

Managing Defence Industries in Transition: Ensuring Compliance with Export Controls

A presentation by Bernardo Mariani, Saferworld, at the Fifth International Conference on Export Controls, held in Budapest, Hungary, on 15-17 September 2003.

Ladies and Gentlemen,

Let me start by thanking the Foreign Ministry of Hungary and the US State Department for having invited me to this conference. It is always a pleasure to visit Hungary and I consider it a privilege to address this distinguished forum.

I will try to illustrate some of the main challenges associated with managing defence industries in transition and ensuring compliance with arms export controls. My special focus will be on Bulgaria and Romania that I have had the opportunity to examine more closely over the past few years.

The debate on the future of the defence industry in former communist countries always revolves around a few key issues: financial and economic crisis, lack of coherent defence industrial policies, decline in traditional export markets, possible repercussions of NATO enlargement and European integration, and the international community's worries about weapons sales to countries of concern. In order to understand the present situation, it is important to recall some of the major events that took place during the transition towards market-oriented economies.

1. The transition towards a market economy

The difficult process of transition, characterised by financial and economic crisis and political instability, had a huge impact on the arms industry in all former communist countries. Traditional export markets declined rapidly, due to a number of factors. Firstly, the loss of state subsidies and military downsizing across Europe meant the loss of many traditional clients; secondly, some traditional markets outside Europe were also lost because of international restrictions and UN embargoes; thirdly, many arms importers, especially those from former communist countries, shifted demand to weapons produced to NATO standards, thus reducing the demand for old soviet-style weaponry.

The state's part during the transition era was characterised by incoherent defence industry policies. Measures were often contradictory and unclear, and the defence industry received confusing signals. On the one hand, there was publicly stated government support for the industry; the recognition of its problem areas, and in some cases the retention of state ownership due to the companies' strategic importance. On the other hand, privatisation was delayed or poorly managed; there was little investment for restructuring and/or conversion, nor were there any tax incentives or subsidies. Moreover, there were no sustainable efforts for international co-operation and integration of the defence industry with foreign partners.

In the new climate of general disarray, manufacturers sought new foreign markets to maintain jobs, keep arms production lines open, dispose of their huge surplus stocks and ultimately bring in hard currency. Very unfortunately, this also led to a number of cases where arms, either new or surplus stocks, were released for export or sale to brokers and found their way into the black market, or countries in conflict, in sub-Saharan Africa, Central and South Asia, the Balkans and elsewhere.¹ Consequently, throughout the 1990s, several countries came under severe criticism for actual and alleged transfers of arms, often small arms and light

¹ 'Arms production, exports and decision-making in Central and Eastern Europe', Saferworld, June 2002, p. 25-29 and p. 150-153

weapons (SALW), to embargoed states or countries of concern, and the need for introducing more stringent controls over arms exports became urgent.

2. Current challenges

Bulgaria and Romania should be given credit for the important steps they have taken to curb the trade of arms to regions of concern and improve their licensing procedures, regulations and enforcement. However, while there has been increasing focus on what more needs to be done to tighten up legal controls, improve enforcement practice and strengthen the capacity of governmental agencies to implement the new policy and normative provisions, not the same attention has been paid to the economic dimensions of implementing strict arms export controls. A precarious economic situation, accompanied by high rates of unemployment, mean the incentives to export arms remain strong and this creates a fertile ground for unscrupulous dealers who operate on the fringes of legality and often beyond them.

In October 2002, a Bulgarian state-owned arms production and repair company signed a contract with a company registered in the United States for the export of military equipment to Syria. In order to circumvent arms trade rules, the goods to be exported, including spare parts for armoured personnel carriers, were labelled as tractor accessories. The police foiled this illegal trade and uncovered a secret export channel that had been operating for at least 6 years. There were media allegations that Iraq had been the final recipient of the exported goods. This case shows that illicit deals continue to represent a serious threat. The most striking aspect of it is the crucial role played by a cash-strapped segment of a state company in evading national controls.

3. The way forward

In Bulgaria and Romania, political or geostrategic interests to be pursued through defence production have ceased to be governments' top priorities. Therefore, in contrast to the predominantly political rationale for arms sales during the Cold War, the motives for arms sales in the post-Cold War period have become largely economic. Under general conditions of economic underdevelopment and high unemployment, the governments' commitment to arms restraint faces serious challenges, especially in towns and regions where defence companies continue to provide the great bulk of jobs. Since there is no substantial internal market, greater restraint in arms exports is likely to cause production cuts and since a lot of companies have already reached minimal production levels and are struggling to survive, further reductions would result in their closure and significant job losses. This is particularly true in the case of Bulgaria.²

Therefore, it would be unwise to pursue solutions concerning the optimisation of export controls that do not also take into account the impact on the defence industrial complex. Indeed, no measures for implementing stricter export controls can be fully successful unless the effect of the overall restructuring of the defence industrial complex is factored in. A one-tracked approach that simply aims to reduce arms exports without providing attainable restructuring chances for defence producers may exacerbate economic blocks and generate serious attempts to evade existing arms export controls.

