly driven by communication equipment and heavy electrical machinery. Regarding dependency, as part of the total share of imports, the rate of imports from China still remains high with 30% for raw materials and about 40% for general machinery and electric equipment. Thus,

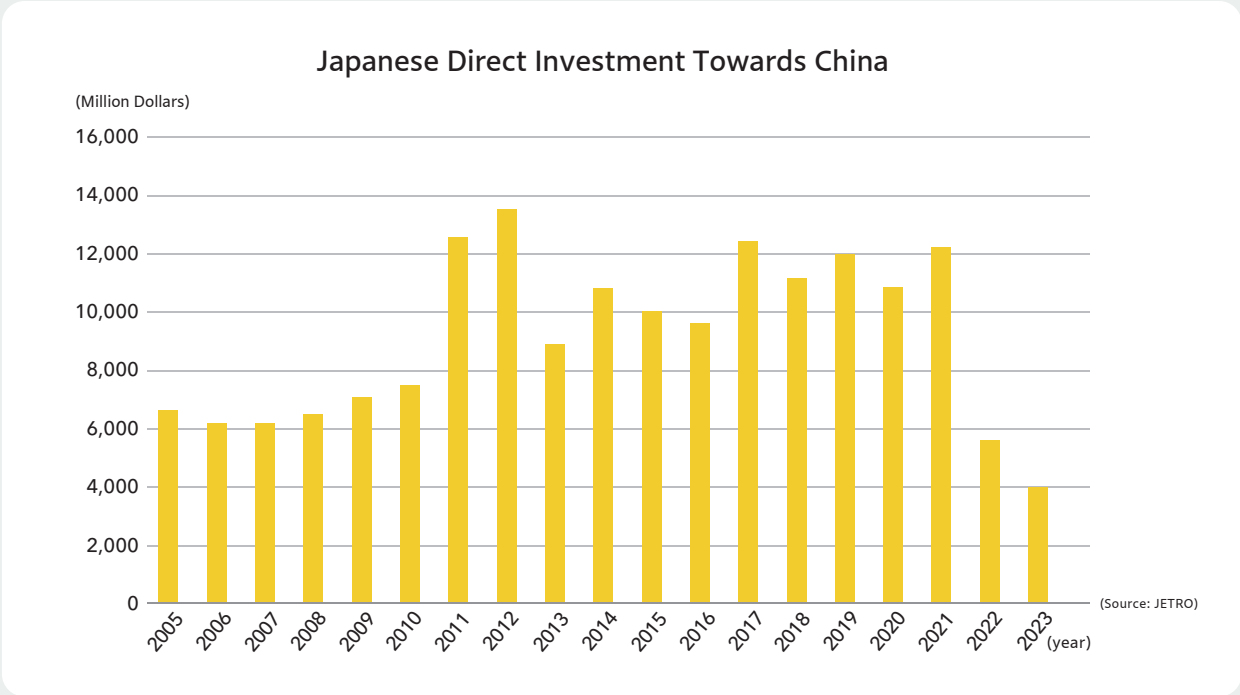
¹ 'Global semiconductor market, in 2023 11% reduction, Gartner Survey' Nihon Keizai Shimbun 2024/01/17 (Japanese Version)
<https://www.nikkei.com/article/DGXZQOUC169YL0W4A110C2000000/>
 (Accessed 2024/04/14)

if we look at trade data between China and Japan in 2023, the impact of supply chain restructuring due to geopolitical factors seems to be limited.

Meanwhile, Japan's direct investment in China, a leading indicator, has also declined significantly, although the extent of the decline is smaller than the global decline in direct investment in China. According to China's State Administration of Foreign Exchange (SAFE), overall Foreign Direct Investment (FDI) fell by 81.7% YoY, marking a significant decline for the second consecutive year and the lowest level since 1993². Japanese FDI towards China fell by 30.7% YoY in 2023, following a 54% decline in 2022. However, the decline is expected to be relatively modest compared to other countries, due to a much wider range of both industries and company sizes involved³, making speedy changes more difficult.

² Japan External Trade Organization (JETRO) 'Inward direct investment in 2023 to fall 80% from previous year, but only a limited amount of companies are considering withdrawing' 2024/02/21 (Japanese Version) <https://www.jetro.go.jp/biznews/2024/02/ea95f89f4be496f4.html>(Accessed 2024/04/14)

³ Japan External Trade Organization (JETRO) 'Are Japanese businesses hesitant to invest in China?' 2023/05/25 (Japanese Version) <https://www.jetro.go.jp/biz/areareports/2023/a453545c93fb987c.html>(Accessed 2024/04/14)



Current status and challenges of supply chain restructuring:

the government should realize economic security together with companies by providing support in need

Despite firms' changing sentiments, neither expansion nor withdrawal

Having said that Japanese companies' investments in China are declining more modestly compared to other countries, an emerging trend of a decline in the past consecutive years is pronounced, which requires further research to grasp the actual state of supply chain restructuring.

According to the 'FY2023 Survey on Business Conditions of Japanese Affiliated Companies' (JETRO survey) conducted by the Japan External Trade Organization (JETRO), the percentage of companies responding that they would consider 'Expansion' in China over the next 1-2 years was 27.7%, a record low and the second consecutive year of decline, a trend similar to the decline in investment⁴. Furthermore, while 9.3% of companies were considering 'Downsizing', up 4.4 points from the previous year, only 0.7% were considering 'Relocating to a third country (region) or withdrawing', a figure half compared to the previous year. Finally, 62.3% were considering 'maintaining the status quo', up 2 points from last year.

