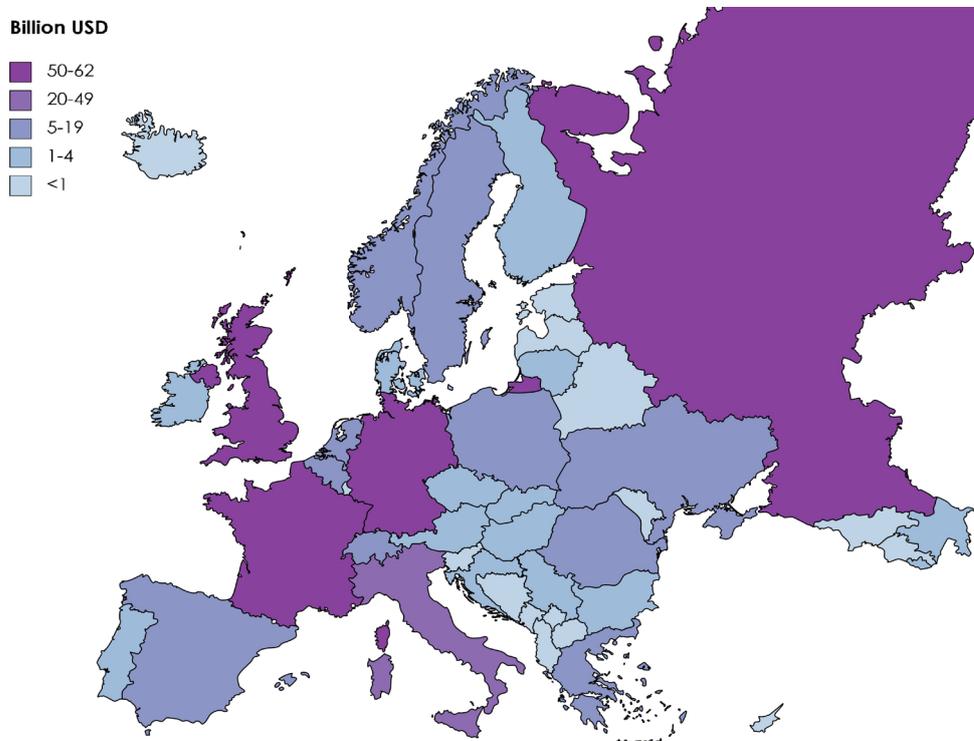


Regional Defence Economic Outlook 2021

Europe and Russia

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This memo complements Defence Economic Outlook 2020 (DEO 2020), which assessed the global power balance focusing on the major world powers, with a regional outlook on Europe and Russia. The memo aims to provide a regional perspective not contained within DEO 2020. Similar to DEO 2020, the regional power balance in this memo is described in terms of military expenditure and macroeconomic trends during the period 2011-2020, focusing on the five largest military spenders. Furthermore, the memo provides a description of the defence industrial capabilities of these countries, as well as the regional security environment.



Figur 1: European military expenditure, 2020 (current prices). Source: SIPRI (2021)

Europe, including Russia, is currently home to four of the world's ten largest military spenders, accounting for USD 378.4 billion in military expenditure in 2020. This is equal to 19.6 percent of global military spending, a share which has declined from 21.8 percent in 2011. According to SIPRI, Russia's military expenditure amounted to USD 61.7 billion in 2020, equivalent

to roughly 16 percent of the European regional total. This makes Russia the largest military spender in the region, as seen in Table 1. In the same year, the UK was the second largest military spender with USD 59.2 billion, followed by Germany with USD 52.8 billion and France with USD 52.7 billion. Italy was the region's fifth largest spender with USD 28.9 billion in 2020.

Table 1: Top 5 military spenders in Europe, 2020. Source: SIPRI (2021)

COUNTRY	BILLION USD (CURRENT PRICES)	SHARE OF REGION (%)	SHARE OF GDP (%)	AVERAGE CHANGE 2011-20 (%)	AVERAGE CHANGE 2017-20 (%)
RUSSIA	61.7	16.3	4.3	+3.0	+1.1
UK	59.2	15.7	2.2	-0.4	+3.1
GERMANY	52.8	13.9	1.4	+2.9	+5.9
FRANCE	52.7	13.9	2.1	+1.1	+0.7
ITALY	28.9	7.6	1.6	-0.2	+1.9

With the notable exception of Russia, military expenditure in the region is concentrated to Western Europe, see Figure 1. Together, France, Germany, the UK and Italy account for over half or 51 percent of the region's total military spending, see Table 1. Russia has given higher priority to its defence than other major European powers, allocating 4.3 percent of its GDP to military expenditure in 2020. The same year, France, United Kingdom, Germany and Italy all spent around or below 2 percent of GDP on military expenditure, according to SIPRI.¹

