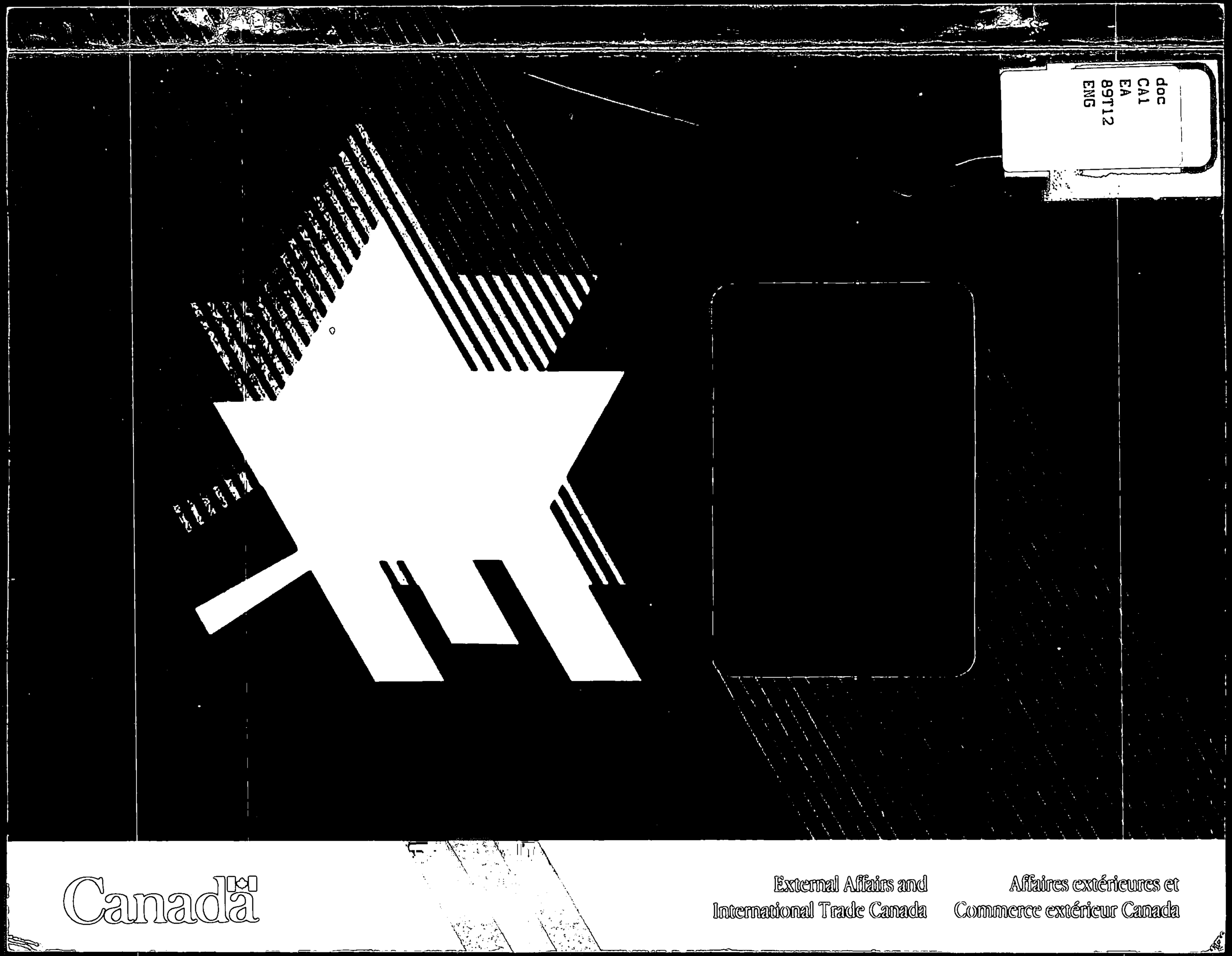

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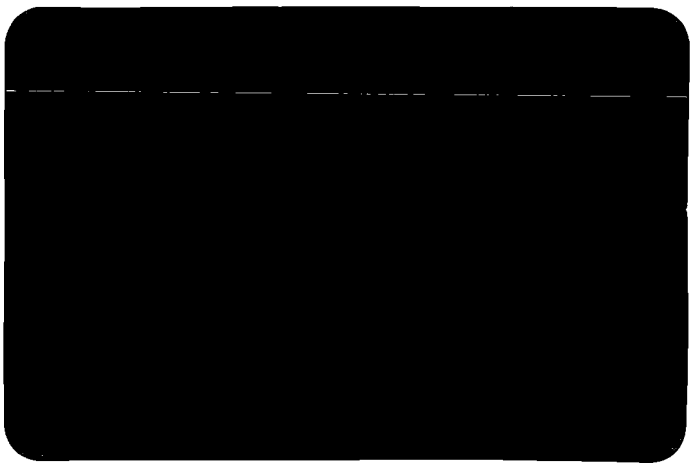

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TASK FORCE ON EUROPE 1992

REPORT OF THE WORKING GROUP

ON

DEFENCE PRODUCTS

(VERSION FRANÇAISE DISPONIBLE SUR DEMANDE)

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TASK FORCE ON EUROPE, 1992

WORKING GROUP ON DEFENCE PRODUCTS

EXECUTIVE SUMMARY

SCOPE:

The aim of the study is to consider the possible effect of a single market in Europe on Canadian defence industry and procurement and its longer term implications for Canada's defence industrial base and for transatlantic NATO co-operation. The measures examined include not only those normally coming under the rubric of the 1992 Single Market, ie. the removal of all physical, technical, financial and institutional barriers among the twelve countries of the European Community but also the proposal of the Independent European Program Group (IEPG) to establish a single defence procurement area among the European NATO countries. The effect of a possible curtailment of duty free importation of defence products into EC countries is also considered.

APPROACH:

The Working Group included representatives of the Department of National Defence; Canadian Commercial Corporation; Department of Industry, Science and Technology, Department of Supply and Services, and Department of External Affairs, each of whom contributed information and expertise. The study was conducted in close consultation with industry, represented by members of the Canadian NATO Industrial Advisory Group (NIAG), with the Canadian Embassy in Washington, the Canadian Delegation to the North Atlantic Council and the Canadian Mission to the European Communities, both in Brussels. Finally, meetings were held in Washington with the departments of State, Defence, Commerce and the Office of the U.S. Trade Representative and in Brussels with the NATO Secretariat.

FINDINGS:

European defence industry as such is not subject to the jurisdiction of the EC Commission, since Article 223 of the Rome Treaty leaves with national governments exclusive responsibility for security. This exclusion has been slightly modified by the 1985 Single European Act but firms producing only defence and security equipment, many of which are state owned, will not be directly affected by 1992. Many defence contractors, however, in Europe as elsewhere, produce civilian as well as military goods and will be subject to the Single Market program. The whole defence products industry will be influenced in varying degrees by the post-1992 environment, e.g. the development of common or mutually recognized EC standards.

The Working Group has not attempted to duplicate studies undertaken by the groups on industrial and transportation equipment and services and on information and telecommunication products and services, whose product coverage spans the defence sector but its investigations lead it to believe that the European industry will face major adjustment in the years ahead and this is likely to influence prospects for the Canadian defence industry.

Defence procurement in most European NATO countries is lacking in transparency and strongly directed in favour of national firms. This results in many instances in short production runs and consequent high costs. The removal of barriers within the Community will face the mixed civilian/military sector with the prospect of significantly increased competition, to which it is responding with a rush of mergers and acquisitions, and the formation of new consortia within member states and to an increasing degree across national frontiers.

The constantly increasing cost of producing defence equipment in less than optimal quantities has given rise to proposals by the IEPG for a new Europe-wide system of procurement which would affect the traditional specialized arms producing firms as well as those serving both civilian and military markets. This program can be expected to reinforce the EC Single Market in the defence sector and lead to more competition, a shakeout of excess capacity and again more mergers and co-operative arrangements. One result will almost certainly be some increased difficulty for Canada's defence industry to sell its products in Europe and a "leaner, meaner" European defence industry better able to compete in North American and third country markets.

The rationalization of the European defence industrial sector may be sought in part through increased protection against North America. Not only is the IEPG proposing to liberalize defence procurement in Europe while continuing largely to exclude North America, but the EC is considering curtailment of the duty-free purchase of defence products which some NATO countries have practiced for the past thirty years. Tariffs of between 5 and 14% would significantly handicap the purchase of sub-systems from Canada and further reinforce the tendency to "Buy European." The change would also serve to undermine NATO co-operative defence programs and further inhibit trans-Atlantic defence co-operation.

CONCLUSION:

The 1992 Single Market program and the Western European defence procurement arrangements being proposed by the IEPG are likely to lead to a stronger and more efficient European defence industrial sector, better positioned than at present to compete with North American producers. Coming at a time when U.S. defence budgets have likely peaked, leading U.S. industry to seek new overseas markets in Europe and elsewhere, any signs of new European protectionism such as tariff discrimination could cause tension within the Alliance with potentially serious political and military implications. Most Canadian companies in the defence sector, however, have corporate links or other co-operative arrangements with partners in Europe but rely primarily on active R & D programs to maintain the technological lead which gives them access to niches in the European market. There is a danger that as major U.S. defence contractors operate through European subsidiaries or partners, some Canadian sub-contractors may be frozen out of the European market. To avoid this it is important that they consider strengthening their own links within the Community and actively seek out areas of co-operation with European partners.

