The current economic crisis and its effects in the Defense market

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The purpose of this conference is to explain from my point of view the links about the current economic crisis and its consequences in the defense market and the new global order. Furthermore than the rational consequences of a reduction of public spending, I am trying to find out the long-term effects of this crisis that could be considered as the biggest in the history with more spread effects than any other crisis including 1929.

It is a fact that the world is changing very fast from that world we knew in the last 40 years and the coming scenario will affect to our marketing activities, and how to finance our sales and mainly who will be the decision makers in 2025, a term that is not so far. We are entering in the XXI century with speed match 2.

During centuries the world has been managed political and economically by the big colonialist countries, United States is the big exception, if we could consider United States as not colonialist country. Some figures will show us that at the end of this century the most dynamic part of the world will be what I call the colonized countries, East Asia, Africa and South America will be also the key players at the end of XXI century besides United States and the decadent Europe.

The traditional gap between developed and developing countries will be reduced dramatically in less than twenty years. It is fact that the Western countries will reduce its weight in the world and that all marketing directors in any company will put the commercial targets in areas like Africa, South America.

But also new competitors will come to the market from these countries that are looking for having a bigger share of the cake. Its improvements in competitiveness will produce a stronger growth when the developed countries recover their consumer spending.

Let's see some figures comparing the current situation between developed and developing countries.

The current imbalance of the macroeconomics in developed countries compared with developing countries is shown in this slide, where public deficits and debt/GDP is compared. It is quite evident that what we call emerging market are in much more better situation to face this crisis and to take the leadership of the world economy recovery.

Just taking about the debt crisis and its consequences, if we analyze, the credits ratings of most developing country sovereigns have not been affected by the crisis. In the worst month of debt market (May 2010) the credit rating of five countries (Azerbaijan, Bolivia, Panama and Ukraine) have been upgrade and non developing countries ratings have been downgraded.

The levels of debt are unknown since the end of the Second World War; the G-7 will reach almost the 120% of GDP. Just to restore a certain level of confidence to the markets, the IMF estimates that high-income countries will need to cut government spending (or raise revenues) by 8,8 percent of GDP for a 20 years period in order to bring debt levels down to 60 percent of GDP in 2030.

Coming back to the main idea of the new global order, forecasts show clearly how more than 60% of the growth of the world economy will come from developing countries.

OECD estimates than Euro area will have yearly GDP growth about 0,8% between 2010-2012 and 1,5% between 2012 and 2025. Unites States present a better shape with an estimated growth of 2,3 for 2010-2012 and 2,3% for the period 2012 2025. In order not to bring an excessive optimism, this growth could be based on the stimulus package that is hammering the macroeconomic balance with a bill that should be paid in the coming 20 years.

For the same period, China will grow three times faster, Brazil 2,5, India 3,5, South America 2 and West Africa 4 times faster.

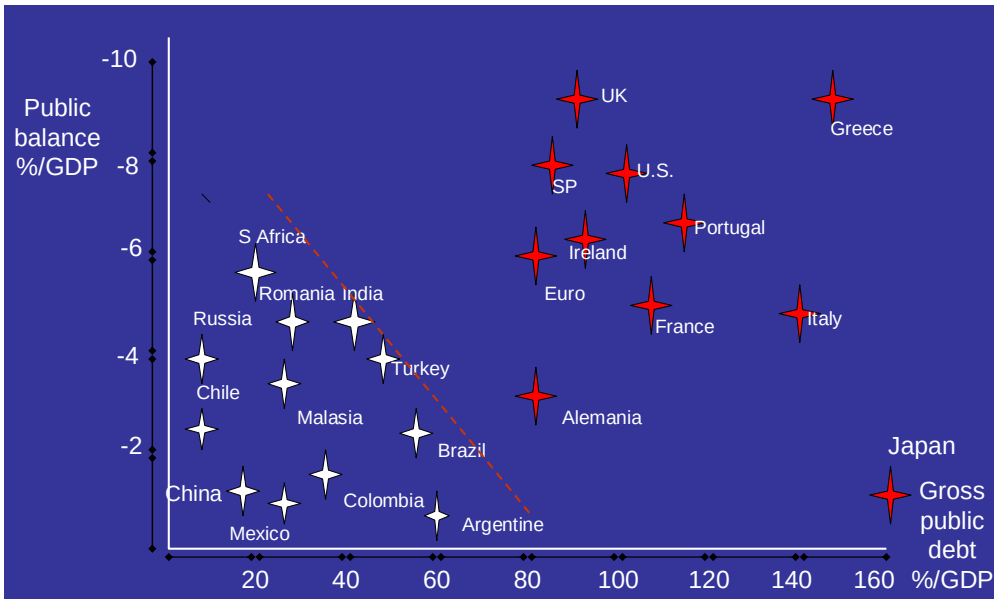
In 2025, in the TOP 10 economies in the world will have China in 2nd position, India 4th position, Russia 7th position and Brazil 9th position, Mexico could be the 10th. This is a very different scenario that we lived since 1945.

