

“European Defence Industrial Restructuring and Consolidation in the Post-Cold War Era: Defence Industrial Base, International Institutions and Complementary Actors/Variables “

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ABSTRACT

“European Defence Industrial Restructuring and Consolidation in the Post-Cold War Era: Defence Industrial Base, International Institutions and Complementary Actors/Variables “

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This thesis analyzes the process of European Defence Industry’s restructuring and consolidation process in accordance with the emerging Post-Cold War period transformation requirements. To achieve this aim it investigates the process in terms of the European Defence Industrial Base on the one hand and international level convergence efforts on the other. It demonstrates drivers of change for the defence industry, namely; the narrowing budgets, changing relationship between state and defence industry, importance of technological achievements, rise of civil sector and internationalization of national defence firms. Regarding the restructuring and consolidation process the thesis examines behavior of firms in terms of merger and/or acquisition... etc activities in order to adopt the Post Cold War transformations. Moreover, due to its significance of being regarded as the first true attempt of creating a transnational defence sector identity the EADS is also investigated. Also it deals with the institutional level of convergence efforts mainly in terms of NATO, EU, WEU/WEAO and OCCAR. To provide a comparative framework, the US defence industry and its impact on the European counterpart is examined.

Keywords: Post-Cold War, European Defence Industry, Restructuring, Convergence

ÖZ

“Soğuk Savaş Sonrası Avrupa Savunma Sanayisi’nin Yeniden Yapılanması ve Konsolidasyonu; Savunma Sanayi, Uluslararası Kurumlar ve Tamamlayıcı Aktörler / Değişkenler”

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Bu çalışma, Soğuk Savaş sonrası dönemin gerekleri çerçevesinde Avrupa Savunma Sanayisi’nin yeniden yapılanma ve konsolidasyon sürecini incelemektedir. Bu nedenle süreç; Avrupa Savunma Sanayisi ve uluslararası düzey çalışmalar boyutunda tartışılmıştır. Sektörü bu değişime zorlayan nedenler; daralan savunma bütçeleri, değişen devlet-sanayi ilişkisi, teknolojik gelişmelerin önemi, sivil sektörün yükselişi ve milli savunma sanayisinin uluslararası alanda aktif hale gelmeleri, başlıkları altında ele alınmıştır. Ayrıca bu süreçte Soğuk Savaş sonrası değişikliklere adaptasyon amacıyla gerçekleşen, şirketlerin birleşme ve/veya satın alma...vb yönünde davranışları araştırılmıştır. İlk gerçek uluslararası savunma sektörü kimliği oluşturma çabasını temsil etmesi açısından, EADS’nin üzerinde durulmuştur. Özellikle NATO, EU, WEU/WEAO ve OCCAR gibi uluslararası kurumlar düzeyindeki yakınlaşma ve uyum sağlama çabaları ortaya konmuştur. Ayrıca, karşılaştırmalı bir yapı sağlanabilmesi amacıyla ABD Savunma Sanayi ve bu ülke sanayisinin, Avrupa Savunma Sanayi üzerindeki etkileri tartışılmıştır.

Anahtar Kelimeler: Soğuk Savaş sonrası, Avrupa Savunma Sanayi, Yeniden Yapılanma, Yakınlaşma

To my parents

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LIST OF ABBREVIATIONS

AHSG	Ad Hoc Study Group
AIC	The Airbus International Company
ARCA	European Armaments, Research and Capabilities Agency
BAe	The British Aerospace Company
BoS	Board of Supervisors
C₄	Command, Control, Communications and Computing Systems
C₄I	C ₄ + Intelligence
CCT	Common Customs Tariff
CEPAs	Common European Priority Areas
CESDP	The Common European Security and Defence Policy
CFIUS	The Committee on Foreign Investment in the United States
CFSP	The Common Foreign and Security Policy
CIS	Common Independent States
COARM	The Working Group on Export of Conventional Arms
COREPER	The Committee of Permanent Representatives
CPD	Coherent Policy Document
DCI	Defence Capabilities Initiative
DDIs	Developing Defence Industries
DGA	The Délégation Générale pour l'Armement
DIB	The Defence Industrial Base
EA	The Executive Administration
EAA	European Armaments Agency
EADC	The European Aeronautics and Defence Company
EADS	The European Aeronautics, Defence and Space Company
EDEM	The European Defence Equipment Market

ESDP	The European Security and Defence Policy
E.P.A.SE.RE.TE	EU Cooperation Programme for Advanced Research and Technology
ERG	European Research Grouping
EU	The European Union
EUCLID	The European Cooperative Long-term Initiative for Defence
EUPM	The European Union Police Mission
FP6	The Sixth Framework Programme
GDP	Gross Domestic Product
GIAT	Groupement Industriel des Armements Terrestres
GNE	Group of National Experts
GPL	Global Project Licence
IEPG	The Independent European Programmes Group
IPRs	Intellectual Property Rights
ISR	Intelligence, Surveillance & Reconnaissance
JSF	Joint Strike Fighter
LoI	Letter of Intent
MEADS	Medium Extended Air Defence System
MDD	McDonnell Douglas
MOD	Ministry of Defence
MOU	Memorandum of Understanding
NATO	The North Atlantic Treaty Organization
NIAG	The NATO Industrial Advisory Group
OCCAR	The Organization for Joint Armaments Cooperation
OSCE	The Organization for Security and Cooperation in Europe
POLARM	The European Armaments Policy Council Working Group
RMA	Revolution in Military Affairs
RDT&E	Research Development Technology and Expenditure
R&D	Research and Development

R&DT	Research and Development Technology
R&T	Research and Technology
Rü-Ak	Rüstungsmitschaftlicher Arbeitskreis
STAR 21	Strategic Aerospace Review for the 21 st Century
WEAG	The Western European Armaments Group
WEAO	The Western European Armaments Organization
WEU	The Western European Union

CHAPTER 1

INTRODUCTION

The Cold War period was mainly structured around ideological and military rivalry of East and West, polarized by United States on the one side and Russian-dominated Soviet Union on the other. With their sphere of influences each of which was fighting against *the other*. The United States was speaking of liberty and democracy; whereas the Soviet Union proclaimed peace and freedom. An extended arms race was characterized by vast quantities of weapons, conventional and nuclear, causing economic burdens and environmental harm to sections of their own citizenry and allies. Military power was used as a tool to divide the world and to broaden influence of in international institutions, which tended to distort political relations throughout the world.

End of Cold War Era had opened the path for a chance to dissolve or transform the military alliances representing the bipolar confrontation. Fundamental changes have transformed the European Security Architecture. Representing institutions of the blocs namely NATO and Warsaw Pact had to redefine their reasons of existence by consequently different ways. Whereas the Warsaw Pact was becoming a part of history, NATO had initiated an alternative structure for European and North Atlantic Security, through reconfiguration of its role and function in the international arena. Hence the end of Cold War altered the relations among members of East and West blocs. The dissolved structure of the Soviet sphere led the former Eastern bloc states to rapproch with West looking for acceptance and identification primarily for the economic benefits, to get help to stabilize fledgling democracies and to distance away from Russia.

In addition to these, *new security challenges* have emerged including the proliferation of weapons of mass destruction, the growth of ethnic nationalism and extremism, international terrorism, crime and drug trafficking due to restructuring of the international coexistence. The multipolar world was now portrayed not as an opportunity for collective security but as an unpredictable destabilized mix of disintegrated economies and over-armed ethnic and regional warlords with ambitions, grudges or religious delusions of divine dominance. Worst-case scenarios involving sub-national actors or state actors and short lived optimistic concept of the initial post-Cold War stage alarmed decision makers of states and international institutions. They had to settle down precautions – effectiveness of which are debatable in terms of consequences and impacts – against for instance an anarchic disintegration of Russian Federation, or growing confidence of China or Islamic fundamentalism. North Korea, Iraq, Iran, Libya were all viewed as potential proliferators or supporters of terrorism. It was, of course important to be prepared for the worst however proposed defences and responses should have to be appropriate in approach and magnitude to the risks and threats. Domestic or international, economic or military interests had to be redesigned in accordance with those added threat perceptions.

As a strategic actor of the new security architecture, the European defence industry has inevitably influenced from all these new challenges and conditions of the Post Cold War Era. Moreover, the new environment has clearly changed the basis of European military planning requirements. Consequently in just over a decade this sector has gone into a drastic restructuring and consolidation process along with all necessary political support at the national or supra national level. How this happened is a story of political and economic requirements combined with existence of various actors.

The defence industry has a divergent characteristic among other industries. Because of the nature of its actors and products it is influenced not only by economic and commercial factors but also political and national security considerations. For many countries with heavy operating industries, it has a strategic importance due to its major role in national security and international affairs. Their exclusive presence is reflected in their sensitive relationship with their national governments.

Governmental support and policies influence operation strategies of defence companies in two ways; for public owned companies, state decisions have always been significant since national governments have been the sole authority that determine both supply and demand amounts of the defence market, acting as a producer and as a customer at the same time. For private companies, due to states' status as a customer, governmental demands determine the variety of products and in return have direct influence on the know-how structure and development of production capabilities of the company. Moreover, as the enforcer of law and regulator of the market conditions, governments have direct affects on decisions of the defence companies that operate within this framework.

In accordance with such an obvious relationship, defence industries have always been considered as strategically important 'national industries'. Until the end of Cold War era there was a relation between states and national defence industries, lines of which was drawn in accordance with the sole task of the industry; meeting the requirements of national armed forces. Hence during the Cold War period,

...the military sector...the military-technological style...military resources were tightly controlled by the state and defence industrial sector remained largely national.¹

¹ Cited in Jocelyn Mawdsley, 'The European Union, the State and Multinational Defence Firms: The Emerging European Political Economy of Defence and ESDP" paper prepared for

However, completely changing conditions of the Post Cold War Era has drastically transformed this relationship. It brought a new commercial dimension to that symbiotic web of interactions. With the new world order, changing political, economic, financial and technological dynamics have gradually altered the characteristics of coexistence through a standard form of business. Where as governments started to act as 'real' customers, defence companies obliged to adopt market economy and to go into a process of rationalization followed by restructuring and consolidation. Throughout Europe and United States this process in time has extended beyond national borders converting project based international cooperations into real transnational integration. At the same time in order to contribute to this inevitable process, necessary political background has been tried to be established through efforts of regulation and/or harmonization of procedures by both governments and international institutions at different levels.

Within this work the analysis is intended to be made on a structural base covering all actors, dynamics and variables of the European defence industrial issues, that have been playing roles in the restructuring and consolidation process of the European defence industry since the end of Cold War. Since, as in the words of John Lovering, quoted in Lungu;

The restructuring of the European [defense] industry is far from being a simple pro rata adjustment of supply to changes in demands arising from objective changes in the security environment. It is inextricably bound up with the development of institutions, policy paradigms (in both the military and the industrial domains), business networks, and relationships between companies and governments²

Within this respect, this work investigates the influence of the factors and actors of the process. Moreover political, industrial, economic and

the British International Studies Association Annual Conference, London School of Economics, 16 – 18 December 2002, p 2.

² Sorin Lungu, "European Defense Market Integration: The Aerospace Sector Between 1987 and 1999", PhD dissertation.

technological circumstances that enabled certain actors to bring about the consolidation will be touched upon. Thus, the structure of the work has been established with the aim of giving an answer to some questions, results of which have been hoped to provide an overall framework that would demonstrate the process of *“European Defence Industrial Restructuring and Consolidation in the Post-Cold War Era: Defence Industrial Base, International Institutions and Complementary Actors/Variables “*.

Initially the following questions were asked to draw the lines of the research;

- What were the general characteristics of the Cold War Era? In what ways and how these changed, consequently establishing the Post-Cold War Era security configuration?
- How the change in the high politics spread to the other dimensions of the non-traditional conceptualizations of international security, in particular how the relationship among economics-power-security reconfigured? Significantly in what ways international institutions adopted their reasons of existence and co-existence into this new architecture?
- What were the variables that brought about transformation to the European defence industry (being the targeted subject of this work). Because in accordance with the Post-Cold War Era transformation process, there must have been various factors affected from general re-composition of the international affairs and in return affected the defence industry in particular.
- As a respond to the pressures coming from various dimensions how the European defence industry reacted? What solutions were initiated

within the industry by the industry itself in order to survive in this increasingly shrinking highly competitive market?

- What were the solutions of the political elites? In what ways national governments and international institutions initiated the process of restructuring, consolidation and convergence in terms of regulatory framework?

- Although being out of the scope of this work, it was important to provide a framework of the US market, with respect to its influence on European defence industrial base. How the transformative effects of Post-Cold War Era were felt in the defence industries of US? In what ways it's restructuring and consolidation affected Europe? What was the result of convergence between two defence industrial bases on two sides of the Atlantic?

- And consequently, what is the recent balance of the defence and military expenditures as being the source of demand side of the defence industrial base?

At the second phase of the work, data collecting has been done in accordance with these questions. And chapters of the work has been designed with respect to this scope,

- In order to be able to mention about old/new security architecture, it's important to put forward the elements that constitute this structure. With respect to this objective it is critical to illustrate whether there exists any difference between Cold War and Post-Cold War security architectures.

The first chapter explains the most striking characteristics of international environments of Cold War and Post-Cold War Eras. The discussion starts with the different threat perceptions of the periods and structures around variables that are conditioned in accordance with this understanding of international affairs.

As for the Cold War Era, the East-West confrontation is assumed as the center of the discussions. Within this respect, western security community and mutual interdependence of European states against a common threat is discussed. Moreover, emphasis has been put on US dominance over a war thorn Europe and NATO has been treated as the core institution of defending values of western community and symbol of transatlantic alliance.

In terms of the determinants of the Post-Cold War Era, evaporation of the fear of 'the other' has been the source of change. Transformation process has begun within all aspects of national and international affairs. Initial objective has been preservation of the western security community along with getting used to live with dismantled Warsaw Pact countries. However, transition phase has not been as smooth as was hoped for. Now there were new security challenges aroused in terms of self determination that erupted with the redrawing of maps. Moreover, the chapter deals with the changing nature of balance of power politics, security regimes and challenged role of states with the raising emergence of new actors in the international security arena.

- The second question, following the illustration of the beginning of a transition phase, should be apart from politics what were reactions of the other actors, namely international institutions together with the rise of non-traditional conceptualizations of international security?

The second chapter 'Transformation only in politics?' demonstrates the skeptical approach that intends to show influence of new security architecture of the Post Cold War Era in other aspects of international affairs. Within this respects it deals with international institutions – in particular NATO, EU and OSCE - summarizing their adjustment efforts and their new roles within this environment. In doing so it perceives the changing threat perceptions as the starting point and reviews reasons of presence of these core institutions. Their policy changes and cooperation attempts to respond new security challenges are also dealt generally. Secondly, rising importance of economic factors are discussed in accordance with the revitalizing market forces. The mutual relationship between security and economics is discussed in order to provide the necessary ground for demonstration of the importance of financial facts in the defence industrial issues. In addition to these, economic factors are related to security not only as challenges to national security issues and agendas but also as being instruments in the conduct of security vis-à-vis other states. It is argued that economic prosperity is one of the factors that bring power together with security and stability to societies.

- However, the relatively flourishing economies of European countries had to be conducted in accordance with the post-Cold War security environment. Since the major reason for the heavy functioning of the defence industry had been eliminated, it was time for to direct resources of the economy to much more effective channels that would contribute to development of states. Moreover, it was time for the industry to return market force realms which would in return re-shape state – industry relationship. Moreover, what were other variables that pushed the defence industry to go into a restructuring process?

The third chapter examines dynamics of change that pushed the industry to take measures and make adoptions necessary in accordance with the configuration of the end of Cold War. Within the chapter, the falling national

defence budgets in real terms as a result of disarmament policies in accordance with changing threat perceptions following the end of Cold War are discussed as the most striking of the elements that forced the restructuring of the industry. This downward trend is accepted as normal consequence of changing nature of security architecture reflecting peace dividends. Also the convergence criteria of the Maastricht Treaty, in particular the three per cent of GDP upper limit of defence expenditures on public deficits is counted as one of the factors that led to change in national defence expenditure budgets. The shrinking defence expenditures have been demonstrated as reasons of increases in the R&D costs of the weapons systems. Consequently not only leading to delays of the projects and spreading the work over time but also simultaneously to reductions in the amount of the procurement programmes. Hence such policies in turn resulted in a contradiction of firm's behavior and rise in unit production costs. Although the discussion is not taken to further from that point, it achieves the aim of the section to demonstrate the significance of narrowing defence budgets in restructuring decisions of defence firms.

As long as the market forces started to prevail, it was inevitable for the actors of that structure to behave accordingly. Hence, it was time for national governments to review their policies and adjust their behaviour in accordance with their titles within the market; a customer, a supervisor or a regulator. Thus, it was time for redefinition of state-industry relationship regarding to a highly sensitive issue of national defence.

As being another variable that brings about change, the development of technology is discussed in terms of impetus it gives to the sector with regards to pushing it to be increasingly global and commercial in character. Since technological developments and R&D capabilities constitute the core sector of any defence related industry it is significant for any government and company to maintain an exclusive control and not to create a technology gap

with its competitors. In this respect a stronger and more coordinated European investment in defence related RD&T would provide necessary means to eliminate gaps and contribute to competitiveness of companies in defence industrial cooperation as well as improving interoperability within alliances. Moreover, at this point increasing efficiency of civil industry and dual-use is not underestimated, which brought integration of both civil and military industries. Thus, predictable result has been as the internationalization of the national industries that were squeezed within the ambitions and capabilities of their national markets.

- European governments have reflected their changing threat perceptions on their security and defence policies. Disappearance of possibility of hot conflicts that would lead to hot contacts, have resulted with gradual decrease of the significance of defence related industries. Hence, restructuring of these sectors, which were once designed in accordance with the conditions of war environment, was required.

The fourth chapter deals with the restructuring and consolidation of the European defence industrial base. For this aim the emphasis is put on the most important defence firms of the European states. The European defence industrial base that is structured around BAe from the United Kingdom, Aerospatiale from France, DASA from Germany, CASA from Spain, GEC Marconi from Italy...etc is taken under focus. Basically, attitude of these national giants in terms of restructuring and consolidation is examined. Particularly, the process of establishment of European Aeronautics Defence and Space Company (EADS) is given importance due to its significance in constitution of convergence of defence industries at European level. Drivers behind the process and objectives of the industry on the path from program based cooperation to structural partnerships are inquired. Generally, the process that led to emergence of the new landscape of the European

defence industrial base that is structured around three giants of BAE Systems, EADS and Thales, is tried to be evaluated.

- It was important to set the appropriate political and regulatory ground for the well functioning of the defence firms in harmony. Moreover, it was significant to harmonize regulations and eliminate restrictions in front of the greater international cooperation and gradual integration of the firms. Now, the task had to be carried out by the national governments and international institutions

Main scope of the fifth chapter is to examine convergence efforts at the regulatory levels that would give political velocity to the restructuring process of European defence industrial base. It deals with the implications and consequences of the industrial restructuring and consolidation process of the European defence industry for the national governments and supra national level. The emphasis is put on their efforts of convergence to respond the challenges of the process on the one side, and not to be isolated from the structure on the other. Critical and appreciated economic and political roles of international institutions and multilateral arrangements will be explained in a process that contributed to the establishment of regulatory framework and harmonization of procedures for the restructuring of European defence industry. Hence, international institutions, particularly NATO, EU and WEU are given importance in this evolution and are examined in terms of their responds and contributions to restructuring of the European defence industrial base. Moreover, WEAO, OCCAR and Lol processes are debated in terms of their contributions to the regulatory framework of the defence market and significant influences in provision of opportunities for governments and companies

- The US has always been an important factor in all aspects of international affairs. Strong diplomatic relations and common interests have produced similar outcomes for the actors of the two allies. Also they have affected each other mutually and implications of any process could have been result or consequence of another.

The sixth chapter looks at the US defence industry in brief in order to give an idea about the counterpart of the European defence industry. Also it emphasizes the influence of this relationship as both rivals and partners in the evolution of transatlantic cooperation and possible integration.

- The share of military expenditure in national budgets has a strong influence on strategic planning of defence companies. Variety and amounts of the products, procurement budgets and areas of interests are organized in accordance with the demand coming from the customers of the companies. Hence recent trends in the military expenditures and government policies on security and defence issues may give an idea about the future trend of the defence industrial bases.

With respect to this scope, the seventh chapter provides arithmetic information on the recent conditions of the defence expenditure budgets making comparisons among European countries and US.

However, differences in national perceptions of defence expenditure, changing budget accounting applications, micro and macro economic effects; such as currency fluctuations, inflation have all made measurement of defence spending a difficult issue. Hence any comparison or aggregation of defence related economic data would reflect a degree of distortion. In order to minimize the risk of gathering wrong or misinterpreted data, within this work and particularly in this chapter the widely accepted references for

defence economic data, such as *The Military Balance (International Institute for Strategic Studies)* and *the SIPRI Yearbook* are used.

Consequently, the initial aim of providing a step by step integrated examination of the European defence industrial restructuring and consolidation in the Post-Cold War Era is tried to be realized.

CHAPTER 2

SECURITY DETERMINANTS AND RISE OF LOW POLITICS

2.1. The Cold War Era

During the Cold War Era, opposing alliances and fear of nuclear threat were the main features of Cold War European security. The bipolar structure of the era from the Western perspective was supposed to be relatively an ordered and more predictable one. In the words of Lord Ismay's³ often quoted observation, it was a security structure that served *to keep the Russians out, the Americans in, and the Germans down*. It was these three factors that drove European security and prosperity in the post war era.

The western security community, which evolved gradually as a counter-product of Cold war era against the so-called Soviet threat consisted of two inseparable elements in common both of which shared the values of mutual security and cooperation. The *Transatlantic link* and *Western Europe* constituted the components of this community. While the Transatlantic link mainly reflected the US strategic culture, the other part; Western Europe itself was product of (i) western European states, which were members of NATO and formed the *European Pillar* and (ii) non-NATO members, which were not organic part of the Atlantic community but on the other hand had economic and political ties and interactions with the western security community.

³ Lord Ismay, (1887-1965) NATO's first secretary general. He was educated in the United Kingdom and later served as deputy secretary to the British War Cabinet during World War II. He was appointed to the post in NATO on March 13, 1952 and took up office both as Secretary General of the Organization and as Vice-Chairman of the North Atlantic Council on April 4, 1952, the third anniversary of the signing of the North Atlantic Treaty. He retired from his post as Secretary General in May 1957.

The European pillar of the western security community, which was absolutely dependent on the very existence of NATO, was surely the most important factor that shaped the cooperation of the community in security and defence matters. Hence its “common experience of being sandwiched between the superpowers”⁴ gave way to development of common understanding of security interests through cooperation on security matters and accumulation of shared experiences. Accordingly the European Pillar had one clear-cut purpose: the emergence of a *European Voice*.

Since the Western Europe came out as a political entity, under the shadow of NATO, its security interests were shaped through the impacts of US and Soviet policies, which made a *super-power squeeze* to the context and application of security matters. Hence, the term *European Security* turned out to reflect a common understanding of western security interests, creating a *security regime* through the emergence of certain order brought about by the mutual interdependence between those Western European states. The accepted understanding of the western security community was the promotion of their security, depending on the mutual cooperation, which was seen as could not be provided by expansionist policies and by the individualistic efforts of each country. Accordingly since 1990, the European security architecture has started to be built upon the foundations and structures of the western security community, which was an inherited body of the Cold War period.

2.2. The Post-Cold War Era

Since the end of Cold War and with the dismantling of the divisions between the East and the West as an ideological, political and military conflict and as a bipolar structure, the international system has entered a transition phase,

⁴ Gülnur AYBET, *A European Security Architecture after the Cold War Questions of Legitimacy* (London: The Macmillan Press, 2000) p.20.

where change would be an integral aspect of the political dynamics and the structural development. The post Cold War rearrangement has constituted a complex political development in contrast to aftermath settlements of the most of the major wars, which were “once-for-all or a definite settlement”⁵

When compared to that of pre-post Cold War era the context and tools of European security had significant differences. The end of bipolar structure, which symbolized by the dismantling of the Warsaw Pact with its all effects and failure of authoritarianism in Eastern Europe led Western Europe to appear as being “more assertive and cohesive”⁶ When one look at the transition of the European security architecture in accordance with the post-Cold War era, one can see that the main target has been the preservation of the western security community inherited from the Cold War and its promotion beyond its Cold War structure, covering the gradual absorption of the post-communist states in its institutions and practices. This objective with its two different issues constituted the starting point of western security community’s agenda for dealing with post-Cold war era security requirements in the continent.

Regarding to that it was not a surprise that the redrawing of maps since the end of Cold War due to the collapse of Soviet Union led the emergence of new countries and brought expected inevitable issues to the agenda with the re-emergence of old ethnic rivalries and concerns for national self-determination. The problem showed itself out as “*nationalism and irredentism*”⁷. This time the Cold War concern about conflict between states has been re-defined as security concerns threatening the domestic stability of

⁵ Michael R Lucas (ed.) The CSCE in the 1990s: Constructing European Security and Cooperation (Germany, 1993) p.1.

⁶ Simon Duke, The New European Security Disorder (UK: The Macmillan Press, 1994) p.204.

⁷ Ibid., p.57

those numerous economically and politically vulnerable states, which might easily spill over the borders. However it was a confusing kind of self-determination, since none of the nations of the European continent could be evaluated as homogeneous in a racial, religious or even linguistic sense. On the other hand there occurred a process of reinventing and refilling of the term nation state in terms of Eastern European realms depending on demands and rights of certain minorities. Those proposed privileges were often based on racial, religious and linguistic factors, instead of being based on the concepts of popular sovereignty and democracy, which cannot be renounced on the behalf of nation state. Also there were some other issues requiring urgent solutions like; the Turkish minority, which is suppressed by the government of Bulgaria, the problems of Romania with its Hungarian minority and its claims to Moldavia, moreover issues of the Albanian majority and Serbian minority in Kosovo and Croatian and Serbian separatism to the north. Those problems coincided with and grew bigger with the collapse of economies of Common Independent States (CIS), political instability and the ambiguous role of the military. On the other hand the persistence of intrastate conflicts and their strong resistance to quick solutions was proved by the continuation of for instance Israeli-Palestinian conflicts, Burundi, Cote d'Ivoire, Indonesia, Liberia and Sudan (Darfur). Institutions or other outside actors are not able to enforce any solution as is case in Afghanistan, Iraq or Sri Lanka. For many authors only a sustained and comprehensive external engagement may be effective as a solution. External assistance, mediation and support should be provided to bring parties to the table and end conflicts.

