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ACCESSING THE EUROPEAN DEFENSE MARKET: A U.S. PERSPECTIVE

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This paper will briefly examine the issues in access of US defense firms to the European defense market. It will touch on challenges that arise from both European nations and from US internal policies, strategies US firms are using today in the European defens e market, and some outlook for the future.

Does the US want a "real" Transatlantic Defense Industrial Base Today?

In January 2002, Burkard Schmitt, then at ISS in Paris, wrote

"Arms trade across the Atlantic has remained primarily a one way street" and *"the US has such enormous financial resources, defense industrial assets, and military capabilities that they simply do not need armaments cooperation or arms imports. From the US perspective, the potential benefit of transatlantic cooperation is, at best, the cohesion of the Alliance. But this argument is hardly sufficient to overcome bureaucratic and political resistance"* [1]

Given its resources, does the U.S. want a "two way street"? Does the U.S. keep up barriers for European imports yet unfairly enjoy few barriers in selling to Europe? Despite the logic of these questions, U.S. goals have not been all "One Way street" for export. The Clinton Administration made significant efforts to reform and streamlines export controls and reaches out to Europeans for a "real" transatlantic industry.

"The Clinton administration wants to actively encourage trans-Atlantic partnerships and mergers in the defense industry, a Pentagon official said… Even a giant U.S. military contractor such as Northrop Grumman…, might be eligible for a European takeover in the Pentagon's eyes. [These] comments by Undersecretary of Defense Jacques Gansler…, underscored a change in attitude among U.S. defense policymakers in favor of a warmer welcome to foreign bidders in the sensitive sector of armaments.[2]

Despite skeptics in Europe and the U.S., during this period the U.S. did approve BAE's acquisition of Sanders, a firm with sensitive products such as electronic warfare --a milestone in the U.S.
However today, questions of transatlantic defense have become complicated with larger issues of the coalition for Iraq and deployments in Afghanistan. In the post 9/11 era, the Bush Administration is unlikely to issue a statement inviting foreign takeovers of national

[1] Burkard Schmitt, *European and Transatlantic Defense Industrial Strategies: A European Perspective*, Analysis No. O, January 2002, Institute for Security Studies, Paris
[2] J. Fitchett, *International Herald Tribune*, July 8,1999, also reported widely in the press the same day, *e.g.* by E. Becker in the Wall Street Journal, July 8, 1999.

security firms. While the Bush Administration generally advocates open trade, the post 9/11 climate created elevated U.S. sensitivity about technology export and eventually, more attention to the foreign acquisitions made in the U.S. And while the Dubai Ports case was not at first a problem of the Administration – but an issue on Capital Hill and a public reaction – in response the "CFIUS" review process has grown more extensive, the approach more cautious.[3]

The U.S. defense industry does sell more to Europe than the US buys in return – but does this mean there are fewer barriers in Europe for U.S. firms?

Is there a better outlook today than Burkard Schmitt saw in 2002? Many in Europe still see trade as that one way street. The December 2007 EC Communication introducing the new Defence Directive Package states:

"*…despite the clear domestic preference, a significant part of Europe's defence equipment is imported, especially from the U.S. While most European markets are open to U.S. manufacturers, European producers often find a closed door when trying to export their defence goods to the U.S.*" [4]

And the numbers may appear to support this view. According to the U.S. General Accounting Office, in the period 2000-2004, U.S. defense exports averaged $11.5 Billion a year, versus imports of $1.8 Billion (all exports, not just to Europe.)[5] While these numbers may appear to reflect an unfair trade advantage for U.S. firms, they must be examined in the context of U.S. investment. In 2005, U.S. defense spending was roughly 10 times that of the next two largest defense spending nations – the UK and France.[6] The EU Communication (referenced above) offers this:

While the U.S. defence budget is about twice as large as that of all European defence budgets combined, it devotes some 35% of its total budget to investment compared to only about 20% in Europe and it outspends Europe by six to one in defence R&D. (p.3)[7]

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[3] In 2006 the U.S. reviewed $186Billion in foreign acquisitions of U.S. properties under the Committee for Foreign Investment in the U.S. (CFIUS) – a record number – but the numbers do not show potential buyers who may have been rebuffed informally.

