

V4 COUNTRIES AND COOPERATION IN DEFENCE INDUSTRY

AUTHOR: KAREL ZETOCHA

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Introduction

The cooperation of the former post-communist Central European countries, grouped in the Visegrad Four (V4) was a success in many respects. Especially, the established common free trade area (CEFTA) helped the emerging economies through a difficult period of transformation and has become a milestone on their path to higher levels of cooperation within the EU. While in the private sector markets have been opening and the volume of mutual trade increasing, the strengthening of similar ties in the defense industry has not occurred. Since the end of the Cold War, V4 countries failed to establish more active cooperation within the defense industry. Despite many proclamations and promising opportunities in the realm of defense, up to date, there was no execution of any substantial new project and possible cooperation among the Visegrad 4 and any cooperation is reserved only to the level of bilateral relations between subcontracting companies. The following paper briefly summarizes the main points of the transformation of the defense industry of V4 countries in the European context. It will also identify factors that have positively or negatively affected the defense industry cooperation

possibilities within V4 (with the emphasis on the Czech Republic and Slovakia). Concluding remarks assess the opportunities for the defense industry of V4 in the future.

End of the 20-th Century: Military Spending Trends

Political and military détente reached after the end of the Cold War in Europe meant an end to an era for the big defense industry business. Defense industry companies had to deal with a number of adverse trends following the disintegration of the Soviet bloc, some of global nature, others resulting from the situation specific to the Central European region. The drawdown of military tensions in Europe brought with it a reduction in military spending, with a profound effect on the defense industry companies on both sides of the former Cold War divide. With the gradual warming of relations in Europe, the sizable armament stockpiles maintained in Europe, became redundant. Suddenly, a large amount of unused and relatively modern technology was on offer for a fraction of the original price, appeared on the market. At the same time, the end of the 20-th century brought rapid technological development especially in the materials and information technology, which was not primarily based on military research. The defense industry had to respond to this technological development and integrate a number of technological innovations from the civilian sector into its own production. The development of new generations of weapon systems was becoming increasingly costly and involved, which of course had to be reflected in the increase in prices of final products. Together with the downward trend in defense spending, the above described conditions resulted in the decrease in the overall number of new equipment purchased. Customers and manufacturers in the arms market found themselves in a downward spiral; the manufacturers had to transfer the rising costs of research in the price of goods, while on the contrary, the customers with a shrinking budget were constrained to order fewer goods. Smaller production runs mean a further increase in prices for single items, perpetuating the negative trends. This situation required a response from all players on the world market and a number of them literally had to fight for survival. As will be shown, responses to critical situations were varied and depended on the specific situation in a particular region or industry.¹

Transformation of NATO Defense Industry

¹ For more on trends in the defense industry, see also Burkard Schmitt, 2000, pp. 5-10.

From a global perspective, the most important changes occurred in the structure of defense industries in the U.S where the Pentagon had to address problems similar to other major players of the world arms market. The overall decrease in spending brought with it a decline in defense industry orders, which necessarily meant a reduction in the existing players dependent on government procurement could survive. The situation that had arisen did not have simple solutions, since the functioning of defense industry companies was interlinked with strong political interests in key member countries of the Alliance. The reaction was the Pentagon's transformation strategy based on three pillars. The first was the introduction of dual-use technologies, when the production of arms had to utilize existing technologies from the civilian sector to the maximum extent possible. The second measure was to revamp the policy of mergers, envisaging the reduction of the number of major contractors in the defense industry, followed with the liberalization of export policy, which was to generate savings through increased production runs.²