During the fourteen years Post Cold War period there have been fifty-nine different major armed conflicts in forty-eight different locations. Except for 1997 (with eighteen occurrences), the number of major armed conflicts in 2003 has been the lowest for the entire period. According to data gathered from SIPRI Yearbook 2004, there were nineteen major armed conflicts in eighteen different locations during 2003. Compared to 2002, the number of

armed conflicts and the number of conflict locations were lower. In 2003 there were two interstate conflicts; the one between Iraq and the multinational coalition and the conflict between India and Pakistan

Table 1

Locations of the 19 major armed conflicts in 2003

Africa	Asia
Algeria	India* (Kashmir)
Burundi	India – Pakistan*
Liberia*	Indonesia*
Sudan	Myanmar (Burma)
	Nepal*
America	Philippines (2 conflicts)
Colombia	Sri Lanka
Peru	
USA	Middle East
	Iraq*
Europe	Israel
Russia	Turkey

* Conflicts each caused 1000 or more deaths. The conflict in USA refers to that between the al-Qaeda and the USA and its coalition partners. The new conflicts registered for 2003 were those in Iraq, Liberia and Sudan.

Source: SIPRI Yearbook 2004

Although theoretical views of change is out of the scope of this paper I would like to mention something about the theoretical concepts of security that characterize the quality of transformations of the post-Cold War era. From the theoretical perspective three concepts were distinguished in the analysis of security all of which were attributed to explain the transformations of the European Security Architecture after the end of Cold War; - balance of power, - security regimes, - security communities.

In terms of balance of power it have been expected that the end of bipolarity would led to a kind of isolationism of the United States in the absence of a single threat in the forms of Soviet Union and dissolution of the NATO and the reconstitution of balancing behaviour in Europe. However, the transformation phase did not take place as was perceived. Not only NATO has survived but also expanded its both functional and geographical scope. In addition to that governments of Europe and United States have strengthened their relations of security through institutional arrangements instead of reverting their balance of behavior into a competitive one.

Stephen Krasner describes regimes as “sets of implicit or explicit principles, norm, rules and decision-making procedures around which actors’ expectations converge in a given area of international relations”⁸ Within multipolar type systems security regimes foster stability since states care about peace and cooperation. Even if the international composition transforms, as happened with the end of the Cold War, security regimes continue their presences because of the expectation of actors that they would do so. Thus, the concept explains why NATO; the first accepted security regime emerged in Europe after the end of World War II, has not been dismantled. Re-institutionalization efforts not only proved the interest of governments in its continuation but also the United States had played a crucial role in its survival by efforts of extending its functional operations and number of membership.

Within a pluralistic security community there are region of states whose citizens maintain dependable expectations of peaceful change. Krahhman in her article defines three factors facilitating security communities by quoting from Adler and Barnett’s article of ‘A framework for the Study of Security

⁸ Stephen D. Krasner, “Structural Causes and Regime Consequences: Regimes as Intervening Variables”, in International Regimes, Ithaca, MA; Cornell University press, 1983, p.2.

Communities' each of which build upon another; "(i) precipitating conditions, such as changes in technology, demography, economics, the new interpretation of social relations and external threats, (ii) factors conducive to mutual trust and the development of a collective identity, such as transactions, organizations and social learning, and (iii) necessary conditions, such as mutual trust and collective identity."⁹ When related with the European security architecture of the Post-Cold War era the concept proposes that due to enhanced relations that have developed among West European states since the end of Second World War, Europe did not revert to competitive balancing behaviour.

The key understanding of those three concepts, balance of power, security regimes and security communities lies in that they tend to decrease security to the absence of war and take the states as the key, but not the only, actors in security. Thus, looking at the roles states are playing in the newly emerging structure of the international arena the perception of those concepts cannot be ignored.

2.3. Transformation Only in Politics?

2.3.1. Institutional perspective

The western security architecture of the post Cold War Era has structured through a set of *interlocking institutions*, which constituted its *modus operandi*. The 'structure' in this sense has occurred as sum of political and economic weight of *European Union (EU)*, the experience of *Western European Union (WEU)* as the exclusive security and defence forum of the Cold War period for the Western European countries, the early warning, conflict-prevention and mediation facilities of the *Organization for Security*

⁹ Elke Krahnemann, "The Emergence of Security Governance in Post-Cold War Europe", ESRC "One Europe or Several ?" Programme Working Papers, No: 36/1, 2001, p.4.

and Cooperation in Europe (OSCE), and the military and intelligence capabilities of *The North Atlantic Treaty Organization (NATO)*.

Although those institutions were sharing common establishment purposes, and foundations of which lay on the belief 'us against them', with the end of bipolar settlement and understanding of the Cold War Era the division of functions among all turned out to be far from clear-cut. It became a big question mark what the European Security Architecture was supposed to do in the shape of interlocking institutions. In other words there appeared confusion at the institutional level about which institution, or institutions, should represent European security concerns reaching a big ambiguity. Hence there emerged the need to re-define (i) the European security concerns of the post-Cold War Era and (ii) the provision and promotion of those matters for whom and under what terms. This was not a sudden requirement; this was because of the development of major external events in which Western European Community had to be involved in a way and accordingly had to re-shape its requirements and priorities for the European security. The collapse of the Soviet Union (December 1991), the out break of war in former Yugoslavia and the Gulf War took place during the same year, when the very foundations of the European security architecture for the post-Cold War era were being drafted on the paper: 1991 was the year of NATO's strategic review, the Maastricht Treaty of European Union and the preparations of the Helsinki summit of the CSCE.

However as Rühle and Williams argue in their article *Better Than It Sounds; Europe's Invisible Security Architecture* with the new phase, the optimism of the early 1990's, when the Charter of Paris structured a new security architecture for a new Europe has disappeared and the concept and spirit of *interlocking institutions* – the key term of the early post-cold war era – is now

turned out to be “interlocking”¹⁰ To demonstrate such an idea authors defend that European institutions had failed in Yugoslav conflict and NATO has undisputedly pushed itself into the center of European security thus subordinating the new European security architecture to the primacy of military security instead of which was supposed to be based on a balanced evolution of political, economic, and military means. The new European security architecture now rests less on the meaning and initial spirit of interlocking institutions which presumed a convergence of institutions, but rather on political processes. This would have a significant influence on the character and the long run evolution of security structure of Europe. These key political processes are well-known ones: the transatlantic partnership, the European integration process and inclusive security cooperation spanning the entire Euro-Atlantic area in frames of which European institutions have acting part. In other words all three processes are reflected across the spectrum of the major institutions, which in turn are being shaped by the same dynamics. Each institution made structuring decision to define itself in the new architecture

With the notion of collective security NATO provided an affordable answer to defence needs during the Cold War. However, in the twenty-first century, the capabilities required are more complex and difficult to define. NATO has committed itself to develop a strategy of security cooperation. For the entire Euro-Atlantic space the alliance has created a framework for military cooperation through the *Partnership for Peace Program* and the *Euro-Atlantic Partnership Council*. This inclusive approach is agreed to be remain unchanged even after enlargement steps of NATO by which the special role of Russia and Ukraine is being taken into account by privileged bilateral partnerships. Also states across Mediterranean are under focus.

¹⁰ Michael Rühle and Nick Williams, “Better Than It Sounds : Europe’s Invisible Security Architecture”, *Comparative Strategy*, 17, 1998, p.121

With such re-structuring of NATO command structure and close cooperation with the Western European Union, ambitions of the allies to develop a European security and defense identity are being met. It will without doubt continue to be the primary interests of all Europeans that NATO should remain viable and also the United States should remain engaged on the other side of the Atlantic. On the other hand, Europe will always be an area of special concern and strategic partner of choice for the United States.

European – United States and intra-European disunity during the Iraq war was made up by efforts of rebuilding consensus between Europe and United States and among European states. Those efforts resulted in major adaptations of both European Union and NATO; -mainly, enlargement of both institutions and NATO's transformation away from territorial defence- to new global challenges.

For the factors shaping European Union are as much as same with NATO. European Union is committed to its enlargement process and has special frameworks for Russia and Ukraine. It has a growing interest in Mediterranean dimension. Also in terms of transatlantic dimension European Union has an approach to broaden its relationship with the United States through a joint action plan agreed in 1995.

On the other hand a major move of European Union towards CESDP was agreed at the European Council meeting at Helsinki in December 1999 with the agreement to create an EU rapid reaction force by 2003, which aimed to provide a European military capability for the conflict prevention, crisis management, peace-making and peace-keeping operations of Petersberg tasks. During 2002 in accordance with the headline goal of 1999 Helsinki which aimed to make European Security and Defence Policy (ESDP) fully operational, member states of the European Union made progress towards enabling the European Union to carry out its Petersberg tasks by the end of

2003, which would be composed of 50.000-60.000 troops able to be deployed within 60 days and sustained for at least one year. Operations in Bosnia (1995), Kosovo (1999) and UN-led missions of Burundi, east Timor, Rwanda (1993), Sierra Leone and Somalia might be past examples of possible missions for the new EU rapid reaction force.

The European Convention (February 2002) gave way to European Union member states and also to prospective member states to discuss and produce ideas of security and defence issues that expand the original headline target of 1999 Helsinki. Within this context two initiatives appeared to be related with the structuring of the ESDP in such a new strategic architecture; - *the principle of solidarity* and - *the enhanced cooperation*, which in common aimed to provide more ambitious material or theoretical advances by groups of alike thinking states. However, from another point of view the initiative of enhanced cooperation “aimed at moving away from the requirement for unanimity in security and defence matters, would help to make EU responses more flexible and efficient, but would also run the risk of creating political divisions within the Union”¹¹ In accordance with such developments, once more it becomes evident that European Union needs to re-define its interests in the sphere of its foreign, security and defence policy.

Since under the Petersberg tasks, collective defense against an external aggression remains exclusive to NATO, the rapid reaction force of EU could be used as a way to harmonize and standardize the equipment requirements, which in turn would lead to new demands for defence equipment as the EU notices gaps of its ability to undertake the Petersberg Tasks. The bureaucratic problems over European Union access to NATO assets have been overcome by the end of 2002. However, for crisis management tasks of

¹¹ Reneta Dwan and Zdzislaw Lachowski, “The Military and Security Dimensions of the European Union”, SIPRI Yearbook 2003, Chapter summary, (Oxford: Oxford University Press).

2002, EU forces were not deployed. On the other hand “in the civilian field the European Union made remarkable progress, crowned with the launch of the *European Union Police Mission (EUPM)* in Bosnia and Herzegovina on 1 January 2003”¹²

In terms of peace missions, fourteen multilateral peace missions were launched in 2003, which is the highest number of new missions initiated within a single year since the end of Cold War.

On the side of national level except for France and United Kingdom prospects for drastic increases in military expenditure were low. However other solutions to the problem of capacity deficits and /or using current resources much more efficiently were being reconsidered and pursued. With the *European Capabilities Plan* rationalization, flexibility and coordination in member states’ efforts were supported in the run-up to the *European Conference on Military Capabilities* in May 2003. Also the idea of creating an intergovernmental defence capability development body, which may in the long run turn out to be a common procurement programme was being supported by governments of France, Germany and the United Kingdom. Such a solution would lift long-standing European Union ban on using European Union financial resources for defence purposes.

In terms of the developments, for that time, the adoption of EU Constitution is proved to be impossible. However, it can be argued that the operational and conceptual foundations of the European Security and Defence Policy were strengthened by several steps taken including the adoption of European Union’s first Security Strategy.

¹² Reneta Dwan and Zdzislaw Lachowski, “The Military and Security Dimensions of the European Union”, *SIPRI Yearbook 2003*, Summary of Chapter 6, (Oxford: Oxford University Press)

On the side of the Organization for Security and Cooperation in Europe (OSCE) there is a broadening agenda as well. Although OSCE as an institution never had chance to play a real role of being a leading all-European player in the hierarchy of security institutions attributed to it by early 1990s, as a framework for Euro-Atlantic arms control or for addressing the huge amount of minority problems in Europe, the OSCE remains without an alternative. Moreover, the OSCE is the sole organization having the commitment of being capable of setting standards of security behavior, and of legitimizing peacekeeping missions.

However, many authors mention that no drastic change is likely to happen in the security dimension of the Organization for Security and Cooperation in Europe in the near future.

In accordance with the reformations it turned out to be clear as previous NATO Secretary General Javier Solana once put it, the security structure of Europe “is based less on the hierarchy of institutions but more on the synergy of political process”¹³ In other words it can be said that the quality of European security architecture will be determined by the deepening of entrenched political processes which is called as *invisible side* of the European security architecture by Rühle and Williams. Also according to authors this invisible side has created a visible effect developing participation mechanisms which enable all interested states – not only the major powers - to have place in European stability through partnership initiatives of NATO and OSCE. Within this system it is obvious that the chances for successful pursuit of hegemonic interests or unilateralist behavior are much decreased. In addition to this even neutral states are given the possibility of engaging in joint security missions, without going under any difficult domestic commitments. However, it is thought to be such system is not completed. It

¹³ Michael Rühle and Nick Williams, “Better Than It Sounds : Europe’s Invisible Security Architecture”, Comparative Strategy, 17, 1998, p.122

still has considerable gaps: For instance Russia does not feel itself fully fitted in the new architecture – the political quantum leap of NATO-Russia Founding Act notwithstanding. And also Turkey's European vocation has yet to be fully reflected. However, within the system the benefits, inducements and restraints of participation are too great for any country to stay outside the system. This can be regarded as the real achievement of the *invisible side* of the security architecture.

Such awareness would with no doubt lead to a new resurrection in the defence industry of Europe.

2.3.2. Economics on the Scene

Although, during the Cold War security studies mainly focused on military threats posed by one state or group of states against the political independence and territorial integrity of another state and had only a military-political component, with the beginning of 1990s, non-traditional conceptualizations of international security have gained ground. The changed political-economic architecture of Europe and complementarity of security and economic objectives gave way to new tensions between them. With its new dimensions; social, ethnical, environmental, educational and economic...etc., security agendas of European countries are now turned out to be more complex.

The relationship between economics and security addresses the basic characteristics of the global economy and in return demonstrates how nation-states and security agendas are affected in the international system, moreover how nation states and supra national institutions use their control over economic instruments to achieve political hence security outcomes.

The relationship between economic factors, power and security has always been a central theme in security studies, since for so long the economic capacity has been accepted as one basis for military power. If it is required to evidence such an approach with history, the Peloponnesian War, for example, can be denoted since it was provoked in part by the rising wealth of Athens and the translation of this wealth into potentially hegemonic power. The wars of the mercantilist period in European history were broken out due to a desire to secure exclusive access to key resources (notably precious metals) and markets. Also the era of colonialism likewise was strongly motivated by efforts to broaden access to resources and markets, which in turn, thought to enhance the state's power in its competition with other states in the international system.

However during the last decades; especially Cold War Era and its aftermath, the nature, content and relation of political and economic interactions among nation states and within each society have dramatically changed from time to time. Growing economic interdependencies due to the global world economy have produced significant transformations in the way nation states view their national interests and objectives, and hence the routes and instruments to achieve them.

The economics of security were surrounded to a degree by the advent of nuclear weapons and deterrence during the era of Cold War. The emergence of two major economic power; Germany and Japan, without military pretensions during that period in relative comparison with USA and Russia raised questions about a possible disconnection between economic power and military power. The rising influence of these two states was perceived to depend more on their place in global trade, investment and financial markets than on their military capacities. Did this mean that power was being redefined in terms of influence in world markets rather than position in international military competition? And the end of Cold War and the

disappearance of bipolarity, the apparent decline of US hegemony and the perceptions of a growing economic threat from Asian markets brought economic factors back to the center of analysis of security.

Rising levels of interdependence and the growing size of transnational flows of goods and services added a new dimension to the relationship between economics and security. The growing amounts of transactions across state borders were accompanied by the rise of transnational non-state actors who frequently control more resources than most of the states in which they operate. Hence such a quantitative growth had produced a qualitative change in the international system.

Economic factors are related to security not only as challenges to national security issues and agendas but also they serve as instruments in the conduct of security vis-à-vis other states. In other words where an economy is more developed, prospects for security and stability are much better. This should not be understood as a one-way approach since it is clear that economic development depends on the policies promoted and implemented at national and international levels. It can be noted that security-stability thus can be achieved more easily, if the prosperity spreads to the greatest extent possible over all the members of the society. It is widely accepted that notions of security-stability offer countries a greater capacity to cooperate and be preoccupied by the economic prosperity of their citizens. Cooperation stimulates economic prosperity and decreases the chances of conflict. Perhaps an even more convincing confirmation of the strong link between economics on the one hand and security-stability on the other is provided by the dissolution of the Soviet Union at the end of Cold War and the way countries of Central, Eastern and South-Eastern Europe were tried to be integrated into the community of democratic societies and market economies. In addition to that, analysis of the situation of these countries confirms once more that while economic prosperity is strengthening security, the latter is in

its turn a prerequisite for long-term economic growth. So security and economic prosperity are necessary complements: one cannot exist without the other.

Since the beginning of the 1990s, as an effect of ending threats of bipolarity, European countries have drastically cut their budgets. Echo of such an approach has been reflected as a decrease in the share of defence spending in national GDP's of EU countries. The reduction has been more significant in Europe than in the USA. The end of Cold War gave a rationale for such a reduction in capabilities to balance the budgets of all NATO nations. The net result has been a sustained decline in military capability and sectoral changes over years. Because the purchasing power of defence budgets has a direct effect on capability of defence industries.

CHAPTER 3

DRIVERS OF CHANGE FOR THE DEFENCE INDUSTRY

The end of Cold War has altered all the balances beyond recognition and made a profound break with the realities of the past. The disappearance of the threat of the 'other' and the bi-polarity of the system not only affected the legitimacy of the international structures of the post World War II period but also led to emergence of new security arrangements forming the basis of the European Security and Defence Policy (ESDP). The perception of the security situation was mainly transformed due to collapse of the Soviet empire, fall of Berlin Wall and unification of Germany, the eruption of Gulf War, ethnic conflicts leading to civil war in Yugoslavia and around the old red periphery.

Walker and Gummatt argue for the early 1990s three observations about the political transformations; (i) For the first time since the 1950s political settlements forming the European defence policies were altering due to the tasks of new era, which in turn required rapid political and security integration of the pieces of the structure – governments, institutions, industry – regardless of national concerns. (ii) Policies of shrinking defence expenditures made the industry more fragile in terms of a number of programmes fall, decrease in demand side, stagnation in the market and more seriously leave of companies of the sector, which can not compete under such circumstances. (iii) The reaction of the industry and firms within depended on the ability to handle the changes through taking some measurements varying from rationalization to internationalization.

The new understanding of security structures, perceptions and concepts of the new century did not happen during an eye blink. The transition period has taken long since the need to alter and adjust was imposed on the establishments of relatively predictable period, which were conservative in

nature and unused to change. In accordance with the new environment governments were suddenly felt the pressure of change towards their thinking in military policies, and whole approach to international security.

Based on this, a long listed agenda opened up in each European country, regarding the future scale and structure of the armed forces and Defence Industrial Bases (DIB) in terms of their future roles and positions inside and outside Europe. Thus, the defence sector and its sub-sectors, between the end of Cold War and the present day, have undergone dramatic transformations. The initial drastic effect of the new environment showed off itself on the national defence budgets of European countries as well as the United States with the altering of assumptions of security interests. Many countries have cut their defence budgets considerably followed up by the shaking of the industry's foundations. States, defence firms and all subordinated agencies of the structure had to cope within less predictable domestic and international settings.

When a comparison is made between the US and the European Defence industrial sectors in terms of, it can be observed that although the approaches of most US and European defence companies have a common understanding and are based on survival through dynamics of globalization, the rules associated with responding to the drivers are significantly different. Moreover, the basic approaches being adopted to achieve industry consolidation in the United States and Europe differ.

3.1. Narrowing Budgets

End of Cold War showed that traditional national approaches to defence problems would not provide adequacy for Europe's defence and wider security needs. Although NATO provided an affordable answer to defence needs during the Cold War era, in the twenty-first century, the capabilities required as an answer to problems are more complex and difficult to define.

On the other hand simultaneously the lack of an obvious direct threat has led to severe reductions in the funds used for military expenditures. Nations and institutions have achieved much in the attempt of shifting armed forces from their Cold War posture into new, more dynamic structures.

Although with agreements like Franco-British accord at St. Malo in December 1998 has demonstrated the will of European nations to be provider of international security for themselves and for others, the disarmament following the end of Cold War has resulted in falling national defence budgets in real terms in Europe. According to data gathered from SIPRI Yearbook 1999 “between 1989 and 1998, the defence expenditure of the three ‘big’ Europeans (France, Germany and the United Kingdom) have fallen by, respectively, 12, 24 and 28 per cent”¹⁴

At the same time, the decentralized production of a public good with cross-border spilling effect is supposed to lead to increase of reliability on alliances and made nations to lower defence expenditures and supply. Although citizens would welcome an increase in defence production, this might only be achieved by a centralized production of defence services.

As most of the experts of the subject argue, the shrinking defence expenditures led to increase in the R&D costs of the weapons systems. Theoretically, restrictions on national defence budgets led not only to delays of the projects and spreading the work over time but also simultaneously to reductions in the amount of the procurement programmes. Most of the projects continuing were the ones started to be done before the restructuring of the environment. Such a policy in turn resulted in a contradiction of firm’s behavior and rise in unit production costs. Schmitt in his work uses the news of Le Monde, 21 January 1999 to give examples of such a rise;

¹⁴ Burkard Schmitt, ‘From Cooperation to Integration: Defence and Aerospace Industries in Europe’, Chaillot Paper 40, Institute for Security Studies of Western European Union, Paris, July 2000, p.3

For the NH-90 helicopter...postponements, spreading of work and the lowering of targets resulted in a rise in the unit price of over 40 per cent (from FF90 to 129 million) for the army version and nearly 30 per cent (from FF144 to 184 million) for the naval version¹⁵.

Falling or at best constant defence budgets also have been subject to rising input costs for both capital and labor. "Typically, equipment costs have risen at some 10% per annum in real terms resulting in a long run trend towards smaller numbers of equipment being purchased for the Armed Forces"¹⁶ As a result for example, a Lancaster bomber costed £ 45.000 in 1945 or just under £ 1 million at today's prices. The Tornado bomber, which is the successor of the Lancaster came into service in 1980, carrying a similar bomb load over similar distances, it costed a twenty times of a Lancaster in real terms. A modified and up-dated Tornado would cost another £ 10 million per aircraft. Hence, it can be argued that each generation of weaponry that has been produced would cost more expensive in real terms than the one it replaced.

In similar way labor costs of all-volunteer force for military personnel have risen faster than wage increases in the civilian sector. As a result of falling real defence budgets and rising input costs, policy makers could not avoid the need for determine new defence choices. Out of various options varying from policies of less training, delays in new equipment programmes or continuing efforts to improve efficiency in competition, outsourcing, incentive budgeting or major review of nation's defence commitments, for European nations, another option is to re-examine the efficiency of their current defence arrangements and the opportunities offered by a European defence policy. Also nations may review their military expenditure policies in accordance with the *convergence criteria* of Maastricht Treaty in order to comply with the

¹⁵ Ibid., p.7

¹⁶ Keith Hartley, "The Future of European Defence Policy: An Economic Perspective", Defence and Peace Economics, 14(2), 2003, p.108

three per cent of GDP upper limit on public deficits.¹⁷ The deficit criterion was generally matched by rising taxes and privatizations, while global public spending either remained constant or increased.

Compared with the United States, the total of European defence budgets were much lower, particularly due to different budget priorities. In terms of R&D activities European countries' budgets are less oriented than of the United States to support their national industries. Furthermore, European governments devote less money than the United States to defence related issues. Indeed, according to data for missiles, combat aircraft and military satellites United States provides around three times of European countries do. Although such a gap between United States and Europe is interpreted as "that there is no real European aim in this area"¹⁸, fragmentation in financing capabilities must handle the responsibility. As long as the sectors of land and naval armaments remain national budgetary support would scarcely contribute to funding for R&D whereas due to impact of transeuropean restructuring aerospace and electronics sector follow the opposite logic.

¹⁷ This norm is still in force under the Stability and Growth Pact associated with the European Monetary Union.

¹⁸ G. Adams, C. Cornu and A. D. James, "Between Cooperation and Competition: the Transatlantic Defence Market", Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p. 54.

Table 2

Defence and R&D Budgets of US, EU and NATO countries

YEAR	UNITED STATES		EUROPE (15 EU Countries)			EUROPE (17 NATO Countries)		
	Defence Budget	R&D Budget (1)	Defence Budget	R&D Budget (2)	Ratio (1):(2)	Defence Budget	R&D Budget (3)	Ratio (1):(3)
1995	274,6	36,6	168,9	12,1	3	172,7	12	3
1998	253,4	36,4	143,5	9,5	3,8	150,2	9,5	3,8
1999	252,3	35,3	131,6	9	3,9	140,1	9	3,9

Source: The Military Balance 1999-2000 (Oxford: Oxford University Press for the International Institute for Strategic Studies, 1999), p.37.

3.2. Relationship between State and the Defence Industry

A true examination of state and its national defence industry must start with drawing the lines of that relationship;

...a state that has a defence industrial capability on its territory can by itself develop weapons system. It has greater control over sources of supply for its armed forces and has at its disposal an instrument with which to evaluate its military technological level of its allies and adversaries. Through participation in cooperative projects it can influence international industrial restructuring and decisions on joint procurement. Last but not least, it can use arms exports as a tool in its foreign and trade policy¹⁹

But the most important thing to be aware of must be the 'sovereignty' of the state on its national element in determining its attitude towards it. In most of the countries of the world regardless of their geostrategic positions or differing circumstances states have always been the main determiner of the

¹⁹ Burkard Schmitt 'From Cooperation to Integration: Defence and Aerospace Industries in Europe', Chaillot Paper 40, Institute for Security Studies of Western European Union, Paris, July 2000, p.1

position and capability of the sector. Hence, national policies of the states become a main determinant in strategy planning of defence companies.

Mainly armaments policy constitutes the core of the concept of sovereignty of the nation state: namely its defence. In the absence of necessary weapons to defend the territorial sovereignty, it is argued that a state cannot be truly sovereign. In addition to this the power and pursuit of identity, national interests are accepted as necessary items for the reason of existence of defence industry of a nation state. Those factors combined together make armaments policy predominantly national in nature and closely related to questions of sovereignty.

However until the end of Cold War Era relation between industry and state has followed a more conservative path in which main aim of the sector had been to meet the requirements of the national armed forces, by every mean. Clear definitions of treat perceptions and constant state of conflict possibility with stable balance of demand, made defence firms to function in accordance with the national interests set by states. Changing conditions of the Cold War Era in political, financial, economic, technological terms have restructured the balance between the armaments market and states. The traditional symbiotic relationship between state and companies has replaced by real market economy realms and ambiguity of government and business relation appeared to be a clearer cut partnership. From now on states and firms started to act in accordance with their positions in the market; whereas the state turned out to be a real customer, market forces enabled the companies of the sector to be much more efficient through product concentration and rationalization.

