The U.S. Defense Industry as an International Player

By

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[The following is a reprint of a paper presented at the annual DSAA-DISAM Symposium, "The Dynamics of Military Assistance," on 19 July 1990 in Dayton, Ohio.]

I am pleased to be back in Dayton addressing this symposium again. I have looked back at my remarks from my appearance last year at this symposium and I find that I am now more optimistic on some issues and less on others. I also note that a year ago, in looking at the future, I seemed to have overlooked a few things, such as the reunification of Germany, the dissolution of the Soviet empire, and the meltdown of the U.S. defense budget.

However, that won't discourage me from having another go at making some predictions. On the down side, from an industry perspective, we seem to be headed into a chaotic slashing of our defense budget. On the positive side, there are some indications that the current pressures will bring about a greater level of cooperation than we have seen in many years between at least some parts of the government and industry with respect to foreign markets.

Let me touch briefly on how I see world market conditions at present, and also make some predictions as to how European integration and U.S. defense export policy will affect U.S. industry's ability to operate in that market. I should note that I am speaking strictly on my own behalf, and not as a spokesman for the Aerospace Industries Association of America.

Today's defense industry is somewhat like the steel and automobile industries in the 1960s and 1970s. There is already over capacity in the industrial world, and this will increase as defense budgets fall. Moreover, every advanced developing country is also trying to build its own industry. The situation may be further complicated depending on what happens to that equipment which is now in industrial country inventories and which may soon become surplus because of conventional arms treaties and/or reductions in forces. Clearly, there will be consolidation in the industry, both here and in Europe. Some companies will be absorbed into mergers, others will shift resources out of the defense industry, and some may simply disappear. There are two ways to reduce the impact of a declining domestic market on one's own firms. Either increase exports or squeeze foreign competitors out of the home market, i.e., protectionism. We certainly have seen such things happen in Europe and the U.S. in such areas as steel and agriculture.

Let me make my predictions up front, then explain how I got there.

- Exports will grow as a total percent of U.S. conventional defense production—from currently less than 15 percent, to 25 percent or more by the end of the decade. In some cases, exports will be all that will keep a production line open.
- I think U.S. industry's present 8-10 percent share of the European defense market, which in turn is about 25 percent of the free world market, will stay more or less constant, but that share will increasingly be served from a European base. Similarly, I expect that U.S. industry's current market share of the third world, which is another 25

percent of the world market, will hold steady or even increase slightly, but over time an increasing share of those sales may be serviced from Europe, not the U.S.

- In the U.S. market, European companies will increase slightly their five percent of the market, but increasingly the increment will be largely a result of increased European holdings in the U.S.

- Government-to-government, cross Atlantic and Pacific cooperative programs will decline, but company-to-company, cross-border cooperative ventures will increase.

- On balance, I would suspect that U.S. defense companies will maintain their overall world market share, albeit of a market which is itself on a slow decline, and that they may do so by increasingly servicing European and Third World markets from Europe. That in turn would mean that the U.S. defense industrial base will decline more rapidly than the decline in our defense budget, and that the European defense industrial base would decline at a slower rate than the decline in their defense budgets.

Two key factors in this analysis involve European integration and U.S. export policies with respect to technology transfer and defense exports, including security assistance.

European Integration. So what are the Europeans doing? Across the board, they are setting out to build world class industries that can compete with the U.S. and Japan. To do that they need economies of scale, and that in turn means a large home market. On the civilian side, they are trying to bring the necessary changes about through the Europe 1992 exercise, which is to provide free movement of products, services, capital, and people within three and a half years. In defense, they are trying to bring about the same results through the Independent European Program Group, or IEPG.

There are two key factors which bear on the issue of European integration and which will probably work to the disadvantage of U.S. defense industries, or at least to the U.S. defense industrial base. And let me hasten to add that in both cases the problem is not so much the Europeans, but U.S. government policy which is unlikely to change, at least not rapidly enough.

The first is technology transfer. In fact, there are three subsets of the technology transfer issue. The first involves what we will transfer to our allies—both in terms of end use items and production technology. Europeans are unlikely to buy end items from us, or to team with U.S. partners in codevelopment or coproduction projects unless we bring technology to the table which is clearly better than what they have or what they can produce. They now can build their own products equal to the U.S. technology of the late seventies or even of the early eighties, which all too often is all that we are allowed to bring to the negotiating table. Furthermore, if we do not bring current technology to cooperative undertakings, we can at best produce only second rate systems, which means the U.S. services will not be interested. Secondly, we want them to agree to control exports to the East—basically, the COCOM [Coordinating Committee for Multilateral Export Controls] problem. They feel we want to control too much, and are not adjusting either to changes in technology in the Socialist bloc or in non-COCOM countries, or to the changes entailed in *glasnost* and *perestroika*. We have seen some signs of improvement here, but at the same time there is a tendency to take items which are coming off COCOM control and to put them under U.S. munitions or foreign policy controls. Thirdly, there is the issue of the strings which come attached to our technology. The Europeans simply will not put up with our third country transfer controls. Much of the reason underlying European integration is for them to be competitive with U.S. products, and they will not tolerate our telling them they cannot sell a product on the world market simply because it has a U.S. component.