These results are consistent with those of the '100-companies survey' conducted by the Institute of Geoeconomics (IOG). Regarding mid/long-term sales-ratio targets in China, 21.7% of respondents said they 'Target an increase', down by 4.1 points compared to the previous year, while 1.4 % said they 'Target a decrease', down by 3.1 points compared to the previous year, and finally, 24.6 % said they would 'Target maintaining the status quo', up by 11 points from the year before (Question 19). The reality of Japanese companies' inability to expand or even withdraw from the Chinese market can be seen.

While the majority of surveyed companies said that they would maintain the current business scale in the Chinese market, this does not mean that there has been no changes in their corporate activities. Among the companies in the JETRO survey that said they will "expand" their business in the Chinese market in the next 1-2 years, 38.9% are considering expanding production of high value-added products, down 5.7 points from the previous year, while 19.7%, up 2.9 points from the previous year, are considering expanding production of general purpose products. This

⁴ Japan External Trade Organization (JETRO) 'FY2023 Japanese firms' foreign expansion fact-finding survey (Asia/Oceania) (2023/11) 2023/02/21 (Japanese Version)
<https://www.jetro.go.jp/world/reports/2023/01/a261e38b2e86c8d5.html> (Accessed 2024/04/14)

gives a glimpse of how Japanese firms try to expand their business in areas that are not likely to be subject to US and Chinese regulations. There are also changes in procurement in the Chinese market. If we compare JETRO's surveys for 2023 and 2022, the Japanese companies' local procurement ratio remained at the same level from the previous year at 68.3%. A decline in procurement from Japan, which fell by 1.3 points to 24.5%, was offset by an increase in procurement from ASEAN, which increased by 1.5 points to 4.1%.

While Japanese firms' overall willingness to expand their business in China is declining, the reality is that neither a significant decrease in trade volume nor a decision to withdraw from the market is happening. To understand the background of this gap between government's direction and the actual circumstances of Japanese firms, we need to look not only at the factors that prevent Japanese firms from expanding in the Chinese market (i.e. promoting supply chain restructuring) such as level of concentration, cost increases, slowing Chinese growth, US-China disputes or regulatory uncertainty, but also the factors that prevent them from withdrawing from the market (i.e. preventing supply chain restructuring). There are three points to keep in mind when thinking about restructuring supply chains.

Point 1: Chinese market's advantage making industrial substitution difficult

The first point is that the remaining advantages of the Chinese market, such as market size, global market linkages and trade structure, higher market levels, and profit margins, make it difficult for other countries to substitute China under the current situation.

Despite weakening economic growth in China, the country remains the second global economic superpower after the US, and such market scale is still a critical element for companies. Moreover, because of its role in the global economy as 'the world's factory', despite continued concentrated efforts in the US to remove dependencies on China for designated sectors, as of today the Chinese market remains indispensable for both global supply and demand. Especially in growing sectors such as Electric Vehicles (EVs), batteries and solar power, China is quite competitive⁵.

⁵ Ministry of Economy, Trade and Industry (METI) 'On national and foreign trends towards carbon-neutrality in the automotive sector' 2023/04/05 (Japanese Version) https://www.meti.go.jp/shingikai/sankoshin/green_innovation/industrial_restructuring/pdf/014_04_00.pdf (Accessed 2024/04/14)
Agency for Natural Resources and Energy 'On solar power' 2023/12 (Japanese Version) https://www.meti.go.jp/shingikai/santei/pdf/091_01_00.pdf (Accessed 2024/04/14)

Current status and challenges of supply chain restructuring:

the government should realize economic security together with companies by providing support in need

⁶ Ministry of Finance ‘Ministry of Finance Trade Statistics’
<https://www.customs.go.jp/toukei/shinbun/happyou.htm> (Accessed 2024/04/14)

⁷ Ministry of Economy, Trade and Industry (METI) ‘Commerce White Paper’ 2023/06 (Japanese Version) <https://www.meti.go.jp/report/tsuhaku2023/pdf/zentai.pdf> (Accessed 2024/04/14)

⁸ Japan External Trade Organization (JETRO) ‘FY2023 Japanese firms’ foreign expansion fact-finding survey (Asia/Oceania) 2023/11/28 (Japanese Version) 2023/11/28
https://www.jetro.go.jp/ext_images/_Reports/01/a261e38b2e86c8d5/20230023rev2.pdf (Accessed 2024/04/14)

⁹ Japan External Trade Organization (JETRO) ‘Are Japanese businesses hesitant to invest in China?’ 2023/05/25 (Japanese Version)
<https://www.jetro.go.jp/biz/areareports/2023/a453545c93fb987c.html> (Accessed 2024/04/14)

The globally integrated Chinese market is extremely important for Japan as well both quantitatively and qualitatively. The share of Japanese exports to and imports from China in 2023 were 17.6% and 22.2%, respectively. While the US became the biggest export destination from Japan, China remained the top import source⁶. In the global value chain, Japan supplies China with intermediate goods, and the opposite is also true. Over the past few years, China has supplied Japan with intermediate goods even more, indicating the increasing risks in supply chains⁷.

The increasing technological level of the Chinese market is also worth attention. In the JETRO survey for FY2023, regarding who is seen as strong competitor in the Chinese market, about 90% of respondents answered ‘Local companies’, an overwhelming response compared to other markets⁸. In the ILOG’s ‘100-companies survey’, when asked about what is most important to compete with Chinese companies (Question 21), ‘Strengthening of Research and Development (R&D)’ has been the most popular response, marking 47.9%. The Chinese market’s increasing technology level intensifies competition, but it also raises the level of the whole supply chain. Finally, for Japanese companies, the Chinese market’s profitability is also attractive. In 2021, the direct return on investment in China was 15.1%, greatly surpassing the average of 6.9%⁹.