What is significant is that it suggests a "rebalancing" of the global economy. The world needs an engine of growth to replace free-spending American and European consumers and their appetite for other countries' exports. Greece's problems are a harbinger; advanced countries can no longer borrow their way to prosperity. Developing countries, especially in Asia, that pursued export-led growth would shift to domestic spending. As I mentioned before, the debt-ridden American and European economies would rely

mainly on exports to developing countries.

It is a fact that China, India, Brazil, and many "emerging market" countries have escaped the worst consequences of this recession. Their economies are growing much faster than ours (almost 6.5 percent annually in 2010 and 2011, compared with a 2.9 percent rate for the United States, as reckons the International Monetary Fund).

The current economy



Bur there are some good news; this fact will boost their demand for the advanced equipment, instruments, and basic industrial supplies (chemicals, coal) that constitute two thirds of U.S. exports. Of Boeing's 3,350-jet backlog, three quarters (77 percent) will go to foreign customers, 70% from developing countries. At least for the coming decades US and European companies will be the suppliers of the equipment for the growth of these economies, and this is a real change for all we are here and for what we have been doing in the past and what we have to do in the future.

Domestic spending is strengthening in these countries, as incomes and tastes expand. In 2002 consumption spending in developing countries was 23 percent of the world total, and the U.S. share was 36 percent. By 2008, developing countries were 32 percent, and the United States 28 percent. In 2025, the US share will be 22% and developing countries 44%.

Developed countries have to face this crisis with some big stones in the path than are affecting also to the deficit levels. These stones produce a distrust atmosphere in the potential growth of the developed

economies and introduce uncertainties in the financial markets.

Considering the starting position in 2011, most of OECD countries are far from macroeconomic equilibrium with large output gaps and deficit higher than 10% of GDP. It is mandatory to reduce these imbalances and just a very severe fiscal policy could be the solution. Public spending should be reducing in OECD area about 10% and to be sustained this reduction for twenty years. From my point of view the social and economic model we knew in since 1945 is dead and governments should reduce their weight in the economy permanently. A real financing reform should be based in the reduction of public spending to less than 40% of GDP in all countries, reducing future tensions for a drastic increase of public deficits in the next crisis like happened in this crisis when we will need thirty years to pay the bill of the stimulus packages implemented in the last three years.

But it should be done when demographics is not helping. The working age population will decrease in Euro area until 2025 at a yearly ratio of -0,1%, with some dramatic cases like East Europe and Russia with ratios of 1% of reduction until 2025. In 2025 the European population will start to decrease and countries like Russia will have 15% less population, some countries in East Europe will face similar rates.

Social policies are also another stones in the path. Spain will devote in 2010 two times more resources to pay a compensation to unemployed that all Public Investment spending; and expectations are that Spain will not reach the average of current unemployment in OECD countries until 2025. A that time Spain still will have two million of unemployed.

Also pensions are another big issue mainly in Europe; in 2050 the rate between working people retired people will be less than one. In 2035 each Spanish worker will devote 1/3 of its output to pay pensions; 1/3 to pay taxes; 1/5 to generate profits and the potential growth and the remaining part, less than 25% will be its compensation.

It is obvious for me that this new environment will produce enormous changes in the strategic panorama and also on the defense market.

Let's consider first which is the starting point in 2010, to analyze alter the effects of current economic scenario in the short and long term.

In year 2009, the defense spending reached its Peak in the history with almost 1,600 billions of US$; United States had a share of 46,5% of the world military spending; Europe had 20%; on the other side China had 6,6%, Russia, 3,5% and India less than 2%.

Also because the current strategic scenario, and particularly because the conflicts in Afghanistan and Iraq, the military spending grew during the global economic crisis, particularly stronger in United States and East Asia.

But forecasts are quite different.

Let's start with the US case. After a sustained period of sizable increases, growth in the DoD budget is expected to slow considerably starting in 2011. Defense discretionary spending is likely to be constrained by built-in budget pressures, both external and internal to the department. Mandatory non-military spending (such as Medicare, Medicaid and Social Security) as well as new administration initiatives, will limit the total amount of budgetary authority given to DoD.

