European Defense Industry Perspectives: The American Viewpoint

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INTRODUCTION

It is a pleasure to have the opportunity to participate in this very important conference and to address the American Viewpoint on Perspectives of European Defense Industry. Since the American Viewpoint is not uniform, I should qualify my comments up front by noting that these are my views and that others within our government and industrial sectors may well have contrasting views.

SOURCE OF PERSPECTIVE

First let me comment on the sources of our Perspective:

Our perspective of European Defense Industry is derived from various sources. Periodicals such as *The Economist*, *Defense News*, *The Financial Times, The Wall Street Journal Europe*, and *Jane's Defence Weekly* provide valuable insights. Personal contact and visits to your industries also provide first hand information. Conferences and seminars such as this one further enhance our understanding. Our perspective is challenged by the wide divergence of industries and the varied national industrial base of individual European nations. It is further difficult to track and generalize given the globalization of trade (EU, NAFTA, WTO, APEC, Andean Group, MERCOSUR, etc.), devolution, the worldwide convergence of supply and demand, structural changes in the world economy, productivity gains, currency and stock market fluctuations, and the daily media flow of news on commercial and defense corporate realignments. In addition, European Defense Industry has structured numerous joint ventures or cross-share holdings not tied to a particular program. To the extent that our perspective as presented this morning is skewed from reality, we look forward to hearing your comments and critique.

PERSPECTIVE

Our perspective of European Defense Industry can be divided into several overlapping categories. For comparative purposes I also plan to comment on the U.S. model and transitions. I have chosen in my remarks today to address these perspectives of European Defense Industry in the following four areas:

- Government Role and Political Influence
- Social and Cultural Environment
- Technology

- Degree of Consolidation: Fragmentation versus Merger and Acquisitions

Let me begin with the Government Role and Political Influence

First the U.S. Government ownership and operation of defense industry in the U.S. is limited. The most obvious example is the research and development labs, maintenance depots which repair and overhaul systems and equipment, and some ordnance production facilities which produce ammunition, artillery, and large caliber guns. There has been a major thrust in some of these areas to bring in corporate competition, to privatize and to outsource. The most important role played by the United States Government in the defense arena is in its allocation of resources to defense programs and specifically to R&D and Procurement. The reductions since the mid 1980's in our defense budget have leveled off to an annual budget of approximately $35B in R&D and $40B in procurement. "Buy America" legislation enacted by our Congress, and generally opposed by the Executive Branch, does inhibit the free market approach which we in Defense normally espouse. Export controls and third country transfer regulations also impact our defense trade. In some cases, as with submarine construction, we have deliberately fostered the position of maintaining more than one source for competitive reasons. There is also a recognition in the U.S. that politically both sides of the Atlantic need viable defense industries in order to be able to manage national and regional foreign and defense policy. In addition, the U.S. government has played an important role in facilitating defense industry consolidation. More on that in a few moments.

European Governments primary impact on defense industry is similarly in the defense budgeting area. Unlike the U.S. where our defense budget has leveled off, defense spending in Europe, under pressure to meet the Maastricht Treaty convergence criteria for the Euro, appears to be on a steeper down slope. In addition, the role of government in European Defense Industries is, from our perspective, much more inclusive. Article 223 of the 1957 Treaty of Rome provides the legal authority to exempt defense industries from competition and free market rules in order to protect security interests. While Europe's largest Defense firms such as British Aerospace, DASA, and GEC-Marconi are privately owned, government ownership is prevalent in other instances (Aerospatiale in France; Finmeccanica, in Italy; and CASA in Spain). Where government does not have a controlling interest, political influence and labor inflexibility play a dominate role. *The Wall Street Journal Europe* quotes a recent OECD study which notes that deregulation of European economies could be worth an extra 3-6 percent of GDP growth. It goes on to note that red tape, restrictive labor-market rules, and curbs on commercial initiatives are robbing European economies of growth opportunities and it attributes up to 80 percent of the unemployment rate to "structural shortcomings."

