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Taking Off

*Civil Aviation, Forward Progress
and Japan's Third Arrow Reforms*

By Patrick M. Cronin



Center for a
New American
Security

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TAKING OFF: CIVIL AVIATION, FORWARD PROGRESS AND JAPAN'S THIRD ARROW REFORMS

By Patrick M. Cronin



(Photos by Getty Images)

I. EXECUTIVE SUMMARY

By Patrick M. Cronin

Civil aviation has long been a critical aspect of the Japanese economy. Two national carriers, Japan Airlines (JAL) and All Nippon Airways (ANA), dominate the industry. Both of these airlines have vied for market control of Japan since the mid-1980s, following considerable government deregulation and the privatization of Japan Airlines. Japan has continued to maintain tight control over its aviation market, creating barriers for both domestic firms and foreign competitors by tolerating political coordination and protectionist policies and by limiting landing slots and airport access. These prohibitory measures have created a skewed and uncompetitive market space. Current regulations are incongruous with efforts to increase exposure and competitiveness for the Japanese aviation market in the international arena.

Many of the world's political and business communities have grown accustomed to the bureaucratic roadblocks and political protections found in the Japanese economy. After decades of such practices, many foreign firms have come to see these tactics as "business as usual," a set of cautionary tales for foreign investors. Yet in December 2012, the Liberal Democratic Party of Japan (LDP) won a momentous victory, ousting the Democratic Party of Japan (DPJ), which had held control since its historic takeover of the Diet in 2009. At the LDP's helm sat Shinzo Abe, an LDP political heavyweight who was prime minister of Japan from 2006 to 2007. Within weeks of his party's dominating the 2012 election and his return to the seat of the prime minister, Abe announced a bold plan to reinvigorate the Japanese economy after two decades of economic stagnation and currency deflation.

This strategy has been dubbed "Abenomics," a sweeping plan promising economic revitalization through "Three Arrows" of reform efforts. The first two Arrows incorporate a program of quantitative easing and a subsequent public works spending

Japanese civil aviation is strongly interconnected with the industries Abe intends to reform by linking Japan's economy with the outside world.

agenda to help stimulate the economy through traditional Keynesian methods. Abe's Third Arrow is by far the most significant factor in encouraging progress and reversing Japan's long-standing economic malaise through structural reform. The Third Arrow endeavors to promote private investment-led growth by opening Japanese markets and encouraging a more flexible and competitive regulatory framework for firms both foreign and domestic. Two targeted sectors that Abe has identified as critical to Japan's economic recovery, reform and expansion are foreign direct investment and tourism.

Japanese civil aviation is strongly interconnected with the industries Abe intends to reform by linking Japan's economy with the outside world. Abe's Third Arrow has the ability to target the protectionism, politicization and opaque regulations that plague the Japanese aviation industry. By addressing these systemic uncompetitive impediments, Abe can simultaneously revitalize the Japanese economy and prove to the international community his commitment to progress. In many ways, proposals to institute true structural reforms in Japan's civil aviation sector serve as a litmus test for the credibility of the Third Arrow.



Japanese Prime Minister Shinzo Abe speaks during a press conference in Manila on July 27, 2013. Abe pledged increased maritime cooperation with the Philippines amid growing territorial disputes with regional rival China.

(TED ALJIBE/AFP/Getty Images)

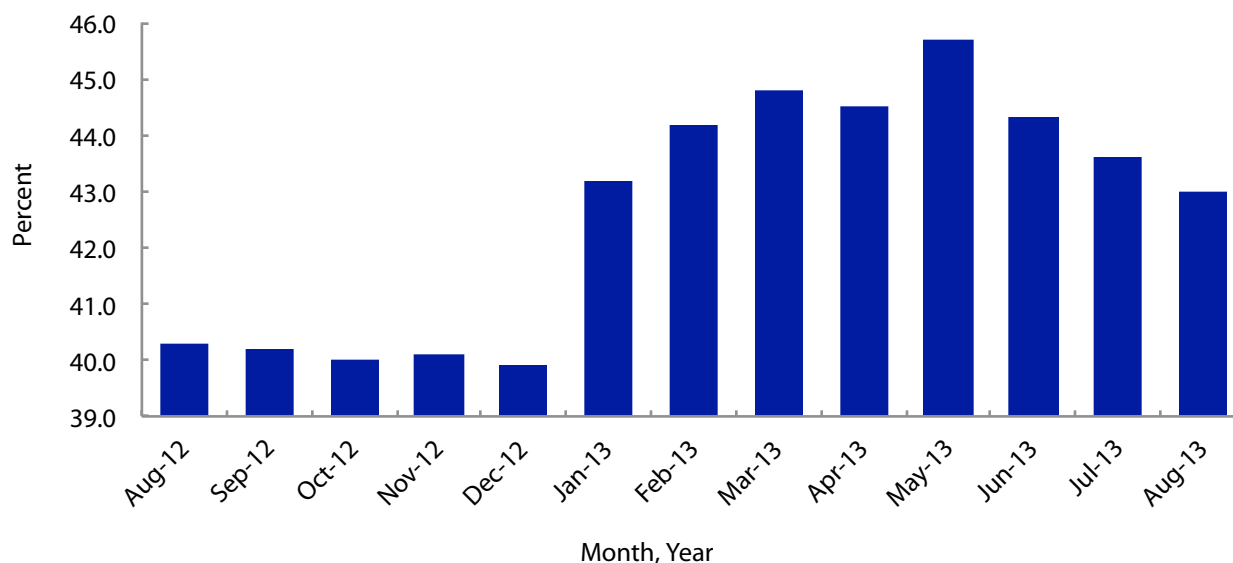
II. ABE'S THREE ARROWS AGENDA

Japan is undergoing its most significant political developments in more than 20 years. In 2009, after decades of economic malaise and stagnation, the Japanese people ousted the ruling LDP party in favor of the DPJ.

The LDP has historically been the party of power in Japan, having previously lost only one general election (1993) since its organization in 1955. The LDP's latest loss was historic in Japanese political history. The Japanese people were dissatisfied with the state of political affairs. Some analysts argue that the DPJ's platform of change and rebirth won the 2009 election. While this may have contributed

to the power shift, the LDP's own political cronyism and party mismanagement also contributed to the political upheaval. On causes of the LDP's first defeat in 16 years, the *Japan Post* writes that "... eventually, public frustration and distrust spread over the LDP's frequent money scandals, apparent favoritism toward vested interests and rotation of prime ministers picked in lieu of general elections, including Abe and Aso, [went unaddressed] until voters finally sent the party packing in 2009 and brought in the DPJ."¹ The DPJ ran on a platform of a crackdown on political cronyism and corruption; educational and health-care reform; and reduction of the corporate tax rate for small and medium enterprises.²

FIGURE 1: JAPANESE CONSUMER CONFIDENCE INDEX FROM AUGUST 2012-AUGUST 2013



Source: Economic and Social Research Institute (Government of Japan Cabinet Office), Consumer Confidence Survey August 2013, September 9, 2013, <http://www.esri.cao.go.jp/en/stat/shouhi/2013shouhi2-e.xls>.

There were high hopes for the DPJ. The first major opposition party victory in nearly five decades, the election was viewed by many as a major turning point in Japanese political history. Yet despite these aspirations, DPJ rule was short-lived. The DPJ was not able to solidify its power base and in the 2010 upper house election lost seven seats to the LDP. Without control of the upper house, the DPJ was unable to address the major policy issues it campaigned upon, and it lost the support of its constituents.³ The DPJ's election to power provided a strong exogenous shock to the LDP. During this period, the LDP looked inward at many of its policies and rearranged its power base. By 2012, the LDP was able to reshuffle its internal factions and resurface with greater unity and cohesion.

In the 2012 general elections, the LDP was voted to its former status as ruling party with its coalition partner New Komeito. The LDP took 294 seats and 43 percent of the popular vote. Its president, Shinzo Abe, was nominated and then voted in for his second term as prime minister, having first

served from 2006 to 2007. Soon after his latest election, Abe made the following announcement at a news conference in Tokyo: "With the strength of my entire Cabinet, I will implement bold monetary policy, flexible fiscal policy and a growth strategy that encourages private investment, and with these three policy pillars, achieve results."⁴ This proposal would come to be the framework for Abe's Three Arrows — his administration's policy agenda to revitalize Japan from decades of economic woes and stagnation while delivering substantial reform.

Shortly after his election, Abe delivered his First Arrow: a bold inflationary monetary policy. He appointed Haruhiko Kuroda as the governor of the Bank of Japan to advance this policy initiative. Working with Kuroda and his policy team, Abe set about orders to increase inflation by 2 percent in order to shock the domestic market out of its deflationary position. Kuroda doubled the monetary base of the Japanese yen, and the markets have responded positively. The value of the yen has fallen from its high of ¥77 to the dollar. As of September 2013,

estimates indicate that the First Arrow adjusted the exchange rate to around ¥100 to \$1. The Nikkei has risen considerably since Abe took office. Consumer confidence has also increased, as demonstrated in Figure 1. While dropping from its May 2013 high of 45.7, consumer confidence has risen 12 percent since Abe took office.⁵ The weaker yen has made Japanese exports more competitive abroad. In fact, the value of Japanese exports reached a three-year high in August 2013, with a 12.2 percent year over year growth in July 2013.⁶ These policies seem to have enacted a positive step toward economic revitalization.⁷

Abe's Second Arrow also came shortly after his election. To supplement his fiscal policies, he announced what he deemed a "flexible" fiscal policy to simulate further growth. Since taking office, the LDP leader has revealed an ambitious investment plan of ¥200 trillion (\$2.02 trillion) to stimulate the Japanese economy during the next 10 years.⁸ Financial analysts from Citi Bank in Tokyo believe that spending will be dominated by "shovel-ready" projects focusing on infrastructure revitalization, such as tunnel repairs and earthquake preparation on vital public works.⁹ This spending plan is quite ambitious; the Japanese government estimates that this stimulus could spur 2 percent growth and create as many as 600,000 jobs.¹⁰ While Abe's office has yet to release specifics on the plan, the administration is keen on delivering with these policies. Coupled with the ambitious monetary policies of the First Arrow, the prime minister has delivered a shot to the arm for the Japanese economy.

Japan's best chance for real long-term growth, however, is the Third Arrow. By all accounts, this is the most ambitious and difficult reform to achieve. Abe has recognized that Japan must reform and deregulate to bring its economy into the 21st century. As one columnist has summarized Abe's challenge: "... to improve its long-term performance, Japan will have to do what it has been

unwilling to do for the last two decades: reform its corporate, financial, industrial, and agricultural sectors. Japan's political system has yet to show the ability to engineer such changes."¹¹ Abe's Third Arrow attempts to end the endemic protectionism that has typified the Japanese economy for decades. His speeches have touched on reforming labor market rigidity, removing barriers to entry for SMEs, reforming stifling bureaucratic regulations, stimulating critical sectors like FDI and tourism and exposing protected industries like pharmaceuticals and agriculture to the open market.¹² Through these efforts, Abe is taking the steps necessary to create a competitive and resilient Japanese economy.

