President's Message

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Putting War to the Cost/Benefit Test

Is war good for the economy? Some think so because, they argue, money spent by the federal government to buy weapons increases output and employment, which tends to boost the economy. (GDP jumped more than 15 percent in some years during World War II. Compare that to last year's anemic 2.4 percent growth!)

This simplistic answer belies several uncomfortable realities, however. Common sense tells us that war cannot be good for those who are killed or injured. If war is not good for people as individuals, it cannot be good for the economy that serves them. Nor can it be productive to devote scarce labor, capital and materials to building armaments that are destroyed.

Going beyond the "swords vs. plowshares" angle, at least two other complications should be considered in ascertaining the effects of war on the economy. First, who pays the bill? The answer can affect the economy for years to come. World War II was financed largely by borrowing from the populace (war bonds and the like). Gross federal debt as a share of GDP surged from about 52.5 percent in 1940 to about 122 percent by 1946, even though at the same time taxes were being raised. Future generations continued to pay the bill. This financing contrasts sharply with payment for the first Persian Gulf War, in 1990-1991. Several foreign governments reimbursed the United States for the bulk of that bill.

A second complication is the coordination of monetary and fiscal policies. During the Vietnam War, U.S. policy-makers ran a swords *and* plowshares policy: Spending was increased on both defense and on social programs. The highly expansionary fiscal policy put upward pressure on demand for goods and services. Regrettably, monetary policy was too accommodative. The result was the Great Inflation of the 1970s and early 1980s. After averaging about 1.75 percent from 1965 to 1967, CPI inflation averaged about 7.5 percent from 1968 to 1981, peaking at 13.5 percent in 1980. It required dogged commitment by a generation of monetary policy-makers to rectify this mistake.

The latest war in Iraq has presented neither of these complications so far, largely because the cost has been relatively low. Even if the price tag hits $100 billion, that's only 1 percent of our roughly $10 trillion economy. Defense spending, in general, totals less than 5 percent of GDP these days, compared to more than 15 percent at the height of the Korean War and more than 40 percent at the peak of WWII.

But the final bill for the war in Iraq—and the related war on terrorism—has yet to be tallied. Among the unknowns is the price we'll pay to make Iraq (and Afghanistan) functional nations. We must also factor in future terrorist attacks and rising expenditures for domestic security.

Although defense spending is necessary for protection against threats to our safety and livelihood, we'd certainly be better off if we could devote our scarce resources to productive capital goods and useful consumption goods. Unfortunately, the history of our civilization suggests that turning all of our swords into plowshares rarely works for extended periods of time. War may sometimes be necessary, but we should never believe that "good for the economy" is a valid justification, or even a side benefit, for war.