Defense Reinvestment in Egypt -- A Proposal: The Time is Now

By

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Until a few years ago, the opposing ideologies of capitalism and communism were locked in a geopolitical struggle for preeminence. The Cold War encouraged nations to achieve and maintain heightened levels of military weaponry never seen before during peace. Indeed, defense became the economic engine creating jobs in many countries on both sides of the Iron Curtain. But, as the Third World became a battleground for superpower brinkmanship, military assistance, in weaponry, technology, and training, became vital instruments to achieve foreign policy objectives. Then, the Berlin Wall fell and set events into motion that led to the collapse of the Soviet Union and the conclusion of the Cold War.

In the aftermath of the euphoria surrounding the historic event in Berlin, the world has changed drastically. Governments around the globe are downsizing and restructuring their armed forces. Along with this unprecedented restructuring, companies world-wide are reacting to shrinking military markets by exploring reinvestment and diversification strategies which can apply manufacturing facilities and military technology to the commercial market. In short, the defense market has quickly become smaller and more competitive.

In Egypt today, the Armed Forces are considering the defense reinvestment of their military factories as one approach to open economic doors and expand employment opportunities. Diminishing requirements for the local production of military hardware and ammunition has prompted military officials in Cairo to begin examining alternatives which would turn military factories into profitable enterprises. Indeed, this transition in thinking can be an opening for American companies to capitalize on low wage labor rates and state-of-the-art manufacturing established in certain military factories by United States' security assistance programs. In a region of the world where business relationships revolve around family contacts, Egypt can be an entree into a Middle Eastern consumer market of over 82 million people.

With over 54 million people, Egypt's population is growing at an exponential rate of one million per year, and the government can barely keep up with providing public services, such as education and health, that are basic to any society. Moreover, military production comprises over 30% of the country's industrial base. It is a closed loop system within the government where one department pays another for the production and delivery of military hardware. This contributes little to economic growth. Like a business paying itself to produce goods for its use and with no revenues from customers sales, the military industries operate in the red. Therefore, defense reinvestment of these facilities makes good sense.

The effort in Cairo to convert these public sector factories, that are in some respects industrial basket cases, may be wishful thinking unless modern management and business techniques are involved. Yet, failure to provide that assistance here will regress progress toward free market reform and exacerbate a tenuous socio-economic situation. In this article we propose an approach to defense reinvestment in Egypt and explain why it is important to the United States.

WHAT IS DEFENSE REINVESTMENT?

Defense reinvestment basically converts a plant's equipment and personnel from production of military hardware to commercial products or to a dual commercial-military product line. We find no how-to manual that teaches us reinvestment because the process depends upon the specific factors surrounding a particular case. The goal of this process, whether it is called defense reinvestment or conversion, is to realize economic benefit from present resources. In fact, reinvestment is change, and success of companies will depend on how well they embrace reinvestment. These are times where business as usual cannot continue, be it business strategies or national policies, but the first step is recognizing the need to change.

Thus far, Egypt's military factories have been exempt from all of the initiatives toward economic reform, and government subsidies continue to pressure an economy showing limited growth since 1991. Reinvesting Egypt's military industrial excess capacity from loss to profit by both rationalization and production of commercial goods must be applied over the long term in concert with economic reforms. This poses formidable challenges.

EGYPT'S MILITARY INDUSTRIES

Egypt's military industries fall under three major organizations: National Organization for Military Production (NOMP), Arab Organization for Industrialization (AOI), and National Service Projects Organization (NSPO). The NOMP has 16 factories manufacturing ammunition, small and large caliber weapons, and armored vehicles. A separate ministry since 1991, military production was brought under the Minister of Defense in October 1993 with the reorganization of the Prime Minister's Council. Infrastructure and plant equipment in these factories are approximately twenty-five to thirty years old; state-of-the-art equipment found is attributed to the co-production projects funded under the United States' security assistance program.