[4] Section 2.3 "*Communication from the Commission to the Council, the European Parliament, and the European Economic and Social Committee, and the Committee of the Regions: A Strategy for a Stronger and More Competitive European Defense Industry*," December 2007.

[5] US GAO Briefing to US Senate Armed Services Committee: *Defense Trade Data Defense Trade Balance: U.S. Exports versus Imports*, January 2007. See also Annex 1 to this paper.

[6] Terrence Guay, *Globalization and Its Implications for the Defense Industrial Base*, US Army War College, February 2007, Table 1, p.7, derived from data of Stockholm International Peace Research Institute (SIPRI)

[7] EC Communication, *Ibid*, p. 3

Despite the scale and technology strength of U.S. defense firms, they face a number of challenges in accessing many European defense markets.

A new study sponsored by the U.S. Deputy UnderSecretary of Defense (Industrial Policy) [DUSD (IP)] is underway to assess the market access barriers faced by U.S. firms in Europe. This study is using both quantitative evidence and analytic judgment to measure the relative openness of various European national defense markets (and notably, the U.S. market in reverse.) The study is still in the data collection phase so results cannot yet be reported.[8] However, without need for results from this new study, there are a few well known barriers to U.S. access in Europe. This paper examines:
1) Current barriers that arise from EU member states,
2) Current barriers that arise from within the U.S. (*i.e.,* "self-imposed" barriers), changes in U.S. industry strategies, *and*
3) A quick look at the future of U.S. access in Europe.

1. Current Barriers that arise from European nations' policies or practices

Obviously not all barriers exist equally in all EU member states. And some may exist despite being questionable with regard to EU policies or objectives. But innumerable sources, including the December 2007 EC Communication (*Ibid*.), document that EU member nations have practices that often limit access to their markets by foreign defense firms, including U.S. firms.

Non-competed contracts, National Preferences or National Favorites

First, there is the simple inability of U.S. firms (or other foreign firms) to compete on many European contract opportunities due to nations using sole source contracting, invoking Article 296, or deciding to exclude U.S. bidders. The December 2007 EC Communication (*Ibid.)* illustrates:

*"However***, *on average, Member States spend almost 85% of their equipment budget domestically…*** *"* and *"European governments have a clear* ***preference for their own national defence industries*** *not only to protect jobs and boost investment but also to ensure security of supply and of information."*[9]

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[8] The author of this paper is supporting the DUSD (IP) study under the auspices of the Johns Hopkins University-School of Advanced International Studies (JHU-SAIS) Center for Transatlantic Relations: Program on Transatlantic Security and Industry. The study commenced October 1, 2007, will be completed September 30, 2008, and a public report will be issued as approved by the DUSD (IP). The timing of the public report will be determined by the DUSD (IP) but is unlikely before early 2009. That study examines many forms of tariff and non tariff barriers, including ethics and corruption, too extensive to be discussed here.
[9] EU Communication, *Ibid,* p. 4

Ownership and Limits on Foreign Investment

A nation's preference for national industrial sources reflects national interests of security, technology, and jobs. These interests may be complicated when the nation (state) itself holds an ownership share in its defense firm, as is the case in several EU nations. The French hold 100% of Nexter, its land vehicle firm, a 75% share of DCNS, its shipbuilder, and a 27.3% share of Thales.[10] The International Herald Tribune reported other examples:

Most countries view their arms makers as national champions. The British government still holds a golden share in BAE Systems PLC…. It also owns equity in Rolls. The Italian government owns [a] percent of Finmeccanica SpA, and the French government controls [a] percent of the pan-European aerospace manufacturer European Aeronautic Defense & Space Co. through its direct 15 percent ownership as well as a 12 percent ownership by Lagardere Group… [11]

In many or perhaps most cases these European governments have been reducing their ownership stakes or altering their roles -- clearly a positive move towards a more normalized market. Yet remaining ownership relationships create dynamics affecting market conditions for contracts and access to capital markets. The USG is concerned about its defense industry, but does not hold ownership stakes. U.S. firms must serve their shareholders, which generally means Wall Street. There can be an uneven playing field when a U.S. firm faces a national champion who may even be financed by the very government who is deciding the competition.

