

14. Military Keynesianism

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Capitalism in the Cold War

In the previous lecture we discussed the costs of the Cold War.

But some people thought the Cold War gave capitalism a free lunch.

Without wars and war preparations, they expected, capitalism would fall into depression (Steindl 1952; Baran and Sweezy 1966).

Military Keynesianism:

- Military spending arises from war or threat of war.
- Military spending stimulates aggregate demand **directly** through government spending.
- And **indirectly** through multiplier effects on private consumption and investment.
- Without the stimulus, capital and labour would remain unemployed.
- Summary (1): market economies rely on war or threat of war for prosperity.
- Summary (2): war capacity is a **free lunch** that will be eaten, not because we are hungry, but because no one has to pick up the bill.

Steindl and others argued this was specific to capitalism: without a coordinating mechanism between households and firms, the economy could fall into depression, with war or threat of war the only way out.

Capitalism in the Cold War

How can we tell? No one, Keynesian or otherwise, disputes that government spending can create employment in the army and in the industries that supply the army.

The core issue:

- Does military spending have an opportunity cost?
- Or, when the government spends on defence, do non-defence investment, consumption, and employment in market economies rise or fall as a result?

If they rise, opportunity cost of defence spending is zero, so military-Keynesianism wins.

If they fall, defence spending has an opportunity cost.

Two questions:

- Is the case for military Keynesianism internally consistent?
- Is the case consistent with external evidence from history?

Internal consistency: Macro 101

A fiscal stimulus **raises aggregate demand** when output is depressed:

Assumptions: Basic Keynes (closed economy, fixed prices or unlimited supply).

$\Delta(G - T) \rightarrow \Delta Y$ (impact effect)

$\rightarrow \Delta C$ (multiplier effect)

$\rightarrow \Delta \textit{employment}$.

In this view, military spending can **sufficiently** cure a depression.

However, is **military** spending necessary for a fiscal stimulus?

- No: any kind of spending increase or tax cut will do.

Is a **fiscal** stimulus necessary?

- No: a monetary stimulus can also work.
- Unless we are already at zero lower bound (ZLB) of interest rates.

Is a **policy** stimulus necessary?

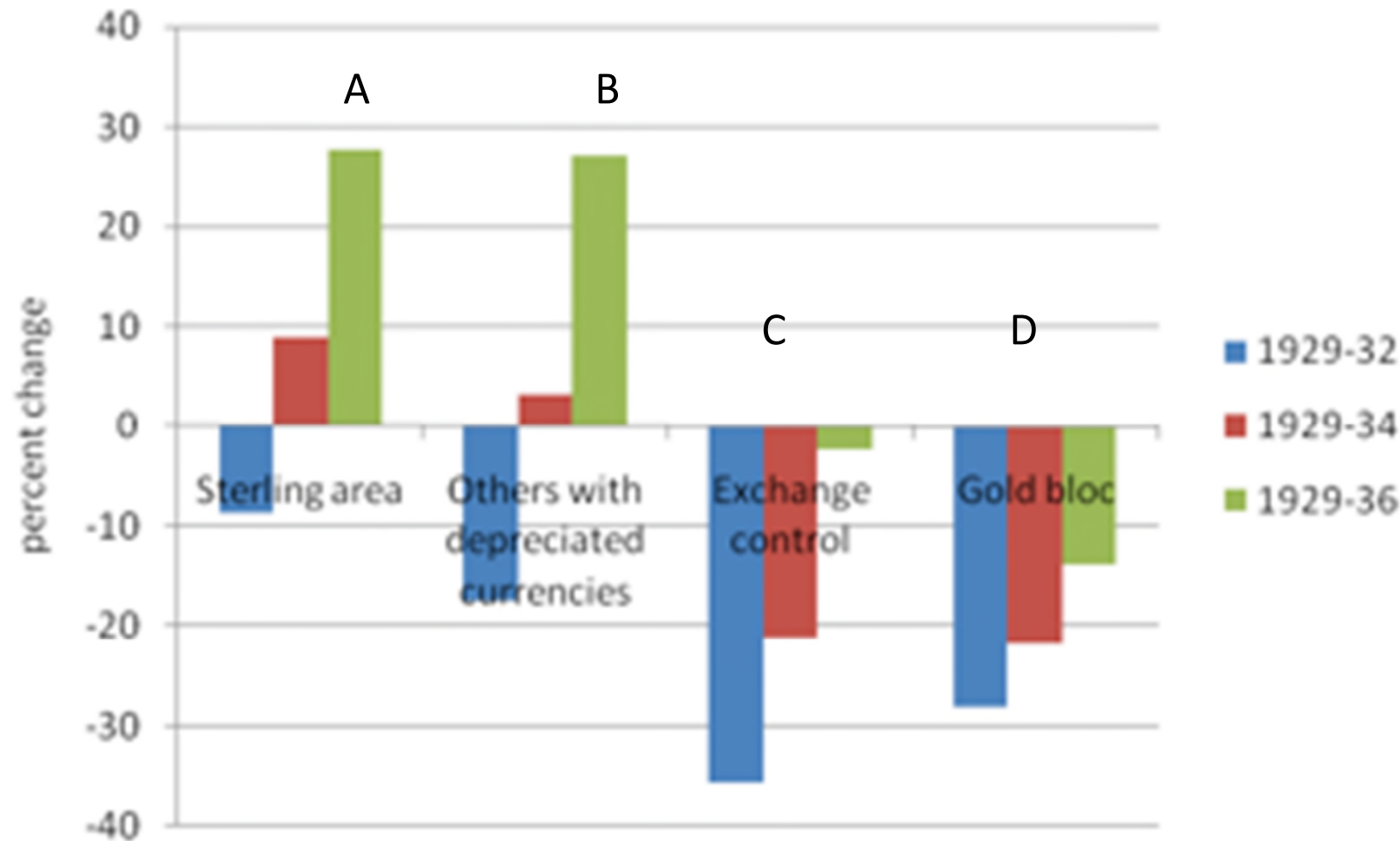
- Animal spirits will recover eventually and can have same effect as fiscal stimulus.