AOI was originally a joint venture of four Arab countries (Egypt, Saudi Arabia, Qatar, and United Arab Emirates) formed after the 1973 October War to enhance Arab military industrial self-sufficiency. This consortium dissolved in dissatisfaction with Egypt's signing of the September 1978 Camp David Accords, thus eliminating the financial base for the original notion of an Arab military production capability. The chairman of AOI reports to the Supreme Committee on Armaments consisting of the President, Cabinet Ministers, and Military Chiefs of Staff. Facilities are considerably more modern than those in the NOMP, and several of the factories are joint ventures with British and American companies, each under separate funding contracts. AOI manufactures an array of military products from electronic equipment to jeeps and rockets. Diversification into commercial products has started in cooperation with private sector companies, such as Jeep Cherokee sedans (Chrysler), televisions (Sanyo), and pipe fittings (Siral).

NSPO provides services ranging from construction to communications, and products from insecticides to optics. A board of directors, appointed by the Minister of Defense, manages the organization separate from the Egyptian Armed Forces. This board has the charter to authorize and administer projects locally and abroad. It also has authorization to enter joint ventures with foreign companies; an example is the Arab International Optronics (AIO) factory which is a joint venture between NSPO and USH Group, a company from the United Kingdom.

As a bastion of Egypt's industrial base, military factories are considered strategic industries and have long been subsidized under the auspices of national security. Egyptian military manufacturing had fulfilled hardware requirements for a military force structure designed around Soviet equipment. More so, technology transfer and technical training was done under the patronage of Soviet industrial management methods practiced in a command economy. This significantly influenced the types of skills and equipment that developed over time in Egypt's military factories.

Over the years, factory management inefficiencies eroded opportunities to improve factory productivity and quality. Sacrificing good quality for lower costs, factory equipment was not upgraded to keep up with state-of-the-art technology, in turn affecting product quality. Guaranteed life time employment of the public sector also burdened the military factories with excess overhead, thus increasing operating costs. Yet, the government continued subsidizing the factories due to their status as strategic industries. Lacking the external pressures on their demand economy, such as competition, there was no impetus to improve productivity. Hence, the technical skills and precision equipment necessary to produce competitive goods and services were never developed.

FORCE MODERNIZATION

The Egyptian military's goal to modernize their armed forces with high technology weaponry further exacerbated the problems of productivity in the military factories. Entering an era of military cooperation with the United States after the Camp David Accords, Egypt embraced the United States' security assistance program as a means to modernize her forces. This initiative diminished the necessity to continue high levels of hardware production for Soviet model weaponry and gradually decreased manufacturing orders to the factories. To offset the decline in orders for military hardware, the factories were directed to increase or start production of commercial products. However, deficiencies in quality and inexperience in marketing restricted the sale of those products to the local market.

Factories with co-production programs funded under the United States' security assistance program, such as the M1A1 Tank Program at Factory 200, are an exception to declining orders for military production. As a means to accomplish modernization goals along with generating industrial development, co-production promoted the technology transfer to support the capability for system production in Egypt. Typically, co-production programs are structured over several phases with manufacturing complexity increasing in each subsequent increment. Hardware is manufactured in the United States and shipped to Egypt as kits. Systems are assembled in country by the local work force with the American defense contractor providing training and technical assistance. The program and goal of co-production is for the factory to produce the system without the assist of the contractor. Although considerable investment in both capital equipment and people have occurred in these programs, management, engineering, and marketing skills are still insufficient to fully enable follow-on uses of the facilities and technology once the programs expire.

The Egyptian military regards commercial production as a possible way to offset the decline in military orders and turn the factories into profit centers. Exports are necessary for economic growth, but it will be difficult without the assistance of international companies. As previously mentioned, factories currently produce a host of consumer goods for consumers, but quality is poor. This, coupled with an unsophisticated approach to marketing and product pricing, further reinforces the idea that Egyptian products cannot compete well. Consumers in the West are accustomed to selecting from an array of good quality products, and Egyptian producers would find it extremely difficult to break into that highly competitive arena. Unable to compete with western products abroad, Egyptian goods are sold to local consumers at subsidized prices. In fact, this creates a cycle that eliminates the need for product improvement and encourages the continuing subsidy of the public sector. Consequently, Egyptian military factories will not be able to independently break the subsidy cycle. A notion of defense reinvestment in Egypt must also consider business ventures with free market based companies.