TASK FORCE ON EUROPE 1992
REPORT OF THE WORKING GROUP ON DEFENCE PRODUCTS

Part I
Introduction

The completion of the Single Market embracing the 12 member states of the European Community is a process intended to result, by December 31, 1992, in the complete elimination of all internal barriers to the free circulation of goods, services, capital and people. The process, which is to cover all sectors of the civilian economy, is not new and indeed was envisaged in the 1957 Treaty of Rome, which still provides its legal basis. In the early years of the Treaty, attention was concentrated on creation of a customs union behind a common external tariff, but this was made more difficult by the accession during the period of six new member states, all with different economic structures and standards. The result was that while national customs tariffs were removed as planned, a host of non-tariff barriers remained and progress toward full integration stagnated. Despite continuing efforts to remove these internal barriers, progress had become extremely difficult as proposed measures came up against areas of sovereign authority in the individual member states, particularly differing regulations and standards in such fields as health, industrial safety, taxation, regulation of financial institutions and transportation policy.

Despite widespread recognition in the seventies that the economic integration of the Community was in danger of running out of steam, it was by no means clear that the necessary political will existed to do anything about it, due to the need for unanimity in the decision-making process. Meanwhile, however, there was increasing concern in Europe over US and Japanese competition, especially in areas of high technology. Economic upheavals since the beginning of the seventies made it plain to Europeans that in certain sectors, including the defence sector, they could only actively shape their industrial future together in a market offering much greater economies of scale. Apart from Britain and France, which are major world exporters of defence equipment and as a result enjoy reasonably long production runs, most European procurement is undertaken within national borders, usually from a very small group of suppliers on a low-volume basis. When not procured domestically, military equipment for European NATO members has normally been purchased overseas from North America; apart from certain high profile special projects, there has until recently been little defence trade between European countries. Under Article 223 of the Treaty of Rome, security and hence defence procurement are an exclusively national responsibility in which the E.C. Commission has no authority - an anomalous situation in view of the fact that a great deal of European defence production is by firms, an increasing proportion of whose sales are civilian in nature and therefore subject to Community jurisdiction. During the incumbency of Jacques Delors as President of the Commission there has been growing awareness in Brussels of this anomaly and an increasing tendency on the part of the Commission,

strengthened by the 1986 Single European Act and with the encouragement of certain member states, to move into areas closely related to defence.

The Single Market - Progress to Date

In 1985, under the leadership of Delors, a consensus was arrived at among member states on the need to establish a Single European Market and Lord Cockfield, one of the two British Commissioners, was charged with preparing a White Paper outlining the measures necessary to achieve this. The resulting document, the White Paper on Completing the Internal Market by 1992 outlining 300 measures required, was in due course adopted by the European Council comprising the twelve Heads of Government. Its implementation was facilitated by signature in February, 1986 of the Single Act which provided streamlined procedures for bringing the necessary measures into law, notably that new directives would be adopted by qualified majority voting, rather than on the basis of unanimity. The Single Act also embodied the longstanding principle of mutual recognition of member states' legal requirements. Instead of trying through tortuous negotiations to harmonize twelve sets of national norms and standards, a pragmatic approach of mutual recognition of respective standards coupled with community level essential requirements (where health, safety, environmental or consumer concerns are at stake) has been implemented to get the single market operational as quickly as possible.

Lord Cockfield's 300 measures (now trimmed down to 279) fall into three broad categories covering:

1) Physical barriers (customs and immigration controls) which restrict the flow of goods and persons across national borders and hence increase costs.

2) Technical barriers (technical standards, health and safety requirements, lack of mobility of labour and professions, restrictions on capital movements, cross-border provision of financial and other services and procurement). These clearly limit efficiency and block access to wider markets within the Community.

3) Fiscal barriers (differing rates of taxation, notably excise and value-added tax) which cause trade distortions when border controls are removed.

These measures are drafted in the Commission and are submitted to the EC Council of Ministers for approval before being referred to member states for action. Initial progress was good, but has tended to fall behind schedule as more difficult areas such as government procurement and the structure of indirect taxation are tackled. Nevertheless, by the end of 1988, 135 or almost 50% of the directives required to implement the Single Market had been approved by the Council. At the same time, the Commission had tabled 90% of the directives in the form of draft

legislation. In effect, the Council has two years to complete action on the outstanding directives since on average a further two years will be required for national governments to draft necessary legislation and secure parliamentary approval by the end of 1992. Even if there is some slippage in the 1992 timetable (and this is almost certain), it is the view of most observers that the process itself is now irreversible and will essentially be completed as planned.

The purpose of the Single Market program is in part ideological but mainly a practical matter of economics and power. For dedicated Europeans, the Community is obviously incomplete as long as barriers and controls exist at every national frontier and these restrictions have severely limited the benefits of the Common Market by continuing its division into national components. The aim by the end of 1992 is to allow industry to compete freely in a Single Market of 320 million people and as a result of rationalization, to compete with greatly increased efficiency in the markets of the world. The 1988 Cecchini study[1] perhaps rather optimistically assumes a 4.25% to 6.50% incremental growth in Community GDP over the four to five year period following 1992, price reductions averaging 6% and two million new industrial jobs. There are clear potential benefits to industry in member countries and for Europe's trading partners to profit from this rich and dynamic market though many outside firms, especially from North America and Japan, are inclined to hedge their bets by establishing themselves within the Community rather than relying on trading access from outside.

Europe's Defence Industries

With a few exceptions, the defence sector in Europe, as in Canada, does not stand alone but forms part of the activity of firms in the automotive, shipbuilding, aerospace, electronics, communications and other high technology industries. The defence sector, however, because of traditional national procurement policies, is fragmented along national lines with each industry doing business mainly with its own Ministry of Defence. Traditionally, particularly in larger countries such as the United Kingdom, France and Germany, defence ministries have undertaken little procurement elsewhere in Europe, and purchased from North America only when necessary. This fragmentation, which has been reinforced by the tendency of each defence ministry to insist on its own specifications for military equipment, has not only emphasized the lack of arms standardization in NATO but has also accentuated the problem of rapidly increasing equipment costs. In recent years considerable attempts have been made to overcome this problem, particularly through teaming of industries and firms within countries and across national borders, notably in the production of the Tornado fighter aircraft, the cooperative production of an advanced trainer by

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[1]Aldo Cecchini: The European Challenge 1992: The Benefits of the Single Market

Italy and Brazil and the currently planned European Fighter Aircraft involving Britain, Germany, Italy and Spain. These projects have generally been successful but have yet to overcome completely the problem of ever increasing defence costs which seems to be leading inexorably to what Thomas Callaghan has called the "structural disarmament" of NATO countries.[2]

As part of the increasing recognition being given to this problem, Britain and France, two of Europe's leading manufacturers of armaments, are increasingly liberalizing their national defence procurement in one another's favour. French firms and consortia are generally free to compete as prime contractors for British defence projects while the British have similar access to the French market. There is also an increasing tendency to form binational and multinational consortia. This process is still in its early stages but already firms in European countries have a significantly preferred position in other European markets over their North American competitors; this margin of preference is likely to increase substantially as a result of new procurement policies being developed among European NATO countries in parallel with the advance to 1992.

The situation is somewhat different in the less industrially developed countries of southern Europe (notably Portugal, Greece and Turkey and in some respects Spain and Italy.) These countries have less sophisticated defence industries and rely for a larger percentage of their requirements on imports from the United States rather than relatively high cost sources in Northern Europe. Defence industry in these countries often means low technology state-owned enterprises not yet developed to their optimum efficiency. The southern-tier members of NATO have substantial reservations about the development of an autonomous European defence industry complex based on protection against North America but have been persuaded to support initiatives in this regard following proposals to share its benefits through the Less Developed Defence Industry (LDDI) program. They have also offered significant opposition to the initiative of the EC Commission to curtail the duty free importation of defence products into Community countries, but are taking part in ongoing discussions of the issue.

Industry's Response to the Single Market

The approach of 1992 has given added impetus to the global trend toward industrial consolidation in Europe and elsewhere. The European defence sector contains a large number of relatively small firms (or units of large firms), many state-owned, often kept in business only by the procurement policies of their respective governments. The advent of the Single Market and the prospect of a regime of defence procurement open to all European NATO countries should bring a

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[2]Thomas Callaghan: Pooling Allied and American Resources to Produce a Credible Collective Conventional Deterrent, a report prepared for the U.S. Department of Defense.

significant increase in competition and probably a shake-out of many weaker units. A more competitive environment would probably reveal the existence of substantial excess capacity which would be exacerbated if, as proposed, some procurement is diverted to the southern-tier LDDI countries of NATO Europe.

European industry is responding to the trend to 1992 and the globalization of competition by an increasing number of mergers and acquisitions. To date, consolidation is taking place mainly within individual countries, e.g. in Germany Daimler-Benz's planned takeover of MBB will give it overall control of some 70% of the FRG aerospace industry while in France the proposed merger of Crouzet, Sfena and EAS, all controlled by Aerospatiale, with the General Avionics Division of Thomson-CSF, will create a single entity better able to compete internationally. Similar national mergers are in prospect in Italy and elsewhere. There are, in addition, new cross-border mergers bruited such as the GEC/Siemens bid for Plessey Plc of Britain, while talks are also taking place between British Aerospace and Thomson-CSF looking toward formation of a joint marketing subsidiary for the two companies' defence products.