4. Recommendations

Improved export controls must be accompanied by concrete actions aimed at enterprise restructuring both on the part of the state and the producers. The key notions in this respect are restructuring, redirection of excessive production capacity into other spheres

² Employment in the Bulgarian defence industry has undergone drastic changes since the 1980s when it employed a workforce of up to 115,000 people. Recent figures suggest that employment in the defence sector has gone down to 25-30,000 causing grave social problems. The effect has been particularly severe on the municipalities of Kazanlak, Karlovo and Lyaskovets where over the period 1995 - 2001 the unemployment rate increased three times (research carried out by the Centre for the Study of Democracy, Sofia, May 2003).

corresponding to national interests, the country's international commitments and Euro-Atlantic integration. Inevitably, there are no quick fixes and this process will be complex and fraught with difficulties. A number of recommendations for managing defence industries in transition can be formulated. Let me mention a few, which are crucial for their impact on national economies and arms controls.

4.1 Co-operation and partnership with international companies

Two years ago, the Romanian President Ion Iliescu stated: "it is clear that we cannot assure the reconstruction of this [the defence] industry with only our resources. We must see what aspects we can promote and modernise in partnership."³ Indeed, the promotion and modernisation of arms production in partnership with international companies offers good prospects, given the existence of qualified staff, relatively low production costs, as well as experience, technologies and well-developed economic relations with western countries. To date, only a few attempts have been made for setting up mixed defence enterprises, although in the case of Romania there have already been a number of international co-operative programmes.⁴ The assignment of public procurement to mixed enterprises could be an effective tool to support that process. If new and old democracies are to face new challenges posed by common adversaries, such as international terrorism, transnational organised crime and drug trafficking, and if the development of democracies is so critically dependent on economic welfare, does it make sense to keep high barriers between national industrial capacities in the defence sector? The scope for potential co-operation, restructuring and mergers can offer unprecedented economic savings and market opportunities. Moreover, technology transfers coming from international companies could help reduce obsolescence and enable local governments to turn to domestic producers once again for their hi-tech weapons systems requirements. However, it is paramount that the economic benefits of co-operation and integration amongst defence industries are not achieved at the expense of arms export controls, thus allowing the proliferation of technology and production expertise. The risk is particularly evident in the case of the licensed production of arms. The discrepancies amongst national arms export controls are compounded by the fact that most countries' export control regimes fail to adequately cover licensed production, leaving a gaping hole in their ability to control the transfer of arms that are produced under licence abroad. Therefore, the internationalisation of the defence industry also requires the development of effective common international standards on export control. Another pitfall in the establishment of effective co-operation and partnership with foreign companies could be the role of corruption in shaping governmental preferences in the award of contracts, whose economic benefits might therefore be called into question.⁵

4.2 Identifying and sustaining opportunities for conversion and diversification

Several conversion programmes were developed during the transition to the free market economy, but they had minimal or no impact because conversion was rather a task for the companies' management than a purposeful policy pursued by the government. It is important to adopt a different approach and methodology whereby the state is able, through investments, tax incentives and subsidies, to develop profitable alternatives to the production of arms. Given that shrinking markets and worldwide overcapacity limit the future of traditional low-tech armaments, it is wise for governments to develop new sectors of the economy with greater potential for sustainable long-term growth. This involves helping defence firms broaden their industrial base and identify areas where shifts to alternative commercial business may be successful. In fact, some industries can be deployed for the production of a

³ 'Interview: Ion Iliescu, President of Romania', Jane's Defence Weekly, 9 May 2001

⁴ Examples of such schemes include: Aerostar SA (Romania), working with Thomson CSF (France), Elbit Systems (Israel), and Aeronautic Defence and Space (Europe); Arsenalul Armatei (Romania) and Romanian Military Equipment and Technologies Research Agency working with Oerlikon Contraves AG (Switzerland); Aerofina (Romania) with Matra (France); and Romaero (Romania) with Britten Norman (UK).

⁵ See Radu P C, 'Corruption casts shadow on Romanian spies', IWPR, 12 December 2002.

variety of goods, from components to complete machinery and if these capacities are developed further, they could be oriented towards sales in western markets.