Western Europe addressed the arisen situation in similar ways, only getting the measures under way proved more difficult: while in the U.S. it was possible to set up a unified strategy, the reality of the newly created European Union was vastly different. Individual member states were defending the interests of their 'national champions' which hindered arriving at a unified transformation strategy. Needless to say, the same struggles were faced also by the defense industry whereby European producers were forced to look for savings, thus integration of civilian production components was a logical solution. Defense companies diverted more of their production facilities to civilian activities, enabling them to stay afloat in spite of the decline in government contracts in the defense sector. After industrial mergers on the opposite side of the Atlantic, it was also clear in Europe that without further transformation the European industry would not be competitive in the long term. In the aviation sector, the major part of the original military capabilities found application in the European private aircraft producer Airbus.³ Although there was a clear intent to implement necessary measures by the industry and the national governments, it took several years since the mid-nineties, before difficult negotiations could be concluded and each party arrived at satisfactory results in terms of maximizing profit and protecting national interests. The Franco-German agreement signed the summer of 1999

² Markusen, Ann, 2000, pp. 24-35. Should We Welcome a Transnational Defense Industry?

³ Schmitt, Burkard, 2000, pp. 15-23.

opened the way for the establishment of EADS, the European multinational syndicate in October of that year and subsequent fusions formed a trimmed-down European defense industry, with two key players - EADS and BAE Systems.⁴

The Defense Industry and V4 Countries

With the end of the Cold War, V4 countries and their defense industry were facing a completely changed strategic position with several strategic factors influencing the way of conversion of defense industries.

While in the U.S and Western Europe we saw a significant, yet gradual reduction in defense spending (in tens of percent), the former Eastern bloc states were forced to limit their defense spending in a far more radical way. Economic collapse forced the Soviet Union / Russia to carry out military spending cuts between 1985 and 1996 more than seven times.⁵

Owing to the central control (which managed to suppress the national interests of members in favor of the whole), the Warsaw Pact armies managed to reach a higher degree of unification of equipment than their NATO counterparts. Moreover, almost the whole of the defence industry of the Warsaw Pact was concentrated in the Soviet Union, where, with a few exceptions, the vast majority of high level research and development capacities were based.⁶ Soviet satellites had only limited own development capacities and the technologies produced by them under license agreements were derived from the models developed in the Soviet Union. Thus, the role of the defence industry of Soviet satellites was limited to a service activity conducted by national armies.

After the disintegration of the Warsaw pact, the defense industry in V4 countries had not only to face the adverse defense industry trends , but also the transformation of the entire economic and political system. Restructuring of the arms production in Central Europe thus presented a much more complicated process given that the arms production was tied with the socialist economy, which knew no private property. While the western national governments retained their significant share in the defense industry, similar to the Central European model, at the level of the subcontracting chain a strong contact with the real market environment was firmly in place.

⁴ Schmitt, Burkard, 2000, pp. 29-39.

⁵ Markusen, Ann 2000, p. 27

⁶ There were major projects such as L 29 and 39 training aircraft in Czechoslovakia, or TS 11 Iskra in Poland, or the Scot armored personnel carrier joint project.

There were also differences in the approach of the political representation in that a successful conversion of the defense industry in the U.S. and the EU was a stated priority. For their Eastern Bloc counterparts, the priority was naturally managing the political and economic transformation, with the defense industry a marginal issue. In addition, members of the new democratic governments saw the venture of weapons manufacturing as something connected with militarism associated with communist regimes, and therefore refused to endorse state support for arms export.⁷ Yet another contributing adverse factor for the Eastern Bloc's defense industry was the course of the first war in the Persian Gulf, where the Iraqi army a major customer of the Soviet Union and its allies. The sweeping victory and minimum losses of the coalition were widely interpreted as evidence of Western domination in the arms production, which further complicated the situation of the former Warsaw Pact countries as producers of arms for the world market.⁸

Transformation and V4

Individual V4 countries chose a different approach to converting the non-profiting industry. A special case was the transformation of the defense industry in the Czech and Slovak Republics, which had to cope with the impact of the division of Czechoslovakia. At the end of the 80's, Czechoslovakia was among the world's leading arms exporters with most of exports going to the partners in the Warsaw Pact (about 50-60%) and 10-20% going to less demanding markets of developing countries.⁹ With the disintegration of the bipolar world order, the Czechoslovak defense industry lost up to 80% of foreign customers within the course of one year.¹⁰

It is important to note that the distribution of the defense industry in Czechoslovakia matched the strategic objectives of the Warsaw Pact. After the establishment of the Iron Curtain, the traditional regions of the arms production in the Czech Republic became a potential war zone. Arms manufacturing, especially engineering companies, were systematically moved to Slovakia.