Nevertheless changing nature of the relationship does not demolish the role of the state being as customer, sponsor and to a extend regulator of the sector although it is no longer the major industrial actor. Companies,

operating with less dependent policies challenge the sovereignty of states on them and in many countries with privatization of defence companies governments started to distance themselves from industry where rules of commerce and increased competition prevail. Consequently, relationship between demand and supply sides of the market constitute new forms of partnerships, with clear cut borders between government and business circles. However, it can be argued that analysis of the stages of consolidation and restructuring paths of firms proves that although modified, a national dimension of the market and existence of state direction are still preponderant. This argument will be supported within the next chapters of this work through putting forward the importance of state policies in behavior options of firms in decision-making processes.

Within the literature various forms of state intervention to the industry are identified. Firstly it is noted that a state can intervene with direct subsidies and tariff policies. Through such form of intervention even unprofitable firms can be maintained on behalf of national interest. Secondly, governments may use a discriminatory taxation to favour strategic industry. Thirdly, export subsidies can be used to make national programmes more viable through economies of scale. Fourthly, for security of supply chain preferential procurement may be used in terms of procuring military equipment from national manufacturers. Fifthly, strategy of state ownership may be used. Finally, state may support the education and research to maintain technological development. Those modes of state intervention have been used by European states at various times and in various combinations to support and maintain national defence industries. For example as in an analysis made by Walker and Gummett, by the beginnings of 1990s France and Britain have constituted two poles of the state-industry relationships. While one of which was trying, even not always succeeding, to preserve a distance between industry and state, the other was in an interweaving relationship. Mawdsley argues that these varying paths of traditional

relationships of European governments had resulted in an incoherent European market.

Legislation, on the other hand, is the main issue that determines the relationship between states and the market. It can either be imposed through national practices or can be applied by a supranational body. Considering Europe besides national implementations, European Union legislation determines the structure of market mainly in terms of the commerce and is enacted by the by the bodies of the organization in its areas of competence.

In terms of the national legislations of European countries, heterogeneity comes to surface and create obstacles mainly during internationalization efforts of the firms through partnerships on temporary programmes or constitution of permanent bodies through joint ventures or marriages. On the process of setting up of a European Aerospace and Defence Company (EADC, 9 December 1997)²⁰ four partners from four different nations (Aerospatiale – France, BAe – United Kingdom, CASA – Spain, DASA – Germany) of the Airbus consortium experienced the disparity of the regulations.

Details of the national legislations are out of the scope of this work. However, some regulatory applications will be touched upon briefly in order to give an idea about the differences of the area. Due to this will, I would like to examine few of European countries and their legislative differences in terms of restrictions on foreign investments since the practice is important for the process of internationalization. For Walker and Gummet “the extent of public ownership, conceptions of industrial policy, the prevalence of fixed-price or cost-plus contracts, the differing social and educational background of decision-makers, the amount of traffic through the ‘revolving door’ (the

²⁰ See, below for the comprehensive evaluation of the European Aerospace and Defence Company.

recruiting of former civilian or military defence ministry employees by industry”²¹ are all denominators of bureaucratic perceptions that have affected European countries over long years.

Literature on the subject distinguishes two groups of countries. In the first group of countries, there is no regulation in theory however, the practice is still interventionist. In German national legislation, there is no specific legal constraint on penetration of national companies into international markets through foreign acquisitions. Likely, Italy does not impose special arrangements for controlling defence industrial agreements. On the other hand there is no strong procurement agency in Italy; instead issues are mainly dealt by individual armed services. Also, so called conservative, the United Kingdom has no specific regulation under ordinary law, concerning international transactions of its market actors. Regarding Germany as being the third largest defence industrial power in Europe, while there is less scope for a defence industrial policy within a liberal economy, the Rüstungsmitschaftlicher Arbeitskreis (Rü-AK), is used as a private forum bringing together senior officials from defence ministry and the chief executives of the major arms firms on a regular basis. It is argued that the industry is generally acting on government consent; during the acquisition negotiations of BAe with STN Atlas in 1998, the authorities implicitly put forward their discomfort about the possible negative consequences regarding access to the German market of a foreign majority holding STN Atlas.²²

Moreover, interventionism in the industrial restructuring of European defence market not only covers state policies but also interests of shareholders. And objectives of these two groups may from time to time differ and/or clash.

²¹ William walker and Philip Gummett, ‘Nationalism, Internationalism and the European Defence Market’, Chaillot Paper 9, Institute for Security Studies of Western European Union, September 1993, p.12.

²² At the end of negotiations BAe could only acquired %49 share in STN Atlas.

Thus, when BAe acquired GEC in January 1999, it was interpreted in four different ways; formation of a Fortress²³ United Kingdom, refusal of an alliance with another European company, acting in favor of shareholders of GEC and a rejection of penetration possibility of an American company into the market.

Specifically in Britain, the Procurement Executive of the Ministry of Defence carries the procurement responsibility. However, lack of centralized authority within its body it does not consist of professional armaments staff, but rather a body of technical and generalist civilian officials and military officers. The key role is played by the Defence Staff being the customer in real sense. Regarding the decision making structure of the industry, private firms dominate the sector.

The second group is involved of countries, in which internationalization of the commerce is regulated by specific body of rules. In France, as one of those countries, there is very restrictive law structure requiring authorization of Ministry of Economy and Finances for any foreign interaction of firms, which has to be limited to %20 of the company's capital as a rule. There is a close relation between state and industry in addition to that the most powerful armaments agencies are operating in France. The Délégation Générale pour l'Armement (DGA) is one of the most powerful elements of the French state influence of which mainly arises from its industrial responsibilities; - supervision of nationalized defence companies of Aérospatiale and Thomson-CSF, - managing production facilities like tank and armaments manufacturing group Groupement Industriel des Armements Terrestres

²³ Here the term 'Fortress' is used as explained by G. Adams, C. Cornu and A. D. James, in "Between Cooperation and Competition: the Transatlantic Defence Market", Chaillot Paper 44, p.51; A fortress is on the one hand a particularly important position which, in order to be impregnable, is protected by various defensive and offensive deterrent devices. On the other hand, a fortress is one of the components of a sphere of influence, which it helps to control and reinforce by various means, including its ability to project forces beyond that zone.

(GIAT)²⁴ In terms of employees in France only around 40 per cent of armaments workers are working in private firms.

On the other side of the continent, in Sweden, total government permission is obligatory for any armaments company and also in Spain government approval is required for any foreign investments in a Spanish defence company.

In terms of export regulations, each of the countries enjoys their national legislation. These regulations in general may consist of obtainment of approval for each case of exportation of the equipment as in the United Kingdom, or as in Germany, France and Spain at each phase of the export process. Bodies that apply those regulations vary from country to country; “interministerial committees or.....the highest level (in France, Germany, Italy, Spain, Sweden) and are sometimes based on specific lists of products (contained, in Italy, in law 474/94, in France in decree 95-589 of 6 May 1995 and in Germany KWKG of 20 April 1961)²⁵

Regarding to heterogeneity of regulations, negative effects are felt in the free circulation of defence related equipments among those countries and make Europeans clash and compete with each other in third markets. Also all these regulations prove validity of national thinking contracting to intentions of European countries for an open internal market.

Mainly most European countries regarded arms exportation as a way to reduce production burdens and gathering income to support R&T. International trade has created economies of scale. In terms of industrial restructuring for firms arms exporting would offer a new path. There also

²⁴ GIAT was privatized in 1990.

²⁵ G. Adams, C. Cornu and A. D. James, “Between Cooperation and Competition: the Transatlantic Defence Market”, Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p. 63.

would appear a clash of interest between firms and some parts of governments who are in favor of arms exports due to economic matters and those opposing them with the pretext of foreign and security policy.

In addition to these it is supposed that several problems may arise at the European level; any common foreign and security policy should consist of a common defence equipments export policy, true functioning of Single European Act, with its elimination of internal barriers to trade should consist of a common policy for defence equipments notably for dual-use technologies. And significantly a common export and import policy should be harmonized in order to encourage firms and governments work together. Governments should support harmonization of such policy in order to increase competitive advantage of national firms in third markets.

In terms of institutional regulations, European Union constitutes another level of legislation. For application a paradoxical situation is argued; members of the union are given right by treaties to put reservations on or to exclude matters that have affect on their national security from the field of application of community law. However, on the other hand, the community law allows the bodies of European Union – the Commission and the Council – to set regulations on certain activities related to armaments. Practically, the Commission has power to intervene competition regulations and partnership activities of defence companies, cross-border control of dual-use goods and technologies and to a degree in Common Customs Tariff (CCT). Other issues are tried to be regulated under three Communications.²⁶ On the side of the Council it has word to say in the field of armaments, mainly regarding CFSP rules.

²⁶ The three Communications of EU are; (i) The Challenges Facing the European Defence-Related Industry, a Contribution for Action at European Level, Brussels, COM (96) 10 final of 24 January 1996, (ii) The European Aerospace Industry – Meeting the Challenge, Brussels, COM (97) 466 final of 24 September 1997, (iii) Implementing EU Strategy in Defence-Related Industry, Brussels, COM (97) 583 final of 12 November 1997.

3.3. Technology, Civil Sector and “Civilianisation”²⁷ of Defence Industry

With the reforming process there appeared a tendency to provide cost efficiency through usage of advances in design and production processes as a result of interaction of military technology with high technology system in general.

The need to think and act rational in order to survive in the market required a strategic thinking which is reflected in defence technology in terms of a US concept of *Revolution in Military Affairs (RMA)*, which proposes “the integration of new intelligence, surveillance and reconnaissance (ISR) and command, control, communications and computing systems (C₄) systems, and long-range precision weapons, into a single ‘system of systems’ that gives complete dominance of the battle field”²⁸ involving technologies of digitization, data processing and global positioning. The most important characteristic feature of RMA systems is mostly that are not developed by defence companies but through commercial activities of civil firms.

However, in spite of importance of using technology effectively would result in reductions in costs and increased chance to meet the trends of the customer requirements Walker and Gummert argue that firms behave reluctant to use modern design and production processes on the one hand, redrawing boundaries between civil and military activities with governments together on the other. This may be understood and might be acceptable to a degree if taken in terms of market and power concerns. Nevertheless sooner or later wind of change and competition rules would prevail.

²⁷ Pierre De Vestel, ‘Defence Markets and Industries in Europe: Time for Political Decisions?’, Chaillot Paper 21, Institute for Security Studies of Western European Union, Paris, November 1995, p.9.

²⁸ Burkard Schmitt, ‘From Cooperation to Integration: Defence and Aerospace Industries in Europe’, Chaillot Paper 40, Institute for Security Studies of Western European Union, Paris, July 2000, p.8.

Technology superiority of US has become inarguable with the weapons used in 1991 Gulf War, 1999 Kosovo, operations in Afghanistan and recent war against Iraq. These conflicts showed that C₄ + Intelligence (C₄I) systems are devastating force multipliers in combat situations. The efficiency may be greater however; the burden to provide those systems is also great. “The average price of fighter planes worldwide increased 10.000 per cent in constant US dollars from 1945 to 1985. More recently, the real price of tactical combat aircraft has been growing at 10 per cent per year”²⁹

However, compared to US those operations proved that European industry is relatively falling behind the US industry due to fewer resources devoted to developing C₄I systems and there is little progress in the will of pooling resources by the national governments for R&DT. On the other hand, within US, the effective lobbying of the industry in return helped the firms to enjoy the benefits of governmental support in developing and integrating C₄I systems.

On the other hand financial concerns determine many things in countries' procurement policies. Within the countries enjoying loose military specifications on suppliers' usage of commercial components in weapons systems provides flexibility to defence firms in order to reduce the cost of military programmes. In theory of economics such a tendency leads to a change in the behavior of states and their procurement strategies and become as 'true' customers. Hence economic considerations make defence sector review its trend and enable to act more industry oriented.

Dynamics of change within the defence industry made firms to adopt characteristics similar to those of industry of other sectors. Market economics and deteriorated intervention of states have given the industry a much more

²⁹ T. Guay and R. Callum, “The Transformation and Future Prospects of Europe's Defence Industry”, in *International Affairs*, 78, 4, 2002, p.764.

independent perspective within the new framework. As a result of all factors mentioned like technological improvements and emergence of civil sector as supporter of the sector mainly in spare parts of products, reducing budgets followed by crisis in the industry and plus process of internationalization (will be dealt in next chapters), freer markets and competition defence industry and market has adopted characteristics of the civil economy.

For De Vestel, the defence industry is gradually alternating its essence through civilianisation due to four main developments; “ – the growing internationalization of companies and armaments programs (once which were monopoly of governments and/or army), - the change in the relationship between manufacturers and buyers, mainly due to privatization and the introduction of competition, - the reduction in defence budgets and the resultant deep cuts in spending in the defence industries, - the change in the relationship between civil and military technologies”³⁰ Consequently, defence firms, industry and the market have adopted features of civil economy.

However, change of technological context on behalf of civil sector as a result of considerable development in civil technologies or those of civil origin constituted the problem of ‘Dual-Use’

3.4. Internationalisation of National Firms

The initial result of the changing nature of the business in defence sector through civilianisation showed itself as internationalisation. Of course as expected, speed of the progress has differed from country to country or sector to sector. Internationalization of defence firms have been taken place through a series of activities; (i) international trade in armaments , (ii) proliferation of joint ventures in development and production, (iii)

³⁰ Pierre De Vestel, ‘Defence Markets and Industries in Europe: Time for Political Decisions?’, Chaillot Paper 21, Institute for Security Studies of Western European Union, Paris, November 1995, p.2.

internationalized supply chains, (iv) development of multinational corporations and (v) rapprochement between defence firms and capital.

Due to specific character of the defence sector and many obstacles appeared in political sphere the internationalisation process of the European Defence industry has for long been delayed and only limited to cooperation among national actors on specific programmes.

Those programmes most of which appeared through strategic planning of states, created opportunities for firms to come closer and find out possible partnership solutions on the way through transnational markets. Waste over production of those firms, which were mostly designed to operate according to Cold War era requirements and pressure of financial and economic constraints pushed them to look for the ways of eliminating barriers of being stucked within national borders. International collaboration enables firms to share the burden of R&D risks and costs, to overcome short production runs and high levels of unit costs, to preserve capabilities, employment and value added is guaranteed in participating countries, a degree of standardization of equipment across armed forces is achieved. At the same time firms secure income and a base from which to export. Also international collaboration entails agreement at all levels of the sector, from state structures down to firms, contractors and subcontractors, on division of the profits. Hence trend of de-nationalization forced such programme or project based national alliances to move out of their national dimensions and strong protection of national markets, turning into transnational joint ventures or partners. Moreover, through mergers or acquisitions firms found out the way to penetrate into local markets of other countries. Arms industries have been granted an extra independence by their new access to financial resources. However, the consequence has not been accepted absolutely favorable by governments. Cited in Mawdsley;

It is already evident that a 'national' defence industry identity has been irrevocably diluted by the flow of outward and inward investment and by the operation of an international supply chain. National governments must now respond to the challenges posed by a globalizing defence industrial system where the demands of industrial efficiency and international trading are likely to conflict with issues such as security of supply, security clearances and controls over technology transfer.³¹

The trend arranged the market of defence as well as units of production and manufacture. Such a tendency proved its validity when "seven principal European centres of aerospace research – CIRA (Italy), ONERA (France), DRA (United Kingdom), DLR (Germany), FFA (Sweden), NLR (Netherlands) and INTA (Spain) announced that they were to work towards improving cooperation between themselves, aiming eventually to build a 'union of aerospace research bodies in Europe'"³², which would only stay as an unsuccessful initiative in the future.

However, Walker and Gummatt note that projects of international collaboration have apparent disadvantages. They argue that these partnerships are

....difficult and time-consuming to set up, and inflexible once in place; their products are either a compromise between the partners' requirements, therefore risking being second-best in combat, or are customized by each partner, thus losing many benefits of collaboration: and they are intrinsically monopolistic.discourage rationalization³³

³¹ Jocelyn Mawdsley, 'The European Union, the State and Multinational Defence Firms: The Emerging European Political Economy of Defence and ESDP' paper prepared for the British International Studies Association Annual Conference, London School of Economics, 16 – 18 December 2002, p.6.

³² Pierre De Vestel, 'Defence Markets and Industries in Europe: Time for Political Decisions?', Chaillot Paper 21, Institute for Security Studies of Western European Union, Paris, November 1995, p.10.

³³ William Walker and Philip Gummatt, 'Nationalism, Internationalism and the European Defence Market', Chaillot Paper 9, Institute for Security Studies of Western European Union, September 1993, p.9

However, although the path to achieve internationalization is difficult to travel over, there was no other satisfactory way of meeting new military requirements with in the new conditions of the international architecture. This also required a sense of real integration consisting of industrial specialization, fair competition and collective identification of operational requirements in two dimensions. Thus, internationalization for the firms did not mean only Europeanisation but at the same time accepting cooperation with other markets such as US or maybe Japan.

CHAPTER 4

CONSOLIDATION AND RESTRUCTURING OF EUROPEAN DEFENCE INDUSTRY

The defence industry has been one of the few areas in which European countries have been able to survive and show their competence free of outside interference. Governments of many countries like France, Germany, United Kingdom, Italy, Spain have invested on their national champions to increase their freedom of action and to promote their national identity as a matter of priority for foreign and defence policies.

The wish to integrate European defence industries and markets in some way or another has always been attempted since the end of World War II. However, post Cold War era has prepared the necessary background to accelerate political and industrial initiations. According to analysis there lie two main points behind those attempts of integration of the defence markets and industries; (i) Aim of constructing a political union among European states, (ii) Optimal management of the production, acquisition and export of military equipment.

The evolving new character of post Cold War Era an important remark has been becoming obvious. Faced with expenditure cutbacks in national markets and a slow down in the global defence markets, European firms were shocked by the velocity of American defence market and firms have reached through industrial restructuring³⁴. Hence they are forced to think

³⁴ Jocelyn Mawdsley, mentions in 'The European Union, the State and Multinational Defence Firms: The Emerging European Political Economy of Defence and ESDP" paper prepared for the British International Studies Association Annual Conference, London School of Economics, 16 – 18 December 2002, "American firms reacted quickly to the falling markets by restructuring and rationalizing. The trend in the early 1990s in the American defence industry was for firms to get either totally 'in' or totally 'out' of defence; there were a large number of both horizontal and vertical mergers, which led to greater economies of scale and lower unit costs. The American government helped push mergers by offering subsidies to

transnationally and have accepted the reality that within the competition against giant American defence companies they must either lose or dilute their national character in order to feel confident within this race.

The internal transformation of the European defence industry had a strong aggressive external element coming from strong competition of US firms. As a result of a series of mergers and acquisitions between years 1993 and 1997 the United States market produced aerospace and defence giants with financial strengths several times stronger than those national champions of the European market. Starting with Clinton administration there has been a reorientation of US export policy globally that takes the form of an exceptional commercial aggressiveness. Moreover, there has been the intention of US industrialists to increase their presence in European market. Regarding European national markets such penetration intent could only be reached through establishment of linkages with local companies. However, such an interaction was carrying its commercial risks together due to difference in size which would de facto rule out an alliance on an equal footing: for instance in a cooperation on a specific task they would have the risk of relegation to the level of subcontractor or a full scale merger could be ended up with the acquisition of the European company by an US giant. As quoted in paper of Schmitt,

The tremendous restructuring of the defence industry, the new importance of exports for American firms, the increased pugnacity of these groups on international markets and the clear intention of the Administration to use arms sales as a way of preserving and developing its technological lead mean that we are now witnessing a new type of arms race between the US and European defence industries ... with the prospect of [US] hegemony through industrial and economic confrontation in both military and civil aerospace and electronics³⁵

cover merger costs and started a vigorous export drive, which was supported at all levels. They also relaxed the anti-trust laws to allow mergers that may damage competition. All this meant that America obtained a larger share of the shrinking cake in defence markets, as their firms were more competitive” For further analysis see chapter on US defence industry.

³⁵ Burkard Schmitt, 'From Cooperation to Integration: Defence and Aerospace Industries in Europe', Chaillot Paper 40, Institute for Security Studies of Western European Union, Paris, July 2000, p.25.

By the middle of 90s, the awareness of US industrial pressure has increased in politico-industrial elites of Europe particularly by the takeover of McDonnell Douglas (MDD) by Boeing. This activity made Boeing available to obtain the means to compensate for the cyclical nature of the civil aircraft market and thus became competitor of Airbus, the only one remaining in the market of civil aircraft market with above 100 seat capacity. The apparent form of such a competition coming from the other side of the Atlantic alarmed both industry and governments with the risk of unbalanced alliances and in the long run occurrence of an US monopoly in the market of high-technology defence industry.

However, since the national decision makers failed to act in time and efficiently to enable the process of European consolidation, actors of the market took the initiative and started to carry on the process themselves. From that moment on thinking of defence firms was no longer purely national, which in return contradicted with their relationship with their national governments. Their new independent area of maneuver best reflected itself when British Aerospace had choosed to buy up Italian GEC Marconi's defence arm rather than merging with German DASA and French Aerospatiale as the British government had wanted.

In order to meet the competitive pressure from United States restructuring of the European defence sector concerned the aircraft, space and electronics. Authors argue that the reformation happened first at the national level between years 1992-1995 and then at the transnational level. Regarding to traditional parts of the sector; land and naval forces, the situation is rather different than the others.

In terms of the land forces it is possible to argue that, impact of the restructuring has not been felt greatly. Several factors can be counted as

reasons of this; initially although US national market of the land forces sector is dominated by several companies, competition has not yet prevailed within Europe itself, even if has been felt stronger in certain third markets. Also US companies are pursuing a dynamic takeover strategy in Europe: For example US firm General Dynamics has the biggest share in the Austrian company Daimler Puch. GMC of Canada has taken control of Mowag in Switzerland and United Defense has taken over the Bofors artillery of Sweden. On the other hand due to monopolistic presence of state in the sector dating back to several centuries has not let the industry to adopt itself to transnational restructuring. Moreover, variety of products and costs has forced the firms to specialize and this characteristic has spread shareholder structures. On the other hand many of the governments were afraid of social repercussions of the industrial restructuring can cause considering vulnerable regions that are historically dependent on land forces. Also firms have rarely associated in commercial activities due to low amount of collaborative programmes due to slow progress towards harmonization of operational requirements made within supranational bodies such as EU, WEU or NATO.

On the side of naval sector the situation has taken a quite different form. Within this sector there appears a structure positioned around a national leader³⁶ dominating its local market. This sector experiences little outside interference from American firms. Because the US sector which is dominated by five shipbuilders³⁷ is unlikely to find an export market to Europe against national dominants. As a natural result demand side of the naval sector has been structured around national markets; “(i) blue water navies that have complete range of ships (France and the United Kingdom) and (ii) navies with

³⁶ As an example; BAE Systems in the United Kingdom, Fincantieri in Italy, Bazan in Spain, DCN in France, and Kockums in Sweden can be counted for national leaders of naval shipbuilding.

³⁷ Examples for US shipbuilding market are; Newport News Shipbuilding Incorporated (an independent firm), two shipbuilders owned by General Dynamics and two other owned by Litton.

more modest ambitions (Germany, Italy, the Netherlands, Spain and Sweden)³⁸

Thus, the emergence of transnational European companies has emerged through different paths depending on the sector. Whereas within the naval and land forces sector the argument is mostly among Europeans, in terms of the aerospace and electronics, where technological and industrial stakes are higher, competition appears to be against American industry.

The 1990s witnessed a constant preoccupation of the Europeans with creating a *European Defence Identity*. And building of a *European Defence Industry* has been perceived as the essential feature of an integrated Europe, which must become an independent and coequal partner with the United States; and the creation of a truly European aerospace sector has been considered as the initial and most important step in achieving this goal.

Nevertheless rational reasons of Europe's will to constitute its own defense structure have been given right. However, for some scholars it has been carrying real political and security risks to the transatlantic security and defence relationship. On the one hand, it tends to erode the political base on which European publics support NATO. On the other, it does not play any important role to stop the trend of the defence industrial bases of Europe and the United States growing apart which is increasingly evident since the mid-1990s.

Within this nature, Europeans also acknowledged that in the strategic high technology industries, like aerospace, behaviour of firms decide whether a nation or integrated block of nations maintains the industrial and economic guarantees of sovereignty, which especially in an industrial structure requires

³⁸ G. Adams, C. Cornu and A. D. James, "Between Cooperation and Competition: The Transatlantic Defence Market" Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p.69.

an industrial base and low level of technological dependency ensures a higher level of independence in policy-making.

Under these circumstances, it is important to explain why firms seek to cooperate in international markets. Two main drivers may be identified behind this logic; Firms wish to share risks and costs of being an international actor and they seek to gain access to areas of dominances held by their competitors which have been out of reach or too costly to acquire. In the defence sector these areas of dominances include technological expertise, employment in the purchasing country and insider knowledge. The technological expertise expands the volume of specialization that can be proposed to the market. The employment in the purchasing country reduces the political reluctance of the country in which production is done, of being a customer of another country. And the insider knowledge provides penetration in governmental and armed forces contacts, thus increasing the chance of the marketing of the goods to local bureaucracies with their distinctive habits and preferences.

Firms mostly work together in areas where the consequences serve their individual interests and help them to guarantee a balance of power within the oligopolistic structure of the defence industry. They maintain complex shifting webs of alliances at divisional levels. Moreover, companies working together on a task may compete in another context. This mechanism proves to be effective since it combines diverse technological capabilities and increases political and institutional support. They are getting accustomed to working together and taking steps to formalize their relationships.

Aerospace and electronics have always been the dominant sectors among defence industries. Since they have been the high-technology industries that produce core systems for the conduct of modern warfare they occupy the dominant position. The importance of these high-tech industries is also seen

in the size of companies; among the world's 100 biggest defence companies, the aerospace and electronics companies hold nearly $\frac{1}{4}$ of the total.

Aerospace and defence electronics sectors are also the areas in which internationalization has made most headway. Most of the firm's activities are seen in those areas and there have been a growing amount of cross-border mergers and acquisitions in accordance with the requirements of the post-Cold War security structure. The commercialization of the business has an effective role in the restructuring of aerospace and defence electronics industries. Within this process civilization of the activities in order to compensate the fall in military expenditures is used as market strategy due to dual-use nature of many technologies and their considerable spillover effects. Also they have a long experience of cooperation through a vast number of joint projects, significant amount of whose turnovers come from such kind of international cooperations.

