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The Unique Economic Policy Environment of Interwar and Postwar America

*Michael A. Bernstein**

Significant transformations in the economic policy environment in the United States have almost always been the exclusive product of significant turmoil, conflict, and war. Within the crucible of open rebellion, Abraham Lincoln struggled to develop an altogether unique set of fiscal, financial, and procurement practices that served both to further federal objectives in the Civil War and forever reorient the role and impact of central government in the nation's economic life.¹ It is clear that the Lincoln government felt compelled to take extraordinary action with respect to civil liberties, judicial due-process, and civil rights in defense of the Union. Similarly, its Treasury and War Departments implemented unprecedented economic policies in pursuit of military victory and the resolute winning of the peace that would follow.² The economic practices thus deployed—most importantly, the imposition of income and excise taxation, the establishment of a national banking system, and the issuance of paper money—forever changed Washington's presence in the macroeconomy³ and they yielded results that were powerfully and uniquely tied to the political, commercial, and social circumstances of their day.⁴ Quite similarly, almost a century later, another unique set of political and economic contexts emerged in American history that would set the stage for another dramatic and vastly consequential change in the policymaking practices of the nation's government. Pondering those quite special circumstances, spanning the period from the Great Depression of the twentieth century through the height of

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¹ See generally Robert D. Hormats, *Abraham Lincoln and the Global Economy*, HARV. BUS. REV., August 2003, at 60.

² See JAMES M. MCPHERSON, *ORDEAL BY FIRE: THE CIVIL WAR & RECONSTRUCTION* 374–83 (1982); see also Stanley L. Engerman, *The Economic Impact of the Civil War*, 3 EXPLORATIONS ENTREPRENEURIAL HIST. 176, 176–99 (2d. ser. 1966).

³ ERIC FONER, *RECONSTRUCTION: AMERICA'S UNFINISHED REVOLUTION 1863-1877*, at 22–23 (1988).

⁴ See BRAY HAMMOND, *SOVEREIGNTY AND AN EMPTY PURSE: BANKS & POLITICS IN THE CIVIL WAR* 202–07, 226–29, 232–35 (1970).

the Cold War conflict with the Soviet Union and its allied states, sets the events and outcomes of the Lincoln era in sharp relief while also affording a better appreciation of the forces that have shaped late twentieth century American experience. While the following derives primarily from several prior works, the content remains relevant to this discussion of constitutional approaches to wartime finance and economics, both in the context of the Civil War and today's War on Terror.⁵

America's greatest depression was not brought to an end by inspired policy choices. Far from it. World War II achieved what the New Deal could not. National unemployment fell to only 7 percent by the time of the Japanese naval offensive in the Hawaiian and Aleutian Islands. America's formal entry into the conflict brought almost instantaneous resolution of the nation's persistent economic difficulties. A wholly collectivized and centralized approach—through rationing, price controls, and federal allocative planning—provided for the kind of reflation and economic recovery that had seemed so unattainable during the worst years of the Great Depression itself. When unemployment fell to just over one percent in the last year of the war, it was clear that, while hardly inspired by specific economic concerns, President Franklin Roosevelt's "arsenal of democracy" nevertheless contained rather vivid policy lessons for economists, politicians, government officials, and the public at large.⁶

New Deal recovery policy has generally been seen as beset by a fundamental contradiction between two strategies. That contradiction was epitomized by the conflict between the advocates of economic planning within Roosevelt's inner circle who celebrated the efficiency and rationality of large-scale enterprise, and those committed to trust-busting, who maintained that excessive concentrations of market power in major sectors of the economy had caused the economic crisis of the thirties. The result of the contradiction was the strange brew of New Deal economic policy, the bewildering movement of the president from a planning initiative to a reform initiative

⁵ The following, with the exception of the conclusion, is excerpted from MICHAEL A. BERNSTEIN, *A PERILOUS PROGRESS: ECONOMISTS AND PUBLIC PURPOSE IN TWENTIETH CENTURY AMERICA* 74 (Princeton Univ. Press 2001); MICHAEL A. BERNSTEIN, *THE GREAT DEPRESSION: DELAYED RECOVERY AND ECONOMIC CHANGE IN AMERICA, 1929-1939*, at 186 (Cambridge Univ. Press 1987); *UNDERSTANDING AMERICAN ECONOMIC DECLINE* 15 (Michael A. Bernstein & David E. Adler, eds., Cambridge Univ. Press 1996); Michael A. Bernstein, *A Brief History of the American Economic Association*, 67 *AM. J. ECON. & SOC.* 1007 (2008).