⁷ See e.g. Szulc 2005, p. 12. In former Czechoslovakia, the idealism of President Vaclav Havel became, somewhat unjustly, the symbol of decline of the defense industry. Given the above objectively existing negative trends, a different approach of the political leadership could not do much to combat the breakdown of the defense industry capabilities in the V4 countries.

⁸ The defeat of the Iraqi army can be interpreted on the basis of deficiencies in training and command, without which the specific parameters of the equipment lost in importance, see Biddle, Stephen 2002.

⁹ Ivánek, Ladislav 2002, p. 133.

¹⁰ Furthermore, figures of the volume of exports are not comparable to the export in the market environment. Trade with countries of the Warsaw Pact took place in the form of exchange and was mostly paid for with deliveries of military equipment. Exports to third countries was not based only on economic principles, but followed also the ideological point of view and foreign policy interests of the communist bloc. Weaponry was often exported with the use of loans, which have become bad debts in subsequent years.

Thus, by 1990 about 60% of the Czechoslovak military production was based in the Slovak Republic with focus on heavy military equipment (tanks, armored fighting vehicles and artillery systems). Manufactures of small arms, ammunition, communications and aviation technology typically remained in the Czech Republic.¹¹

In 1990, Czechoslovakia launched a radical program of conversion of military production with a target of decrease defense industry output by 85-89% compared to 1987 figures, with the brunt of the the impact of conversion resting with the Slovak part of the federation. The decrease in arms production was accompanied by the conversion program for military projects. The federal government bought majority of surplus stocks from the companies in order to compensate the losses incurred by the sharp decline in production, subsidizing these efforts from the federal budget. However, the underfunded convergence program could not replace the sharp drop in demand.¹²

The division of Czechoslovakia at the end of 1992 led even further loss of customers as well as a number of subcontractors as the foreign and security policies of the Czech and Slovak Republics went different directions. While in the Czech Republic there was always a strong political consensus on the country's NATO membership, the Slovak government kept building closer ties with the Russian Federation. This divergence signalled a cooling down in mutual relations, which most notably resulted in the freezing of cooperation in security matters with adverse effects for the defense industries of both countries.

After the split of Czechoslovakia the civilian convergence projects continued, but went down a different path. The Czech Republic favored privatization of companies through coupon privatization and passing legislation to enabled potential foreign entrants into the industry to take a share of up to 50%. The result of these efforts was the de facto disintegration of the original structure of the Czechoslovak defense industry with a number of smaller companies coming into being with fragmented ownership structure. This in turn led to a marked decrease of the original capability, with their ability to survive conditioned by launching civilian production.

Slovak Republic, on the contrary, was the first of the V4 countries to create state holding companies, which in themselves concentrated the key capacities of the defense industry. There were also legislative changes, allowing the entry of foreign capital into the sector. While Hungary

¹¹ Ivánek, Ladislav 2002, pp. 133-134

¹² In 1992, amount roughly equivalent to USD 23 mil. was released for the Convergence Program. Ivánek, Ladislav 2002, p. 135.

did not prohibit foreign capital to enter its defense sector, and the Czech Republic allowed foreign owners to obtain a 50% share in the company, Poland took significantly more protectionist approach (limiting foreign investment to 20% share), which was similar in Slovakia. Thus, Slovakia and Poland favored creating several state-owned holding companies, merging viable companies in the defense industry.

Cooperation in V4: Opportunity Lost

During the transformation of defense industries, individual V4 countries were faced with similar difficulties. The theoretical possibility of preserving regional production capacity existed through cooperation between at least some of the V4 members, which would help increase the size of contracts and keep development projects at an economically profitable level. V4 countries, however, failed to generate plausible projects in the sphere of armaments, even on a bilateral level. The highly individual approach of each V4 member contributed to a significant reduction in the overall defense industry capabilities in V4. Below is a list of positive factors in favour of initiating joint projects, and strengthening regional cooperation in defense.