Abe's Third Arrow attempts to end the endemic protectionism that has typified the Japanese economy for decades.

He has already stepped forward to deliver on some of these structural reform efforts. In March 2013, Abe announced his intentions for Japan to enter the Trans-Pacific Partnership free trade agreement. In August 2013, Japan became a full negotiating partner in the agreement. This initial free-trade zone would encompass 12 Pacific Rim countries (including Japan).¹³ Negotiators distinguish this FTA as a "high-quality agreement" that would contain across-the-board reductions in tariffs and nontrade barriers, including competition-stifling protections and regulations. By joining negotiations, Abe has demonstrated that his administration is willing to enact wide domestic reforms on some of its most entrenched industries, including agriculture.

Abe also announced his intentions to double tourism and FDI through the Third Arrow

agenda, as discussed below.¹⁴ He has boldly endeavored to reduce trade barriers and create an open, transparent and competitive environment for foreign and domestic firms alike. His efforts have not gone without notice. American investors are watching from the sidelines, eager to invest in the Japanese economy and contribute to growth by working with industry leaders and politicians. Their investment appears hinged on the administration's commitment to reform efforts. In a letter to Sony's CEO Kazuo Hirai, American investor and hedge fund manager Dan Loeb expressed the sentiments of many within the American business community: "Under Prime Minister Abe's leadership, Japan can regain its position as one of the world's preeminent economic powerhouses and manufacturing engines. The most critical of Prime Minister Abe's 'Three Arrows' approach [The Third Arrow] will be unveiled next month: initiatives to create more economic growth in Japan through deregulation and structural reform. Leading business like Sony with leaders like you, Mr. Hirai, can spearhead this important growth."¹⁵

Despite this sentiment, U.S. investors are looking for tangible steps by the government of Japan to show that Abe's efforts are more than rhetoric. They are looking for concrete examples to counter perceptions that the Japanese investment climate remains stacked against foreign firms. The Japanese civil aviation sector may be a litmus test for the Third Arrow's credibility. The international business community is waiting to see if it will be business as usual or representative of international norms, supporting a transparent, fair and equitable environment for aviation stakeholders.



Planes fly with Mount Fuji in the background.

(Photo by Aron Pena)

III. THE HISTORY OF THE JAPANESE CIVIL AVIATION SECTOR

To better comprehend the current political climate in Japanese aviation, it is important to understand its historical antecedents. The history between the major players in commercial aviation, particularly after Japan Airlines' full privatization in 1987, is crucial to understanding the current competitive environment.

The duopolistic competition between Japan Airlines and All Nippon Airways animates not only the current but also the early history of Japanese civil aviation. In August 1945, General Douglas MacArthur instituted "Order No. 1." Circulated by the Imperial Headquarters

in September 1945 after Japan's surrender, the order banned the operation of private aircraft, with the intention to "prevent any possibility of Japan preserving an air force nucleus for future aggression."¹⁶ After seven years of countrywide groundings, the ban on Japanese civil aviation was lifted with General Order 10 on April 28, 1952, which followed the conclusion of the Treaty of Peace with Japan.¹⁷ These two firms were established soon after the ban was lifted, and they quickly became the pre-eminent postwar carriers.

After the lifting of the ban, the Japanese had the opportunity to establish their own domestic airlines. Predicating this establishment was a treaty between the United States and Japan that outlined the rights afforded to each nation's carriers. The

first aspect of the treaty indicated that a U.S. or Japanese carrier could increase or decrease its flights per week without limit or need for prior approval, in essence an early predecessor to current-day open skies agreements. The second aspect of the treaty intimated that, while a carrier could leave from any location in its home country, it must land at predesignated cities in the partner country. Finally, the treaty granted U.S. carriers unlimited “beyond rights,” which granted U.S. carriers the ability to use Japanese airspace and airports as a through point to further destinations in Asia.¹⁸

For some years, this precedent of U.S. preferential rights dominated U.S.-Japanese aviation relations, adding to the protectionist tendencies built into the Japanese marketplace. Perhaps in an ironic foreshadowing, this imbalance would play out in favor of the Japanese carriers in the decades to come. This treaty, with small amendments made to it, remained as the *de facto* legislation underlying U.S.-Japanese air travel cooperation for four decades. This treaty was set as a precedent for further negotiations even as recently as 2009, when Japanese and American representatives renewed aspects of the agreement in the U.S.-Japan Air Transport Agreement of December 14, 2009.¹⁹ When the current Open Skies Agreement was enacted, this treaty was overhauled and superseded in 2010.

Haneda and Narita Airports: Roles and Operations

Haneda was Tokyo's first main airport. It opened in the early 1930s, with its first runway constructed in 1939. Haneda served as the base of Japan's then-flagship carrier Japan Air Transport and served locations in Japan, Korea and Manchuria. In 1945, U.S. armed forces occupied Haneda and renamed it Haneda Army Air Base; it served occupying forces until they returned it to Japanese control in 1952.

Haneda then began service again as a commercial airport. It served in both a domestic and international capacity for numerous carriers. In 1964, in

Narita International Airport was designed to expand the domestic feeder network in Japan, while also enhancing Tokyo's function as an international hub.

anticipation of the Tokyo Olympics, the Japanese government lifted the ban on Japanese citizens traveling abroad. Demand surged at Haneda airport, and passenger traffic reached unmanageable levels. Despite the construction of a new runway and international terminal, capacity expansion efforts could not keep pace with demand.

Within Japan, domestic pressures built against further expansion into the 1960s and 1970s. The cost of adding more runways, given Haneda's location on the water, was extremely high. By 1966, ground plans had been laid to create a new airport some 45 miles away. By the time Narita International Airport was completed, Haneda became a predominantly domestic airport as air traffic was diverted east to Narita.

Narita International Airport was designed to expand the domestic feeder network in Japan, while also enhancing Tokyo's function as an international hub. After groundbreaking, incredible opposition from local residents arose against Narita. These demonstrators and protesters caused considerable damage to Narita (including roughly \$500,000 in damage to the aerodrome control tower before the airport's planned opening in 1978), while also leading to the eventual deaths of protesters and police officers. When construction was finally completed, Narita International's capacity was at roughly 13 million passengers per year. Even before \$1.36 billion was invested in a new

terminal in 1992, Narita International was handling more than 22 million passengers annually in 1991.²⁰ Haneda and Narita served as gateways to the Japanese economy — a symbol of the country's rapid development growth and extraordinary economic success in the 1980s.

Despite previous cost reservations over expanding runways into Tokyo Bay, Haneda constructed an additional runway in 1988. By 2000, two more runways were also completed. With added capacity at Haneda and a mounting passenger problem at Narita, Japanese policymakers agreed that Haneda could begin to serve international traffic once again. Some reports also indicate that Japanese citizens traveling abroad were increasingly using foreign international hubs in lieu of Haneda and Narita.²¹ Due to transit times between the two airports, it is easier for those outside of the Tokyo metropolitan area to use transit hubs in the Republic of Korea or China rather than fly domestically to Haneda and then transfer to Narita for an international connection. In 2003, the Japanese government allowed certain airlines to serve in a very limited international “scheduled charter” service, where JAL and ANA (along with Asiana and Korean Air) were only allocated one flight per day between Tokyo and Seoul, which serviced Gimpo Airport in the far western end of Seoul, South Korea.

Pressures from policymakers advocating for increased use of Narita limited the amount of traffic that Haneda could serve. This, compounded by internal pressures from local government officials in Tokyo over sound pollution from Haneda, increased challenges to the bureaucratic regulatory frameworks that needed to be adapted. To compensate both parties, officials deemed that Haneda could serve international flights that depart or arrive between 11 p.m. and 6 a.m., when Narita is closed in deference to local demand. In their current configurations, the Japanese Ministry of Land, Infrastructure, Transport and Tourism (MLIT) has

designated Haneda as a predominantly domestic airport, providing auxiliary short-haul international service for Narita, which serves as the main international hub in Tokyo.

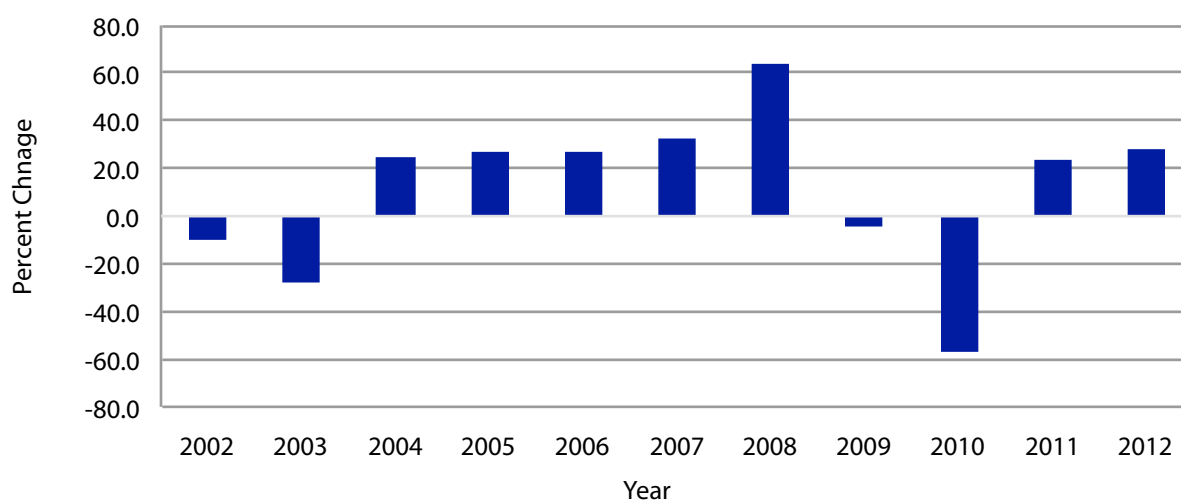
The two national carriers of Japan, ANA and JAL, are the dominant carriers at Narita and Haneda. To more completely paint the picture of current capacity and regulatory issues at Haneda airport, as well as more fully describe Haneda's opportunity to propel Japan's economic recovery and reform forward, it is necessary to understand the growth and development of both JAL and ANA. Their evolution through the years has been central to Japan's economic growth. Understanding their shared competitive history is necessary to have a comprehensive view of their relationship moving forward.