Implication: military Keynesianism is not ruled out, but military spending is not the only way out of a recession.

Internal consistency: Macro 101

Military Keynesianism is not ruled out, but military spending is not the only way out of a recession.

In an open economy, there are still **other ways** out of a recession.



Evidence from industrial production in the Great Depression (Eichengreen and Irwin 2009):

- (A) and (B) Countries that **allowed their currencies to depreciate** recovered most rapidly.
- (C) and (D) Countries that **defended a fixed gold exchange rate** suffered more; those that suffered most turned to exchange controls and import quotas.

Internal consistency: Macro 201

A military spending stimulus may not be **necessary** to counter a depression. Is it **sufficient**?

New-Keynesian assumptions: households are forward looking, maintain Ricardian equivalence, and calibrate consumption to permanent, not current income.

- No one is fooled by a fiscal stimulus.
- There is no multiplier.

A fiscal stimulus **redistributes aggregate demand** over time.

How does a fiscal stimulus work?

- By changing **inflation expectations**.

$\Delta(G - T) \rightarrow \Delta\pi^e$ (inflation effect)

→ $\Delta r < 0$ (Fisher effect | works even at ZLB)

→ ΔC (households shift consumption from future to present)

→ Δ *employment*.

Implication: military Keynesianism is not ruled out, but a defence spending stimulus works to counter a depression, if at all, only by raising inflation expectations, not by a mechanical multiplier process.

Internal consistency: Macro 301

A military spending stimulus may not be **necessary** to counter a depression. Is it **sufficient**?

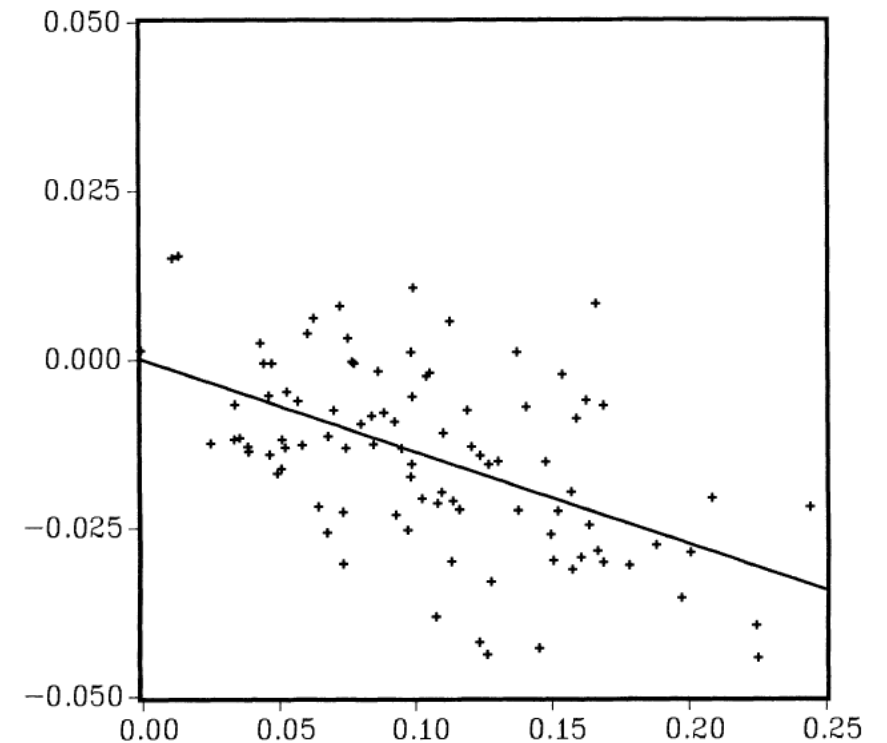
Not in the long run, if high government spending is **damaging to growth**.

Assumptions: Lucas critique (rational expectations, fiscal stimulus works only when unused and so unanticipated).

