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## COOPERATIVE INTERNATIONAL ARMS TRADE--ARMS SALES OF THE FUTURE

By

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"Without some form of countertrade, we will conclude few major arms sales to developing countries in the future." [1]

Cooperative International Arms Trade is gradually transforming the scope and environment of arms transfers through the growing demands of coproduction, offsets, and a multitude of new creative management and financing techniques. This article presents a review of the foundations of cooperative agreements and defines the variations that have arisen. It also examines the major arguments in favor of and opposed to these agreements, and the role of security assistance in this complex arena. Finally, the article assesses the future of Cooperative International Arms Trade, and provides recommendations for dealing with the arms transfer environment of the 1990's.

### Development of Cooperative International Arms Trade

The term Cooperative International Arms Trade (CIAT) is used herein to describe a cooperative agreement between government(s) and industry which may be bilateral or multilateral, and which involves the transfer of military articles. It embraces the possibility of creative methods for financing such transfers, to include barter or other types of offsets, as well as shared production. The term is derived from the most appropriate elements of all the other less comprehensive terms which are currently in use, such as Multinational Coproduction, Industrial Collaboration, Defense Industrial Cooperation, Armament Collaboration, Arms Cooperation, and Reciprocal Defense Procurement. Each of these terms is adequate to describe a certain facet of the cooperative trade environment, but none encompasses, as does CIAT, the entire spectrum which ranges from coproduction of an F-16 in industrialized Western Europe to a barter offset in a developing country. (See definitions at Appendix A.)

The US policies on arms transfers are a reflection of current political and economic factors, and as these factors change, so does policy. In its earliest stages, arms transfers consisted of grants to rebuild and rearm war-torn Europe. As nations recovered both economically and militarily, the US shifted its emphasis from grant assistance to foreign military cash sales for the industrialized free world. At the same time that these nations had reestablished their industrial capabilities, an awareness grew that the economic environment of the 70's did not permit unlimited military spending, and only greater efficiency and cooperation in arms development and production would guarantee more bang for the buck. The synergistic advantages of arms cooperation introduced Rationalization, Standardization, and Interoperability (RSI) into the vernacular of arms transfers. RSI then became the linchpin of cooperative international arms trade in the mid 70's. Public Law

94-361, Section 802, commonly referred to as the Culver-Nunn Amendment stated,

It is the policy of the United States that equipment for use of personnel of the Armed Forces of the United States stationed in Europe under the terms of the North Atlantic Treaty should be standardized or at least interoperable with the equipment of other members of the North Atlantic Treaty Organization.[2]

Furthermore, this act also provides that the Secretary of Defense shall report to Congress on all "offset" agreements entered into with NATO countries and on all major systems that are not standard or interoperable with other members of NATO. It is the "sense of Congress" that RSI would be facilitated by greater reliance on licensing and coproduction agreements among NATO signatories.[3]

The late 1970s witnessed an increase in pressure for RSI and armament collaboration with European nations, and legislation continued to favor NATO allies in an attempt to increase the potential for standardization and interoperability. In 1978, a Defense Science Board study listed the US goals of armament collaboration, which was still centered on our most favored allies:

- a. To improve NATO operational effectiveness.
- b. To increase efficiency in the allocation of alliance-wide resources for research, development and acquisition.
- c. To strengthen NATO cohesiveness.
- d. To encourage a politically stable and economically strong Western Europe and European defense industry.[4]

To increase the practical applications of RSI and accomplish these goals, the US followed a three step policy with the member states of NATO, Australia, New Zealand and Japan. The first initiative was to develop reciprocal and general Memoranda of Understanding (MOUs) with these countries. The MOUs were designed to foster bilateral arms collaboration, increase the visibility and dialogue on armament production, reduce barriers to codevelopment and production, and most importantly, make more efficient use of national defense resources. The second step was the negotiation of agreements for the dual production or coproduction of weapon systems, at or near the development stage. By producing a developed system, the purchaser could avoid long lead times and development costs, while enhancing standardization. Finally, RSI would be enhanced by identifying undeveloped families of weapons, that is, systems which fit into a larger package and complement one another. By identifying and assigning developmental responsibility to a particular country early in the concept development stages, the potential for redundant research and development and incompatible systems would be reduced.

Growing efforts in fostering RSI altered the role of the US as the free world's major supplier of major armaments. The 1980s ushered in modifications and new creations in the world of CIAT. Each major armaments transfer carried its unique aspect of creative development, manufacture, or financing.