⁶ MICHAEL A. BERNSTEIN, *A PERILOUS PROGRESS: ECONOMISTS AND PUBLIC PURPOSE IN TWENTIETH CENTURY AMERICA* 74 (Princeton Univ. Press 2001) [hereinafter *PERILOUS PROGRESS*].

agenda, and the generally poor record of Roosevelt's first two terms with respect to economic recovery.⁷

Ever the consummate strategist, Roosevelt evaluated economic policy proposals primarily with reference to electoral and political impacts, far less with convictions concerning the logical coherence or intellectual (not to mention professional) pedigree of the argument. As a result, his economic decisions tended to be skittish, sometimes timid, and often unpredictable. Federal government vacillation between the imposition of a centralized blueprint for recovery, as exemplified by the Industrial Codes of the National Recovery Administration, and the prosecution of antitrust tactics to foster a competitive revival never ceased. Fiscal spending targets were more often than not simply too low to do the job, and their allotment was driven as much by hardheaded projections of their influence in the electoral college as by closely measured multiplier effects on consumption and investment.⁸

Consumption and investment behavior played a major part in the great prosperity of the late forties and fifties. On the domestic side, reconversion was itself an investment stimulus. Modernization and deferred replacement projects required renewed and large deployments of funds. Profound scarcities of consumer goods, the production of which had been long postponed by mobilization needs, necessitated major retooling and expansion efforts. Even fear of potentially high inflation, emerging in the wake of the dismantling of the price and wage controls of the war years, prompted many firms to move forward the date of ambitious and long-term investment projects. On the foreign side, both individuals and governments were eager to find a refuge for capital that had been in virtual hiding during the war itself. Along with a jump in domestic investment, therefore, a large capital inflow began in the United States in late 1945 and early 1946.⁹

Domestic consumption was the second major component of postwar growth. Bridled demand and high household savings due to wartime shortages, rationing, and controls, coupled with the generous wage rates of the high-capacity war economy all contributed to a dramatic growth in consumer spending at war's end. The jump in disposable income was bolstered by the rapid

⁷ MICHAEL A. BERNSTEIN, *THE GREAT DEPRESSION: DELAYED RECOVERY AND ECONOMIC CHANGE IN AMERICA, 1929-1939*, at 186 (Cambridge Univ. Press 1987) [hereinafter *GREAT DEPRESSION*].

⁸ *PERILOUS PROGRESS*, *supra* note 6, at 76.

⁹ *UNDERSTANDING AMERICAN ECONOMIC DECLINE* 15 (Michael A. Bernstein & David E. Adler eds., Cambridge Univ. Press 1996).

reduction in wartime surtaxes and excises that had been a central part of the federal government's strategy of war finance. And the baby boom of the wartime generation expressed itself economically in high levels of demand for significant items like appliances, automobiles, and housing. G.I. Bill benefits additionally served to increase the demand for housing and such things as educational services with associated impacts on construction and other bellwether sectors.¹⁰

Foreign demand for the American exports grew rapidly in the immediate postwar years. In part the needs of devastated areas could only be met by the one industrial base that had been nearly untouched by war-related destruction. Explicit policy commitments to the rebuilding of allied and occupied territories, such as the Marshall Plan in Europe, also served to increase the foreign market for the output of American industry. Even so, one of the most powerful influences on the impressive postwar growth of the American economy was the unique and special set of arrangements developed for international trade at the Monetary and Financial Conference of the United Nations in 1944. Along with the creation of the International Bank for Reconstruction and Development (known today as the World Bank) and the International Monetary Fund, the Conference decided to establish fixed exchange rates between the U.S. dollar and all other internationally traded currencies. The value of the dollar was itself set in terms of gold at \$35 per ounce. This installed a benchmark against which the value of all other currencies was measured. American postwar prosperity and the benefits of world economic leadership continued throughout most of the 1950s. The added fiscal stimulus of the Korean War also played a role in maintaining the high levels of growth and employment characteristic of the decade.¹¹

Federal research expenditures had increased more than tenfold between 1938 and 1944, from \$68 million to \$706 million per year.¹² As Clark Kerr of the University of California had so accurately and succinctly implied some years later, what had been the "Land Grant College" funding strategies of the nineteenth century gave way to the "Federal Grant University" systems of the twentieth.¹³ Further stimulated by Russia's successful test of an atomic bomb in September 1949 (and of a "super" or "hydrogen" bomb in the summer of 1953), the coming of war in the Korean peninsula the following year, and such

¹⁰ *Id.* at 15–16.

