Commentary

Financial Lessons From 1946

Jason E. Taylor 06.09.10, 2:20 PM ET

Over the past two years nations around the world have engaged in the most stimulative fiscal policies ever seen, at least outside of wartime. Greece, the U.S., India and the United Kingdom, among others, currently have government deficits above 10% of GDP. The average deficit for all Organisation for Economic Cooperation and Development (OECD) countries is a staggering 8.2% of GDP. Of course, this is the classic "Keynesian" response to an economic downturn--when demand from the private sector falters, government must fill the gap to keep the economy from collapse.

Historically, the notion that massive deficits, such as those we've seen over the past two years, could help bring an economy back to full employment drew upon the experiences of the Great Depression and Second World War. Economies returned to full employment only after massive wartime deficits were deployed. To illustrate, in the U.S. deficits ranged between 21% and 27% of GDP between 1943 and 1945 (doubling the deficit-to-GDP ratio experienced today) and unemployment fell from around 14% in 1939 to around 2% during wartime.

But does the economic experience of World War II really provide evidence in favor of Keynesian fiscal policy? In a paper published in the June 2010 issue of the *Cato Policy Report*, Richard Vedder of Ohio University and I argue that the true economic lesson from the era lies in the experience of 1946, the year the wartime economic "stimulus" was dramatically unwound.

Keynesian economists of the day argued forcefully that if the government disbanded the army and stopped producing armaments, unemployment would rise back to Depression-era levels. Despite these protests, the government sent most soldiers home, canceled war contracts and removed wartime economic controls. Forecasts of economic Armageddon followed. In September 1945 forecasters predicted that the U.S. unemployment rate would rise to anywhere between 12% and 35%.

Despite these warnings government spending fell from $84 billion in 1945 to under $30 billion by 1946, and by 1947 the U.S. was running a budget surplus of close to 6% of GDP to pay off the debt it had accrued during the war. It was the "Great De-stimulus"--the largest and fastest turnaround from deficit to surplus in history. And here's the kicker: Despite widespread predictions to the contrary, unemployment remained under 4.5% between 1945 and 1948.

How did this happen? Labor markets adjusted quickly and efficiently once they were finally unfettered. Most economists today acknowledge that constant intervention during the 1930s, particularly on wages, extended the length and depth of the Great Depression. Certainly the employment situation in the postwar era was aided when some wartime workers voluntarily withdrew from the labor force and went back to school or to their prewar roles as housewives. But still, the data show that despite the huge withdrawal of government stimulus from the economy, civilian employment *grew* by over 4 million between 1945 and 1947 at a time when Keynesian models forecast that it would drop like a stone.

The irony is that just three short years ago, Keynesian fiscal policy was considered an intellectual dead end. History (via a substantial body of empirical research) has shown that fiscal stimuli are a largely ineffective tonic for an ailing economy. If the lesson had not been fully learned by the 1990s, the experience of Japan during its "lost decade," when large deficits and massive government intervention lead to stagnation, seemed to throw dirt on the Keynesian corpse. The tombstone was then etched by Bill Clinton's Secretary of Treasury, Robert Rubin, who turned Keynesian economics on its head by claiming that surpluses, not deficits, stimulate the economy by keeping interest rates low.

Economists have long asserted that Keynesian fiscal policy is ineffective at creating jobs or boosting GDP because deficit spending "crowds out" private sector spending by eating up resources that would otherwise have been available. There simply are no free lunches. Of course, the counter to that is that the withdrawal of the government's fiscal shadow likewise need not mean job losses or lower GDP.

With deficit-reducing austerity measures currently being implemented across Europe--and at least under discussion in the U.S.--the lessons of 1946 provide some measure of comfort.

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