This trend is clearly important and shows every sign of accelerating in the rundown to 1992 and beyond. The long-term prospect is for a substantially reduced number of national firms in the defence sector with a few transnational giants including European subsidiaries of US majors. The widespread practice of operating through consortia is likely still further to limit intra-European competition. These developments should be kept in perspective, however, as major defence industry consolidation is broader than just Europe - indeed European firms show as much interest in transatlantic acquisitions as in expanding nationally or within the Community.

For EC member nations, despite some well publicized acquisitions, the approach to 1992 has proceeded with some caution. For example, although the amount spent by British companies on EC acquisitions doubled last year to 2 billion, it was still well short of the 17 billion spent in the United States. Language differences, the still fragmented nature of the European market and legal/institutional barriers against hostile takeovers meant that UK acquisition spending was unlikely to switch quickly from the US to Europe. In addition, potential acquisition targets in Europe are now bringing large premiums over their net worth while the fall of the dollar against the leading currencies of Western Europe has meant that there are industrial bargains still to be found in the United States and Canada. Increasingly, however, European investment attention is being drawn to opportunities in Europe itself, to permit firms to position themselves better for the Single Market.

Among Western European countries outside the EC (most of which are members of EFTA), there is an increasing recognition of the need to come to terms with the Single Market and

the onset of 1992. As members of EFTA, these countries (Norway, Sweden, Finland, Iceland, Austria and Switzerland) have free trade in industrial goods among themselves and with the Community. They are increasingly concerned, however, at being excluded from the non-tariff liberalization of the Single Market and are taking steps to align their regulatory policies with those of the Community and to establish and strengthen institutional linkages. Sweden and Norway are mirroring their trade and regulatory legislation with that to the EC and favour strengthening the EFTA Secretariat to facilitate negotiations with Brussels. Finland and Switzerland, however, are opposed to closer institutional links, mainly for fear of compromising their neutrality, though Austria, also neutral by virtue of the 1955 peace treaty, is actively contemplating seeking EC membership if the political problem can be overcome, while Norway is considering a second bid for membership if a domestic consensus can be reached on the issue. Norway, as a NATO member, is actively involved in discussions on European defence procurement but the neutrals are excluded from this cooperation except to the extent that they establish joint ventures or other facilities in EC countries.

The industrial strategies being pursued by European industry parallel those of Japanese and U.S. firms. Japanese enterprises have for some years been establishing manufacturing plants in Europe, particularly in Britain, in order to serve Community markets, though certain EC countries have applied restrictive rules of origin to limit their access. They are now devoting increasing attention to investing in Spain and southern Italy and Japanese financial institutions, particularly the Bank of Tokyo, are facilitating this response through the provision of soft financing and up-front funding.

United States industry is already well represented in Europe through past investments and acquisitions dating back to the 1960s and in some cases much earlier. These subsidiaries are generally accepted as European enterprises and as such expect to benefit from the Single Market. Some firms, such as Allied Signal and Martin Marietta, are planning to increase their European base through new investments or acquisitions. In January Texas Instruments announced plans to build a US $250 Million plant in southern Italy to produce the next generation of memory chips and other types of advanced semiconductors. The project will complete a network of European manufacturing centres in West Germany, Portugal, the United Kingdom and France. A major motivation for this move is that the EC requires semiconductor products to be fully fabricated within Europe to meet local content rules on electronic and computer equipment; a regulation that has prompted several major semiconductor companies to plan new European production facilities. While representatives of the US government express concern over the proposed rules of origin (generally 50% EC content to be regarded as European products for civilian procurement purposes) US major industry seems

prepared to take this requirement in its stride and to emphasize the gains to be made in doing business with an integrated Community.

According to press reports[3] small and medium sized US industry is also showing positive interest in business prospects in Europe after 1992; although fears of Fortress Europe were seen as a factor, the main reaction was to see the Single Market as an opportunity rather than a problem. A survey conducted in January by the Bank of Boston Corporation shows over 50% of respondent firms that do not already have a presence in the EC are considering establishing some form of operation there in the next few years. According to the poll, 24% said they planned to form joint ventures, 18% would seek to enter the market by hiring sales representatives, 17% by establishing a branch or subsidiary and 15% by opening a distribution facility. (Annual sales among the respondent firms - just over 12% of those polled, ranging from electrical machinery manufacturers to fabricated metal producers - averaged US $35 million). Proposed destinations were Britain 23%, Germany 19%, France 12%, Italy 9% and Spain 7%. Some 84% of respondents cited Europe's planned integration after 1992 as an opportunity to expand sales and operations based on a Single Market of 320 million people, the standardization of import requirements and a perceived diminution of bureaucratic intervention in commercial affairs.

Part II
The Larger Picture and Its Implications for the Alliance

The general response of industry to the Single Market is only part of the purpose of this study, given the fact that the defence sector as such is largely excluded from the Commission's mandate, although, as we have seen, it is bound to be influenced by the 1992 program. To get a clear picture it is necessary to consider the 40 year history of NATO defence procurement both in Europe and Alliance-wide, the failure to achieve more than a modicum of arms standardization throughout NATO and the ruinous escalation of procurement costs. Although one original aim of the Alliance was a pooling of resources to meet the common threat to its members from the greatly superior conventional strength of the Soviet Union and its Eastern Bloc allies, this was quickly replaced by a United States guarantee of Europe based on an overwhelming US nuclear superiority. Even when the USSR achieved nuclear parity and essentially nullified the US guarantee, the Allies continued to go their separate ways in procurement. The United States as a superpower with world-wide strategic interests going far beyond Western Europe was not prepared to accept interdependence with its leading European allies; the latter for their part continued wherever possible to procure defence equipment from their own national industries, except when for financial reasons or the lack of necessary technology they were obliged to purchase from North America.

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[3]See, for example, the International Herald Tribune of February 14, 1989.

European Procurement Practice

Detailed information about public procurement policies and processes of European countries is difficult to obtain. Procurement decisions are generally made administratively on a case-by-case basis, largely out of the public view, and policies are rarely formally stated in law. This lack of detailed information makes it difficult to identify the specifics of commonality in European government procurement practice.

By comparison with North America, European procurement is greatly lacking in transparency. When bidding is competitive, the usual practice is not to announce either the details and amount of the winning company's bid or information about unsuccessful bidders. In Britain, France and Germany, bids are usually not disclosed and unsuccessful bidders have the right to only limited information as to why a bid was rejected. European authorities do not explicitly state the process by which foreign bids are compared with those of domestic firms, and as a result, the extent to which domestic industries are given preference is difficult to determine. Instead of an established process favoring domestic industry by a certain margin, European countries have traditionally employed a variety of subtle methods to achieve much the same objective. These include limiting bid submission time, applying residence requirements, using technical standards to restrict the ability of foreign companies to comply and inviting only domestic industries to bid.

One of the more protected public procurement sectors in Europe is telecommunications. Governments protect domestic sources with unique national standards as well as with local certification requirements which favour domestic suppliers. The implementation of more open bidding practices, harmonization of technical standards and increased competition are intended to open the telecommunication markets, as well as other public procurement sectors, to all EC suppliers. While the EC's mandate does not as yet extend to the defence sector, the civil telecommunication industry is a high technology area with many similarities to and applications for military communications and electronics.

In the area of defence procurement, European countries have consistently favoured domestic sources. In addition to maintaining a domestic defence base, European defence purchases are directed to domestic industry in order to provide jobs, develop high technologies and address economic concerns such as the balance of payments. The degree of protection given to defence firms varies from country to country depending on many things, including percentage of public ownership, industrial structures and strengths, trade opportunities and political considerations. To date, few European governments have stressed competitive sourcing for defence procurement, and in some countries the majority of defence contracts are negotiated without competition, or bidding is

limited to particular invited firms. While proportions vary from country to country, generally speaking competitive purchasing of defence equipment is quite limited.

While Europe is still a patchwork of defence procurement practices, some efforts towards integration have been started. The thirteen nation Independent European Program Group[4] has worked towards the coordination of defence requirements which should lead to the identification of joint development and production opportunities. The NATO Conventional Armaments Planning System (CAPS) was initiated in 1986 by the Conference of National Armaments Directors. The concurrent initiative by the IEPG should serve to identify and distinguish European requirements and opportunities within overall NATO procurement planning. The IEPG have decided to establish a permanent staff to facilitate defence procurement coordination and have given priority to fostering defence R & D.

Another factor which will influence the degree of unification achieved in the European defence market is the current general industrial restructuring activity in the face of the Single Market. As noted earlier, the number of buy-outs, mergers and teaming arrangements as well as the rationalization and growth of multinationals in the defence sector is likely to continue and accelerate in the years ahead. The resulting European defence industrial base should be leaner and more competitive in world markets.

Failure of Equipment Standardization

When NATO was formed there was a general expectation that collective defence would lead to complete standardization of military equipment and, in that sense, complete commonality has often been held to be the objective of equipment cooperation. Over and above the obvious political realities it is recognized, however, that such a goal is probably not achievable because of the practical difficulties which result from the fact that nations replace equipment in different time-frames. Nonetheless, NATO has pursued standardization since its inception, but apart from limited success in some areas and occasional hopeful signs of more, there has never been any consistent progress in those areas that really count, ie. common development and production of major defence equipments. To achieve real standardization among the European NATO allies would probably require the creation of a European Defence Community, a concept which flourished in the early 1950s but died in 1954 after its rejection by France.