There is a huge literature which does not all point in one direction, and this is not a representative sample:

- Evidence on growth (based on Barro 1991): The figure shows the partial association between GDP/head growth (vertical axis) and government outlays exc. education and defence (horizontal axis) for 98 countries, 1960 to 1985; controlling for GDP/head in 1960, primary and secondary school enrolment, two measures of political instability, and a measure of market distortion).
- Evidence on fiscal consolidation (based on Alesina, Favero, and Giavazzi 2012): Supply recovers from recession faster when fiscal consolidation is based on expenditure cuts rather than tax increases.

Implication: military Keynesianism is not ruled out, but perhaps it should be ranked bottom of the list of potential remedies for a depression.



Internal consistency: Political Economy 301

A counter-argument: might the threat of war be **necessary** to counter a recession?

- Peacetime restraints on fiscal policy might be overcome only in an atmosphere of crisis and mobilization.

Paul Krugman and Kenneth Rogoff (on “Fareed Zakaria GPS,” CNN, 14 August 2011):

Krugman: “If we discovered that, you know, space aliens were planning to attack and we needed a massive buildup to counter the space alien threat and really inflation and budget deficits took secondary place to that, this slump would be over in 18 months. And then if we discovered, oops, we made a mistake, there aren't any aliens, we'd be better –”

Rogoff: “We need Orson Welles, is what you're saying.”*

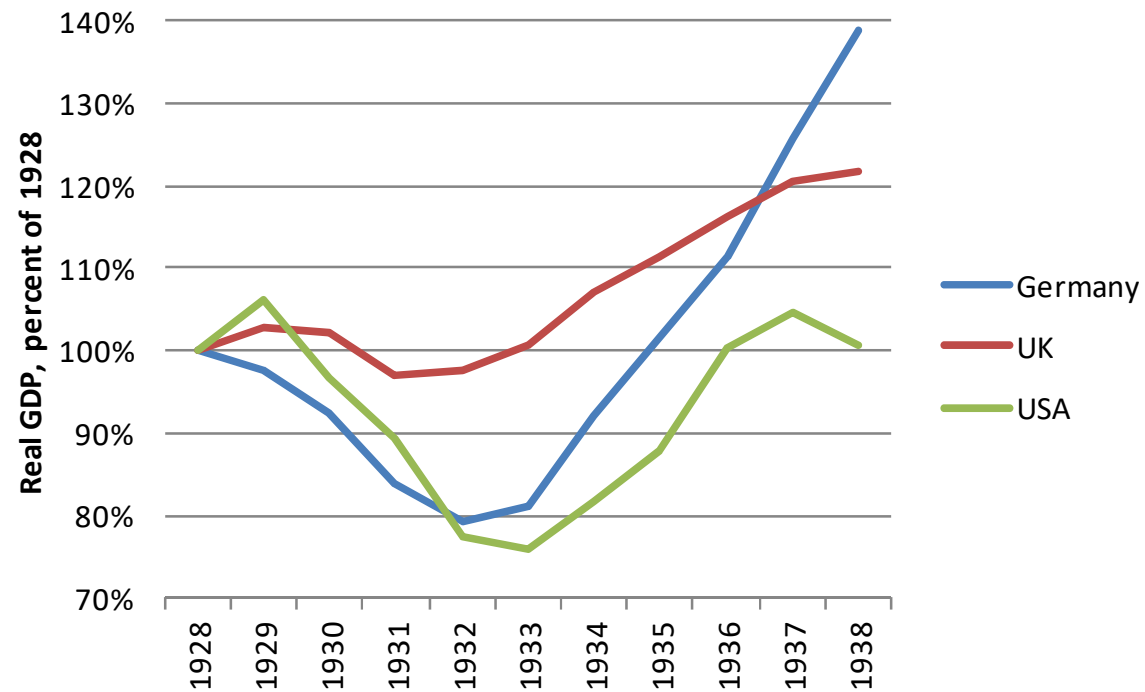
Krugman: “There was a ‘Twilight Zone’ episode like this in which scientists fake an alien threat in order to achieve world peace. Well, this time, we don't need it, we need it in order to get some fiscal stimulus.”

Question: Should defence spending be decided by the need to **spook the public**, or by **defence considerations**?

- (And, if the latter, is it **in fact** decided by defence considerations? Discussed in last two lectures).

* This refers to the role of Orson Welles in the 1938 radio broadcast of a dramatization of *The War of the Worlds*, by H. G. Wells, which led some listeners to believe that America was being invaded by Martians.

Recovering from the Great Depression: Germany



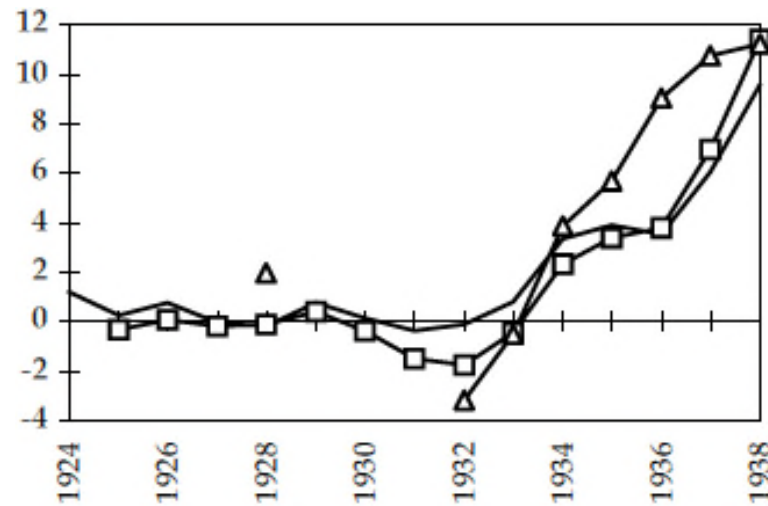
Germany, according to Joan Robinson (1972:8): “Hitler had already found **how to cure unemployment** before Keynes had finished explaining why it occurred.”