4.3 Improving domestic dialogue on export controls

Along with the development of the legal basis for arms export controls and the structures responsible for their implementation and enforcement, it is important to increase efforts that encourage greater dialogue with the defence industry and promote better understanding of and compliance with the new arms control norms amongst producers and exporters of defence goods. Greater awareness of export control measures will help companies plan their activities and avoid situations where a company will engage in negotiations with potential customers only to realize at a later stage that the deal would be in breach of the national export control system and could not be authorized. This can be achieved, for instance, by holding regular workshops to inform and educate licensed companies on arms export control issues and the implementation of the law. I understand that Bulgaria and Romania have held seminars to inform licensed companies about the latest trends in international and national export control policies. However, such efforts should be made more systematic and should include, where appropriate, a follow-up dimension, such as training for relevant company representatives on how to establish and implement effective internal control systems.

4.4 Developing internal control systems

Some progress has been made in making companies assume more responsibilities for their trading conduct, but more needs to be done to ensure that companies have both the capacity and the resources to establish internal control systems. Bulgaria now requires all licensed companies to appoint designated employees who will have the responsibility to ascertain whether a proposed deal is in compliance with the Bulgarian legislation and the established export control system. Although these are important initiatives, it is important to stress that the ultimate responsibility in ensuring the implementation of arms export controls rests with the relevant government authorities. Companies have a role to play in reducing the administrative burden put on the government administration, but surely they cannot be the implementers of arms export controls. Such an activity, due to its intertwined security, economic and strategic dimensions, should remain the prerogative of government institutions.

4.5 Strengthening international co-operation

Bulgaria and other Eastern European countries are paying a high price for their contribution to international security, through more rigorous arms trade control policy and legislation. It is the price of substantial reduction of their military industrial complex, high level of unemployment and shrinking arms markets. Without such a policy, it is fair to assume that developed countries would probably have to spend much more on humanitarian aid, economic recovery and peace-keeping forces deployment worldwide. One should also accept the fact that NATO enlargement is costing candidate countries dearly as they have very limited resources to pay for their new weapons systems.⁶ These arguments should be an incentive for EU and NATO co-ordinated programmes to assist countries like Bulgaria and Romania in restructuring their defence industry, converting the most unprofitable production lines and participating in joint defence projects, which will enhance the countries' prospect for integration. It would be unreasonable for NATO and the EU to expect Eastern European partners to restructure and modernize their defence industries on their own.

⁶ Although in August 2003 Bucharest announced a defence budget cut of 1,033.1 billion lei, ('Romania cuts defence budget, increases spending on internal security', BBC monitoring Service – 27 August 2003), 2001 saw a 30 percent increase in the Romanian defence budget to \$1 billion, with a further rise to \$1.1 billion (2.38 percent of GDP) for 2003 (Jane's Defence Weekly, 18 September 2002). Yet the Ministry of National Defence in 2002 was procuring only five percent of its equipment from domestic producers, compared to seventy percent before 1990. \$700 million was spent on imports in the period 1997–2001.

4.6 Enhancing public transparency

The development of greater transparency is also a priority because 'grey' and black market arms trading feeds off a lack of transparency and without a good level of publicly accessible information on the defence trade, defence manufacturing outputs, as well as military budgets and procurement programmes, there can be no reliable evaluation of the challenges faced by a defence industry and the measures required to address them. Even nowadays the old 'secrecy mentality', a well known problem in all former socialist countries, is hard to erase and the still high degree of secrecy surrounding defence industries in the region is yet another obstacle standing in the way of defence industry restructuring. When information concerning the state of the defence industry is not available from the government and military industrial policies remain unclear, the defence business cannot be expected to develop. Old prejudices regarding the disclosure of defence industry-related data preclude an informed public debate on the topic, as well as any matching research and analysis and high-level political discussions. All too often, this has created unrealistic public expectations on the revitalisation of the defence business, which are not supported by any reliable analysis of the industry's capabilities and the actual level of arms production and export. Such unrealistic expectations inevitably collapse and create a fertile ground for instability, social tensions and frustrations and disillusionment on the part of manufacturers, which may lead to illegal/grey sales.

5. Conclusions

Drawing the conclusions from the points outlined so far, there is a need to suggest an alternative approach to the problem of implementing responsible arms export controls. At a time when countries like Bulgaria and Romania continue to face economic hardship and arms production is still a means of earning hard currency, such an approach calls for a comprehensive programme to tighten up controls and enforcement practice while addressing the outstanding challenges posed by the transformation and restructuring of the defence industries. It is in the countries' interest to develop and implement such a programme which would boost their credentials as reliable producers and exporters of arms while seeking membership of the NATO alliance and the European Union. It is also in their interest to put at the disposal of the public the data necessary to allow for greater scrutiny, analysis and debate to assist the political and industrial decision-makers in adopting appropriate strategies. Finally, the preservation of international security also demands a serious engagement by western countries to provide viable alternatives that help reduce the overwhelming economic reliance on weapons sales. Donors' support in this field is long overdue.

Thank you