Russian military spending grew by an average of 3.0 percent, between 2011 and 2020, helping to fund the country's ambitious military modernisation efforts. However, military spending growth has slowed in recent years. This slower spending growth could either be due to shifting priorities in the face of slower economic growth or that Russia is satisfied with the results of previous modernisation efforts. Trends in military expenditure among the other major European nations offer a somewhat mixed picture. France and Germany increased their military spending, between 2011 and 2020, while the UK and Italy decreased theirs slightly. In later years military expenditure has increased somewhat in France and Italy, while the UK and Germany have increased their military spending substantially between 2017 and 2020. Prior to the coronavirus pandemic, several Western European countries were set to increase their military spending. However, it remains to be seen how fast economies will recover and what level or priority defence will have in the aftermath of the pandemic.

Regional Security

The European continent faces a challenging security environment, both in its east and to its south. The Russian invasion of Georgia in 2008, annexation of Crimea and military intervention in eastern Ukraine in 2014 as well as military support for the regime of Syrian President Bashar al-Assad, have significantly impacted Russia's relationship with the EU and NATO. In response to Russia's aggression against Ukraine and annexation of Crimea, the EU and the

US imposed a number of financial sanctions, in the form of frozen assets and restrictions against certain Russian sectors, entities and individuals. Russia's increased military spending, ambitious modernisation efforts and large scale exercises have done little to ease Western concerns. The views on Russia as a threat vary greatly among European countries. Nevertheless, in the face of its deteriorating relationship with Russia and increased pressure from the US to allocate more resources to their own defence, several Western European countries have sought to increase their military spending. For its part, Russia sees NATO's eastward expansion and alleged Western support for so called colour revolutions as strategic threats. Russia also argues that military modernisation serves as a mean to narrow the technological gap towards the West.

Tensions between Russia and the rest of Europe are not the only security concern facing the region and its immediate neighbourhood. Southern European countries are concerned about developments in Africa as well as increasing tensions with NATO-ally Turkey. While the focus on armed forces in Europe has shifted towards national defence, several western European countries are still involved in military operations outside the region, such as French counter-terrorist operations in Africa and the Middle East. Similarly, British defence policy is still to keep the UK secure by continuing to combat terrorism. The UK has troops deployed in Afghanistan and in Iraq and it is contributing to the counter-ISIS coalition. The presence of terrorism in Europe itself has been a serious concern throughout the last decade. While, the number of jihadist terror attacks and lives lost in such attacks decreased in 2018 compared to previous years, acts of violent terrorism still make their presence felt.

While priorities on security policy may vary among NATO and EU members, there have been a series of initiatives regarding European defence integration in recent years. NATO has taken a several measures since 2014 in order to strengthen the collective defence of Europe. The EU has also taken further initiatives towards defence

¹ Note that SIPRI's definition of military expenditure differs somewhat from NATO's. For instance, SIPRI includes indirect military expenditure such as military related activities of the French Gendarmerie or the Italian civil defence, which could cause SIPRI and NATO data to differ.

integration. The umbrella of EU Common Security Defence Policy (CSDP), instruments for EU coordination and integration have been in place for well over a decade, such as the European Defence Agency (EDA) and Capability Development Planning (CDP). However, initiatives aimed at deepening European defence cooperation have intensified in recent years. The European Defence Fund (EDF) and the Permanent Structured Cooperation (PESCO) was established in 2017. As was the Coordinated Annual Review on Defence (CARD) process, which is meant to support and complement the CDP in providing inputs to PESCO and EDF.

These EU processes are seen as complements to NATO cooperation, acknowledging the continued centrality of NATO for military security in Europe. The US is also an important provider of equipment as well as key components and technologies for the European defence industry and armed forces. However, the close relationship between the EU and the US was put under increased pressure during the Trump administration. Disagreements over trade policy, defence expenditure, climate change and the Iran nuclear deal are just some examples where the transatlantic relationship has strained, made worse by the open and often harsh criticism of EU leaders by the former US president. While the relations have already improved with Biden administration, it is not merely a question of personalities. The US will continue to increasingly prioritise its strategic rivalry with China and continue its pivot to Asia, regardless of who sits in the White House. Likewise, the US pressure for “burden sharing” with respect to Western defence will not disappear. This will increase the need for European defence efforts and further European defence integration, welcoming deepened partnership with the US while becoming less dependent on it.

Macroeconomic Trends

Overall, European economies saw a stable economic recovery since the financial crisis of 2008 and fiscal crisis of 2009-2010. However, the financial crisis impacted European countries differently and some countries, such as Italy and Spain, had yet to fully recover when the coronavirus struck Europe in March 2020. While international trade tensions and Brexit had slowed regional economic growth rates already in 2019, it was the coronavirus pandemic which pushed the continent into recession.