¹¹ *Id.* at 16.

¹² PERILOUS PROGRESS, *supra* note 6, at 100.

¹³ *Id.* at 102.

challenges to America's aeronautical capabilities as the orbiting of a Russian earth satellite (the *Sputnik*) in October 1957, government support of science and engineering became the basis of yet a new (and more powerful) "arsenal of democracy."¹⁴

High rates of growth, robust levels of employment, and stable prices were the standards by which a capitalist society could demonstrate its advantages over command economies premised upon socialist or communist designs. As the emblematic "Kitchen Debate" between Soviet premier Nikita Khrushchev and Vice President Richard Nixon had suggested in 1959, winning the cold war involved more than husbanding a credible nuclear deterrent, deploying fleets, garrisons, and air wings around the world, and utilizing special forces in counterinsurgency campaigns. It also required that an economic system deliver the goods to the people. Prosperity was an essential weapon in the struggle for the hearts and minds of any society.

A vigorous national economy was thus essential both to equip the armed forces and to demonstrate the virtues of American capitalism. Guns *and* butter were the protocol; a "New Economics" could provide the means to that end. Both the experience of the Great Depression and the challenges of world war had made clear to a new generation of specialists that the public sector occupied a crucial niche in the mechanisms of the national economy. Properly managed and monitored, the macroeconomy not only would provision an appropriate quantity and quality of public goods on its own behalf but also would afford the private sector the wherewithal to expand output targets, enhance productivity, and maintain employment. Interweaving public and private accumulation strategies, reckoning with the "mixed economy" of the postwar era, denoted the ascendancy of what was arguably the defining characteristic of the arguments of John Maynard Keynes. Independent of specific policy initiatives, Keynesianism represented a new way of thinking about the economy as a whole, one that dovetailed with broader governmental objectives tied to the struggle against Communism. Whatever the intellectual foundations of the "Keynesian revolution," its historical moorings were made fast by the exigencies of the Cold War.¹⁵

Recapturing the presidency and the Congress in the election of 1952 encouraged many Grand Old Party stalwarts in the belief that the potent Democratic influence of two decades had, at long

¹⁴ *Id.*

¹⁵ *Id.* at 107.

last, come to an end. Whatever the tenuous nature of their control on Capitol hill—one seat in the Senate, nine seats in the House of Representatives—and despite the ideological moderation of the Dwight Eisenhower, whose national popularity had prompted some of his champions to indulge fantasies of a bipartisan presidential endorsement, Republicans viewed with satisfaction the imminent opportunity to dismantle the most objectionable manifestations of the New Deal and the Fair Deal. The blurring of party differences wrought by the beginnings of the Cold War, the marginalization of the Right by the victory of the Grand Alliance over fascism, the suppression of the Left by the gathering momentum of McCarthyism—all this emboldened the enemies of federal economic intervention, primarily but not solely Republicans, to settle accounts.¹⁶

To be sure, the run-up to the 1952 campaign had been an occasion for spirited and, at times, hot-tempered debate within the major parties themselves. Supporters of Senator Robert Taft of Ohio refused to make Eisenhower's nomination unanimous at the Republican national convention in Chicago. Harry Truman's decision to step down sparked a struggle for power among the Democrats as well—the wounds of the "Dixiecrat" rebellion still festering after the party's improbable victory in 1948. The president's choice of Illinois governor Adlai Stevenson as his successor eased tensions in the four-way race for the nomination that emerged between Averell Harriman (governor of New York), Estes Kefauver (senator from Tennessee), Richard Russell (senator from Georgia), and Stevenson himself. But in the final analysis, on election day, Eisenhower's thirty-three million votes, then the largest popular tally in a presidential canvass, signaled what some pundits referred to as "the revolt of the moderates" and the start of what the president-elect himself hoped would be a "Second Era of Good Feelings." No matter how the 1952 returns were read, it was clear that, in the wake of Roosevelt's reconfiguration of his party, one of the great transformations of American political history had taken hold: on the one side, the party of Jefferson, the defender of states' rights and localism, had in short order become the champion of federal authority and centralized power; on the other, the party born of the nineteenth-century crisis of the Union, the vanguard of a modern administrative state, stood as a resolute critic of Washington's increasing presence in almost every aspect of the nation's life.¹⁷

Unlike any other industrialized nation in the world at the

¹⁶ *Id.* at 115.