These elements are appeal of the Chinese market, which is difficult to replace overnight, even in the face of increasing US-China confrontation and policy uncertainty, which may raise hurdles for supply chain restructuring.

■ Point 2: Companies’ understanding and interests

The second point concerns the limits in companies’ understanding of, and interests in, supply chain restructuring to achieve economic security. In the ILOG’s ‘100-companies survey’, on the topic of practical efforts underway to achieve economic security (Question 4), 58% of firms responded ‘Supply chain revision and diversification’, 25.9% responded ‘Customer revision and diversification’, 23.5% responded ‘Transfer of production base’. It can be seen that supply chain restructuring among the surveyed companies is already underway.

On the other hand, in the ‘Survey on the impact of changes in the international state of affairs on business management’ (Impact Survey) conducted by the Japanese Chamber of Commerce and Industry (JCCI) and the Tokyo Chamber of Commerce and Industry (TCCI), which surveyed broader companies, there seem to be not much awareness of the urgency of supply chain restructuring. While 25.9% of the respondents indicated that supply chain stabilisation and strengthening ‘Should be dealt with as an urgent matter’, more respondents of 42.2% indicated that it ‘Should be dealt with in the medium/long-term’¹⁰.

Furthermore, in the same Impact Survey, it became clear that the comprehension of and interest towards economic security are limited. Regarding the Economic Security Promotion Act, the highest 46% of respondent companies answered ‘Not particularly interested and do not understand it well’. Regarding the government support towards supply chain strengthening, 73.5% of firms responded ‘Do not know’. In addition, regarding the global direction moving forward, views are split between: ‘Development of reshoring to Japan’ accounting for 32.6%, ‘Continuation of globalization’ accounting for 30.5% and ‘Development of friend-shoring’ with 27.5% of respondents. The results indicate that there is no common understanding of the trends having a major impact on supply chain restructuring.

Although companies’ understanding and interest in economic security has significantly increased over the past few years, the current situation suggests that there is still much room for improvement regarding supply chain restructuring.

Point 3: Government’s supply chain restructuring focuses on re-shoring

The third point of interest regarding supply chain restructuring consists in the very different outcomes that re-shoring, near-shoring and friend-shoring could bring. On the one hand, the Japanese government advocates for supply chain strengthening in cooperation with other countries, but the support offered to companies so far centres on re-shoring. One of the pillars of the Economic Security Promotion Act is the promotion and securing of stable supply of key designated materials, however, with the

¹⁰ Tokyo Chamber of Commerce and Industry (TCCI), Japan Chamber of Commerce and Industry (JCCI) ‘Survey results of the ‘Survey on the impact of changes in the international situation on corporate management’ 2023/12/14 (Japanese Version) https://www.jcci.or.jp/20231214_tyosakekka.pdf (Accessed 2024/04/14)

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exception of materials that are highly dependent on external sources and therefore require external cooperation, such as natural gas and critical minerals, the act actually centres on strengthening domestic production and domestic capital investments. Furthermore, in the IOG's '100-Companies Survey', when asked about 'Which countries or regions do you consider important for supply chain restructuring?' (Question 25, multiple choices allowed), the respondents answered 'Japan' the most (76.6%). The actual state of play is that both companies and the government emphasize reshoring.

Depending on how it is carried out, the impact of supply chain restructuring on corporate earnings and the global economy will differ. Some estimates suggest that geoeconomic fragmentation could reduce global GDP from 0.2% (limited fragmentation, low adjustment costs scenario) up to 7% (deeper fragmentation, high adjustment costs scenario) in the long term, with an even greater impact if fragmentation in technological fields is considered¹¹. Also, there are estimates regarding advanced Asian economies (including Japan), where it is said that friend-shoring would be more costly than near-shoring¹².

Assuming that re-shoring continues to a level exceeding what is necessary, in the medium-long term, companies will have to maintain inefficient production systems with a high chance of weighing down the entire economy.

Realizing economic security through government support tailored to firm's realities

In supply chain restructuring, taking into account the difficulty to substitute the Chinese market, the companies' economic security interests and understanding, and the current focus on reshoring, the government should consider pursuing three initiatives proposed below.

First, after taking into consideration the difficulties of substituting the Chinese market, going beyond simple economic support for supply chain restructuring, the government should offer assistance in order for businesses to take appropriate decisions. Many companies still lack sufficient interest in and understanding of economic security and support measures. For supply chain restructuring to

¹¹ International Monetary Fund, "Geoeconomic Fragmentation and the Future of Multilateralism", 2023/01/15 <https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2023/01/11/Geo-Economic-Fragmentation-and-the-Future-of-Multilateralism-527266> (Accessed 2024/04/14)

¹² Mitsubishi Research Institute (MRI) 'Cost increases in global supply chain reconstruction' 2023/05/18 (Japanese Version) <https://www.mri.co.jp/knowledge/insight/20230518.html> (Accessed 2024/04/14)

truly contribute to economic security, support measures to help companies make decisions, such as intelligence sharing, human resource development, information exchange platforms, and points to consider when maintaining the current supply chain, are needed.

Second, in response to the issue of companies' understanding and interests of economic security, the government should approach a wide range of companies and provide support tailored to the circumstances of each industry. In the 'Action Plan in strengthening the production and technological foundations regarding economic security' published by the Ministry of Economy, Trade and Industry (METI) in October 2023 (revised in May 2024), the importance of the public-private strategic dialogue is emphasized. Moreover, for example, in the field of storage batteries manufacturing equipment, there are efforts to form alliances to strengthen manufacturing bases¹³. The acceleration and expansion of specialised initiatives aimed at different industries are indispensable to realize Japanese economic security.

