

The Summer Solstice of the Welfare State

by Gary North

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This weekend brings the longest day of the year, unless you live south of the equator. Enjoy the daylight while you can. There's going to be less and less of it.

Economics is not predictable in the way that astronomy is. Economies are not rotating spheres in space. Men make choices and change their minds. Gaia is a myth.

Still, there are long, widespread patterns of growth and contraction in economies. Spain's economic growth after 1492 continued for about 150 years, although it was confined to the upper classes. Then, when debt escalated and gold shipments sagged, Spain slid into poverty. It was a long night. Only in the last two decades has Spain's economy recovered to the general level of Western Europe.

Some Spaniard in 1650 may not have wanted to accept the new economic reality. He may have had great plans for his economic future. And, if he was smart enough or lucky enough, he got rich. But most of his countrymen didn't. Anyone who decided to stay in Spain had to battle the comparative economic stagnation of the Spanish economy. He would have been wiser to emigrate, either west or north.

WHEN BUBBLES BURST

Someone who stayed in a NASDAQ stock after March, 2000, battled its collapse. Maybe he owned a company that overcame the trend, but not many people did. The NASDAQ was a bubble. It was the joint product of expansionary Federal Reserve credit, enormous hype by lying promoters, brokerage firms that milked their clients, and the general

mania that accompanies a bubble. It was a mania that operated against all odds and all financial history, yet even smart investors who understand math thought that it would last forever, or at least until their retirement.

The NASDAQ was clearly a bubble in December, 1999. A market index that has a price/earnings ratio of 207 is clearly a bubble: you pay \$207 to buy \$1 in profits, not discounting for price inflation. But the "experts" did not see it coming. I can think of one newsletter writer who predicted that the NASDAQ index would be larger than the Dow Jones Industrial Average. He did not mean that the Dow would head down faster than the NASDAQ was about to head. As for me, I begged my *Remnant Review* subscribers to get out, in February, 2000, and again in March.

Today, Warren Buffett says that there are no companies out there that impress him, other than the ones Berkshire Hathaway already owns. Nevertheless, investors have recently rushed back in where Buffett fears to tread. They have driven up the P/E ratio of the S&P 500 from 27 to 36 in just a few weeks. Bullish sentiment among forecasters is higher than it was in 1999. The stock market is rising into bubble-like territory on bubble-like sentiments.

Like a Spanish investor in 1650, American investors are convinced that the past is prologue. The Spaniard imagined that there would soon be new gold mines discovered, new military strategies to thwart British privateers, new lenders to roll over existing loans at existing interest rates, new ways to make entrepreneurs out of fourth-generation bureaucrats living on declining revenues. The American investor imagines that this country's balance of payments will be balanced without pain to consumers, that the dollar will not fall in value internationally, that a Federal deficit of \$500 billion doesn't matter, that businesses will again start investing in capital equipment, that the FED can cease inflating at any time without producing a recession, and that Congress will lower taxes again Real Soon Now.

Problem: dreams must be financed if they are to become realities. Dreams must also be realistic if they are not to consume the financing: "good money after bad."

To keep the receptacle for invested money from becoming a sink hole, there must be a growing economy. What are the common features of a growing economy? These:

1.
A high savings rate
2.
Minimal government regulations on the economy
3.
Low taxes, especially on capital gains
4.
A culture favoring entrepreneurship
5.
Future-orientation of the masses (save!)
6.
Stable money
7.
Freedom of contract
8.
A court system that enforces contracts
9.
A growing population

The United States had all this in the 19th century. It steadily surrendered all of this in the 20th, but other European nations surrendered even faster, and fought two world wars in addition.

John Maynard Keynes (B.A., mathematics) became the economist of choice in the West after 1936. He and his followers offered a different list.

1.
A high consumption rate
2.
More government regulations on the economy
3.
High taxes on the rich and "unearned" income
4.
A culture favoring formal education
5.
Present-orientation of the masses (spend!)
6.
Fiat money
7.
Trade union restrictions enforced by law
- 8.

A court system that protects the poor

9.