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[4]See page 14 for particulars

While standardization means the same weapons, the same ammunition and the same repair parts it also means much more since it has military, economic and political dimensions. Militarily it means that Allied forces can refuel, rearm, repair, reinforce, support, supply and communicate with each other, and identify friend from foe. With common, standardized equipment, forces can use the same terms, refer to the same manuals, train on the same simulators and possess identical hands-on familiarity with equipment performance. Economically, standardization means non-duplicative development, long production runs with lower unit costs, common training and maintenance and much simpler logistics arrangements with every base, depot and repair unit able to service not only its own equipment but also that of allies. Politically it means the closest possible cohesion among NATO members, because the economic and military benefits cannot be realized without coordination and complementary political, industrial and labour efforts at every level. Due to its different history and structure, the Warsaw Pact generally speaking has this advantage which NATO conspicuously lacks.

NATO member nations now have their own developed defence industries and, as we have seen, given the need for consensus, it is nearly impossible to arrive at a common standard for military hardware. It was possible in the early years of NATO to set universal specifications for some things such as rifles and tank rounds but even then some countries remained out of step. As a result of this experience standardization of equipment within NATO has been abandoned in favour of interoperability. The consequences of the failure to settle on a single standard for any piece of equipment is that NATO has become a collection of musicians, each playing its own equipment tune, rather than an orchestra. That has a profound effect on the fighting ability of the Alliance which in a prolonged conflict can only diminish: as each nation's forces consume their on-hand stocks, the rear area will become clogged with the multitude of separate supply chains each trying to rush its own, different, materiel to the front. While the absolute necessity of interoperability has been clearly recognized, so that the phrase RSI (Rationalization, Standardization, Interoperability) is now used to express the goal of cooperation, it is also apparent that mere interoperability between the diverse national weapons systems is no longer enough. Spurred by the need to reduce R&D and production costs there has been movement towards armament cooperation through the medium of NATO Cooperative Armaments projects.

Europe's Quest for Defence Autonomy

Escalating equipment costs driven by product complexity and differentiation are placing an almost insupportable strain on defence budgets everywhere. In Europe's case the problem is compounded by two other factors - a defence industrial base fragmented along national lines and military requirements reflecting contrasting specifics to an unacceptable extreme.

The main challenge to the European armaments industry arises from its own fragmentation and a resultant shortfall in R&D in many sectors which leaves it behind the United States, particularly in the most demanding of new technologies. US superiority results largely from the massive US investment in defence, including government funded R&D, with its emphasis on the exploitation of technology to the limit of the state of the art. While there have been a number of notable instances of satisfactory and profitable collaboration on weapon system projects between European partners, there have also been striking examples of inter-European competitive products splitting the market and weakening resistance to external competition. For this and related reasons, largely based on costs, European governments have been forced to consider offshore purchase of defence products which in theory Europe should have been fully capable of manufacturing for itself to meet local operational needs.

The need for Europe to establish a position of reasonable technological and industrial equivalence with the United States is increasingly perceived as a matter of fundamental political and economic importance which also underlies the 1992 Single Market program. There could be many practical benefits if European defence industry could organize its latent strength against growing US (and Japanese) competition. Europe would be able more easily to cooperate in sophisticated programs with the US and to introduce European defence products to the US and Canadian defence markets. The challenge then is for European defence industries to arrange their activities so as to improve the cost ratio of R&D to production so that unit costs are reduced to a competitive level. A further challenge is to strengthen the European technological base through the coordination of research programs and the elimination of unnecessary duplication.

Increased Co-operation

Over the last twenty years, with the growing success of the European Community in the economic and more recently in the political sphere there have also been attempts to strengthen specifically European co-operation in defence matters. There are now three separate bodies - the Western European Union (WEU), the Eurogroup, and the Independent European Program Group (IEPG), each with somewhat different membership operating in this field while the EC Commission, under its new mandate, is charged with promoting industrial and technological development in the interests of the security of the Community.

The WEU came into existence in 1954 as a precursor of NATO, dedicated to promoting defence co-operation among its member states: Belgium, France, Italy, Luxembourg, the Netherlands

the United Kingdom and later Germany. With the establishment of NATO in 1958, WEU became somewhat redundant but continued in existence as a European forum for discussing defence questions at the political level (but not in military or industrial terms). In 1986, as a means of promoting European defence co-operation, WEU was given a more active role with increased staff and a new Secretary General. Membership has expanded with the entry of Spain and Portugal with other European allies such as Norway likely to follow. The revived WEU has yet to establish a clearly defined role, however, lacking as it does a military and industrial dimension, though it was the forum which decided on the dispatch of minesweepers from several European countries to support the United States action in the Persian Gulf. Its headquarters is still divided between Paris and London.

Established in 1968 and composed of all the European NATO nations except France and Iceland, the Eurogroup is more multi-faceted than WEU. While its objectives include a forum for an exchange of views on policy and strategic matters at the Ministerial level, its primary purpose is to provide a pragmatic and flexible structure of working groups for fostering practical cooperative efforts in defence communications, logistics, military medicine, training and conceptual long-term defence equipment collaboration. The latter sub-group is often the genesis of projects undertaken by the IEPG. Although not Eurogroup members, Canada and the United States have participated in some Eurogroup activities and currently are still active in the Euro-NATO Joint Jet Pilot Training Program. The final and most dynamic grouping is the IEPG, formed in 1976 and having the same membership as the Eurogroup with the addition of France. It is, however, outside the formal structure of NATO and overlaps the responsibility of the Conference of National Armaments Directors (CNAD), minus the United States and Canada, as well as Eurogroup. It operates both at the level of Defence Ministers and of National Armaments Directors and thus provides both the political will and the technical ability to translate armaments collaboration goals into realistic and achievable co-operative programs. The most important achievement of the IEPG to date is the report[5] released in December, 1986 drawing attention to the weak and fragmented state of European defence industry and calling for the institution of a multilateral system of procurement among the European NATO countries. The Vredeling Report makes it clear that while the team was concerned with increasing the efficiency of defence procurement in Europe, it is equally concerned with the need to strengthen European industry, particularly in those high technology sectors where development has lagged behind Japan and the United States.

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[5]Towards a Stronger Europe: A Report by an Independent Study Team established by Defence Ministers of Nations of the Independent European Program Group to make proposals to improve the competitiveness of Europe's defence equipment industry. The team was chaired by Netherlands Defence Minister Henk Vredeling.

United States Response

As already mentioned, the general reaction of the US business community, particularly the major corporations, to the approach of 1992 tends to be positive, despite considerable publicly expressed fear of Fortress Europe. Most of the majors have EC subsidiaries or other co-operative arrangements and in addition a broad spectrum of medium-sized and smaller companies are familiar with the European scene; in the twenty years since 1958 the US has earned a cumulative surplus of $20 billion in trade with the Community, in contrast to a deficit of $300 billion with Japan. In 1988, due in part to dollar depreciation, the value of US exports to the EC increased 25% while imports rose only 5%, cutting the year's trading deficit in half. US industry seems generally confident of its ability to compete in Europe and those firms already established in the Community are conscious of the advantages of doing business in a Single Market in place of twelve separate entities. Although the goal of complete market homogeneity may be a distant dream, and perhaps even a chimera, there should be real advantages to Europe's trading partners as a result, for example, of there being uniform standards for manufactured goods and a Single Administrative Document for customs purposes (replacing up to 150 documents for certain goods) which should greatly reduce the administrative cost of selling into the Community.

US business optimism also appear to be based on confidence in the readiness and ability of the US Government to defend their commercial interests in Europe. The Department of Commerce is engaged in an active program designed to sensitize business to the changes now taking place and the opportunities these present. The program is part of the overall effort to reduce the US trade deficit, with particular attention being directed toward the EC as the USA's largest individual market. According to a senior Commerce official[6], over 6000 US companies have contacted the Department and 50,000 copies of individual EC directives have been distributed to firms - mostly to small and medium-sized companies. Business confidence is no doubt reinforced by awareness that their government is prepared to go to considerable lengths to protect their interests in Europe either as exporters or as the parents of industrial subsidiaries domiciled in the Community.

This buoyancy of outlook, however, is somewhat muted in the US defence industry, which sees itself faced with rather special problems. After eight years of escalating defence budgets under the Reagan Administration, the defence sector now faces the prospect of at best a budget freeze and the likelihood of significantly reduced spending in real terms. The natural reaction, as

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[6]Frank Vargo, Deputy Assistant Secretary for Europe, Department of commerce, in testimony before the House of Representatives Small Business Committee, February 9, 1989.

in other major arms manufacturing countries, is to look to exports to take up the slack, but in Europe the outlook is not encouraging. Not only has European opinion, in response to conciliatory noises from Moscow, cooled to the notion of increased arms expenditure but European governments working through the IEPG are actively seeking to increase the cost effectiveness of local defence procurement in Europe and in the longer term reduce their dependence on North American sourcing. This will clearly not happen over night, given that most European countries have generally only purchased from the United States and Canada when their own technology was inadequate or when the difference in price was too great to be ignored.