EU member states also impose controls or limits on the foreign ownership of national security related businesses via explicit laws or by practice. In France and Germany, while U.S. firms have had some success in civil aerospace, U.S. firms do not have ownership of core defense businesses. The United Kingdom has looked more favorably on foreign ownership -- Lockheed, Finmeccanica, and Thales have made solid defense acquisitions there.

National technology and industrial jobs and intellectual property

European national practices of national work "offsets" or forms of juste retour, have created barriers to U.S. firms. Some European nations have moved beyond such explicit formal demands, but require retaining intellectual property and a share of jobs performed indigenously. Depending on implementation, these arrangements may work, or may create difficult program/value solutions or market dynamics. If the U.S. is not allowed to bid to perform technical tasks outside the buying nation *(i.e.,* perform the tasks in the U.S.) but also not allowed to own indigenous national businesses, such arrangements may make it impossible for U.S. firms to compete.

[10] French ownership shares are available in many public sources, including the French MOD DGA website, and various studies published by the Fondation pour la Recherche Strategique (FRS), Paris, also available on the FRS website.

[11] S. Reier, *International Herald Tribune*, European Defense Firms Struggle to Catch Up, June 9, 2001. The ownership percentages may have changed somewhat since this article in 2001.

In summary, many of the barriers that European nations pose for U.S. firms are similar to in nature to those barriers European firms face in accessing defense business in the U.S. market. However they vary by degree and intensity. Like European nations, the USG does concern itself with where its taxpayer dollars and defense jobs are going. However the US does not have formal programs or Government managers demanding formal workshare or juste retour-like arrangements. These issues are a question of a firm's strategy in understanding the local market and how to position itself to win, as evidenced by the NG/EADS win of the USAF tanker program. Market strategy in a foreign market is an issue in almost any industry – it is considered in commercial markets by firms such as General Electric or IBM, who want to participate in China or India for example. U.S. firms must assess and understand the unique business settings of the EU and buying EU member state, and the access barriers implied by national policies – just as European firms must do in the U.S.

2. Current Barriers that arise from within the U.S.

Self Imposed Barriers in ITAR

One notable barrier to U.S. firms is the U.S.'s own ITAR restrictions. Obviously the USG must protect its large investment and strength in critical technologies and products. But ITAR restrictions can imply extensive and time consuming reviews of export licenses and limit early discussions and commitments by U.S. firms. A 2007 study by the Institute for Defense Analysis warned that ITAR attitudes and reality could lead to "diminished competitiveness of leading edge U.S. industries."[12] This is a constant concern of the U.S. defense industry. The U.S. National Defense Industrial Association's Top Issues 2008 asserts a need for improved two way transfers: "Technology transfers must not impede the transfer of equipment and needed capabilities for allies fighting together." [13] In May 2006, Vice Admiral Ray (Retired), President of Raytheon International Europe, said in Berlin:

"To be competitive, we have to come to market at the right time and in a timely way…. At a glance, the [U.S.] technology transfer system greatly complicates our ability to be a good provider to our international customers and also complicates our ability to plan…You on your part need to include us in your requirement discussions... You also need to keep pressuring the United States government…[14]

Leaders of U.S. firms in Europe are telling the new DUSD (IP) study team they understand ITAR and can often work within the process to support their export needs. However, there are increasing signs that ITAR review and enforcement is becoming so unpredictable and

[12] Richard Van Atta et al, *Export Controls and the U.S. Defense Industrial Base,* U.S. Institute for Defense Analysis (IDA), January 2007, see Overall Summary, p. 1-7.
[13] NDIA web site, Top Issues 2008, Issue 6, Ensure International Competitiveness of US Defense Industrial Base, p. 22
[14] 23rd International Workshop on Global Security, Berlin, May 2006

time consuming that products from the U.S. with an ITAR string are less desirable ("ITAR-tainted"). They may even be left out of European nations' or companies' plans and designs altogether (this will be explored fully in the study report for DUSD (IP)).[15]

