CENTRE FOR EUROPEAN REFORM
policy brief

A transatlantic defence market, forever elusive?

By Clara Marina O'Donnell

★ EU member-states and the US would benefit from more open defence markets across the Atlantic. Military forces would find it easier to co-operate in the field, governments could pay less for defence goods, and the transatlantic relationship would be strengthened.

★ But markets remain fragmented. States are often more concerned with creating jobs than with buying the most cost-effective equipment. And they are reluctant to rely on each other to supply defence goods or to protect their military technologies from falling into the wrong hands.

★ Commendably, Washington and the EU are taking steps to loosen their excessive export controls. But to be effective the reforms must be more ambitious and co-ordinated. In addition, European governments must use the economic crisis as an opportunity to stop shielding unsustainable national defence industries.

The US and most countries in Europe have had close political and military ties for decades. Through NATO, they are committed to their mutual security and they have often fought side by side, including in Kosovo, Iraq and Afghanistan.

For years many experts, industry leaders and politicians have been highlighting the potential benefits for transatlantic allies of more open defence markets. Greater competition would allow for cheaper defence goods and promote cutting-edge technological development. Fewer bureaucratic barriers between national markets would make it easier and more cost-effective for governments to buy and develop weapons together. Their armed forces would use more common equipment, improving their ability to fight side by side. Currently, multinational deployments are often hampered by countries using incompatible hardware – for example, different radios have made it hard for troops from various nations to communicate on the battlefield. Finally, an integrated market would help cement the transatlantic alliance.

Yet defence markets across the Atlantic remain hamstrung by heavy restrictions on technology transfer, burdensome export controls and government reluctance to buy equipment from abroad. For the US, which alone accounts for half of the world spending on defence, the current state of affairs is sustainable, although very inefficient. But in Europe defence budgets have become too small to maintain national industries and the survival of the European industrial base is at risk.

Guns and jobs

For decades the US and European countries with large national defence industries have relied mostly on domestic suppliers. And when contracts have been awarded to foreign firms, states – including those in Europe without their own defence industry – have generally required that a certain amount of the production take place on national soil. Governments have preferred equipment to be made at home partly because they want to ensure access to, and control over, sensitive weapons systems and technologies. But buying defence goods has often also been seen as a way to support the national economy. Politicians, particularly those with constituencies that employ people in the defence sector, have been reluctant to spend taxpayers' money abroad.

A recent study by the Center for Transatlantic Relations, commissioned by the US Department of Defence (DOD), discerns a trend since 2006 towards more openness in defence markets across the Atlantic and 'somewhat "better value" buying habits'.[1] But there is a long way to go. The report acknowledges that the Pentagon still awards around 98 per cent of its procurement budget to US companies and that various European countries still rely mostly on domestic suppliers. For example, between 2006 and 2008, the Italian government awarded 60 per

[1] *Jeffrey Bialos, Christine Fisher and Stuart Koehl, 'Fortresses and icebergs', Center for Transatlantic Relations, Johns Hopkins University, 2009.*

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cent of its new defence contracts to Italian firms, while 56 per cent of new German defence programmes went to German suppliers.

In addition, local employment remains important. American defence manufacturers sometimes spread their production efforts across various US states in order to strengthen support within Congress for their contracts. Washington officially waives its 'Buy American' requirements towards most countries in NATO. (The Buy American Act requires the US government to prefer US-made products in its purchases.) But in practice, foreign companies must still create jobs in America if they want to win a sizeable defence contract. In Europe, governments frequently ask for compensation policies known as 'offsets'. These oblige foreign firms to invest in the country or transfer technology as part of the sale. Offsets are often worth more than the value of the contract and frequently the investment is not even in the defence sector. For example Saab's offset arrangements with Hungary, in order to lease its Gripen fighter, led Electrolux to set up a factory to manufacture refrigerators in the north of the country.[2] Defence companies have also built hospitals and schools.