In Washington there is no clear consensus on the significance of European developments [7], apart from an underlying concern that these are directed at least in part against US interests and by inference represent a threat to NATO and Western solidarity. Despite traditional US support, going back to 1962 and President Kennedy, for the concept of a "two-pillar" alliance linking Europe and North America, current European defence initiatives are seen by some as an attempt to reduce US influence in Europe and create an inward looking Community vulnerable to seductive blandishments from the East. This critical attitude seems to have spilled over to US officials at NATO where the Assistant Secretary General for Defence Support, former US Senator Mack Mattingly, was highly critical of IEPG which he described publicly as an "inward-looking cozy Europe-only club, not an outward-looking force and contributor to wider Atlantic cohesion".[8]

The current US attitude is compounded of varied ingredients and irritants, some of which have been in the works for many years but have become increasingly abrasive in an environment where the world supremacy of the United States is being openly questioned. US economic problems are seen in certain quarters as those of a weary titan with over-extended responsibilities, while the European allies (as well as Japan and Canada) have failed to shoulder their share of the burden. The need for more equitable burden sharing has become almost an article of faith on Capitol Hill

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[7]This was possibly due to the fact that the interregnum between the Reagan Administration and its successor essentially began in October, 1988 and was still continuing five months later, since few senior political positions in the departments concerned had yet been filled.

[8]Jane's Defence Weekly, 4 March 1989, p. 344.

and Congressional sensitivity on the issue has been reflected in increased pressure for burden sharing both at NATO headquarters and in capitals. In these circumstances any overtly protectionist and self-serving European policies such as a tariff on defence products from the United States or a procurement system too obviously rigged to further reduce defence imports from the US would risk provoking a strong reaction from Washington with serous potential implications for the Alliance[9]. U.S. concern over an increasingly self sufficient and independent Europe is not based only on self-interest and wounded amour propre, however; there is also a genuine fear that with no central political authority in prospect the European pillar would have a weak and divided collective leadership, a poor substitute for the present leadership of the US.

Role of the European Community

It has proved extremely difficult to obtain information about EC activity in the defence products sector due to a dearth of published information (in contrast to the torrents of paper on the subject of the Single Market proper) and the confidentiality of many of the discussions. Part of the reason lies with Article 223 of the Rome Treaty, which by preserving the sovereign rights of member states in matters relating to national security has precluded any overt role for the Commission. This has been modified, but rather intangibly, by Article 30 of the Single European Act which requires member states to co-ordinate their positions more closely on the political and economic aspects of security and give the Commission authority to maintain the technological and industrial conditions necessary for the Community's security. This has encouraged intensified consultation and collaboration on a bilateral basis, e.g. between France and Germany in a Joint Defence Council and between France and Britain in defence procurement, as well as broader discussions through the European Political Consultation (EPC) process, in WEU and in other fora. Broadly speaking, however, although the Single European Act hints at the formation of a defence component of the European Community the latter's role is still primarily one of influencing civilian sectors which overlap with defence industry rather than the defence sector per se.

The European Community has been active in promoting research and development, designed to strengthen the scientific and technological basis of European industry, through such programs as ESPRIT (information technology), EURAM (advanced materials), RACE and BRITE (concerned with basic research in advanced communications and industrial technology respectively).

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[9]One who has foreseen this danger and suggested a way to avoid it is Thomas A. Callaghan Jr., a Washington consultant on US-Allied defence co-operation and author of a recent report calling for a two-pillar NATO based on arms co-operation between the United States, Canada and the European Allies. Despite having been commissioned by the Defence Department Callaghan's well-informed and imaginative study does not appear to have been widely read in defence policy circles in Washington. Callaghan, Op. Cit., p. 6.

The same group of countries with some others participate in IEPG programs for improving defence R&D and procurement and in the industrial EUREKA program (which also includes such neutrals as Sweden, Switzerland and Austria). The differences between military and civilian R&D are gradually becoming blurred, e.g. in the application of new composite materials for aircraft or in the development of Very High Speed Integrated Circuits for faster computers. Similarly at the component or material level it is very difficult to differentiate between fundamental research which will have a military application and that which will be of purely civilian significance. This common basis of research allied to the calls by both the European Community and IEPG Ministers for more European co-ordination in R&D (and a growing tendency in the United States to apply "No Foreign" restrictions to the fruits of publicly funded R&D) tends inexorably to draw the EC more directly into defence.

Public procurement is another area where the Commission's proposals for further liberalization under the Single Market, while applicable to civilian sectors hitherto excluded, particularly telecommunications, will reinforce the IEPG program and increasingly affect defence procurement. The proposal is to introduce transparency in tendering applicable to 70% of contracts this year increasing to 100% by 1992. The IEPG initiated similar steps at its November 1988 meeting in Luxembourg, agreeing to exchange information about all forthcoming defence purchases, thus opening the way to cross-border tendering within the group. In this sector, however, the objective is to achieve 80% liberalization in the US $500 billion defence procurement market. Since this liberalization will be within NATO Europe only, procurement will likely remain a major source of protectionism in the years ahead.

Many of the Community's new Directives relate to technical standards which impinge upon defence equipment procurement in a variety of ways from broad design and development methodologies or techniques to detailed standards for particular products. Standards are the subject of a study by a separate Working Group:[10] suffice to say here that at the basic level there is much overlap between defence and civilian industry standards and common national standards are used across both sectors. The existence of separate national standards has provided a major barrier to open procurement and to overcome this the Commission's reform program calls for mutual recognition and equivalence. This will likely have an important impact on intra-European defence procurement as manufacturers may find themselves obliged to consider using components or materials specified to an acceptable standard in another EC country, instead of their customary national source. This will likely apply initially to dual use civil/military items rather than those

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[10]EC 1992 Task Force: Working Group on Standards: Interim Report, February, 1989.

for exclusive defence use but can be expected to spread to defence-specific equipment. It is not clear at this stage whether the IEPG plans to develop all-European standards for defence equipment and if so whether these would be distinct from NATO standards. Such a development would clearly impact seriously on procurement from North America but can hardly be worse than the present network of separate national standards.

Another area of EC involvement in the defence products sector, described by a State Department official as a "neuralgic point" in the relations between the United States and the Community, is a Commission proposal to curtail duty free entry of defence products now granted by certain NATO countries. The tariff treatment of defence products entering the Community is currently quite uneven: certain countries mainly in the south but including Britain have interpreted Article 223 as allowing them to grant exemption from duty to any import intended for security or defence purposes. Others follow a quite different policy - France, Germany and the Netherlands, for example, levy duty on military imports not only from outside the Community but also from one another, on the principle that defence goods are totally excluded from Common Market arrangements. Those countries granting duty-free entry have done so on the basis of a certification from their Defence Ministry that the goods in question are required for defence purposes and some have used the loophole to import such questionable items as automobiles and even alcohol free of duty. Particular problems have arisen with the Commission when such dual use items, bona fide or otherwise, have been released to the civilian economy without reimbursement of duty. The Commission has calculated the total cost of such exemptions claimed as about ECU200 million or about $260 million. This is viewed as a drain (albeit a small one) on the straitened Community budget and a diversion of resources to some member countries at the expense of others. The Commission claims that Article 223 merely exempts defence industry from EC rules such as those governing competition but does not confer exemption from the common tariff. Pending an advisory ruling from the European Court of Justice, which is likely to support the Commission's view, they have made a compromise proposal to apply Article 28, which permits temporary suspension of duties, to cover a short list of equipment such as tanks, helicopters, aircraft munitions and ancillary components and equipment for defence hardware, and parts therefore. Products not on this list would be subject to duty generally in the 3-5% range, but going as high as 14%.

Canada and the United States have objected strongly to the Commission's proposal as likely seriously to impede co-operation between the European and North American wings of the Alliance. The proposed list of core items eligible for duty suspension is a very basic one - indeed it is understood that it was prepared for illustrative purposes by civilian officials unfamiliar with the complexities of modern defence trade. Certainly it would exclude many of the components and sub-assemblies which constitute the bulk of trans-Atlantic sales - particularly Canadian sales to

Europe. Even a 3% tariff would be a burden on national defence budgets in favour of the Community and 14% could be a serious impediment, particularly to NATO Co-operative Programs in such areas as communications and electronics, in many of which Canada is an active participant. While the core list of items proposed for duty suspension would be quite inadequate to safeguard trans-Atlantic defence sales, even a greatly expanded list would constitute a strait jacket seriously inhibiting future trade in high technology items. A comprehensive list could be comparable in magnitude to those of COCOM or the EC Common Customs Tariff and any changes would likely require complex and time-consuming negotiation.

Canada and the United States have both urged retention of essentially the present system whereby duty free entry is granted automatically on certification that goods are required for defence purposes. As a result of many high level and urgent representations the Europeans are seized of the importance of the issue to the two North American allies and the need to find an acceptable compromise if serious divisions are to be avoided. Despite its obvious drawbacks, the Europeans are still attracted by the idea of some sort of list but the issue is unlikely to be resolved before mid 1989 at the earliest and probably not before the end of the year. From being a rather technical and legalistic issue with protectionist overtones on which defence ministries often have markedly different views from the trade and finance ministries of the same government, it has caused divisions between European governments and between Europe and North America.

Part III
Canada's Defence Industry

Most of the Canadian defence industrial sector consists of firms manufacturing both civil and military products, thus permitting maximum cross-over benefits from R&D and an ability to exploit niche opportunities in the US and European defence markets. This characteristic also means that they are less vulnerable than they otherwise might be to protectionist trends in the procurement practice of the foreign governments concerned. From considerations largely to do with rapidly escalating costs, Canada has since about 1960 adopted a policy whereby most major defence systems are procured from offshore sources, in preference to domestic source development. As a result, Canadian defence industrial activities have proceeded, in the main, by:

- assembly and systems integration on particular domestic projects, e.g. ADATS (Oerlikon) and CPF (PARAMAX);

- the supply of sub-systems, components and sub-contract manufacturing to US primes (and

to a lesser extent direct to the US Department of Defense) through the access provided by the Defence Development and Defence Production Sharing Arrangements (DD/DPSA);

- the provision of repair and overhaul services to DND for Canadian Forces equipment.