A stagnant population

Asia became the testing ground of these two theories after 1945. India adopted the second list. Hong Kong adopted the first. The results could no longer be ignored by 1980. India was the largest basket case on earth. Hong Kong was a dynamo. India switched oxen in mid-Ganges around 1980.

The same test came in the two Chinas: Taiwan vs. Mainland. The results were even more dramatic. Deng Xiao Ping reversed course in 1979. The result is the fastest growing economy on earth, despite a monetary policy that will eventually backfire: [M-2 growth at 16.5%](#).

Asians still favor formal education, especially in mathematics. But the rise of entrepreneurship has been so fast and so pervasive in mainland China that not even State-funded schooling could overcome it. The government cannot afford to put the vast majority of Chinese students into a university. Salaried bureaucrats do not teach most young adults in China. This is a distinct advantage for the development of entrepreneurship.

Bubble economies are the result of inflationary monetary policies. This is why China's current boom is partially a bubble, as was Japan's in 1985–90. But the core of the economy is what counts most. By this, I mean the core economic faith of the people and their ability to work out that faith in fear and trembling.

Europe's core is rotting. It's finished. Population statistics tell the story. Through immigration and reproduction, Islam will dominate Europe in a century.

The United States is still alive and kicking, but its level of capital taxation and business regulation is high when compared with East Asia's. (India is still very bureaucratic, and its masses have little respect for the concept of Western linear time, but its business sector is growing rapidly.) America's tax-funded school system is a visible disaster. Even at the graduate school level, where both science and technological education are the best in the world, half or more of the Ph.D. candidates in engineering are foreign students. This is true across the board in the natural sciences. American taxpayers are paying for the education of

foreign nationals.

That's why Americans live in a bubble economy. The bubble mentality is steadily replacing the entrepreneur's mentality. Because of government regulation and Federal Reserve credit, the stock market has become more like a gigantic casino than a place where visionaries and investors join in their search of better ways to serve future consumers.

What is true of all casinos is this: those who bet against the house are going to lose. They are there for the action, and, statistically speaking, the action is inevitable: losses. They say they come to win, but their actions testify against them. They bet against the law of large numbers. They come to lose, but they want excitement while they're losing. They want the excitement of thinking they will win big.

At the height of the NASDAQ boom in the first quarter of 2000, investors were on a roll. Lady luck was with them. They did not perceive that they had been transformed from investors to players, from entrepreneurs to gamblers. This transformation marks every market bubble, just before it bursts.

The S&P 500 is a bubble. It will burst.

People who are invested in a bubble market are like gamblers who bet against the law of large numbers. They may say they are going to get out before it bursts, just as the gambler insists that he will quit when he is ahead. Both are self-deceived.

My father-in-law, R. J. Rushdoony, was a missionary on the Western Shoshone reservation in the late 1940's and early 1950's. It covered a large part of Idaho and Nevada. One of the few white men he saw every year was a vacationer who came to fish. The man worked in a casino in Nevada. He once said that the only person he ever saw who quit while he was ahead at the dice table had been blind drunk when winning, and passed out while he was ahead. The next day, hangover-afflicted, the man cashed in his chips. The fun was now gone, so he took his money and drove home.

The winner was blind drunk. The vast majority of today's stock market investors suffer from a similar condition: blind faith.

BLIND FAITH

Most Americans are not invested in the stock market. That's because most Americans have no savings. They live from paycheck to paycheck. They don't worry about Social Security and Medicare because they don't worry about anything more distant than the next paycheck. They don't worry about under-funded private pensions because they don't have pensions.

These people vote. They believe that if they need something badly enough, they can vote for it. They share this belief with seniors, who are convinced that all it takes for Social Security and Medicare to remain solvent is Congress's willingness to vote to keep it solvent.

Congressmen do not write their constituents letters (postage paid for by the government) telling them that the system cannot possibly remain solvent after 2017. From the top to the bottom of society, no one will face the numbers. It's Spain, 1650, and everyone pretends that it's 1550.

Everyone pretends that the economy's summer solstice is always ahead of us.

The one identifiable group that remains unconvinced of all this is the underclass, whose members don't vote, don't trust the government, and have no hope for the future. Show me a man on skid row, and I'll show you a committed skeptic regarding the wisdom of Congress. The underclass doesn't pay for lobbyists in Washington.

