INFO FLASH
Finabel
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FINABEL - THE EUROPEAN ARMY INTEROPERABILITY CENTRE

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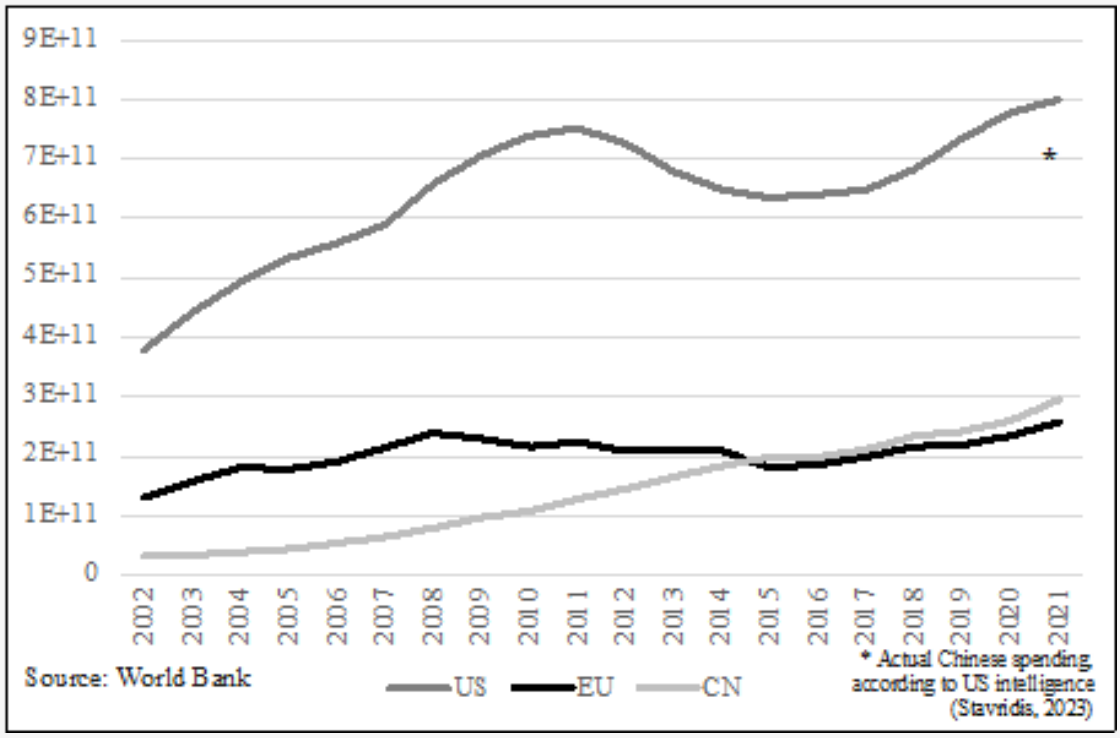
Introduction

The global military expenditure rose by 3.7 per cent in real terms in 2022 to a record high of $2.24 trillion (Tian et al., 2023). The United States, China and the European Union (as the aggregated national expenditures of its member countries) make up the three largest (see first chart). Given the rising demand, governments and the defence industry are increasing their investments. Evaluating the strengths and weaknesses of each market will be essential in determining the necessary steps forward.

Chart 1. Military expenditure in current US dollars (i.e., 1E+11 equals 100 billion).



For this reason, this Info Flash aims to compare the investment climates in the markets of the largest spenders. An investment is regarded as an 'act of putting money or effort into something to make a profit or achieve a result' ('Investments', 2023). An investment climate is the extent to which countries or trading blocs can attract domestic and foreign investments. While the investment climate consists of various components, such as the insurance system and social risks, such variables will not be discussed at length.