Third, to make a step beyond the current domestic-focused reshoring measures, the government should communicate its international direction to companies more clearly. While Japan is accelerating its efforts with like-minded countries, such as the G7 and QUAD, it is also a member of the IPEF, CPTPP and RCEP which also includes China. It is essential for the government to show a more concrete direction for medium- and long-term supply chain restructuring, including near-shoring and friend-shoring as well as reshoring, in order to achieve economic security together with companies.

Japan has played a pioneering role globally in economic security policymaking. One of the key pillars of this policy, supply chain restructuring must be promoted by providing support that is tailored to the actual conditions of the companies and ensure their economic security. Such support will likely prove essential to realize Japanese economic security.

¹³ Ministry of Economy, Trade and Industry (METI) 'Progress of measures related to the battery industry strategy and current plans' 2023/09/29 (Japanese Version)
https://www.meti.go.jp/policy/mono_info_service/joho/conference/battery_strategy2/shiryo4.pdf Accessed 2024/04/14);
Cabinet Secretariat 'Summary of the eighth meeting of the Council of Experts on Economic Security Systems'
https://www.cas.go.jp/jp/seisaku/keizai_anzen_hosyohousei/r5_dai8/gijiyousi.pdf (Accessed 2024/04/14)

How will Japan respond to new U.S. investment rules?

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In recent years, as countries increasingly focus on their economic security, much of the discussion on bolstering investment regulations has been centred on inbound investment. Japan's rules in this area have largely been influenced by developments in the United States — namely, new regulations to strengthen the Committee on Foreign Investment in the United States (CFIUS).

In addition, U.S. President Joe Biden signed an executive order last August to establish new outbound investment regulations under the so-called “small yard, high fence” concept. This means that strict regulatory measures will only be taken in sectors that could potentially threaten national security.

The U.S. Treasury Department is leading the formulation of these draft regulations while it seeks to generate public comments, mainly from the private sector. Against this backdrop, Japanese businesses — especially those that could be impacted by the proposed changes — need to make their voices heard before the new rules are finalized.

■ U.S. inbound investments

Since 1975, CFIUS — an interagency body chaired by the Treasury Secretary — has been reviewing inbound investments that could pose a threat to American security. Between 2015 and 2016, a surge of Chinese investment in the U.S. and the growing importance of dual-use technologies led policymakers to rethink and update CFIUS regulations — in part to address the increasingly held view of China as a strategic competitor. Congress passed the Foreign Investment Risk Review Modernization Act (FIRRMA) in 2018, which was signed into law by then-President Donald Trump.

In early 2020, the Treasury Department implemented the final regulations designed to strengthen CFIUS, which put certain transactions — such as acquisitions of American companies — under tighter scrutiny in the areas of critical technologies, critical infrastructure and sensitive personal data, among others.

The Biden administration picked up where the Trump administration left off and in September 2022, the incumbent signed an executive order indicating the areas that the CFIUS review process would consider “critical.” This included technologies such as microelectronics, artificial intelligence, biotechnology and biomanufacturing, quantum computing and advanced clean energy. Some members of Congress have also called on Biden to block Japan’s Nippon Steel from acquiring U.S. Steel under the updated CFIUS screening mechanism.

In view of U.S. presidential elections in November, the proposed takeover has become a campaign issue. Although both Trump and Biden have politicized it and come out against the deal, CFIUS’ decision on whether to approve the acquisition should be made consistently with the small yard, high fence concept, purely from a national security perspective. In other words, the issues of national security threats and domestic employment should be treated as distinct.

■ Outbound investment rules

Last August, Biden signed the aforementioned executive order on outbound investment, targeting China. The order focuses on three critical technology areas: semiconductors and microelectronics, quantum information technologies and artificial intelligence. It requires transactions in these areas to be notified and prohibits those involving serious threats.

As a senior Biden official explained to journalists, “The thing we’re trying to prevent is not money going into China overall, because they have plenty of money. The thing they don’t have is the know-how.” The official also signaled the government’s intention to prevent the outflow of advanced technologies not covered by conventional export controls — again, as part of the small yard, high fence approach.

A February 2023 report sheds some light on the background to these restrictions. It states that American venture capital firms, such as those owned by major American semiconductor companies, have provided various forms of support to China’s AI industry, in addition to investment. The report, “U.S. Outbound Investment into Chinese AI Companies” by Georgetown University’s Center for Security and

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Emerging Technology, provides an example of a company receiving American venture capital investment and subsequently being placed on the Department of Commerce's list of companies banned from exporting, known as the Entity List.

The new regulations are expected to impose a comprehensive web of restrictions in these and other related cases. Following Biden's executive order, the Treasury Department published what is known as an "advance notice of proposed rulemaking" and requested public comments in response to 83 questions.

The department indicated that it intends to prohibit transactions involving specific technologies in the three critical areas and to subject others to notification requirements. For example, under semiconductors and microelectronics, the Treasury Department is considering prohibiting transactions involving advanced integrated circuits and supercomputers under certain conditions. It is also contemplating a notification requirement for the "design, fabrication, and packaging of other integrated circuits" — a system that is also designed to help the U.S. government better understand the nature of investment practices and inform future policy.

In response, 61 submissions were made by industry associations and other interested parties mainly in the U.S. (none came from Japan). They provided specific comments about investments and technology and many also requested that the Treasury Department limit restrictions so that existing businesses would not be affected. The U.S. Chamber of Commerce and the Semiconductor Industry Association, for example, stated that the scope of the regulations should be clarified and narrowed down and that international coordination is needed to ensure that the rules do not affect only American firms.

