

Case A.2

The UK Defence Industry

Structure–conduct–performance

With the collapse of communism and the ending of the Cold War, defence industries around the world were faced with fundamental changes in their business environment.

A PEST analysis can reveal some of the most important changes. When conducting such an analysis not only are relevant factors identified, but also it is possible to distinguish between strengths and weaknesses. The table below shows a PEST analysis carried out on the UK defence sector.

The most significant threat to this sector has come from political change (i.e. the decline in the perceived external threat) and its economic consequences (i.e. the reduction in defence expenditure). With the ending of the Cold War, military expenditure declined at a rate of 7.2 per cent per annum between 1988 and 1993. [UK military expenditure as a percentage of GDP](#) fell from a peak of 5.2 per cent in 1985 to 3.8 per cent in 1994, to 2.5 per cent in 2007.

With troop commitments in Iraq and Afghanistan, however, and with threats from global terrorism rising and successive governments' commitment to combating it, UK defence expenditure has risen again slightly as a percentage of GDP. In 2009 it had risen to 3.0 per cent, but had fallen back to 2.0 per cent in 2015. [This compares](#) with 3.3 per cent in the USA, 1.8 per cent in Russia, 1.9 per cent in France and 1.2 in China, 1.1 per cent in Germany and 1.0 per cent in Japan.¹

Despite ongoing military commitments, the Coalition government of 2010–15 sought to make substantial cuts in defence expenditure. Following its Strategic Defence and Security Review it decided to reduce defence expenditure to under 2.5 per cent of GDP by 2015 – which it succeeded in doing. Businesses in the UK defence sector have had to respond to this and similar cuts in military expenditure in export markets.

The incoming Conservative government in 2015 pledged to keep defence expenditure to at least 2.0 per cent of GDP for the remainder of the decade.

Response of the defence industry

Businesses within the defence sector have responded to the decline in military expenditure, not only by rationalising their business activities, but, most crucially, by seeking out partners in order to establish collaborative ventures. By pursuing such a strategy, they are able to share the huge research and development (R&D) costs that are associated with products within this sector, and subsequently they spread the risk of new product development.

The development of the Eurofighter Typhoon is in many respects a classic example of this approach. The [Eurofighter](#) ([see also](#)) was developed by the UK, Germany, Italy and Spain in the mid-1990s, with development costs alone amounting to some £35 billion. It came into service in 2003. It is assembled by BAE Systems in Warton, Lancashire, with left wings made in Italy, right wings made in Spain, the central fuselage made in Germany and the remaining parts made in the UK.

Industry analysts suggest that, as technology becomes more expensive, many products, such as Eurofighter, will no longer be feasible for any individual company, or even country,

¹ Figures from the [International Institute for Strategic Studies \(IISS\)](#)

to develop alone. As such the conduct of business will involve working with, rather than against, potential business rivals.

As well as reducing R&D costs, collaborative business ventures also represent a way in which businesses with distinct specialisms can focus their production in these specialist areas and operate within niche markets. For example, British Aerospace has specialised in the production of aircraft wings and GEC in military electronics.

Although collaborative ventures and rising specialisation seem the most likely direction in which the defence industry will develop, there are several alternative strategies that businesses within this sector could adopt. For example, a business might seek to strengthen its market position by merging with or taking over its rivals, either domestically based or overseas. Alternatively, businesses within the defence sector might look to diversify, and locate business activities in non-defence markets. Such a strategy crucially depends upon the ability to transfer technology between different markets, and ultimately between different products.

Even given the structural change of many markets within the defence sector, such markets still remain dominated by relatively few producers, which, given the specialist nature of their business, acts as an effective barrier to new firms entering the market.

In search of maintaining performance (profitability, market share, etc.), companies in the defence sector have had to adjust rapidly in the face of a changing world political situation. Crucially for European producers, the impact of this has been to reduce competition and enhance collaboration – a far safer alternative.

PEST analysis of the UK defence sector

	<i>Strengths</i>	<i>Weaknesses</i>
Political	Industry is a powerful lobby group – ability to influence government	End of the Cold War Cuts in defence spending Lack of long-term government action
Economic	Skilled labour force Specialist service	Economic specialism creates dependency Vulnerable to world economic activity Impact upon regional economy of defence cutbacks such as regional unemployment Costs of restructuring Direction in restructuring: i.e. what markets to locate in
Social	Proactive management culture Union commitment to business	
Technological	High technology base	Need for constant innovation R&D cost

Question

1. In what ways have the defence industries responded to the ending of the Cold War?
2. Using an Internet search, find out how the defence and security industries are responding to the threat of terrorism.