- The establishment of technological niches where world-class capabilities are recognized, e.g. gas turbine engines, avionics, naval helicopter handling systems, flight simulators and military vehicles. However, Canadian firms have made individual sales, small but strategically important, of sub-systems to European primes and governments, particularly in Britain.

Taken together this makes for a sector with firms engaged in widely different areas of activity and reflecting diverse customer characteristics. To the extent that general observations can be made, these would include a pronounced degree of specialization, very little vertical integration and a significant and on occasion predominant proportion of civil business. Canada has contributed about $1 billion to NATO infrastructure programs but our return on this contribution over the years has totalled about $100 million or roughly 10%. Industry has not had great success in bidding for contracts under these programs.

Although defence production occurs in a number of different industries, the principal ones are aerospace, electronics, marine, vehicles and munitions. An outline of these is as follows:

Aircraft, Engines, Missiles and Avionics

This industry is highly export oriented and pursues a strategy of product specialization and niche market applications.

In the complete aircraft field, its product range includes corporate jets, regional airline turboprops, utility aircraft, helicopters and unmanned aerial vehicles.

Its small gas turbine line commands a substantial portion of the world market. Other firms in the engine sector undertake a wide range of repair and overhaul and component development and manufacture.

The avionics element features internationally competitive navigation and radar systems, electronic display, control and monitoring systems.

World class positions have also become established in the flight simulator, air traffic control, battlefield reconnaissance drone systems and other fields.

Defence Electronics

Here the capability includes component and sub-systems development, integration of complete electronic systems and sub-systems, for land and marine applications, tactical fire control, signal processing, electronic warfare and military communications systems. There is also some prime contracting capability. This industry is strongly export oriented and closely integrated with foreign primes, particularly in the U.S. NATO markets are also served.

Again the theme is strongly one of specialization and many of the firms are also present in the preceding sector.

Marine Industries

There is considerable diversity in this sector with shipyards engaged principally in meeting Canadian government procurement requirements, while component specialists serve much wider markets.

In contrast to the general policy governing major systems defence procurement in Canada, this sector does provide instances of prime contractual responsibility. The Frigate Program and the TRUMP refit are current examples.

Land Systems

This sector features heavy truck, all-terrain vehicles and armoured vehicles production. Activities are largely in the form of assembly with comparatively little vital or major component production. In its present form, the sector is not expected to be a player in the European defence market with the exception of specialized sub-systems responding to niche market opportunities.

Munitions

The sector is defined here as one involved in the production of small arms and ammunition. Its existence is maintained for national security considerations. Certain specialized product lines in the field of propellants and pyrotechnics are successfully exported, principally to the United States. Potential access to Europe would presumably be governed by considerations of reciprocity and it is not likely that these would be acceptable to the munitions sector as a whole. In terms of a significant and consistent export record, the Aerospace and Defence Electronics group is dominant and

its statistical data is the more comprehensive and timely. The following analysis applies to this element of the defence sector which is considered to be of principal relevance to the issues associated with Europe 1992. Incomplete 1988 trade figures[11] for this aerospace-electronics sectoral composite are as follows:

	Canadian $ billions	Percentage
Total Sales	6.28	100
Domestic Sales	1.88	30
Sales to the US	3.08	49
Sales to the rest of the World	1.32	21

31.7% of overall sales is defence related, a somewhat higher proportion than usual.

The preponderance of civil sales has been constant for some years and is not expected to change, according to the five-year outlook provided by the industry itself. It follows therefore that the greater part of our defence trade takes place in the reasonably distortion free environment governed by the GATT Agreement on Trade in Civil Aircraft and the OECD Aircraft Agreement on export credits. It is assumed that the Single Market regime emerging after 1992 will be in compliance with the Community's obligations under the GATT and will therefore not involve additional barriers facing most of the firms in this sector.

Unlike the defence industries of most other countries, Canada's reflects a high incidence of foreign ownership. Over half (54%) of firms have US parents while a further ten percent are under European, principally British, ownership. This makes for international trading which reflects territorial and on occasion world product mandates as defined by corporate headquarters.

Trading linkages with Europe have been largely in Canada's favour. They have taken the form of co-operative programs and procurements - e.g. the CL 89/289 reconnaissance drone consortia; stand alone transactions such as the Challenger sale to the German Federal Republic and CAE flight simulators for the Tornado and Alpha Jet programs. More enduring linkages are provided by Pratt and Whitney Canada - engines to British Aerospace, Shorts and Aerospatiale; and

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[11]Business Forecast Enquiry, Survey 88, Statistical Report Department of Regional Industrial Expansion, 1988. It should be noted that two major companies, Oerlikon (Canada) and PARAMAX, failed to reply to this enquiry which was directed to AIAC member companies and therefore also excluded GM and others.

engine components by Rolls Royce Canada to its UK parent. It must be stressed, however, that in this latter instance the business is civil.

Defence trade with individual European countries (both in NATO and with neutrals such as Sweden and Switzerland) is handled under Research, Development and Production (RDP) Agreements. These can serve a useful function in promoting both inter-governmental and industry to industry contacts with EC countries and in laying the ground for joint ventures and other forms of inter company co-operation, though it is important that meetings be adequately prepared and staffed.

Effect of Change in Europe

The implications of the Single European Market for Canadian industry as a whole are still far from clear and those for our defence industry are likely to be less direct and therefore more difficult to determine with any precision. It is clear that Western Europe has a defence industry which in terms of capacity is more than adequate to meet the perceived needs of European NATO countries and the trans-border rationalization will make the existence of excess capacity more evident. This can only grow if despite the reservations of certain of the major defence equipment manufacturing countries a significant effort is made to locate some new defence industry in the LDDI countries of the south. Furthermore, the emphasis now being placed by the EC Commission on R&D reinforced by the efforts of the IEPG in R&D and defence procurement is clearly aimed at ensuring that this capacity is matched by a first class capability. The intention appears to be both to reduce dependence on North America for sophisticated defence equipment and to increase Europe's share of defence sales to third countries. Everything suggest that the substantial surplus currently earned by the United States in defence trade with Europe will be under increasing pressure in the years ahead, particularly if the conciliatory signals coming from the Soviet Union and its allies lead to some mutual reduction of forces in Europe.

United States defence industry is already facing some problems from the planned levelling off or even reduction in US defence budgets, and is looking to European and other overseas sales to fill the gap. As far as Europe is concerned it is unlikely that these efforts will be successful and indeed in third country markets the US will face an increase in the already strong competition from Europe (particularly France and Britain), as well as the Soviet Union and in some markets China. The United States is Canada's largest market for defence products but the ready access provided by the DPSA has eroded in recent years under increasing protectionist pressures. Countering these pressures has been and is a high priority for Canada but the task will not become easier as US defence industry faces increasing difficulties at home. US defence firms most likely to continue to prosper in Europe are those with close corporate links (subsidiaries, joint ventures

or other forms of partnership) with major European firms but as prime contractors they will find increasing inducements to purchase sub-systems in Europe to the extent that they are available, rather than in Canada. This need not be catastrophic for Canada, given the fact that already our sales are virtually limited to filling particular niches where we have a unique capability. It indicates clearly, however, that Canadian companies must continue to maintain and enhance whatever technological advantage they have to maintain their sub-share of European defence purchases and their own direct sales to European prime contractors.

The leading Western European markets for Canadian defence equipment are the Federal Republic of Germany, Britain and the Netherlands (in that order) and it is not coincidental that the these countries account for the bulk of corporate links - either through ownership of subsidiaries, partnership consortia or joint ventures - between European and Canadian firms. For historical and cultural reasons the largest number of such arrangements are with Britain as the following break-down shows, but Germany and the Netherlands also reveal important ties.

United Kingdom

a) UK defence companies with Canadian ownership:

Comdev (UK)	Comdev Ltd	
MDA (UK)	MDA	
Caltronics	Canadian Astronautics Ltd	
STC	Northern Telecom	(also has subsidiaries in France, Germany, Switzerland, Turkey, and and Ireland)

b) Canadian companies with British ownership:

Leigh Instruments	Plessey Plc
Micronav Ltd	Plessey Plc (via Leigh Instruments)
Canadian Marconi	General Electric Co. Plc
Dowty (Canada)	Dowty Plc
Orenda Engines	Hawker Siddeley Plc
Rolls Royce (Canada)	Rolls Royce Plc
Racal Filter Technologies Ltd.	Racal Plc
Field Aviation	Hunting Group Plc
EHI (Canada)	EHI Plc

Indal Ltd.	Rio Tinto Zinc Plc
Bristol Aerospace Ltd	Rolls Royce Plc

Federal Republic of Germany

a) FRG companies with Canadian ownership:

CAE Electronics GmbH	CAE Electronics Ltd
Challenger Aviation Service GmbH	Canadair Ltd
Garrett GmbH	Garrett Manufacturing Ltd

b) Canadian companies owned by German Interests:

Diehl Canada Ltd	Diehl GmbH
Ernst Leitz Canada Ltd	Ernst Leitz GmbH
MBB Helicopter Canada Ltd.	Messerschmidt - Boelkow-Blohm GmbH
Bear Head Industries Ltd	Thyssen AG

Netherlands

a) Dutch defence companies with Canadian ownership NIL

b) Canadian companies with Netherlands ownership:

MEL (Canada)	Philips (through Philips Canada)
Stork Werkspoor Canada Ltd.	Stork Werkspoor Bronswerk Div.
PROMAC Controls Inc	Van Rietschoten and Houwens

There are in addition joint venture and licensing arrangements too numerous to list here with companies in these and other countries of NATO Europe. Since an increasing proportion of trade in manufactures tends to move between parent and subsidiary or between joint venture partners there is little doubt that to the extent they already exist these links will be helpful in maintaining ongoing defence trade ties. EC spokesmen have consistently maintained that foreign owned companies now domiciled in any country of the Community will be regarded as European under post 1992 arrangements, subject to a degree of reciprocity as yet undefined. It seems highly unlikely that the issue of reciprocity will significantly inhibit defence trade based on corporate

partnerships, provided Canadian companies through the development and use of technology can continue to fill niches in European procurement needs.