It is taking the Treasury Department some time to analyze all the comments and then draft its regulations — a reminder that formulating outbound investment controls is no simple task. Meanwhile, the National Critical Capabilities Defense Act was introduced in the U.S. House of Representatives in May 2022. The scope of its restrictions was broader than Biden's executive order, however,

the bill did not pass due to disagreements over its scope and methodology.

Therefore, the Treasury Department's draft regulations may well influence future discussions in Congress — and in like-minded countries, including Japan.

Japan's investment regulations (inbound and outbound)

In November 2019, Japan strengthened its inbound investment regulations by amending the Foreign Exchange and Foreign Trade Act. The threshold for transactions requiring prior notification had previously been foreign investments of 10% or more, but the new rules lowered this to 1% or more. In addition, the notification system was expanded to include cases such as proposals for appointing directors and details of business transfers in certain sectors.

However, exemptions under specific conditions were also established, including when foreign investors are not involved in management and do not have access to undisclosed technical information. Foreign companies are required to determine whether they meet the exemption criteria at the time of the business transaction and, if so, whether it would be sufficient to file a later report.

The government has thus significantly expanded the scope of regulations while establishing a wide range of exemption criteria. Its task now is to monitor compliance. Japan aims to increase its balance of incoming foreign direct investment from ¥46.2 trillion, as recorded at the end of 2022, to ¥100 trillion by 2030. Therefore, it needs to ensure that enough specialist personnel are available to monitor whether foreign investors using the exemption system are indeed not involved in management or privy to private technical information.

On the other hand, unlike in the U.S., an open, public discussion about Japan's outbound investment regulations is not taking place. This is despite the Group of Seven leaders' statement on economic resilience and economic security made at last year's summit in Hiroshima, which specifies that "appropriate measures designed to address risks from outbound investment could be important."

How will Japan respond to new U.S. investment rules?

Outside of Japan, the European Commission adopted new initiatives in January to strengthen its economic security. Among them, the commission intends to “identify potential risks stemming from outbound investments in a narrow set of technologies.” However, the EU executive also expressed caution, citing a lack of data to proceed with the initiative. For this reason, after a process of public consultation, the commission will recommend that member states undertake one year of monitoring and its assessment is scheduled for next fall.

Given the complexity and economic impact of outbound investment regulations, it is necessary for G7 countries to gather more data and hold further discussions. It is also important for the Japanese government to first gain a better understanding of outbound investment flows by dialoguing with and collecting data from the private sector.

On this basis, in addition to discussing outbound investment regulations for Japan, it is also important for Japan to express its opinions on the proposed U.S. regulations soon to be released by the Treasury Department. It goes without saying that once these rules have been decided, it will be too late for Japan to make its views known. The impact on Japanese companies, including Japanese-owned American firms, will be significant, and they need to start preparing now.

■ Survey of 100 Japanese Companies

The Institute of Geoeconomics (IOG) has published a survey on economic security every year since 2021, targeting 100 global Japanese companies representing various industries. In this year’s third survey, two questions on U.S. investment regulations (inbound and outbound) have been newly added.

First, Survey Question 7 inquired about “the impact of U.S.-China competition on your company”. Of the 64 companies that responded, 10 (15.6%) indicated that U.S. investment regulations are affecting their businesses.

In the ‘CFIUS 2022 Report’ published by the U.S. Department of the Treasury in July 2023, Japanese companies

applying to the CFIUS 'Declaration' in 2022 placed second after Canada, while for companies applying for the more detailed CFIUS 'Notice', Japan came in fifth after Singapore, China, United Kingdom and Canada, placing Japanese companies in the top spots of countries for CFIUS applications. Comparing with the response to the 100-companies survey cited above, it is possible that a certain number of Japanese companies may be struggling with CFIUS applications etc.

Second, Survey Question 24 asked about “considerations for U.S. businesses,” and of the 75 companies that responded, “considerations as a consideration.” Since Question 7 asks about the “impact on businesses,” it can be inferred that the answer to this question was made by considering the existing inbound investment regulations etc. In contrast, Question 24 may have taken note of the proposed outbound investment regulations that the U.S. Department of Treasury is currently considering.

In the fourth Survey of 100 Japanese Companies on Economic Security scheduled for early 2025, the Institute of Geoeconomics (IOG) plans to examine Japanese companies' trends in more detail by separating the questions and options regarding U.S. investment regulations (inbound and outbound).

The Opportunity and Duty for Japan's Defense Exports Amid the Demand-Pulled International Defense Economy

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The Economic Security Promotion Act enacted in 2022 stipulates as its objective “the promotion of national security through integrated economic measures.” In light of this, it would be correct to understand that the government’s concept of “economic security,” most succinctly expressed, is the use of economic measures for the purpose of enhancing national security.

Likewise, but slightly differently, it would be the defense industrial policy in that the two elements of security and economy are overlapping. The defense industry is an indispensable element of sustaining national security in the sense that it has the function of manufacturing defense equipment. On the other hand, it also has an economic aspect in which its function is dependent on companies. Therefore, just as economic security is a concept that symbolizes the growing awareness of the importance of economic aspects in national security, it is becoming increasingly important to take into account such aspects of the defense industry when considering its sustainability amid the situation where procuring defense equipment becomes more costly and requires more advanced technology. However, conventional discussions on the defense industry have not given enough emphasis on its economic aspects. Specifically, there has been a lack of consideration for maintaining the defense industry in a sustainable manner as an industrial sector. The most obvious manifestation of this is the former Three Principles on Arms Exports, which had restrained the overseas transfer of defense equipment, and the Three Principles on Overseas Transfer of Defense Equipment, which slightly expanded the options for exports.