Within the DoD, three principal factors will present continued budgetary challenges. First, the QDR will refocus the department's spending priorities, adding additional requirements as well as questioning current investment strategies. Second, continued cost growth above inflation, particularly in acquisition, manpower and maintenance accounts, will continue to erode DoD discretionary spending. Finally, overseas contingency operations will continue to age equipment, demand new equipment and stress operations accounts. Winners and losers will emerge as procurement spending is prioritized toward the most critical areas, including non-traditional warfare; low-density assets and cyber warfare; and away from large hardware programs associated with traditional operations.

Increases in mandatory spending such as Medicare, Medicaid, Social Security, federal retirements and debt service will limit funding available for the discretionary budget (including defense). Mandatory spending is projected to rise 11% from $2.3 trillion to $3.9 trillion between 2011 and 2015, increasing from 62% to 69% of the federal budget. As a result, the discretionary budget is expected to remain flat $1.4 trillion, compared with the 30% increase of the previous five years. The Congressional Budget Office's projections are for defense spending to decrease from 3.2% of GDP in 2015, to 2.6% of GDP in 2028. Today US military spending is higher than 4,5% of GDP

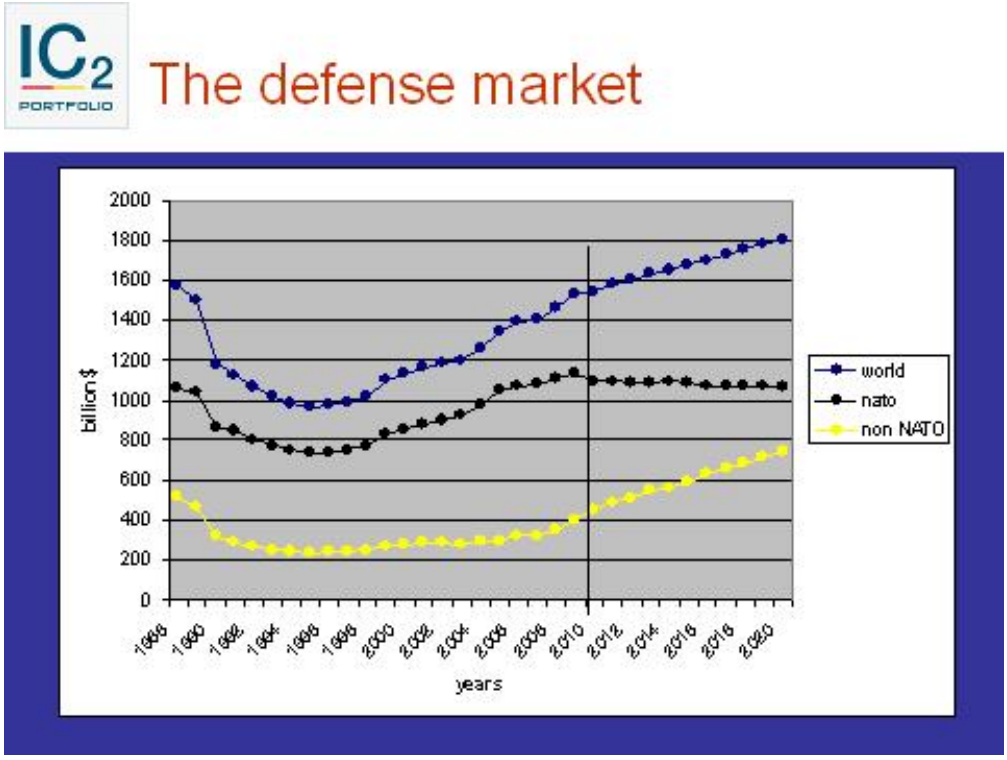
Given the current economic climate and security posture, the baseline defense budget is expected to increase just over 1% per year to $743 billion by 2015, placing tremendous pressure on procurement spending. This projection is in stark contrast to the previous five years, in which the defense budget increased over 6% per year. While there is pressure from Congress and others to eliminate Overseas operations funding, missions in Afghanistan will likely necessitate some form of supplemental funding into the foreseeable future, thereby reducing (but not eliminating) some pressure on the baseline budget.

In addition, supplemental costs of roughly $130 billion to $150 billion (slightly less than the $155 billion spent in 2009) will be transitioned into the baseline defense budget for the first time since 2002. Despite the drawdown of troops in Iraq, the United States is unlikely to receive the expected peace dividend due to an increased presence in Afghanistan and new scenarios will come to the scene. Although troop levels will be far lower, logistics-related spending is expected to increase due to that country's lack of infrastructure and abundance of mountainous geography.