All Nippon Airways: Historical Overview

Founded in December 1952, ANA began its operating history as the Japan Helicopter & Aeroplane Transports Co., Ltd., after the abatement of the civil aviation ban and General Order No. 10. Starting with ¥150 million in capital (in 1952 terms), the company had ambitiously started its own chartered and scheduled passenger service by October 1953. In December 1957, the company changed its name to All Nippon Airways. After merging with Far Eastern Airlines in March 1958 (increasing its capital to ¥600 million), ANA introduced a series of new airplanes.

The early 1960s were a turning point for ANA as it capitalized on widespread growth throughout the passenger aviation market. It listed on the Second Section of both the Osaka Securities Exchange and the Tokyo Stock Exchange in October 1961, and later merged with Fujita Airlines, increasing ANA's capital further, to ¥4.65 billion, in 1963. By 1964, ANA had introduced a number of jets and began increasing its scheduled domestic service, as JAL had the *de facto* monopoly on scheduled international passenger routes. By 1970, revenue

FIGURE 2: ANA NET INCOME BETWEEN 2002-2012



Source: All Nippon Airways, Financial Data: Eleven-Year Comparative Summary, 2012, http://www.ana.co.jp/eng/aboutana/corporate/ir/excel/summary_2012_e.xls.

passenger-miles had increased to more than 2,700, a near fourfold increase. In February 1971, ANA commenced international chartered service between Tokyo and Hong Kong. In the mid-1970s, ANA achieved an extensive domestic Japanese network.

In 1978, ANA established Japan's first all-cargo airline as a joint venture with the shipping company Nippon Yusen. Named Nippon Cargo Airlines, this newcomer operated an impressive fleet of Boeing 747 aircraft and capitalized on incredible growth opportunities presented by Japan's astronomical growth.

By 1985, ANA had solidified its position as a leader in domestic Japanese service. In October of that year, it served its cumulative 300 millionth domestic passenger. At that time, pressure was mounting from both the Japanese political realm as well as U.S. leaders to deregulate the Japanese international transport market. As ANA saturated its domestic market, reforms were passed in 1986 that privatized JAL and allowed ANA to establish its first international scheduled service.

ANA seized on demand for both inbound and outbound travel to Japan, establishing numerous international routes. It added service to Beijing, Sydney, Hong Kong and Dalian in 1987, followed by service to Stockholm, Bangkok, Vienna, London and Moscow in 1988. In five short years since the Japanese civil aviation industry deregulated and allowed ANA to service international destinations, the airline was able to increase its total number of passengers served by roughly 22.5 percent, an incredible logistical feat.²²

However, as with JAL, the 1990s were challenging for the Japanese civil aviation industry and the wider Japanese economy. Throughout the early 1990s, ANA struggled to remain profitable, and by 1994 ANA experienced its first loss in 27 years. ANA reported a \$27.9 million loss for the fiscal year ending in March 1994, as well as plans to begin restructuring and reducing its payroll.²³ Adding additional legitimacy and exposure to its brand equity in the global aviation market, ANA joined the Star Alliance in 1999. The mid-2000s were quite successful for ANA as traffic demand



All Nippon Airways (ANA) jetliners sit parked at Tokyo's Haneda Airport on July 30, 2013. ANA said on July 30 it had swung into a loss for the April-June quarter as fuel costs soared and problems with Boeing's Dreamliner also weighed on results. The Japanese carrier lost 6.6 billion yen (67 million USD), reversing a small year-earlier profit, while revenue climbed 4.4 percent to 358.3 billion yen.

(YOSHIKAZU TSUNO/AFP/Getty Images)

grew considerably. In 2005, after some decades of success, ANA sold its share of Nippon Cargo Airlines and established another joint venture the following year, with Nippon Express (a courier and logistics company), Japan Post and Mitsui, a Japanese trading house. The fleet for this cargo airline consisted of Boeing 767 freighters.

However, the 2008 global financial crisis challenged ANA's profitability margin, and passenger demand (and especially cargo demand) plummeted. Although 2008 was a year of record profits, the following crash on the air travel market from the financial crisis took its toll on ANA in 2010. The company suffered a ¥57.38 billion loss (approximately \$656 million in 2010 real terms). That same year, ANA folded its cargo joint venture and absorbed the operations into the ANA network.

Since 2010, however, ANA has shown considerable resiliency. In the wake of the economic recession (as seen in Figure 2), ANA's profitability has rebounded to its mid-2000s level. In its Fiscal Year (FY) 2012 annual report, operating income

increased 43.1 percent year over year to a record ¥97 billion. ANA has forecast that its FY 2013 net income will grow some 42 percent year over year.²⁴ Despite these positive projections, ANA announced a net ¥6.6 billion loss for the first quarter on July 30, 2013. Rising fuel costs as well as a weakening yen contributed to this loss, as well as the temporary grounding of ANA's Boeing 787 "Dreamliner" crafts. On September 13, 2013, ANA announced that it intended to order some 25 jets. ANA's CEO, Shinichiro Ito, indicated that the company would order either Airbus A350 or Boeing 777X (still in production).²⁵ ANA has made clear that it intends to become the lead domestic provider of air services to the Japanese market. It has pushed hard publicly to deliver a message that corporate restructuring for JAL was unfair and that ANA should be compensated by receiving more capacity at Haneda airport to offset past government support to JAL.

Japan Airlines: Historical Overview

Founded in 1951, Japan Airlines is the oldest Japanese airline still in service. It was founded on August 1 of that year with ¥100 million in capital as Japan Air Lines. It opened its headquarters at Haneda airport, which had been used previously as a U.S. Army air base during U.S. occupation. Shortly thereafter, JAL opened satellite offices in Fukuoka and Sapporo. Before the official ban on Japanese civil aviation was lifted, JAL entered into an agreement with American carrier Northwest Airlines in November 1951. Northwest provided JAL with a suite of flight operations, because of restrictions still in place grounding Japanese aircraft. By the time the ban was lifted in 1952, Japan Air Lines began training its own set of pilots, navigators and flight attendants. On August 1, 1953, under the Japan Air Lines Company Act put forward by the Japanese Diet, Japan Airlines formed as a national flag carrier for Japan out of the formerly private Japan Air Lines. At this point, the government of Japan owned roughly a 60 percent stake in JAL.²⁶

By the beginning of 1955, JAL had offices across the United States, including Chicago, San Francisco, Los Angeles and New York, and was operating intra-Asian flights between Tokyo and Hong Kong. In 1972, the Japanese Ministry of Transport fully enacted JAL as the international flagship carrier of Japan by giving it sole operational rights on international flights as well as major trunk routes in the Japanese domestic market. This allocation of routes evolved from the “70/72 Scheme,” which was named after a Cabinet-level meeting in 1970 titled “Approval on Management Regimes of Airline Companies” and a commensurate response in 1972 from the Ministry of Transport (later to be assimilated into the Ministry of Land, Infrastructure, Transport and Tourism). This framework essentially predetermined the business spheres of leading Japanese airlines.²⁷ The 70/72 Scheme became the policy rationale for a total lack of competition on numerous Japanese flight routes. JAL and ANA were granted sole operating rights for certain routes. By 1978, JAL had reached a total of 100 million domestic and international passengers since the foundation of the company. The flagship carrier had established itself as the representative airline of Japan.

In October 1985, the Aviation Policy Extraordinary Committee of the ruling LDP announced a report that recommended full privatization for JAL while encouraging it to retain its position as the official national flag carrier of Japan. By 1987, Japan Airlines had completely privatized, with the Japanese government selling its 35 percent share in the company. At this point, ANA was allowed to engage in unregulated competition with JAL on both domestic and international routes. Increased competitive pressure on JAL led to a corporate restructuring, dividing domestic and international passenger service as well as founding a cargo service within JAL.²⁸ The economic malaise in Japan of the 1990s hit JAL hard, and it posted considerable operating losses or at best tepid growth throughout the decade.



Japan Airlines (JAL) aircraft are seen on the tarmac at Haneda Airport in Tokyo on April 30, 2013. JAL said on April 30 its net profit in the fiscal year to March was down 8.0 percent to \$1.8 billion, as the carrier slashed its full-year earnings outlook by almost one-third.

(TORU YAMANAKA/AFP/Getty Images)

In 2001, JAL received its first government assistance package, followed by a 2002 merger with Japan Air System. In 2007, JAL joined the Oneworld alliance. JAL was hit hard by the economic recession of 2008 and 2009. Despite accepting further government aid, it suffered nearly \$1.4 billion in losses from March to September 2009.²⁹ At the point of announcing its bankruptcy, JAL held nearly \$25 billion in debt, requiring significant restructuring.³⁰

The JAL bankruptcy proceedings were arduous, a humbling experience for this historic pillar of Japanese aviation and commerce. JAL entered into a court-supervised restructuring and received considerable government support under the Corporate Rehabilitation Law. Amid the controversy over the bankruptcy proceedings, JAL's CEO Haruka Nishimatsu resigned. Kazuo Inamori, former CEO of Kyocera and noted for his ability to turn around ailing firms, was tapped as Nishimatsu's successor.

Around the time of its announced bankruptcy, a number of American carriers courted JAL, looking to entice the ailing Japanese carrier out of the Oneworld alliance. In an attempt to lure JAL to the SkyTeam alliance, the only major global airline alliance without

a Japanese partner, Delta Air Lines offered JAL a financial assistance package worth \$1 billion to leave Oneworld.³¹ American Airlines, a representative of the Oneworld alliance, raised its own package from \$1.1 billion to \$1.4 billion as a counteroffer.