In the US, most of the defense industrial base consolidation has been through direct merger and acquisition activities. Whereas in Europe, there have been many forms of business arrangements among defence companies, taking much more significant approach with wide range of strategies being employed varying from full ownership to much more loose partnerships like franchising. Each arrangement has differed in terms of the kinds of dimensions like degree of control, political significance, market dominance and financial results, moreover the nature and characteristics have varied considerably.

Table 3

Examples of Alliance Strategies in the European Defense Industrial Base

APPROACH	ILLUSTRATION
Mergers & Acquisitions	Thales purchase of Racal
Joint Ventures	Matra – BAe dynamics
Strategic Alliances	BAE Systems shareholding in SAAB
Consortia	Sealion grouping of BAe, Stena & financial institutions bidding for the UK ferries contract
Partnering	BAE Systems – Vosper Thornycroft co-operation on defence services and training support
Ad hoc Business Arrangements	Six European companies joint bid to supply A400M engines

Source: Derrick J. Neal and Trevor Taylor, "Globalisation in the Defence Industry: An Exploration of the Paradigm for US and European Defence Firms and the Implications for Being Global Players", in *Defence and Peace Economics*, 12, 2001, p.347.

Looking over the years between 1960 - 1970s initial forms of those cooperative programmes had no common structures but were organized on the basis of task-sharing. Each partner was carrying out a defined part of the development and production work and marketing of the product was made on the basis of a simple distribution of markets. The next stage happened in the form of setting-up semi-structured projects. In those forms the development and production phases was also distributed between partners. Differently from the initial stage commercialization, after-sales services and possible programme coordination works were done by a common subsidiary, which constituted the only contact with the customer. Although such kind of cooperation decreased the burden of fixed R&D and industrialization costs, and longer production costs, also each participant had the chance to take place in a joint project as an opportunity to improve its own know-how and

develop its technological capabilities; it also had perverse results as duplication and overcapacity. Moreover, administrative and industrial organizational complexities have created extra costs for the coordination and management of such kind of joint programmes. Also, commercial results of those programmes did not provide the expected satisfaction.

Hence, the requirements of the 1990s necessitated development of more integrated structures, namely joint ventures. These companies are generally common subsidiaries of two or more parent companies operating the whole of sector activity. In the case of joint ventures rather than ministries or any section of state decision-making usually industrial managers take the initiatives even if government consent is usually required before arrangements can be implemented. Initiation process of the administrative responsibilities of the industry happens at two levels; the corporate level, where companies interact in wide strategic alliances and the divisional level, where relatively expertised operational units join their know-how across boundaries, temporarily or permanently to serve for specific markets of defence industry.

Table 4**European Joint Ventures at the Initial Stages of Consolidation**

YEAR	NAME	PARENT COMPANY
1990	Matra Marconi Space	Matra, GEC-Marconi
1991	Eurocopter (helicopters)	DASA, Aerospatiale
1994	TDA (missile propulsion systems)	DASA, Thomson-CSF
1996	Thomson Marconi Sonar (sonar)	Thomson-CFS, GEC-Marconi
1996	Matra BAe Dynamics (missiles)	Matra, BAe
1998	Alenia Marconi Systems (electronics)	Finmeccanica, GEC-Marconi

SOURCE: Burkard Schmitt, 'From Cooperation to Integration: Defence and Aerospace Industries in Europe', Chaillot Paper 40, Institute for Security Studies of Western European Union, Paris, July 2000, p.17

Joint ventures are neither limited to a particular programme nor limited to a settled period of time. There are companies resulting from the merger of existing divisions or subsidiaries. In terms of the defence sector, field of activity of the joint ventures can be both civilian and military like Eurocopter.³⁹ Generally they take the organizational and structural form of the holding companies; and each of the partners organizes its operations within the partnership in a company subject to its national law. These companies are generally polynational in nature rather than pan European, in the sense that their home markets are the local markets where their parent companies are located, rather than the European market as a whole.

The holding structure of joint ventures preserves the national identity of each identity while providing an area of maneuver to coordinate marketing, exports, finances and strategy under a uniform single administration. However, effect of governments is also felt in distribution of capabilities and

³⁹ Eurocopter (helicopters) was constituted in 1991 by parent companies of DASA and Aerospatiale

organization of work in joint ventures, since governments have chance to intervene directly using their regulatory power. Under these conditions distribution of posts and work shares and balance of partners are determined generally in accordance with national sensibilities. In their functions joint ventures are independent in their daily work but depended on their parent companies for strategic decisions. Decisions are normally taken under unanimity however this method becomes very complex when interests of several partners clash. Hence, minimization of the number of parent companies is essential for optimizing the internal working of joint ventures.

The importance of such cooperation appears in that the long experience has prepared the basis for mergers between parent companies. Initially, the habit of working together emerged. Then they used the network of joint structures for further consolidation and finally the awareness highlighted necessity to take the integration to a higher level.

4.1. Inner Dynamics, Interests and Agendas of the Main European Actors

Before analyzing the integration process of European defence industry, I think it would be useful to give a brief summary of ambitions and aims of main actors involved in the process. Due to main roles are shared among, Britain, Germany and France will be analyzed and the other European actors would be examined briefly.

Britain has always been in a silent attitude towards the institutionalization process of the concept of Europeanization. Any attempt for the creation of an integrated dimension in the European defence industry and markets has created a sense of skepticism within the elites of British government. But on the other side London has showed its support to its European partner when necessary particularly in cooperation on armaments issues. Nevertheless,

British presence in joint programmes such as EFA or Tornado is interpreted as show of autonomy and power vis-à-vis the United States.

With the fears of rules of competition that could work against privatized British national champion defence firms, who operate under strict British rules of competition and price control, there was considerable opposition in the country to any process of defence and security related integration that carried out on a Community basis. Also there was hesitation of British defence companies that did not enjoy the benefits of same financial and political support of their German or French rivals.

In *France*, characteristic of relationship between state and defence companies is a 'quasi-symbiotic' one which includes a 80 per cent dominance of state control over the production of military equipment. With the great influence the defence industrial sector occupies a privileged position. However, this uniqueness of French market complicates the integration process of the industry in European level.

France has always been ambitious in the struggle against American competition and due to this attitude has a clear cut mode of presence vis-à-vis European defence cooperation. Cold War era has been seeking of French autonomy combined with resistance to US hegemony within Europe. However, changing balance of Europe after the end of Cold War shaken the position of France vis-à-vis European integration. Rise of Germany in non-military affairs made French authorities to think of their policies and show effort to maintain an advantageous position in military sector which could be used as an option in the European defence consolidation.

Germany, has been the country that is most benefited from the restructuring of the post Cold War era. However, its defence industry had been the one that is most effected and passed through a difficult period by the reduction of

procurement for production and R&D. In spite of the rise in export numbers, even national champion companies like DASA were seriously affected by the reduction in business capacities.

However, German defence sector could able to survive and maintain its position in the system and proved its strength in the field of components, certain subsystems and naval shipbuilding. Also Germany devoted its resources to the areas of R&T, intelligence and telecommunications. Moreover, there was a process of redefining defence industrial and technology policy and modification of equipment procurement procedures in order to maintain cost efficiency.

These three main actors of European defence structure accounted for some 80 per cent of defence production and 90 per cent of defence expenditure. However, although small in volume or size, presence of other actors can not be ignored within the process of European defence market consolidation. Despite their low effect presence small countries have always been attractive for the giants of the defence market in terms of their internal industrial markets. In spite of small differences, small countries of Europe have two main points in common; (i) not to be isolated from European defence integration process. (ii) provision of principle of *juste retour*⁴⁰ or industrial and technological compensation.

Italy, being the most important actor among 'the others', shows similar characteristic features with three major players of the Europe. National champion of Italy, Finmeccanica has a production volume between 75-80 per cent of defence production. However, political issues of Italy prevent it to play a leading role in the consolidation process.

⁴⁰ As mentioned by D.J. Neal and T. Taylor in "Globalization in the Defence Industry: An exploration of the paradigm for US and European Defence Firms and the Implications for Being Global Players" in Defence and Peace Economics, 12, p.349, principle of *Juste Retour* ensures that each country in a project receives development and production work in proportion to its government's projected share of the orders for the final product.

Swedish defence policy carries its inherited characteristic of neutrality and its industry has a limited financial resources to build a significant capacity to design military equipment. The system is mainly based on a combination of the integration of imported know-how technology and national innovations.

4.2. European Aerospace and Defence Company

Britain, France and Germany have been the first states that called for political support for the industrial consolidation by a trilateral declaration (9 December 1997). National champions of each nation are tasked with presenting a joint plan and timetable by 31 March 1998.

The four partners of Airbus project; Aerospatiale, BAe, CASA and DASA have laid down founding principles of European Aerospace and Defence company (EADC) on 27 March 1998, which also accepted as a tool to respond to the mercer of Boeing and McDonnell- Douglas in the United States market. The report has also been presented to SAAB of Sweden and Finmeccanica of Italy. The grande idée was born of an extraordinarily ambitious new European defence industries structure that would be brought under single management of the national champions of the six major countries; France, Britain, Spain, Germany, Sweden and Italy. With the contributions of six countries; plus Matra (represented by Aerospatiale) and Dassault Aviation through a set of exchange of ideas and general discussions of opportunities, a second report was presented in mid-November 1998.

The report has highlighted five characteristic factors of EADC, which should have;

- An integrated single structure;

- Defined areas of concern; satellites and satellite operations, space launchers and orbital infrastructure, aerospace systems, helicopters...etc.;
- Economic and financial rationality and targets in accordance with the business objectives with the aim of profitability in each business sector.
- Unified management entity, totally owning and controlling all accounts and resources. The management structure was agreed to have three elements; a headquarter which would be responsible central functions including central finance, management coordination, group strategy and policy; task groupings coming together with similar businesses and containing the necessary resources and assets; and local departments responsible with the management of interactions with national governments.
- Principles of shareholders' rights; none of the parties' should exercise dominance over the business, relevant measures should be taken against any attempt of takeover, the detached interests of a distributed shareholder base should not be disadvantaged with respect to the concentrated interests of block shareholders.

4.2.1. Two dimensions path; national consolidation efforts & path to failure of the EADC

Although these points were agreed by the six companies, some other areas were left blank and the whole European Aerospace and Defence Company concept emerged vulnerable from the start; hidden agendas of companies on

the one hand and the profound cultural differences that separate Europe's national defence industries on the other.

In parallel with the given task, European companies have been exercising bilateral negotiations some of which have even been started earlier than the discussions of the reports. Each attempt of the industrial consolidation carried the aim of having the biggest slice from the cake.

On the side of United Kingdom and Germany, in spite of British concerns about German banks having block control over DASA's parent company Daimler Chrysler, BAe and DASA have begun merger negotiations at the beginnings of 1998. Having much in common due to participation in the main European programmes – Airbus and Eurofighter – and defending no governmental shareholding in the firm's capital structure, they approached each other. This was a sign of isolation of France and its national champion Aerospatiale due to ties of the government and the company. Such a rapprochement was interpreted as a creation of a closed group by Britain and Germany in order to provide means to compete against France and maintain strong position in negotiations of single European entity. In spite of differentiations of size and shareholding structures became apparent negotiations reached to a final stage.

However, on the side of another company; there were developments that would destroy strategic planning of BAe drastically. GEC declared that it was agreed to sell its defence electronics division Marconi and this was a great opportunity for BAe to have the technology to design and produce platforms systems, an area where its traditional rival was giving up its priority. It also meant an important attempt in the market share increasing the volume of portfolio and integration of the division would decrease the risks of production gaps that were the general fear of all platform producers. Moreover, the purchase of Marconi would reduce the company's dependence on other

foreign firms and provided direct access to the giant American market through US subsidiary of Marconi, Tracor. However, the u turn of BAe shocked the administration of DASA and this broke down the relationship of the two companies and ended up opportunities for a possible Anglo – German axis with a view of creating the first truly pan-European aerospace company.

BAe acquired Marconi for over £ 7.7 billion establishing a national giant with a turnover over £ 17.4 billion compared to other European national champions, becoming much stronger than Aerospatale – Matra with £ 11.6 billion and DASA £ 17.4 billion turnovers. Hence BAE Systems (known as since December 1999) has been established with its defence industry expertise. In terms of the strategies of consolidation; BAE Systems has consolidated much of the national defence infrastructure of the UK into one company, without any major cross-border ties, by which BAE Systems has become a ‘hypernational champion’. At first glance although BAE Systems may look like a national champion However, it has acquired transnational ties with the other side of the Atlantic. By merging with GEC, BAe could able to acquire Tracor, which is the GEC’s largest subsidiary in the United States. Hence, although any formal merger between BAE Systems and a US company is probably out of probability in the next coming years, with this merger strategy BAE Systems could able to enjoy preferential access to US firms and know-how technology. Such a privilege is accepted as critical today, since with the events of 11 September US is more nervous about the possibility of sophisticated technology falling into the hands of enemy through European partners. However, Britain has always been a trusted partner thus is allowed to integrate into US defence market, in a way that other European countries do not.

France representing another pole of the industry was having a much more slow process of national consolidation. Strong presence of state on the one

hand and debates of the privatization on the other dominated industrial landscape. Within this frame, ideas of French President Jacques Chirac to federate companies of defence around electronics area and defence area and in the mean time linking this restructuring to the privatization of Thomson-CSF and Aerospatiale have been failed by the attempts of Alain Juppé government. Chirac wanted to privatize Thomson-CSF and bring Dassault Electronique – the space and defence electronics business of Alcatel – and the satellite division of Aerospatiale within one company.

However, slow process of consolidation and interventionist policies, brought the French national champion Aerospatiale on the point of being isolated inside the European aerospace industry through a set of reversal of alliances. British government was insisting on that French government should first relinquish or at least reduce state ownership in companies before that company in question could become part of the multinational defence grouping. At that time German DASA decided to break its relation with its traditional partner, Aerospatiale and establish relation with Matra Hautes Technologies, the defence division of the Lagardère group. Also DASA merged its satellite activities with a joint venture of Matra – Marconi, MMS and sold 30 per cent of its LFK missile department to the joint subsidiary of Matra and BAe, MBD. In addition to these, DASA and BAe supported Matra's proposal for the privatization of Thomson-CSF against the offer made by Aerospatiale – Dassault – Alcatel consortium.

Elections in France changed the path of national restructuring once more. The left-wing government managed to turn the project of a Gaullist president into a definitive solution. Initially, in 1997, the government decided to integrate the space, defence electronics and military communications divisions of Alcatel, the satellite division of Aerospatiale and defence electronics division of Dassault into Thomson – CFS. Two new subsidiaries emerged from this strategic attempt; Detexis, a specialized company in

electronic countermeasures totally owned by Thomson – CFS and 50-50 joint venture of Thomson – CSF Alcatel satellites; Alcatel Space. Consequently, with the industrial contributions of Alcatel (16 %), Aerospatiale (4%) and Dassault (6%) into the shareholder structure of Thomson – CFS the share of the state fell in about 40% from 58%.

In July of 1998 the French government decided to privatize Aerospatiale by merging it with the defense division of Lagardère Group; Matra Hautes Technologies. Through a set of complex financial and relational negotiations, Aerospatiale – Matra merger has been established in February 1999 and the new privatized aerospace champion quoted to stock exchange in the June of the same year.

All these developments and unsolved problems accelerated the end of European 'big bang' and made the European Aerospace and Defence Company just a wishful thinking.

However, only few months later, the European rapprochement that many thought impossible gave birth to a new opportunity. As a part of privatization activities Spanish government opened the way of CASA to integrate with a European partner. With a letter of intent signed in June 1999 it was agreed with DASA – the awarded bidder- that CASA will be privatized through establishment of a holding company 87 per cent of which would be owned by DASA and the rest by Sepi. Intention of two companies remarked a change of mind in companies since for the first time two national champions decided to unite their activities. This action also provided CASA, strategically the smallest of the six national champions of Europe, to acquire a key position in joint programmes.

However, negotiation between DASA and Aerospatiale – Matra about merger of these two companies seemed to be leaving Spanish CASA out of the

picture. However, after four months of negotiation period the creation of the first transnational company – *European Aeronautic, Defence and Space Company (EADS)* – announced on 14 October 1999 and with the integration of Spanish partner on 2 December 1999 the restructuring concluded.

4.3. European Aeronautics, Defence and Space Company

European Aeronautics, Defence and Space Company was established through the strategy of ‘merger of mergers’. Sectoral consolidation of the EADS did not necessarily take place at national level, which means that its partnership has a heterogeneous structure. Instead, national consolidation of the companies forged newly merged entities to maintain a stronger position during negotiations of transnational ventures. The consolidation strategy applied was the application of transnational mergers of the national champions of individual countries within similar sectors of the defence industry– like aerospace, missile, aviation...etc.-

Constitution of EADS has altered the ranks of defence industry in Europe. According to data of Defense News Top 100, EADS is the eighth company among the other according to total and defense revenue in 2003. It has 109.135.employees (as of 31.12.2003) and a turnover of € 30,1 billions

Table 5**TOP TEN DEFENCE COMPANIES by 2004**

Rank	Company	Leaders	Country	Last Year's Rank	2003 Defense Revenue	2003 Total Revenue
1	Lockheed Martin	Vance D. Coffman, chairman & CEO	U.S	1	\$30.097	\$31.824
2	Boeing	Harry C. Stonecipher, President & CEO	U.S	2	\$27.360	\$50.500
3	Northrop Grumman	Ronald D. Sugar, Chairman, CEO & President	U.S	5	\$18.700	\$26.200
4	BAE Systems	Mike Turner, CEO	U.K	4	\$17.159	\$22.359,3
5	Raytheon	William H. Swanson, Chairman & CEO	U.S	3	\$16.896	\$18.100
6	General Dynamics	Nicholas D. Chabraja, Chairman & CEO	U.S	6	\$12.782	\$16.617
7	Thales	Denis Ranque, Chairman & CEO	FRANCE	7	\$8.476	\$13.310,4
8	EADS	Philippe Camus and Reiner Hertrich, co-CEOs	NETHERLANDS	8	\$8.036,5	\$37.796,6
9	Finmeccanica	Pier Francesco Guarguaglini, Chairman & CEO	ITALY	9	\$5.895,5	\$10.856,8
10	United Technologies	George David, Chairman & CEO	U.S	11	\$5.300	\$31.034

SOURCE: Defence News Top 100, <http://www.defencenews.com>

Due to awareness of the exigencies of the defence industry market of the industry executives, creation of EADS has become inevitable. Thus, within the framework of defence related industry, European Aeronautics, Defence and Space Company has an area of interest covering wide range of activities

and EADS pursues a central role in most of the European joint programmes. As identified by Schmitt, there are five core issue areas of business;

- *Space*; In terms of the space industry, EADS has 75 per cent capital in the new European space company, Astrium. Also, in Arianespace, EADS holds the 25,9 per cent of shareholdings.
- *Helicopters*; In terms of the helicopter business, due to previous integration of the partners of EADS into the Eurocopter programme, the new structure does not apply any change to the current situation. However, partnership of CASA would provide Spain an opportunity of full integration into the Tiger programme
- *Civil Aviation*; At the same time Airbus was reorganized by the rationalization and restructuring of individual European defence companies. Since its establishment in 1970 Airbus has operated as a consortium of four partners (Aerospatiale, DASA, BAe, CASA) mainly against the dominance of US aerospace companies, particularly Boeing. However, restructuring requirements of Post Cold War era necessitated alternations in the legal corporate status of the company mainly in order to increase its competitiveness vis-à-vis Boeing. At the moment, Airbus is owned by EADS with a share of 80 per cent and by BAE Systems holding 20 per cent. Almost two-thirds of total EADS revenues are attributable to sales of Airbus passenger aircraft. When EADS was formed in 1999, financial analysts attributed all the earnings of the company to increasing success of Airbus vis-à-vis Boeing. However, the future success of EADS is bounded to overcoming of the doubts about German and Italian commitment to the A400M Airbus military transport aircraft project. “By 2004, orders from nine countries to build Europe’s first heavy-lift military transporter

are forecast to boost EADS defence-related earnings to 40 % of total profits”⁴¹

- *Military Aviation*; Within the Eurofighter programme, one of the partners of EADS; Aerospatiale – Matra has a share of 45,76 per cent through Dassault Aviation and other partners CASA and DASA have 43 per cent share. On the other hand, this 43 per cent of share is used in the new 50-50 EADS-Finmeccanica joint venture European Military Aircraft Company (EMAC). Moreover, EMAC has the majority holding in Eurofighter programme with 62,5 per cent of share.
- *Missiles*; Regarding to missile industry, EADS has 50 per cent of share in MBDA, the world’s second largest maker of missiles (behind Raytheon) which was formed in 2001 by merging the missile interests of EADS, BAE Systems and Finmeccanica.

In addition to these above mentioned core issue areas of EADS, business partners apply specialization activities; Aerospatiale-Matra in regional aircraft activities, CASA in light military transport aircraft and DASA in defence electronics business.

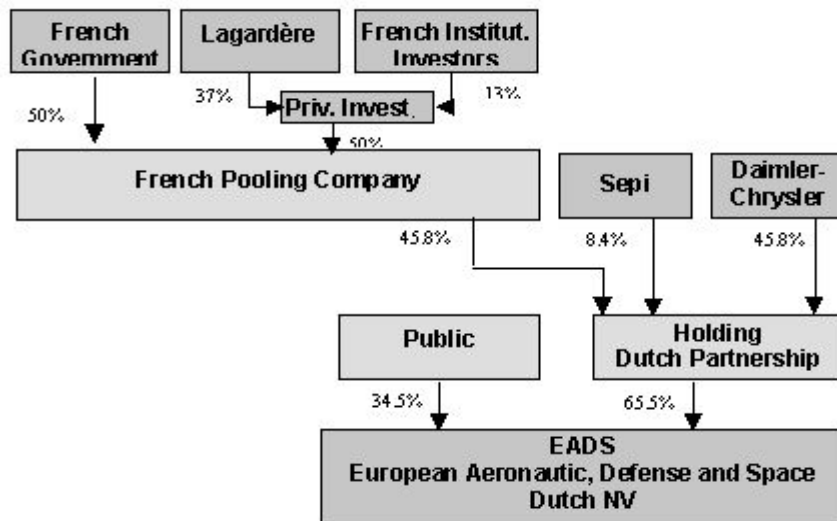
4.3.1. Shareholding Structure

In terms of the shareholding structure there are two levels; at the first level, there is a holding company composed of state, Lagardère SCA and French institutional investors, respectively holding 50, 37 and 13 per cent of shares. And at the second there is another holding partnership made up by the contributions of the French holding company of the first level, DaimlerChrysler and Sepi, which controls 65,57 per cent of the EADS

⁴¹ Giles Merritt, “Industrial Aspects of European Defense and Concrete Measures”, in K. von Wogau, ed., The Path to European Defence (Maklu Publishers, 2004) p.218

through their respective shares of 30 (the German and French together) and 5,57 (Sepi) per cent. Remaining share of 34,43 per cent is opened to public in the Paris, Frankfurt and Madrid stock exchanges. Most importantly due to fiscal reasons EADS is registered in the Netherlands without a European company status.

Schéma: EADS - Structure capitalistique



Scheme 1

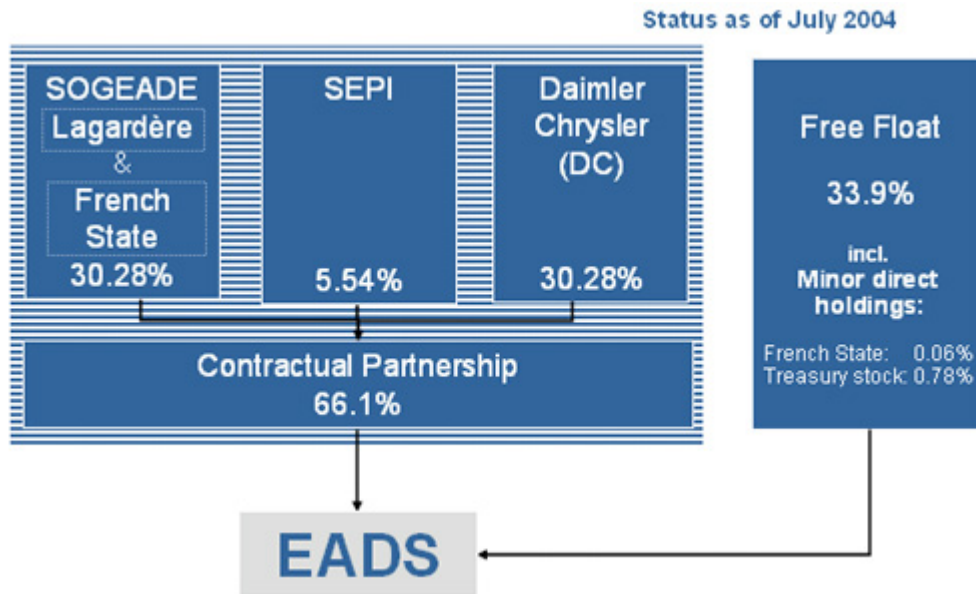
EADS SHAREHOLDER STRUCTURE (status as of 2000)

SOURCE: Burkard Schmitt, 'From Cooperation to Integration: Defence and Aerospace Industries in Europe', Chaillot Paper 40, Institute for Security Studies of Western European Union, Paris, July 2000, p.41.

The initial establishment single body of EADS has had a complex top-level structure. The distribution of responsibilities corresponded to the relative sizes of the three partners. With regarding to schema above, in spite of

Franco – German dominance appearance, the shareholder structure of the EADS was mainly designed in order to highlight the principal of equal rights between the main shareholders; DaimlerChrysler and the French part, and in accordance with this principal decisions were taken collectively especially in core issues like new investments over € 500 million, new partnership operations...etc. Also, any share of the company could only be sold through stock exchange market and French and German shareholders have a pre-emptive right on shares sold in the market.

However the provisions of the shareholders' agreement concerning the stability of the shareholder structure ceased to have effect in 2003 leaving Daimler and Lagardère free to dispose their share. Consequently the shareholding structure has been changed as below:



Scheme 2

EADS SHAREHOLDER STRUCTURE (Status as of 2004)

SOURCE: www.eads.com

According to schema 60.56% of the share capital of EADS is held in equal proportions by DaimlerChrysler and SOGEADE who jointly control EADS through a Dutch law contractual partnership⁴². On the other hand SEPI, being a party to the Contractual Partnership, holds 5.54% of the share capital of EADS. The public (including EADS employees) and the Company hold, respectively, 33.06% and 0.78% of the share capital of EADS. The French State holds directly 0.06% of such share capital, such shareholding being subject to certain specific provisions.