[2] *'Quid pro quo: The changing role of offset in the global defence market', Jane's Industry Quarterly, October 2009.*

Offsets and broader job creation requirements can damage the armed forces and competition. A company may win a contract not because it has the best product, but because it offered the most generous compensations.

Officially, the EU has recognised offsets as inefficient and costly. Member-states have even taken steps to limit them: in 2009, most governments signed up to a voluntary code of conduct which promised to reduce their scope. Member-states have also agreed on an EU directive on defence procurement, which from 2011 is designed to put an end to compensation policies within the EU. But until recently several members-states, notably Poland and Bulgaria, were still introducing national legislation to make offsets mandatory. In light of the importance several European countries attribute to offsets, it is likely to take years before national behaviours change. And the European Commission might have to take recalcitrant member-states to the European Court of Justice.[3]

[3] *Clara Marina O'Donnell, 'The EU finally opens the European defence market', CER policy brief, June 2009.*

The struggle for market access

Aware of the need to create local jobs and avoid the label of 'foreign suppliers', defence companies in the US and Europe have developed various strategies to break into each other's markets. They have developed partnerships, set up joint ventures and bought local defence firms. European defence companies, increasingly cash-starved at home, have been particularly active in their attempts to sell to the Pentagon. Indeed while annual budgets for defence equipment across the EU are about €40 billion combined, the US spends around €165 billion on procurement. And while member-states spend a total of around €8 billion a year on research and development (R&D), Washington spends approximately €55 billion.[4] Broadly speaking, European companies have adopted three approaches:

[4] *'European – United States defence expenditure in 2008', European Defence Agency, December 2009.*

**** The BAE model***

Over the years, BAE Systems has acquired several large American defence companies and become a significant employer in the US.[5] The firm has also underplayed its British origins, stressing American patriotic values in its advertising campaigns. The strategy has been very effective and BAE has become the only European among the top five suppliers to the DOD.

Others have tried to replicate BAE's success, and between 2007 and 2009 alone there were 75 mergers and acquisitions by European firms in the US.[5] British companies, including Rolls-Royce and Meggitt, have found it easier to make big investments, due to close political ties between London and Washington. However in the spring of 2008, the Italian firm Finmeccanica broke new ground by becoming the first continental group to buy a sizeable American company, DRS Technologies, in a deal worth $5.2 billion.

[5] *'Return of the giants', Jane's Industry Quarterly, May 2010.*

Some European firms believe that the 'BAE strategy' has drawbacks. Washington requires European groups who buy US companies to introduce extensive security firewalls between their American and European operations. (Firewalls prevent staff in different departments from sharing information and European owners from having access to details of sensitive US programmes). As a result, companies such as BAE have only partial knowledge of the activities of their American subsidiaries. And instead of benefiting from synergies, they often have to maintain separate research departments and separate production lines when they supply the US and European markets.

**** The EADS model***

Like BAE, EADS competes for very large DOD contracts. It has notably bid for a deal worth over $50 billion to build the next generation of air-to-air refuelling tankers. But unlike the British defence giant, the European group has not acquired any large American defence firms. EADS builds factories in America whenever it secures a contract with the Pentagon. But the lack of US subsidiaries has at times made it hard for the European company to win bids.

**** The Thales model***

Thales has adopted a more modest level of ambition than either BAE or EADS. To date, the European defence firm has not succeeded in making any major US acquisitions. So Thales has avoided bidding for large US defence contracts, recognising that its relatively small presence in America and its partial ownership by the French state could limit its chances.

In order to supply the US armed forces with weapons systems, Thales has often teamed up with leading

American companies. Several years ago, Thales and the US firm Raytheon formed the largest transatlantic joint venture to date, in order to sell radars and other equipment to Europe and the US.

