Boeing's WTO complaint: The last battle?

For over a decade, Boeing and the U.S. government have considered taking trade action against Airbus, which receives new jetliner development launch aid under the terms of a 1992 bilateral agreement. On October 6, 2004, the U.S. nullified the bilateral and announced that it would initiate a WTO (World Trade Organization) trade action.

The two sides met again in early November but made little progress. If both parties were satisfied that progress was being made, the talks could stretch on almost indefinitely. But if longstanding grievances result in a trade case being brought before the WTO, there is likely to be a protracted battle with a confusing series of claims and counterclaims.

Aid and Airbus's growth

In 1992, the U.S.-EU bilateral Large Civil Aircraft agreement limited direct government aid to one-third of a new jetliner program's development cost. From the U.S. point of view, the agreement was a necessary evil—while the one-third limit sounds high, it was a substantial improvement over the 60% provided by European governments for the A330/340 development program in the 1980s. Any kind of agreeement was also a major step forward, with previous jetliner trade negotiations effectively stopped by U.S. industry, partly for fear of alienating European clients such as Air France and Lufthansa.

Since the 1992 agreement, Airbus has steadily increased its market share. In 2003, the European company outdelivered Boeing in numbers of planes. In 2004, Airbus finally achieved victory in terms of value of deliveries. What is even more significant, as of late 2004, Airbus's firm order backlog was about 50% larger than Boeing's. In effect, seven years after the Boeing/McDonnell Douglas merger, Airbus has won the battle for McDonnell Douglas's jetliner market share.

There are now 3,300 Airbus jets in service worldwide, and the company employs about 50,000 workers. From Boeing's perspective, Airbus is no longer an infant industry in need of protection from outside predators. Rather, European governments are providing a mature company with money for the stated aim of expanding its market share and beating its rival. This effort represents a form of aggressive, managed trade. This was not the environment in which the 1992 agreement was created, and the U.S. has made efforts to renegotiate this pact.

On the face of it, Boeing has a strong case. Public support for a market-leading company appears unjust and predatory. And many of Airbus's defenses against this complaint are relatively weak. While Airbus counters that Boeing receives aid in the form of indirect subsidies, Airbus gets comparable support too.

The European position

European governments are quick to point out that Boeing receives extensive military and NASA contracts for technology development, and that these help strengthen the U.S. company's jetliner market position. Boeing has certainly benefited from this research in the past; work on the B-47 and B-52 bombers, plus the KC-135 tanker, helped create the first Boeing jet transport, the 707. Similarly, some work done for the Air Force CX-HLS transport competition (which resulted in Lockheed's C-5) helped in the design of Boeing's 747.

But the bulk of this work was done in the 1950s and 1960s. Today's military and space research work has far less relevance to the commercial sector (and is far less lucrative). Unless the world decides to start flying blended wing-body jetliners, oblique-wing planes, or other radical new designs, this research is of marginal importance. And in 1999, NASA canceled its High Speed Research program, which funded Boeing's supersonic transport work. This eliminated one of the last potential areas of direct U.S. government funding for jetliner development.

Europe's counter-accusation also ignores the considerable military and space work done by Airbus's parent corporations, work that strengthens their ability to fund Airbus and offer new technologies for jetliner manufacturing. In fact, BAE Systems and EADS frequently cite the technological cross-pollination between their civil and military sides, pointing to the synergies between jetliner and military aircraft work. While it undercuts the Airbus argument, it is an irresistibly compelling message for them to give investors.

In the 1960s, European governments provided 60% of the development costs for the Airbus A330/340 aircraft program.

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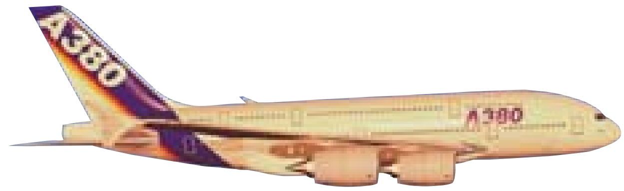
Meanwhile, Airbus now has its own military division, which has a firm contract for the A400M pan-European military airlifter. The A400M should be worth at least $30 billion to Airbus Military. It also offers composite materials technology development work for Airbus, which could be directly relevant to the company's proposed A350 medium market jetliner.

The Europeans have also argued in the past that Boeing's access to Japanese public money serves as an indirect subsidy. This accusation may have some merit, given the important position of the pro-Boeing three prime Heavy Industries in Japan. These industries take advantage of government loans, and would have a more difficult time participating in Boeing development programs if they had to rely on the private sector for cash. But Airbus has also benefited from this aid, albeit to a lesser extent, by placing work in similar subsidized industries in China, South Korea, and even Japan itself.

The question of damages

The strongest part of the U.S. case concerns damages. Boeing alone can show that it has been injured by the other party's aid. Proving damages is key to any trade complaint, and with its serious market share erosion, Boeing has an easy metric for showing the impact of Airbus's government support.

Airbus, by contrast, has shown nothing but progress over the past 10 years, in terms of market share and profitability. With only good news to report, Airbus will find it difficult to launch a counter-complaint. Even Europe's best argument—concerning Japan's public money for new Boeing product development—is effectively meaningless if Airbus cannot explain how this assistance hurt them.



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Unfortunately for Boeing, Europe has one very strong defensive argument that could stop the U.S. complaint from succeeding: At no point in the past decade was Boeing unable to fund a new aircraft. The company's financial situation was quite strong. However, Boeing chose not to spend its ample cash on jetliner development, giving Airbus a strong product advantage and ultimately causing market share erosion. Instead, the money was returned to shareholders.