Managerial duties are under responsibility of a board of directors and an executive committee. The board of directors is run by two non-executive chairmen - one German, the other French – together with five directors – two

⁴² The “Contractual Partnership”

German (appointed by Daimler Chrysler), two French (appointed by the French government and Lagardère) and a Spanish (appointed by Sepi). Also there are two chief executive officers of EADS and two outside directors. In order to prevent skepticism about the objectivity of the voting process, decisions are taken by a qualified majority of seven votes out of eleven.

Organizationally, departments of the company are structured in five divisions. Posts are distributed between the shareholders in accordance with the distribution of the board of directors; Airbus and space systems are headed by a French, aeronautics, defence and civil systems are by a German and lastly military transport aircraft by a Spanish. Each division has full responsibility on their activities. Besides, there are three central headquarters, responsible for all strategic, financial and marketing activities of the company. Those five core business departments and plus three managerial headquarters constitute an executive committee headed by two chief executive officers – one French and one German. In terms of departmental management, there are nineteen senior branches working integrated to each other. All kinds of managerial disputes between departments are dealt by the board of directors and in the event of requirement further solution two non-executive chairmen of the board of directors are informed.

However, from another point of view it is argued that the two co-chairmen structure is supposed to be open for implicit problems; each answering to different national political pressures and each heading a culturally distinct German and French business structure. Moreover, significant position of French state in the shareholding structure proves the supremacy of the State especially in issues like acquisitions, strategic alliances or capital increase.

In terms of the Spanish, the founding member; Sepi, is represented in the board of directors of both the Dutch holding and the EADS's board of

directors. Moreover, within the military transport aircraft sector Spain has the lead and receives 10 per cent of the Airbus A3XX. However, Schmitt argues that shareholding rights of Spanish do not give them a privileged position as French enjoys. Moreover, there are still question marks about once Spanish disposal of its shares from the two boards of directors.

4.3.2. Challenges to be overcome

Although EADS can be regarded as the first true attempt of creating a transnational defense sector identity and provides opportunity to its partners for further consolidation of the sector, authors argue that it still has many problems to be overcome. Efforts of eliminating barriers between parent companies and integration of core activities may lead to efficiency in economic and industrial matters. However, these initiations may create challenges in particular business sectors, since more than 70 per cent of these have already been organized in common joint venture programmes. Moreover, due to existence of MoUs that set the rules of the workshare of ongoing joint venture programmes, the industrial rationalization would only have its full effect in new cooperative programmes. In accordance with this context, EADS's participation in *Rafale* and *Eurofighter* programmes at the same time would provide opportunity of accessing new export markets and maintain a standardization of procurement. Also, these programmes would benefit EADS in terms of know-how and give EADS technological advantage to make progress in the next-generation combat aircraft projects.

In terms of the problems that may arise, regarding to military sector, Schmitt mentions that the cross border industrial rationalization is supposed to be limited due to complementarity ability of three partners.

- In missile sector, French facilities of MBD and the missile department of the former Aerospatiale have relative dominance over LFK. In the

event of duplication of the activities among all three, EADS has to think and act strategically in order not to endanger its access to the German market by applying measures only on the production capacity of LFK.

- In terms of the defence electronics, dominance of DASA is not arguable. Hence, possibility of synergy is not expectable in this sector.
- Regarding the combat aircraft field, establishment of possible cooperation is being delayed due to presence of Dassault Aviation and European Military Aircraft Company (EMAC) as separate entities.
- In transport and special mission aircraft sectors, Spanish division of EADS and the Italian subsidiary of EMAC should establish a common action ground in order to minimize the duplication.

In addition to questions regarding to sector, due to absence of any European company status, there arise legal and social problems. EADS is bounded to commercial law of the Netherlands. Politically, this choice is preferred to maintain a sense of neutrality between French and German partners. In terms of the fiscal reasons, the alternative is regarded as the best due to company law and tax law of the Netherlands. However, EADS is obliged to make separate employment contracts in accordance with the social regulations of the countries where it operates due to absence of European employment and social law. All these social and legal constraint prevents the company to enjoy full benefits of being a transnational merger.

Schmitt also touches upon the problems that may arise due to complex heterogeneous structure of employment. For him, the greater degree of integration always leads to greater divergences in national and business cultures. The difficulty of setting up a joint managerial structure doubles with

the difficulty of combining individuals of different nationalities and company backgrounds under the roof of a new organization. In accordance with this, when examining EADS, one must look at the existence of many French, German, and Spanish cultural particularities. And besides all these, “....it will be fascinating to see how EADS manages to develop its own truly European corporate identity”⁴³

4.4. The New Industrial Landscape of Europe

As a result of the all restructuring process, the whole industrial landscape of Europe has changed. Regarding the new structure authors define two levels; the core and the periphery.

The Core;

The core consists of two main entities; European Aeronautics, Defence and Space Company and the BAE Systems. EADS, which has reduced the number of participants in the various joint venture programmes through a horizontally integrated structure with strong civil business connections, simplifies cooperation with BAE Systems. And BAE Systems has a specialized vertical integration in the field of defence, where operates in a wide range of activities. These two giants of Europe structurally interact with each other through a number of joint venture programmes:

- In missiles industry, MBD, the joint 50-50 per cent subsidiary of BAE Systems and Matra dominates the industry. Also integration of the missiles business of Alenia Marconi Systems (AMS) into MBD gave

⁴³ Burkard Schmitt, 'From Cooperation to Integration: Defence and Aerospace Industries in Europe', Chaillot Paper 40, Institute for Security Studies of Western European Union, Paris, July 2000, p.48.

way to a new triad entity with € 2,32 billion turnover and over 10.000 employees. This structure controls 80 per cent of European missile production. Through a set of negotiations each of the BAE Systems and EADS holds 37,5 per cent of MBD and Finmeccanica 25 per cent.

- In space sector, Astrium, the merger of Matra Marconi Space (MMS) and the space business of DASA, with a turnover of €2,25 billion and over 8.000 employees has an important place in Europe. In spite of its shareholding is divided between MMS with 55 per cent and DASA with 45 per cent, the partners have equal voting rights in decision making mechanism. However, the merger of DASA-Aerospataiale-Matra merger gave EADS chance of having 75 per cent share of the company whereas BAE Systems has 25 per cent.
- In combat aircraft field, there is a relatively complex relationship between EADS and BAE Systems. The joint venture of Finmeccanica and EADS, EMAC has a 62,5 per cent share in Eurofighter programme whereas BAE Systems only has 37,5 per cent share in its own combat aircraft programme. However, integration of Marconi, a major subcontractor for the Eurofighter, provides BAE Systems a chance to increase its share by around 10 per cent and to maintain its technological leading presence in the programme. On the other hand, EADS has 45,76 per cent of the capital of Dassault Aviation, the manufacturer of Rafale. This situation creates a contradiction for the French government; since it is a party of Eurofighter programme through its share in EADS simultaneously it is the only customer of the rival programme, Rafale.
- In civil aviation business, BAE Systems participates in Airbus Company by construction of wings of the airplanes. Through this

activity it gets 20 per cent capital of the AIC. Within the AIC managerial structure, BAE Systems has two representatives in the shareholder committee and two in the executive committee. Daily activities are decided on the basis of a simple majority, whereas decisions of strategic importance are taken by both EADS and BAE Systems. Moreover, BAE Systems can decide to sell its shares in AIC to EADS.

Beside these joint programme interactions the management elites of the two companies declare their intentions of creating much stronger links. In the short term, it is supposed that activities related to above mentioned fields will remain stable except for combat aircraft sector. Regarding to this area questions arise about possible establishment of a single European entity, including BAE Systems, SAAB, Dassault and EMAC under one roof. Or will there be a transatlantic establishment in the sector, through alliance with Boeing or Lockheed Martin. It is also argued that there is no short term possibility of seeing a full-scale merger of BAE Systems and European Aeronautics, Defence and Space Company. There remains only one real fact that the successful presence of the one in the European defence industry landscape is linked to success of the other since around 68 per cent of the business activities of EADS is related to various joint ventures with BAE Systems whereas 25 per cent of business turnover of BAE Systems comes from its activities with EADS.

The Periphery;

The remaining national champions of the European industrial base are positioned around the two companies of EADS and BAE Systems, establishing the periphery. Relationships are organized either in the form of cooperation or competition. Within the periphery structure is divided among Thomson - CSF, Finmeccanica, SAAB and Dassault Aviation.

- Thomson – CSF has the leader position of Europe in defence electronics field. Within the restructuring process of the European defence industry, Thomson – CSF had strategically diverged from its counterparts aiming development of its activities in commerce and geographical diversification of its defence business. Regards, it had alliance with Alcatel, having opportunity to use synergies between civil and military electronics, particularly in telecommunications. In other parts of the world it has been following a multidomestic approach through local buys.⁴⁴

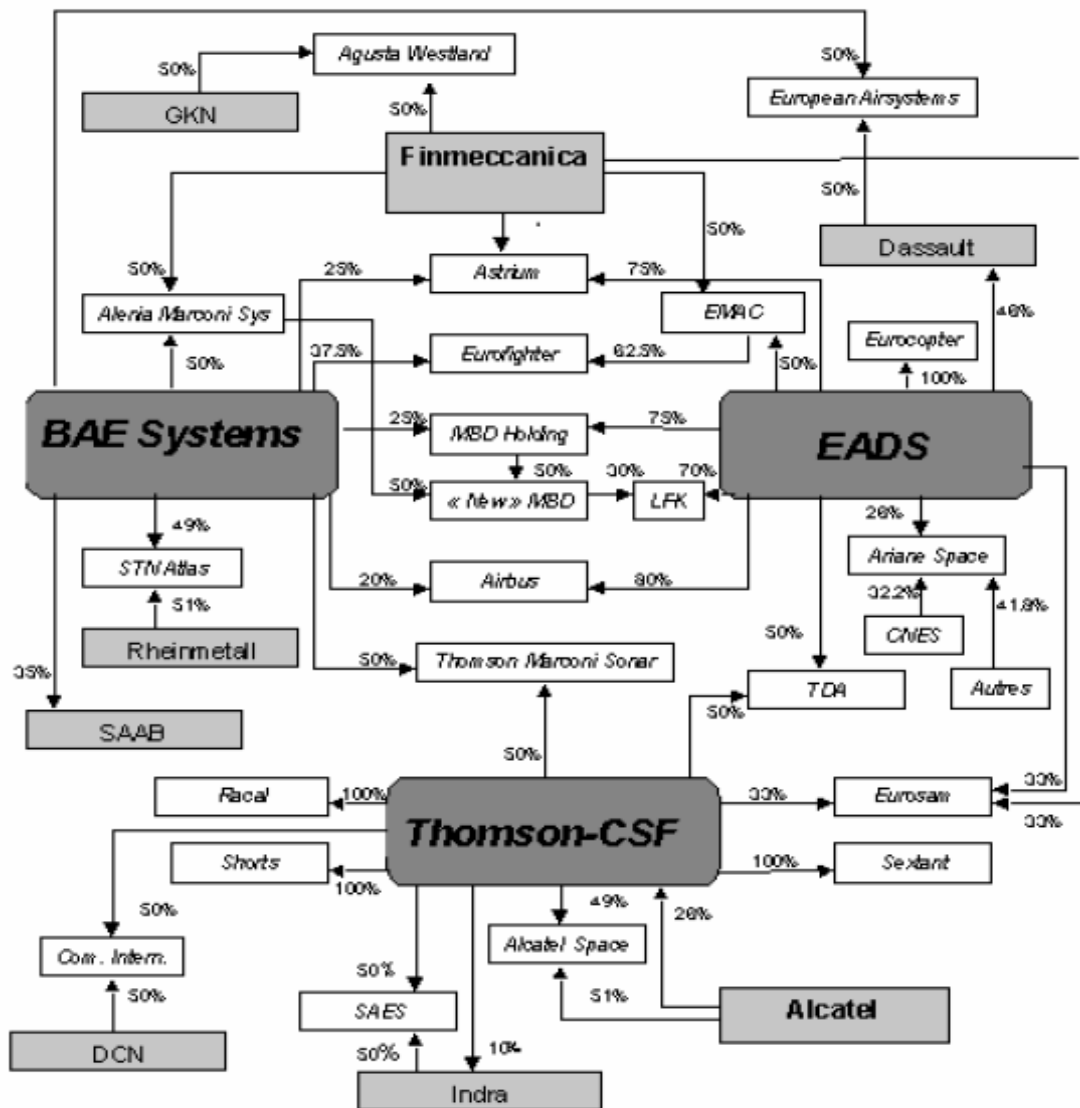
Regarding the complex relationship of Thomson – CSF with EADS and BAE Systems, Thomson – CSF has simultaneous partnerships: with EADS in TDA and Eurosam and with BAE Systems in Thomson Marconi Sonar. Also the company is leading supplier of AIC, Dassault and Eurocopter. Moreover, it is in competition with both companies in space, missiles and defence electronics sectors. And rival of BAE Systems in naval systems business.

- Swedish SAAB has relation with BAE Systems through commercialization agreement of the Gripen aircraft. Strategically, both of the companies enjoy the benefits of being on the same side rather than competing on export markets. Regarding to the merger taking place in France and United Kingdom, management of SAAB has had some hesitations as the CEO of the company Bengt Halse mentioned in May 1999 that the these mergers have created two European

⁴⁴ Burkard Schmitt mentions several activities of Thomson – CSF around the world in accordance with its multidomestic approach in 'From Cooperation to Integration: Defence and Aerospace Industries in Europe', *Chailot Paper 40*, Institute for Security Studies of Western European Union, Paris, July 2000, p.55. According to him Thomson – CSF; in Australia acquired ADI, in Brazil participated in Embraer together with Aerospatiale – Matra and Dassault, in South Korea purchased 50 per cent of the capital of Samsung's defence electronics subsidiary, in Singapore acquired Avimo, in South Africa completely controlled its subsidiary ADS and in the United Kingdom acquired Racal and completely controlled Shorts.

groups that are too big for the company to have a position in them. On the other hand, SAAB directed its activities to local firms and took over Celcius; the second big company of the Swedish defence industry. Also, German HDW has control of SAAB's submarines division and for the near future plan the company will probably integrate its combined missile activities in MBD.

- Dassault Aviation although has a formally independent structure, it is under the sphere of influence of EADS. In the aftermath of the declaration of establishment of EADS, Dassault insisted on the right to end the effect of shareholder agreement which has been effective since 1998 and has given Aerospatiale – Matra a veto on strategic decisions taken by Dassault. Also, an item of this agreement mentions that in the event of any change of control, Aerospatiale –Matra must decide on whether selling of its shares or relinquishing of its special rights within Dassault Aviation. Now, EADS is a shareholder of the Dassault Aviation. Thus, within the decision making mechanism it has the right to block any decision requiring agreement by two thirds of the shareholders. Schmitt predicts two possible future scenarios regarding the relationship between Dassault Aviation and EADS; Initially Dassault may divide its activities into two parts; civil and military and integrate the military part into EADS. However, he notes that this scenario is unlikely to happen. Secondly, Dassault Industries could integrate its 49,9 per cent shareholding in Dassault Aviation to EADS and become a shareholder in this company. This option can be favored by the French government, however regarding the two partners at the moment it is a rejected possibility. However, both cases produce same result of merger of Dassault Aviation with EMAC, reducing Finmeccanica's participation from 50 per cent to 35 per cent.



Scheme 3

The new Landscape of European Aerospace and Defence Electronics Industry

SOURCE: Burkard Schmitt, 'From Cooperation to Integration: Defence and Aerospace Industries in Europe', *Chaillot Paper 40*, Institute for Security Studies of Western European Union, Paris, July 2000, p.41.

CHAPTER 5

EFFORTS OF CONVERGENCE AT EUROPEAN LEVEL

Parallel to efforts by the European states, international institutions were trying to create a common policy for the armaments sector. Since national regulations of European countries regarding defence sector are not particularly homogeneous, they pursued complementary functions aiming to establish a procedure that is applicable to all levels of the defence sector. These attempts were seen as a tool for eliminating barriers that present major obstacle for the Europeanisation of the industry. Efforts within international institutions allowed members to deal with issues together and search for areas of convergence. Moreover, complexity of multilateral level armaments issues were highlighted and transatlantic relations were emphasized. These initiatives on a significant number of aspects of armaments policy have taken place in international institutions consequently constituting a common ground for the parties through institutional documents.

5.1. NATO

NATO has always been an institution that has the greatest competence in European defence. Within the NATO structure several bodies have particular responsibilities regarding the questions of defence and armaments.⁴⁵ Through these structural bodies NATO provides an international legal framework for armaments programme management and logistic support.

However, the results of the Alliance activities in the field of defence are debatable. In spite of the programme management regulations, a degree of

⁴⁵ These bodies, which separately report to the North Atlantic Council, are the Conference of National Armaments Directors (CNAD), the NATO Consultation, Command and Control Organisation (NC3O), the NATO Air Defence Committee (NADC), the Senior NATO Logisticians' Conference (SNLC) and NATO Committee for Armaments Cooperation (NCAC).

standardization and armaments planning have not been reached since these subjects are still regarded under sovereignty of national states. Moreover, within NATO there is no established body for the harmonization of the operational requirements of the various armed forces. Instead issues are dealt by different committees in their respective spheres of competence.

Regarding to transatlantic links, under NATO umbrella there are in fact few collaborative programmes. However, most of the NATO support seems to be given particularly to initiatives between European countries. In terms of the transatlantic industrial cooperation, NATO Industrial Advisory Group (NIAG) document of '*Ways to improve cooperation amongst defence industries within NATO – phase 2*' provides significant points regarding to barriers of the area. Particularly the document underlines "differences among the nations with regard to their views on the way in which transatlantic cooperation should be conducted and, indeed, the objectives of doing so. Previous attempts to generate agreement on these issues have failed since their basic requirement has been for a generic solution which did not recognize all aspects of the problem"⁴⁶ Accordingly scholars argue that only Defence Capabilities Initiative (DCI) of NATO can be an opportunity to improve these complex interactions.

5.2. European Union

Although it is supposed that European Union should be the core institution that provides a common ground for the countries on defence related issues, however, its explicit role in defence industrial policy has been restricted by the Article 223 of the Rome Treaty (Article 296 of the Amsterdam Treaty)⁴⁷.

⁴⁶ G. Adams, C. Cornu and A. D. James, "Between Cooperation and Competition: the Transatlantic Defence Market", Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p. 74.

⁴⁷ Article 296 (Ex article 223) of the Treaty establishing the European Community;
1- The provisions of this Treaty shall not preclude the application of the following rules:

According to these articles, all kinds of armaments activities including production, trade and procurement have been deliberately put out of the scope of the European integration process by the member states, who, until end of 90s have preferred to maintain purely national control mechanisms on these activities. However, despite the article's clear clauses, it is argued that the more integrative bodies of EU – the Commission and the Parliament – and member states have been unsuccessful to persuade the intergovernmentalists – the Council and, among members, the United Kingdom and France – to allow the defence related industry to be ruled by European Union regulations as is applied to every other economic sector. Paradoxically, despite armaments questions have been left out of the scope of European integration process, there are many tools that may be used to build up a strategy such as theoretical models, budgets and areas of competence. Hence it should be kept in mind that in spite of reservations of certain states, only European Union offers a binding legal structure via provision of a framework for coherence and action.

Consequently, the Commission started to look for every area that could provide area of maneuver to it on the governance of European defence industrial base. It has repeatedly expressed a will to be more closely engaged with European armaments matters. Despite the Article 296 the Commission tried to gain more influence on defence industrial policy regulation by using Single Market legislation where defence industry is not covered. It took R&D frameworks of defence-related projects under the

-
- a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;
 - b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or the trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.

2- The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew upon April 1958, of the products to which the provisions of paragraph 1b) apply.

projection of EU structure and supported those activities especially in information technologies, industrial materials and telecommunications, which have both civilian and military applications. It made merger activities depending on its approval. Moreover EU supported regions that were in need for economic development with programmes such as Perifra and Konver⁴⁸ in order to accelerate the diversification of economic activities of regions that were heavily dependent on the defence sector and decrease the burden of unemployment due to termination of activities of defence firms in these areas. Also during the initial stages of 90s EU developed a collection of ad hoc policies administered by several directorates-general (DGs) within the Commission. In 19 December 1994, regarding to a common control regime for dual-use goods exports to third countries, the Commission started an identification process for international trade purposes and a list of permitted or proscribed destination countries was made by the Council. The regime was a cross-pillar approach aimed at dealing with the responsibility dilemma concerning the specificity of dual-use goods. For legal and practical reasons, the regime of dual-use export control was revised during 2000 and replaced by a new control regime.⁴⁹ The reviewed regime has established a new consultation mechanism that would on undercutting area improve cooperation between European Union countries. Previously, where member states could freely grant an export licence for an item to a third party, which the authorization was rejected by the other member state(s), with the application of the latter regime members now should “(a) inform each other on denials of export licences; (b) consult with each other on their intention to

⁴⁸ According to Jocelyn Mawdsley, ‘The European Union, the State and Multinational Defence Firms: The Emerging European Political Economy of Defence and ESDP’ paper prepared for the British International Studies Association Annual Conference, London School of Economics, 16 – 18 December 2002, p.8, KONVER (1993 – 2000) consists of measures eligible for support included; advisory and business support services to improve know-how and encourage diversification, job creation and vocational training schemes , redevelopment of military sites for civilian use, environmental and community facility improvements and the promotion of tourism.

⁴⁹ For detailed history and all documents related to the trade of dual-use goods in the European Union, see www.europa.eu.int/comm/trade/goods/dualuse/index_en.htm.

undercut; and (c) explain their decision to do so”⁵⁰ However, in an environment which lacks of existence of a common export policy, it remains to be seen whether this mechanism can provide a solution for the control regime. Today, records prove that the regime only offers a common framework for diverse national policies with unclear principles within which members recognize each other’s export licences but do not share the same point of views on each other’s export policies.

Starting with 1994, the Commission and the Parliament started a significant support for a more explicit EU defence industrial policy. Accordingly, over the next three years three core documents were published regarding the subject; (i) The challenges facing the European defence-related industry: a contribution for action at European level (1996), (ii) Implementing European Union strategy on defence-related industries (1997), (iii) Draft action plan for the defence related industry (1997). Being the most significant of the these three documents, the last one identifies fourteen areas in which immediate EU action is required necessarily; particularly in

...the standardization of defence equipment and national export policies, the incorporation of the defence industry sector into the EU’s competition policy and state aid regulations, and cooperation in armaments R&D and procurement⁵¹

The importance of these documents is that they show the active attempt of the Commission to bring the European defence industry within the general area of interest of the European Union and the single market programme.

⁵⁰ Burkard Schmitt, “The European Union and Armaments; Getting a bigger bang for the Euro”, Chaillot Paper 63, Institute for Security Studies of Western European Union, Paris, August 2003, p.31.

⁵¹ T. Guay and R. Callum, “The Transformation and Future Prospects of Europe’s Defence Industry”, in International Affairs, 78, 4, 2002, p.767.

The European Council conducts armaments aspects of the European policy in two main working groups; Working Group on Export of Conventional Arms (COARM)(1993) and European Armaments Policy Council Working Group (POLARM)(1995) chaired by the country holding the EU presidency.

The COARM, which meets six times a year, consists of foreign ministry representatives of the member states usually accompanied by defence ministry experts. The activity area of COARM mainly consists of exports to third countries based on eight export criteria defined by the Council meetings in 29 June 1991 in Luxembourg and in 26-27 June 1992 in Lisbon.⁵² These criteria constituted the foundations of the Code of Conduct adopted by the Council in June 1998.

With in the European Union, the only formal forum for discussions on armaments issues is the ad hoc European Armaments Policy Council Working Group (POLARM). This body was established in 1995 and works directly to the Committee of Permanent Representatives (COREPER). This body, which composed of foreign ministry representatives of the member states (usually experts from ministry of defence participate), formally meets three times during any one presidency. However, context of its activity mainly depends on the specific interest of each presidency. It was not until the Greek Presidency period (January-June 2003) that POLARM could reach an agreement that demonstrates a clear desire to deal with armaments issues within the EU structure. Three draft resolutions that have been adopted by the Council on the areas of standardization, restructuring challenges in the European Union armaments sector and security of supply. Moreover, during

⁵² According to C. Adams, *op.cit.*, in note 45, p.87; the eight export criteria are; “1. Respect for international commitments of the EU Member States, 2. The respect of human rights in the country of final destination, 3. The internal situation in the country of final destination, 4. Preservation of regional peace, security and stability, 5. The national security of the Member States, 6. The behaviour of the buyer country with regard to the international community, 7. The existence of a risk that the equipment will be diverted within the buyer country, 8. The compatibility of the arms exports with the technological and economic capacity of the recipient country.”

the same period discussions on EU Cooperation Programme for Advanced Research and Technology (E.P.A.SE.RE.TE.)⁵³ were started within POLARM assigning the group to continue on working military based research.

In 8 June 1998, the General Affairs Council adopted a not legally binding – the reason of the main criticism directed to this initiation - but voluntary Code of Conduct on Arms Exports by which governments committed to consult each other on issues of granting export licences to countries. It can be accepted as the first sign of the Council's engagement in this sensitive area. But on the other hand this application has shaken the fragile role of the Commission in efforts of establishing a common armaments policy. In fact, because this procedure mainly aimed harmonization of measures on arms exports rather than establishing a unified regulatory structure. The implementation and operation discussions of the Code take place in COARM. The overall objective of the application is provision of transparency in arms transaction activities that would be backed up by a growing convergence of national export policies. The code bases on two main elements; (i) it establishes a set of criteria to define the cases where export activities should be avoided and (ii) puts on pressure on member states not to conduct an export activity to where the other state has refused. Thus, through these elements the code indirectly provides a mutual exchange of information and consultation mechanism among the member states. However, if a member country wants to grant an export licence to a third country that has been previously refused by another member state, it is obliged to inform and consult only with the member state that first issued the refusal. Nevertheless to protect the standards of the so-called first step towards a common European approach to arms exports, the Code sets eight criteria, which establish framework of the management and control of the arms export

⁵³ According Burkard Schmitt, op.cit. , in note 49, p.32; the E.P.A.SE.RE.TE contains proposals for rules governing strategic R&T activities that are very similar to those of the EUROPA MOU. The Commission in turn, has accepted them for the management of its preparatory action.

transactions⁵⁴. These principles offer a comprehensive framework covering issues of human rights, regional security and development concerns through an export control mechanism. In order to complete this arrangement, in 2001 member states agreed on a reference list of defence related equipments that are subject to the Code of Conduct, however member states are free to use their own lists.⁵⁵ In terms of the relative success of the mechanism, The Fourth Annual Report according to operative provision of eight of the European Union Code of Conduct on arms exports (November 2002) mentions in its review of the fourth year of implementation of the Code that ;

...The European Union Code of Conduct on Arms Exports consolidated its position as the most comprehensive international arms export control regime, providing for a high degree of internal and external transparency, dialogue, respect for denial notifications and dynamism.⁵⁶

Nevertheless, in spite of the efforts to establish a regulatory ground by the end of 90s, it is argued that the EU had a loose collection of policies regulating different aspects of the defence industrial base and the structure was far behind a comprehensive policy that would guide or even assist the restructuring of this industry. Moreover efforts of three main actors of the EU structure – The European Parliament, the Commission and the Council – for

⁵⁴ These eight criteria are based on the eight export criteria of the Luxembourg and Lisbon summits that are mentioned in note 51. These are extended in context as such; “1. Respect for the international commitments of EU members, in particular the sanctions decreed by the UN, the EC, and non-proliferation agreements, 2. The respect of human rights in the country of final destination, 3. The internal situation in the country of final destination, as a function of the existence of tensions or armed conflicts, 4. Preservation of regional peace, security and stability, 5. The national security of the member states, as well as that of friendly and allied countries, 6. The behaviour of the buyer country with regard to the international community, as regards in particular to its attitude to terrorism, the nature of its alliances, and respect for international law, 7. The existence of a risk that the equipment will be diverted within the buyer country or re-exported under undesirable conditions, 8. The compatibility of the arms exports with the technical and economic capacity of the recipient country.” Burkard Schmitt, op.cit., in note 49, p.33.