Really?

- The German depression was particularly sharp.
- So was the German recovery.
- Which began from 1932, **before** Hitler took power.

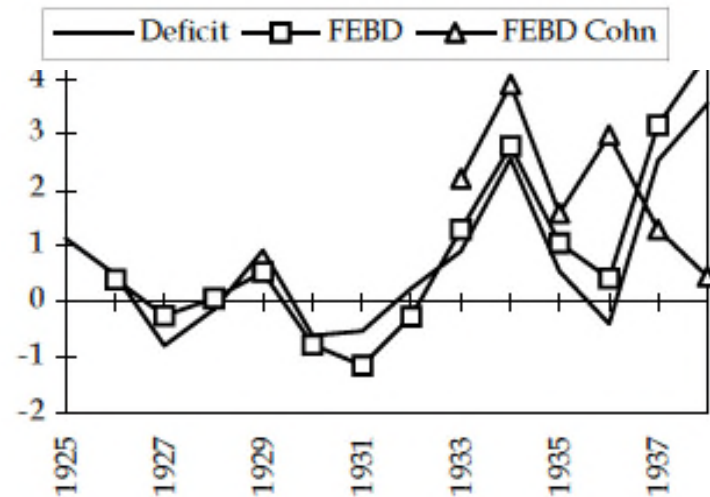
Source: Germany from Klein (1959: 253); UK and USA from Angus Maddison at ggdc.net/maddison.

Recovering from the Great Depression: Germany



Ritschl (2002) fixes longstanding data issues (secret budgets began in 1920s under reparations and expanded in early 1930s; deficit finance and debt payments counted as regular revenues and outlays; transactions smoothed between fiscal years), and compares previous best estimate by Cohn (1992).

- The diagrams show actual and full-employment budget deficits (FEBD) in RM billion (German GDP was RM 90.8 billion in 1928). Upper diagram shows deficit and FEBD in levels; lower shows first differences, $d\text{Deficit}$ and $\text{FI} = d\text{FEBD}$. “FEBD Cohn” refers to Cohn (1992).



Ritschl’s conclusions:

- **Fiscal stimulus was modest** until 1937: FEBD did not become substantial until 1937; FI followed an erratic path and was largely withdrawn in 1935 and 1936).
- **Multiplier effects not identified** with any confidence: household consumption was unresponsive to current income (short-run MPC = 0.3 to 0.4); from 1935, consumption was repressed to make room for public investment and rearmament).

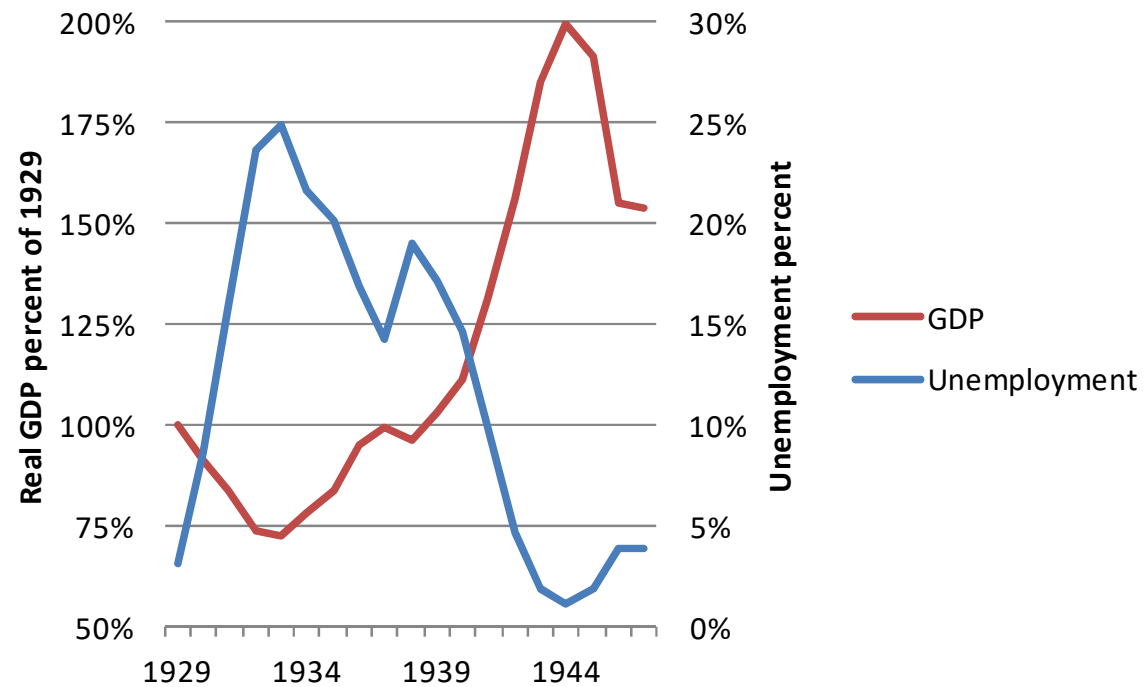
Recovering from the Great Depression: Worldwide