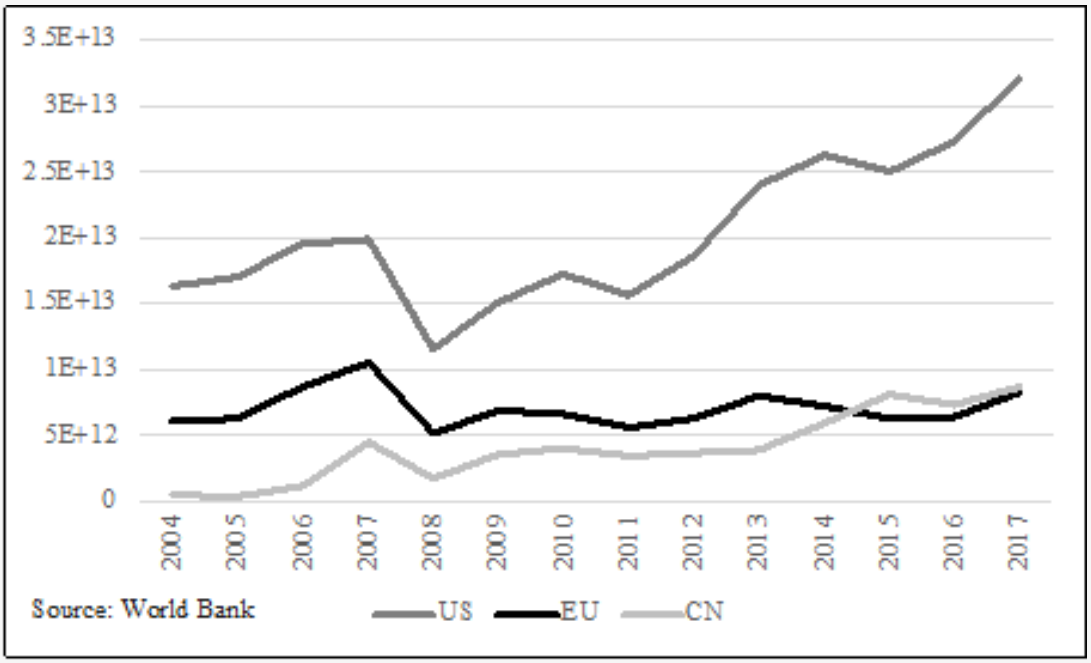
Instead, two determining – non-exclusive – factors are identified. First, money flows determine the total market capital that can be attributed to defence investments. Second, public policy is vital since governments are the ones purchasing military material. Government influence on the financial market and the defence sector greatly determines the investment climate. This includes the market size, as this determines the natural sales area of these companies.

The bigger the market, the more said companies can apply economies of scale and thus suppress costs. The US, Chinese and European markets will be assessed for each factor. At the end, the final remarks will underscore the crucial points.

Money Flows

The size of the capital market and money flows hereon determine how much money can be attributed to investments. Simplifying matters, the total size is deduced from the market capitalisation of domestic firms. The US has the most significant capital market (see second chart). The country's currency has been the primary global reserve currency since 1944, meaning that trading or investing in US dollars reduces exchange rate risks and helps facilitate global transactions (Chen, 2022). During times of crisis, entities typically reallocate their resources into US dollars, boosting the country's economy.

Chart 2. Market capitalisation in current US dollars (i.e., 1E+13 equals 10 trillion).



In July of this year, the dollar accounted for nearly 60 per cent of international payments through SWIFT, an interbank messaging system used for transactions (SWIFT, 2023). The euro is second with almost 14 per cent, followed by the British pound and Japanese yen with around 5 per cent. The fact that these currencies are freely tradeable assists in attracting investments. My colleague Francesco Baronio finds so-called internationalisation wherein American and European companies collaborate to distribute costs and risks, access innovative foreign technologies, attain economies of scale and penetrate foreign markets (Baronio, 2023). Conversely, the limitations placed on the circulation of the Chinese renminbi and government intervention in the financial markets have hindered the currency's growth and use for cross-border investments (Huang & Wu, 2017; Siripurapu & Berman, 2023). Presently, only 2.2 of global transactions are paid in renminbi (SWIFT, 2023).

The American financial market's preferability over its Chinese and European counterparts can also be attributed to its integrated structure. The latter two remain segmented, albeit for different reasons. Chinese financial market differentiates between state and non-state enterprises. At the start of the reform and opening-up period in the late 1970s, less efficient state-owned enterprises (SOEs) were supported, resulting in a form of distortion and a shortage of financial services in the formal sector (Huang & Wu, 2017). The dominance of large state-owned banks, which primarily fund SOEs, has contributed to this (Allen et al., 2017).

Overall, research finds that capital mobility across regions in China is low, even without formal prohibitions (Boyreau-Debray et al., 2005). This further limits the money flows needed for investments. In cases where capital circulates nationally, the government, rather than the private sector, tends to allocate it, diverting it from more productive regions to less productive ones (Boyreau-Debray et al., 2005). While the defence industry is being opened up to the capital market, the state-owned industries are expected to reap the greatest benefits. Their monopoly power is not expected to decrease (Cheung et al., 2017). Financing private firms remains dreadful and tedious, curbing innovation.