During the early 2000s, Russia experienced rapid economic growth. However, the global financial crisis hit the Russian economy hard. After a brief recovery it started to decline again after 2011. Falling oil prices and sanctions by the EU and the US following the annexation of Crimea in 2014, exacerbated the economic situation. A more

structural factor which continues to weigh on Russia's economic growth is its inability to diversify the economy from the dependence on oil and gas. The IMF indicates that the Russian economy contracted by 3.1 percent in 2020, due to the coronavirus pandemic and the consequent fuel price decline in early 2020. IMF also projection that the Russian economy will recover by 3.8 percent in 2021.

According to IMF estimations the Eurozone economy decreased by 6.6 percent in 2020 although it is projected to increase by 4.4 percent in 2021. The German economic growth is estimated to grow by 3.6 percent while in 2020 it contracted by 4.9 percent. The economy of France is expected to grow in 2021 by 5.8 percent after an estimated decline by 8.2 percent in 2020. Italy's economy is projected to recover by 4.2 percent after an estimated decline by 8.9 percent in 2020. The UK economy is projected to increase by 5.3 percent in 2021 after an estimated contraction by 9.9 percent in 2020. While IMF estimates the entire Eurozone and the UK to recover in 2021, several uncertainties and risks remain.

As of 31 January 2020, the UK ceased being a member of the EU. The exact consequences of Brexit will depend on the outcome of difficult negotiations between the UK and the EU. However, the uncertainties surrounding the lead-up to Brexit have already had a negative impact on the UK economy, some assessments point to long-term negative effects as customs risks being reintroduced and added regulations introduced. Meanwhile, the consequences for the security architecture of Europe may be modest, as the UK has clearly stated the will to be a vital part of Western defence and NATO also in the future. However, UK access to EU defence funding will certainly be more limited than if it had remained an EU member.

Defence Industry

Russia, the UK, Germany and France all have large and diversified defence industries, but otherwise differ widely. The Russian defence industry is organised into roughly 65 state owned or controlled holding companies. The number of employees for these companies has fluctuated a bit during the 21st century. From about 2 million people in early 2000, down to 1.6 million in 2005 and then back up to 2 million in 2018. These companies mainly engage in military production, 65 percent, with the remaining share being civilian. According to SIPRI, among the 100 top arms-producing and military services companies in 2018, 10 were Russian.

Russian arms production includes missile, electronics and munitions manufacturer. Some of the most significant Russian arms producing companies are Almaz-Antey, United Aircraft Corporation, United Shipbuilding

Corporation, and Tactical Missile Corporation. Together, these large conglomerates account for about 80 percent of Russian defence production. While not all production within these companies is military in nature, half of the country's scientists were working in the defence sector in 2016. In fact, Russia has the highest share of scientists and engineers working within the defence sector of any country in the world.

The State Armament Programme (hereafter GPV), has provided funding which has helped the defence industry to improve during the past decade. The previous programme, GPV 2020, outlined significant procurements for the Russian Armed Forces with the ambitious target that 70 percent of all equipment should be modern by 2020, even though the definition of modern has not been specified. The most recent programme, GPV-2027, builds upon the previous programme, and is leaner, more focused and likely more achievable. Furthermore, while the GPV-2020 focused on air and naval forces, the GPV-2027 gives higher priority to the ground forces.

Russia is the world's second largest arms exporter, with its customers mostly located in Asia, the Middle East and North Africa. India, China and Algeria was Russia's largest arms export customers during the period 2016-2020. Russia's main arms exports during the same period were aircraft by a substantial margin, followed by engines and missiles. In the two periods 2011-2015 and 2016-2020, the arms export in Russia decreased by 22 percent. If this trend were to continue, it would be problematic for Russia as the importance of exports is likely to increase for the defence industry, as domestic demand seems to be more modest under GPV-2027 compared to the previous armament programme. Exports are unlikely to fully compensate for decreased domestic demand. Therefore, diversification by increasing the share of civilian production has become a priority. President Putin has set the target for civilian production within the defence industry at 30 percent by 2025 and 50 percent by 2030.

Russia will need to keep production volumes of modern weapons high enough to replace ageing legacy equipment. In the face of more modest domestic demand, however, Russia might struggle with catching up technologically to Western countries and maybe even keep pace with a rapidly developing China. On the other hand, Russia maintains its place as the world second largest arms exporter and China still relies on Russian technology for some of its most advanced military equipment, remaining a key customer to Russia.

