Military Spending and the Economic Outlook

by Michael F. Bryan and Owen F. Humphage

The United States is embarking on an unprecedented peacetime defense-spending program. The program has prompted heated discussions about the implications of defense spending on fiscal policy, aggregate supply and demand, and overall price levels. Most economists expect the defense buildup to have a relatively small, yet significant, overall effect on the components of demand, activity and price levels over the next few years. Nevertheless, the direction of the military-spending process on some sectors, such as durable goods, and specific prices should be monitored closely.

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the current quarter and subsequent five quarters (see chart 1). The strongest correlation occurred in the second and third quarters following a change in prime-contract awards. Small weapons, cloth, clothing, and trucks can be delivered almost immediately. More sophisticated equipment requires longer lead times; some equipment surely takes much longer than five quarters.

Delays, however, are a poor indicator of the economic activity caused by military spending. Investment in plant and equipment and inventory accumulation of supplies may quicken to a full pace if not hampered by production bottlenecks or resource shortages. As production proceeds, items in progress (or work-in-process) may represent a lagged dependence on prime-contract awards. Thus, if the initial production and employment of items in production are highly correlated with prime-contract awards in the current month or quarter, trends in the series are likely to be similar. Consequently, a six-month moving average of monthly percentage changes was calculated for each of the four lags to adjust for the masking of longer time periods that occurred in the studies. The six-month lag was chosen for its lower correlation with the base months.

Employment: Because the prime-contract series is seasonally adjusted to one month or quarter or higher, seasonally adjusted percentage changes were calculated for each of the four lags to adjust for the masking of longer time periods that occurred in the studies. The six-month lag was chosen for its lower correlation with the base months.

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