The Mother of All Sequesters: Fiscal Policy in the 1940s

• In the early 1940s, war-driven deficit spending and loose monetary policy lifted the economy out of the Depression.

• One of the most interesting economic aspects of this period was that growth continued despite a massive withdrawal of fiscal stimulus in 1945 and 1946.

• Using today’s terminology, the sizeable reduction in government spending could be described as “the mother of all sequesters.”

• That the economy boomed after World War II may be due to a delayed reaction to government fiscal policy.

• Another strong possibility is that the recovery of the 1940s was driven by circumstances unique to the time.

• This last idea is worth contemplating as, perhaps mistakenly, we wait for Washington, Berlin or Beijing to determine our future growth trajectory rather than imagine a recovery stemming from circumstances unique to present times.

An Economy Lit by Fire

The Depression of the 1930s stands out for its severity and duration. For the better part of the decade, the government practiced tight monetary and fiscal policies—a mistake on both counts according to most economic textbooks. Then, toward the end of the decade, the government changed course and pursued extremely aggressive forms of monetary and fiscal policy. In our last Review & Outlook, we documented how the Fed printed large amounts of money that trickled into the economy in the form of higher inflation. In a moment, we will turn our attention to the fiscal stimulus that results from extraordinary deficit spending. Driven in large part by the build up to World War II, such policy rapidly accelerated a recovery that had already begun.

Fiscal policy stimulates the economy in a fairly simple way. The government borrows a lot of money and then spends it (or gives it back to people in the form of lower taxes). In the short term, business revenues and personal incomes rise. Once the “pump has been primed” and the economy is moving again, fiscal stimulus can be withdrawn.¹

¹ Keynesians need a better analogy—popular knowledge of how to start the water flowing from a water pump has gone the way of rotary phones and vinyl records.
As shown in the chart below, WWII deficit spending was much more dramatic and powerful than 2009/2010 fiscal stimulus. Where government debt-to-GDP jumped from 45 percent to 122 percent during World War II, debt-to-GDP rose by “only” 39 percent five years ago. From a Keynesian perspective, the size of the bump in the deficit is a more important indicator than the absolute amount of the deficit.

EXHIBIT 1: Federal Deficit as % of GDP

In January 1939, approximately 30 million people were employed in the United States. This compares to 42 million in December 1943, two years after the Japanese bombed Pearl Harbor—a 40 percent increase. The unemployment rate, which had been close to 15 percent at the beginning of the 1940s, dropped to less than 1.5 percent by 1944.

EXHIBIT 2: U.S. Employment (1939 - 1950)

Source: Glenmede, FactSet
The fact that war spending and fiscal stimulus successfully put people to work is not surprising. This has been the case since long before we could spell Keynesianism (which is, in fact, a little tricky). More interesting is the fact that when massive fiscal stimulus was withdrawn rapidly at the war’s end, job growth barely paused and the economy excelled through the latter part of the 1950s.

**Job Growth after the Mother of All Sequesters**

By some people’s reckoning, the fiscal policy of the early 40s is a prime example of the merits of Keynesian stimulus policies. Yet, had jobs in the private sector not materialized after the war, and had the country slipped back into the Depression, this policy would likely have fallen into disrepute.

In fact, in September 1945, shortly after Germany surrendered and V-J Day, employment fell below 39 million from the previous January’s wartime high of 43 million. However, within ten months, the American workforce swelled to more than 42 million workers, and over the next five years, grew 20 percent to include an additional 8 million workers.

This upward climb occurred in concert with slashed government spending. The economy is the sum of four parts: private consumption (e.g., food, cars and houses), private investment (e.g., machines, offices and factories), net exports (exports minus imports) and government spending. Over the 1945/1946 period, GDP was essentially flat. As government spending fell by almost half ($43 billion), the difference was made up by increases in the three other factors (private consumption, investment and net exports). Were this not the case, overall GDP would have fallen by nearly 20 percent. A commensurate drop in employment would have reduced job levels to pre-war levels.
Where government spending in the 1930s may have led the economy out of depression, the private economy offset massive cuts in government spending after the war. Why was that the case and more so, did fiscal policy work as intended?

**A Coiled Spring and the Triumph of Optimism**

World War II involved a unique set of economic circumstances, introducing both positive and negative effects. On the positive side, the labor force was revived, first to help supply the Allies and then to supply the American war effort. Suddenly, people had jobs and, more importantly, income.

On the negative side, it was hard to buy anything as the sudden demand for goods caused inflation. The government responded by instituting price controls and rationing, which quelled inflation for a bit, but also created real and artificial shortages. By the end of World War II, the country had experienced an extended period of forced savings. With the war’s end, businesses and consumers could again spend freely, resulting in new housing, businesses and consumer goods.

Back to the question at hand—did fiscal policy work as intended? It is possible to argue that the explosion of spending was merely a delayed reaction to the severe conditions of the Depression. Then again, private spending picked up dramatically even as the government administered massive spending cuts. What made private employers hire and private consumers spend in the face of dismal circumstances? Certainly this contrasts sharply with the noise surrounding the recent sequester and related spending cuts that some believe “crippled” our economy.

To be fair, some post-WWII government programs, such as the 1944 GI Bill, eased the transition from a government run economy to private sector driven growth. Drafted by a Democratic senator from Arizona and a former Republican National Committee chairman, the bill provided low interest loans and cash payments for tuition and living expenses so that veterans could attend college, high school or vocational school. The bill, which also funded one year of unemployment compensation, was such a success that it has essentially been built into our current fiscal policy through low cost educational loans and extended employment insurance. Both programs have played a large role in recent fiscal policy.
The American economy of the 1940s also benefited from U.S. foreign policy at the time. Certainly net exports contributed to growth in 1946, but the centerpiece of American aid was the Marshall Plan, ratified much later in 1948. It is worth noting that the U.S. stock market prospered through the late 1940s and 50s.