Beyond government-sponsored restructuring, JAL removed a large number of its unprofitable routes serving domestic and international locations. In fact, JAL removed 50 domestic routes, nearly all of which were incredibly unprofitable for the company. JAL shut down 28 international routes that were unprofitable or not flying at capacity. Beyond its route reorganization, it also closed 11 international bases and eight offices and removed nearly a third of its bloated workforce, saving the company some ¥81.7 billion annually in labor costs.³² In addition, JAL made tough cuts on employee pension plans, which had weighed heavily on operating costs. JAL received ¥600 billion from the Japanese government under the bankruptcy-restructuring program. The Enterprise Turnaround Initiative Corp. of Japan provided ¥350 billion, while the remaining capital was acquired as bridge loans from the Development Bank of Japan. JAL was able to reimburse its debts in full after its relisting on the Tokyo Stock Exchange on September 19, 2012.³³

In an unprecedented economic turnaround, JAL has returned to profitability. According to its 2013 annual report, total operating profit margin remained extremely high, at 15.8 percent, while operating revenues for FY 2012 increased by 2.8 percent from the previous year. JAL reduced its operating costs from a staggering ¥2 trillion to ¥1 trillion from FY 2008 to FY 2011. Moreover, while operating profit declined from ¥204.9 billion to ¥195.2 billion from FY 2011 to FY 2012, JAL reports that this loss is due to increased operating expenses stemming from higher fuel prices and a weakening yen. In recent decades, JAL faced an uncertain future and considerable profit loss, but given its current profitability and performance, JAL is back on even footing.³⁴

IV. CIVIL AVIATION AND THE JAPANESE ECONOMY

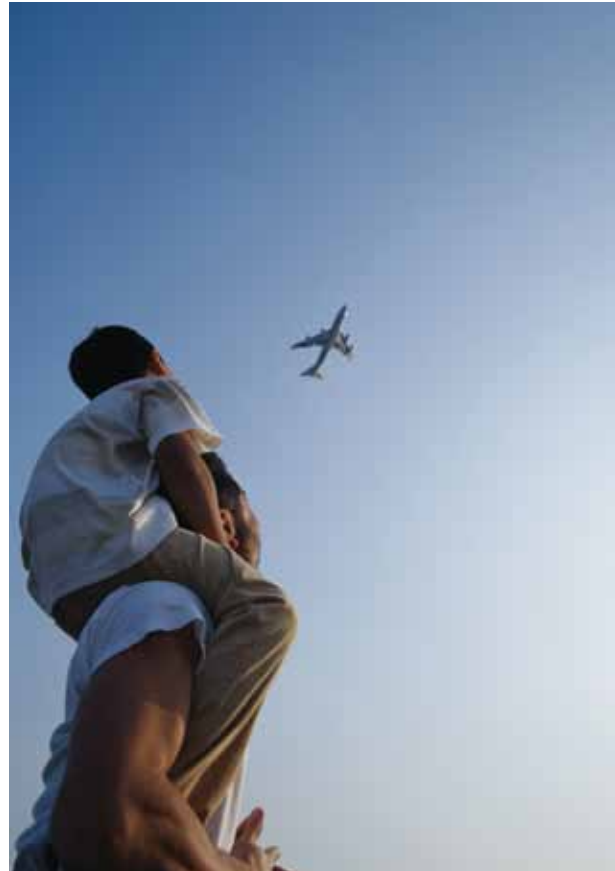
Japan is one of the world's largest and most central markets. It is a hub of interconnectivity for Asia and the wider world. Japan's civil aviation industry ties together this archipelagic nation. As International Air Transportation Association (IATA) CEO Tony Tyler noted in late 2012:

"Japan is important to global air transport. And air transport is critical to Japan. Could this island nation have grown to be the world's third largest economy without effective air links? The answer is no. In fact, there is no clearer example of the aviation industry being a catalyst for economic growth than Japan where it provides vital — irreplaceable — links to global markets. But I believe that aviation could be an even more powerful force in Japan's economy."³⁵

Despite its market maturity, Japan's domestic air market is still growing. In fact, the domestic Japanese market surged nearly 6 percent, increasing from 4 percent growth in the previous month.³⁶ As a service provider for through traffic to Asia and the West as well as a facilitator of Japan as a final destination for business and leisure travel, Japan's aviation sector continues to play an important role in the global economy.

Given its 6,800-plus islands, Japan relies heavily on airports to serve as key infrastructural centers for the movement of people and goods. As of February 2012, Japan operated 98 airports, five of which the government has deemed as hubs. These are Kansai International, Tokyo International (Haneda), Narita International, Chubu International and Osaka International (Itami). The aviation industry is responsible for transporting a large portion of Japan's trade flows. Figures 3 and 4 show that roughly 35-40 percent of Japanese trade flows were handled via aircraft.³⁷

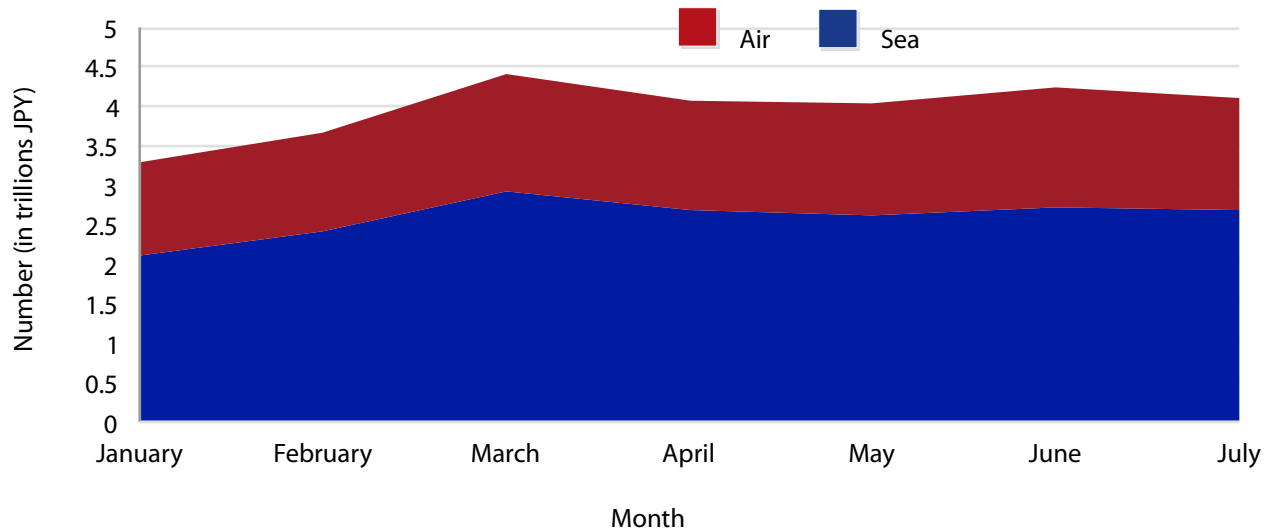
Though there is high traffic between these central airports and foreign destinations, many



(Photo by Seiya Kawamoto)

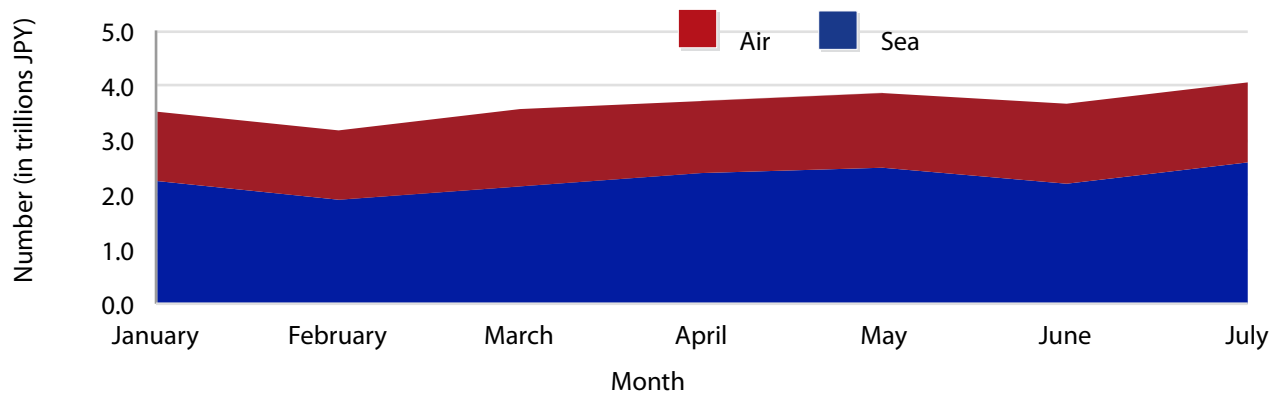
rural Japanese airports are suffering from flat-lined passenger traffic. Misplaced demand projections have led to critical overcapacity in some airports and undercapacity at others. However, many of these airports were not intended to be competitive. According to a 2012 report by *The Japan Times*, many rural airports struggling to turn profits were not built on economics, but instead were "... compounded in large part by politics, with decisions made to build airports in rural, virtually no-traffic areas where turning a profit was never a realistic proposition but just a way to get voters government-backed jobs from more pork-barrel projects."³⁸ While traffic at rural, regional airports has been limited, some argue that a reassessment of airport ownership structures as

FIGURE 3: 2013 JAPAN EXPORTS BY MODE (IN TRILLIONS JPY)



Source: Japanese Ministry of Finance, Trade Statistics of Japan Database, January to July 2013, http://www.customs.go.jp/toukei/info/tsdl_e.htm.

FIGURE 4: 2013 JAPAN IMPORTS BY MODE (IN TRILLIONS JPY)

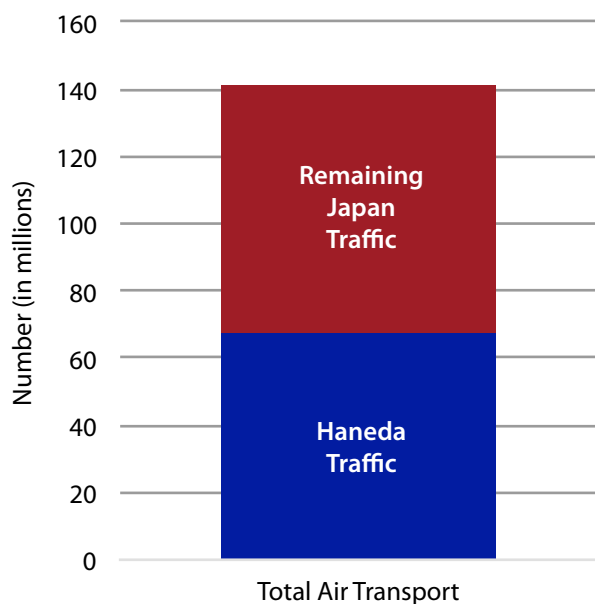


Source: Japanese Ministry of Finance, Trade Statistics of Japan Database, January to July 2013, http://www.customs.go.jp/toukei/info/tsdl_e.htm.

well as liberalization surrounding low-cost carriers (LCCs) can help increase traffic.

While there are a considerable number of airports operating throughout Japan's borders, the majority of traffic flows through its two main Tokyo hubs – Narita International and Tokyo International, also

known as Haneda. According to the 2013 IATA World Air Transport Statistics report, Haneda ranked as the world's fourth-busiest airport by passenger traffic, handling 67.78 million passengers (7.9 million international and 59.9 domestic).³⁹ The report also listed total Japanese air travel at 141.55 million passengers.⁴⁰ Haneda thus served

**FIGURE 5: 2012 JAPAN AIR TRAFFIC BY AIRPORT
(IN MILLIONS)**

Source: IATA, World Air Transport Statistics (WATS) Report 57th Edition, July 16, 2013.

approximately 48 percent of Japan's total passenger air traffic (see Figure 5). Narita International is also a critical airport for both passenger and freight services: It ranked as the world's 10th-busiest airport in 2011 for cargo and mail volume. Narita handled roughly 1.95 million tons of cargo, ranking immediately behind Louisville, Ky. (2.18 million tons), which houses Worldport, the central hub and processing facility of UPS Inc. Clearly, the Tokyo metropolitan area is the central node for Japanese air travel and commerce.

