

ECONOMICS: US PERSPECTIVES

NATIONAL DEFENSE: IS ANOTHER SPENDING BOOM ON THE HORIZON?

+ Joseph G. Carson, US Economist and Director—Global Economic Research, [REDACTED]

President Trump has promised to increase defense spending—and there’s support from key members of Congress. If a large multiyear plan is approved, it would represent a sharp reversal from what has been the weakest trend in defense spending in the past 50 years. And the timing and scale would have important implications for the outlook on growth and inflation.

National Defense—The Trump Plan

President Trump has promised to deliver an ambitious program to rebuild the US military. It would include modernizing US nuclear weapons systems, investing more in cybersecurity, enlarging the navy’s fleet and increasing the number of fighter aircraft for the air force. Trump’s plan also includes additional military personnel—well over 100,000, according to some estimates.

The details of Trump’s first Pentagon budget will form part of the overall budget he’ll submit to Congress in late February or early March. The actual funding request for the current fiscal year (which ends September 30) must be completed by April 30—that’s when the current legislation funding the military budget is set to expire.

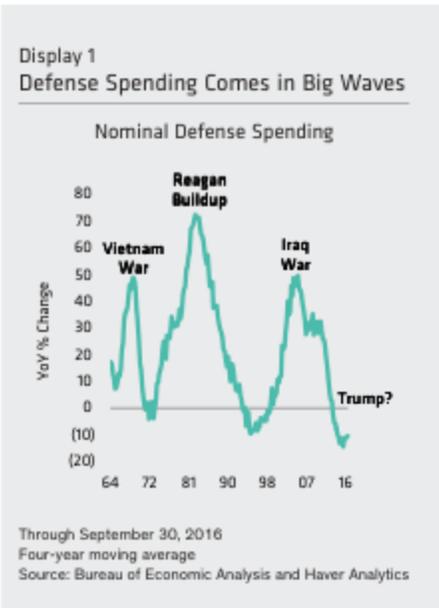
More important, Trump’s blueprint for the Pentagon budget could set the baseline for defense spending for at least the next four years. It’s also worth noting that Trump’s military expenditures could be at the low end of what some in Congress are proposing.

For example, Senator John McCain, who chairs the Senate Armed Services Committee, recently released a white paper on defense spending, *Restoring American Power*. McCain argues that the US has underinvested in the military for several years, and that it is now vital for the US to substantially increase funding for the Pentagon. His plan calls for a \$640 billion defense budget for fiscal year 2018, which is \$58 billion above the current budget baseline. Moreover, the McCain defense plan urges an additional \$430 billion in military spending over the next five fiscal years.

Defense Spending Patterns Are Unlike Other Federal Programs

History shows that defense spending programs are unusual in that they’re neither cyclical nor countercyclical. Most often they are based on military and political strategies as well as ongoing readiness to respond to or engage in global encounters.

Based on historical gross domestic product (GDP) data, there have been three large defense-spending programs in the past 50 years (*Display 1*). The first buildup



occurred in the mid-1960s, during President Lyndon Johnson’s term, and ran for five years. That was tied to the military engagement in Southeast Asia.

The second large defense-spending boom occurred during the first four years of the Reagan presidency. This buildup was part of Reagan’s political and military strategy to rebuild the military apparatus after what he saw as years of neglect.

The third major increase started during the first term of President George W. Bush. This one was linked to events surrounding 9/11 and the following events in the Middle East.

From a political and military standpoint, the Trump defense plan parallels the goals and objectives of President Reagan's military push. And with McCain's more aggressive plan aligned on the same premise of modernizing and improving the readiness of the US military, Trump will likely have the backing of this influential member of the Republican congressional leadership.

Today's Economic Backdrop— Similar to the 1960s

The economic and financial implications of a large, multiyear defense-spending plan must be weighed against the economic environment at the time of implementation. And from a historical context, today's conditions have more similarities to the economic setting of the mid-1960s than during the defense buildups of the early 1980s or early 2000s, which were either in recession or the very early stages of recovery.

In contrast, the US economy in the mid-1960s was already in its fifth year of expansion, the jobless rate of 4.5% was relatively low and inflation was tame (roughly 1.5%). Nonetheless, the extra defense spending boosted domestic demand growth and added significant pressure to labor costs, materials and supplies, and product prices. So much so that the acceleration in consumer price inflation (from 1% in 1961 to near 6% in 1970) from the start to the end of that business cycle was one of the largest of any economic growth cycle during the postwar period.

Today's economic backdrop looks similar in many ways. The economy has been in recovery for seven years, the jobless rate is in the mid-4% range and inflation is stable (at around 2%). While many domestic and global factors are different now, we would still expect a large multiyear defense-

spending program to add to growth and put upward pressure on labor costs and inflation in the coming years. Keep in mind that we're coming off the weakest five-year defense spending trend in the past 50 years, so Trump's defense spending need not match any of the prior three to have a major impact.

Stay tuned for the unveiling of Trump's budget and pay close attention to the defense spending request. A large multi-year program would definitely lift inflationary pressures. While we wouldn't expect an acceleration like that in the 1960s, a sustained rise of 100 to 200 basis points in general inflation would still seem reasonable—and far above what the Federal Reserve and financial markets are currently expecting. ■

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