

## **The future of European defence industry**

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Twenty years ago the US faced huge defence budget cuts. The Cold War had ended after the fall of the Berlin Wall. The first Gulf War had been successfully completed. It was time for the peace dividend. In the autumn of 1993 Deputy Secretary of Defence Perry called all captains of American defence industries to a dinner. He told them that there was no longer room for all companies to be sustained by defence orders of the US government as sufficient money would be lacking. The event is known as the last supper.

It resulted in the consolidation of the US defence industry in the big five: Lockheed Martin, Boeing, General Dynamics, Raytheon and Northrop.

Towards the end of the same decade the first consolidation wave occurred in Europe with the establishment of EADS and BAe Systems.

Today, twenty years after the last supper we face a comparable situation, at least in budgetary terms. The decline of the Pentagon budget has started this year. In Europe defence budget cuts have become a normality since a couple of years.

Are we on the eve of a new last supper? Will the European Council in December provide the venue for the dinner? Is the fragmented European defence industrial sector approaching its end and will we witness the realisation of a true European Defence and Technological Base (EDTIB) – which according to the European Defence Agency's EDTIB strategy of 2006 should be the ultimate aim? Are the European Commission's proposals in the Communication "Towards a more competitive and efficient defence and security sector" of 24 July showing the direction for the consolidation of Europe's defence industries?

Looking at the security situation and the status of the defence industries in Europe one would logically argue that a big jump forward is indeed needed.

Why?

Firstly, because we need credible and modern armed forces in Europe to deal with an instable world. In fact, instability has reached Europe's frontiers – not in the classical sense of big tank armies – but with an Arab Spring that has turned into a storm, including sectarian violence and fighting in countries like Syria.

Forecasts on future security developments all point to a world that will become multipolar, more complex, less predictable and characterised by an arc of instability reaching from the Caribbean through North-Africa to Asia.

In short, the future will be more uncertain and the likelihood of all sorts of local or regional conflicts is rather high with all kinds of negative fall-out for Europe, such as illegal immigration, international

crime and disruption of trade and energy flows, but also the dangers posed by the proliferation of missiles and weapons of mass destruction.

Secondly, the big jump forward is needed in view of diminishing demand for Europe's defence industries. Defence budgets are declining, with percentages varying from single figures in France, Germany and the UK to double figures in smaller countries. Just a few years ago the EU as a whole spent about 200 billion Euro annually on defence. In 2013 the figure is down to about 170 billion. Some analysts predict a further drop to approx. 150 billion in the next few years. A 25% decrease compared to just a few years ago.

Investment in R&T has gone down, despite agreed benchmarks and declarations signed by Defence Ministers to spend more, to spend better and to spend more together. Procurement has been curtailed. The numbers of aircraft, ships and vehicles on order have been slashed. In some cases even complete programmes have been scrapped such as the Nimrod maritime patrol aircraft acquisition in the UK or the Eurohawk unmanned aerial vehicle in Germany.

Earlier this year the EU Institute of Strategic Studies in Paris predicted that continued inadequate investment could lead to the emergence of "bonsai" armies in 3-5 years, an industrial exodus in 5-8 years and the loss of technological leadership in 8-12 years.

And the future economic outlook is not good. The Eurozone rules to rebalance government income and spending will have a structural effect on limiting defence expenditure. The result: levelling of budgets at best, further cuts at worst, but certainly not more money for defence. That will be the reality.

The third point why the big jump would be needed: the status of European defence industries. Today, one could say the situation doesn't look that bad. Production lines are still open, that is true. But current production is based on orders from the past: Eurofighter, Rafale, A400M, NH-90 and so on. New large European armament programmes are not on the horizon.

As a consequence of reduced acquisition by European governments the prime producers in Europe are desperately seeking to sell to export markets. There are some success stories – in the Middle East, India and elsewhere – but most likely the positive effect will be of short duration. The rising economies demand technology transfer. They will throw money at their own industries to further improve the technology. In due course this will lead to in-house production.

Thus, markets now open for European defence products will be closed while elsewhere in the world competition will increase with the new economies themselves selling their products at lower prices. The study "The Balance of Trade" of Jane's, released in July this year, predicts that global defence trade will increase due to quickly rising defence budgets in Asia and elsewhere, but that the Western share will decrease. Today, China is already the 8th largest world arms exporter while for the home market imports are declining as own production is taking over.

