It Ain't 1945
Yesterday's Solutions Can't Fix Today's Economy
Market Perspectives
December, 2010
Claude Gruen

"In the absence of other information, the best predictor of the future is data from the past." So said my graduate school statistics professor on the first day of class. While he modified that statement as the course progressed, his original dictum is apparently being followed by policy makers seeking to fix the current sluggish high unemployment economy. Both the public policy makers in charge and their critics are considering only two tools as they seek to make the needed fix: fiscal policy (i.e. the stimulus program) and monetary policy (i.e. augmenting the money supply and driving down interest rates). Some economists, such as Paul Krugman, argue for adding more public dollars, as suggested by the Keynesian recipe for re-invigorating a stagnant economy; others, such as political analyst Gary Wills, suggest further deficit spending will weaken the confidence of the private sector, overburden the future with too much debt, and increase the threat of destabilizing inflation.

The Way It Was

Both sides of the argument about how much fiscal and monetary powder should be used to blast the economy into a high growth, employment-generating orbit point to historic examples of success, or counter-productive overkills, which resulted from the various uses of those policies. The post-World War II era is the most dramatic and frequently cited example of a historic victory over the threat of a stagnating economy and unacceptable levels of unemployment. The U.S entered that war on December 7, 1940 with high unemployment and an economy that had remained depressed for over a decade. The dramatic duo of fiscal policies (a huge wartime deficit) and monetary policies (a series of Federal Reserve actions that kept interest rates low so that the Treasury could sell low interest rate bonds) is credited with powering the economy with enough strength to provide jobs for over 12 million returning veterans and pushing up standards of living for post-war generations.

But the arguments for reliance on fiscal and monetary policy built on statistical correlations between post-1945 economic prosperity and the use of these two instruments of public policy are flawed. Largely ignored in the debate about how much of the two polices to use now, are the differences in the underlying structural characteristics of the post-World War II and the contemporary U.S economies. The 1945 economy had strong comparative advantages in terms of industrial productivity and capacity, as well as innovative capability, over the rest of the world's economies. Today, we have an economy with major structural imbalances and weaknesses that place us at a disadvantage when competing in world markets. The many U.S.-owned firms that have been moving both production facilities and research laboratories overseas are trying to get away from these structural weaknesses. A major reason for the success of the fiscal and monetary policies initiated in 1945 was that they were able to build on and catalyze the structural strengths of our underlying economy.

An important reality, which is all too often forgotten, is that while the Great Depression of the 1930s worked hardships on the American people, the country's industrial base actually increased in size and productive efficiency during that period. When the war started, that capability, plus a motivated and highly cost effective labor force, augmented with the wives and sweethearts of the 12 million men who went into the military, was able to out-produce the Axis powers. While the Nazi Tiger tanks were better than the Sherman tanks General George Patton took into battle, American factories could far out-produce the German war machine.

Innovation also played its part, and not just in the field of nuclear warfare; the British Spitfire fighters could out-fly the Messerschmitts because of the high octane fuel that American chemists invented, U.S. refineries produced, and U.S. ships brought to the British Isles. While the rest of the world's industrial base was in shambles after the war, the U.S. economy was still building its already powerful muscles by taking advantage of cheap urban and agricultural land and an increasingly productive workforce.

Unlike the period after World War I, when unemployed veterans staged "bonus marches" that were put down by troops under the direction of General Douglas MacArthur, returning GI's were able to train for the skills needed by a strong economy. When I entered undergraduate school at the University of Cincinnati as a "co-op," enrolled in a five year program that allowed me to work for eight weeks and then go to school for the next seven weeks, about half of the men who lived in the fraternity house had fought in the jungles of the Pacific or the hedge rows of France. They were not using their government-paid education to gain self esteem or enhance their understanding of contemporary political issues – they were motivated to learn the concepts and techniques that would prepare them for a job that would pay enough to raise a middle-class family. Labor costs, particularly in the public sector, had not included the level of pension and health benefits now standard in many wage packets.

Innovation was spurred further as the military establishment "suited up" for the Cold War by researching what could be learned from the scientific programs of the Axis powers. Building the Armed Services Technical Information Agency and similar programs instituted to share research findings among the military and their contractors led to discoveries, of which the Internet was but one example. Urban centers such as the agglomeration of research labs and electronic manufacturing that grew around Boston and the area in California that became known as Silicon Valley could be built and added to quickly and relatively cheaply, as growth was considered "progress."

This description of the American economy between 1945 and the 1960s, which had the comparative advantages needed to produce world-class products and services across a broad spectrum of industrial and professional categories, is more than nostalgia. It pictures an economic structure flexible and powerful enough to stay highly competitive within most national and international markets during all stages of a business cycle that rose and fell with changes in monetary and inventory conditions, as well as changes in levels of consumer demand. Under those circumstances, the Federal Reserve Board, the President and Congress had only to spur demand and investments during the down cycles and tamp down inflation during the up cycles. If used wisely, the fiscal and monetary tools at their disposal permitted them to accomplish those tasks.

Team Effort Needed

To an increasing degree, the industrial and scientific bases of European, and particularly Asian, countries have been strengthening in the last decades, while major sectors of our base, as well as our publicly-provided infrastructure, have failed to maintain their power. That is why we have seen American companies expanding their factories, laboratories and service activities to locations outside of the United States. This weakening of our comparative advantages, particularly versus other nations (most importantly in relation to China), also means that the tools available to the federal government are not sufficient to avoid slow economic growth and stagnation. Fiscal and monetary policies alone do not constitute a winning industrial policy.

Successfully launching the American economy on a sustainable growth path of 5 percent to 7 percent per year, or twice the growth we have now, will take the cooperation of the private business sector, labor unions, and all levels and departments of government. Business will have to invest more, consumers will have to do what they are, in fact, beginning to do -- which is to save at least 6 percent of income -- and labor will have to go further in showing the flexibility and wage/benefit restraint along the lines of recent auto industry contracts. Government will have to pay for, rather than make loans to, students of all ages who are willing to shoulder the tough discipline of learning the skills and adapting to the work habits needed to re-build the comparative advantages of the American economy.

While the President will have to lead the country in such a rebuilding effort, neither he nor other elected officials can be expected to do it alone. The citizenry has the right to expect its leaders to lead, but we must be willing to follow when rational economic policies are suggested. Given the state of our economy relative to those of other developing and developed nations, we should not expect fiscal and monetary policies alone to create a full-employment economy. Only after our economy builds back up to something close the comparative advantages it had in 1945 can we expect fiscal and monetary policies alone to guide it to full employment and the provision of rising and equitably distributed living standards.

Claude Gruen is Principal Economist, Gruen Gruen + Associates, a research and consulting firm with offices in San Francisco and the Midwest.
www.ggassoc.com