

## War and Macroeconomic Response

**Lawrence R. Klein**

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In the uncomfortable, uncertain environment in which the US economy finds itself, after a year of terrorism and war in Afghanistan, a number of questions are being raised about our economic performance. The economy is not functioning in a normal way at present (Autumn, 2002), and some of the questions that weigh heavily on our minds now are:

- What is the effect of our present military stance on the labor market - our job prospects?
- Will escalation of war in Iraq make matters better or worse at home?
- Is the US economy heading for a prolonged recession with falling (average) prices, as in Japan at this time?
- Will financial markets stabilize soon?
- Will a major program for missile defense prove to be an intolerable economic burden and will it offer the protection being sought?

### **Goodbye PEACE DIVIDEND**

After the end of the Cold War, we entered a decade of extremely rapid and favorable expansion. Even though there was considerable reduction in defense spending and in the size of the military establishment the economy of the US enjoyed a remarkable period of prosperity. From the point of view of economic analysis, the period of the PEACE DIVIDEND showed why simplistic multiplier calculations of changes in government spending and the simultaneous changes in GDP do not, by themselves, show the underlying causal pattern of what is happening in the macroeconomy.

The causal structure is much more complex, and one must take account of other things that are also happening in the economy such as

- The indirect effects from financial markets.
- The changes in technology that are taking place.
- Price movements in interrelated markets.
- International trade flows and foreign exchange fluctuations.
- Leads and lags among many economic magnitudes that govern the dynamics of the economy.

The total economy consists of a very large number of interrelated sectors and variables and not just bivariate relationships between aggregate public spending and aggregate economic activity - surely not a reliable relationship between defense outlays and GDP alone.

For starters, the economic analyst must consider both demand-side effects and supply-side effects associated with significant changes in defense spending. At the same time, a careful and insightful analyst must consider both short-run effects and long-run effects.

To understand how the PEACE DIVIDEND worked its way through the US economy after the Gulf War and how its reversal after the onset of terrorism Gulf War and how its reversal after the onset of terrorism is working its way into economic performance, it is useful to review some policy changes that have taken place.

Persons on active duty in the military fell steadily after 1989, but the rate of decline was reduced during 1990 and 1991 because of the Gulf War activity.

Active Duty in Military and Real Defense Expenditures		
Year	Thousand	\$ Billion
1998	2,130	443
1990	2,069	443
1991	2,003	417
1992	1,808	417
1993	1,705	395
1994	1,611	376
1995	1,518	362
1996	1,996	357

The number continued to fall, but by 2000 had nearly stabilized. Military spending, in constant dollars, was quite high in 1989 and did not fall during the Gulf War, but large decreases started in 1991 and 1992 and were repeated, year after year, until the decreases became quite small after 1996.

It was more than just a pair of declines in total defense spending and the size of the armed forces, it was a mixture of fiscal and monetary policy that seemed to be effective when implemented together in a balanced way. The managed reduction in operative short-term rates, such as the federal funds, was not powerful enough, by itself, to lead to job creation and a vigorous climb out of recession, but a mixed program between monetary policy, aiming at the overnight rate, and fiscal policy which engineered large reductions in defense spending, while holding non-defense spending tightly in line. This felicitous combination of monetary and fiscal policy finally brought down the important longer term interest rates. Financial markets, where longer term rates are determined wanted to see a strong effort at prudent budgeting before they would act to reduce the cost of private borrowing. As a consequence, capital formation took hold after longer term rates responded in recognition of the fiscal conservatism. From that point, the expansion that immediately followed the pump priming effects of joint fiscal and monetary policy took hold, and the expansion fed on its own power. In due course, federal deficits were reduced, eventually to turn into the very remarkable debt reduction. It was not only a move to bring down the deficit, but the unbelievable lowering of the national debt that took place.