Shrinking demand in Europe and shrinking market shares on the world market should lead to ringing the alarm bell. The big primes in Europe have expressed their worries. They are already changing their business strategies to be prepared for the future.

However, there are no new big consolidation steps. The failure of the EADS-BAe merger earlier this year has shown that governments of the larger industrial countries are simply not ready to move to a new round of consolidation. Fear of loss of jobs and income is more powerful than the will to build a stronger defence industrial base in Europe by ending duplication and by merging primes. Yet, the civilian sector has shown the way. Airbus is the competitor of Boeing at the global level. But when it comes to defence industry the national political, military and economic barriers to move into the same direction still seem to be too high.

The situation has perfectly been described by Bernard Lévy, CEO of Thales, at the recent DSEI defence exhibition in London: "On the one hand governments want competitive products; on the other hand they want to buy from companies that create jobs in their own countries."

That is the problem of European defence industries. It is not so much an economic problem but a political governmental problem. As long as the majority of defence acquisition remains nationally planned, nationally ordered and delivered, the chances of creating a true European DTIB remain low.

This implies we are unlikely to witness the big jump forward in December at the European Council. Evolution rather than revolution will characterise the reform of Europe's defence and industrial landscape. It doesn't mean that important steps cannot or will not be taken. The European Commission's Communication offers a wide range of proposals and suggestions which can help to transfer from the current situation of fragmentation to future consolidation.

The following four elements are the most important ones. Not all of them are listed in the Commission's Communication and not all of the proposals in that Communication are necessarily positive.

First, the role of the Commission as the guardian of an increasing open defence market should be strengthened. The Commission should closely monitor the implementation of the Procurement Directive, which has come into effect in 2011. Member states are likely to have different interpretations of the Directive. The use of article 346 should be limited to real cases where national security interests justifies the exemption of open market competition.

The Commission has indeed announced it will monitor the member states' behaviour and ensure strict interpretation of exclusion provisions, such as government-to-government sales. That's fine, but we also need more clarity on what can be exempted and what not. In other words: which procurement can stay within national borders because of national security concerns. Which not?

Another issue is offsets. The Commission has reinforced its attack on the use of offsets, which it considers contrary to European law as offsets distort the market. Countries like France, Germany and the UK with second and third tier suppliers within their national territory are likely to support the Commission's view. But smaller European countries, whose Small- and Medium-sized Enterprises too a certain extent are dependent on offsets, will not favour the Commission's campaign. They see the anti-offsets campaign as an attack on the smaller defence industries in favour of the bigger countries.

But also in principle they have a case to defend. The argument that offsets are a distortion of the free market is selectively chosen. As long as art. 346 is in place there is no "level playing field" – thus, why attacking one specific element of market distortion while the big fish is left untouched?

Abandoning offsets at once may lead to the closure of many SMEs in Europe which the Commission rightly describes as companies that "secure the heart of Europe's defence innovation". We need to balance legal market principles with the specifics of the defence sector. The solution lies in a more gradual approach, which is in line with the evolutionary character of transferring to a future EDTIB. Such a gradual approach would consist of step-by-step measures of restricting offsets in order to give SMEs the necessary time to adjust. The final abandonment of offsets should be linked to the abandonment of art. 346. Such linkage would serve *all* European countries.

The second area of evolutionary progress is industrial reform and restructuring. No big mergers lie ahead but more limited forms of cross-border industrial cooperation, coordination and even integration might be possible. Increasingly, European countries are closely cooperating with their neighbours or regional partners in defence clusters: Franco-British, Benelux, Nordic Defence Cooperation. Why not copy the same model on the defence industrial side?

In fact, it is already happening. France and the UK have agreed to buy together new anti-ship missiles. MBDA will use this case to scrap duplications in the companies' structures and create cross-channel dependencies in industrial terms. French and German naval shipyards are exploring scope for coordinated development and construction. Conventional submarines might be another area of naval shipbuilding where countries can create synergies by combining acquisition and construction. Industrial clusters should be promoted by the Commission and not neglected as currently is the case. It would be an interim-step towards the longer term goal of a true EDTIB and a fully open market.

Third element is research and innovation. R&T is in troubled waters as the figures show. But investment is unlikely to go up. If there won't be more money available the logical step is to invest more commonly. There is still huge scope for improvement. Around 80-85% of defence R&T budgets are spent purely at the national level.