Boeing Commercial's noncontract R&D budget (what it spends on new commercial jetliner development) has stalled since 777 jetliner development ended in the mid-1990s. Through 2003 it stayed below $800 million annually, enough to develop minor variants of existing aircraft, but far from enough for an all-new design. Predictably, this resulted in a few market failures. The derivative 767-400 failed against the A330-200. The stretched 757-300 simply failed to find a place in the market.

By contrast, Airbus has shown little concern about its investors, and instead has consistently spent heavily on new product development. Over the past three years Airbus has spent over twice Boeing's level, helping it to develop its new 550-seat A380 super jumbo. Government aid is helping to make the A380 happen. But given Boeing's unimpressive new product spending record, there is no guarantee that an equivalent level of U.S. government aid would lead Boeing to spend aggressively on new product development. Airbus's ability to spend heavily could have much to do with its structural insulation from shareholders.

Therefore, Europe can argue that Boeing's damages were self-inflicted. They could even use this example to make the broader political argument that Europe's insulated market economy is superior to the U.S.'s shareholder-driven capitalism, which deprives new technologies and products of development money.

The enforcement issue

After a papal objection to a Soviet government action, Josef Stalin once sarcastically inquired: "How many divisions has the Pope?" The same question could be asked about WTO.

WTO has no enforcement arm. It simply gives successful plaintiff governments the right to retaliate, which could change behavior by the offending party. This retaliation can take direct forms (putting tariffs on Airbus planes imported into the U.S.) or indirect forms (taxing other European imports in an effort to pressure the EU into changing its policies).

Since this trade retaliation would exacerbate existing U.S.-EU trade and political tensions, it could produce a trade war, conceivably leading to a breakdown of the free trade principles embodied by the WTO. If President Bush wants to repair relations with Europe in his second term, this could be an easy place to compromise. In short, with the election out of the way, the administration might not view the Boeing/Airbus issue as important enough for expending a high level of political capital.

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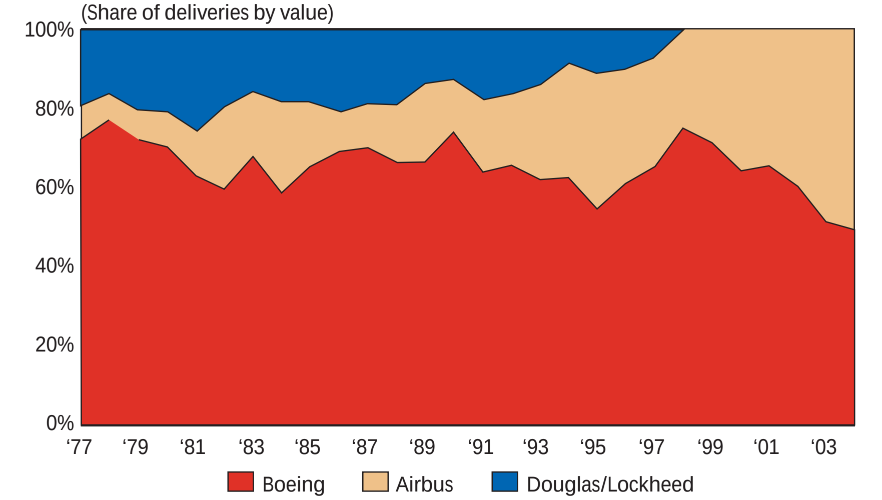
AIRBUS'S DECADE OF GROWTH



As a past precedent for WTO ineffectiveness in aerospace, it is worth considering the example of Brazil's Embraer and Canada's Bombardier, which enjoy a similar duopoly in smaller regional jetliners. The WTO decided that both sides had broken the rules, a finding that gave the two countries the right to retaliate. Yet neither country—aside from extending its own national assistance package to its respective manufacturer—has acted to stop the other country's aid. Changing another country's behavior is difficult, particularly when that country views its national aviation champion as a source of jobs and prestige, and as a great way for politicians to prove they can directly help the economy.

Meanwhile, government aid to industry that is declared illegal by the WTO can be reconfigured into a more palatable form, still producing the same effect. This was well illustrated by the recent WTO ruling on U.S. manufacturing export tax credits. The WTO ruled the tax break illegal, and the U.S. merely gave most of the same companies tax breaks in different forms.

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For Boeing, this status-quo outcome might actually be satisfactory. Many observers have focused on the U.S. election as the likely cause for the Boeing WTO complaint, yet the real catalyst is probably the 7E7, Boeing's new 250-seat long-range jetliner. While commercially launched by an All Nippon order, the 7E7's industrial arrangements have not been firmly put in place. This is partly because Boeing's industrial partners and investors on the project are concerned about a subsidized Airbus competitor. Because Boeing needs about 60% of the 7E7's development costs to come from outside supporters, reassuring partners is a high priority for the company.

Airbus has said it will ask for $1.3 billion in government loans for its A350, now envisioned as an advanced variant of its current A330 that would compete with 7E7. But this might not be enough. To challenge the technologically ambitious 7E7, Airbus might need an all-new plane. The WTO talks might serve as a way of reassuring Boeing's 7E7 partners that European governments will think twice before funding this expensive new aircraft.

Once the 7E7's industrial arrangements and financing have been firmly put in place, Boeing can resume its overdue jetliner market counterattack. The WTO complaint will have served its purpose. And Europe can go back to supporting its national jetliner champion.

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