

Economic Analysis of the Peace Dividend

By Lawrence R. Klein

For more than 200 years, economists have been concerned with the trade-off between 'guns and butter.' Adam Smith concentrated on this trade-off in his *Wealth of Nations* by focusing in particular on the four French wars and two Dutch wars and their impact on the productivity and treasury of a nation. Though Smith put the matter as succinctly as any of his successors, he did not have the voluminous array of quantitative information which is now available to economists for studying the trade-off. This subject has been repeatedly investigated since the end of World War II.

My first post doctoral assignment was to prepare a model of the US American economy, starting in 1944, in order to assess postwar conversion. I repeated this exercise again after the Korean War, the Vietnam War, the Gulf War, and, on a world scale, after the Cold War. In all cases, I put forward contrarian views which claimed that:

- (i) The United States would not revert to the conditions of the Great Depression after 1946
- (ii) There would not be a new '1929 Crash' after 1953, only a mild recession
- (iii) There would not be a serious or prolonged recession after 1969
- (iv) There was a cyclical downturn in process in 1990 before the Gulf War and that balanced policy prescriptions would be needed after 1991
- (v) There would be a peace dividend for the United States, and the world at large, after the ending of the Cold War in 1989.

At the end of World War II, 'military Keynesianism' dominated our thinking, and realization of pent-up demand was very important in propelling the US economy, but there were some very short run surges in unemployment and price indexes. We learned two lessons for future analysis, namely: (1) that we must separate short-run and long-run effects of changes in defense budgets (for goods, services, and

"In the course of the four French wars, the nation has contracted more than a hundred and forty-five millions of debt, over and above all the other extraordinary annual expense which they had occasioned, so that the whole cannot be computed at less than two hundred millions. So great a share of the annual produce of land and labour of the country, has, since the revolution, been employed upon different occasions, in maintaining an extraordinary number of unproductive hands, whose labour would have replaced, with a profit, the whole value of their consumption. The value of the annual produce of the land and labour of the country, would have been considerably increased by it every year. More houses would have been built, more lands would have been improved, and those which had been improved before would have been better cultivated, more manufactures would have been established, and those which had been established before would have been more extended; (...)"

The Wealth of Nations by Adam Smith (p. 328)

jobs), and (2) that we must treat the economic projections carefully on both the demand side and the supply side.

Although the demand side of the equation has received extensive attention, the supply side requires further review. In order to understand the full impact on the supply side, it is important to combine the real analysis with a monetary analysis, where the cost of capital and interest rates are significant, especially in relation to the overall public budgetary position which, in turn, depends on the defense budget. Also, the international effects must be brought into play through exporting and importing, not only in armaments but in the overall growth factors for modern economies. Ever since the end of World War II, trade among nations has been a strategic growth factor, and obviously trade is enhanced in a more peaceful world. The expansion of trade since the end of the Cold War has already contributed to international economic progress. More is yet to come, if peaceful international relations continue to provide an environment which is supportive of traffic among nations.

People are impatient and want to be able to see immediate concrete manifestation of the peace dividend in the form of more hospitals, cultural facilities, educational establishments, technologically advanced infrastructure and other tangible evidence. There is a cynical view that the peace dividend has vanished.

That view is not correct: the world economy would be in a much less satisfactory condition, were it

not for the ending of the Cold War. The dividend is already present and will, in due course, become much larger. It is not a static world, and other events have obscured the dividend—natural disasters or policy changes (Pinatubo volcano, Kobe earthquake, the NIKKEI bubble, the Maastricht requirements, Tiananmen Square, the Mexican financial crisis). These disturbances must be isolated in projections and counter-factual simulations.

In an overall sense, however, the restructuring of transition economies, the eradication of most pockets of inflation and the prevalence of modest interest rates all show up in international model simulations with good capital formation and improving levels of consumption. In a sense, Adam Smith's invisible hand has guided 'the market' in the allocation of the peace dividend. A dividend in the form of reduced global spending for military purposes has, in fact, been realized, but its distribution is not visible to the naked eyes of the lay observer. But to the eye of the analytical economist, it can be seen. The distribution of the dividend is, by no means, unique and one can be dissatisfied with the distribution which has taken place, but one cannot deny the existence of a peace dividend.