The European Defence Agency's formula of Defence R&T Joint Investment Programmes has proven its value, in force protection and in other areas. The available tool can be used more intensively (by increasing investment levels) and more broadly (by extending from basic to applied research). The latter is particularly important if the aim is to connect R&T better to capability development, for which demonstrators and tests are needed. Clearly, this would also bring in industries as they will be needed for moving from demonstration to full development and production.

At the same time the scope for dual-use technology development should be fully explored. The Commission's proposals to look for synergies with the defence sector in its future projects under the Horizon 2020 programme deserve full support. And the Commission is now even going a step further. For the first time it is opening the possibility of co-investing Union money in member states' defence

R&T projects when this involves dual-use technology. That is an important breakthrough. It should be explored as soon as possible in order to enlarge the funding of collaborative R&T.

The fourth and last element of reform is to explore more systematically the potential of combining civilian and military capabilities. The new threats and challenges to Europe's security lie mainly in spill-over effects from instability outside Europe. Civilian security actors dealing with border control, maritime safety and security, cyber security, energy security and environmental protection – all of them use capacities which at least partially overlap with those owned and operated by the military.

Those dual-use capacities are growing and increasingly they will be arranged beyond the national level. Maritime surveillance is an excellent example. The European Maritime Safety Agency (EMSA) provides maritime data to the EU's anti-piracy operation Atalanta. Coast guards in EU member states are using civilian and military vessels and maritime patrol aircraft. Transport planes and helicopters can be deployed for military operations, but equally they are used by police forces or for humanitarian relief operations. Frontex, the EU's border control agency, is already using on an ad hoc basis military assets of member states such as ships of European navies. Satellites, both for communication and for observation, are dual-use reconnaissance and intelligence platforms.

Dual-use synergies should not be limited to R&T/D but extended to procuring, operating and maintaining dual-use assets. The Commission has proposed to explore the potential of "assets directly purchased, owned and operated by the Union", based on an assessment of dual-use needs for the EU security and defence policies to be made jointly with Lady Ashton's European External Action Service. To prevent a long process of debates and turf battles a deadline should be set for delivering the assessment study in order to move as quickly as possible to realisation.

If member states we can create a C-17 transport aircraft pool in NATO and the European Air Traffic Command in the Netherlands, why not *pooling* of transport aircraft, helicopters, medical equipment and supplies, intelligence and reconnaissance assets, CBRN defence capacities and others which can be *shared* by civilian and military users?

Again, this should not necessarily be done immediately at the EU level. Regional or bilateral civil-military capability clusters can be realised quicker and more easily than at the overall European level. In the maritime area the Baltic Sea, the North Sea, the Atlantic approaches and the Mediterranean are the logical regional sectors to look at for clustering maritime patrol aircraft, ships and other naval & maritime assets.

But what we need at the European level is a big programme on unmanned aerial vehicles (UAV), now called remotely piloted aircraft systems (RPAS). This cannot be done at cluster level, because their civilian use for border control or environmental monitoring affects all EU member states. Also, the industrial aspects ask for a European solution. The market is too small in Europe for different medium altitude RPAS programmes. The current duplication of developing a next generation European MALE-UAV has to stop. Dassault, EADS and Finmeccanica themselves have even proposed this to European governments.

So, here the European Council should take a decision to launch a civil-military development and procurement programme. It would serve European armed forces, civilian security users and industrial reform in Europe. It fills an important capability gap. It fits in related efforts to create a Single European Sky and to realise air traffic insertion of unmanned aircraft. In short, a golden opportunity at the right time serving Europe's security needs.

## **Conclusion**

The European Council on defence in December this year is an important opportunity to raise the awareness of EU presidents and prime-ministers about the value of defence, armed forces and industries. Key member states are not ready to make the big jump forward with industrial consolidation. Therefore, presidents and prime ministers will not have a last supper, but more likely an extended dinner concluded with strong coffee. Nevertheless the European Council can and should mark an important milestone to further reform European defence and Europe's defence industries. To deliver results the debate will have to be focussed and aimed at concrete deliverables. The preparations look good, but at this stage I am less convinced of concrete outcomes as member states are already toning down expectations and withering down proposals. Let's hope that President Herman van Rompuy and Heads of State and Government show a bit more courage to take decisive steps in order to safeguard the security and defence interests of the EU and its member states.

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