From the industrialized nations of Europe and Asia to the developing countries of the Third World, the non-competitive cash sale quickly became a relic of the past for several reasons. The main impetus for this trend has been the fact that the purchasing countries have become much wiser and more cautious buyers. They no longer have to rely on one contractor, one country, or one political philosophy. They can shop around and find comparable end items at the most competitive price. They are also much more politically and economically sensitive, and therefore better attuned to how a major arms purchase and the outflow of money affect the economy and workforce in their countries. Finally, the original goals of European armaments collaboration (military effectiveness, efficiency of defense dollars, ally cohesiveness, and economic and political stability abroad) now carry over in varying proportions outside the NATO theater.

### Types of Cooperative International Arms Trade

In the armament world of today, each major system purchase will bear the mark of the uniqueness of the political, economic, and military situation in the purchasing country. That unique combination of factors will dictate the conditions under which the transfer will occur. As environments change in the future, so will the way the US and the other major suppliers of arms do business.

Robert Foxcurran has identified eight types of international weapons development and production systems:[5]

Type 1 - Licensed Production to Overseas Country. This is the oldest method of international production whereby the US licenses the data and manufacturing technique to the purchaser. This method provides employment, technology transfer, and industrial base benefits to the purchaser. Example: Bell Helicopters built in Italy and the Federal Republic of Germany.

Type 2 - Licensing Production to Overseas Consortium. Same as Type 1, except that rights are conveyed to a multinational consortium which has the advantages of increased production needs and established industrial base. Example: Hawk surface-to-air missile production in Belgium, Germany, Netherlands, Italy and France.

Type 3 - Codevelopment and Coproduction Among Foreign Countries. Industry joins in both the R&D and production under a multinational management scheme. When initiated at the concept development stage, this method shares the development costs and reduces chances of redundancy in development. Example: Euromissile's ROLAND, HOT, and Milan, Franco-German missile projects.

Type 4 - License Production in US of Foreign System. This is reverse of the traditional NATO country purchasing from the US. The US purchases a foreign developed system as is, or with some modifications, thus reducing developmental costs and shortening lead time. For example, in the ROLAND program, "it has been estimated that the cost of developing a comparable US system could have cost \$1.2 billion, while requiring 8-11 years from concept to a low rate initial production. The actual cost of the US ROLAND, based on the European developed system, was only \$300 million and took less than four years." [6]

Type 5 - Transatlantic Joint Development. Similar to the joint development in Type 3 with possible follow-on joint production, this type has the same advantages of lower R&D costs and respective national industry participation. Example: NATO Sea Sparrow surface-to-air missile program.

Type 6 - Bilateral Offsets. To help compensate the purchasing country for acquiring a system, the seller agrees to offset a portion of the system cost with purchases from the recipient country. These offsets can cover a wide range of categories such as financial investments, industrial goods, or military items, and even agricultural commodities. Direct offsets normally refer to the seller buying components for the end items from the purchaser, while indirect offsets refer to the seller making investments or purchases from the buyer which are not related to the end item. Recent examples of offset requirements include Australia's insistence on 30% for all purchases, Saudi Arabia's 35% offset on the Peace Shields C<sup>3</sup> program, and Norway's national policy requiring 100% offset. The latest wrinkle in the offset game is countries requiring contractors to pay a flat rate or percentage penalty if offsets are not met.

Type 7 - Transatlantic Joint Production and/or Systems Management by a US Led Consortium. Similar to Type 2 but the consortium managing the production is US led. "All in all, this mode of operation represents a complex management situation within which all parties, especially the US program office, must operate. Successful completion of such programs requires flexibility and creativity in coping with the numerous problems having international ramifications." [7] Example: The F-16 aircraft being produced by the US, Belgium, Denmark, Norway, and the Netherlands.

Type 8 - Family of Weapons. In this program, the requirements of a number of countries are pooled for a family of weapons of a given type, for example, missiles. The development of the parts of the family are allocated to different countries or combinations of countries, thereby dividing R&D costs among separate entities, reducing duplication in R&D, and sharing the economic production benefits. Example: The US has taken the lead in developing the advanced medium range air-to-air missile (AMRAAM). For the advanced short range air-to-air missile (ASRAAM), a European consortium has the lead.

#### Opposing Sides of Cooperative International Arms Trade

As these types of CIAT have increased in application and scope, a natural byproduct has been the formation of opposing positions, either advocating or condemning the political, military, and economic effects of CIAT on the US. Proponents view cooperative transfers as the only way to do business in today's environment. They admit that it is a competitive buyers' market and to remain competitive one must present the most attractive sale. Such businesslike practicality is generally coupled with arguments stressing the economic benefits of shared R&D costs, the reduction in redundancy in development and/or production, the savings which will result from lowered production costs through greater economies of scale, the increases in jobs, and an upgrading in the technological capability of participating countries. On the political-military side, advocates cite the benefits of increased alliance strength through standardization and interoperability, increased weapon

system capability as each country acquires the advanced system, and closer ties to our allies. Their bottom line focuses on the fact that RSI cannot exist unless it is economically beneficial for the foreign country; thus, the military benefits of RSI are subject to the realities that employment and economic considerations drive RSI and cooperative transfers. Finally, proponents of Cooperative International Arms Trade note the value of foreign government stability and the role cooperation plays in that stability, that is, creates jobs, corrects national technology deficiencies, forces investment in countries which otherwise would not occur, and assists export sales of indigenous goods and services.