Among various peace dividend scenarios, the Bonn International Center for Conversion is taking up a new approach in distinguishing three separate dividends which make up the entire peace dividend process. Another approach has already shown results: the models of Project LINK have been simulated under the conditions of a 25 percent reduction in the ratio of defense spending to GDP for 14 large industrial countries, 3 large developing countries, and Russia. Also, a fiscal accommodation in the form of tax reductions which render the spending cuts deficit-neutral for the G-7 countries produces an estimate in the G-7 countries of 0.77 percent increase in total private consumption by 2002 (after 10 years). In value terms, the estimate of defense reduction of US \$178 billion (1993) is associated with a consumption increase of US \$33 billion (1993), that is, normal consumption growth along a baseline path without an unusual defense reduction was expected to be realized by 2002, plus an increase in consumption of US \$33 billion (1993) in the G-7 countries.

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Staff Spotlight:



Ksenia Gonchar

Ksenia Gonchar, an economist from Russia, works at BICC and the Russian Academy of Sciences (Institute of World Economy and International Relations, IMEMO) as a researcher in the field of Russian defense conversion. She studied economics in the Moscow State University and defense economics in a post-graduate program at IMEMO. At BICC, she is responsible for research projects linked to Russia.

Her main research project last year was Research and Development (R&D) conversion in Russia. The main aim of the project was to analyze the changes which have occurred in defense R&D since the onset of monetary and systemic reforms. The forthcoming BICC report No. 10 summarizes the developments of the last four years, including studies of sectoral differences, regional and employment aspects, institutional reforms and international R&D cooperation ventures.

The main focus of her research, this year, is on industrial conversion including the reforms taking place in restructuring and consolidation of what is known as the defense industrial complex in Russia. This work forms part of the BICC *Conversion Survey 1998*.

Another project deals with the participation of BICC, in cooperation with the Professional College in Cologne, as a subcontractor in the TACIS-Tempus program which foresees establishment of a program in the International Management and Law School in Nizniy Novgorod (NiNo). This year, it is planned to prepare a study on the economic structure and market potential of NiNo which aims to conceptualize the re-training courses, specifically directed towards former defense enterprises of this region.

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Marketing former military land via Internet

In its continuing commitment to support communities in the base conversion process, the Bonn International Center for Conversion released its 'Marketing Homepage' for conversion of former military sites earlier this month. Ex-military bases for sale in Germany are now on the *ConverNet*, providing investors around the world with a new resource for finding land for commercial and housing developments. The Marketing Homepage (<http://bicc.uni-bonn.de/bmarket>) is an extension of the Base Closure and Redevelopment section of *ConverNet*, which contains more detailed information on the reuse and redevelopment of former military bases around the world.

The goal of the project is to attract the attention of potential investors to industrial real estate and provide a contact person for their initial inquiries in the respective community. Finding potential investors for former military lands is a complex problem in Germany, where more than 4,000 sites have closed. Particularly difficult to market are large sites in unfavorable locations or large barrack complexes. BICC conducted interviews with sample investment companies in Germany to determine what criteria are

most important for their land development plans. The results of these interviews were compiled in a questionnaire and sent to the officials responsible at some 120 North Rhine-Westphalian communities.

Services for base closure communities include development of an individual 'homepage,' maintenance and updates on the BICC server for two years. The response from local communities with regards to this project has been positive as only a few of the communities currently have access to the Internet. Enough information is presented to spark the investor's interest—existing buildings on the site, possible or planned reuse, and location relative to regional infrastructure—and initial contact can be made with the person named in the homepage.

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Three Years of Conversion Work at BICC

In March 1997, BICC looked back on its first three years of research and practical conversion work. A variety of projects in different parts of the world have been undertaken, ranging from long-term research studies to practical consultation and assistance, from short-term and on-the-spot support to conversion practitioners to broad-based exchanges of experience, from documentation of successful and 'best-practice' conversion experiences to publishing the negative by-products of the disarmament process.