Measures to strengthen the defense industry as a whole, including not only defense exports but also the entry of new companies with advanced technologies, are discussed in detail in the report “Comparative Study of Defense Industries: Autonomy, Priority, and Sustainability,” published in 2023 by the Institute of Geoeconomics. On the other hand, in this article, I analyze the opportunities for Japan and the expectations of its role in exporting defense equipment overseas, with particular attention to the trends in the international defense market.

International Defense Market Led by a Strong Supply Side

In general, countries with large defense expenditures tend to have large arms exports. According to the Stockholm International Peace Research Institute (SIPRI), the top 10 large defense spending countries in 2022 were, from top to bottom, the United States, China, Russia, India, Saudi Arabia, the UK, Germany, France, South Korea, and Japan while the top 10 largest arms exporters in the five years from 2018-2022 were the United States, Russia, France, China, Germany, Italy, the UK, Spain, South Korea, and Israel.¹ Of the top 10 defense spending countries, only India and Saudi Arabia, which have weak domestic defense industrial bases, and Japan, which has been restraining arms exports, are not among the top 10 arms exporters. The development and production of defense equipment require a large initial investment and advanced technologies while the scale of economy with a large demand does not usually apply, which means that it is important to expand overseas demand. Therefore, it is evident from these international trends that overseas exports are an indispensable means of maintaining a defense industry of a certain scale domestically.

In addition, while the scale of global arms exports has been increasing in recent years, the scale of US arms exports has been growing at a faster pace than that of the rest of the world. The scale of arms exports from the world's top 100 countries has increased 1.8 times over the past 20 years while that of the United States has tripled over the same period, accounting for 40% of the world's total.² While the increase in the size of global arms exports represents an increase in demand for arms, the significant increase in the share of US products with a technological edge suggests increased competition on the supply side. When looking at the US Department of State release, the size of Foreign Military Sales (FMS) increased by 55.9% from \$51.9 billion in FY2022 to \$80.9 billion in FY 2023.³ Of this amount, \$62.3 billion was paid for transactions that were not funded by the federal budget (such as grants or loans), but this is still significantly higher than the previous year's total.

By contrast, it is not easy for a latecomer in arms exports to rapidly increase its market share in an international market that has been dominated by strong suppliers. Thus,

¹ SIPRI, *SIPRI Yearbook 2023* (SIPRI, September 2023).

² This is based on SIPRI's trend index value (TIV) which measures the size of arms exports. SIPRI, Arms Transfers Database, <https://www.sipri.org/databases/armstransfers>.

³ Department of Defense, "Fiscal Year 2023 U.S. Arms Transfers and Defense Trade" (January 29, 2024), <https://www.state.gov/fiscal-year-2023-u-s-arms-transfers-and-defense-trade/>.

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even after Japan formulated the Three Principles on Overseas Transfer of Defense Equipment in 2014, which reversed its previous policy of uniformly restricting commercial arms exports, it has been unable to expand its overseas exports due to its lack of strength as a latecomer, combined with the limited areas of equipment which can be exported.

Revision of the Three Principles on Overseas Transfer of Defense Equipment to Enable Participation in International Supply Chains

Out of an awareness of the crisis over this situation, the government revised the Three Principles on Overseas Transfer of Defense Equipment and its Implementation Guidelines in December 2023. The revised Three Principles emphasize that the overseas transfer of defense equipment is an important policy tool for creating a desirable international security environment and for supporting countries that are suffering from aggression. This is based on the recognition that, in addition to responding to aggressors, defense equipment transfers would contribute to improving the security environment surrounding Japan by building medium-to-long-term relationships with the recipient countries through equipment maintenance, education, and training. Moreover, the Three Principles stipulate that overseas transfers would contribute to the improvement of its defense capability and the maintenance and enhancement of the defense industrial base, which is described as a defense capability itself. This may be a sign of the recognition that ensuring the sustainability of the operations of defense companies is essential for strengthening the defense industrial base, and that defense equipment transfers will contribute to ensuring such sustainability.

The revision also allows Japan to directly export indigenously manufactured parts and technologies incorporated into jointly-developed products, and to export licensed products to the licensor countries, which was previously limited to the exports of licensed parts to the United States.

On the other hand, as of the end of 2023, the Liberal Democratic Party (LDP) and Komeito were unable to reach an agreement in the ruling party discussions on broadly allowing the direct exports of jointly developed products from Japan to the third countries (other than the co-development

partners) and the exports of finished products developed indigenously, beyond those related to the so-called “five categories” (rescue, transport, warning, surveillance, and minesweeping).

In light of the above, the recent review of the Three Principles was carefully designed in order not to block deals with pragmatic benefits while still keeping reluctance to take a bold initiative in exporting finished lethal products. In particular, regarding international joint development, it can be said that the review is aimed at reducing the risk of undermining the overall benefits of the joint projects through Japan’s veto to third-party transfers initiated by partner countries.⁴ In addition, the full lifting of the ban on exports of licensed products and the lifting of the ban on component-level exports are realistic strategies for a latecomer to exports as they allow the Japanese defense industry to get integrated into the international supply chain by utilizing established markets already explored by foreign defense primes.

On the other hand, unless direct exports of jointly developed finished products from Japan to third parties and exports of equipment beyond the five categories are made possible, it will remain difficult for Japanese defense companies to leap forward as international defense primes. To examine the remaining issues in this regard, the ruling parties are resuming discussions on the second phase of the revision of the Three Principles early in 2024.

Indeed, the revision at the end of 2023 has significantly increased what the Japanese defense industry can do. Nevertheless, the author argues that the remaining issues mentioned above should be resolved as early as possible. There are three reasons for this.