⁵⁵ The Council may be invited by unanimous decision of the Commission to modify the list.

⁵⁶ Burkard Schmitt, “European Armaments Cooperation Core Documents”, Chaillot Paper 59, Institute for Security Studies of Western European Union, Paris, April 2003, p.29.

implementation of initial mechanisms of a common European armaments policy was only at the 'embryo stage'.

Moreover the Common Foreign and Security Policy of EU, that was brought to the agendas by the Maastricht Treaty (1991) has dominated the agendas of the institution emphasizing mainly cooperation and collective action of the member states against common perceived threats directed to the sovereignty of one or all. Although, this second pillar of the EU is hoped to be accepted as the EU common defence policy, its context and scope was far from the industrial issues. However, specifically, the 1997 Amsterdam treaty, which defines the EU's common defence policy as a combination of humanitarian and rescue tasks, peacekeeping tasks and tasks of combat forces in crisis management, including peacemaking (the so-called Petersberg tasks), that would be conducted through European Security and Defence Identity changed the situation on behalf of defence industry. Particularly, application of these would give the Commission a chance to improve its role in defence industrial policy making. As Commissioner Liikanen mentioned establishment of a unified European defence market has become the primary target, which in return would support the European defence industrial base.

Consequently, during the following years developments have taken place that could benefit the Europe's defence industry. Moreover, EU summits have served for the establishment of new politico-military instruments in the framework of CESDP.⁵⁷ Although it is argued that these attempts lack of sufficient legal basis to start the process of a comprehensive armaments policy, at least but not the last they have established a cooperation framework among the member states of EU.

⁵⁷ These new instruments are; 1. Political and Security Committee (PSC), 2. Military Committee 3. European Military Staff. For detailed information about EU structural bodies as well as NATO see, François Heisbourg *et al.*, "European Defence: Making It Work", Chaillot Paper 42, Institute for Security Studies of Western European Union, Paris, September 2000.

During the 1999 December Helsinki Summit it was decided to develop an autonomous capacity, by 2003, to be able to decide, launch and conduct EU-led military operations in areas where NATO is not engaged and set a timetable for the establishment of a rapid reaction force. Thus, in accordance with these commitments of the member states, in December 2000 Nice Summit EU pledged 100.000 troops, 400 aircrafts and 100 ships to establish a rapid reaction force to be sent to areas of regional conflicts or humanitarian crises.

Since the European defence industry would be the major supplier of the required items, the skepticism regarding the Common Foreign and Security Policy during the beginnings and mid-1990s had been replaced with the optimism starting with the St. Malo (December 1998) and Helsinki (December 1999) declarations that provided political support for private sector restructuring. However, it should be noted that there is the possibility of Europe not being able to achieve its policy ambitions via CFSP unless those political commitments are not supported by security and defence industrial capabilities of individual states. Moreover, in budgetary terms, the development of a European Armaments Policy depends on the voluntary commitments of member states.

In terms of the civil research funding European Union implements the Framework Programme for a four years period, which has been used as a main instrument of the area since 1984. Organizationally, programmes to be adopted are offered by the European Commission and decided to be implemented through a co-decision procedure worked out by the European Parliament and the Council. The latest of the instrument – The Sixth Framework Programme (FP6) - was decided at the Lisbon Summit in March 2000 and has been fully effective since September 2002. It mainly deals with the establishment of 'Networks of Excellence' and 'Integrated Projects' with

the aim of constituting a structured 'European Research Area'⁵⁸ The FP6 budget is only used to fund non-military civilian projects. In order to strengthen the R&DT areas of aeronautics and space industry of Europe €1.075 million are allocated out of the overall budget (€17.500) of FP6. Moreover, the dual-use technologies are also integrated into the agenda of the programme, where products of military interests are increasingly developed by civil technologies.

Coming to new millennium, regarding the aerospace and defence industrial policies the European Advisory Group, which was established in 2001 to analyse the adequacy of the current political and regulatory structure for aerospace in Europe, prepared a review report. It was presented to the President of European Commission, Romano Prodi in 16 July 2002. The STAR 21 Report (Strategic Aerospace Review for the 21st Century, creating a coherent market and policy framework for a vital European industry) mainly emphasizes two points; (i) the need for rapid development of a more coherent defence market and (ii) the need for great development in the R&T structure of civil aeronautics, defence and space. The most important aspect of STAR 21 is how it shows the attempts of the major defence and aerospace companies to establish an image of the traditional state-company relationship at the European level. The report mentions the complementary and mutually dependent character of civil and defence aerospace sector and underlines the need of immediate action against the competition coming from American side. Accordingly, it identifies and evaluates the key areas that are expected to be determinants of the future competitiveness of the industry. In dealing with the aerospace industry from a European perspective, the report identifies four issues; (i) Aerospace industry should be considered as vital in meeting Europe's aspirations in achieving economic growth, security and quality of living. (ii) A globally strong and competitively effective defence industrial base is significant since it would bring necessary options and

⁵⁸For detailed information on FP6 see www.europa.eu.int/comm/research/fp6/index_en.html.

choices to Europe in its decisions as regards its presence and influence on the international arena. (iii) The European aerospace industry should be a strong competitor in order to be accepted as an industrial partner in the global aerospace market. (iv) Europe should be among the major technology producers in order to have an innovative and competitive aerospace industry⁵⁹

In March 2003, the European Commission revitalized its aim of setting up a communication, which was firstly initiated in November 1997. The first attempt, aiming to promote the emergence of a European defence market via a draft Common Position on the Framing of a European Armaments Policy and an Action Plan did not achieve to a desired level. However, recent industrial consolidations combined with the development of ESDP have opened the way for progress that was made impossible by the member states five years ago due to their disagreement on the existence and necessity of a common armaments policy. The Communication is intended to contribute to greater efficiency in the defence equipment industry for the industry itself on the one hand and for the success of ESDP on the other. Also it was a explicit signal of the Commission to the member states, showing its willingness to contribute to the process of a possible EU defence equipment policy with its all expertise on industrial and market issues.

Nevertheless, within the literature arguing the effectiveness of those policies that EU has adopted on the operations of the European defence companies, it is argued that it would be difficult to mention these attempts have played a decisive role in the restructuring and consolidation process of the defence sector in the post Cold War Era. Although some progress has been made in several of areas, the political and regulatory framework should be improved in order to narrow the gap between ambitions and capacity to achieve them.

⁵⁹ For comprehensive information about STAR 21 see Burkard Schmitt, "The European Union and Armaments; Getting a bigger bang for the Euro", Chaillot Paper 63, Institute for Security Studies of Western European Union, Paris, August 2003, pp.130-162.

As an effective institution the EU can play a decisive role in the establishment of a common armaments policy, however its regulatory capabilities should be backed up with the agreement of member states on the ultimate objective and also with the body that will take the responsibility of carrying out the process.

5.3. Western European Union / Western European Armaments Group

When the Treaty on European Union was signed (1991), the Western European Union (WEU) was seen as both an integral part of the European Union and the European pillar of the Atlantic Alliance. These responsibilities as being the case WEU has become the body of addressing questions of armaments production.

The Western European Armaments Group was established (December 1992) as an intergovernmental forum within Western European Union in the aftermath of signing of Maastricht Treaty. It has taken over the responsibilities of Independent European Programmes Group (IEPG)⁶⁰, which had been created in peak Cold War days of 1976 and was the only European body competent to deal with defence and armaments issues. Main responsibility of WEAG is provision of a European armaments cooperation based upon more effective grounds. With its 19 full members⁶¹ at present WEAG deals with four dimensions of European armaments policy;

⁶⁰ Independent European Programme Group was established in 1976 by the defence ministers of European NATO countries, except Iceland

⁶¹ Full members of WEAG are; Austria, Belgium, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Turkey and the United Kingdom. Also, Bulgaria, Estonia, Latvia, Lithuania, Romania, Slovakia, Slovenia are taking place as the associate partners of the organization.

- The first aspect is the more efficient use of national resources through harmonization of armaments programmes of European countries and identification of operational requirements of this aim.
- Secondly, establishment of cooperation in research and technology fields.
- Thirdly, with the cross – border interactions elimination of barriers and opening up of the markets.
- Finally, provide every mean in order to strengthen the European defence technological and industrial base.

According to founding principles of WEAG, each member country is entitled to take place fully and with the same rights and responsibilities in any other European defence industrial cooperation. However, it should be aware that there should be a single entity for cooperation on these issues.

The structural body of WEAG, the National Armaments Directors (NADs), which consists of ministers of defence of member countries, meets once in a year. Day to day activities are dealt by permanent representatives of the NADs located in Brussels. Activities of WEAG are organized under three panels; (i) The Panel I aims promotion of cooperation in equipment and procurement programmes. Mainly with a reporting procedure it compares the armaments replacement status of the member countries, and in case of possible cooperation harmonizes requirements. (ii) The Panel II deals with the strengthening activities and opportunities of cooperation in defence related R&T. There are 13 Common European Priority Areas (CEPAs) identified. (iii) The Panel III conducts with basic dimensions of common defence economic policy and armaments cooperation procedures. It has a

set of principles regulated by Coherent Policy Document (CPD)⁶², which mentions that;

...during a transition period, application of the juste retour principle and support for countries with developing defence industries (DDIs) are two important aspects of the creation a European Defence Equipment Market (EDEM)⁶³

As discussions have taken the form of deadlock, it was once more the responsibility of individual states to initiate bilateral projects to achieve the success of Europeanisation of the defence industry. While the supply side has been reorganized through the efforts of actors of the industry, now it was up to governments to re-regulate the operational framework of the market and the functioning of the demand side. In spite of having differences in perceptions and procedures, states had two aims in common, between which it will always be difficult to maintain the right balance ; (i) Protecting their national interests vis-à-vis an increasingly transnational defence industrial base, simultaneously (ii) creating necessary backgrounds and conditions for transnational companies to operate in a rational, optimum way. It was understood that the traditional forms of cooperation of ad-hoc programme-by-programme approaches no longer provided sufficient solutions. Hence, governments were pushed to a transformation in their modes of cooperation and redefine their roles of being customers, sponsors and regulators of the consolidated industrial base.

In November 1994 Noordwijk ministerial meeting, members of Western European Union agreed on the guiding principles of functioning of a European Armaments Agency (EAA). During the same meeting, establishment of a research body in spring 1995, to support the EUCLID

⁶² CPD was approved by the defence ministers of the WEAG countries in 1990 and in 1999 it was updated.

⁶³ Burkard Schmitt, "The European Union and Armaments; Getting a bigger bang for the Euro", Chaillot Paper 63, Institute for Security Studies of Western European Union, Paris, August 2003, p.21.

programme⁶⁴ was agreed at the defence ministers' level of the thirteen member countries of WEAG. This programme is accepted as the main instrument of WEAG for R&T. According to EUCLID procedure, projects of the member states must be approved by the Panel II, which is mentioned above. However, in terms of influential force the Panel II does not have any effect on the choices of development of these projects.

However, the EUCLID programme did not succeed as was hoped for. At that time, France and the United Kingdom devoted only about 1 per cent of their research budgets to the programme whereas Germany only 2 per cent and other countries between 5 – 50 per cent. In terms of the reasons of this relative failure of EUCLID there were lack of new projects and increasing competition from the bilateral and multilateral programmes that were established irrelevant to the EUCLID programme. Also being within the same framework, in May 2001, the ministers of defence of the member countries signed another Memorandum of Understanding (MOU); EUROPA, which provides its participants a space in terms of developing their own regulations particularly for Intellectual Property Rights (IPRs).

In 7 December 1995 French and German governments initiated a bilateral project of the Franco-German armaments structure, which would give birth to OCCAR one year later. They were agreed on five principles which are called Baden-Baden principles;

- Best cost efficiency in programmes

⁶⁴ The European Cooperative Long-term Initiative for Defence (EUCLID) was established with the aim of provision of broad, systematic collaboration in research, which was to be one of the privileged paths towards the creation of a future armaments market. It began as a French initiative in 1989 and launched in February 1990, with a memorandum of understanding signed between 13 nations in November 1990. The programme is structured around thirteen common European priority areas mainly dealing with research and technology projects. Participation to the programme is *a la carte* and each participating member country pays its own national firms and laboratories for the government funded element of projects in which it is participating.

- Coordination of long-term military requirements
- Competition in procurement
- Industrial cooperation based on a multi-lateral programme, multi-year over balance.
- Participation by other countries

Simultaneously, at WEU ministerial meeting in Ostend on 19 November 1996, the Western European Armaments Organisation (WEAO) was established to deal only with multilateral defence R&TD projects. The establishment of WEAO is based on the workings of the Ad Hoc Study Group (AHSB), which was established in 1993 in order to examine the possibilities of establishment of a European Armaments Agency. However, at that time lack of necessary political, financial and legal conditions there was no possibility of creating such an agency. As a subsidiary body of WEAG structure, WEAO has the ability of providing a legal framework for issues of armaments cooperation. In spite of Articles 6 and 7 of the WEAO Charter⁶⁵, which mentions wide range of areas that the organization may deal with potentially, it provides services for its member states in the field of military research, development and technology.

⁶⁵ According to Burkard Schmitt, "European Armaments Cooperation Core Documents", Chaillot Paper 59, Institute for Security Studies of Western European Union, Paris, April 2003, p. 12-13, Article 6 of the WEAO Charter mentions that; " The aim of the WEAO is to assist in promoting and enhancing European armaments cooperation, strengthening the European defence technology base and creating a European defence equipment market, in accordance with policies agreed by the WEAG" and the Article 7 is: "In order to carry out the aim defined in paragraph 6 above and in compliance with the provisions of Section IV below, the WEAO may undertake in the name of the WEU and on behalf of one or more participants, the following functions; a. defence research and technology activities; b. procurement of defence equipment; c. studies; d. management of assets and facilities; e. other functions necessary to carry out the aim of the Organization.

In theory the WEAO was designed to become in time a European Armaments Agency⁶⁶; - “When WEAG ministers decide that conditions to move to a full European Armaments Agency (EAA) are met...”⁶⁷- however, states participating in ad hoc group on the EAA which proposed the establishment of WEAO, could not protect the initial establishment aim and ultimate target of the body. Up to now WEAO could only managed several defence programmes⁶⁸ and its future depends on cooperation efforts of states.

After the ministerial meeting in Erfurt (November 1997), defence ministers agreed on the operation of a Masterplan, which defines the required steps to be taken for the establishment of a European Armaments Agency. At the same time a Group of National Experts (GNE) was established to work out the developed rules and procedures. However, following the ministerial meeting of 16 May 2002 Rome where it was formally supported the establishment of EAA as soon as all the conditions had been met, the GNE was dissolved. Unfortunately, no supportive voice came from the side of national governments to apply the recommendations of the Masterplan into being. It was so clear that, there was no political ground for constitution of EAA under the structure of WEAG.

In terms of the effectiveness of the WEAG authors argue that in spite of these efforts, it just represented a forum for discussion and just a platform of

⁶⁶ As quoted from the Parliamentary Assembly of WEU, in Pierre De Vestel, “Defence Markets and Industries in Europe: Time for Political Decisions?”, Chaillot Paper 21, Institute for Security Studies of Western European Union, Paris, November 1995, p.40, a European Armaments Agency was thought to deal with tasks of; (i) management of cooperative programmes, (ii) management of EUCLID programme, (iii) management of joint research and testing facilities, (iv) technological and operational studies, (v) the establishment of information and data services.

⁶⁷G. Adams, C. Cornu and A. D. James, “Between Cooperation and Competition: the Transatlantic Defence Market”, Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p. 77.

⁶⁸ Those programmes are; EUCLID (since 1990), EUROFINDER (1996), THALES (1996) and SOCRATES (1998).

testing procedures. Since its establishment it was weak in terms of absence of both political support and interest from national authorities. And due to decision-making procedure of consensus (not binding) WEAG has not been able to give desired acceleration to European cooperation. Also, the principle that each member country is entitled to take place fully and with the same rights and responsibilities in any other European defence industrial cooperation has forced the major defence equipment producing countries to establish other structures that allow for bigger room for greater flexibility. In short, it can be argued that although the organization had pointed out right dimensions of cooperative European defence industrial base, it has suffered from the absence of required will and bodies to apply founding principles via appropriate solutions. During the 20-21 March 2003 meeting of WEAG NADs, it was decided to prepare necessary ground for the possible transfer of the functions of WEAG under the structure of European Union.

In terms of the R&T projects, the EUROPA MOU – European Understanding for Research Organisation, Programmes and Activities – provides a general structure: Although it does not contain detailed rules for the conduct of R&T projects, it provides a greater degree of flexibility to its parties in developing their own rules. Hence as Schmitt argues in Chaillot Paper 63; the creation of European Research Grouping (ERG) in accordance with EUROPA would provide a ground for the carrying out of several individual projects or a single major programme. Since the membership to the group is flexible – any country which shows its interest in joining the group and agreeing on the principles on ERG agreement will be welcomed – it would enhance cooperation in the different aspects of R&T such as contracting, finance, security and intellectual property rights.

The first European Research Grouping under EUROPA MOU was established in December 2001. It had 14 members⁶⁹. The ERG No: 1 provides a greater flexibility to its participants in the conduct of their individual R&T projects. They are free to engage in bilateral interactions free of approval of other members. Also the juste retour principle is not applied on automatic basis and the shares are decided on freely case-by-case basis. The outline of the projects does not have to be proposed to the approval of the Panel II of the WEAG and participants may ask for support of WEAO. In terms of these attractive opportunities, both MOU EUROPA and the ERG No: 1 provide, they are expected to become the core structures for the future of European defence industrial related R&T projects.

5.4. Organization for Joint Armaments Cooperation (OCCAR)⁷⁰

Based upon the 1995 Franco-German agreement, the Organization for Joint Armaments Cooperation was agreed to be established on 12 November 1996 with the participation of Italy and United Kingdom. Within the MOU establishing OCCAR, there was no agreement to present the organization as a subsidiary body of WEU nor to integrate it in the EU structure. The OCCAR Convention was signed in September 1998 and ratification procedure of the OCCAR convention was completed in December 2000 and OCCAR gained its legal status on 28 January 2001

The quadrilateral procurement agency of OCCAR, establishment of which was seen as a vehicle to assist the European Defence Industrial Base in the process of consolidation, is the first European armaments management organization. According to Article 7 of the 9 September 1998 OCCAR Convention;

⁶⁹ Members are ; Belgium, Denmark, Finland, France, Germany, Greece, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Turkey, United Kingdom

⁷⁰ Organisme Conjoint de Co-operation en Matière d'Armement (OCCAR)

OCCAR shall coordinate, control and implement those armament programmes that are assigned to it by Member States, and coordinate and promote joint activities for the future, thereby improving the effectiveness of project management in collaborative projects, in terms of cost, schedule and performance⁷¹

The working methods and procedures of the organization are based mainly of number of innovative principles which would be applicable to all countries willing to join OCCAR;⁷²

- Provision of true industrial and technological complementarity among France, Germany, Italy and the United Kingdom;⁷³
- Establishment of common procurement principles;
- Application of a more flexible calculation of industrial juste retour replacing the strict application of ‘cost-share equals work-share’ on a project-by-project basis by a multi year/ multi programme balance in favor of an overall balance.
- Establishment integrated transnational teams from both governmental and industrial circles.

⁷¹ Quoted from 1998 OCCAR Convention, in Burkard Schmitt, “European Armaments Cooperation Core Documents”, Chaillot Paper 59, Institute for Security Studies of Western European Union, Paris, April 2003, p. 47.

⁷² In addition to these principles that the nominating countries have to accept, there is the rule of being participated in at least one major collaborative project for those that would take place within the organization.

⁷³ I think this principle is highlighted in the Article 6 of the OCCAR Convention. Although, the founding members of the OCCAR do not have the aim of establishing a closed group for the benefits of themselves, the Article clearly proves that the priority is given to these four countries; as quoted from 1998 OCCAR Convention, in Burkard Schmitt, op.cit. , in note 55, p.47:

“When meeting the requirements of its armed forces, each Member State shall give preference to equipment in whose development it has participated within OCCAR”

The main decision making body of the organization is the Board of Supervisors (BoS). It consists of the ministers of defence of the member states or their delegates who meet two or three times a year. There are several committees under BoS established to work out some functions of it; Future Tasks and Policy, Finance, Security and Programme Committees. The BoS takes important decisions such as the admission of new member states, new rules and regulations, organizing the OCCAR Executive Administration and appointment of the director. All these decisions are reinforced by a qualified majority and each member state has a right to veto. The voting rights of the four founding members are equal to ten. This means that a decision cannot be taken if there are ten opposing votes.

The Executive Administration (EA) is structured through; (i) a central office responsible for coordinating issues of human resources, development of managerial tools and getting hold of new joint programmes and (ii) several programme divisions dealing with management of collaborative programmes, system specifications, preparation of contracts and organization of financial issues.

Similar to WEAO, in terms of the mission attributed to OCCAR, its structure and areas of interest represent the potential of OCCAR, by which, may be turn out to be a true European Armaments Agency in the future. According to Article 8 of the Convention, OCCAR could cover a wide range of activities and become a fully-fledged armaments agency. However, authors argue that the lack of political commitment of the member states has prevented the application of this potential of the organization. In terms of its records, OCCAR has acted just as a project management agency. Its main aim is to achieve optimization in the management of joint defence equipment and procurement programmes. In addition to that, there are some issues to be applied regarding the institutionalization process of OCCAR; on the one hand there is the problem of transferring all the work and responsibilities of

national structures who are dealing with the ongoing programmes, to the administrative structure of the organization and on the other the legal appropriateness of the functioning of OCCAR should be designed in accordance with the Community Law in order to provide common legal ground in the event of litigation. Unfortunately, up to now solution regarding these two areas is unclear.

In terms of the financial structure there raise a number of issues too; the managerial budget system of OCCAR is still ruled by national entities and the financial control is kept by programme managers. This system provides a limited scope of the organization's financial flow and prevents general management from calculating a true multi-programme *juste retour* as aimed in founding principles.

Up to 2000, the agenda of the organization was dominated by the theoretical issues such as definition of its governing rules and procedures. Several projects were conducted as pilot applications (HOT, Roland and Milan) However, now it can be argued that due to political unity background OCCAR provides an opportunity for European's to take place in joint programmes. Its efforts to eliminate main challenges of not fully demonstrating its effectiveness and efficiency in its core issues like the management of joint transnational projects made OCCAR a much more functional organization. Besides participation provides optimum management of financial resources of individual states and generates economies of scale for its member countries. It is said that "the four OCCAR countries represent about 75 per cent of the EU's defence expenditure and 80 per cent of its procurement (RDT&E included) spending."⁷⁴ As a result of this rapprochement OCCAR currently managed several programmes; including

⁷⁴ Jocelyn Mawdsley, 'The European Union, the State and Multinational Defence Firms: The Emerging European Political Economy of Defence and ESDP' paper prepared for the British International Studies Association Annual Conference, London School of Economics, 16 – 18 December 2002, p.7.

the Franco – German project of Tiger attack helicopter, the Future Surface-to-Air missile family of France and Italy and the A400M transport aircraft (B/E/FR/GE/T/UK), which is significant both to due size of the project and participation of non-OCCAR members. Due this programme Belgium has become the fifth member of OCCAR in May 2003. However, compared to other founding members' ten voting rights within the BoS decision making mechanism, Belgium holds five voting rights. Spanish participation in A400M programme provided a candidacy opportunity to this state. However, it is said that Spanish demand to hold eight voting rights in the BoS is not acceptable by existing member states unless Madrid accept to join in another European project of Tiger. Also due to internal problems the Netherlands had to withdrawn from candidacy and Swedish interest to become a member waits for a programme that could increase demand on this country.

However, so far member states have not established a common criterion of deciding which programmes should be conducted by OCCAR. For Schmitt, this system is reasonable to a degree since there is absence of a European body regulating the procurement structure that would assign OCCAR in a more systematic way. But on the other hand, he argues that there is an unsatisfactory aspect too; because for fully effective usage of OCCAR, the organization needs much more number of new projects where it can prove its potential. In fact, all previous or ongoing joint programmes of the OCCAR agenda have been organized under intergovernmental agreements. As a result of this, there is a pre-defined structure of work-share and regulation. Regarding to this, application of OCCAR working principles to those programmes is a matter of question although OCCAR structure provides a degree of cost efficiency. Hence, simultaneously OCCAR should find out new programmes to engage in with its all means.

According to Cornu, in order to wider the number of members to gain a potentially greater cooperation, there should some modifications be made in

certain principles of the OCCAR Convention in terms of flexibility. The Article 5 of the Convention mentions that;

To enable a strengthening of the competitiveness of European defence technological and the industrial base, the Member States renounce, in their cooperation, the analytical calculation of industrial juste retour...and replace it by the pursuit of an overall multi-programme/multi-year balance.....This cooperation will enhance the creation, between Member States, of genuine industrial and technological complementarity in the relevant fields, thereby guaranteeing support for their armed forces under all circumstances.....⁷⁵

However, at first sight although core aim of the article seems to be encouraging by establishing a kind of procedure to make all member states to take place in all joint programmes, it does not leave space to countries to act in accordance with their will or industrial capacity.