In the European Union, the capital market is also relatively underdeveloped. In 2017, it was approximately four times smaller than that of the US (again, see chart 2). Two reasons can be found. Firstly, according to Boldeanu and Tache (2016, p. 78), 'poor performance [exists because] the capital market in the Western EU countries is much more developed than the one in Eastern Europe'. Moreover, most of the equity market, where issuers and buyers of stocks interact, lacks cross-border connections. Since citizens and enterprises subsequently choose to invest in their own country's stocks, risks and rewards are not divided adequately between European countries. This poses a particular challenge for small and medium enterprises (SMEs) in securing suitable, low-cost financing (Boldeanu & Tache, 2016).

Secondly, an excess of competition can be a concern for investments. The financial market is fragmented due to rivalry between governments, for instance, in attracting foreign direct investments (FDI) (Reurink & Garcia-Bernardo, 2020). Furthermore, the absence of a consolidated European banking sector complicates European investments in matters such as defence, where unified action is critically important. Contrarily to the US, the EU avoided making banks bigger after the 2007 financial crisis (Foer & Resnikoff, 2014). This came at the cost of reduced concentration and competition, factors that contribute positively to financial stability and the investment climate (Pawłowska, 2015; Boldeanu & Tache, 2016).

Government Policy and Its Effects on the Market

Since national governments are the ones buying – mostly national – military equipment, they are the biggest defence financers. Their presence on the market and regulation determine the defence landscape and investment climate. In this regard, China's state of affairs differs significantly from Europe and America's.

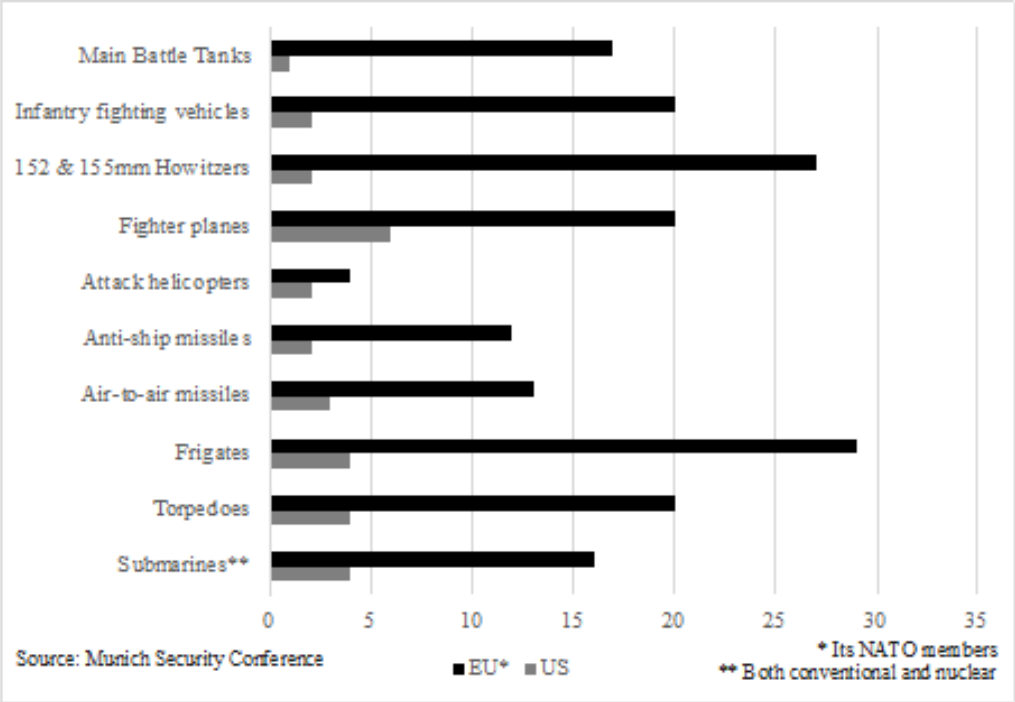
China's political system is more centralised and hierarchical compared to its equivalents. This demonstrates strengths in efficiently mobilising and directing political coordination, economic resources, and research and development (R&D) capabilities around programmes that the top leadership deems significant. Research shows that these programmes face fewer challenges (Cheung et al., 2017). The Communist Party's (CCP) renewed emphasis on security may lead to a system where investments and the investment climate become more favourable.