Recent breakthroughs

In recent years, the volume of defence trade across the Atlantic has increased, largely due to the military operations in Iraq and Afghanistan. But in light of the size of procurement budgets in Europe and the US, the trade is still limited. The study by the Center for Transatlantic Relations estimates that between 2002 and 2007, US sales to Europe grew from $1.2 billion to $5 billion (peaking at $6 billion in 2006). Meanwhile European sales to the US increased from $511 million in 2002 to $1.2 billion in 2007, of which half were British exports.

The fact that US companies have traditionally sold more equipment to Europe than vice versa has prompted many Europeans to characterise the transatlantic market as a one way street. A certain discrepancy in trade flows is to be expected. After all, the Pentagon's procurement budget makes up half of world arms purchases. As a result American firms, benefiting from Washington's significant investment, have often been able to develop weapons which were not available in Europe, or which were better value.

Over the last five years, European groups have won some substantial contracts in the US. In 2005, the government selected Finmeccanica, as part of a consortium led by Lockheed Martin, to replace the presidential helicopter. The US Army chose EADS North America to build its light utility helicopters in 2006. The following year a joint venture between the Italian company Alenia and the American firm L-3 Communications was asked to supply the DOD with military transport aircraft. And in 2008 the Air Force selected EADS, in partnership with Northrop Grumman, to develop its air-to-air refuelling tankers.

However several setbacks in the past two years have soured the atmosphere across the Atlantic. The White House will purchase fewer transport aircraft than expected and it cancelled the contract for the presidential helicopters because of cost overruns. (The government has issued a new tender.) European companies do not see these cuts as examples of American protectionism. They recognise that the Pentagon has also ended several programmes where US firms were the principal suppliers – including the F22 fighter aircraft and the long range bomber.

But the DOD's revocation of the contract it awarded to EADS and Northrop Grumman to supply the refuelling tanker has been far more controversial. Officially, the Pentagon changed its mind in the autumn of 2008 because the Government Accountability Office disapproved of the tendering process. But many Europeans believe that Boeing (the main competitor) got another chance for no good reason. Worse, when the DOD re-issued the tender in September 2009, the requirements seemed biased in Boeing's favour, prompting Northrop Grumman to withdraw from the competition. Several European leaders, including French President Nicolas Sarkozy, loudly accused the US government of protectionism. The Pentagon, keen to maintain a competitive process, encouraged EADS to submit a bid even without Northrop.

At the time of writing, EADS is planning to go ahead without any US partners. It is the first time a European firm is competing alone for such a large contract. But the outbursts of protectionist rhetoric within Congress during the controversy are a stark reminder that origin still matters in the American debate. Experts have predicted that EADS has little chance of winning the tanker contract and that the company is only taking part in order to secure the DOD's goodwill for future deals. But is it worth noting that, based on past behaviour, neither France nor Germany would be likely to award an equivalent contract to Boeing instead of Europe's aerospace champion.

Trust, what trust?

The most striking feature of the defence markets across the Atlantic is the extent to which governments control the export of military goods and technologies amongst allies. Governments must ensure that sensitive equipment does not fall into the wrong hands. But given the closeness of military ties and the globalised nature of today's defence industry, some of the current checks are disproportionate. They merely hamper industrial collaboration and co-operation amongst troops in combat operations. Commendably, the EU and the US are taking steps to improve their export controls, but to be effective their reforms must be ambitious and co-ordinated.

Until now most EU governments have required a national export authorisation whenever military goods were moved between two member-states. This has applied not only to major equipment, but also to spare parts and components. Yet export requests within the EU are hardly ever rejected. Last year governments acknowledged that such onerous controls were unnecessary. They have agreed a directive which from 2012 should create a more efficient system: all member-states will introduce general and global export licences.[6] The hope is that only sensitive goods will still require individual authorisations.