The European tax structure for social security, on income and capital gains, is more burdensome and less conducive to investment. While "Buy Europe" policies are often less explicit than "Buy America" legislation, there is a "European Preference" philosophy promoted in some European quarters that can be equally restrictive to free and open competition. The formation of WEAO (Western European Armaments Organization) and OCCAR [Organismes Conjoints de Cooperation en Matiere d'Armement (Organization for Joint Armaments Cooperation), a Franco-German-British-Italian Procurement Agency] offer the prospect of a bias towards procurement from European only sources. Export controls among European nations are disjointed in that they must accommodate a multitude of governments with varying political views on defense exports. Whereas the United States government has a hands-off policy on "Offsets" established by Presidential Executive Order, European governments are active in promoting and orchestrating, managing and tracking "Offset" agreements in specific commodity areas. Varying memberships among European nations in NATO, WEU, and EU further constrain the formulation of a pan-European armaments policy.

The second area I want to address is the Social and Cultural Environment. There is a social and cultural dimension to the divergence between the U.S. and European Defense Industries. This includes the relative role of labor unions, welfare programs, comparative minimum wage levels, job security, and social programs, including unemployment benefits and pensions. European marketplace regulations and traditions tend to keep new entrants out of the marketplace. Some say that Bill Gates never could have launched Microsoft in Europe, because its illegal to work in a garage; no-windows. The Maastricht Treaty with its third pillar of cooperation in Justice and Home Affairs provides a common framework in Europe in areas such as working conditions and worker's rights to information and consultation. The European summit on jobs held last week (November 20-21) in Luxembourg is the most recent example of the overarching social role played by the EU. It is generally agreed that Americans work a longer work week, have fewer benefits including vacation time, are less secure in their jobs, and have less of a social safety net than their European counterparts. It is of course difficult to generalize and we make no judgment on which social model is best. Some European nations (Netherlands and UK) have instituted more flexible labor markets where lifetime employment is no longer the norm and part-time or temporary employment is more prevalent. These factors impact the competitiveness of industry. Americans are also more mobile in their employment with geographic moves and career changes more prevalent. American entrepreneurs are also more willing to take risks which translate into the availability of venture capital and the startup of industries such as the explosive growth in computers and software, the internet, and cyberspace.

The third comparative area is Technology. There is a growing technology gap between the U.S. and Europe. The gap is wide spread from high tech sensor and information warfare systems to basics such as logistics and transport. Our Ambassador to NATO noted in a recent speech that this gap is becoming one of the most important issues in the Alliance. Three technology tiers are evolving with the U.S. in the lead, a second tier consisting of our closest European allies, and a bottom tier consisting of new Alliance members. A convergence of technology levels is important to ensuring standardization, interoperability, and the ability to conduct coalition warfare in NATO. A recent survey of productivity in the electronics industry, conducted by the management consulting firm McKinsey & Company, found a 20 percent gap in productivity between North America and Europe. It also notes that commercial electronic manufacturers are 20 percent more productive than defense firms. Of concern on both sides of the Atlantic is that the survey noted that the rate of productivity increase in the commercial sector was 11 percent per year versus 5 percent per year in the defense sector. Meanwhile the Electronic Industry Association in the U.S. has projected that the annual spending on defense electronics is likely to increase by 14 percent to $59B over the next decade while the overall defense budget is expected to contract. This reallocation of defense resources to the procurement of electronics is indicative of the Revolution in Military Affairs with its shift from the procurement of platforms to information intensive technology. All this suggests a need to close the transatlantic divergence in technology and the accelerating gap between defense and commercial sector through dual use application and commercial insertion. Teaming arrangements, joint ventures, mergers and acquisitions offer technological synergys and economies of scale required to remain competitive in a global economy.

Finally, we have the Degree of Consolidation: Fragmentation versus Merger and *Acquisitions.*

In the United States over the last five years, there have been over 30 major mergers and acquisition in U.S. Defense Industry; the most prominent include the formation of today's Lockheed-Martin, Hughes/Texas Instruments/Raytheon and Boeing/McDonnell-Douglas.