With appropriate policymaking, an advantageously located airport can attract a remarkable amount of investment. Japan's role and reliance on global aviation is seminal. At the center of that aviation system is Haneda, which is responsible for roughly 48 percent of Japan's passenger traffic. Haneda plays a critical role in the local Tokyo economy, employing roughly 87,000 people directly in 2012, with indirect, induced



Sunrise at Osaka, Japan.

(Photo by spiraldelight)

and catalytic employment estimated at more than 190,000.⁴¹ At nearby Narita International, employment has dropped nearly 20 percent since 2009 due to the global economic downturn, but 40,000 people still hold jobs there.⁴²

Japanese aviation is a key economic driver in Japan, facilitating tourism and foreign direct investment – which are already key elements of Abe's Third Arrow agenda. With the September 2013 announcement of Japan as the host of the 2020 Olympic Games, the opportunities for increased tourism and investment are even higher, as are the stakes for failed reform efforts.

Tourism

Japanese tourism constitutes a very large portion of incoming investment. In 2012, the Japan National Tourism Organization in conjunction with the Japanese Ministry of Justice recorded that 8.36 million foreign visitors entered Japan,

6.04 million of whom were tourists.⁴³ Most tourists arrive by air; in 2007, for example, almost 93 percent of tourists arrived by air, while less than seven percent arrived by sea.⁴⁴ The combined economic benefits of aviation and its contribution to tourism totaled roughly 1 percent of Japanese gross domestic product (GDP) and 1 percent of the Japanese workforce (around 620,000 jobs).⁴⁵ Moreover, Japan hosts 16 UNESCO World Heritage Sites, many of which are situated in the historic city of Kyoto. Tokyo is also a popular destination for tourism, including Mount Fuji. Many of Japan's cities rely heavily on this influx of foreign and domestic visitors.

South Korea, Taiwan, China and the United States constitute the largest portion of foreign tourists to Japan. Northeast Asian tourism dominates, including more than 2.04 million visitors from South Korea in 2012. Visitors from Taiwan and China totaled 1.47 million and 1.43 million, respectively.⁴⁶ U.S. tourists numbered 720,000, far and away the largest non-Asian tourist segment.⁴⁷

JAL and ANA have a considerable stake in tourism. Both have low-fare programs to attract foreigners to experience Japan. When traveling on JAL and departing Japan on a Oneworld carrier, JAL offers a special fare-reduction program called "Oneworld Yokoso." JAL also has a secondary program called "Welcome to Japan." Both provide incredibly reduced fares for foreign visitors flying within Japan – the Oneworld Yokoso program allows foreigners to purchase one-way tickets for more than 30 cities for ¥10,500 (\$105). ANA provides similar programs. The "Experience JAPAN" program, launched in August 2012, offers competitive low pricing to JAL's programs, reaching a wide number of city destinations for ¥10,500. Many destinations offered by these programs are key stops for foreign and domestic tourists, including Okinawa, Ishigaki, Sapporo and Fukuoka.

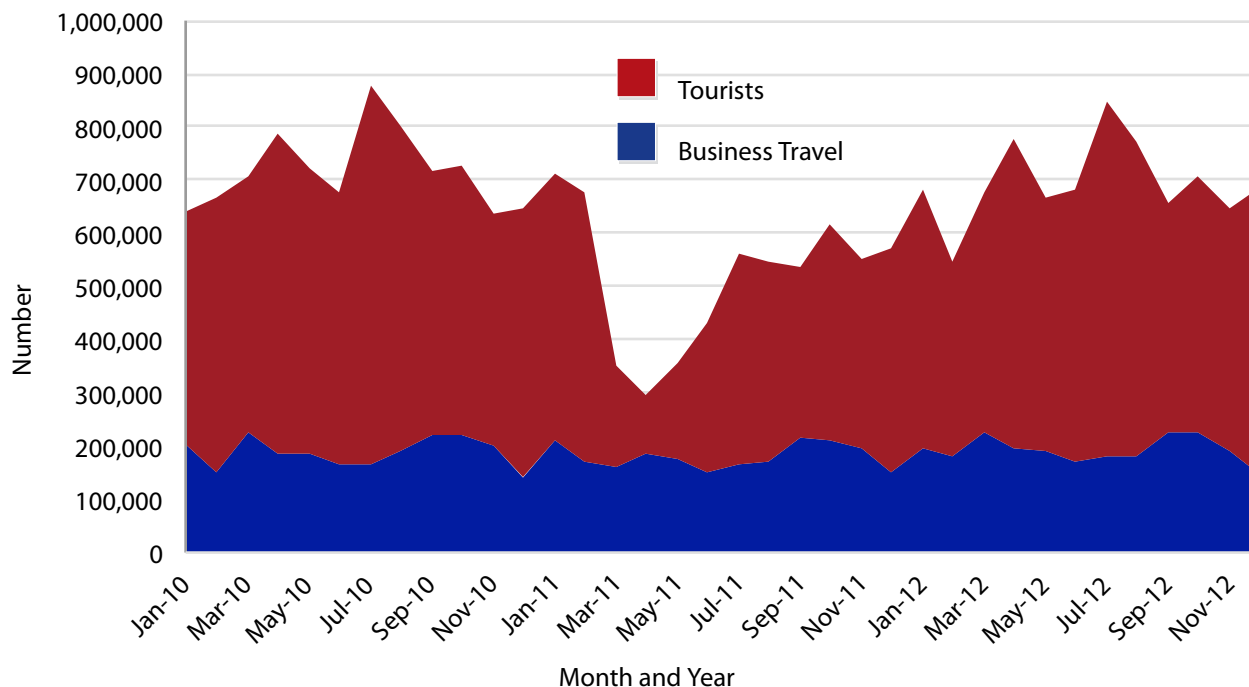
THE 2011 EARTHQUAKE AND TSUNAMI

In March 2011, a massive earthquake peaking at a magnitude 9.0, struck off the coast of Japan. It was the largest earthquake in Japanese history and the fifth most powerful earthquake in recorded seismological history, according to the U.S. Geological Survey. This earthquake triggered a massive tsunami, which crashed into the eastern coastline of Honshu in a region known as Tohoku. The disaster caused an estimated 20,000 deaths, \$200 billion to \$300 billion in property and infrastructure damage, and the Fukushima nuclear disaster.⁴⁸ This nuclear meltdown, following loss of power at the Fukushima Dai-ichi Reactor, caused a devastating ecological tragedy. Initial reports indicated that the situation was under control. Yet two years later, news reports broke that radioactive water had been leaking into the Pacific Ocean despite persistent denials from TEPCO.⁴⁹

The Tohoku disaster hit Japanese tourism hard. In the aftermath, many airlines reduced flights to and from Japan due to a sharp drop in demand. JAL cut flights from Tokyo Narita airport to Hawaii, China and Korea.⁵⁰ As depicted in Figure 6 compiled with data from the Japan National Tourism Organization, foreign tourism dropped 56 percent in the months after the disaster. Although tourism has more or less returned since then to pre-disaster levels, many foreign visitors' views of Japan are still affected by the disaster. With reports circulating that radioactive waste from Fukushima Dai-ichi is far from contained, the situation remains fresh for many across the world.⁵¹

Both ANA and JAL have invested to support reconstruction efforts in Tohoku. JAL created its "Visit Tohoku!" project, which encourages consumption and promotion of Tohoku products to bring economic stimulus back to the local community. JAL also set up a donation fund, providing children and families affected by the earthquake with vacation packages to Okinawa. ANA created

FIGURE 6: FOREIGN VISITORS TO JAPAN FROM 2010-2012



Source: Japan National Tourism Organization, Annual Foreign Visitors & Japanese Departures Report, All reports between 2010 and 2012, <http://www.jnto.go.jp/eng/ttp/sta/PDF/E2010.pdf>, <http://www.jnto.go.jp/eng/ttp/sta/PDF/E2011.pdf> and <http://www.jnto.go.jp/eng/ttp/sta/PDF/E2012.pdf>.

a flight program to provide free transportation of relief workers as well as vital supplies to the Tohoku region at the request of the Japanese government. ANA also established a Star Alliance dividend miles program, through which mile holders can donate their accrued miles to individuals affected or displaced by the disaster. While support for reconstruction efforts is expected of Japan's most influential and powerful corporations, JAL's and ANA's specific programs reflect the vested interest both share in rebuilding the local economy and increasing air traffic and tourism to the region once again.

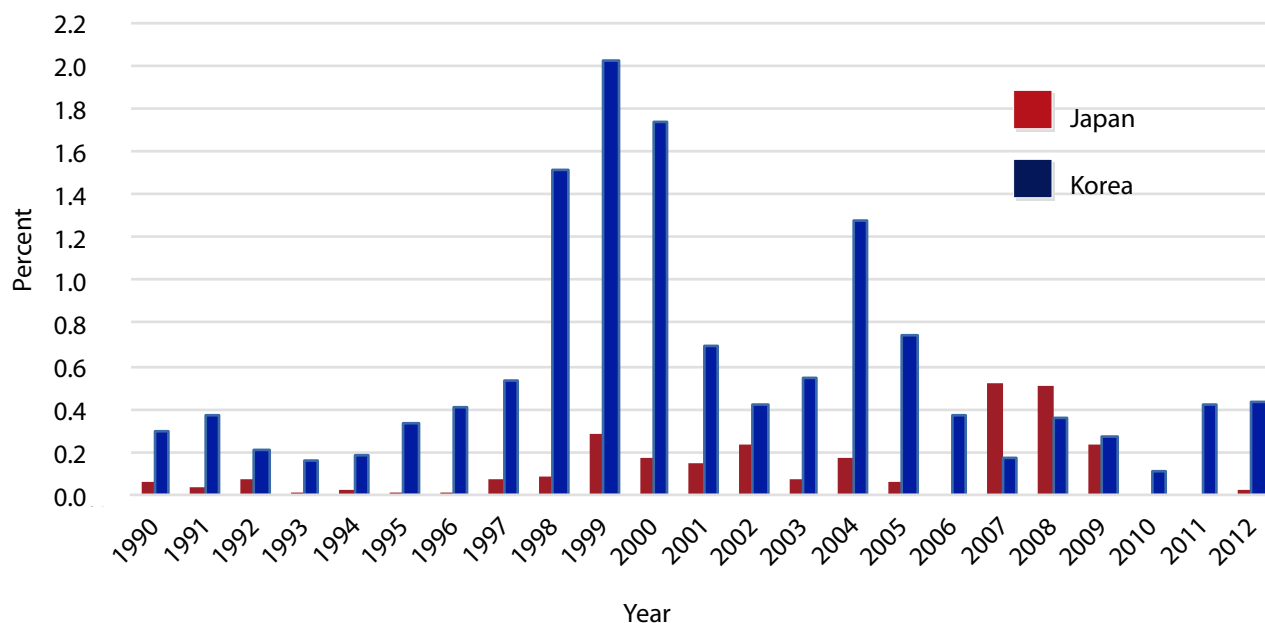
With air travel so intrinsically tied to the tourism industry, Abe's reform efforts offer considerable opportunities to energize that segment of the economy by making changes in the rigid Japanese aviation sector.