Past U.S. Attitudes and Success as a barrier

Ironically the successful history of U.S. defense products and sales in foreign markets has added to cultural barriers for U.S. firms. The U.S. has been viewed in some markets as arrogant, disregarding national needs, e.g. "I have the best product, you can buy my superior system with all subsystem elements and my support, with my ITAR restrictions – take it or leave it." Of course this is an unfair generalization. As long ago as the 1970s, the F-16 was an international co-production program, and the JSF sought international partnership from the start. But the "arrogant U.S." view persists among some in Europe – and the U.S. approach to partners may amplify this attitude. A quote from the French FRS on the JSF illustrates:

"As well as limited influence on the program, the partner states must accept a low level of selection of their industries and their exclusion from bidding in sensitive areas. American regulation of technology and information transfer renders this competition… particularly inoperative. The dominant position of the U.S. on this programme, and consequent second rank position of the partner states, also show through in the strategy planned for production and support."[16]

While the U.S. clearly has strong technology and products, and is spending its resources to earn this strength, this perception of a U.S. giant that forces its will on Europe has *not* fostered a desire among Europeans to further reduce barriers for U.S. market access. Rather it has led to fears of U.S. hegemony in some industry or technology areas.

U.S. Firms Are Changing Strategies – and Attitudes

While this perspective of "arrogance" persists, in fact U.S. defense firms have grown in global savvy in the last 10 years, and are developing strategies for **improved access by more meaningful presence and cooperation.** Where U.S. firms can find a promise of business return, some are pursuing a pragmatic strategy to play a supportive role in local markets. Some key factors reported by U.S. firms in their strategies:
- Create an in-nation operation of sufficient size and bench strength. Having a credible national presence is key to assuring the buying nation the U.S. firm can complete this complex contract -- while addressing national needs for defense jobs and technologies to be built locally. Recent wins or positions on competitions by U.S. firms in the UK – e.g.,

[15] As just one indication, the French MoD web site reflects a 2008 study to evaluate the French and Franco European dependence on ITAR for armaments export French Minister of Defence website, Directeur Charge des Affairs Strategiques, Programmes des Etudes 2008.
[16] Helene Masson, *JSF/F-35 In Europe: the Price of Pragmatism*, English Summary, 2004, Fondation pour la Recherce Strategique, Paris.

FRES, Services contracts, illustrate that, where allowed to hold ownership in the UK, U.S. firms can operate more as multinational firms.
- Understand and develop strategies to address even the subtle, informal local rules or needs. This means knowing your customer, what will work in that customer's national setting, and what is acceptable in the government political, military and public dimensions.
- Recognize it as a long term investment of time and resources. Becoming a trusted long term supplier with in–country presence may take time to pay off. Firms may work years to get solid progress. This is hard for U.S. firms, who must address shareholders in real time – they do not have 10 years for a return on investments. But firms increasingly recognize that successful multinational sales require multinational presence, and so must seek a more patient balance of investment and pay off.

3. The Future: A Perfect Storm, or Smoother Sailing for Transatlantic Relations?

A number of forces may be coming together to form changed market conditions for U.S. firms in Europe – the question is whether it will be better or worse.
A first key force is the new EC Defense Directives Package issued in December 2007. This is a capstone to years of work – the debate and document trail clearly lead to this moment. This three part "EC Defense Package" would provide a "harmonizing" legal framework for defense procurements- the *Communication (Ibid.)* explaining the EU Strategy for a stronger and more competitive European Defence industry, a Procurement Directive to govern buys, and a Transfers Directive for export coordination within the EU Community.[17]
This package – and its application by EU member states – pose potential concerns for U.S. market access in the EU:

Direct implications of the Directives

The Directives' language and authors say their full intent is to reduce pan-European fragmentation, the misuse of Article 296, and competitive barriers existing among member states. Some in Europe suggest the Directives package is aimed to create a European-centric market and make U.S. suppliers a second choice behind Europeans. Yet even if not by design, the Directives may inadvertently create new barriers, by offering member states authorities and procedures, legal within the EU, by which they may exclude U.S. bidders. Notably this could be done on the basis of Security of Supply (and the Transfers Directive linking simpler intra-European export licensing to assured sources). Or, it could be done over time by the emerging set of EC standards, which incorporate defense and "security" in their scope and may designate European standards not used globally. This could create technical barriers for U.S. firms' products, or make them more costly by needing changes