Another point that is argued about OCCAR structuring is its possible effects on the transatlantic relationships. Naturally, OCCAR membership or participation in several programmes would increase dependency among those states, however on the other side; it would loosen industrial ties with US market. Most probably dependence of those countries on US firms and market in terms of defence related equipment, know-how or technology would be revised unilaterally by Europeans. But in terms of interaction, in order to change the balances to a win-win situation US firms would like to enter into the European market through such a stronger partner and also would like reduce the risk of cooperation with several partners or competition with several rivals.

⁷⁵ Burkard Schmitt, "European Armaments Cooperation Core Documents", Chaillot Paper 59, Institute for Security Studies Western European Union, Paris, April 2003, pp.46-47.

5.5. The Letter of Intent (LoI)

Harmonization of the existing national regulations was another issue that required immediate solution in order to achieve greater cooperation between European defence industries. With this aim, the defence ministers of the six major countries; United Kingdom, Germany, France, Italy, Spain and Sweden have signed a *Letter of Intent* on 6 July 1998 calling for the rationalization along European transnational lines of the aerospace and defence electronics business of Europe. Whilst the Letter of Intent did not instruct change, it demonstrated the existence of political will to consolidate the industry. With the aim of designing a framework for the restructuring of the industry, six working groups were established each of which would present a report by 30 June 1999 on the basis of their examinations. Based on the findings of the working groups an executive committee prepared a final document that was signed by the parties in July 2000 as the Framework Agreement and was decided to be a legally binding treaty that lies outside the EU context, covering six specific areas⁷⁶ as follows;

- *Security of supply*; is considered as significant since internationalization and transnational character of the defence industry necessitate flow of defence related equipment across borders and defence policies of states become much more independent from the sole decision-making mechanisms of the governments. Regarding to that establishment of a procedure that would benefit suppliers of the industry is required.

In this area the participants agree that transnational restructuring and consolidation would bring a possible abandonment of national

⁷⁶ Five of these six areas would be covered by implementing arrangements that would specify in detail how the system should work. Security of Information is the only area where there is no such application since the provisions of the Framework Agreement give sufficiently detailed information.

industrial capabilities and mutual dependence. In order to eliminate this, they accept not to prevent the supply of defence related items and services produced on their national territory to the other Lol countries, and to provide them eventually from their own stocks. Moreover, the Lol countries agreed to establish an information exchange system on industrial restructuring basing on national regulations of practice with industry. Under this application the participant defence industrial companies accept to consult to their national governments before any decision of change in the shareholding structure or context of their activity. Then as a chain reaction these respective governments should inform all Lol governments who have been in interaction with those companies as a customer during the previous three years. Regards it can be argued that the system is also has a sub consideration; the possibility of the transnational companies taking decisions on the organization and internal distribution of their work independently due to commercial considerations, would lead to disappearance of certain national capabilities and in time those countries concerned would become interdependent. In addition to this system, the industry is supposed to sign national codes of conduct including commitments to give priority to national demands and reallocation systems in the event of a crisis. The implementing Arrangement of this area puts forward the commonalities for these priority systems; however each Lol country is freed to specify the modalities in accordance with its own necessities.

- The area of *Simplification of procedures and adoption of common regulations for exports control*; required attention since there are numerous clauses regarding the export regulations of defence related equipments. These clauses differ according to the country or contractors that draw them, but consequently set out standards with which national industries are obliged to obey when conducting export

business. The reason of the differences in the regulations can mainly be attributed to divergences in political orientation. Thus, the lack of common export policy and regulatory framework barriers possibility of industrial cooperation in general and independent functioning of transnational companies that are obliged to deal with national export procedures in particular.

Hence, the attempt of the Framework Agreement to establish Global Project Licence (GPL) is significant since it aim to rationalize export procedures especially for joint transnational programmes. If any programme grants for GPL then its any component gains the freedom of movement within the territory of the six partners. In terms of the non-Lol countries participation in a joint programme provides them a consensus based permitted export destinations, which is adjustable in accordance with the political circumstances of the export destination.

- In *The Harmonization and Simplification of Procedures for Security of Information* area, the main problem was to maintain suitable security conditions for classified information of the projects and to ensure that these are enforced within transnational defence companies. Moreover, this challenge should be eliminated without putting unnecessary restrictions on the free flow of components, sub-systems, information or personnel of the projects. However, the progress in this area generally is delayed due to national hesitations, but also due to clash of interests of outside partners of Lol countries, particularly the United States.

As a result of the need to harmonize security regulations, in terms of the future MOUs to be signed on international joint programmes, the Lol countries agreed on the establishment of general principles that should be attached. Moreover, visits to industrial bases and/or

governmental facilities were agreed to be done according to common procedures and requirements. Also, they agreed on a common understanding of dealing with national security clearance and developed a consultation process for cases where non-Lol countries need access to classified information.

- *Coordination of Military Research and Technology Programmes and Financing*; is one of the most important areas which determines the conditions of the competition in the field of defence industry. However, in spite of the attempts, the absence of a central authority has prevented the existence of exchange of information on systematic basis on defence related research and technology programmes. The initial consequence of such a system shows itself as duplication of efforts - development of several military programmes of the same characteristics and aim - and increase of relative costs. Since national governments mostly devote their R&T budget shares to their respective national programmes, existence of transnational defence companies does not change the situation. Consequently, in order to avoid reverse effects of the duplication, harmonization of the procurement process should be achieved and governments should take their place in the middle of this process.

Hence, the Lol countries have involved in a process of establishing a system for exchange of information including defence related research and technology programmes covering all the policies and strategies as well as the on going ones. Also they have organized a Group of Research Directors to organize management of research and technology cooperation through provisions of a code of conduct that would regulate relationships between states and transnational defence countries. For the operational part, the EUROPA MOU and ERG No: 1 are agreed to be used as the instruments of this aim.

- *Harmonization of military requirements (the process of planning and procuring defence equipment);* is significant since it has effects on both governments and defence industry at the same time. It's essential for governments, since they always have diverse priorities due to their diverse geostrategic orientations, harmonization of procurement requirements – especially on common requirements or programmes - would benefit them in terms of decreasing their defense expenditures. Although it is difficult to achieve a solution in this area due to existence of very heterogeneous structure including many military, political and industrial bodies, within the international security architecture several attempts were done in this area through attempts of NATO, WEAG and now the Lol. When the industry is concerned, the importance of the process comes from the need to rationalize production and manufacturing methods and to improve the competitiveness of the companies.

Regarding to the area the signatories of Lol, have developed a new data base system with a complete list of their future requirements in order to inform each other about their respective defence related national planning. A common board was also assigned to identify common needs and common solutions matching to these needs. In the event of a agreement, establishment of a joint requirement team was agreed to define common staff target.

- *Easier Access to Technical Information in the Event of Transnational Restructuring and Legislation Relating to Intellectual Property Rights;* were issues also touched upon since ongoing applications on the communication and use of technical data created obstacles to the effective functioning of transnational defence companies. Regulations on this area required because on the one side governments need to be assured that the existence of a transnational enterprise would not

have any affect on their rights on technical data and on the other industry required an area of functioning freed from governmental interference.

The Framework Agreement of the area, thus, is consisted of provisions on development of common standards for issues of Intellectual Property Rights (IPRs). And the Implementing Arrangement gives the ownership right of the IPRs to the companies, but also governments are assigned with some privileges particularly on transfers of IPRs and the payment of royalties.

The Lol, ratification process of which ended in July 2003 attempted to rationalize and harmonize the national regulations of its six participants and intended to bring convergence to the legal systems. Since these six countries of Lol process are said to be hold nearly 80 per cent of procurement budgets in Europe and 90 per cent of European industrial capacity, it can be argued that Lol initiation would encourage other Europeans to take actions even within the European Union structure. In terms of the membership, scholars mention that participating conditions are quite demanding and discriminatory. Other EU countries can only become a member with the approval of the all of the six founding members of the Lol. In the case of European but non-EU countries, the six founding countries must be agreed on the invitation of the candidate country. However, in fact attitude of the Lol countries shows that they “have decided to continue their work in a restricted group, preferring deepening to widening.”⁷⁷

Concerning the deficits of the process, there was the desire of achieving concrete results immediately mixed with reluctance to take steps to a more

⁷⁷ Burkard Schmitt, 'From Cooperation to Integration: Defence and Aerospace Industries in Europe', Chaillot Paper 40, Institute for Security Studies of Western European Union, Paris, July 2000, p.70

comprehensive reform. As a result, the process has a limited capability record consisting attempts of establishing compatibility between national rules and procedures instead of constituting a new regulatory framework. In terms of the six areas it deals with, due to absence of will of the signatories to overcome their traditional divergences at the first hand, neither sufficient degree of standardization nor harmonization can be achieved. Efforts cannot offer comprehensive solutions but only led to complex, vague or not sufficiently binding results. It also remains to be blurred to what extend this framework will be able to carry European cooperation forward especially in the fields such as R&T and harmonization of military requirements, where progress has always been difficult.

About the future of the Lol process, Schmitt argue that there is no possibility of the process to become a permanent institutional structure. Nonetheless, its credibility and contributions cannot be despised. However, the process to be succeeded requires high-level political will and supervision. In case of absence of such a political input and monitoring, it will be hard to predict whether national defence industrial elites will be able to incorporate provisions of the Framework Agreement into their operations. But it should be noted that the process provided a synergy that would be beneficial to take the conditions forward. The Framework Agreement and the Implementing Agreements of the various areas should be seen as the first steps of a child. However, I think, coordination with other European institutional structures and political supervision would provide it a chance to create more comprehensive solutions.

Regarding the effects of the Lol on the transatlantic relations, from US point of view there began a new phase that calls for a new approach. In this respect the United States takes measures in response to Lol process. In order to break down the closed ties of the group it develops counter-strategies. Thus serving to this aim, US choosed a privileged partner for itself

in the Europe – in this case this partner has been the United Kingdom and they have signed a declaration of principles (5 February 2000 Munich) covering industrial cooperation between two countries – or proposes comprehensive offers along with joint arrangements. In short it can be mentioned that the Lol initiative created nervousness on the other side of the Atlantic and with no doubt will be confronted with resistance.

5.6. Evaluation of the Efforts; What Has Done So Far What Should Be Done From Now On?

The first thing that should be noted about all these above mentioned efforts is that all institutions and policies have been developed and adopted without coordination. Hence the structure lacks of both a common strategy and institutional linkages. There is no coherent arrangement and aspects of defence related issues are not systematically covered and various issues are left blurred. There is a partial overlapping of memberships. In terms of the convergence among European states, there has been and still continuing hesitancy and the process is in need of greater deepening and better expression of its aim and strategies to European public opinion. This presentation is significant to demonstrate that process of restructuring and consolidation within industry along with political support of national governments means rationalizing the available resources rather than increasing share of defence budgets, due to its consequences on the allocations of national defence budgets.

Regarding the process with its all institutional elements the main challenge is to use, improve and combine capabilities and finally integrate them into a coherent institutional structure. The complexity of the defence industrial sector should be eliminated by the establishment of a defence equipment market that can be regulated through an armaments agency. Hence, the number of actors involved can be decreased, eliminating difficulties of

reaching common positions and lowering inter-institutional rivalry and frictions.

For Europe, in order to maintain a competitive Defence Industrial and Technological Base and improve its military capabilities a coherent common policy should be developed in the areas of procurement, research and the defence market. The European Union could provide sufficient framework for such a policy because of its effective instruments. The latest Communication of March 2003 and plans for establishment of a European Armaments, Research and Capabilities Agency (ARCA) are accepted as important tools to achieve political support and reformation in European defence sector. The creation of ARCA seems to be most probable. According to discussions main objective of ARCA structure should be twofold; "it must ensure that the capability needs of Europe's armed forces are met, wherever possible, through European cooperation in order to foster standardization of military equipment and generate economies of scale. Second, it must enhance the efficiency of cooperation in order to exploit potential cost savings effectively"⁷⁸ Within the framework of ARCA, the OCCAR can be used as programme management organization of the agency procurement division. As such, it would be responsible for the development, production and in-service support of all projects defined by ARCA. However, in its current potential, OCCAR lacks of new programmes to apply its own principles. Moreover, it needs to be granted more autonomy vis-à-vis member states. Hence, it can be easily transformed into a fully-fledged armaments agency.

In terms of the Lol countries, they should be aware of that the Framework Agreement is just an intermediate step towards a homogeneous defence economic space and its traditional cooperation schemes no longer provide

⁷⁸ Burkard Schmitt, "The European Union and Armaments Getting a Bigger Bang for the Euro", Chaillot Paper 63, Institute for Security Studies Western European Union, Paris, April 2003, p.40.

sufficient structure. Moreover, they should continue their activities under the roof of a supranational body through which a single set of procedures can be established and close and permanent political supervision can be provided. On the other hand they should recognize that this unification does not mean the end of their national sovereignty in defence issues, however elimination of national egoisms. As for possibility, the Lol countries could adopt a more ambitious second phase and develop common rules and procedures.

On the part of WEAG, there should be a new frame that could meet the requirements of current challenges. It should be noted that traditional intergovernmental methods no longer provide solution. High level armaments cooperation requires strong governance, effective decision-making mechanism and structural bodies combined with legally binding commitments.

However, when all attempts combined together the framework do not provide an adequate, to the point solution. Sharing the same point of view with most of the scholars of the area, I think that the best solution of the problems would be found within the EU structure with its bodies, policies and member states' capabilities.

CHAPTER 6

US DEFENCE INDUSTRY AND TRANSATLANTIC COOPERATION IN BRIEF

Since US security and defence policy, US defence industrial base and their structural dynamics throughout post Cold War period can be a topic of another work and require detailed information gathering, comprehensive examination of these titles is left out of the scope of this work. However, explicit role of US in international politics and its reflections on European defence industrial restructuring and consolidation can not be ignored. Hence, within this chapter a summary of evaluation of US defence industrial consolidation will be made to be able to give an idea about the other part of the transatlantic environment. Then, a brief analysis of the transatlantic cooperation will be made in order to complete the framework of European defence industry's restructuring in the Post Cold War Era.

In terms of the security and defence policy, as a heritage, US has always pursued a policy towards Europe which has been a fact of significance due to deep relational roots, perceptions of shared values and Alliance relationships. Concerning all these aspects, political concerns have regarded NATO as the core symbol of relationship. According to US officials NATO has not been just a military alliance; in fact, it has represented common values of a community that has been more than unification against a common threat. Thus, top priority has been given on ensuring the organization's continued vitality since the organization has been seen as a tool of protection of US interests in Europe. Hence concerning the European efforts of determining its own defence and security issues through development of a European Security and Defence Policy outside NATO structure, has been supported by US officials and public to a degree as long as such cooperation would not disturb US interests in the transatlantic

alliance and decrease security burdens on US. Accordingly under these circumstances the US was pushed to apply a sensitive policy towards Europe, which would not be interpreted as unilateralism or withdrawal from European politics but instead cooperative and competitive within two areas; NATO structure and defence industrial base.

Post Cold War security architecture has drastically affected US security and defence perceptions as was the case in Europe. In return, administrative elites of US decision-making mechanism adopted policy transformations to meet the new challenges of the environment. Simultaneously, changing structure of defence and security policies have echoed in the defence spending and defence industry. Because historically, the engine of the growth for US defence industry has been national demand aided by the Cold War requirements.

Hence, as well as European defence industry, there has been profound transformation within US market shaped by similar declines in defence budgets and transformation in government policies. Hundreds of military bases have closed and volume of production of military equipments down considerably. Millions of defense workers, military personnel and civil servants have lost their jobs. Moreover, there appeared a tendency towards a more global and commercially based defence industrial base. The grouping of companies and rationalization of production and research infrastructure were put on the first place by internal considerations. The excess capacity of the system that was mainly designed for Cold War requirements, pushed decision-making elites of both government and industry to adopt policies of adjustment of the current state of the defence industrial base in accordance with the necessities of the post Cold War needs..

Starting with 90s, military spending in US declined steadily as throughout the world. The Pentagon wished to reduce its budget significantly and put

pressure on producers to reduce their costs. The sharpest decline occurred in the military's share of GDP. By the end of 90s it was at its lowest level since before the Second World War.

The consolidation of the US defence industry depended clearly on the economic rationale of the post Cold War industrial structure but it was more than simply the result of market forces. By 1993 after the clear message of the Defense Department – so called 'last supper' that US defence industry should consolidate, a transition period started. The US government played a significant role in this process, reducing enforcement of anti-trust laws and supporting contractors in terms of the costs of consolidation. However, although US government pushed industry consolidation, the shape of the process provided that it was mainly companies and their financial advisors that determined the period. As a result thousands of firms were pushed outside the industry terminating their operations. The number of major active participants in the industry has declined drastically. The aerospace/defence activities of many firms – including General Electric, General Motors, Chrysler, Texas Instruments... etc. – have been sold. Many of choosed to establish partnerships like mergers or acquisitions and as a result several of them like McDonnell Douglas (with Boeing), Martin Marietta (with Lockheed) and Hughes (with Raytheon) have disappeared. Now, the US defence industrial base is dominated by four giants of aerospace sector– Lockheed Martin, Raytheon, Northrop Grumman and Boeing along with several other big companies including, General Dynamics, Litton... etc. The result was a radically transformed defence industrial and technological base with an independent route determining its future structure.

Until the end of 1997, seven consolidation arrangements were subsidised by the administration amounting \$1,5 billion. However, US also limited this consolidation process of the market. In 1998, acquisition process of Northrop Grumman by Lockheed Martin was blocked by the Defense and Justice

departments since the result was seen as against competitive structure of the market. In terms of the position of the government about the consolidation process which characterized by merger or acquisitions, when asked whether opposition to merger of Lockheed and Northrop presented the new official policy, the then Secretary of Defence, William Cohen declared that this was the “same policy that has existed before...To the extent that companies can merge and consolidate without hurting competition in the defence industry...”⁷⁹

The US defence industry consolidation has coincided with European industrial restructuring since both were surviving within the common structure of Post Cold War Era.. Particularly, the process has been a competitive element that pushed European national firms to come closer and become transnational. In another way it increased pressure on European defence companies to accelerate efforts to restructure their defense industry. The consolidation process in Europe created tree giants – EADS, BAE Systems and Thales – that match their US counterparts in terms of size, turnover and area of activities. As a result of simultaneous consolidations of the US and European markets along with political support, there appeared possibilities of transatlantic cooperation and competition at the same time.

Transatlantic ties have emerged through a relatively slow process. At first, there were government led programmes mostly shaped by Cold War concerns. In the aftermath of Second World War with its advanced military technology and industry, United States has been the major supporter of Europe and NATO alliance against the threat of Soviet dominance in Western Europe. Throughout Cold War period transatlantic collaboration continued in accordance with NATO requirements in terms of standardization, rationalization and interoperability of defence equipment.

⁷⁹ T. Guay and R. Callum, “The Transformation and Future Prospects of Europe’s Defence Industry”, in *International Affairs*, 78, 4, 2002, p.763.

Also there were government-to-government initiatives to promote arms cooperation within NATO structure.

Similarly by the end of Cold War, numbers of government-to-government joint weapons development programmes were conducted within NATO. However, there was the difficulty of harmonizing military requirements of NATO members together with the lack of political commitment of governments. Also the Clinton administration gave political support to achieve greater NATO armaments cooperation. For this goal several programmes were launched; such as The British – American land vehicle known as Trace, US-German-Italian MEADS terminal air defence system and Joint Strike Fighter (JSF) project with strong participations of Turkey and the United Kingdom.

In time due to challenges of government led collaborations, these were replaced by industry-led joint programmes. This trend reflected the intention of defence companies to move beyond government policies and exploring transatlantic ties based on mutual corporate interest and market access. Moreover, political support was given for greater defence industrial cooperation depending on three factors; (i) opening up markets would increase mutual competition and provide counterbalanced domination in the sector. (ii) there was wish to prevent both sides establishing 'fortresses' in which foreign companies would be excluded from procurement programmes of each fortress. (iii) there was a belief that transatlantic defence industrial cooperation would provide necessary ground for promotion of greater interoperability between NATO forces. Thus several transatlantic alliances have been established during the last decades.

Table 6**Examples of Current Transatlantic Defence Industrial Relationships**

Type	Example	Participants
Licensing	Patriot PAC-3 upgrade for German army	Lockheed Martin (US) EADS (France /Germany/ Spain)
Co-Production	Rolling Airframe Missile	Raytheon (US) BGT (Germany)
Co-Development	Joint Strike Fighter	Full Development Partners: United Kingdom, United States Associated Partners: Denmark, the Netherlands, Norway Informal Partners: Canada, Italy Major Participants: Israel, Turkey, Singapore
Teaming	Meteor	Matra BAe Dynamics (France / UK) Alenia Marconi Systems (Italy) EADS (France/ Germany/Spain) SAAB Dynamics (Sweden) Boeing (US)
Strategic Alliance	Alliance for medium calibre ammunition	Primex Technologies Inc. (US) NAMMO, AS (Norway)
Joint Venture	Lockheed Martin Alenia Tactical Transport Systems	Lockheed Martin (US) Alenia Aerospazio (Italy)
Acquisition	Lockheed Martin aerospace electronics business	BAE Systems (UK) Lockheed Martin (US)
Supply Chain	SAAB JAS-39 Gripen	General Electric – Volvo Aero (US/Sweden) Honeywell (US) Lockheed Martin (US) Sundstrand (US)

SOURCE: G. Adams, C. Cornu and A. D. James, "Between Cooperation and Competition: the Transatlantic Defence Market", Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p. 121.

However due to due to long-standing resistance of US to direct foreign investment in US defence industry there were major obstacles in front of foreign firms that were seeking to establish presence in the US market

through merger with or acquisition of US defence industries. These obstacles were both political and bureaucratic. At the end US government recognized that opposing such investments could prevent US reaching potentially useful commercial markets. As a result US government has set up regulatory procedures for foreign direct investment in US with respect to defence industry. For the functioning of these procedures a pre-established body, the Committee on Foreign Investment in the United States (CFIUS) was given the task of reviewing and making recommendations on foreign takeovers.

Moreover strong pressure was coming from Europe; in terms of the efforts of European defence firms to get a share from US defence market cake. These accelerated many small scaled partnership activities. For example, British defence companies have always pursued aggressive policies to enter into the US market. As a result of a number of acquisition or merger activities with local US companies, especially BAE Systems has become one of the main suppliers of the Pentagon. Moreover, the Pentagon accepts BAE Systems North America as if an American firm, which provides a clear advantage to this firms when tendering for contracts or making further partnership initiations in the US. In return the company no longer defines itself as a British company but as a global one. During 90s UK companies became dominant in a number of important and sensitive US defence industrial assets. Also, with US government permission GEC Marconi acquired defence electronics company Tracor. Beside industrial attempts, this policy indicated support of US administrative elites for closer transatlantic industrial transactions and there was a process of reviewing regulations to meet the requirements of transatlantic acquisitions and other industrial partnerships.

In addition to European activities to penetrate into US market, defence companies of the other side were also entering into much more active partnerships or joint venture discussions with European defence giants. There have been discussions among many companies like Lockheed –

EADS and Airbus, Boeing and BAE Systems. Besides, MOU that was signed between EADS and Northrop Grumman in 2000 to explore opportunities in the defence market and establishment of a joint Raytheon and Thales (ex Thomson-CSF) company reflected the initial indications that transatlantic discussions could lead to joint ventures or full strategic partnership. Moreover, there were attempts of US firms to participate in specific programmes as was the case in British ASTOR ground surveillance system, where Raytheon won bidding. Such arrangements were in favor of both government and industry since it would have given both a voice in the emerging European defence and procurement policies at the multilateral levels of European defence industrial base restructuring.

Another way of penetrating into the European market for the US defence firms has been supplying of defence related requirements of several European countries. Although frequency and variety of export activity has been differed from one country to another, almost all of the European governments have been customers of US defence firms. According to estimations, cited in Adams," nearly 40 per cent of the equipment of European armed forces is American origin"⁸⁰ With respect to these estimations, experts identify four groups of states;⁸¹

- Group A, consists of countries that are capable of producing their own defence related equipments and rely on very little amount of US equipment. (France and the United Kingdom)
- In group B, there is a country that is able to manufacture complete systems and imports US equipment whenever necessary. (Germany)

⁸⁰ G. Adams, C. Cornu and A. D. James, "Between Cooperation and Competition: the Transatlantic Defence Market", Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p. 55.

⁸¹ Ibid.

- Group C includes countries with limited, specialist or considerable defence equipment production capabilities and purchasers of medium amount of US equipment. (Belgium, Finland, the Netherlands, Italy, Spain and Sweden)
- Group D countries are the one with little industrial capabilities and heavily dependent on US equipment. (Denmark, Greece, Norway, Portugal and Turkey)

Nevertheless, these export and import activities raise concerns about the principle of 'Buy European', where each country has different rationale. Concerning the countries in group A, it is the case that they rely on US equipments which can be produced by them however lack of required funding. Also from time to time, UK applies the principle of 'best value for money'. For the French, the only option to buy American is either because it is not possible to find European originated of the product or because it is more rational to buy one that is pre-produced. In the case of Germany its industrial links are limited to a number of products. The countries of C depends on US equipment on varying ranges in accordance with their requirements. The last group has different logic in addition to their defence related necessities; intention to acquire a privileged position in diplomatic relations with the US:

However, defence industrial market is a small cake. And such activities increased the concerns about the future implications of transatlantic defence industrial relationships. What is clear is that defence companies of the both sides would face important pressures to expand their international activities and use transatlantic relations to get the bigger share from the market. But on the other hand, US and many European countries do not share the same intention of increasing defence budgets, which meant shrinking number of defence programmes. Thus, it becomes the first priority of defence

companies to participate as many new joint programmes as they could and reduce their vulnerability by distributing their dependencies to several contractors or several states. In accordance with this need, European and US defence companies may go into aggressive export activities that characterized by strong competition especially in third countries. Nevertheless, not loosing presence in local markets was vital for any company that wants to participate in major programmes. Also they needed to share the costs and risks of new programmes. Thus, transatlantic cooperation is structured for the US firms by a desire to share joint programme costs, access different technologies and seek new resources of capital. On the other hand for European companies transatlantic relations offer them access to US technology and market which in return enable them to meet requirements of new programmes that can be commercialized in third countries.

Companies have used various strategies to develop transatlantic cooperations. In terms of the specific defence companies, amongst the others BAE Systems has already established its transatlantic ties through a number of partnership strategies. British Aerospace acquisition of GEC Marconi Electronic Systems opened the doors of US market via GEC's recent acquisition of Tracor. The BAE Systems strengthened its presence in the US market when it acquired Lockheed Martin's Control Systems division in May 2000 and then aerospace electronics business of the same company. The latter acquisition activity is significant because as a result for that time "BAE Systems replaced Lockheed Martin as the largest defence company in the world."⁸²

⁸² G. Adams, C. Cornu and A. D. James, "Between Cooperation and Competition: the Transatlantic Defence Market", Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p. 112.