Those who advocate CIAT are encountering increasing resistance from critics who argue that these cooperative ventures are detrimental to US interests, mainly economic. They state that given the nature of many of these programs, the tendency is for foreign countries to become subcontractors for US prime contractors, and that this trend is slowly eroding the American defense industrial base at the secondary and tertiary levels of subcontractors and suppliers, and therefore harming the readiness of US industry. They charge prime contractors with looking for short-term profits which lead to long term industrial decline. The critics also loudly point out that enhancing the industrial base overseas results in technology transfer which then returns to the US as additional competition for American industry. Finally, they claim that CIAT takes away jobs, increases costs, and creates a more unfavorable balance of payments position.

Since any given factor (cost, effectiveness, employment) provides fuel for both the advocates and opponents of CIAT, there appears to be no simple answer to the question of the value of CIAT to the US. However, as the applications of CIAT increase, we can expect the arguments to grow louder. A basic problem in addressing this issue centers on the prioritized objectives of arms transfers. Traditionally in the US, the priority has been political considerations, followed by military, and finally, economic goals; in Europe, however, concern for economic factors has been the top priority consideration. As economic issues come to play a more significant role in US decision making in the 1980s, one suspects such concerns will have an increasing impact on US policy toward international arms agreements and the value of CIAT.

#### Role of CIAT in US Security Assistance

A 1983 DOD report indicated that within the next five years, about \$30 billion in potential US arms sales are expected to involve some type of offsets to improve the economic and industrial position of the recipient.[8] The role of security assistance and security assistance personnel will vary based upon the type of cooperative agreements involved (Types 1 through 8), the host country, the personalities involved, and DOD policy. Given the rapid rise in the number of international cooperative arguments, official policy has lagged somewhat. The two major policy guidelines governing CIAT involve restrictions on offsets and the use of FMS credits for coproduction and are contained in the Security Assistance Management Manual (DOD 5105.38-M):

DOD Policy. It is DOD policy not to enter into government-to-government offset arrangements because of the inherent difficulties in negotiating and implementing such arrangements. Any foreign

government requesting offset should be informed that the responsibility for negotiating any offset arrangements resides with the US contractor involved. The US Government will not commit a US contractor to an offset commitment without having its prior concurrence. [9]

Coproduction Programs Financed by FMS Credits. The AECA, Section 42(b), requires the Secretary of State to provide advice to the Congress prior to the approval of the use of any credit or guaranteed loan proceeds involving coproduction or licensed production abroad. Such advice must include a description of the particular defense article or articles which would be produced under license or coproduction and the probable impact of the proposed transaction on employment and production within the US.[10]

Security assistance personnel find some additional guidance in the President's Conventional Arms Transfer Policy of 1981 which views US industry as a valuable partner in security assistance and outlines the types of assistance overseas personnel could provide to US contractors.[11] Finally, specific bilateral Memoranda of Understanding (MOUs) provide the environment for closer government-to-government assistance in eliminating trade barriers and promoting cooperative arms trade.

Although not necessarily a part of security assistance, a major aspect of the CIAT programs is the interest of foreign industry and governments in penetrating US markets. Again, policy is limited to the previous restriction on entering into offset arrangements; however, there is ample advice to security assistance personnel overseas on how to deal with foreign industry/governments. One of the best source documents for the uninitiated is the publication Doing Business with the Department of Defense - A Guide for Foreign Firms. This guide explains the DOD contracting process and lists the major buying offices and the commodities they purchase. An often repeated piece of advice is that even with trade facilitated by MOUs, foreign contractors must be competitive and follow US acquisition procedures. The major recommended method to accomplish this is as a subcontractor to a US prime. A majority of the US procurement dollars is allotted to only 15% of all contracts awarded annually; of these large contracts, almost half of the work involved is subcontracted. Therefore, a substantial portion of the procurement dollars is available to subcontractors. Subcontracting also provides a high probability of future contracts for replacements and spares, as well as a reduction of many of the costs and administration inherent in selling direct, plus the marketing expertise and advice of the experienced prime contractor.

