THE EFFECT OF ENDING HOSTILITIES ON OUTPUT AND EMPLOYMENT

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Keywords: unemployment, demand, labor force, recession, surplus, deficit, Keynesian

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Summary

Since periods of hostilities are associated with rapid economic expansion, some have concluded that the only form of politically acceptable Keynesian spending policies is what might be termed "military Keynesianism". By exploring the history of the U.S. economy, especially since World War II, this paper indicates that military Keynesianism is not a necessary condition for producing a prosperous growing national economy.

1. Introduction

Peace is usually considered socially desirable. Yet, the historical record indicates that the ending of hostilities can cause severe economic problems in the form of a significant increase in the rate of unemployment and a downturn in national production even for the victorious nations.

One of the most cited economic homilies is that after the end of every war, the cessation of hostilities produces a major recession. The main rationale for this view is that during a period of war, governments borrow heavily in the financial markets in order to finance the cost of hostilities in terms of men under arms and materials. During the war, governments spend as much as possible on munitions and armaments—sometimes up to approximately half of the Gross National Product—to support the expanded armed forces. In so doing, the economy rapidly approaches full employment as demand expands while the available civilian labor force shrinks as able-bodied young people are absorbed into the Armed Forces.

Once the hostilities are over, government spending quickly returns to its peace-time spending pattern thereby depressing aggregate demand, while simultaneously reducing the size of the armed forces and thereby substantially increasing the available civilian labor force. With the demand for labor contracting and the supply of labor in the market place expanding rapidly, a significant increase in unemployment seems inevitable.

2. The Early 1900s

In 1917, just before the United States entry into the First World War, the total federal debt was $3 billion. By the end of 1919 the total federal debt had ballooned to $25.5 billion, an increase of over $22 billion spent primarily on the war effort and subsequent demobilization. In 1920 the U.S. government ran a surplus of almost $291 million as federal government expenditures, which had reached a peak of $18.5 billion, fell to $6.4 billion in 1920. As government expenditures continued to decline during the 1920s, the federal government's surplus increased every year reaching a peak of $1.2 billion in 1927. Although the surplus each year after 1927 diminished, the U.S. government did not run an annual deficit again until 1931 when the deficit was $462 million. The total outstanding federal debt that had peaked in 1919 at $25.5 billion declined throughout the roaring twenties to a low of $16.2 billion in 1930.

In 1918 the Armed Forces totaled 2 897 167 persons but by 1920 the number of military personnel on active duty had declined to 343 342. (Earlier, during the Spanish-American war, the Armed Forces had increased from 43 000 to 235 000 between 1897 and 1898. By 1899 the armed forces had been cut to 100 000.) By 1929 this number had shrunk to 255 031. Less government deficit spending after 1919 should have eased conditions in financial markets but the newly created Federal Reserve maintained a high interest rate policy to fight inflation. Consumer prices, which had risen on average by less than 1% a year since the Spanish-American war at the turn of the century, began to escalate in 1917. Even with the cessation of hostilities, prices continued to rise. By 1920 the consumer price index was 58% greater than it was in 1917. With the severe recession of 1920-22, consumer prices dropped by over 16% from 1920 to 1922 and then stabilized throughout the rest of the 1920s. To fight the inflation of the 1917-20 period, however, the Federal Reserve had raised its discount rate from 4% in 1918 to as high as 7% in 1920 and 1921. These relatively high interest rates in the period after the end of hostilities depressed private investment spending.

Even with low interest rates after the cessation of hostilities, private spending would find it difficult to expand quickly enough to pick up the slack left by the tremendous reduction in aggregate demand caused by the reduction in wartime deficit-financed government spending. With the high interest rate policy of the Federal Reserve, the lack of sufficient increase in private spending was exacerbated. Finally, even the export sector was depressed after the end of World War I as exports dropped precipitously after the war from a high of $10.7 billion in 1919 to $5 billion in 1922.

The result was a substantial recession and significant increase in the rate of unemployment. Gross National Product decreased by 3.5% in 1919, and by an additional 4.3% in 1920, and 8.6% in 1921. The unemployment rate increased from 1.4% in 1918 to 11.7% by 1921.

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Biographical Sketch

Paul Davidson is currently Editor of the *Journal of Post-Keynesian Economics* and Professor Emeritus at the University of Tennessee. Previous positions include: Professorships at Rutgers University, University of Pennsylvania, visiting positions at Bristol University and Cambridge University, visiting professor, University of Nice and Latapsis Research Institute, professor, international summer school, Centro di Studi Economici Avanzati (Trieste), visiting professor, University of Strasbourg (France), visiting professor, Institute for Advanced Studies (Vienna), and Assistant Director of the Economics Division of the Continental Oil Company. The author has also been a member of the Brookings Economic Panel as well as a consultant to the Canadian Government, the Central Bank of Ecuador, the Central Bank of Venezuela, Resources of the Future, Western Union. Energy Policy Project (Ford Foundation), National Board of Advisors, Public Interest Economics Center, Senior Visitor, Bank of England, Board of Editors, *The Energy Journal* (Journal of the International Association of Energy Economists), Interamerican Institute of Capital Markets, Central Bank of Uruguay, Chase Econometrics Associates, State of Alabama, New York State Consumer Protection Agency, Federal Trade Commission, Joint Economic Committee (U.S. Congress).

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