[6] *Broadly speaking, goods which benefit from a general licence can move across EU borders without exporters having to ask for specific licences to do so. Global licences are granted to defence companies and allow them to transfer several goods to various recipients over several years.*

But for the initiative to be effective, EU countries will have to trust their neighbours to ensure that their defence equipment is not re-exported to undesirable destinations. That trust does not yet exist across the whole of the Union. Some states, such as Germany and the UK, are known to have very reliable export controls. But others suffer from lower standards, in particular some of the new member-states such as Romania and Bulgaria. All governments have promised to develop thorough controls before the new system comes into force. They must deliver on that commitment. Otherwise national

export control authorities will use general and global licences for only a limited range of defence goods – or perhaps none at all.

US export controls are even more cumbersome than those in Europe. Through International Traffic in Arms Regulations (ITAR), Washington requires individual authorisations for even the most anodyne spare parts and components, including bolts or rubber hoses designed for military aircraft. In addition when a US component is shipped to a new country it frequently requires a new authorisation – even sometimes when a bolt is moving between plants of the same company with operations in Germany and Spain. Washington authorises over 95 percent of export requests to Europe. But as the requests are treated in the same way as those to other parts of the world, including the Middle East, they sometimes take months to be processed by the different government agencies involved. And to the great confusion of exporters, sometimes one department grants an export request while another one turns it down.

For years many American think-tanks have highlighted the shortcomings and the costs of a system designed for the Cold War: by wasting time on trivial items, US officials have fewer resources to focus on sensitive cases.[7] Some foreign companies are reluctant to sell equipment to the US because they do not want to have to comply with ITAR. American firms find it harder to compete in foreign markets, including Europe, because governments prefer to avoid US parts for fear of Washington's export controls slowing down future repairs or re-exports. European manufacturers market some of their goods as 'ITAR-free', meaning that the potential buyer need not worry about dealing with cumbersome US legislation.

7 See for example 'Beyond "fortress America": National security controls on science and technology in a globalized world', The National Academies Press, 2009.

American military technology is also subject to very onerous export restrictions. As mentioned earlier, European manufacturers that collaborate with US ones have to put in place extensive firewalls, while those which own US firms outright often must set up proxy boards. These need to be made up of American citizens: they run the company and decide what sensitive weapons to produce, while the European owner only has access to financial information. In addition, a lot of sophisticated American equipment sold to allies has 'black boxes' installed: the armed forces who buy the goods, such as combat aircraft and radars, are given enough information to operate the weapon system but they do not have access to the IT systems and codes which underpin it.

Again such heavy controls have costly side-effects. For example, extensive firewalls hinder synergies in research and development efforts. This eliminates one of the main benefits of transatlantic industrial collaboration. European defence ministries that buy American weapons are dependent on Washington for upgrades and repairs. If a US built fighter jet breaks down, it often cannot be fixed in the combat zone because that would require access to protected information. Instead, the aircraft has to be shipped to the United States to be repaired by American engineers. If equipment is out of action for long periods of time, military operations can suffer. This affects US security too, as often American armed forces are fighting side-by-side with European partners. Even Britain – Washington's closest ally – has often failed to gain access to the technology underpinning US military systems. The British government has publicly decried such treatment.

America tries to move into the 21st century

The Obama administration has acknowledged the harmful implications of current US export controls and it is trying to overhaul the outdated rules. Previous American governments have already tried to streamline ITAR. But while some initiatives have made the system slightly more efficient, their overall impact has been limited. In April 2010 Secretary of Defence Robert Gates stressed the urgent need for reform, arguing that the current arrangements were failing to prevent harmful exports while holding back useful ones. Gates has laid out a series of ambitious plans. Over the next year, the government wants to simplify the web of bureaucracy, notably by creating a single licensing agency. The administration also aims to loosen checks on non-sensitive equipment in order to focus on critical technologies, which Gates has referred to as the 'crown jewels'.

The proposed changes would be a significant improvement. But several of the reforms will need approval from Capitol Hill and traditionally Congress has been very reluctant to loosen export controls, blocking several attempts by previous US administrations. There are fewer strong opponents in the House of Representatives and the Senate than in the past. But the slow ratification of the UK-US defence trade treaty is not encouraging (see box page 5).