■ Emergence of a Demand-Pulled Defense Market

First, defense trade, which used to be a supply-pushed market where countries with large domestic defense industries competed with each other to expand their exports, is now turning into a demand-pulled market. Signs of this have been seen for several years due to the recent great power competition. But it has become even more pronounced with the protracted war in Ukraine.

⁴ Even under the original Three Principles, it didn’t issue a blanket rejection of co-developers moving finished products made with Japan-derived components and technology to a third country, and it was possible to give a pre-ordained approval. In particular, when participating in an international system that accommodates for sharing components (such as the USA’s ALGS) or when providing components to the license holder (the provision of F-100 engine components for the F-15/F-16 to the USA) one did not adhere to the pre-approval procedure under the defense equipment transfer agreement, and instead undertook a more simple procedure that allowed for the transfer to a third country with the approval of the destination country’s import management system. With the revision undertaken in the end of 2023, in light of the possible necessity of a co-developer nation to directly transfer finished products with Japan-derived components or technology to a third country for maintenance and upkeep, it became additionally possible to directly export said products to a third country. The aforementioned case of direct export was (except for when there are high technical intricacies involved) also included under the simplified procedure for approving third country transfers with the approval of the destination country’s import management system, without the pre-approval procedures for the transfer agreements. With these procedures in place, for example, if a finished product of GCAP was manufactured in a British or Italian factory, if Japan pre-approves or checks the export management system of the third country, the UK and Italy can export the GCAP to a third country. However, since the GCAP is postulated to be manufactured by a Japan-UK-Italy Joint Venture, there may be a case where Japan may be asked to export a finished product through the manufacturing allocation for third countries, under the “spirit of equal partnership” (Japan-UK-Italy Joint Declaration). Under the 2023 amendments, there was yet to be consideration for these types of cases, and the Three Principles is undeniably acting as a restriction against Japan taking a leading role in GCAP’s manufacturing allocation discussion.

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⁵ John Ismay and Eric Lipton, "Pentagon Will Increase Artillery Production Sixfold for Ukraine", *The New York Times* (January 24, 2023), <https://www.nytimes.com/2023/01/24/us/politics/pentagon-ukraine-ammunition.html>; Doug Cameron, "Why Ukraine Hasn't Been a Boon to U.S. Defense Companies", *The Wall Street Journal* (January 31, 2023), <https://www.wsj.com/articles/why-ukraine-hasnt-been-a-boon-to-u-s-defense-companies-11675176026>.

⁶ "Europe needs a decade to build up arms stocks, says defence firm boss", *BBC News* (February 13, 2024), <https://www.bbc.com/news/world-europe-68273449>.

⁷ "Ukraine Uses Five Times Less Artillery Ammunition Than Russia – RUSI", *Defense Express* (January 8, 2024), https://en.defence-ua.com/industries/ukraine_uses_five_times_less_artillery_ammunition_than_russia_rusi-9125.html.

⁸ Department of Defense, "National Defense Industrial Strategy 2023" (January 11, 2024), <https://www.businessdefense.gov/docs/ndis/2023-NDIS.pdf>.

The United States, the largest assistance provider to Ukraine, had not maintained a large inventory of ammunition and portable anti-tank and anti-aircraft missiles, which are important in a war of attrition on the ground. It was because the US military had adopted to a force structure optimally designed for a short and decisive war through overwhelming military capabilities and technological superiority. As a result, when ammunition and missiles are in short supply to provide weapons in response to the war of attrition, their components and production lines have become bottlenecks, requiring long lead times to increase production.⁵ In addition, ammunition and missile inventory shortages are a common issue not only in the United States but also in NATO members in Europe.⁶ Furthermore, there is strong Republican opposition in the US Congress to arms aid to Ukraine, particularly in the House of Representatives, and there is little prospect of securing the stable funding necessary for such aid. As a result, as of January 2024, Russia can expend 10,000 artillery rounds per day, while the Ukrainian side can only consume 2,000 rounds per day, leading to the imbalance in firepower which is further expanding.⁷

In this regard, the National Defense Industrial Strategy (NDIS) released by the US Department of Defense in January 2024 identifies the lack of US defense production supply chain resiliency as a major challenge as it has emphasized efficiency through "just-in-time production" without excess inventory. The NDIS also recommends an increase in the supply chain visibility, investment in excess production capacity, and international defense production cooperation.⁸ The fact that the NDIS calls for cooperation with allies and partners in addition to its emphasis not only on the quality but also the quantity and redundancy of defense production represents in a sense an opportunity for Japan, a latecomer to exports, to participate in the US market. Such participation will not only contribute to the maintenance and strengthening of Japan's defense industrial base but will also indirectly support Ukraine, which is being placed in a disadvantageous position due to the shortfalls of ammunition and equipment.

Furthermore, as the NDIS acknowledges, the US defense supply chain becomes more vulnerable to risks as it goes to lower tiers. If so, the possibility for Japan to participate in the US market at the component level may

increase shortly. However, the international demand for defense production, including from Ukraine, is not limited to participation in the US supply chain. In particular, with the passage of the Ukraine assistance budget in the US Congress in jeopardy, Japan might be called upon to play a larger role, including in the export of finished products though it is realistic to assume a slow and incremental process.