I fear that the U.S. will not change its rules fast enough to satisfy the Europeans. This will make U.S. defense companies less attractive as vendors and partners unless we find ways to develop R&D and production offshore which is independent of U.S. controls. This is harder to do in the defense industry than in other industries, but it is already beginning to happen.

A second major issue is that the Europeans are responding to the unpleasant fact that the development and production of new major weapons systems is beyond the capacity of any single European country. As they are forced into new cooperative programs, I suspect that the umbrella of the IEPG, plus the willingness of the major players to assure smaller countries a piece of the action, will make it more difficult for U.S. companies to sell an American product, even to the smaller European countries.

The only way to head off this trend is for the U.S. to increase the emphasis on NATO cooperative programs; in other words, outflank the IEPG in an even larger arena. But despite the Nunn legislation, I don't believe that either the Services or the average Congressman is really convinced that these programs make sense—not so much technically, but politically and administratively. And while we in the defense industry invite the Secretary of Defense to our meetings and listen to what he says, we *really listen* to our ultimate customer, the Services and the Congress.

This means that we are unlikely to head off a steadily increasing bifurcation of the free world defense market. There will be a U.S. system and a Eurosystem for most major defense products over the next decade or two. And for an American defense company to get a piece of the Eurosystem will increasingly involve some kind of presence in Europe.

I should note that this process is likely to be slower than I might have predicted last fall, as budget cuts will likely slow the development and introduction of new systems on both sides of the Atlantic. But the trend is still there.

U.S. Export Policy. If both the European and American defense industries are facing a declining home market, logic would dictate that we will increase our struggle for third country markets. We certainly shall. So will the Soviets. The difference, however, is that the European and Soviet governments will support exports from their industry. I believe the U.S. Executive Branch will increase its support for exports, and I will discuss that in a moment, but I am less optimistic about the Congress.

Let us start with the Executive Branch. We all know that under the Carter Administration the government was officially opposed to defense exports, and the Executive Branch was told not to be helpful to the defense industry. The Reagan Administration reversed that policy, but we still suffer from a number of relics of that period, both in regulation and in attitude. Furthermore, the Reagan Administration brought with it a high level of suspicion of technology transfer, which as noted, has perhaps done as much damage to our ability to export to, and to team with our allies, as the damage done by Carter's policies.

We have seen a considerable shift in the Bush Administration, if we ignore the initial awful confusion evidenced during the FSX debate. And we are seeing new interests in the Services in looking at exports as a way of holding down unit costs, and in some instances, of keeping production lines open altogether. What are the kinds of things we in industry would like to see? Let me give you a quick rundown.

• **Clarity on defense export policy**. We would like to see the Administration state that defense exports are important and will be supported. We are making some progress. A cable went to all embassies last week from Deputy Secretary of State Eagleburger stating that defense industry should receive the full support of the embassies. [Editor's note: see "U.S. Embassy Support for Defense Trade," elsewhere in this issue.] We anticipate a speech by Secretary Baker early this Fall on the same theme. We would very much like some kind of internal memo to be issued by the Secretary of Defense indicating that all things being equal, he would expect DOD elements and the Services to find ways to make exports happen, not to find ways to block them.

- **Reduction and standardization of Service-imposed export license provisos**. There is a tendency by some export licensing folks to add a variety of provisos to export licenses, sometimes to the point where the license is useless. The government needs to hold such provisos to a minimum, and to work with industry when necessary to see if Service interests can be protected while still meeting the needs of the customer.

- **Support from DOD in demonstrating equipment**. Currently, companies must lease equipment from the Services, insure it, and pay all operating costs in order to demonstrate it to potential customers, either in-country or at trade shows. We would like to find ways in which DOD and the Services could either provide such equipment on more favorable terms, or demonstrate it themselves. After all, if a sale is made, DOD will benefit as well as the company.

- **Flexibility and reduction of recoupment of R&D costs**. Currently, when we sell an item, a charge must be included in the price to cover a proportional share of the costs incurred by DOD in developing the product. We don't object to this in principal, but at times this percentage rises over 20 percent, sometimes as high as 60 percent, and this may price us out of the market. We would like to see such charges limited to major defense equipment, which is all that is required by the law, and perhaps capped at 5 percent.