Even if Congress endorses the reforms, they will only be effective if the 'crown jewels' are defined narrowly. For transatlantic partners to reap the benefits of defence co-operation, Washington must also allow its European allies to access some of its sensitive technology and co-operate on advanced weapons. But there is a significant risk that only the least sensitive US equipment will be granted more lenient checks. The DOD shares the concerns of many Western Europeans about the weak export controls within some Central and East European countries. Many in Washington also fear that their allies might choose to re-export more American technology than the US would like to countries such as China and Venezuela. The Senate and the government are particularly wary of some political choices of the French government.

France exports dual-use goods, including satellites, to China.[8] It is also currently considering the sale of warships to Russia.

8 Dual-use goods can have both civilian and military applications.

The need to co-ordinate EU and US reforms

In order to maximise the potential of the reforms being introduced on both sides of the Atlantic and to lay the ground for future improvements, the EU and the US must co-ordinate their efforts and develop more mutual trust.

The US struggles to loosen controls with the UK

US export controls towards its closest ally most starkly illustrate American reluctance to share technology. For years, Britain has been asking for lighter controls, highlighting close political ties as well as extensive military co-operation and intelligence sharing. But efforts by successive US presidents to loosen checks have foundered due to opposition from Congress.

The Obama administration is trying to ratify a treaty agreed in 2007, under President George W Bush, designed to facilitate defence trade between the US and the UK. Under the new rules, trusted companies would no longer require authorisations to move a variety of goods between both countries. The bill would make it faster for British armed forces to receive equipment from America. It would also make it easier for manufacturers from both countries to bid jointly for contracts. (Under current rules, defence firms are often required to ask for a government authorisation merely in order to hold talks about the possibility of partnering.)

But the Senate has resisted ratifying the treaty for three years. It is concerned that the bill will weaken its control over defence exports to the UK. The Senate is also holding up a similar deal between the US and Australia. Few Washington insiders expect either agreement to be ratified soon.

Even if the UK-US treaty did enter into force, it might not significantly improve things. A lot of sensitive technology would be not be covered by the agreement. The British and American governments have not yet said which technologies would be excluded. But many in the defence industry expect that, amongst other things, some jet engine technology would not benefit from more lenient export controls. If that were the case, some defence companies, including the engine manufacturer Rolls-Royce, would barely benefit from the treaty. The bilateral agreement would also introduce new and expensive bureaucracy for firms which wanted to qualify as members of the 'trusted community'.

In addition, the treaty could create divisions within the European defence market. Defence equipment (including components and know-how) which arrived in Britain through the bilateral agreement would be subject to ITAR regulations as soon as it was re-exported to European countries. Defence companies in the UK would therefore need to manage two sets of export control rules (EU and UK-US). Some industry representatives fear that British firms might find it increasingly difficult to co-operate with other EU companies without infringing ITAR. Small and medium sized companies might have to choose between supplying the UK-US market or the European market.

As part of the Obama administration's efforts to reform American export controls, Gates has confirmed the government's ambition to ratify the UK-US treaty. But it might be better for the administration to abandon the treaty and focus on an ambitious reform of ITAR.

In particular, Washington and Brussels should ensure that American defence goods benefit from the EU's new streamlined export controls. When all member-states start using global and general licences, they will be able to move non-sensitive defence equipment within the EU faster. But if Europeans still have to ask the DOD for individual authorisations in order to move goods with US components, it will weaken the impact of the EU's reforms. In the longer term, US defence companies could suffer. In an attempt to maximise the potential of the EU's streamlined controls, European governments and defence companies could increase their preference for ITAR-free goods.

The simplest solution would be more lenient US export controls. But if Gates' proposals to reform ITAR fail to deliver, Washington should opt-in to certain aspects of the EU's new system. In June 2009, the CER proposed that as a first step, the EU and the US should have common certifications for major defence companies. These firms would then benefit from fast-tracked export authorisations.[9] Speaking in a personal capacity, some US officials have suggested that Washington could take part in the EU's new system by issuing its own general and global licences. This would allow some American defence equipment to move more freely within the EU.