Researchers from over a dozen countries work on projects at BICC, emphasizing the international perspective which disarmament and conversion require. After a first decade of disarmament, the tempo of the military draw-down has slowed down, but disarmament and conversion are still occurring and it is still essential to make constructive use of the resources freed.

After regular internal reviews of BICC's work, an international evaluation team is presently looking at BICC's mandate, relevance of work, cost effectiveness, and public standing. When the evaluation team presents its report in May 1997, BICC's board and staff hope to receive a blueprint for the future development of its work.

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Bonn International Center for Conversion bulletin No. 3

As an independent, non-profit organization, the Bonn International Center for Conversion (BICC) supports and promotes the processes by which people, skills, technology, equipment, financial and economic resources are shifted from the military or defense sector towards alternative, civilian purposes.

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BICC Publications

In addition to its annual yearbook *conversion survey* and other books, BICC publishes series such as *reports*, *briefs* and *papers* that analyze the background of the international conversion process, report on conversion projects and experiences, and offer scientific as well as practical know-how in the various fields of conversion. Recent publications include the following:

paper 7: Irmgard Nübler, Human Resources Development and Utilization in Demobilization and Reintegration Programs, January 1997

paper 8: Denise Spencer, Demobilization and Reintegration in Central America, February 1997

report 9: Jörn Brömmelhörster, KONVER II Konversionsförderung durch die Europäische Union [Fostering of Conversion by the European Union], March 1997

Forthcoming:

report 10: Ksenia Gonchar, Research and Development Conversion in Russia, April 1997

report 11: Keith Cunningham, Base Closure in Eastern Europe, June 1997

Upcoming Events

BICC will hold a press conference to launch its second yearbook *Conversion Survey 1997* on 27 May 1997 in Bonn.

The **Fourth International Technical-Practical Conference on Productive Reuse of Former Military Sites: Environmental and Economic Aspects of Demilitarization** will take place June 9-13, 1997 in Minsk, Republic of Belarus under the Nunn-Lugar Cooperative Threat Reduction Initiative between the United States of America and the Republic of Belarus.

350 years of Peace of Westphalia in 1998: Numerous activities will take place in Münster and Osnabrück where the Treaty ending the Thirty Years War in Central Europe was signed in 1648. BICC has been asked to contribute to this event by presenting contemporary experiences with international peace-building and conversion measures.

BICC Notes

On 18-19 February 1997, BICC and the Centre for Conflict Resolution at the University of Cape Town, South Africa (CCR) held a workshop in Cape Town on "Demilitarization and Peace-building in Southern Africa." The workshop, funded by the International Development Research Centre (IDRC), Canada, was attended by development experts, Ministry of Defense officials and researchers from a number of Southern African countries, including Angola, Mozambique, Namibia, South Africa and Zimbabwe. BICC and CCR, in cooperation with research organizations in several Southern African countries, are currently developing a research program which will examine the dynamics and regional aspects of demilitarization and peace-building in Southern Africa.

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BICC has completed its third report on troop reductions and base closure in North Rhine-Westphalia, Germany on behalf of the government. The report focuses on 'best-practice' conversion projects and will be approved at a cabinet meeting in mid-April.

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On March 5-7, BICC hosted a Conference on Regional Approaches to Defense Conversion at the Gustave Stresemann Institute in Bonn. Academic participants and practitioners came from over a dozen countries to compare notes on the extent to which regional initiatives have facilitated conversion of both military bases and industrial facilities and the extent to which regional experiences are comparable. A number of papers will be published from the Conference.

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New in May

BICC publishes its second yearbook:

Conversion Survey 1997—Global Disarmament and Disposal of Surplus Weapons, Oxford University Press, UK, 1997 (price £17.99, \$27.95, DM 45.00), 318 pages.

Copies of the Survey can be ordered in advance from BICC.