¹⁷ *Id.* at 115–16.

time, the United States met the 1950's with an economy not only physically intact but also organizationally and technologically robust. The demographic echoes of war set the stage for acceleration in the rate of population growth, while the labor market effects of demobilization surprisingly sparked a rise in wages and incomes. Rapid and profitable conversion to domestic production was further engrossed by foreign demand—most vividly and poignantly emanating from those regions most devastated by the war itself—for the products of American industry and agriculture. As for international finance, the nation stood as creditor virtually to the entire world, and the dollar, both by default and by the multilateral agreement first reached by the Allied nations at Bretton Woods, had become a kind of numeraire to a newly emergent system of global commerce. With no small justification, the fifties and sixties would come to be regarded as a golden age of American capitalism.¹⁸

Macroeconomic management, demanding under any circumstances, was made substantially easier for a postwar generation that found itself the beneficiaries of historical circumstance. Far from solving the cruel puzzle of idle capacity and widespread unemployment that had characterized the Great Depression, and unlike the challenge to rationalize allocation and maximize production in the emergency of war, the task that lay before American economists by the mid-1950s was both more straightforward and less difficult. More straightforward because, thanks to both the “Keynesian revolution” in economic thought and the policy experience derived from mobilization and war, the relationship between individual market behavior and aggregate outcomes was finally subject to systematic understanding. Less difficult because, given the sturdy rebound of the economy in the wake of World War II, there existed both the confidence (most especially exemplified by the moderate rates of return in the markets for Treasury bills and other government obligations) and the means (most vividly represented by rising income tax receipts) to realize fiscal spending targets with a minimum of redistributive implications.¹⁹ Indeed, so optimistic were politicians and the vast majority of economists concerning the effectiveness of stabilization policy techniques that it became fashionable by the early 1960s to speak of the “end of the business cycle.”²⁰

¹⁸ *Id.* at 117–18.

¹⁹ *Id.* at 118.

²⁰ Michael A. Bernstein, *A Brief History of the American Economic Association*, 67 AM. J. ECON. & SOC. 1007, 1019 (2008).

A remarkably prosperous decade in the United States, the 1950s were nevertheless punctuated by three recessions. Relatively brief and mild, these downturns stood as a sturdy challenge to mainstream macroeconomists who believed that a new learning could make such fluctuations a thing of the past. They also assumed, especially in the case of the last slump (which occurred right on the eve of the 1960 presidential campaign), a growing significance in the minds of politicians eager to “score points” in electoral contests that had been, at least since the thirty-fourth president’s reelection in 1956, fairly tame. For Massachusetts Senator John F. Kennedy in the very closely contested presidential race of 1960, tarring his opponent, Vice President Richard Nixon, with the brush of the 1959 recession was a useful and ultimately successful, if decidedly opportunistic, tactic.²¹

Faced with an economy the insipid performance of which had left the unemployment rate around seven percent, the new administration in Washington was also discomfited by middling productivity gains in the nation’s workplaces that now weakened America’s international trade position. What had been almost two decades of unchallenged national supremacy in world markets, a circumstance both facilitated and recognized by the Bretton Woods agreements of 1944, could no longer be sustained in the face of the revitalization of the economies of Western Europe and Japan. As they reestablished their international economic presence, nations like the Federal Republic of Germany and Japan exploited the advantages of an advanced technological base that was the outgrowth of the recent rebuilding of their major industries. Ironically enough, they also thrived because of their relative insulation, under international treaties and protocols (exemplified by the erection of a “nuclear umbrella” by the United States to forestall what was feared to be the potential for Soviet and Chinese aggression), from the burdens of defense spending. Consequentially, their major manufacturing sectors—such as automobiles, electronics, and steel—became powerful competitors with their American counterparts. Whatever the concerns of President Kennedy’s advisors with the domestic weaknesses of the national economy, the international context within which these difficulties emerged could not be ignored.²²

Given these fairly stark international realities, it was hardly surprising that some of the most powerful policy makers in the Kennedy government sought to frame the nation’s economic

²¹ PERILOUS PROGRESS, *supra* note 6, at 130–31.