Given enough time, given enough indirect effects, the PEACE DIVIDEND really paid off, demonstrating the longer run multiplier effects. Now, however, war is upon us; enlargement of the conflict is distinctly possible but we face the situation in significantly weaker fiscal condition. The environment is quite different and made much worse by lax regulation of private business, which has led to scandalous accounting and cronyism. This has generated the air of uncertainty that pervades our financial markets, as well as the lack of spirit of capital formation.

### **Economic Policy without the Help of a PEACE DIVIDEND**

The US economy had slowed down markedly before the terrorist attacks of 9/11/01. The effect of terrorism, which shows up clearly in surveys of households (University of Michigan Consumer Sentiment; Conference Board Consumer Confidence; and UBS Index of Investor Optimism) has been to introduce some erratic behavior and broader volatility in consumer and investor behavior. It has also opened the way for fiscal policy choices of the public authorities. Before the terrorist attack, there was a move to reduce taxes, even to distribute a rebate to taxpayers, because the fiscal surpluses of federal, state, and local governments seemed to be so large. After the attack, the tax reductions already granted and more to come were interpreted as counter cyclical incentives to

promote consumer spending and possibly business investment. Consumer spending aided and abetted by various generous terms for motor vehicles and other items sustained US economic performance in 2001 and 2002. It was a short-run stimulus package but sub-optimal, in that some of the tax reduction measures were not aimed at citizens who were truly in need of income supplements. The unemployment rate has risen, and many of the longer term unemployed have exhausted benefits; they are in need of help, and their support would have reached further, at this time, in helping the economy to recover.

The new military situation requires that the armed forces and support personnel be augmented. This leads to increased government spending and the enlargement of public deficits. The fiscal year 2002 accounts of the federal government are back to deficit imbalance, in contrast with a surplus in FY2001. State and local governments, across the nation, are also shifting to deficit status. For the immediate future, deficit spending supports the economy, but there is not much long-term capital formation taking place in order to ease future inflationary potential or to bring better living conditions from the supply side of the economy.

The higher level of military spending and tightening of security throughout the nation are supportive of jobs and income flows, but not through productivity gains. The US is still benefiting from carry-over gains in productivity, but these can last only so long. On the supply side, productivity is rising, but not at the pace that was established during the era of the PEACE DIVIDEND.

Obviously, security has first call on our resources, but the kinds of spending that are now taking place are not building for the future. There is small likelihood that increased efforts at providing security, higher costs of a military establishment on a war footing, and the mood of uncertainty will throw the US economy into prolonged deflation, of the sort that Japan has experienced for several years. One cannot rule out future recession, but it does not look now as though we are approaching prolonged deflation.

At the international level, the economy of the US has lost its dominant attractiveness. World investors will not regard the US as the same kind of safe haven that they sought in the summer of 1998. The US dollar has depreciated against some major currencies such as the euro, Swiss franc, the pound, Canadian dollar, Australian dollar, and others. This may eventually lead to a reduced trade deficit, but that has yet to take place. It will not contribute to holding back future tendencies of inflationary effects of the military and security burdens from showing up in higher prices (cost-push inflation).

With respect to the uncertainties that have accompanied the trend decline, with intermittent volatility, in stock markets it is difficult to discern when a dependable bottom has been reached. An extension of the War to Iraq will not improve the judgment of that source of uncertainty. Effectively, we have been witnessing two distinct developments, parallel in time but not in magnitude. The real economy, based on producing, consuming, and working is not in the worst of conditions. It appears to be growing at a modest pace, well under 5%, and shows no sign yet of deviating very much from that path, but financial markets are very subjective and not behaving according to a very predictable pattern.

The project for a missile defense shield, lurks in the background, and remains just a talking point in the absence of a fresh terrorist attack. As in the Cold War preview (Star Wars) it appears to be a wrong headed, but very expensive, use of resources and cannot be expected to be economy friendly, except for some very short-run gains in activity and employment. This subject, of course, is under much more careful investigation as an ECAAR project.

*Lawrence R. Klein, who received the Nobel Prize in Economic Sciences in 1980, is a Trustee of ECAAR and its*

*founding Co-Chair together with Kenneth J. Arrow.*

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<http://www.epsusa.org>