1. *Similar geopolitical position.* V4 countries dealt with similar problems in the field of foreign security policy, where they shared interests. Their armed forces had to be prepared for similar deployment scenarios. Central European area found itself outside any military bloc and individual countries had to ensure their own security and face an entire spectrum of possible threats individually (which their armed forces were not ready for).
2. *The same equipment and training* of armies from the time of the Warsaw Pact. V4 armies operated the same types of military equipment originating from the Warsaw Pact period. The possibility of joint action in case of upgrading was a feasible possibility.
3. *Similar process of transformation.* Financial constraints did not allow for rapid replenishment of military equipment and all V4 countries had to develop similar programs for modernization of the existing equipment. V4 countries were starting the same or very similar armament projects, while they often did not have enough resources for their satisfactory implementation individually. Individual armies could not afford to modernize their equipment in volumes that would guarantee profitability and guarantee further development of the project while reducing the price per unit.

4. Similarities in *Czech and Slovak Republics*: both countries had a complementary foundational defense industry; mutual dependency on each other in many areas of manufacturing, etc. However, but the political situation did not allow to finding an agreement on common action in the field of armament.

The four mentioned Central European countries, therefore, had a number of areas where there was a potential to initiate joint projects, at least on the research level. Coordinated action to compete with foreign producers could also bring significant savings in the area of military acquisition. And there is evidence of some cooperation: since 1998, the V4 countries actually created several working groups to open up space for cooperation in the field of armament. There were negotiations of possibilities of cooperation in the modernization of T-72 tanks, modernization of air defense equipment (development of radars, missile purchases), establishing a training center for pilots, or the possibility of upgrading the MI 24 helicopters. It has to be said that all such endeavours eventually remained at the stage of consultation and individual countries opted to act alone.

Why Did the Defence Industry Cooperation of V4 Fail?

1. *The struggle for survival*. With the disintegration of the Warsaw Pact, all European countries lost the target market for their armaments almost overnight. Individual companies generally had no other outlets for manufactured firearms than the contracts with their own army. Sharing the contracts with manufacturing industries of neighboring countries was unimaginable for domestic producers. In contrast, the defense industry in Western Europe had been calling for joint projects and multinational cooperation since the mid-90's. Industrial enterprises in the V4 countries started to grasp the benefits of cooperation in the transition process only at the beginning of 21-st century.
2. *Mutual competition*. Similar structure and capabilities of defense industries of the V4 countries meant that potential partners would become major competitors among themselves. The main export opportunities were in modernization projects of Soviet-made equipment, for the production of which the V4 countries owned a license. The most important defense industry companies in V4 countries kept their domestic orders and competed hard on foreign markets.

3. *Political strategy of protecting own industry.* While Western Europe was able to find a political consensus on integration of national defense industry champions, V4 lacked similar broader strategy. Instead, V4 governments acted independently and prioritized contracts for their industry with larger partners from Europe or the U.S. Cooperation in the fields of defense industry and military acquisition within V4 was regarded as unviable. Individual countries acted according to their short-term interests and opportunities with disregard for the possibilities of cooperation within the region.
4. *Offset programs as a simpler alternative.* The governments of the V4 countries maintained internationally uncompetitive portions of defense industry through offset programs. Buying from foreign manufacturers represented a simpler option in the short term than uncertain international development efforts. Big foreign manufacturers had to supply the V4 markets through domestic partners who were involved in the production of a specific contract. Such approach ensured the survival of several state enterprises, but typically did not lead to establishment of a long-term cooperation beyond the specific contract. In many cases, expectations about the benefits of new technologies did not come materialize, as foreign producers carefully protected their own manufacturing patents. State enterprises involved in defense industry were able to succeed in the real international competition only in a few cases.
5. *Political and economic transformation* of the V4 countries was necessarily accompanied by negative phenomena such as corruption and organized crime. Non-transparent domestic military acquisition processes shaped the environment that suited specific political and business groups. Interest in the effective functioning of the defense industry and military acquisition was often outweighed by interest groups linked to the military budget.
6. *Unprepared state bureaucracy.* Management of international armament projects is one of the most difficult managerial disciplines. During the transformation period, administrative apparatus of the MoDs was not ill prepared to manage such complex projects. Similar situation was in the management of state enterprises, which had no prior experience with international projects and found it difficult to orient themselves in the new market conditions.