- **Defense export financing**. As you are all painfully aware, security assistance today is for all practical purposes limited to five or six countries. Thus, we have difficulty competing against Europeans and other countries in such areas as South America, Southeast and South Asia, and even in poorer NATO countries such as Turkey and Spain. We would like to see some form of export credit guarantee program, perhaps administered by DOD with some input from the Export-Import Bank, which would remove this major disadvantage to U.S. companies.

Now, let us turn to the Congress. Even when the Administration has its act together, Congress has heartburn over a sale of defense equipment to any Middle East Arab country, as well as to its current list of villains. This attitude has provided Europeans with markets where we are not allowed to compete, and gives Euronationalists a strong argument against cooperating with U.S. companies.

Congress has recently discovered a new reason to oppose sales of defense equipment—preservation of the defense industrial base and future competitiveness. First offsets, and now, in the case of the FSX, codevelopment, have both been deemed to be shortsighted marketing moves by U.S. industry which will come back to bite us. The Congress is determined to save industry from itself. And they are supported by some in the Executive Branch.

The fact is, politicians the world over want more than just the best product for the best price when they spend taxpayers funds. They want other political benefits. Domestically, U.S. defense companies have legal obligations with respect to minority and small business set-a-sides, which assuredly raise the price of the product and divert defense funds. Politically, large prime contractors know they also must distribute their own plants and their awards to subcontractors in ways which maximize the political attractiveness of their product. All of the above represent domestic offsets, but we don't call them that.

When DOD buys offshore, we want the technology and production transferred to the U.S. Witness the Harrier, T-45, Multiple Subscriber System, and Barreta pistol. We call it a warm production base for security purposes; however, Europeans think it looks a lot like offset and mandated coproduction. As a result, they are increasingly opening their own Washington offices and buying U.S. firms.

So what's going to happen? I think the Administration is moving in the right direction on technology transfer and support for exports, but it is moving too slowly. As an example, a study on the subject of export finance for defense products has been sitting in Office of Management and Budget (OMB) for months because there is no consensus in the Administration to even admit that there is a problem.

I have even less hope for Congress. It will continue to try to run the world with unilateral export controls, and even unilateral retaliation, on issues ranging from missile technology, to CBW, to production technology, to offsets. And the net result will be to shift market shares abroad, and to convince more U.S. companies to find ways to establish overseas production bases immune from Congress. I don't see us finding the political will to pay for that which we need, ranging from export finance to increased R&D, so again I suspect we will see U.S. companies looking for both offshore.

Is all of this too bleak? And can, in reality, U.S. defense companies go offshore the way civilian industry has long responded to unfavorable conditions domestically? Let us look at some recent examples:

- FMC conducted a two-year contest against a British and a German competitor for the sale of armored infantry fighting vehicles to Turkey. They won a billion dollar contract, and it will all be sourced from Europe. The Dutch and Belgians have been building a similar vehicle under license, and their governments were willing to help with the financing; ours was not.

- Saudi Arabia purchased 80 Blackhawk helicopters, but bought them from the United Kingdom where they are built under license by Westland, which is 20 percent owned by United Technologies. Why? They avoided the U.S. Congress, and the U.K. government was willing to work some creative financing built around oil exports from Saudi Arabia.

- A major U.S. electronics house developed a new system in a European county with that country's defense funding. Although the same company already had a system in the U.S. to accomplish the same mission, the company could not get permission to export it. Now it has a system it can in turn export to the rest of the world without the involvement of the U.S. government, and this system will undercut the market for its own U.S. system.

- The U.S. Congress denied Saudi Arabia 200 Stinger launchers and 600 reloads in 1986. At the Paris Air Show last year, Matra announced the sale of 3000 Mistrail missiles to Saudi Arabia, and the next day McDonnell Douglas announced an arrangement with Matra to market the Mistrail in the U.S. market.

What is happening? The same thing every other U.S. industry has done in the past: struggle to maintain world market share—from a U.S. base if it can, from offshore if it must. If it does not, it loses its momentum and associated economies of scale. Can the U.S. government take steps to prevent this from happening? Yes, but it is a close call as to whether it will do so, at least through measures which would make it attractive to do business offshore from a U.S. base. It is more likely to look for ways to keep U.S. industry from increasing its offshore activity, which is to say, to find ways to make industry shrink faster and decline in vigor.

Is this the end of the world? Of course not. The U.S. defense market is still the largest in the world, and will continue to be so. We will still sell U.S. defense products to the rest of the world from a U.S. base. We will continue to fight restrictions by Congress, and we will often win. But we may not do as well as we could or as we should, and if we don't, we will see a migration offshore of U.S. production, research, development, and talent, which is not necessary. But then, if it were not ever so, people like me would have to find other gainful employment.