THE 2020 OLYMPIC GAMES

On September 7, the International Olympic Committee announced that Tokyo would host the 2020 Olympic Games. After this announcement, the Nikkei Index soared 2.5 percent in a day, building on already impressive gains for the year. The Japanese government estimates that hosting the games will draw up to 8.5 million tourists to the Tokyo metropolitan region during that 28-day period, roughly the usual number of visitors annually.⁵² When factoring in Olympics-related investment and spending, hosting of the games will inject roughly ¥3 trillion (\$30 billion) into the Japanese economy, with one report from NBC World News estimating the boost to be as high as \$40.4 billion.⁵³

The Olympic Games are the boon that Abe and his team have been hoping for to spark investment and drive the domestic economy. One report from

FIGURE 7: FOREIGN DIRECT INVESTMENT INFLOWS (AS PERCENT OF GDP) BETWEEN 1990-2012



Source: OECD, FDI Statistics Database: FDI inflows (annual, as % of GDP), July 4, 2013, http://www.oecd.org/daf/inv/TablesOfFDIStatistics_master.xls.

CNN Money accurately describes this victory for the Japanese government: “Winning the Olympics is in itself no guarantee of long-term economic gain – plenty of host cities have ended up paying a heavy price – but analysts believe Tokyo’s victory could give Abe the confidence to press ahead with the third pillar of his strategy, namely structural reforms the Japanese economy desperately needs.”⁵⁴

The airport capacity necessary to handle 8 million tourists within 28 days is considerable. Shortly after the Olympics news broke, MLIT announced plans to expand landing slots at Haneda and Narita to handle this influx beyond original slot increases in 2013 and 2014.⁵⁵ The expansion of slot allocations is a positive step at both airports, particularly Haneda. Japanese bureaucrats must work efficiently and precisely to ensure that allocated slots maximize market coverage. However, given precedent of current negotiations, these slot expansions have the potential to become politically charged, as discussed below.

Foreign Direct Investment

Identified by Abe as a main target for Third Arrow reforms, foreign direct investment could further push the Japanese economy forward in the 21st century. Yet despite these policy aspirations, Japan has historically ranked low when it comes to openness to FDI. In one recent report, Japan ranked 47th of 59 in receptiveness to FDI, below both Kazakhstan and Colombia.⁵⁶ Japan’s FDI inflow as a percentage of GDP is compared against South Korea (see Figure 7).⁵⁷ Even compared to a country of similar technological, social, geographic and economic development, Japanese FDI inflows are markedly behind South Korea’s. The United Nations ranked Japan 132nd of 182 economies in a scale of FDI attractiveness. This suggests that the situation is worsening, since Japan ranked 95th in 1999.⁵⁸ As noted by the Abe administration, attracting FDI has the ability to cultivate economic growth and prosperity by catalyzing innovation and job business investment to local communities and Japanese firms. Ken Lebrun, chair of



People celebrate after Tokyo is selected as the host city for the 2020 Olympic and Paralympic Games at the Tokyo Metropolitan Government Building on September 8, 2013 in Tokyo.

(THE ASAHI SHIMBUN/Getty Images)

the FDI committee at the American Chamber of Commerce in Japan, said, “... [O]ver the last five years, 90 percent of my work has been outbound deals [leaving Japan].”⁵⁹ Japan has ranked as the most closed economy on the Organisation for Economic Co-operation and Development’s index of regulatory restrictions to FDI. These include foreign equity holdings, screening and approval procedures, rules on hiring foreigners and laws on capital retention.⁶⁰ Japan’s future economic revitalization depends on increasing productivity, which in turn depends on deregulation, which in turn will attract serious overseas investment.

Similarly to tourism, FDI is closely linked with the civil aviation sector, specifically in the U.S.-Japanese bilateral relationship. InterVISTAS, an aviation and transportation consulting group,

compiled a comprehensive analytical report in 2005 titled “The Economic Impact of Air Service Liberalization.” The report cited numerous studies, including one primary research study that established a causal link between Japanese FDI into the U.S. based upon the amount of air service provided. This study examined FDI outflows at a state level. An excerpt from the InterVISTAS report follows:

Hansen and Gerstein (1991) investigated the relationship between Japanese air service to the United States and Japanese direct investment in the United States. Using data from 1982 to 1987, the analysis related the amount of Japanese investment in each U.S. state to measures of level of air service operated between Japan and that state (and other background factors). The analysis found a significant positive relationship between investment and air service. The results also suggested that the amount of service provided by Japanese carriers had a larger impact on investment than service provided by U.S. carriers. The issue of causality is also addressed (i.e., does more air service lead to greater investment or does greater investment lead to more air service), with the authors concluding that the evidence indicates that air service impacts on investment rather than the other way around. The authors concluded that better air service supports the input needs (i.e., labor and materials) of the Japanese ventures in the U.S. and enables greater awareness and information flows in Japan for U.S. regions.⁶¹

This relationship is applicable to Japan: Increased air service by Japanese carriers will stimulate wider increased investment. A government can be a catalyst for attracting greater investment through increasing both the frequency and capacity of air transportation to a region. For instance, one report found that a general 10 percent increase in air transport use will increase business investment by 1.6 percent across a five-year period.⁶²

*A general 10 percent increase
in air transport use will
increase business investment
by 1.6 percent across a five-
year period.*

There is a strong relationship between civil aviation and FDI and tourism. It is an intrinsic aspect of attracting increased investment, especially in the island nation of Japan. Based on this historical evidence, liberalization of the Japanese civil aviation sector could serve as a critical pillar to advance Abe's reform efforts and stimulate FDI and tourism growth. There are structural challenges within both the FDI and tourism sectors in Japan that stem from overregulation, protectionism and misplaced government support. By re-evaluating its policies and ensuring a competitive and liberalized air transportation market, the Japanese government can encourage growth in its targeted industries that are linked to aviation while working in parallel to ensure an open regulatory environment for investment.



(Photo by Philip and Karen Smith/Getty Images)

V. REGULATORY AND INTERNATIONAL CONSTRAINTS

Aviation has a long history in the Japanese economy. It constitutes a significant portion of total productivity and creates hundreds of thousands of jobs for the Japanese people. Yet there are acute issues nascent in the industry that hamper competition and prevent effective regulatory operations. Japanese civil aviation has long suffered from chronic undercapacity in Tokyo and overcapacity in rural airports. Stemming from critical miscalculations and political favors, these factors have caused a series of failing rural airports and a hostile politically charged regulatory environment in Tokyo. Furthermore, this has hindered the development and success of low-cost carriers in Japan. While capacity issues are easily solved, special interests are heavily

entrenched, hanging on to a skewed system of favoritism and political influence. These factors have coalesced into a matrix of uncompetitive and rigid regulations.

Domestic Regulations and Haneda Capacity

In May 2008, the Japanese Ministry of Land, Infrastructure, Transport and Tourism announced that scheduled passenger international traffic would be allowed at Haneda once again. To increase capacity in a limited fashion, MLIT officials solicited requests for specific landing slot allocations. These allocations directly correlate to revenue for an airline – each allocation represents the opportunity to conduct one flight.

The allocation of landing slots is a very technical process. The International Air Transport Association has created a comprehensive guideline to ensure fair and equitable distributions, based

on industry best practices. As outlined in full by IATA:

... [this] process governs the allocation and exchange of slots at congested airports worldwide, on a fair, transparent and non-discriminatory basis... The prime objective of the slot process is to allow airlines to acquire, retain and exchange slots necessary to operate at a given airport. Through the allocation of slots, limited airport resources are efficiently used to benefit the greatest number of airport users and travelers.⁶³

If implemented as outlined, slot allocations can ensure a level playing field and transparent regulatory framework, as well as the most efficient use of available capacity.

In recent years, tensions over the limited landing slots and unfair regulatory practices at Haneda have dominated discussions in Japan because of critical capacity challenges at Tokyo's central airport. Capacity constraints at Haneda have reached such heights that carriers must resort to the largest aircraft in their fleets to maximize passenger transportation.⁶⁴ Haneda and Narita rank among the highest airports for seat capacity to annual passenger volume ratio.⁶⁵ However, with inadequate capacity and an opaque allocation process for landing slots, leading airlines resort to redress through public forums or, in some cases, private communiqués with bureaucratic officials. In a study on Northeast Asian airport efficiency, Hun-Koo Ha explains the situation in Tokyo as such:

That airline liberalization, both domestically and internationally, has come relatively slowly to Japan may have to do with the capacity constraint at its major airports, particularly landing slots at Tokyo Haneda, Tokyo Narita, and Osaka (Itami). In the past Japan's Council for Transport Policy argued that because of airport capacity constraints, an American style of deregulation

did not suit the circumstances of Japan. While the overall national capacity has increased in parallel with the deregulation, slot shortage at congested airports has not been resolved. Yamauchi points out that slot shortage has been the single most important barrier to expanding air services to and from Japan for a long time.⁶⁶

In recent years, tensions over the limited landing slots and unfair regulatory practices at Haneda have dominated discussions in Japan because of critical capacity challenges at Tokyo's central airport.

In some instances, these tensions aired in the media, where industry leaders levied their frustrations. Initial indications were that Japanese bureaucratic decisionmaking would be more or less consistent with IATA best practices, reflecting industry needs and carrier capacity. Yet as the domestic slot allocations were announced for Haneda, it appeared that allocations were not following this designated system. As limited expansions at Haneda have increased, so too has the media spotlight on allocation proceedings, which have revealed troubling trends. Press coverage and academic research of the airport have illuminated a systemic series of uncompetitive tactics and regulatory barriers that hamper fair competition in the Japanese civil aviation market.

Announcements came in late 2012 that MLIT had decided on domestic Haneda landing slot allocations. After the restructuring and government support for JAL, ANA lodged considerable

complaints with the Japanese government, centered on the argument that support provided to JAL granted an unfair competitive advantage. MLIT – under the ruling party at the time, the DPJ – released a document in August 2012 titled “Ways to Deal with Rehabilitation of JAL.” MLIT stated that it would exercise oversight on JAL to ensure a competitive environment and make adjustments on JAL as appropriate. That November, an announcement was made about the 11 open domestic slots for domestic carriers at Haneda airport; ANA received eight to JAL’s three.

Historically since the “re-internationalization” of Haneda, JAL and ANA had received equal slot allocations for international flights. As part of its policy goal of increasing capacity at Haneda, MLIT also announced that it would expand international access by providing additional landing slots during the winter schedule of 2013.⁶⁷ Beginning in the end of March 2014, Haneda capacity would increase to accommodate roughly 40 additional international flights per day. Of those, MLIT noted that it would allot 20 for domestic airlines and the rest for foreign carriers.