[9] *Clara Marina O'Donnell, 'The EU finally opens the European defence market', CER policy brief, June 2009.*

But currently the Pentagon fears that the EU's new system will lower the effectiveness of European export controls. US officials are concerned that looser controls amongst EU member-states will increase the risk of technology leaking out of the EU into the wrong hands. If Europeans want the US to take part – and if they want it to take more ambitious steps in dismantling barriers to transatlantic defence co-operation in the future – they must address the existing trust issues.

The best way to reassure the US about the inadequate technical standards of export controls within some European countries is for EU governments to implement thoroughly the EU's new streamlined system of controls. If efficient pan-EU controls are proven to be effective, the US will feel more confident about exploring possible synergies.

But Europe and Washington must also address their political disagreements on what exports to third countries are unsafe. It will be difficult for Paris and Washington to overcome their disagreements. But in an attempt to forge at least some compromises over the years, Europeans and the US should hold sustained exchanges on the

subject (as used to happen during the Cold War). Some of those confidence building dialogues should take place within an EU context – as the Union is likely to play a growing role in regulating the European defence market.

The economic crisis: a catalyst for change?

Fewer obstacles to trade across the Atlantic would not only allow governments to buy more cost-effective defence goods but also help ensure armed forces receive the best equipment, in as timely a fashion as possible. But this would require, amongst other things, the US to allow its European allies to access some of its sensitive technology and to co-operate on the development of advanced weapons. And while the Obama administration seems keen to reform US export controls, the traditional reluctance from Congress towards loosening ITAR makes significant change unlikely.

The size of the Pentagon's defence budget and its significant investment in R&D reduce the pressure on the US to change how it buys defence equipment. Spending four times more than all EU member-states combined, it can maintain a large domestic industrial base and produce most of the world's cutting-edge military technology. European countries on the other hand, cannot afford to sustain their small and fragmented national defence markets. So while Washington might chose to preserve some barriers to industrial collaboration with its allies, European countries must at least integrate their own defence markets.

For years EU governments have acknowledged the need to develop a "truly European" defence industrial base, but they have been slow to act upon their commitment.[10] The code of conduct on offsets and the EU directives to streamline export controls and increase competition in defence procurement are steps in the right direction. However, their impact will depend on whether member-states use the new rules to their full potential. And ministries of defence will have to take other actions too – for example, increase the proportion of military hardware they procure collectively and pool more of their R&D spending.

[10] *'A strategy for the European defence technological and industrial base', European Defence Agency, 2007*

European countries should profit from the financial constraints caused by the global economic crisis. They should introduce the pan-European – and when appropriate, transatlantic – synergies that would allow them to get maximum value from their limited money, even if this is to the detriment of national employment. Governments on both sides of the Atlantic are being forced to review their defence budgets in light of the crisis, and major cuts across Europe are inevitable. Even Britain – which has one of the largest defence budgets in the EU – might have to abandon some air defence combat ships or fast jets.

The economic downturn will put pressure on governments to protect jobs. But if EU states continue to defend already weak and sometimes unviable national industries, the long-term prospects of Europe's defence industrial base look bleak. Low defence spending, and particularly low R&D funding, have already undermined the competitiveness of European companies. The growth in transatlantic defence trade has not helped to reduce the EU's technology deficit. It is profitable for European manufacturers to supply the Pentagon but until now American export restrictions have limited their ability to feed the technology developed in the US back into the EU.

If member-states do not start spending their defence budgets more efficiently, they will be forced to rely increasingly on American firms to provide the most technologically advanced equipment. Some European countries already do. But if this became the case across the EU, Washington would lose a source of healthy competition, making it harder to keep costs down in its own market. And under current US export controls, a greater reliance on America for defence equipment and repairs would hamper the ability of Europeans to conduct military operations.

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