The collapse of the proposed merger of BAES and EADS has left Britain's largest defence company in the lurch. The proposed deal had a lot of industrial logic about it. The fit between BAES' defence businesses and EADS Airbus business was potentially a world beater. However the deal was finally de-railed by the wish of the French and German governments to retain their beneficial shareholdings in the proposed company. This will not have surprised many observers.

By Nick Watts, Great North News Services

For both BAES and EADS the proposed deal represented unfinished business. A previous attempt to merge Deutsche Aerospace (DASA) and British Aerospace (BAe) failed because the British partners saw the future in defence work, rather than in civil aerospace. The company kept a proportion of shares in the resultant European company EADS but finally sold this off to pay for expansion into the US market.

BAES' bet on the US market has given it a share of the US market, but in an era of declining defence expenditure, even in the US; its position alongside rival contractors begins to look increasingly exposed. The company will come under pressure in the US market, as the pork barrel politics of US defence budgets will seek to exclude the foreign competitor.

BAES' wish to embrace the proposed merger with EADS represents the logical outcome of the UK Government's "buy off the shelf" policy. The company realizes that it will not be able to survive as a stand-alone defence company. The markets now know that the company is for sale and have a good idea of what sort of price is acceptable. Many senior Conservative MPs were unhappy with the proposed merger, but were happy for a deal with a US company. The future of BAES and its UK based workers will therefore be decided not by the UK Government but by the markets.

Arguments about technology exchanges between the UK and the US will not be settled if BAES is finally bought by a US entity. US contractors are, after all, rivals to UK and European contractors around the world. The ITAR rule by which US technology is judged for its sensitivity, operates as a non-tariff barrier. The Saudis want to fit Paveway 4 bombs onto their Typhoons, having seen how they performed over Libya. The US Government is resisting UK efforts to sell this technology to Saudi Arabia, a US ally. This cannot be over security concerns, as US contractors operate in Saudi Arabia.

From the European perspective the tendency for Governments to retain shareholdings in defence companies reflects their wish to retain control of both the technology and the management of these companies. This is often reflected in accusations of political patronage. This would appear to place a limit on the amount of consolidation which will be possible among European defence contractors. The resultant duplication of manufacturing and R & D will ensure that European contractors underperform against their UK and US rivals. Will BAES be in business independently this time next year?