The recession after the recent global financial crisis has promoted new economic history research: Was fiscal stimulus was productive when the economy was depressed or interest rates at ZLB?

- Using data across twenty countries for 1920 to 1929, Martineau and Smith (2012) look for evidence of output responses to fiscal policy, using the variation in fiscal reaction functions (counter-cyclical in some, passive in others) and find “**little evidence.**”
- Using quarterly British data for GDP and “defence news” from 1920 to 1938 Crafts and Mills (2012) find **government spending multipliers from 0.3 to 0.9**, even with interest rates at ZLB.
- Using U.S. data from 1919 to 1953, Gordon and Krenn (2010) find government multipliers were **larger (1.8) before mid-1941** (when the U.S. economy was depressed) than after (less than 1).
- Using quarterly data for unemployment, GDP, and “defence news” in the U.S. (1890 to 2010) and Canada (1921 to 2011), Owyang, Ramey, and Zubairy (2013) find **U.S. government multipliers are 0.7 to 0.9** and do not increase when the economy is depressed; Canadian multipliers are 1.6 under high unemployment and 0.4 at full employment.

Was War Good for America?

Did World War II save America from the Great Depression?



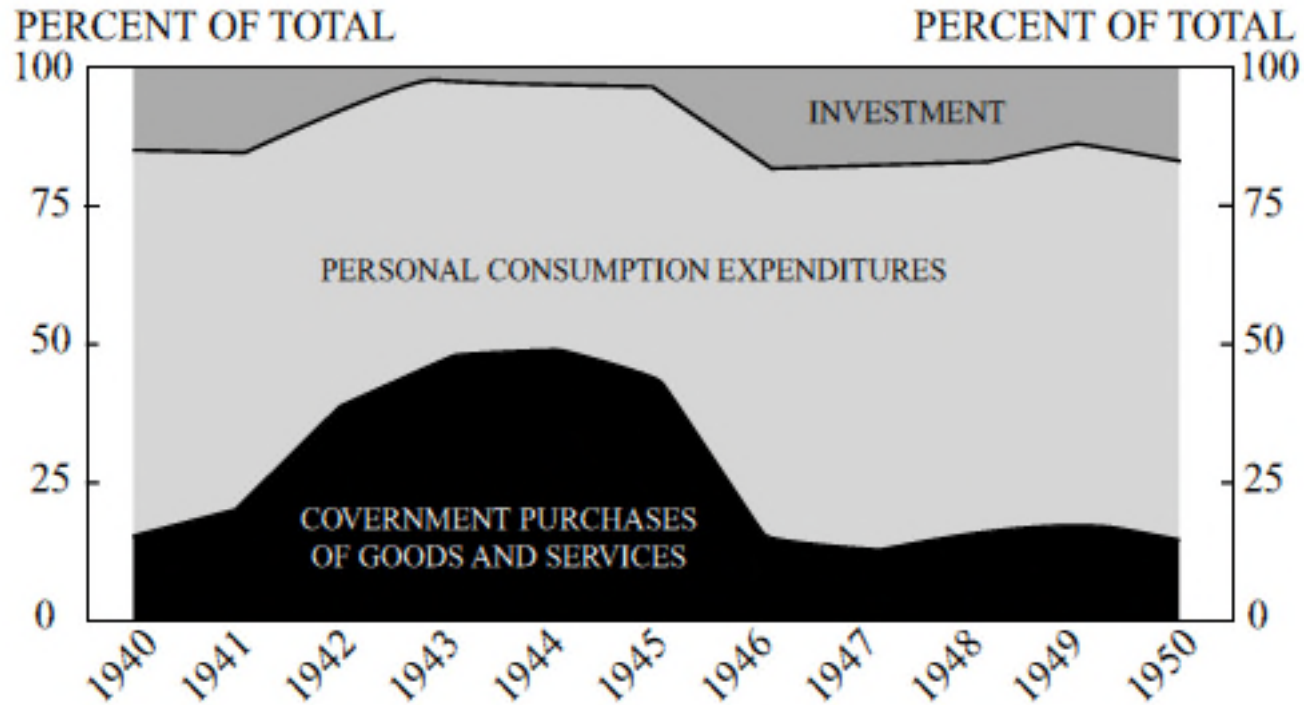
- No: for the 1930s, main driver of the U.S. recovery was private investment.
- First year that federal outlays on national defence exceeded 2 percent of GDP was 1940 (Rockoff 1996, p. 83).