Another area of the CIAT agreements that should be stressed involves foreign expectations. With the exception of those agreements in which industry guarantees some type of offsets or production capability, arms collaboration is nothing more than facilitating trade or removing barriers to that trade. An MOU or other international agreement promoting or encouraging reciprocal trade does not guarantee that the foreign industry can be competitive. By employing representatives in the US, either by using US agents, or by subcontracting with a prime contractor, a foreign industry can facilitate its entering the US marketplace; however, this takes time and expertise. Foreign expectations generally foresee an immediate proportional increase in sales continued over time. In reality however, until the foreign contractors

a successful learning process over several years, they cannot normally be competitive to the degree initially anticipated.

### Future Directions in Cooperative International Arms Trade

In the next decade, the direction of US policy covering Cooperative International Arms Trade will be shaped by the conflicting views of those who favor and those who oppose these methods of arms transfer. The opposition, focusing on the potential detriments to US industry and the economy, will seek international agreements and legislation to lessen the impact. A recent GAO report reviewed trade offsets in Foreign Military Sales and concluded that:

FMS credits, as a general rule, should not be used directly or indirectly to expand the industrial base of an FMS recipient at the expense of the US industrial base and US jobs, especially where countries' FMS credits have a significant grant element, are forgiven, or might not be repaid.[12]

The report recommended a policy to prevent a country which has received FMS assistance, in the form of a grant or FMS credit, from requiring an offset commitment from a US firm as a condition of sale.

In another view, Dale W. Church recognizes a problem of meeting foreign country desires while avoiding the creation of unnecessary production capability.[13] He recommended the liberalization of credit terms, arguing that the more defense a country can buy outright, the less they would try to produce. He also suggested allowing larger agent's fees which would reduce agent's demands for offsets. Neither recommendation would change the overall environment or remove the key motivations of foreign governments' insistence on CIAT: employment, technology transfer, industrial upgrade, and political acceptability. Finally, in a 1983 survey of US aerospace and electronics industries, half of the industries surveyed recommended government action to negotiate international agreements to limit or eliminate offsets as a way of doing business.[14] It seems highly unlikely that foreign governments would agree to something so contrary to their national interests, and the unity of industry's voice readily disappears in the reality of competing for the next major sale.

As long as we face a competitive buyers' market, as appears to be the continuing direction, there is little chance of any major changes to the CIAT aspects of arms transfer. Greater competition in a dwindling market will increase the number of countries participating in unique applications of CIAT. The larger industrialized countries will continue to try to sell at an acceptable profit; the small industrialized countries will seek offsets and collaboration to reduce the outflow of currency and protect their limited industrial base, and the developing countries will increasingly meet their defensive needs through barter arrangements and the introduction of the rudiments of an industrial base. The change from purely cash sales to creative development, manufacture, and finance, cannot be halted by legislation or agreements, since the impetus rests with larger factors. The United States is no longer the sole producer. Further, rising expectations in second and third world countries, and the economic-political situation throughout the world, mandate the continued evolution and growth of the Cooperative International Arms Trade.

## APPENDIX A

### DEFINITION OF OFFSET ELEMENTS

Although the terms of an offset on individual contracts may vary substantially, and a contract may call for more than one kind of offset, offsets can generally be grouped into the following types:[15]

#### COPRODUCTION

Overseas production based upon a government-to-government agreement that permits a foreign government or producer to acquire the technical information and know-how to manufacture all or part of an item of US equipment. It includes government-to-government licensed production. It excludes licensed production based upon direct commercial arrangements by US manufacturers.

#### LICENSED PRODUCTION

Overseas production of all or part of an item of US equipment based upon the transfer of technical information and know-how under direct commercial arrangements between a US manufacturer and a foreign government or producer.

#### SUBCONTRACTOR PRODUCTION

Overseas production of a part or an item of US equipment. The subcontract does not involve the license of technical information or know-how, and is usually a direct commercial arrangement between the US manufacturer and a foreign producer.

#### OVERSEAS INVESTMENT

Investment arising from the offset agreement, taking the form of capital invested to establish or expand a subsidiary or joint venture in the foreign country.

#### TECHNOLOGY TRANSFER (other than licensed production and coproduction)

Transfer of technology occurring as a result of an offset agreement that may take the form of:

1. Research and development conducted abroad.
2. Technical assistance provided to the subsidiary, or joint venture of overseas investment (see above).
3. Other activities under direct commercial arrangement between the US manufacturer and a foreign entity.

#### COUNTERTRADE

Purchase of goods and services from the buyer country as a condition of the offset agreement, excluding purchases under coproduction or licensed or subcontractor production. These purchases may be made by the US government [although this is prohibited under present US policy], the US contractor, the contractor's suppliers, or by third parties with whom the contractor acts as a middleman. The purchase may involve products for defense or civil use.

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