Offsets in Defense Trade 1997

EXECUTIVE SUMMARY

This is the second report on offsets in defense trade prepared by the Department of Commerce's Bureau of Export Administration (BXA), as authorized under the 1992 amendments to Section 309 of the Defense Production Act of 1950, as amended. The report includes data on both new offset agreements struck in 1995, and transactions completed to fulfill agreements made in previous years. The same data is also provided for the years 1993-1994 to put the new numbers in perspective and highlight trends.

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In 1995, U.S. prime contractors entered into 45 new offset agreements valued at over $6 billion. The defense export contracts which these agreements facilitated were worth $7.4 billion. This represented a substantial increase in new obligations over previous years, both in value and as a percentage of export contracts. European governments demanded by far the largest portion of offsets at $5.2 billion, or 86 percent of the value of all new U.S. offset agreements. New agreements made with this region rose to 104.3 percent of the value of defense export contracts. A total of 21 of the 26 new offset agreements entered into with Europe were for 100 percent or more. With the removal of one country's new agreements, the European average declines to 96.2 percent.

The decrease in defense budgets, large national debts, and significant unemployment which plague Europe appear to be driving increased offset demands in that region. Such figures are also a symptom of the increasingly competitive international arms market, where the buyer wields a great deal of leverage. In addition, major declines in U.S. defense procurement of aircraft in recent years have placed U.S. aerospace companies in a position of greater reliance on international sales for their revenues. Consequently, the importance of offsets as a marketing tool has apparently increased in the current environment.

Prime contractors reported a total of 671 offset transactions in 1995 valued at $2.7 billion. This figure represented an increase over previous years as well. Europe was the major demander of these transactions, receiving over 70 percent of the value of transactions. About 40 percent were direct offsets (related to the exported defense system), which is somewhat higher than the previous two years, but not a significant reversal of the general trend toward more indirect offsets. Over 75 percent of 1995 transactions were comprised of purchases, subcontracting, and credit transfers. The transfer of technology accounted for another eight percent. The same categories composed slightly less of the total in 1993-1994.

Among the beneficiaries of offset transactions were 738 different public and private foreign organizations. The great majority were private firms. Most were involved in only one or two transactions, though one firm received 35 offsets valued at $216 million. The entity which gained the greatest value received 16 transactions worth $248 million, or 3.8 percent of the total. Foreign public concerns to whom offsets were transferred included defense ministries, individual branches of the armed forces, and other entities such as ministries of economic affairs, research institutes, and industrial development agencies.

According to the surveyed prime contractors' 1995 offset transaction reports, over 90 percent of existing offset agreements arose from the export of aerospace systems.

However, only 50 percent of offset transactions were aerospace-related. The balance cut a wide cross section across the rest of the economy. This supports the contention made last year that indirect offsets are increasing both in volume and in scope.

The goods and services used to fulfill existing offset obligations 1993-1995 were distributed among 172 industrial sectors, with 45 new sectors added in the final year of the survey. Nearly 81 percent of the offsets were manufactured products, especially concentrated in certain sectors. The broadly defined transportation equipment sector comprised almost 51 percent of the value of all offset transactions. Another 13 percent involved electrical machinery and equipment, and 10 percent were non-electrical machinery. These three manufacturing sectors accounted for nearly 75 percent of transactions. Within the transportation equipment sector, aircraft and parts comprised 43 percent of total transactions, and commercial shipbuilding and repair, five percent. In the service sector, bank credit accounted for six percent of offset transactions.

The impact of offsets upon three specific industries was analyzed: machine tools, commercial shipbuilding, and gears. Viewed from an industry-wide perspective, the immediate impact appeared small in absolute dollar values. However, there can be some indirect impacts of offsets. For example, foreign suppliers are strengthened and introduced to new customers. At the level of the individual company, the impact of offsets may also be significant. Offsets can also cause purchasing decisions to be based on contractual criteria, where specific suppliers must be identified in buyer countries to meet the offset demands. As a result, U.S. firms lose work to foreign companies when production is transferred overseas. These circumstances are evident in the machine tool and gear industries.

Based on separate information collected by BXA, 114 U.S. defense subcontractors (out of a population of 703) reported being directly involved or impacted by offsets. Almost 80 percent of the 114 respondents stated that the impact was negative. Additional analysis of the data indicated that larger subcontractors with higher defense market shares were more likely to report any impacts. The 20 percent that reported being positively impacted by offsets were primarily the largest firms, while smaller firms were more likely to report negative impacts.