The existence of hordes of lobbyists points to the continuing faith of most Americans that there is hope in what Washington does, that there is money to be had, that all it takes to keep a nation rich is voting and Federal Reserve credit to back up the votes.

As surely as the statistical reality of a casino will remove money from the "guests" into the bank account of the "host," so are Social Security and Medicare statistically doomed. Yet the President is ready to sign a law subsidizing drug payments for Medicare recipients. The Democrats complain that the legislation is not generous enough. This is evidence of the gambler's mentality: faith in luck over numbers. "Pass a law, and lady luck stays with us." Legislation can beat the law of large numbers: here is the faith of American voters.

People invest in a bubble stock market because they have faith in Alan Greenspan's ability to persuade the FED's Federal Open Market Committee (FOMC) to buy more government debt, thereby creating

more money for Americans – preferably consumers – to borrow at low rates. This is faith in the Federal government as the provider of long-term wealth, despite the nation's minimal rate of savings. This is faith in the wisdom of the Federal Reserve System, in contrast to faith in the wisdom of Congress. There is not much to contrast.

I call this summer solstice investing. It is investing based on faith that tomorrow will bring even more sunshine, despite the statistical reality of the numbers. This is an ancient faith, described by the prophet Isaiah about 2,750 years ago:

Come ye, say they, I will fetch wine, and we will fill ourselves with strong drink; and to morrow shall be as this day, and much more abundant (Isaiah 56:12).

Almost half a century ago, the chairman of the FED, William McChesney Martin, defined the FED as the party-pooper who takes away the punch bowl just as the party is getting rolling. He was too self-congratulatory in his defense of sobriety. The FED is the agency that provides the wine for the government's punch bowl. Then, when most of the guests are well into their cups and no longer thinking clearly, it takes the punch bowl away.

Alan Greenspan, who may beat Martin's tenure as the longest-surviving chairman, is unwilling to remove the punch bowl, despite the greatest party since the FED was created in 1913.

But at some point, every credit money-induced party ends. Either the guests drive home at high speed, daring the cops to catch them, or else they pass out. In either case, the survivors will experience a hangover the next morning.

NASDAQ investors, who drank the hard stuff, sobered up first. S&P investors, who have stuck with spiked punch, are now putting lamp shades on their heads and singing the old songs. It's 2 a.m., but they pretend that it's 9 p.m. the night before.

Happy days are here again.

If you're still at the party, put down that cup and call a cab. I hope you have some tomato juice in the refrigerator. You'll need it when you wake up.

CONCLUSION

The summer solstice is about to arrive for the American economy. Europe's has already passed. That's not to say that America will not have another solstice. When the government's Medicare bills come due and are not paid, a new political order will manifest itself. We don't know what kind it will be. We can be sure that new dreams and new expectations will replace the impossible dreams and crushed expectations of those today who believe that the government can make us all comfortable at somebody else's expense.

Between now and then, there will be a great deal of discomfort – and maybe pain. Those who invest as if America's summer solstice still lies ahead because the winter solstice has been banned by law have darkening days ahead of them. We all do, but only a few people are preparing.

The recession of 2001–the present created renewed interest in Austrian economics, which explained it better than other theories. Bad economic news created interest in good economic theory – the reverse of what happened after 1936. There is more bad economic news ahead over the next three decades. The winter solstice lies ahead.

I hope Austrian economists are preparing for rising demand for plausible explanations. Only the Austrians have predicted the outright collapse of the Ponzi scheme known as Social Security/Medicare. The other schools of mainstream economic opinion admit that the system has "problems," but nothing that equation-directed tinkering with the welfare system can't solve. For them, numerous marginal problems of the welfare State never needs to produce catastrophes. For them, there never can be a winter solstice for the economy, for the Federal Reserve System and Congress will simply not allow it.

To which I respond, 1650-style, "Hasta la vista, Baby."

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Gary North is the author of [Mises on Money](#). Visit <http://www.freebooks.com>. For a free subscription to Gary North's newsletter on gold, [click here](#).

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