DEFENSE REINVESTMENT THROUGH JOINT VENTURES

Defense reinvestment in Egypt can be structured by using joint ventures as the core of a program to spur commercial production for export. An emphasis on producing for export can energize the economy by creating jobs, and it would be a means to break out of the subsidy cycle. The joint venture brings together assets from different companies, and in the case of defense reinvestment in Egypt, a business alliance can be consummated between a multinational and Egyptian company. Technical skills and modern technology found in multinational companies will be needed to orient the focus to exports. A multinational or bi-national corporation indeed has the resources to make up for shortcomings typically found in Egyptian military factories, such as quality, management, and marketing. Furthermore, a local Egyptian private sector company is essential for business networking in country. In a culture where everything revolves around personal contacts, the involvement of a local company is a pragmatic necessity to effectively conduct business in Egypt.

Before companies consider making a product in a foreign country, there has to be an opportunity for a reasonable return on investment that would make it worth the business risks. This return, of course, depends on the market, industrial, and economic feasibility of a project. Typically, the common response in grappling with defense reinvestment is to conduct an industrial capabilities analysis. This is an assessment taking into consideration everything from skills and education through capital equipment and infrastructure. Although this is an essential step, the effort can be cost prohibitive and time consuming if product groups are not defined before initiating a review.

A market study must precede any industrial feasibility evaluation to define the products and/or services that may have a commercial niche. For Egypt, the government should encourage prospective investors to focus the study on regional versus local markets because exports are fundamental to energizing an economy. Defining a market niche will lead to examining the industrial capability and infrastructure necessary to deliver the product or services to the consumer. Using the data from the market and industrial feasibility studies, a company can thoroughly examine the economics of the investment versus the risks. Evaluation of industrial capability should encompass the existing infrastructure and plant equipment of military factories to keep costs down. The conclusion on this last phase may be that the risks are not worth the costs of producing or assembling a product in Egypt. On the other hand, a company may decide to proceed with the investment, although not profitable initially, in order to establish a corporate presence.

OWNERSHIP VS OTHER

Given that a joint venture concludes to set up production operations using a military factory in Egypt, the business relationship with the military factory becomes the issue. Foreign ownership of military industries is prohibited by Egyptian law, so the acquisition of military real estate or infrastructure is presently restricted. In Egypt, foreign companies that formed joint ventures with factories have been restricted by public sector rules. This public-private sector arrangement is presently evidenced by several companies in Cairo, such as the Arab-American Vehicle Company; ownership is split between Chrysler (49%) and Arab Organization for Industrialization (51%). A limitation of this method is the loss of autonomy by a private sector company. Unless Egyptian law is changed in the short term, joint venture ownership of military industrial assets is not a practical approach given existing legal obstacles.

Ruling out joint venture ownership of military industrial assets, a contractual relationship can be a workable approach with the factory as a vendor. After identifying a product or service, the joint venture can develop a program by first selecting the myriad of vendors needed to get a product to the consumer. Vendors, both international and local, must be identified and qualified to provide for everything from raw materials and component parts to shipping and handling; thus the complexity of a program depends on the product type and tasks required. The joint venture designs the process architecture through which materials and parts flow, and it manages the process to ensure schedule compliance with its customers. Like spokes on a wheel, vendors are linked to the joint venture at the hub through contractual arrangements. Military factories can be placed on contract as vendors and integrated into the process architecture, thereby optimizing the use of excess industrial capacity.

CONTRACT TYPE

The vendor relationship with a joint venture may take on three different approaches depending on the contract structure. A subcontract, rental, or consultant contract may be negotiated with the military factory, and the selection of each type contract will be determined by a variety of business factors including what is acceptable to both negotiating parties. Critical in the decision matrix along with cost should be the objective to maintain autonomy from the public sector in order to freely execute business decisions in response to the market demand. Each contract approach has different levels of risk associated with it with subcontract being high and consultant being low.

Military factories can be viewed as industrial parks with the capacity for a myriad of activities within the same facility. This presents opportunities to house different businesses or microenterprises performing different projects. Government has to create the conditions to attract joint ventures, and then allow them to operate. The same incentives to attract business that apply to established industrial parks, such as Egypt's 6th of October and 10th of Ramadan Cities, can also include military factories. This can allow for the immediate and multiple utilization of facilities that follows the three approaches mentioned previously. In fact, the job creation generated by microenterprises in military factories is real economic development vis-a-vis economic assistance.