Canadian companies have been urged from many quarters to establish corporate links with Europe, where they do not already exist, so as to confront the Single Market after 1992 from a position inside the Community. There is no doubt, as most of the larger Canadian companies in the defence sector have already discovered, that acquisitions, joint ventures and the like are a valuable assist to doing business in Europe and elsewhere and are part of the current globalization of world business. As such they are to be encouraged though only when justified on their own merits. There seems no reason to recommend that companies invest in Europe or establish other forms of corporate linkage merely for the purpose of positioning themselves inside the Single Market, when there is no substantive reason for doing so. On the other hand, where there is a sound bases for such action companies should consider moving quickly to link up with potential partners since a great deal of industry consolidation is expected to be in place by the end of 1990.

Part IV

Conclusions and Recommendations

1. Although the EC Single Market changes are addressed to civil industry their effects will impact in varying degrees on the defence sector. It is therefore important that a watching brief be maintained and directives analyzed for their effect, however indirect, on defence industry.

2. Canadian posts in Europe should be tasked to monitor and report on corporate concentration and linkages within each country, within the Community and with firms in North America. Posts should also report on major defence contracts and changes in patterns of defence trade in their territory.

3. The advantages of a soundly-based and substantive corporate presence in one or more EC countries for facilitating market access to the Community are evident from this study.

4. LDDI countries are becoming an important part of the NATO-European equation. In some instances there may be a case for considering joint ventures or other links with firms in these countries.

5. It would be advisable for Canadian companies to conserve and strengthen their links with US industry and to employ every means possible to increase access to the US defence market. The threat of growing US protectionism in the defence sector makes it important, however, that they also make every effort to maintain and enhance their small foothold in the European procurement market as a prudent alternative.

6. Close liaison should be maintained with the US in the interests of monitoring developments in Europe and making representations should this prove necessary.

7. Research, Development and Production (RDP) Agreements with European allies are a useful mechanism for developing bilateral cooperation and advancing defence marketing interests on behalf of Canadian industry. Although the RDP mechanisms and priorities are under review, the operation of the agreements should be sustained as part of Canada's bilateral relations with European NATO partners.

8. The EC Commission's proposal for curtailing duty free entry for certain defence products and sub-systems poses a threat to Canadian sales and to NATO co-operative programs. The situation should be watched closely with a view to making an appropriate response if necessary.

9. Given the niche nature of our defence trade with Europe, Canadian companies can view the approach of the Single Market with qualified optimism, assuming the present degree of duty free access is maintained. We are a specialized supplier of defence sub-systems to NATO Europe through US prime contractors and on occasion direct to European primes and provided we maintain our technological lead in specialized areas we should be able to continue to fill this role.

10. Industry associations such as the Canadian NATO Industrial Advisory Group and the Aerospace Industries Association of Canada should consider the use of channels available to them for sensitizing European industry to the possible long-term trade impact of measures arising from the 1992 program.

ANNEX I

COMMENTS FROM THE CANADIAN NIAG GROUP

REGARDING EC EUROPE '92 PROPOSALS

The questions posed to the Canadian NIAG Groups by Ted Gibson at the 12th January meeting with the Working Group on Defence Products of the Interdepartmental Task Force on Europe 1992, can be summed as:

(A) what did C/NIAG think and know about Europe '92 and

(B) what does C/NIAG want from and plan to do about Europe "92.

These are best answered by reviewing the three main issues of concern among the members of the Canadian NIAG Group recognizing how European Community (EC) move to Europe '92 will impact on Canadian industry. These are:

1. The EC proposal to limit defence tariff exemptions allowed member states, to be replaced by a uniform Community suspension of tariffs on a more limited range of goods;

2. The improvements in the competitive strength which European industry will possess as the result of Europe '92; and

3. Although not literally part of Europe '92, the implications of the activities of the Independent European Program Group (IEPG).

Comments and suggestions on (B) above are contained in this paper. On (A) above, there currently is a fair understanding albeit with a bit of confusion, within the C/NIAG Group. In most cases, however, industry in general has not grasped the full implication of Europe '92. Industrial associations in Canada are attempting to improve this situation. Specifically, the Canadian Exporters' Association (1) has sponsored a series of seminars where Donald McDonald, the High Commissioner in London, is stressing the importance of action now by Canadian industry in establishing relationships in Europe rather than waiting for 1992, and using the phrase "Partner Europe" rather than the more common "Fortress Europe", and (2) has had correspondence with Canada's Ambassador to the EC regarding import duties on certain weapons and military equipment. In addition, the theme of the Aerospace Industries Association of Canada's Semi-Annual Meeting in Ottawa in April was "Europe-Post 1992."

TARIFF ON DEFENCE-RELATED EQUIPMENT

The EC proposal undermines NATO cooperative armaments projects and discourages North American participation and invites Canadian and United States retaliation.

On the problem of a tariff on defence-related equipment, it has been suggested that in the event that the EC imposed a tariff on defence and defence-related equipment, Canada, in conjunction with the US, must prepare a list of those items which should be exempt from the tariff. This list would be lengthy, difficult to prepare, quickly outdated, and subject to bureaucratic misinterpretation. Many items will be components used not only for defence equipments, but also for non-defence equipment. It would be prudent to begin work on such an "exempt" list as soon as possible if that approach is selected. An alternate, more manageable approach might be to prepare a shorter list of those items which would be subject to tariff. Because of the possibility of bureaucratic misinterpretation, it is considered that an exempt list, long or short, is the least acceptable option.

In his reply to the letter from CEA, Ambassador Molgat makes an observation regarding the longer form of a list where he says, "the solution might be to enlarge the scope of the proposed regulations so that is does, indeed, include products of interest to Canada and the United States. Our early impression is that the Commission may not be adverse to doing so."

Another problem which requires a strong Canadian Government position relates to the use of common infrastructure funds on equipment. The use of common infrastructure funds to pay the Common European Tariff (CET) on equipment purchased under the NATO infrastructure Program could be invoked. Two of many examples could be:

(A) if US or Canada wins an infrastructure contract, will the EC charge CET when the finished product is imported into a NATO EC nation?

(B) if a NATO EC nation wins an infrastructure contract, and this country uses North American components in the equipment, will the EC charge CET on these components?

In either example, if the answer is yes the common infrastructure funds will be used for paying custom duties. This was never the intention for the use of these contribution funds. It is the C/NIAG opinion that this is a completely unacceptable use of Canadian contributions to NATO infrastructure, i.e. Canadian taxpayers dollars. Since nations are unlikely to increase their annual contributions to the infrastructure program, the result will be less funds available for commonly-used equipment/facilities.

The US, who contribute 28% of the infrastructure budget, would also be paying 28% of any imposed CET on infrastructure equipment. It is a situation completely unacceptable and unfair. If it were to happen, there could be some retaliation.

Even for NATO cooperative armaments projects, there is no reason to believe that the EC would give blanket CET exemptions. This could mean that throughout the R&D phases, each time a North American component is imported by an EC partner in a collaborative project, the item would be subject to duty. Further, one could expect that production items for a European assembly line imported from Canadian or US partners would also be subject to duty. Obviously, to maintain a balanced arrangement for the project, countervailing tariffs might have to be levied on EC nation items imported into North America for the same purposes. The overall result will be higher priced end-items for defence.

Should the EC Commission proposal become a reality, it could make NATO EC nation suppliers more competitive with EC boundaries and would tend to discourage collaboration with North American partners.

Together, the United States and Canada could threaten to impose tariffs on European defence-related products purchased for North American needs. Canada could also use its future Major Capital Projects as a lever in arguing against the implementation of CET by showing how countervailing Canadian duties, when added to European proposals, would reduce their competitiveness against competition from the United States.

EUROPEAN COMPETITIVENESS

There are already major changes taking place in Europe related to Europe '92, which the Canadian industry must consider. Mergers and takeovers are occurring as EC companies begin to position themselves to take advantage of all industrial competitive opportunities by being a bigger company. Canadian companies may wish to look at such corporate strategies in the light of a stronger EC.

It has been reported in "Defence News" by their Italian correspondent, that there is an awareness in Italy, and one can assume elsewhere in Europe, that only firms with strong technological and commercial capabilities are expected to survive the competition unleashed by the crumbling of trade barriers. This unified market will be characterized by increased corporate cooperation, teaming and mergers across national borders.

The Chairman of the Italian equivalent of the Canadian Manufacturers Association said that "an integrated Europe can't be made without the defence sector, and I think that it will be a good chance for streamlining the different national manufacturing capabilities." That association anticipates fewer resultant Italian firms. They state, "the actual groups of defence manufacturers will be thinned out, with the loss of the less competitive and technologically capable firms. But only a general plan can tell where these people must go," and further, "times have come that one must think in terms of survival. So the industries are forced to diversify their production toward civil items. The Italian government should step in and draft an industrial plan to help steer industries away from commercial markets already saturated."