²² *Id.* at 132–33.

challenges with respect to global financial networks. Both Treasury secretary Douglas Dillon and his undersecretary for monetary affairs, Robert Roosa, regarded the growing imbalance between imports and exports, and the potential drain on national gold stocks of which it warned, to be the defining economic policy problem of the New Frontier. In this assessment they were joined by William McChesney Martin, chair of the Federal Reserve System Board of Governors. As a central banker, Martin was further troubled by the inflationary bias that any deterioration in the value of the dollar (and thus in its “buying power”) would engender. Both Treasury and the Fed were thus of like mind that relatively high interest rates were, by late 1961 and early 1962, a desirable and appropriate goal of administration economic policy.²³

For President Kennedy’s Council of Economic Advisers, however, no matter how customary and venerable the medicine, the proposed monetary cure was worse than the fiscal disease. The debate over the proper “mix” of fiscal and monetary policy during the Kennedy administration would become emblematic of national policy discussions through the remainder of the century. Late in 1961, the members of the CEA began to formulate a plan to bring unemployment down to the four percent level. In their view, the most efficient and politically expedient method to reach that target was through an income tax cut. An annual macroeconomic growth target of five percent had been made part of the party’s convention platform at Los Angeles.²⁴

For this purpose, lead presidential economic advisor Walter Heller’s adroit skill in rendering policy argument as graceful prose linked up well with his colleague James Tobin’s sharply honed analytical instincts. Turning to another White House staff economist Arthur Okun, Tobin asked his former Yale colleague to estimate, if possible, the relationship between the level of unemployment and the magnitude of the gross national product. Out of that statistical protocol emerged “Okun’s Law,” a rather straightforward calculation which showed that for every one percent reduction in unemployment there could be garnered (through direct impacts on levels of output and indirect reductions in the “underemployment” of contracted labor in slack times) a three percent increase in national product.²⁵ In President Kennedy, Heller and his colleagues found a sympathetic student of the New Economics, nervous all the same

²³ *Id.* at 133.

²⁴ *Id.* at 133–34.

²⁵ *Id.* at 134.

about its political implications; in William Martin of the Federal Reserve System, and, to a lesser extent, Douglas Dillon at Treasury, they encountered more problematic skeptics. The timidity of his first budget message to the Congress notwithstanding, the president had refrained from asking for a tax increase to supplement additional military expenditures (between \$3 and \$4 billion) in the wake of the Berlin crisis.²⁶ Taking the measure of the naysayers at Treasury and the Federal Reserve Board had, by contrast, less to do with persuasive argumentation premised on scholarly credentials than with straightforward and hardheaded struggles for the president's ear. By far, Douglas Dillon was the easier opponent for the New Frontiersmen of the Kennedy Administration. A lone Republican in a Democratic cabinet, his freedom of maneuver was already quite constrained. More to the point, so profound was the mutual admiration between Heller and Undersecretary Roosa that the Kennedy Council enjoyed special access to the highest echelons in the Treasury building.²⁷

Federal Reserve Board Chair William McChesney Martin had neither the political obligations to President Kennedy nor the official responsibilities to the executive branch that constrained the conduct of Secretary of Treasury Dillon. The "independence" of the Fed from the executive branch was the result of both conscious intent in its founding legislation and decades of practice among a Board of Governors whose sensibilities were more attuned to the needs of the nation's banking industry than anything else. Martin had refused, contrary to the traditional script, to offer his resignation to the new president. By early 1963 the president encouraged his Council of Economic Advisors to prepare, for inclusion in his 1963 budget message, the formal tax-cut proposal so long debated and which he believed the Fed (in the person of its chair, now comforted by his renewed term and authority) would, if not endorse, simply tolerate. Its ultimate legacy was the Revenue Act of 1964. Peacetime deficit spending as an explicit growth policy of the federal government had finally come home.²⁸

Federal intervention in the national economy, both in the mid-nineteenth and late twentieth centuries, was the product of unique circumstances tied to serious and threatening developments both within and beyond the nation's borders. The very contexts within which powerful and unprecedented

²⁶ *Id.* at 135.

²⁷ *Id.* at 135–36

²⁸ *Id.* at 136.

manipulation of economic outcomes by the national government made sense were themselves the product of singular forces of historical change, armed conflict, geopolitical struggle, and ideological contestation. For particular generations of Americans, the responsibility of the national government to take decisive steps to influence market outcomes was forged in these critical epochs—years during which the nation was tested, reconfigured, and ultimately strengthened. For all these reasons, it seems (and seemed) obvious to many that economic policy lessons thus learned in grave moments could then be generalized and universally applied. Even so, it is the unfortunate reality of history that its lessons are rarely straightforward, and its implications become complex riddles that often take generations to unravel. As vividly demonstrated by the profound difficulty of simply applying the jurisprudence of the Lincoln years to the present-day War on Terrorism, the economic policy practices of the mid to late twentieth century are clearly not directly applicable to the exceptional challenges occasioned by the Great Crash of 2008. Even so, by appreciating their exceptional qualities, we are warned off of simplistic (and dangerous) decisions—and we are reminded that, in facing dilemmas both vexing and unnerving, our generation is hardly alone.