Perhaps historians, with their emphasis on leadership, social trends and technological change, are better equipped to explain the robust post-Depression economic recovery than economists and their macroeconomic models. Earlier generations survived a terrible war, sacrificed to great extents, emerged victorious and in the process, spearheaded innovations in technology and business. Despite the many wartime casualties, the country was relatively untouched. Survivors, this reminds us, often emerge from hardship with a renewed sense of resolve, willingness for change and determination to achieve great things.

Thank goodness our recent Great Recession arose from excess mortgage debt and not the bloodshed of war. I am tempted to think the recovery after WWII had less to do with fiscal stimulus and more to do with the confidence of private individuals and businesses to take risk. It might be worth keeping this in mind as we watch the news to learn how Washington, Berlin or Beijing will institute policies to spur the economy back to greater heights.

It is possible we are now seeing the private sector’s delayed snapback from 2009 fiscal stimulus, similar to the delayed reaction to WWII fiscal stimulus. In the 40s, war conditions forced individuals and businesses to save. Today, tough credit conditions have provided the incentive.

Similar to the 40s, this current recovery may depend on factors unrelated to fiscal stimulus. This includes new technologies sourced by Silicon Valley or Austin, Texas, domestic energy development, the desires of Chinese consumers for a middle class lifestyle, efforts to revive aging midwest and northeastern cities and the overall resolve of the American people to work hard to better their families and communities.

EXHIBIT 5: S&P 500 Composite Price Index (1940 to 1955)
From the Mother of Sequesters to the Mother-in-law of the Investor

Over the past 26 years, I have had a small problem. I liked and admired my mother-in-law. Typically, when a man begins a conversation with “My mother-in-law…..,” he transcends ethnic, racial, religious and social divides, establishing common ground with other married people. Unfortunately, with the exception of a “wicked” Rhode Island accent, there wasn’t much about Genevieve Ralph that I could complain about, though much to appreciate.

After 86 years, she passed last month. Our family gathered in Providence, Rhode Island for the ritual calling hours, funeral, internment and reception. I come from a part of New England that does not hug easily. Have you ever seen a Connecticut car bearing the bumper sticker “Go hug an actuary?” Over two days, I was gripped and embraced by cousins, friends and even the development officers from our nearby alma mater. Yet, these rituals had the effect of transforming sadness into closure. Much credit goes to my wife, who organized a “damn good” funeral. The centerpiece of her work was the eulogy she delivered.

For the purpose of this commentary, the interesting thing about Genevieve Ralph was the fact that she lived through the Depression and was 18 years of age at the war’s end. Her values provide a window into this period, illustrated by a few excerpts from my wife’s talk below:

My mom was a child of the Great Depression and of what she termed, ‘simple, task-oriented folk who respected hard work and practical accomplishments.’ It was a time when her family cautioned, ‘FHB’ or ‘family hold back,’ so dinner guests would have ample food. Another standard admonishment was, ‘Never ask for anything’ though if offered she could say, ‘Yes, thank you or no, thank you.’ If you asked, and the person couldn’t afford your request, you’d have embarrassed him or her. What Mom did take from this home life was her character, a solid structure built with stability, routine and tradition and the strong love of a close-knit family.

Her childhood might have begun in monochromatic grays, but through her drawing and painting, she developed an artist’s eye for viewing the natural world. Mom did not go to the Rhode Island School of Design as she had wanted. With her grandmother’s oft-repeated mantra, ‘Work or want, that is your future,’ art school was neither a respectable nor practical choice for a young lady of that time. Instead, Mom attended nursing school. I am sure she must have been disappointed, but I never heard her say so and never heard her speak with regret. Regret and ‘what ifs’ were not in Mom’s vocabulary.

Mom’s career in nursing not only satisfied her desire to care for others, but also gave her the opportunity to fulfill new roles as advocate and leader. The woman who never asked for anything on her own behalf thrived as a mentor to and advocate for the nurses and patients that came under her wings. In the Emergency Cardiac Care Unit at Kent Hospital, the nurses and doctors, who reverently dubbed her the General, became extended family.
As she aged, Mom continued to grow by figuring out new ways to live independently. Though she had long known the computer as a word processor, by her 80s, Mom recognized the internet as a different kind of tool. When navigating a grocery store’s aisles became too difficult and usurped an entire day’s energy, she discovered on-line shopping, banking and bill paying, along with Skype. Eventually, she had her own Facebook page for keeping up with her grandchildren’s lives, checking out the latest family photos and connecting with friends, though I do admit to receiving a few too many Farmville offers from her.

When more recently her dear friend and I suggested that she really should lock the doors to the house, her answer was, ‘Only good people come to my home.’ I have never heard her speak disparagingly of anyone.

By today’s standards, my mother-in-law’s restraint and professional choice might seem quaint or unfulfilling. Her positive attitude toward work and future possibilities are hallmarks of her generation. Perhaps, these attitudes contributed to the era’s rapid recovery in private spending at a time of diminished stimulus spending. This hypothesizing fits more easily into a historical narrative than a back-tested macroeconomic model. Without a means of quantification, an economist would have difficulty determining the real value of these attitudes.

Macroeconomic models, however, don’t tell the whole story, nor do macro-policies determine the economy’s fate. This is pertinent for anyone attempting to forecast the world’s economic trajectory. It is likely that energy development, productivity improvements in service industries and the continued growth of the emerging market middle class will have a greater effect on macroeconomic policies over the next five years than was the case the past five years.

These trends, not macro-data, might make one a bit more optimistic. My guess is that Genevieve Ralph would be completely comfortable with this viewpoint.
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