War of Attrition as a Result of Stalemates of Technological Competitions

Secondly, the protracted conflict in the form of attrition indicates that it may not be limited to the specific characteristics of the war in Ukraine. For instance, in the CSIS report on the Taiwan war game published in January 2023, a shortage of standoff missile inventory in US forces was observed in the iterated games.⁹

On this point, in the strategic studies literature, it is pointed out that when modern armies engage in combat, they need to balance the trade-off between projecting firepower and advancing to secure territory and increasing survivability by dispersal and concealment. Recent studies, however, have shown that the equilibrium of this trade-off is moving in the direction of more emphasis on ensuring survivability due to the evolution of defense technologies in this century which have improved precision and lethality of firepower.¹⁰

As a result, troops need to be widely dispersed and ensure that they are not swiftly neutralized by the enemy's missiles, drones, and other precision firepower. Conversely, however, this makes it more difficult than ever to penetrate the enemy's defense lines and secure territory through the concentration of forces. In fact, in the Ukrainian war, it was pointed out from an early stage that the Ukrainian troops were dispersed more compared with the conventional Western standard to increase survivability.¹¹ Furthermore, against a dispersed enemy that is difficult to neutralize with concentrated firepower, extremely large quantities of ammunition will be required, and there will be huge risks of civilian casualties.

⁹ Mark F. Cancian, Matthew Cancian, and Eric Heginbotham, "The First Battle of the Next War: Wargaming a Chinese Invasion of Taiwan" (Washington DC: Center for Strategic and International Studies, January 9 2023), https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/230109_Cancian_FirstBattle_NextWar.

¹⁰ Stephen Biddle, *Nonstate Warfare: The Military Methods of Guerillas, Warlords, and Militias* (Princeton: Princeton University Press, 2020), chaps. 3, 4, and 10.

¹¹ Mykhaylo Zabrodskyi, et al., "Preliminary Lessons in Conventional Warfighting from Russia's Invasion of Ukraine: February–July 2022" (London: Royal United Services Institute for Defence and Security Studies, November 30, 2022), 53, 62–63.

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Based on these observations, if denial military technologies, such as missiles and drones, which can degrade enemy forces but do not directly contribute to holding territory, are developed and the dyad to the conflict has comparable capabilities in this regard, it would be inevitable to see a stalemate. If so, the unprecedented use of drones and missiles in the war in Ukraine would be by no means unrelated to the fact that war of attrition has become a common practice. If the United States and China were to balance similar asymmetric capabilities, the conflict would likely be prolonged, with the quantity of equipment and ammunition becoming decisively important. While it has been discussed so far that future warfare would involve the short and decisive war enabled by transformational technologies, hybrid warfare, or non-kinetic warfare which may not accompany physical destruction, the fact that wars of attrition are still being waged between parties with comparable capabilities indicates the need to review the current trends from a longer-term and historical perspective.

In any case, as long as it is recognized that the contemporary form of warfare demands the munition quantity, increasing redundancy in production capacity to prepare for a war of attrition will not be a temporary demand, but rather a medium-to-long-term requirement. Therefore, as Japan is located near the potential conflict zones of the Taiwan Strait and the Korean Peninsula, it will be necessary to respond to the international demand for such redundancy from a medium to long-term perspective.

■ The Need for Derisking in the Supply Chain

Thirdly, the concept of derisking concerning China discussed from an economic security perspective, will have a similar impact on the international defense supply chain in the future. The US NDIS cited above also points out a concern about dependence on potential adversaries for materials, technologies, components, and capital. The importance of supply chain visibility and defense production cooperation with allies and partners is also discussed from this perspective. Some of the critical minerals of which China accounts for a large supply share are also essential for the production of defense equipment, such as rare earth materials, and a situation in which the defense supply chain is bottlenecked by an adversary that the United States and its allies are

attempting to deter would not be strategically favorable.¹²

At the same time, the NDIS is also concerned about the tapering off of the skilled labor force involved in the defense industry, and it will not be easy to onshore the supply chain once it has gone offshore, even if the government rapidly invests money to strengthen the industrial base.

Of course, Japan is not immune to the problems of supply chain dependence on foreign sources and labor shortages. However, efforts to mutually complement each other's vulnerable supply chains with allies and partners including the United States are likely to become even more required in the future.

In this regard, it would be most realistic to start derisking efforts in the defense supply chain with cooperation on component supply. On the other hand, it is also important not to exclude all options, including the export of finished products and local production in allied and partners. The first thing to do as a derisking measure in the area of defense equipment may not either be investment or subsidies, but to remove barriers that block opportunities to mutually eliminate vulnerabilities in their own countries and those of their allies. From this perspective, not only the transfer of equipment parts which was made possible by the revision of the Three Principles at the end of 2023, but also the export of components that are installed on large platforms such as aircraft and vessels (those that can independently perform their functions are not regarded as parts in the Three Principles) should be made fully possible. It will also be important for the Japanese government to encourage the United States to allow Japanese companies to participate flexibly in its government procurement programs involving sensitive information.

In the survey of 100 Japanese companies on economic security conducted by the Institute of Geoeconomics at the end of 2023, Japan (domestic return) as well as allies and friendly countries such as the United States, India, and the EU were listed as the most important countries as destinations for diversification of supply sources. In the context of the overseas transfer of defense equipment, there is a growing demand for such “onshoring” or “friend-shoring” from the same perspective. In addition, there is the unique

¹² Hirohito Ogi, “De-risking in US Defense Industry Policy”, *Journal of World Affairs* (Kaigai Jijo) Vol 71, No 5, (Institute of World Studies, Takushoku University, October 2023), 51-68 (in Japanese).

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circumstance that the effect of the revision of the Three Principles has been unprecedentedly strong for defense equipment, for which international demand is expected to grow over the medium-to-long term, even though the exports in this field have traditionally been extremely restrained in Japan. Responding to this situation swiftly will become an effective means of strengthening the defense industrial base, and at the same time, it will help fulfill its duty to take the initiative to shape and maintain a desirable international security order.

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