Source: GDP from Angus Maddison at ggdc.net/maddison; unemployment from U.S. Bureau of the Census.

Was War Good for America?

Next question: Was World War II good for America's private sector?

Shares of U.S. GDP:



Source: Field (2008).

- Not good for American investment and consumption.

Was War Good for America?

Next question: Did World War II lay foundations for postwar US prosperity?

Field (2008): Wartime mobilization created positive and negative shocks.

Positive shocks:

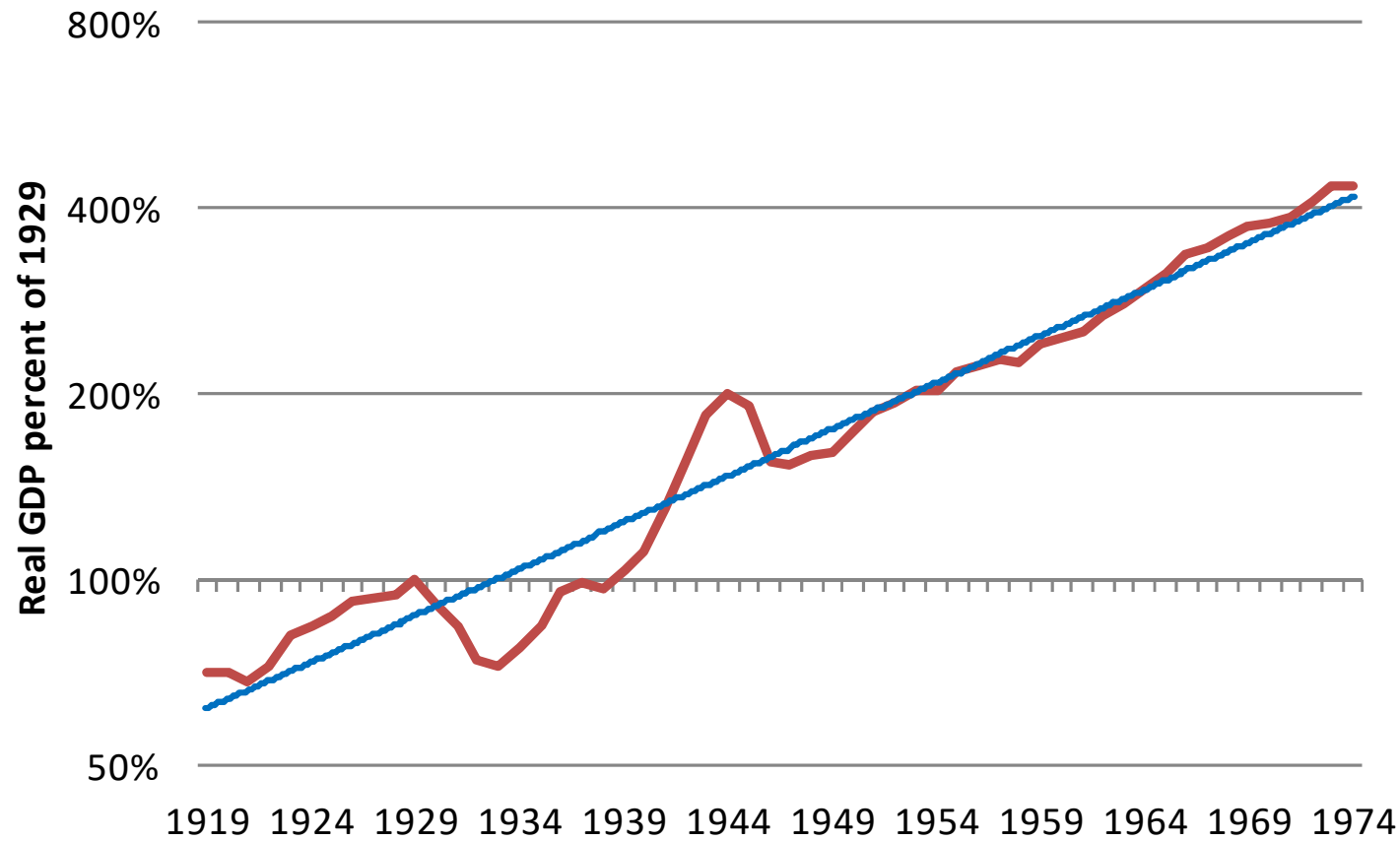
- Mass production of airframes, ships, engines, pharmaceuticals, chemicals.
- Learning by doing, productivity gains.
- Millions of citizens improved their lives by moving North from South and Mid-West.

Negative shocks:

- Mobilization and demobilization incurred direct cost.
- Productivity gains were transitory.
- Investment and consumption were squeezed.

Was War Good for America?

Next question: Did World War II lay the foundations of postwar U.S. prosperity?



- The positive shock of war does not look very persistent.

Source: US GDP from Angus Maddison at ggdc.net/maddison/.

Was War Good for America?

Next question: Did World War II lay the foundations of postwar U.S. prosperity?