Besides mergers and takeovers, there are more and more instances where a consortium is a natural beneficiary of the EC changes because it can pool resources across European borders and can take advantage of economies of scale (ergo we must be more competitive) as the cost of weapons/equipment rises.

Since a stronger, more unified European defence industry will be in a better position to compete with the stronger US industry, it makes sense for Canadian companies to team with US companies to create an even stronger North American Defence Industry Base. The US/Canada Free Trade Agreement may be the vehicle to pique US company interest in this area.

Under the FTA, the whole area of subsidies must be carefully considered over the next few years. While on the one hand a reduction of subsidies could come about as Canada and the US implement the Free Trade Agreement, EC subsidization of their industries could have an adverse effect on our ability to compete.

Some major American companies are not as concerned as Canadian firms with Europe '92, and this is probably because of their role as prime contractor for major systems. Stanley Pace, Chairman and CEO of General Dynamics, in reply to a question on the impact of Europe '92 on the US aerospace and defence business said:

> "I think it will have a larger impact on the US commercial business because there's a lot of trade back and forth that is won or lost in the marketplace. There are competent people in Europe to do industrial manufacturing and solid marketing, and so I think that how it evolves could have a significant impact on US industry. With aerospace we've studies it, the defence part of aerospace -- and that is so controlled by the government today except for the odd occasion -- we don't sell any defence aircraft overseas except as our government allows us to do and as government-to-government negotiations are completed. So, to a certain extent, that is a bilateral government controlled market. If we have a fighter or a missile or a weapon system that the Europeans want, today it takes a government-to-government agreement and after 1992, it will still take a government-to-government agreement."

INDEPENDENT EUROPEAN PROGRAM GROUP

The actions of the Independent European Program Group (IEPG) to establish in effect a "Fortress Europe" for defence programs have been considered as part of a review of Europe '92. It should be remembered of course that the IEPG and the EC are not synonymous. Both groups include the same major partners, but Norway and Turkey, which are part of the IEPG with the 11 other European NATO members, are not part of the EC. Further, Ireland is not in the IEPG or NATO, but is in the EC, and Iceland is in NATO but is in neither IEPG nor the EC.

The IEPG is a forum for promoting greater cooperation in armaments development among member nations. The Chairmanship of the IEPG passed from Spain to the UK on 1 Jan. 1989 for a two year term.

OTHER MULTILATERAL EUROPEAN GROUPS

There are other multilateral groups within Europe which should be included in any discussion regarding the EC's Europe '92 plans and whose direction and intentions may be relevant. Such a list would include the Eurogroup, the Western European Union and the European Free Trade Association. These various groupings within Europe do not have common membership and it is difficult to see how their objectives and policies can be implemented in concert with the broader EC Europe '92 directives.

The Eurogroup is an informal group which was formed, before the IEPG with the objective of strengthening European cooperation within the Alliance. Its membership is Belgium, Denmark, Germany, Greece, Italy Luxembourg, Netherlands, Norway, Portugal, Spain, Turkey, and UK. France is not a member.

Similarly, the Western European Union, (WEU) works closely with NATO on European security issues, although the member countries include France which is outside the NATO

The European Free Trade Association (EFTA), which consists of Austria, Iceland, Norway, Finland, Sweden and Switzerland, has three objectives: to achieve free trade in industrial products between member countries; to assist in the creation of a single market embracing the countries of Western Europe; and to contribute to the expansion of world trade in general.

In recent years there has been increased activity by all NATO nations in seeking to participate in NATO Cooperative Armaments Programs. This initiative was necessary to share the costs, risks and technology of the armaments necessary to meet the Soviet threat. Canada, both government and industry, has participated in several of these cooperative armaments programs. There will be more opportunities in the future. The Canadian government should assist Canadian industry to take a more active role in participating in NATO Cooperative Projects.

CONCLUSIONS

On the initial questions on what does NIAG want from Europe '92, and what does NIAG plan to do about Europe '92, there are a number of possible answers offered by members of the Canadian NIAG group more for discussion than as firm position statements. These include:

1. The formation of consortia will be more frequent and essential in the defence and defence-related sector in the future. Canadian companies should continuously be on the lookout for opportunities for such teaming arrangements and their industrial strategy should be reviewed to reflect the dynamics of such early consortia participation.

2. Research and development will be essential in not only keeping abreast of technology advances, but the goal should be to move well ahead of the competition. Industry must work increased R&D into their own industry strategies while keeping up the pressure for an adequate, tangible response from Government in the R&D field.

3. Canadian companies might look at their corporate business plans to ensure they fit the future. The period of return-on-investment might have to be lengthened to compete in the new EC 1992 market.

4. Companies must increase the quality and reliability of their products as they strive for excellence. At the same time, such products must meet the minimum requirement at a competitive cost. In addition, productivity must be improved to lower costs and therefore to become more competitive.

5. Companies could have closer or different arrangements with their parent companies to allow the Canadian component access to the European market. This is particularly important if the parent is an EC company.

6. The liberalization of the rules governing the transfer of technology would improve conditions for companies to do business with one another. Obviously the necessary safeguards must be respected and such transfers must be on a quid pro quo basis.

7. Every means must be reviewed and if applicable, implemented to breach Fortress Europe. The RDP agreements which Canada has with eight IEPG/EC nations would appear to provide such opportunities.

8. Another possibility might be consideration of US Secretary of Defense's "Two Pillar Research and Defence Base" initiatives, where the US/Canada and the EC would divide their military needs into areas of specialization. Equipment for some areas would be developed in Europe, and some in the USA/Canada. Manufacture would be similarly split, but always with second sourcing in the continent which did not do the original development.

9. As an alternative, the competition would not follow the past pattern of pitting North American and European firms against one another, a procedure that never produces agreement. Instead, it would take place among several consortia, each including both North American and European firms like the ACCSCO and AMS consortia in place for the NATO Air Command and Control System (ACCS). The North American government and their European allies would thus be offered the choice not between national tank models, but between alternative tanks, each of which had substantial North American and European content.

10. The Canadian Government should assist Canadian industry to take a more active role in participating in NATO Cooperative Programs.

CANADIAN NATO INDUSTRIAL ADVISORY GROUP MEMBERSHIP

Mr. W.C. Tate (Head of Delegation)
Chairman
Allied SIgnal Aerospace Canada
255 Attwell Drive
Rexdale, Ontario M9W 6L7

Mr. G.R. Rutledge (Deputy Head of Delegation)
President & Chief Executive Officer
Indal Technologies Inc.
3570 Hawkestone Road
Mississauga, Ontario L5C 2V8

Mr. Keith Burrows
Vice President
Marketing and Contracts
Bristol Aerospace Limited
P.O. Box 874
Winnipeg, Manitoba R3C 2S4

Mr. George A. Franklin
Senior Vice President
MICROTEL Limited
155 QUeen Street, Suite 1106
Ottawa, Ontario K1P 6L1

Mr. R. Leboeuf
Vice President
Belgian Offsets
Bombardier Inc.
800 Blvd. Rene Levesque West
29th Floor
Montreal, Quebec H3B 1Y8

Mr. Lionel Leveille
Executive Vice President
Oerlikon Aerospace
225 Seminaire Blvd South
Saint Jean Richelieu P.Q J3B 8E9

Mr. J.D. MacNaughton
Executive Vice President
Spar Aerospace Limited
5090 Explorer Drive
Suite 900
Mississauga, Ontario L4W 4X6

Mr. Stephen J. May
Vice President
Business Development
and Corporate Planning
The MIL Group
1010 Sherbrooke St. West, Suite 910
Montreal, P.Q. H3A 2R7

Mr. T.J. McGuigan
President
Litton Systems Canada Ltd.
25 City View Drive
Etobicoke, Ontario M9W 5A7

Mr. D.R. Tait
Vice President
Technical Development & Sales
CAE Electronics Ltd.
C.P. 1800
Saint-Laurent, Quebec H4L 4X4

Mr. G.M. Mount (Honorary Chairman)
Senior Vice President
Computing Devices Company
P.O. Box 8508
Ottawa, Ontario K1G 3M9

Mr. M.J. Montague (Executive Secretary)
Director Armaments Cooperation
National Defence Headquarters
Major-General George R. Pearkes Building
101 Colonel By Drive
Ottawa, Ontario K1A 0K2

Mr. R.E. Marcille (Rapporteur)
Vice President
Business Development
Indal Technologies
3570 Hawkestone Road
Mississauga, Ontario L5C 2V8

Annex II

TASK FORCE ON EUROPE 1992

WORKING GROUP ON DEFENCE PRODUCTS

Chairman

J.E.G. Gibson
Director General
Defence Programs and
Advanced Technology Bureau (TDD)
Department of External Affairs

Executive Coordinator

J.M. Harrington
Defence Programs and
Advanced Technology Bureau (TDD)
Department of External Affairs

Members

J.F. Gridley
A/Director General - International Programs
Department of National Defence

G.M. Kerr
A/Director
Defence Industries and Emergency Planning Branch
Department of Supply and Services

R.G. Sandor
Director, Defence Programs Division (TDP)
Department of External Affairs

T.M. Williams
Director General - Supply Policy & Defence Industry
Department of National Defence

T.J. Wright
Director - Planning and Analysis
Department of Industry, Science and Technology

A.R. Harley
Special Projects Officer
Canadian Commercial Corporation