These companies have not simply merged. They have or soon will restructure by closing excess facilities and "right sizing" their work force. The U.S. Defense Department served as a catalyst and provided a framework for these consolidations. You have undoubtedly seen press reports regarding a dinner meeting at the Pentagon in 1993 between a dozen industry chiefs and the then Secretary and Deputy Secretary of Defense (Aspin and Perry). Mr. Perry is quoted as having told the executives that there were twice as many of them as he wanted in five years time. Those present at this event, now referred to as the "Last Supper", heeded this message. Economic incentives were offered to the industries involved to claim reimbursements for the restructuring costs associated with mergers and acquisitions. Antitrust authorities demonstrated flexibility in their reviews while still working to ensure adequate competition for defense programs. Selective divestiture of key defense related units was mandated as was the imposition of "fire walls" within a corporate structure to preserve competition. Some have suggested that we in the U.S. have gone too far and that domestic competition is at risk. A recent Defense Science Board Study has cautioned on the extent of vertical integration of US Defense Industry. Risks described in this study deal with the potential impact on cost, quality and performance. Based on the results of the DSB study, the Defense Department has increased monitoring of sub-tier supplier product and technology areas, to foster competition and innovation and to enhance the knowledge of managers about industry. One could describe the U.S. Defense Industry restructuring process as radical and revolutionary. As a result of these consolidations in the U.S. we have something approaching equilibrium between defense industry requirements and capacity.

The Pan-European Defense Industry consolidation process has been more gradual and evolutionary, although in our view, picking up speed. Completion of the single market in Europe, capped by the launch of the Euro, is adding to the urge to achieve pan-European economies of scale, and leading to increasing transparent flow of commercial goods and services across national boundaries and a growing trend toward global markets. While the trend in consolidations is being lead by non-defense sectors such as in consumer products, publishing, insurance and financial services, we note a momentum to include the defense sector. This reflects a recognition that mergers and acquisitions provide the means for achieving a more efficient use of capital and a more competitive industrial and commercial structure. Unlike the U.S. where there was a rush to consolidate, the trend in Europe has been to preserve the existing national industrial capability, although at a reduced level of activity. The result is overcapacity and a failure to achieve economies of scale. One might refer to the U.S. model as vertical cuts, eliminating defense corporations through merger and acquisition, and the European model as horizontal cuts, preserving firms but a lower work level. The result is that the U.S., with a defense budget twice the size of the combined European defense budgets, has fewer by far than half the number of contractors that exist in Europe in all major areas of defense industry; aircraft/helicopters, missiles, tanks/APCs and shipyards.

WAY AHEAD

The EU Commissioner for Industrial Affairs, Mr. Martin Bangemann, in a recent policy paper, noted the need for European Aerospace and Defense Industry to drop protectionist policies and rapidly restructure. This is a prerequisite to being competitive with U.S. industry. It requires national governments to accelerate passage of legislation which would facilitate integration on a pan-EU basis. It also requires the use of common procurement procedures and the application of Article 223 only on a limited scale for the most sensitive defense procurement. The UK Defense Secretary, Mr. George Robertson is quoted in *The Financial Times* as saying that the European Defense sector must "rationalize or die". *Jane's Defense Weekly* notes the views of BAe Chief Executive Sir Richard Evans, that restructuring of European Defense Industry needs to be stepped up as American companies begin to look outside their national boundaries. Europe needs to think in transatlantic terms but it also has to do some sorting out of its own defense industry. Some positive signs are on the horizon. The partial sale of Thomson-CSF, Europe's largest military electronics firm, is a crucial step in consolidating French armaments companies. It works to increase its competitiveness with Lockheed-Martin and with Raytheon.

In March of this year, Secretary of Defense Cohen issued a policy statement on International Armaments Cooperation. He noted that International Armaments Cooperation is a key component of future U.S. security. In the evolving environment of coalition warfare, limited resources, and a global industrial and technology base, we need to be engaged in this cooperation. Cooperation can achieve the deployment and support of interoperable equipment with potential coalition partners, and provide the best technologies and leverage resources through cost sharing and economies of scale. We also need to remove impediments to armaments cooperation. Along this line, earlier this year our Under Secretary of Defense, using authority granted to him by the U.S. Congress (Defense Authorization Act), waived certain domestic source code restrictions with those nations which have reciprocal procurement MOU's with the U.S.

The bottom line is that we need a viable, efficient, technologically advanced, and competitive defense industrial base on both sides of the Atlantic to ensure the best technology and economical procurements. We need to foster transparency and a level playing field in defense procurement. We need to cooperate early in the life cycle of systems and equipment, initiating discussions on common military needs and work towards harmonizing requirements. We need to recognize our interdependence and buy systems in a competitive environment. We envision strategic alliances across the Atlantic. The British Aerospace teaming with Lockheed Martin on the Joint Strike Fighter is a move in that direction. European industry, in our perspective, needs to rationalize, restructure, and consolidate. This translates into acquisitions and mergers both within the continent and transatlantically and a move towards trans-national firms in the defense sector as we have witnessed in the commercial sector.