	<i>TFP</i>	<i>Output/hour</i>
1919–29	2.02	2.27
1929–41	2.31	2.35
1941–8	1.29	1.71
1948–73	1.90	2.88
1973–89	0.34	1.34
1989–2000	0.78	1.92

Source: Field (2008). Figures are annual growth rates; coverage is the private non-farm economy.

Was War Good for America?

Now turn the question round: was peace bad for America?

Baran and Sweezy (1966: 153):

“If military spending were reduced once again to pre-Second World War proportions, the nation’s economy would return to a state of profound depression.”

For the years 1944 to 1947, **we don’t need a counterfactual**.

- US military outlays fell by 37 percent of GDP, but 3.9 million civilian jobs were created (Rockoff 1998, pp. 83, 101).

External validity: Germany.

- German military outlays fell from 70 percent of GDP to near zero, but civilian output of West Germany in 1947 was already 30 percent above 1943 (combining percentages from Harrison 1998 and Maddison 2010).

OK . . . then, how did military spending evolve as the Cold War developed?

Capitalism in the Cold War

If capitalist economies risk falling into depression because consumption fails to grow as fast as output per head, and if the solution is rising defence outlays, we'd expect the defence share in GNP to rise as GNP/head grows.

Military spending over time, percent of GDP:

	1870 to 1913	1920 to 1938	1960	1970	1979
USA	0.7	1.2	8.9	7.9	5.2
UK	2.6	3.0	6.5	4.8	4.8
France	3.7	4.3	6.3	4.2	3.9
Germany/West Germany	2.6	3.3	4.0	3.5	3.2

Sources: 1870-1913 and 1920-1938 from Eloranta and Harrison (2010); postwar years from Murdoch and Sandler (1984).

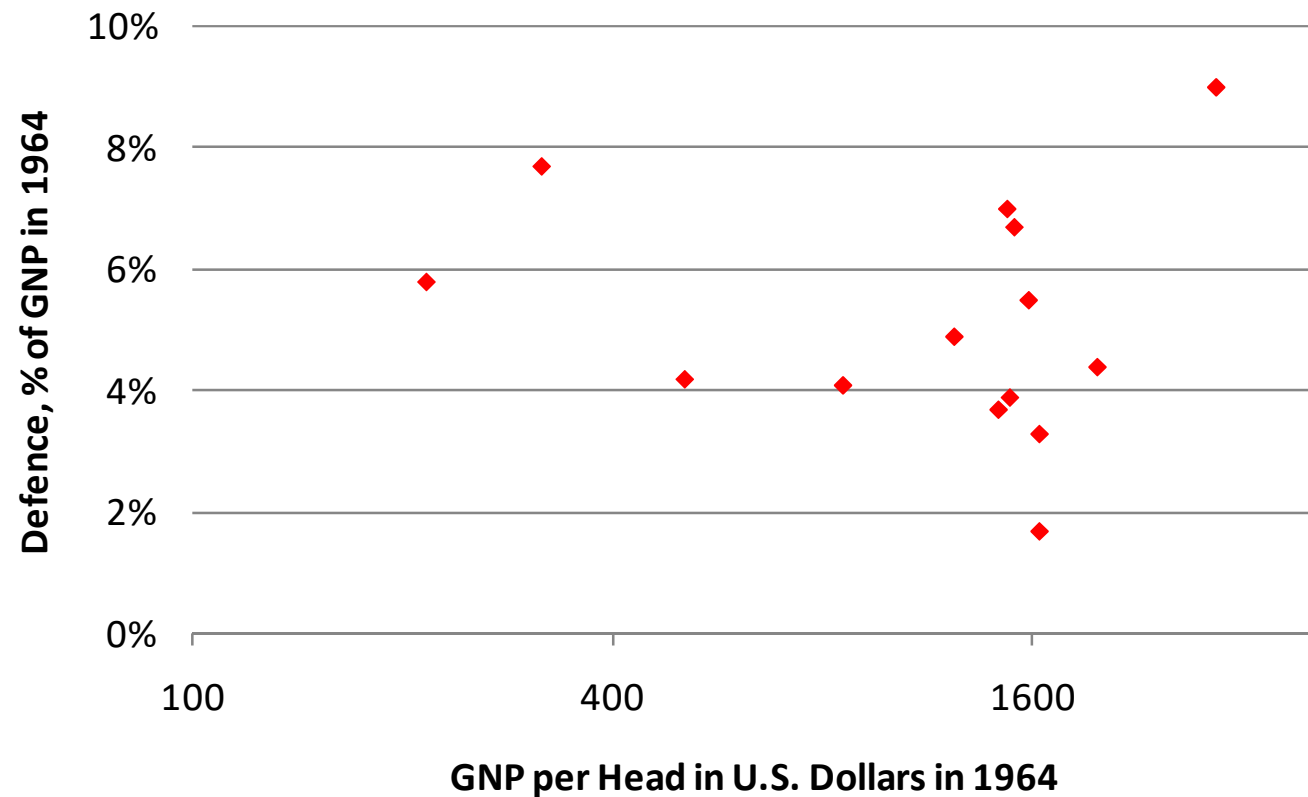
- During the Cold War, NATO military spending, percent of GDP, was much higher than before 1939 or 1914.
- Suggesting that military spending might have been a source of stimulus.
- But within the Cold War, while the market economies became increasingly prosperous, their defence shares tended to **decline**.