Summary

Since the beginning of the 21-st century, it has become clear that maintaining state-owned enterprises in the defense industry is not profitable for small countries. Domestic defense contracts proved insufficient for keeping up the quality and production development programs in the long term. If the state cannot provide a sufficient volume of contracts and investments, then the state ownership of the production capacity is a luxury, which the defense budgets cannot afford. In open competition on the international market, state management of the defense industry proves as is highly inefficient.

In practice, state-owned enterprises had secured orders from national armies, which eliminated competition and failed to lower prices in case of real competition. Paradoxically, it were the armies that suffered from the state ownership of defense industry, being obliged to rely on domestic suppliers rather than using the most effective tool for price reduction, i.e. an open competition.

Moreover, prohibitive costs in recent years forced the V4 governments to further privatize the defense industries, a trend first taking root in companies specializing in aviation production. The cost of further development simply exceeded the possibilities of limited government budgets and new production capacities in the civilian sector proved more viable. This led to the 2002 sale of the traditional Czech training aircraft manufacturer Aero Vodochody to a private investment group Penta. Similarly, Poland had to realistically reassess its options in the aviation industry, inclining toward the sale of domestic aerospace manufacturers. to strong foreign partners in the in the aviation industry.¹³

The new security environment in Europe has pushed the alternative of large-scale military mobilization into the realm of highly improbable. The shift in the perception of security is marked by increasing likelihood of swift, asymmetric security threats, which necessarily reduces the reaction time for countermeasures. Moreover, the rising cost of development and acquisition of weapon systems pose a limit on the strategic options in the event of a conflict. Thus, it has become unsustainable for the majority of countries to maintain a domestic defense industrial base, ready for production programs in the event of war. Owing to the technical complexity of

¹³ 2001 PZL Warszawa-Okecie for EADS CASA, 2007 PZL Mielec for Sikorsky Aircraft Corporation, 2010 PZL Swidnik for Augusta Westland.

current and future weapon systems, it is doubtful that in the event of deterioration of the security situation, the start of new weapon production would be fast enough.

Moreover, having the capacity to produce weapons is not sufficient, it is also necessary to prepare them for operational deployment. Indeed, equipping and training of troops of modern armies has become a very complicated process that cannot be handled within a limited period of time; rather, a long-term professional training is necessary. A large-scale mobilization is thus becoming a historical phenomenon associated with the wars of the 20-th century. What's more, providing state security is no longer a sufficient argument for spending enormous resources to maintain domestic defense industry capacities.

Moreover, the painful experience of transforming the V4 defense industry capacities after the Cold War brought a significant decline in the share of this sector in GDP of the member states.¹⁴ Thus, state support for the defense industry is no longer a matter of necessity for the national governments, and economic efficiency becomes a prominent factor in any decision-making in this realm.

With the exception of a few strongest military powers, states are unable to self-finance the development of advanced weapon systems. For most EU members, the only viable alternative is in the development of common EU market with defense material and implementing joint research and development projects. The past cooperation of V4 countries has only demonstrated its usefulness at the level of expertise and coordination, but has not succeeded as a plausible alternative in terms of development, production or joint procurement of military material. . Despite the rocky track record, the V4 countries still share a number of common interests, which should motivate them to cooperate more closely in the areas of military acquisition and defense research. However, any such cooperation will already take place within the broader framework of the EU.

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¹⁴ For instance, in 1987, the defense industry accounted for almost 2% of the total industrial production of the Czech Republic (6% in the Slovak Republic); in 1995 the industrial production of the Czech Republic defense industry contributed 0.4%. Ivánek, Ladislav 2003, p. 11.

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