PROS AND CONS

There are many risks associated with doing business with military industries in Egypt. Current labor laws, which prohibit layoffs, mitigate against worker incentives and place the burden on management for efficient business operation. Although the General Authority for Investment and Free Zones (GAFI) was established by Investment Law 203 to streamline the process for foreign investment, Egyptian bureaucracy is still complex with ministerial departments often working at cross purposes from one to another. A declaration of a national emergency by the Egyptian Government could direct military factories to halt commercial production, thus affecting delivery schedules and payments. Moreover, a joint venture attempting to export products made in Egypt must overcome an international reputation for poor quality.

Conversely, there are advantages to doing business ventures with military factories in Egypt. A corporation seeking to expand its presence in the Middle East could lower its costs and increase product services by developing an industrial capability using military-industrial facilities. In spite of all the visibility given by the media to rising terrorism, the political stability of Egypt provides a reasonably secure environment in which to operate and maintain a business. Economic reform in Egypt is making satisfactory progress, albeit slowly, as evidenced by the recent debt reduction for adopting and completing economic plans proposed by the International Monetary Fund. Western companies in Egypt suggest that Egyptian worker productivity is comparable to the Southeast Asian's who is always touted as a model for production efficiency. And, as the cultural and political center of the Arab world, Cairo offers many business contacts with other Middle Eastern countries—a potential market of over 82 million people.

IMPORTANCE TO U.S.

Business opportunity in Egypt can be developed. As a "base of operations", Egypt is a natural gateway for access to a virtually untapped Middle Eastern consumer market. But, a company having an entree into the region must demonstrate a commitment for the long haul and not just pull out after short term gains. Developing business contacts and fostering personal relationships is an art in many cultures, and this is strongly the case when doing business in the Middle East. Furthermore, it is important for companies to understand that business networks in the Middle East revolve primarily around family relationships, and it takes time to cultivate a rapport of mutual respect and trust. Therefore, nations that are established in Egypt early on with a long term business commitment stand to be a competitive presence in the Middle East.

To this end, the United States can encourage the expansion of American business by easing the terms and conditions for financing for interested companies. Financing linked to the utilization of a military factory can be earmarked from a host of sources like the Overseas Private Investment Corporation (OPIC), Agency for International Development (AID), and Export-Import Bank of the United States (Eximbank). Approval of financing should be predicated on quantitative business criteria which will show that the proposed venture is technically, economically, and financially sound. Indeed, a cohesive United States strategy is presently lacking that focuses all of these funds for the common purpose of encouraging the expansion of business overseas. Easing financing can do much to ameliorate the common complaint among United States companies that inadequate financing for working capital is one of the biggest obstacles to increased exports.

Some may say that the United States has no business in the defense reinvestment of Egypt's military factories; defense reinvestment is an Egyptian problem. On the other hand, America must fiercely vie for international markets in a robust global economy, and exports are critical to the business health of key sectors in manufacturing, such as computers, aerospace, and heavy equipment. With exports accounting for over 60 percent of overall United States economic growth in the past five years, exports means jobs; this is the new equation for the American economic future. By developing new markets abroad, companies can create and revitalize jobs in the United States. Using the existing military industrial infrastructure and capacity can be a means to lower costs for exporting products to either an Egyptian or regional market.

CONCLUSION

Certainly, defense reinvestment is an economic challenge with no instructional manuals on how to execute. Egypt is beginning now to consider the reinvestment of defense industries to make them profitable. But, fundamental shortcomings of skills, management techniques, and business incentives may hamper Egypt from independently developing and carrying out such a program. Suggested here is defense reinvestment by American and Egyptian companies forming joint ventures and contracting with military factories. This program can be economically beneficial for both Egypt and the United States subject to the consumer market and available financing. Without any doubt, the road to get there is a long one and the ride will not be smooth. But, it is said that "failing to plan is planning to fail," so the process must begin to develop this economic opportunity. The time to begin is now.

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