Capitalism in the Cold War

If capitalist economies risk falling into depression because consumption fails to grow as fast as output per head, and if the solution is rising defence outlays, we'd expect the defence share to rise as GNP per head grows.

Military spending of 15 NATO countries in 1964 in cross-section from Olson and Zeckhauser (1966).

- Oops.

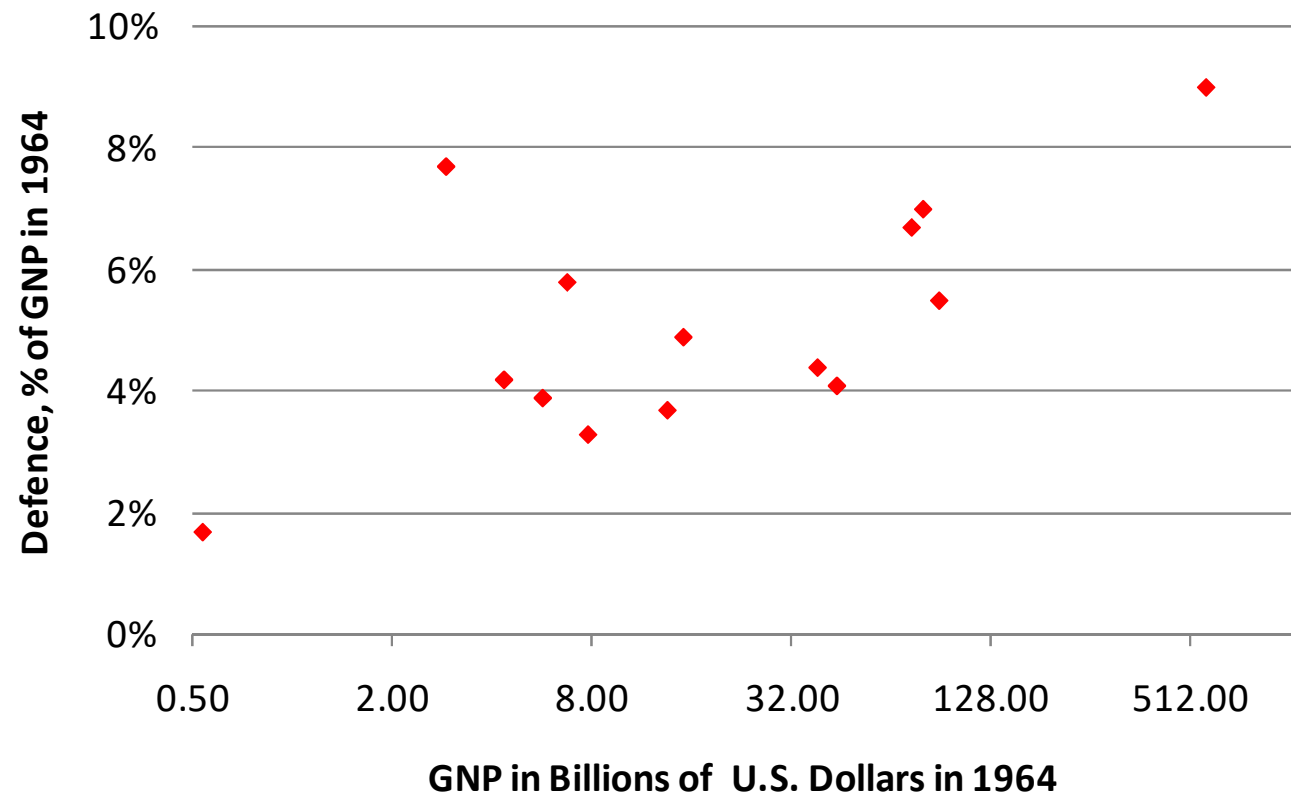


Capitalism in the Cold War

If capitalist economies risk falling into depression because consumption fails to grow as fast as output per head, and if the solution is rising defence outlays, we'd expect the defence share to rise as GNP per head grows.

Military spending of 15 NATO countries in 1964 in cross-section from Olson and Zeckhauser (1966).

- There is a relationship between military spending and income . . .
- But it is between the defence share and **total** GNP, not GNP per head.
- Suggesting **size** matters, not deficient demand (Smith 1977).
- And introducing our **next lecture**.



What We Have Learned

- Military Keynesianism rests on the idea that military spending is required to boost private spending.
- Modern macro presents no clear theoretical support.
- The German recovery from the Great Depression started before Hitler came to power and its continuation cannot be clearly attributed to the fiscal stimulus of Nazi rearmament policies.
- From other countries, there is no clear evidence from the interwar period that multipliers were large enough for fiscal policy to have contributed much to recovery.
- For the U.S. economy, World War II resulted in an extraordinary war boom but consumption was squeezed and productivity growth was slower than in the depressed 1930s.
- No evidence that military spending averted a new Great Depression after World War II, and some evidence to the contrary.

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