Even though this decision broke with the precedent of allocating equal international slots ANA senior executives vocalized their discontent through media outlets. On May 25, 2013, ANA CEO Ito conducted an interview for *Toyo Keizai* in which he was quoted as saying: “We are asking for remedial action on the current unfair competitive environment (between JAL and ANA). To be frank, ANA should be allotted more slots (than JAL from among Haneda’s new international slots). We want them all.” Three months later, Ito remarked again on Haneda international slots: “I have nothing against JAL and it put a lot of effort into turning itself around, but the way it was saved was not right. ... The Haneda slot distribution can go some way to fixing the skewed competitive environment.”⁶⁸



Tokyo's Haneda International Airport watch tower at sunset.
(B. TANAKA/Getty Images)

On the side of the regulatory authorities, reports indicate that many within the Ministry of Land, Infrastructure, Transport and Tourism desire fair and transparent allocations. A 2010 capacity analysis report from MLIT that the Japan Civil Aviation Bureau (JCAB) “thinks it appropriate that the slot swap or slot exchange between domestic and international flights should be encouraged at Haneda Airport. The JCAB ... strongly believes that Haneda Airport should be categorized as level 3 airport by IATA and the schedule coordination services should be conducted by NRT/KIX [Narita/Kansai] schedule coordination on [a] neutral, nondiscriminatory and transparent basis according to IATA world slot guidelines.”⁶⁹ However, with unexpected uneven domestic slot allocations following considerable pressure and politicization of this issue by industry leaders, it is unclear how the allocation decision will unfold for international slots.

Reports of industry politicization are probable. With such little capacity, Japanese carriers must

fight tooth and nail to seize as many revenue opportunities as possible. Current international slot allocation expansions are worth an estimated \$400 million.⁷⁰ JAL and ANA are waging an incredibly intense battle. JAL's restructuring succeeded and propelled the former flagship carrier to profitability and rebirth. ANA has shown considerable economic resiliency through the economic recession, confident it can step forward as the dominant carrier of Japan. However, industry politicization appears to have affected regulators and allocation proceedings. Regulatory inefficacy has certainly contributed to such animosity between these two carriers. However, the structural competition and regulatory inefficacies that exist between JAL and ANA in international landing slots at Haneda go far beyond domestic economics.

Japan-U.S. Bilateral Constraints

There are numerous foreign carriers, particularly in the United States, that are monitoring current allocation deliberations with interest. American carriers play a large role in the Japanese civil aviation sector. From July 29 to August 4 of this year, American carriers represented 21.3 percent of total flights at Narita International. Japan held 37.7 percent of flights. South Korean flights represented only 8.7 percent. While international landing slots for foreign carriers are separate from those for domestic carriers, the allocation decisions have lasting consequences for the international aviation market. Within the Tokyo metropolitan area, the Star Alliance has the largest share of international slots, with roughly 40 percent of Haneda and 39 percent of Narita. Oneworld holds a 31 percent and 26 percent stake in Haneda and Narita respectively, while SkyTeam holds roughly 17 percent and 24 percent. Many American carriers have consistently fought hard for access rights to Haneda. By dint of its strategic location, Haneda has the opportunity to facilitate a considerable amount of business travel, as well as tourism.

U.S.-JAPAN OPEN SKIES

After years of negotiation, the United States and Japan signed an Open Skies Agreement in October 2010. The agreement was signed by then-U.S. Ambassador to Japan John Roos and MLIT Minister Sumio Mabuchi. This was the first major overhaul of the original 1952 aviation treaty between the two countries in more than two decades.

Despite the promising developments that took place under the Open Skies Agreement, there has yet to be a major redress of U.S. concerns surrounding its terms. U.S. airlines continue to push for daytime rights at Haneda, which remain limited by the 11 p.m. to 6 a.m. Narita curfew; international daytime slots at Haneda are only allowed for short-haul flights to Asian destinations. Without allowing for daytime access rights, Haneda was functionally limited for many American carriers. Without daytime rights, flights leaving U.S. hubs such as Dallas/Fort Worth would otherwise have to leave at extremely late hours to arrive in the designated time window for Haneda. Many American carriers have advocated for transferable rights of landing slots to Haneda from Narita in order to take advantage of its location and proximity to Tokyo.

YOKOTA AIR BASE

After the Japanese surrender, the United States took control of numerous military installations across Japan.⁷¹ As discussed above, Haneda airport was first a military field and later claimed by the U.S. Army for use until 1952. In western Tokyo, the Imperial Japanese Army established Tama airfield in 1940. It served as a test center for the Imperial Japanese Army Air Service. After U.S. forces claimed the air base, it has been actively used for several decades, including operations throughout the Korean War. In 2006, the Japan Air Self-Defense Force (JSDF) co-located its base of operations to Yokota.

Today, Yokota serves as a base of cooperation between the JSDF and U.S. military forces. It is actively involved in the forward deployment of U.S. military assets in the region. Drawing from our previous study, Yokota Air Base is a vital strategic asset for the U.S.-Japan alliance and would play crucial roles in combat, combat support and strategic lift in the defense of Japan. Japan would be a central staging base for combat, command and control, and strategic transport operations in the event of a future crisis in Korea, continuing the precedent set during the Korean and Vietnam wars.

Yokota serves as an example of the deep ties shared in the U.S.-Japan alliance, but it could also become an important part of Japanese civil aviation. As early as 2003, there were discussions between Prime Minister Junichiro Koizumi and President George W. Bush over potential cooperative civil aviation use for Yokota Air Base. Current capacity challenges at Tokyo's main airports, particularly Haneda, now make dual use even more feasible. This proposal has enjoyed considerable bilateral support, with members of the U.S. military as well as the Tokyo Metropolitan Government advocating for its dual military and civilian use.⁷²

There are some marked challenges involved. Dual use could help improve civilian air traffic management and capacity expansion. However, as a requirement of dual use with the military base, any efforts to develop its civilian capabilities must also work to increase military capacity (both at Yokota as well as possibly increased contingency access to other airfields). Yokota would also need to meet a long list of technical and logistical requirements to operate in a civilian capacity, including continued U.S. operational control, retained military priority and a relatively high degree of combat readiness.

As the United States continues its strategic rebalance to the Asia-Pacific region and the current LDP administration seeks to deepen its bilateral

engagement with the U.S., civil operations could help advance a more robust role at Yokota while also cultivating shared commercial ties through civil aviation.

Yokota has a 10,000-foot runway, capable of handling both narrow- and wide-body aircraft. Both MITRE and the International Civil Aviation Organization (ICAO) have evaluated the technical viability of Yokota's runway for civil aviation use. The runway has passed all certifications except for the new Airbus A380, which falls under the ICAO 4F Aerodrome classification.

Summary

In its current state, the regulatory frameworks surrounding the Japanese aviation industry are opaque, uncompetitive and in need of redress. Haneda has the opportunity to draw incredible revenue, both from domestic carriers and American carriers. Despite considerable contention surrounding slot allocations as well as the general endemic protectionism and favoritism in the Japanese market, the airline industry in Japan remains a strong potential catalyst for economic growth. Reform efforts from Prime Minister Abe and the LDP are coinciding with the culmination of frustrations of many Japanese civil aviation stakeholders. As part of his Third Arrow, Abe wants to demonstrate his commitment to 21st-century business practices, facilitating reform and attracting both foreign direct investment (FDI) and tourism to Japan. This is a positive-sum game. Both JAL and ANA, along with American carriers and stakeholders, stand to gain from a reformed and deregulated airline industry. If reforms are handled correctly, Abe and his team can push Tokyo and wider Japan onto the leading edge of aviation and in doing so project a Japanese investment climate that is "open for business."



(Photo by Yameme Photography)

VI. RECOMMENDATIONS: ADDING CIVIL AVIATION TO THE THIRD ARROW

The prime minister's reform efforts go across the spectrum of the Japanese economy, touching on various industries, geographies and communities. Yet one sector that the administration has failed to mention in its reform efforts is civil aviation. This industry is crucial to the Japanese economy; it is responsible for more than one-third of Japan's total trade flows and much of its tourism industry. Because of the current capacity and regulatory barriers of the industry, civil aviation may also prove to be a significant bottleneck for the 2020 Olympics. Based on the goals of the Third Arrow and our analyses of the critical linkages between aviation and Abe's targeted industries, we have compiled a number of recommendations

for the Japanese administration. These policy recommendations can help reform one of Japan's strategic industries while simultaneously removing uncompetitive practices and creating a fair and transparent regulatory environment. As the world turns to Japan in anticipation of its rebirth under Abe, regulators have the opportunity to demonstrate real reform efforts in one of its most critical and uncompetitive industries.

The following recommendations include four areas of policy focus to both revitalize the aviation industry and increase air transportation capacity: liberalizing the regulatory environment surrounding low-cost carriers, increasing Haneda landing slot allocations and allocation transparency, converting Yokota Air Base to dual civil-military use in peacetime and investing in

critical infrastructure projects to facilitate the 2020 Olympic Games. These areas incorporate established topical research and literature as well as the leveraged policy expertise of CNAS research.

Low-Cost Carrier Regulatory Reform

The low-cost carrier segment of the Japanese airline market has room for growth. The infrastructure of many of Japan's airports revolves around a twofold ownership scheme. The central government frequently owns runways and taxiways, deemed critical infrastructure for the operation of the airport, while local governments or private firms often hold the rights to terminals and parking lots. This means that the central government receives revenue for landing fees, which are not tied to profits gained from the terminals. Therefore, airports are unable to leverage reduced landing fees to increase traffic without enticing the central government to do so. This has prevented numerous low-cost carriers (LCCs) from entering the Japanese market, as operating margins are often lower. These LCCs simply do not have the operating margins to allow for such high fees. On average, Tokyo Narita landing fees are more than double the fees at Incheon (Seoul) and Changi (Shanghai) airports. While Narita cut landing fees for international flights by 5.5 percent in April 2013, this does not account for a large benefit to many carriers, including budget airlines that could drive passenger traffic.

The 1999 Civil Aeronautics Law created a friendlier regulatory environment for Japanese LCCs, liberalizing the licensing procedures and fare approval systems.⁷³ This has helped facilitate the establishment of LCCs. However, operability and profitability still hamper current ventures. Despite the success of other Asian LCCs, Japanese firms have achieved very slow growth. This can be attributed to limited access to secondary airports, to some degree. In a 2007 empirical analysis, Hideki Murakami also concluded that the Japanese regulatory environment tolerated predatory behavior

and drove these LCCs out of potentially competitive markets. Furthermore, he identified a trend of collusive code sharing between ANA and numerous LCCs, also contributing to the uncompetitive environment.⁷⁴

Simultaneously, many of Japan's airports are suffering from overcapacity. While Narita and Haneda handle most of Japanese air traffic, there are still nearly 100 airports operating across the country. State-run airports are frequently running up large debts fueled by a lack of traffic. Many have chronically lost revenue, to the point where there were discussions of full privatization of managing rights for many ailing rural airports while the property ownership would remain in the hands of the public sector.