Adding to this pressure manpower costs are increasing. These are driven by both larger personnel bills associated with increased end-strength numbers requested by the armed services, and the fact that troops are expected to experience real increases in pay and benefits above inflation indices. Since 2003, military pay increases have been based on the annual Bureau of Labor Statistics' employment cost index for wages and salaries in private industry, which is expected to exceed the GDP deflator by an average of 1.4% from 2011 to 2015. Out-of-proportion health care cost increases and additional personnel programs to address issues related to long-term conflict will only contribute to the cost of the department's number-one asset: people.

My forecasts for the US market are a real reduction of the defense spending about 5% a year in the coming five years; investment will be cut a 15% and R&D will be reduced at 20% in the coming four years. In five years the demand from DoD to the defense industry will be reduced about 25% from current figures.

It is obvious that this trend is to affect heavily to the defense contractors. Over the past year, defense stocks have taken a beating. In the US, Lockheed Martin shares were down by 40%, while Northrop Grumman has lost almost 40% of its value. In Europe, BAE Systems and Thales have fallen by similar amounts. Defense companies stocks feel in the last 3 years a 40% more than the rest of industrial sector, however the continuous growth of defense spending in this period. Taking into account the future, the situation couldn't be worst.



The picture looks challenging though. The Core US defense Budget will edge towards USD600 billion a year but the supplemental

budget which funds current operations will decline sharply in 2010, as US and other NATO forces winds down in Iraq and wages a more limited campaign in Afghanistan. The total spending on research and new procurement will fall by almost USD100 billion from its 2008 peak by 2010, resulting in a radical shakeup of the sector.

In the 1990s, after the end of cold war, the industry reduced capacity through a wave of mergers, but with so few players left that is not an option in 2010. Then in year 2010 there are no options for restructuring and the defense companies will suffer this specific crisis with big losses that will imply a big reduction of the size of the military sector.

In Europe situation will be worst because during the last 10 years, however the conflicts in Iraq and Afghanistan, the military demand has been reduced in real terms. The Defense expenditure in Europe is in 2010 about 205.000 millions $; (US 700.000 million); forecasts for 2015 estimate a reduction of military spending of 15% in real terms because the fiscal adjustment and also because the pacifism reigning in Europe. Europe will not be more a significant player in the international arena.

From the side of the investment, that has a stronger relation with the defense companies situation is more dramatic. In year 2010, military investments in Europe are 42 bn $US and 200 bn $US in United States. Forecasts for 2015 is a military investment of 32 bn $US in Europe and 150 bn $US in United States.

From the macro economic point of view, this is a necessary reduction because the need to reduce the current economy imbalances. If Europe and United States will not recover soon the economic instability, there will be strong strategic implications because the debt will be in hands of the emerging markets and the social conflicts that could appear in Europe because unemployment and poverty, immigration, nationalism will bring us a worst scenario.

The Arab countries that have been important customers of Western contractors are also suffering the economic crisis. Nowadays the rate of unemployment in Arab countries is close to 20% and almost the 30% of youth in Arab countries is unemployed More than 30 million of people is a very high figure for countries without social protection and big internal conflicts in almost all of them; another bomb for the stability of the world

But let's see what is happening in emerging economies. Defense budget will increase 4 o 5 times faster than Western country budgets. In the same period that NATO countries will reduce their defense budget, China will increase at a rate of 15% a year, India 10%; Brazil 6%; Some other countries with difficult social and political situation will increase also their defense budgets to sustain a non weak strategic position like Middle East, Iran, Caucasus, Russia, Maghreb and South America.

Nuclear proliferation linked to emerge of new military superpowers in countries where there is not enough democracy will bring a big instability in the future. In 2015 at

least more than 5 non-democratic countries will have a nuclear bomb and ballistic missiles; another 10 countries are pursuing some kind of nuclear capacity, like Egypt, Venezuela, Libya, Saudi Arabia.

In 2025, United States will share less than 37% of the world military spending; Europe less than 12%. NATO will have less than 50% of world military spending; China will reach 20%, India 12% and Brazil 8%.

Spain, will have in 2011 the defense budget of 2000 but with non the same costs. In 2025, the Spanish defense budget could be, if it exists, similar to Morocco, and Algeria; situation is the same in many other countries.

From my perspective, the world is to face increasing risks with less means to avoid them; the economic crisis will affect dramatically to defense spending in coming years. In the meantime, emerging economies will grow much faster and all these countries are looking to increase its strategic position with a real conscience of increasing military spending. They understand that the sustainability of the model in the long term is based among others pillars in a strong foreign and defense policy and all of them will look for a stronger defense policy investing more in defense.

It will imply a new global order that most of us will know; this is not fiction science or non real histories; these are facts and what we have to find out is how to face these facts; how to sustain the western values in this new scenario and how industries have to adapt to the new environment in order to survive and provide the means that assure our security and the predominance of Western technology in the world.

Thank you.