Concerning the strategies of EADS establishment of a transatlantic cooperation has also been intention of the company. As a path to achieve this aim, EADS has signed a MOU with Northrop Grumman to look for opportunities of cooperation in ground surveillance and defence electronics areas. Moreover, in order to decrease the dependence of the company on Airbus, it is amongst the plans of EADS management to strengthen its defence activities through acquisitions in US market

Another giant of European market, Thales also seeks to expand its presence in US market. Due to its French origin, it has always been a source of suspicion for US officials. Its ties with Raytheon have not been influential to eliminate this approach. However, its acquisition of UK defence electronics company Racal in 2000 provided the desired opportunity for the company due to this company's position in the US market as a leading supplier of radio systems and data recorders to the US armed forces. Moreover, Thales won two major contracts from Lockheed Martin that would provide closer ties with US companies. With these contracts the company has become the supplier of electronic warfare equipment for Turkish F-16 fighter aircraft and radio and communications systems for F-16s being sold to the United Arab Emirates.

In contrast to European companies, US counterparts have chosen the policy of wait and see...the outcomes of European consolidation before entering into new relationships in European market. Sooner or later they have established their penetration contacts. Initial steps were taken through Northrop Grumman – EADS MOU, Raytheon – Thales relationship. Lockheed Martin has already been in contact with Aerospatiale-Matra.

Table 7**Examples of Transatlantic Mergers and Acquisitions 1998 – 2000**

Year	Acquired Company	Acquirer	Sector	Price Paid
1998	Tracor (US)	GEC (UK)	Electronics	\$1,4 bn
1999	Lucas Varity (US/UK)	TRW (US)	Electronics	\$ 7 bn
2000 (April)	Santa Barbara (Spain)	General Dynamics (US)	Combat Vehicles	\$0,05 bn
2000 (May)	Lockheed Martin Control Systems (US)	BAE Systems (UK)	Electronics	\$0,51 bn
2000 (June)	Bofors Weapons Systems (Sweden)	United Defense (US)	Ordnance and precision weapons	Not disclosed
2000 (July)	Lockheed Martin aerospace electronics business (US)	BAE Systems (UK)	Electronics	\$1,67 bn

SOURCE: G. Adams, C. Cornu and A. D. James, "Between Cooperation and Competition: the Transatlantic Defence Market", Chaillot Paper 44, Institute for Security Studies of Western European Union, Paris, January 2001, p. 122.

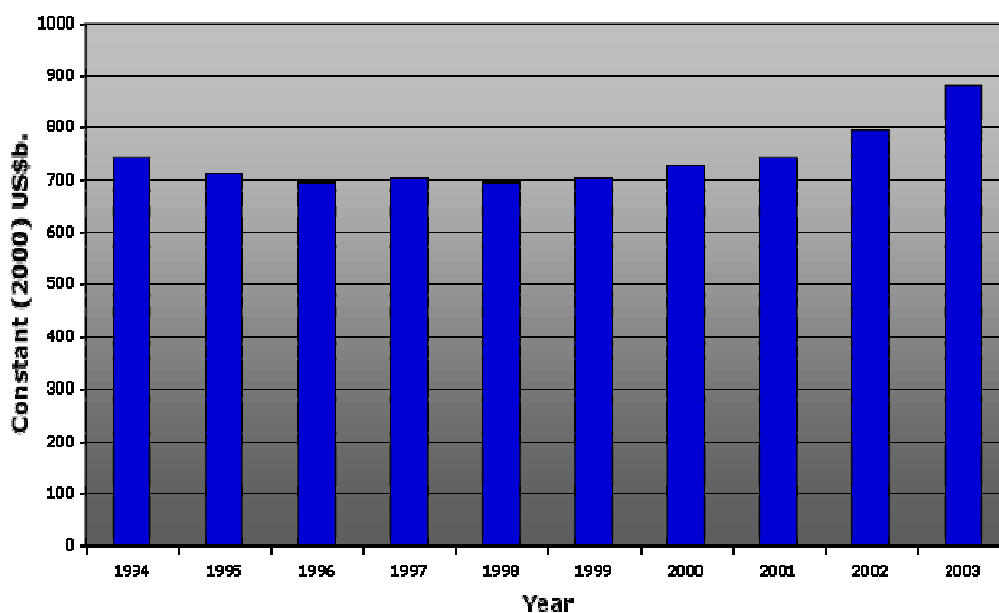
Regarding the characteristics of the transatlantic cooperation process, it is possible to argue that the future of transatlantic defence industry will be determined by the commercial decisions of defence firms. Financial considerations, market positions will be more influential than the concerns of national governments. International institutions will be forums for governmental interests. However, within the regulatory framework of them, industry led decisions will determine the future characteristics of the transatlantic defence industry.

CHAPTER 7

RECENT BALANCE OF MILITARY EXPENDITURES

Although the rate of decline in the national defence budgets slowed down by 1995, the trend has not slowed down but tended to remain more or less constant until 1999. Revitalizing needs of security interests due to agenda of European Security Architecture of the period starting from 1999 up today led to an increase in military expenditures again creating inconsistencies between theoretical expressions and applications. For Hagelin and Sköns there are three major changes that give rise to this challenge; “- the global pattern of armed conflict, - the increased focus on the threat of transnational terrorism, - the trend for a stronger link to be made between military security and economic development-reflected in the new concept of *human security*.”

World military expenditure, 1994-2003



Graph 1

World military expenditure, 1994-2003

Source: SIPRI Yearbook 2004, Table 10A.1

Note: Some countries are excluded because of lack of consistent time-series data. World totals exclude Afghanistan, Angola, Benin, Congo (Republic of), Congo (Democratic Republic of), Iraq, Liberia, and Somalia.

According to data provided by the International Institute for Strategic Studies, the United States has spent \$52 billion on new defence equipment. And for Europe's largest spender UK the figure has been \$8.5 billion. When all the Europe's NATO members combined the amount is just \$29,3 billion.⁸³

⁸³ International Institute for Strategic Studies (2000) The Military Balance 2000-2001, London: Oxford University Press, p.41.

Although there observed a constant trend between years 1995-1998, there has been a continuous increase beginning with 1998 and accelerating by 2002. (%6 increase in real terms, \$794 billion in current prices, which is accounted for 2.5% of world GDP and was \$128 per capita)⁸⁴ When it is compared to post-cold war era of 1998 the current level is %14 appears to be higher but on the other hand its is still 16% below of it's 1988 level, when the world military expenditure was close to Cold War peak.

The increase of 2002 was mainly dominated by a 10% increase in real terms by United States. After a period of reductions in military expenditure during 1987-1998 with the changes in US military doctrine and strategy after the terrorist attacks of 9/11, moderate increases of 1998-2001 periods turned out to be huge military spending in 2002 and 2003 and accounted for almost half of the world total. Military operations in Afghanistan and Iraq are showed as the main reasons for significant increase and blamed for the boom in much more slower increasing rate of US military expenditure. For some scholars in the absence of these operations the world military spending would follow an increasing trend of 4% rather than 11% in 2003. A stated goal of the increased spending is to pursue the transformation of US armed forces to better meet the challenges of 21st century warfare. However, this has been argued under the continuation of a large number of legacy systems designed during the cold war period On the other hand although military expenditure of several other major countries also rises, the level of increases are much lower, and there is little indication that the strong increase in US military spending is resulting in an equally strong tendency for other countries to follow suit.

World military spending in 2003 has increased by about 11% in real terms. When compared to increase of 6.5% in 2002 this is a remarkable rate of

⁸⁴ All figures mentioned regarding data of military expenditures are taken from SIPRI Yearbook 2003-2004

increase. Over two years world military spending showed an increase by 18% in real terms and reached \$ 956 billion in 2003. Although high-income countries have a share of 16% of world population they account for about 75% of world military spending. The extent of military spending of these countries when combined together reach a level that is “slightly higher than the aggregate foreign debt of all low-income countries and 10 times higher than their combined levels of official development assistance in 2001”.⁸⁵ Under such circumstance there appears a wide gap between the amount that high-income countries are willing to provide for military means for security and maintain their global and regional power status quo and ability to alleviate poverty and promote economic development.

In 2003 the USA has had a share of 47% of world military expenditure, when currencies are converted at market exchange rates, as in the Appendix 1. Besides, the top five spenders – the USA, the UK, France China and Japan – account for %64 of total world military expenditure and the top 15 account for 82%. (Appendix 1).

When such a determination is made on regional basis according to statistics, in 2001 (the most recent year for which data are available) starting from the less; Latin America spent only 1.3%, Africa, Asia and Western Europe also spent less than the world average (2.1%, 1.6% and 1.9%) while Central and Eastern Europe spent 2.7% and North America 3% on military expenditures. However, the Middle East spent 6.3% of gross domestic product on the military items compared to a global average of 2.3%.

During 2003 much of the national military spending debates continued to be focused on the necessity to increase military expenditures to a level that would meet increasing threats and risks in such a globalized and unpredictable environment. War on terrorism has been accepted as the

⁸⁵ Elisabeth Sköns *et al.* (eds.), “Military Expenditure”, SIPRI Yearbook 2003, Summary of Chapter 10, (Oxford: Oxford University Press).

major fact of increase of US military expenditure. Moreover, the UK and France legalized increases of military expenditures in their budgets linking it to developing *network-centric* warfare, which has been accepted as important in the war on terrorism. However towards the end of 2003 and in early 2004 there appeared some other indications that were related to the economic burden of the military sector and also to ethnical agendas, which gained importance in several countries.

Table 5 below illustrates defence budgets of European Union countries between 2001 – 2003 and shows European Union defence expenditure as a percentage of GDP of 2001 and 2002. Accordingly there have been growing defence budgets rate in almost every EU country. However, there is a point which many authors warn about; measurement values of different countries in national currencies (euros, pounds or US dollar) make a kind of fake increase that can mainly be attributed to currency fluctuations.

Table 8**Defence Budgets and Defence Expenditures of EU Countries****2001- 2003**

EU COUNTRY	DEFENCE BUDGET (Bn of CURRENT US\$)			DEFENCE EXPENDITURE (% OF GDP)	
	2001	2002	2003	2001	2002
United Kingdom	33,60	36,60	41,30	2,4	2,4
France	25,80	30,70	34,90	2,5	2,5
Germany	21,50	25,10	27,40	1,5	1,5
Italy	15,90	20,20	22,30	2,0	1,9
Spain	7,10	7,80	8,50	1,2	1,2
Netherlands	5,70	6,90	7,20	1,6	1,6
Sweden	4,10	4,30	5,20	1,9	1,7
Greece	3,40	3,60	4,00	4,6	4,4
Poland	3,40	3,50	3,90	2,0	1,9
Belgium	2,30	2,80	3,00	1,3	1,3
Denmark	2,10	2,24	2,60	1,6	1,6
Austria	1,50	1,80	2,50	0,8	0,8
Finland	1,40	2,10	2,30	1,2	1,4
Czech Republic	1,20	1,40	1,90	2,1	2,1
Portugal	1,60	1,70	1,90	2,1	2,3
Hungary	0,82	1,10	1,40	1,7	1,8
Ireland	0,79	0,78	0,79	0,5	0,6
Slovakia	0,35	0,46	0,62	2,0	2,0
Slovenia	0,28	0,27	0,39	1,5	1,5
Cyprus	0,35	0,37	0,38	2,6	2,4
Lithuania	0,17	0,27	0,36	1,8	1,8
Luxembourg	0,15	0,20	0,23	0,8	0,9
Latvia	0,08	0,11	0,20	1,2	1,8
Estonia	0,07	0,10	0,16	1,2	1,6
Malta	0,03	0,03	0,03	0,7	0,7

EU – 15 Total	126,94	146,83	164,12	1,9	1,9
New Members	6,73	7,62	9,34	1,9	1,9
Total					

EU - 15 Average	8,46	9,79	10,94	-	-
New Members Ave.	0,67	0,76	0,93	-	-

EU - 25 Total	133,67	154,44	173,46	1,9	1,9
EU – 25 Average	5,35	6,18	6,94	-	-

LoI Total	108,00	124,70	139,60	2,0	1,9
LoI Average	18,00	20,78	23,27	-	-

United States	329,00	362,10	382,60	3,0	3,4
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The LoI includes Europe's most important arms producing countries (France, Germany, Italy, Spain, Sweden, and UK)

SOURCE: The Military Balance 2003 – 2004, ISSS London

Regarding to data provided above, during period 2001 – 2003 among the biggest three while German defence budget remained constant, in Britain and France share of defence budgets increased.

On the other hand when budgets of EU countries and United States compared, there is a wide gap demonstrated in the table. During 2003 defence related spending of United States has been two times more than the 25 EU members' spending combined together. Moreover, with the expected increase in US defence budget in 2004, the transatlantic spending gap tends to be widening even more.

According to data of The Military balance 2003 – 2004 and SIPRI Yearbook 2003 regarding the future planning of European defence budgets; for the period 2005 -2006 there is a 1, 2 per cent planned increase in real terms in

United Kingdom. On the contrary German government has frozen its budget share at €24, 4 billion per year until 2006. In France, the equipment procurement budget will be increased to an average of €14,6 billion for the period 2003 – 2008.

At the same time, the decentralized production of a public good with cross-border spilling effect is supposed to lead to increase of reliability on alliances and made nations to lower defence expenditures and supply. Although citizens would welcome an increase in defence production, this might only be achieved by a centralized production of defence services.

CHAPTER 8

CONCLUSIONS

Since the end of Cold War, there have been a multitude of initiatives aimed at fostering and improving defence industry cooperation in Europe. These were tried to be applied under the dilemma of budgets constraints and increasing costs of defence related equipments for the provision of a competitive European Defence Industrial Base with improved military capabilities. Therefore, the aim has been development of coherent policies in three areas; procurement, RD&T and defence market. While legally it is duty of the national governments to establish a new regulatory environment for European defence industry, to reflect the changed realities, there is nothing to prevent the involvement of other actors such as the international institutions or even non-regulatory players like the defence firms themselves into the process.

However, despite the motives of technological, financial and economic considerations that push defence companies to the path of globalization, in terms of many issues defence has always been considered as a national matter. Hence as customers, supervisors and regulators governments have always played and still continue to play an essential role; but a fragmented one in terms of the ex-traditional symbiotic relationship with companies. The main task that is attributed to them is to harmonize national regulations to create a more homogenous defence area where an integrated defence industrial base could function with increasingly appropriate solutions.

In terms of the defence firms, restructuring, consolidation and internationalization process have established the basis of a competitive European defence industrial base. Throughout the process each company has followed an individual path; While EADS was constituted as a result of

complete merger of three national champions (DASA, CASA, Aerospatiale), Thales and BAE Systems became internationalized through the acquisition of subsidiaries abroad and the creation of joint ventures. However, within the highly competitive market of defence industry they should take effective measures in order to rationalize their dependency on capital. Although on going short or medium projects may provide solutions to current budgetary constraints, the long-term prospects are less optimistic since a substantial increase in defence budgets does not seem probable. In this context, access to third markets, US market in particular is essential.

However in order to maintain strong transatlantic link many political and regulatory constraints should be overcome. A substantial degree of harmonization of export procedures, investment rules...etc. should be achieved. Two sides of the Atlantic should avoid of establishing fortresses. The most importantly reluctance and hesitancy to go into transatlantic cooperation should be eliminated. Such issues require strong political commitments from governments and attitude change towards national defence industrial capabilities and national security. Although number of acquisitions have been concluded in terms of transatlantic cooperation, full mergers between leading US and European defence firms seem unlikely under current circumstances. However, cooperation on specific projects rather than merger seems to remain the principle means through which defence companies would seek to develop transatlantic relationships. On the other hand, this gradual rapprochement would allow the confidence building between governments and firms and would establish business cooperation experience which would lead to an integrated transatlantic defence industry.

Concerning industrial restructuring and consolidation, due to significant diverse characteristics and varying industrial capacities of European countries internationalization attempts have not affected them similarly.

For instance, with establishment of EADS, the three of the six Lol countries – France, Germany and Spain – incorporated their major part of defence industries into one single entity. However, even this establishment did not provide same advantages to all its parties; participation would be in the interests of France and Germany but to a lesser extent Spain. But on the other hand they had to sacrifice a part of their interests to survive in the market. In terms future of the process, the Lol countries should recognize that traditional cooperation frameworks do not give adequate answers to problems anymore. They should consider transfer of their prerogatives in military sector to a supra national agency that can be established within EU structure would not mean the end of their national sovereignty in defence issues. This implies that they should eliminate their hesitancies via instruments of an international institution.

In terms of the OCCAR process, there are many possibilities of developing common rules and regulations. It is argued that fully integrated defence industrial capabilities, permanent well functioning structures, harmonization of military requirements, procedures can be achieved through a much more developed OCCAR structure. This can be achieved through a greater autonomy given to OCCAR to broaden its areas of interest and to increase number of projects.

These actions regarding Lol and OCCAR processes would strengthen the possibility of establishment a European Armaments Agency. However, in the current situation, the emergence of two-level structure seems more probable. These two establishments demonstrate that the programme management and harmonization/regulation of procedures and rules that would govern those programmes would be carried out independently of each other. In time this process could be transferred to the European level. Among the other international institutions the EU could be the appropriate structure for developing and implementing such policies, particularly because of its broad

range of member commitments and CFSP instruments. For many scholars, discussions on integrating WEAO and OCCAR into existing EU structure should be considered in the context of the EU Commission that has been being more aggressive in taking initiative in the armaments field. If the institutionalization of defence procurement, which would be built upon the Lol process and Framework Agreement, could be succeeded, it would be the core of enhanced defence cooperation in Europe. Moreover, this would be the solution of handicaps the European defence firms have vis-à-vis their American competitors, mainly bound to political weakness of Europe. If only this level could not be achieved, cooperation of arms producing states may continue in a restricted framework of OCCAR dealing with its core issues of R&T and the management of joint programmes and leaving procurement issues to WEAO.

To sum up;

- As highlighted in the European Security Strategy of December 2003, EU is becoming an important actor in world politics. Hence it should much more actively take part in defence industrial issues.
- National governments should overcome their reluctance in transferring their prerogatives in military sector to a supra national agency.
- International agencies should be given greater autonomy.
- Defence companies should take effective measures in such a highly competitive market in order to rationalize their dependency on capital.
- Since substantial increase in national defence budgets does not seem probable, access to third markets is essential.
- For a stronger transatlantic link political and regulatory constraints should be overcome.
- In order to close the capabilities gap with the US in terms of defence sector, the European governments should take effective measures.

APPENDICES

APPENDIX 1

THE MAJOR SPENDERS IN 2003

Figures are in US \$b., at constant (2000) prices and exchange rates. Figures in italics are per centages.

Military expenditure: in MER dollar terms					in PPP dollar terms*		
Rank	Country	Level (\$b.)	Per capita (\$)	World share (%)	Rank**	Country	Level (\$b.)
1	USA	417.4	1419	47	1	USA	417.4
2	Japan	46.9	367	5	2	China	[151.0] 3
	UK	37.1	627	4	3	India	64.0
4	France	35.0	583	4	4	Russia	[63.2]
5	China	[32.8]	25	4	5	France	38.4
Sub-total top 5		569.1		64	Sub-total top 5		734.0
6	Germany	27.2	329	3	6	UK	35.0
7	Italy	20.8	362	2	7	Japan	32.8
8	Iran***	[19.2]	279	[2]	8	Germany	30.4
9	S. Arabia	19.1	789	[2]	9	Italy	26.4
10	South Korea	13.9	292	2	10	S. Arabia***	25.6
Sub-total top 10		669.3		76	Sub-total top 10		884.2
11	Russia	[13.0]	91	1	11	S.Korea	25.0
12	India	12.4	12	1	12	Iran***	[23.7]
13	Israel	10.0	1551	1	13	Turkey	22.5
14	Turkey	9.9	139	1	14	Brazil	[21.0]
15	Brazil	9.2	51	1	15	Pakistan	15.0
Sub-total top 15		723.8		82	Sub-total top 15		991.4
World		879		100	World		..

[] = SIPRI estimates.

MER = market exchange rate; PPP = purchasing power parity.

* The figures in PPP dollar terms are converted at PPP rates (for 2000), calculated by the World

Bank, based on comparisons of gross national product (GNP).

** The top 15 list in PPP terms would probably include Myanmar, if data were available.

*** Data for Iran includes expenditure for public order and safety and is a slight overestimate.

Sources: **Military expenditure:** *SIPRI Yearbook 2004 – Armaments, Disarmament and International Security* (Oxford University Press: Oxford, 2004), appendix 10A; **PPP rates:** World Bank, *World Development Indicators 2002* (World Bank: Washington, DC, 2002), table 5.6, Relative prices and exchange rates.

The 15 countries with the highest military expenditure in 2003 are listed in rank order in the table above: first, when the comparison is made at market exchange rates (the left-hand columns); and second, compared at purchasing power parity (PPP) rates (the right-hand columns). The table shows that the major spenders accounted for 82 per cent of world total military expenditure in 2003, when calculated at market exchange rates (for the base year 2000). The USA alone accounted for 47 per cent, taking into consideration the supplementary budget allocated for the war on terrorism, which by itself is over 25 per cent higher than the total military expenditures of each of the next four in order: Japan, the UK, France and China. These four each account for a 4–5 per cent share of the world total.

Military expenditure per capita varies widely between the major spenders. While

Israel and the United States spend roughly \$1500 per citizen and year, some of the poorer major spenders—Brazil, China and India—spend less than \$100 per capita.

The alternative series based on PPP rates is provided because of an acknowledged problem in international comparisons of economic data: market exchange rates tend to understate the purchasing power of expenditures in developing countries and countries in transition, thus distorting international comparisons⁸⁶. As shown in the table, the use of PPP rates for conversion has a significant impact on the figures for China, India and Russia. These figures better reflect how much the military budget could buy in terms of a standardized basket of national output. On the other hand, they overstate the purchasing power on the international arms market and do not reflect appropriately the technological level of the military equipment.

⁸⁶ For more information on the relative merits of using market exchange rates and PPP rates see Sköns, E. *et al.*, 'Military Expenditure', *SIPRI Yearbook 2003* (note 7), pp. 304–306.

APPENDIX 2

MILITARY EXPENDITURE AS A SHARE OF GDP, 1997-2002

Figures are shares (%) of gross domestic product (GDP).							
Country ^a	Income group ^b	Military expenditure					
Africa		1997	1998	1999	2000	2001	2002
Algeria	Middle	3.6	4.0	3.8	3.5	3.5	3.7
Angola	Low	(22.3)	11.3	21.4	4.8	3.1	3.7
Botswana	Middle	3.1	3.9	3.7	3.6	3.5	4.0
Burundi	Low	6.4	6.6	6.3	6.0	8.0	7.6
Eritrea	Low	12.8	35.3	37.5	36.1	24.4	23.5
Ethiopia	Low	3.4	6.7	10.7	9.6	6.0	5.2
Guinea-Bissau	Low	0.7	1.4	..	4.4	3.1	..
Liberia	Low	..	..	..	..	( 7.7)	(7.5)
Libya	Middle	4.1	5.3	3.8	3.2	2.9	2.4
Morocco	Middle	3.9	3.7	4.0	4.1	4.1	4.3
Rwanda	Low	4.1	4.4	4.6	3.8	3.9	3.3
Zimbabwe	Low	3.3	2.6	4.7	4.9	3.2	3.2
Asia and Oceania							
Brunei	High	7.3	9.4	[7.3]	[6.5]	[7.6]	7.0
Cambodia	Low	4.6	4.2	3.8	3.5	3.0	[2.7]
Pakistan	Low	4.9	4.8	4.7	4.5	4.6	4.7
Singapore	High	4.7	5.5	5.5	4.7	5.1	5.2
Sri Lanka	Middle	4.2	4.2	3.6	4.5	3.9	3.1
Turkmenistan	Middle	4.0	3.1	2.9	..	..	..
Europe							
Bosnia and Herzegovina	Middle	..	..	..	9.0	..	..
Croatia	Upper-middle	5.7	5.5	4.3	3.0	2.7	2.5
Cyprus	High	4.2	3.6	2.1	2.1	2.4	1.6
Greece	High	4.6	4.8	4.8	4.9	4.6	4.3

Macedonia (FYROM)	Middle	2.2	2.2	1.8	1.9	6.6	2.8
Russia	Middle	[4.2]	[3.1]	[3.5]	[3.7]	[4.0]	[4.0]
Serbia and Montenegro	Middle	[4.8]	4.4	4.5	5.9	4.9	4.5
Turkey	Upper-middle	4.1	4.4	5.4	5.0	5.0	4.9
Middle East							
Bahrain	Upper-middle	4.6	4.8	4.9	4.0	4.2	3.9
Iran	Middle	2.9	3.2	3.0	3.8	[4.3]	[4.0]
Israel	High	8.4	8.4	8.4	8.2	7.7	9.2
Jordan	Middle	8.7	8.8	8.9	8.8	8.6	8.4
Kuwait	High	8.2	9.1	8.3	7.7	9.0	10.4
Lebanon	Upper-middle	4.6	4.3	5.0	5.4	5.5	4.7
Oman	Upper-middle	12.5	12.5	11.4	10.6	12.2	[12.3]
Saudi Arabia	Upper-middle	10.7	14.3	11.4	10.6	11.5	9.8
Syria	Middle	5.7	5.8	[5.6]	[5.5]	[6.4]	[6.1]
UAE	High	4.8	5.1	4.5	3.5	3.6	3.7
Yemen	Low	6.5	6.7	5.6	[5.3]	[5.5]	7.1

^a Countries have been selected on the criterion that the share of their military expenditure was known to be higher than 4.0% in any of the years 1997–2002.

^b Based on GNI per capita in 2000.

Sources:

Military expenditure as a share of GDP: SIPRI Yearbook 2004, Appendix 10A, table 10A.4;

Income group: World Development Indicators 2002.

APPENDIX 3

DEFENCE RESEARCH AND DEVELOPMENT AND EQUIPMENT SPENDING IN SELECTED NATO STATES: IN CONSTANT 1999\$US BILLION.

Country	R&D in 1996	R&D in 2000	Equipment procurement in 1996	Equipment procurement in 2000
France	5,1	3,1	7,9	5,3
Germany	1,9	1,3	3,9	3,4
Italy	0,8	0,3	2,1	2,3
Spain	0,3	0,2	1,3	1,1
UK	3,6	4,0	8,5	8,5
USA (Department of Defense)	37,1	33,7	45,1	52,0
NATO, (Europe total as per centage of US total)	32,2	27,3	69,8	57,2

Source: International Institute for Strategic Studies (2000), The Military Balance 2000-2001, Oxford University Press, p.41.

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