There has been some recent growth in the sector. Spring Airlines Japan just announced that it would offer increased service to western Japanese cities and Narita starting in May 2014. While the number of LCCs provided to consumers is increasing, the competitive landscape remains stifled, dominated by the traditional names of Japanese aviation. LCCs offer a compelling opportunity for the Japanese aviation sector. As noted, many rural districts are not easily accessible (especially to Tokyo). These districts have little demand for air services. However, these airports are critical public infrastructure, providing residents with access beyond the local municipality. In the past, carriers like JAL and ANA were asked to provide service to these regions, despite their stark unprofitability. These domestic routes contributed significantly to JAL's sustained losses and its eventual restructuring.

By liberalizing the environment surrounding LCCs and airport fees, the Japanese government can encourage a regulatory environment where service to these removed locales can be restored while still retaining a degree of profitability. This would in turn allow full-service national carriers the latitude

to leverage their own competitive advantages and not serve on unprofitable lanes. This would be a positive sum gain for LCCs looking to establish further in Japan, full-service carriers avoiding unattractive routes and Japanese consumers benefiting from increased connectivity.

The Japanese government should consider creating a more open and competitive landscape by:

- Allowing airport management companies (including both local governments and private firms) full ownership of runways. This will allow greater pricing competition and the ability to adjust landing fees.
- Enforcing landing fee caps across Japan. Narita International has taken steps to decrease fees by incentive programs. However, rising landing fees will further lock out future innovators and competition that LCCs bring to the market.
- Encouraging an industry-led discussion on how reform of the LCC market can restore service to removed areas of Japan, filling gaps in the aviation market while still supporting profitability for flagship carriers. By advocating regulatory reform and not dictating air service on a given route, the government of Japan can demonstrate its commitment to market-based solutions.

Haneda Slot Expansions

As discussed earlier, Haneda is at the center of the Japanese aviation market, with about 48 percent of Japan's total air passengers traveling through Haneda. It is the world's fifth busiest airport, and second in Asia, only behind Beijing Capital International Airport. Both JAL and ANA have hubs at Haneda; it is the core of Japan's aviation market.

Despite its crucial role in both the Japanese economy and the wider global marketplace, there are still critical competitive barriers and opaque regulatory frameworks that surround Haneda. American carriers are at a distinct competitive

disadvantage due to the short-haul limitations on daytime outbound flights. Limited international slots create an acute capacity crunch and a disharmonious competitive environment for aviation players. Allocations are politicized and do not reflect industry best practices.

Despite its crucial role in both the Japanese economy and the wider global marketplace, there are still critical competitive barriers and opaque regulatory frameworks that surround Haneda.

There is a strong body of evidence correlating airport expansion with increasing net benefits for the surrounding economy. One study developed an extremely complex model to map the expansion of Haneda slots to direct economic gain for the Tokyo region. Unlike standard transportation demand forecasting models, this model incorporates micro-economic decisionmaking and behavior theories. It found that "slot increases lead to rescheduling of flight plans and finally to change in levels of service. Airline competition in aviation markets may reduce the price of air tickets, and increasing the frequency of flights may also reduce waiting times and therefore the average travel time."⁷⁵ In analyzing a 10 percent slot increase at Haneda at a net cost of ¥180 billion (pegged to 1995 values), the authors found that the social net benefit was ¥33 billion per year. Of this 33 billion, ¥11 billion went back to the Tokyo metropolitan area while ¥22 billion was returned to other rural regions of Japan through increased consumption and ticket

purchases. Through this study, direct expansion of slots at Haneda can not only improve the competitive environment for both consumers and airlines, but also directly stimulate consumption. Industry experts agree with this analysis; for instance, Hirotaka Yamauchi, a professor at Hitotsubashi University and acclaimed transportation expert, contends that Haneda slots should be allocated on purely consumer benefits.⁷⁶

In discussions leading up to the previous domestic slot allocation increases as well as upcoming international allocations in October 2013, industry stakeholders have been weighing in on the allocation process. As mentioned above, ANA CEO Ito has consistently lobbied for increased allocations at the expense of JAL. He argues that the JAL restructuring put ANA at a competitive disadvantage, and he has called on regulators to even the competitive landscape. Hajime Tozaki, a professor at Waseda University specializing in transportation policy, agrees in part with this analysis. However, he caveated this in an interview with *The Japan Times* last September: “One of the biggest reasons behind JAL’s bankruptcy was the intervention of politics. If such intervention comes back due to the recent argument over unfairness (of JAL’s rehabilitation process), the carrier will return to its old self. That would be a huge loss for Japan’s economy.”⁷⁷

The Japanese government should consider reforming Haneda’s regulatory environment by:

- Increasing slot availabilities to both domestic and international destinations in advance of the 2020 Tokyo Olympic Games.
- Allowing long-haul daytime departure and arrival slots at Haneda to provide for increased capacity while widening the potential net of passenger destinations. This will bring both increased consumption and profitability to both the Tokyo area and aviation players.
- Ensuring fair and equal distribution of slots,

either neutrally or per consumer benefit, to maintain a competitive market. This would send a message to the world’s investment community of the administration’s commitment against politicized regulations and influence peddling in Japan’s industries.

- Establishing a Blue Ribbon Council, staffed by industry experts and stakeholders, academic researchers and policymakers. This council will serve as a third-party observer to the allocation process, leveraging industry expertise to help ensure a transparent and equitable process. Establishing this council will help further demonstrate the Abe administration’s commitment to fair and equitable allocations.

The Civil-Military Transition at Yokota Air Base

As part of a larger effort to revitalize and reform the civil aviation industry, Japan should pursue the introduction of civil aviation use of Yokota as a complementary airport to the Tokyo metropolitan area. While Narita and Haneda serve east and south Tokyo, west Tokyo remains removed from any major air hub. As a previous CNAS report noted, “If civil aviation could be introduced without undermining Yokota’s principal purpose as a military base, then shared use could fundamentally rebalance civil aviation in Tokyo. It would also restore Tokyo’s competitiveness as an aviation gateway and as a business center. The positive effect of strengthening Tokyo’s infrastructure and business profile should be a prime consideration of U.S. alliance managers.”⁷⁸

The Japanese government should therefore consider:

- Implementing Yokota as a dual use civil-military airport. This will help rebalance capacity constraints as well as provide airport access to underserved districts of Tokyo.
- Encouraging dual use as a method to advance

bilateral dialogue on regulatory challenges and competitive barriers faced by stakeholders in Japanese civil aviation.

- Leveraging shared U.S.-Japanese stakeholder responsibility as a method of ensuring that slot allocations at Yokota are decided openly, transparently and by industry best practices. There is an opportunity to begin allocations at Yokota under a different regulatory regime, advancing a more fair and competitive system than the one currently in use.
- Making capital investments to expand infrastructure capacity at Yokota. Doing so will help divert excess traffic from Haneda in advance of the 2020 Olympic Games.
- Using the introduction of civil and business aviation at Yokota as a way of facilitating more military contingency-time access to other civilian airports in Japan.

Critical Infrastructure Investments Before the 2020 Olympic Games

The 2020 Olympic Games have the potential to bring upward of 8 million tourists in and out of the Tokyo metropolitan region in the span of 28 days. The games will bring considerable investment and spending to Tokyo, stimulating growth and helping to deliver on Abe's Third Arrow reform efforts.

Based on the current regulatory and competitive environment in Japanese civil aviation, the industry simply is not adequately prepared to mitigate this influx of tourists. There are critical limitations to passenger capacity at Narita given its curfew from 11 p.m. to 6 a.m. Haneda does not currently accept long-haul international flights during its daytime operations. Normally, technical and transparent decisionmaking regarding capacity allocations is fraught with influence peddling and politicization. The above policy recommendations take steps to address these inefficiencies. In order to increase long-term capacity, the Japanese government should consider:



Japanese Prime Minister Shinzo Abe reports to his cabinet members about Tokyo's successful bid to host the 2020 Summer Olympics and Paralympics at the IOC meeting in Buenos Aires following his return from Argentina in Tokyo on September 10, 2013.

(ITSUO INOUE/AFP Photo)

- By 2018, ensuring that slot allocations adhere to IATA World Slot Guidelines, the internationally recognized best practices for fair and equitable capacity management.
- Establishing a joint government-industry task force to correct misconceptions and establish working goals for the future of Tokyo's civil aviation space. This task force should incorporate both foreign and domestic industry stakeholders as well as key bureaucrats from MLIT's Civil Aviation Bureau.
- Utilizing new policy councils⁷⁹ to receive industry-critical information as well as provide a forum for inclusive policy development. This would encourage cooperation and communication between established domestic carriers such as JAL and ANA.

VII. CONCLUSION

Japan's aviation industry is at a critical juncture. It is a central aspect of the Japanese economy, supporting hundreds of thousands of jobs and facilitating travel for millions of tourists and business professionals. Efficient air travel is critical to facilitate trade and investment, especially for this island nation. With the tremendous prospects for continued growth and economic revitalization under Abe, coupled with the economic boon of the upcoming 2020 Olympic Games, Japan's aviation industry has the potential to provide a catalytic stimulus to the Japanese economy.

Yet despite its importance and visibility, civil aviation in Japan is extremely uncompetitive, entrenched in political venality and opaque regulatory barriers. These systemic challenges are notable, as they are the expressed targets of Abe's Third Arrow reforms. Foreign firms and governments alike are watching current efforts unfold with great attention. While Abe's first Two Arrows are moving forward, the Third Arrow is a litmus test for the administration's commitment to effective structural reform. Stepping up against such protected industry forces is a considerable test of Abe's political will. In many ways, the symbolic and actual benefits of civil aviation reform—in particular the politicized yet highly visible allocation process—present a fundamental choice for Abe and his team. It will either be “business as usual” or indicate a new and revitalized investment climate.

The political risks associated with such reforms, particularly in the aviation sector, are considerable. Special interests and corporate interlocutors have a vested interest in maintaining the status quo. Nevertheless, as the world watches and political commentators begin to question whether the scope of the Third Arrow is truly feasible, Abe has an incredible opportunity. By driving forward with his Third Arrow reform efforts and targeting the uncompetitive landscape of the aviation industry, Abe can demonstrate that Japan is back in business and cleared for takeoff.



Osaka, Japan, Kansai International Airport, waiting area inside the terminal building.

(CHRIS STOWERS/Getty Images)

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