[17] Communication from the Commission: "*Strategy for a Stronger and More Competitive European Defence Industry"; Procurement Directive: "Proposal for a Directive of the EU Parliament and of the Council on coordination of the Procedures for the award of certain public works contracts, public supply contracts and public service contracts in the fields of defence and security*"; and the Transfers Directive: "*Proposal for a Directive {…} for Coordination of Procedures on simplifying terms and conditions of transfers of defence-related products within the Community*".

to meet EU standards. These concerns are speculative, but many in the U.S. – government and industry - view these Directives with caution. Note these questions are also of concern to U.S. firms with European holdings and programs – will they be treated as European or as U.S. firms, if there is a "preference"?

A second force in European defense market change *is the indirect implication of this package* – the need for the EU to act on the inferred imbalance of defense trade and market access between the U.S. and Europe. If this is a goal, then the use of the Directives, the activities of the EDA (Cooperative EU R&T, etc.) and other EU initiatives could be among the means to support a European preference in supply – while consistent with their goals for pan-European cohesion.

A further force at play for the shaping future is the role of French President Sarkozy in the direction of the EU in defense. His view of a strong EU in Defense, and the concerns this raises in NATO, are widely known:

[Sarkozy wants] *"...more progress on European defence. Mr Sarkozy, in short, wants the British to back European defence properly, and the Americans to stop distrusting this on the ground that it may be a rival to NATO…Something less than a full-blown EU defence headquarters would not satisfy the French; anything too grand or NATO-duplicating would not get past the British."* [18]

The Bush Administration has offered a few subtle nods towards more support for the Sarkozy view (notably U.S. Ambassador Nuland's recent statements in Paris.)[19] But in general the U.S. appears discomfited by the emergent EU defense activities. It seems likely Sarkozy, in his upcoming time as EU President, will seek to strengthen the EU defense identity, and the EU defense technology and industrial base on which its market rests?

So, at what price will this emergent EU defense activity come to U.S. defense firms in the European marketplace? Will there be a large shift towards a European preference, and no chance remaining for a transatlantic industry? Are U.S. products so strong and desirable, so technologically attractive, it will not cause a large impact? A Burkian view might be that the market will go on as is, with less dramatic and possibly only incremental changes over time. In either event, the U.S. Government and industry must clearly pay increasing attention to the emerging form of the EU market.

Author's note: This paper represents the findings and views of the author only and in no way reflects views or positions of the DUSD (IP) whose study she is currently supporting.

[18] *The Economist,* Jan 17, 2008.

[19] Victoria Nuland, US Ambassador to NATO, " I am not talking about combining institutions or even melding their mandates, don't worry. That wouldn't make sense for Europe or for North America. Europe needs a place where it can act independently, and we need a Europe that is able and willing to do so in defense of our common interests and values." Paris Press Club, February 22, 2008.

Annex 1

U.S. Gao Briefing to Senate Committee on Armed Services Defense Trade Data Defense Trade Balance: U.S. Exports versus Imports

Objective 2
What does the available data indicate about the U.S. defense trade balance from 2000 to 2004?

Answer: Based on our analysis of Census data, U.S. defense exports averaged $11.5 billion a year, versus imports of $1.8 billion a year. U.S. exports of defense articles ranged from $10.7 to $11.9 billion while imports ranged from $1.5 to $2.1 billion.
Another measure of the defense trade balance shows that imports averaged only 15 percent of exports during the period 2000-2004.

Calendar year	Defense exports (billions)	Defense imports (billions)	Imports as % of exports
2000	$10.7	$1.5	14
2001	11.6	1.6	14
2002	11.8	1.9	16
2003	11.6	1.7	15
2004	11.9	2.1	18

Source: GAO analysis of U.S. Census Bureau data.

[5] Data are all in nominal values, unadjusted for inflation. Data represent actual deliveries and shipments of defense articles for calendar years 2000-2004. As noted on page 5, BEA service trade data was not used in our analysis because it did not allow us to present defense service data in accordance with our definition.

GAO-06-319R Defense Trade Data Jan 27, 2006, Page 8