The western European defence market is fragmented and each country is dominated by a few large prime contractors who often form national monopolies within

their respective sectors. Of the world's 100 largest arms producers in 2018, 8 were British, 4 were German and 6 were French according to SIPRI. The French defence industry consists of a few major private and state owned prime contractors, including firms like Thales, Naval Group, Safran and Dassault, together with a large number of small and medium-sized enterprises (SMEs). The industry directly employs about 165,000 people. From the 2000s and onwards, the French defence industry has undergone the parallel processes of privatization, consolidation and increased European collaboration. However, the government maintains a strong influence as main customer and owner of either majority or minority stakes as well as cross-holdings between the largest companies. France was the world's third largest arms exporter, between 2016 and 2020, with the main export costumers being India, Egypt and Qatar. While having a high degree of self-sufficiency, France is striving towards deeper European integration. For instance, France cooperates with Germany and Spain in the development of a sixth generation future combat air system (SCAF) by French Dassault and Trans-European Airbus and Spanish Indra. France and Germany are also cooperating in the development of future armoured vehicles, through the joint venture between French Nexter and German Krauss-Maffei Wegmann (KMW). France's Naval Group has also signed an agreement with the Italian naval shipbuilder Fincantieri, entailing the creation of a joint shipping venture called *Naviris*. Outside of the EU, France and the UK maintains a joint collaborative agreement called the Lancaster House Treaties since 2010.

Similarly to France, the German defence industry is dominated by a small number of large industrial conglomerates, such as Rheinmetall, KMW and Thyssen Krupp Marine Systems (TKMS). Arms production is often a division within these companies. Estimates of the numbers of employees within the German defence industry varies greatly, but estimates of direct and indirect employment from 2014 indicate between 90,000 and 116,000 depending on definition. The German defence industry seems to favour European cooperation, such as the aforementioned Franco-German initiatives. The German defence industry is also a major arms exporter, fourth in the between 2016 and 2020, its main export recipients during that period being South Korea, Algeria and Egypt.

The defence industry in the UK underwent a process of privatisation and consolidation during the 1980s. Similarly to the defence industries of other major regional powers, it consists of a few large prime contractors, such as BAE Systems, Rolls Royce, Babcock, Cobham and Melrose Industries together with several SMEs. The UK defence industry employed about 140,000 people directly and an

additional 120,000 indirectly in 2017. The UK was the world's sixth largest arms exporter during the period 2016 to 2020, the main recipients were Saudi Arabia, Oman and the US. The UK is currently working to modernize the equipment of its armed forces, but due to depreciation of the pound the defence budget is facing some headwinds.

British defence firms are privately owned, but the government has a veto on strategic issues. Due to the fact that foreign owned companies are classified as British while operating in the UK, they can compete "without discrimination" for contracts from the UK Ministry of Defence. The UK has teamed up with Sweden and Italy, to develop a future combat aircraft system, in competition with the Franco-German-Spanish project. Following Brexit, it remains to be seen what kind of access will be granted to the UK based defence industry to initiatives such as the newly established European Defence Fund. Regardless of Brexit, several UK defence companies are quite integrated with their EU counterparts. Meanwhile, the National Technology and Industrial Base (NTIB) is an initiative to reinforce the relationship between the US, the UK, Canada and Australia that was remodelled in 2017. One of the main purposes with the NTIB is to support national security objectives and to increase innovation and integration of technologies. The UK and the US also have some bilateral defence trade cooperation treaties. However, the actual effectiveness of these have been questioned. Nevertheless, the UK has strong and enduring defence industrial ties to the US.

Summary

The European security environment has been challenged by Russia since the invasion of Georgia in 2008, annexation of Crimea and military intervention in eastern

Ukraine in 2014. Consequently, European countries have been focusing in reconstructing their defence and establishing closer cooperation with one another through NATO and the EU as well as bilateral and other multilateral arrangements. However, priorities vary between countries. Besides tensions between Russia and the West, many European countries are also concerned about the developments in Africa and the Middle East as well as tensions with China in East Asia. Furthermore, several countries have been victims of terrorist attacks in the past years and views terrorism as a very real threat.

After the financial crisis in 2008 and the fiscal crisis in 2009, most European countries have experienced a stable recovery, yet recovery was uneven and some countries in southern Europe continued to struggle. Furthermore, international trade tensions and Brexit had begun to slow regional economic growth rates when the coronavirus pandemic hit the continent and pushed it into recession. The Russian economy, for its part, has been on a downward path for years. Falling oil prices following the financial crisis and sanctions from the EU and the US as a result of the annexation of Crimea in 2014 together with a lack of economic reforms, contributed to lagging growth even before the corona pandemic.

Several European countries, among them France and the UK, have expressed a continued desire to increase military spending. However, the long-term defence funding in Europe relies on political priorities and the consequences of Covid-19. The pace and stability of recovery will also have an impact on defence industrial capabilities of the region, both for western European countries and for Russia. While there has been no immediate de-prioritisation of defence, the long-term consequences for military spending and capabilities remain to be seen. ■