One example of this is the industry in dual-use technologies. China's leadership is employing Military-Civil Fusion (MCF) as a strategy to position the country to compete militarily and economically in the evolving technological and strategic competition with the US (Bitzinger, 2021). These efforts appear to be paying dividends, with various commercial technologies being adapted militarily in several areas, such as information technologies, shipbuilding, aviation and space (Bitzinger, 2016).

That is not to say that its system is without drawbacks. The defence industrial base remains heavily statist. For example, ammunition production is predominantly performed by non-competitive SOEs shielded and supported by the central government. There have been only minor alterations to include a more corporate management style (Bitzinger, 2016). Efforts are underway to address weaknesses stemming from the industry's historical top-down structure, which include bureaucratic fragmentation, an outdated pricing regime and corruption. These challenges are being tackled by shifting towards a more competitive and indirect regulatory framework. However, strong vested interests hinder substantial changes (Cheung et al., 2017).

Alternatively, the European and American markets are dominated by a small number of big firms. They use cutting-edge technologies and predominantly sell their production to their respective governments (Acosta et al., 2017). EU member countries tend to specialise in their fields: Western Europe houses the largest share and more diversified companies; Northern Europe is more specialised, particularly in surveillance and communication systems; and Central Europe focuses on less technology-intensive sectors like small arms and ground platforms (Béraud-Sudreau & Scarazzato, 2023). While this seems good at first, it leads to fragmentation in the defence market (see third chart).

Chart 3. Weapon systems in service in the EU and US in 2016.



The difference between American and European markets is the number of buyers. While the US government centrally procures material through its Department of Defence, national governments rule the European markets. This influences regulation and its impacts. The US regulates and procures uniformly, which provides some indication of investment opportunities. EU Member States essentially set their own regulation and standards since 'essential interests of [Member States'] security' are excluded from the Union's internal market under Article 346 of the Treaty on the Functioning of the European Union (European Union, 2012). Different demands make the market fragmented for investments (again, see the third chart). This limits the possibility of scaling up and hence makes investments less sensible.

The Russia-Ukraine War has accelerated the EU's effort in this regard. Short-term regulation on common defence procurement and ammunition procurement and support for ammunition production is a promising start, my colleague François Barbieux writes (2023). The European Defence Fund aims to provide financial backing for joint defence research and the development of capabilities. Commission President Ursula von der Leyen announced a European Defence Industry Strategy that will 'support our industry ramp up the production of critical equipment' and create 'an industrial front' in the long term (Pugnet, 2023). Although these measures are just the beginning, they can bring about a lasting shift in the defence industry, moving it away from fragmentation caused by competition between Member States and enterprises.

Concluding Remarks

In all, the size of the capital market and government influence determine the investment climate in the defence industry. The US dollar is set to maintain its status as the global reserve currency, while the euro and renminbi will continue to face challenges unless reforms are undertaken. The EU should improve its Economic and Monetary Union (EMU) and banking sector to create cohesive European economic and fiscal policies to reduce the regulatory competition between Member States. This will allow funds to flow freely, which is much needed for cross-border investments, especially in a defence industry that is becoming more consolidated and international (Baronio, 2023).

In China, the CCP should liberalise the banking sector, moving the renminbi towards being a freely transferable currency. Furthermore, discriminatory barriers for private enterprises should be tackled to lessen market distortion and increase the chances of acquiring investment funding. The CCP could also loosen its grip on capital distribution to guarantee that money flows to the right parts of the defence industry. Small, innovative companies need to be centred herein.

Regarding government influence in the defence sector, the CPP could consider lowering its influence in the interest of efficiency. While its control can be beneficial for achieving politically defined priorities, such as advancing dual-use technologies, it tends to centralise the industrial base around non-competitive SOEs with government support. Bureaucratic fragmentation, an outdated pricing regime, and corruption are also perceived disadvantages of the current system (Cheung et al., 2017). Overcoming these drawbacks will be challenging due to various entrenched interests. However, injecting more dynamism into the defence sector could enhance its ability to absorb and mitigate shocks.

On the other end, the European and American markets are dominated by a small number of big commercial firms. The American market is largely integrated and diversified. In contrast, European companies have strong ties to their respective governments and produce a diverse range of – often not interoperable – systems, resulting in a fragmented landscape. So-called task specialisation in the EU is a solution. Moreover, regulations and standards should be set collectively, either on the European level or within NATO. Less weapon systems will redirect investments to just a few technologies, assisting in further development and scaling up. The EU has seen this priority and responded with new legislation on this matter since Russia's renewed aggression against Ukraine. The continued engagement shall be beneficial.

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