

## The American Consumer as a Magician

by [Gary North](#)

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Housing prices on the two coasts continue to rise. The spending boom is still running at full tilt. American consumers are spending like there is no tomorrow.

In the good old days, economists would tell us that this is all wonderful. It is a sign of increasing productivity, evidence of people's confidence in the future. That was then. This is now.

Headline, London *Financial Times* (May 10): **Real Wages Fall at Fastest Rate in 14 Years**

The author of the article, Christopher Swann, reports on a recent survey of wages and prices. A nominal wage is what someone is paid in currency terms. Real wages reflect what that income will purchase. If retail prices are rising faster than nominal wages, the worker is being squeezed. This is what is now happening.

Inflation rose 3.1 per cent in the year to March but salaries climbed just 2.4 per cent, according to the Employment Cost Index. In the final three months of 2004, real wages fell by 0.9 per cent.

The last time salaries fell this steeply was at the start of 1991, when real wages declined by 1.1 per cent.

It is worse than this, of course. In addition to being squeezed by the rising cost of living, he is being squeezed by the income tax: state

(probably) and federal (surely).

Many economists believe that in spite of the unexpectedly large rise in job creation of 274,000 in April, the uneven revival in the labor market since the 2001 recession has made it hard for workers to negotiate real improvements in living standards.

There is this problem. [The supposed increase in the number of jobs is a guess made by the Bureau of Labor Statistics.](#) This guess is based on an imputed statistic known as the birth-death ratio of businesses. [I have commented on this statistical legerdemain before.](#) So have others.

The most significant factor in any recovery is employment by profit-seeking businesses. Things are a lot worse than the government's statistics imply. [If we are talking about employment generated by actual consumer demand, the U.S. economy is in worse shape than it was four years ago.](#)

Even after last month's bumper gain in employment, there are 22,000 fewer private sector jobs than when the recession began in March 2001, a 0.02 per cent fall. At the same point in the recovery from the recession of the early 1990s, private sector employment was up 4.7 per cent.

### ***EVERYONE LOVES AN ILLUSION***

The American consumer is no doubt optimistic. He continues to spend, despite the fact that his real income is falling. He thinks, as Mr. Micawber thought in Dickens' *David Copperfield*, that something will eventually turn up. But, so far, nothing has . . . except prices.

I begin to suspect that America's consumers are modeling their expectations – great expectations – after the more recent David Copperfield, who somehow gets an attractive lady to float in mid-air.

Mr. Copperfield's performances are good fun because they rest on illusion. I keep wondering what the consumers' optimism rests on. I keep wondering what will happen when the applause ceases after the curtain has come down.

The American consumer, like Mr. Copperfield, has drawn a large and

enthusiastic audience: politicians, economists, economic forecasters, and foreign investors. Everyone in the audience is amazed at what they see. Instead of the old magician's truck of pulling rabbits out of a hat, the American consumer is stuffing rabbits into a hat.

Everyone in the audience is thinking: "How does he do that?"

Next, he tells the crowd that he can do the same trick with anything the audience has in their pockets. He calls on the audience for volunteers.

The economists never do anything for free, so they just sit there.

The politicians figure they are going to get a percentage of everything that goes into the hat, so they just sit there.

The forecasters, not having a dime in their pockets and not wanting anyone in the hall to find out, just sit there.

The foreign investors line up. They come on stage, and the consumer gets them to put everything they have in their pockets onto a table. Then, item by item, he stuffs everything on the table into his hat. The volunteers all go back to their seats with empty pockets.

The economists insist that it's not a trick; it's just Keynesianism in operation at the micro level. It's all quite productive.

The politicians say it's good for the economy as long as whatever is in the hat is not assessed at the lower capital gains rates.

The forecasters say that they see no reason why the show will not go on indefinitely as long as enough foreign investors show up.

The foreign investors think they will get their stuff back after the show. "What good fun!"

The curtain falls, the crowd goes home, and word spreads about the fabulous rabbits-into-the-hat trick. Amazingly, even more foreign investors show up the next night. Soon, the performer must rent a larger hall.

A month later, on page 6 of the *Wall Street Journal*, there is a brief story about the rising price of rabbits.

## ***STRINGS ATTACHED***

The American economy is like the lady in the air. We all know the wires are there. We just can't see them. She won't stay suspended after the curtain falls.

Yet there is no doubt about one fact: the levitating economy trick has gone on a lot longer than the skeptics in the audience ever thought was possible.

At some point, there is a tendency of the audience to conclude that maybe, just maybe, there are no strings. Maybe, somehow, Mr. Copperfield has found a way to overcome the law of gravity. The audience starts filling up with true believers. Maybe it's like flying saucers. Maybe flying saucers are real. Maybe the government is suppressing the truth.

The government's official explanations of the causes of the recovering economy look more and more like its reports on Roswell. There is something else: the more that I listen to Alan Greenspan, the more he sounds like a space alien. (He plans to leave soon. "A.G. call home!")

Are there no strings attached?

Yes, there are. They are supplied by lenders. Lenders are convinced that the show will go on, that revenues will continue to flow, and the economy will continue to be suspended safely at ever higher levels.

The supply of strings seems secure, and every time this is called into question by events, the Federal Reserve System turns on the string machine.

Lenders are to the economy what investors are to a Broadway show. As long as the audience fills up each night, the director can ask investors for just a little more money, a little more time. Meanwhile, the crowd standing in line is going to pay for its tickets with their credit cards. More strings.

The complexity of the web of debt is so great that no computer, no data-gathering agency has the ability to track it. The derivatives market alone is estimated to be in the range of \$150 trillion.

Investors, consumers, and government regulators are all assuming the truth of what the anti-market ideologues have denied from the beginning, namely, that individuals can make self-interested decisions regarding personal and corporate debt, and the economy will prosper. "Deficits don't matter" – not personal, not corporate, not government.

I would agree with the defenders of debt, were it not for the fact that central bankers, politicians, academic economists, and administrators of government-guaranteed bank insurance programs have assured the public that in case of a crisis, the government will bail out the credit system to keep it open for business. The debt-ridden public has believed this. Lenders have believed this. Investors have believed this.

There is a movie scene that you should keep in mind whenever you read that a government agency will keep the credit system afloat. In "Superman," Lois Lane has just fallen off the roof. Superman flies up, grabs her, and assures her, "Easy, miss. I've got you." To which she replies, "You've got me? Who's got you?"

Debtors see the strings, but assume that these can be broken legally in a pinch. Lenders extend the strings, but assume that someone, somehow will grab hold of the strings if the existing debtors break them. Everyone knows that if the system of strings ever breaks, the result will be a catastrophe. Yet the intertwined system of strings looks more like the Gordian knot these days than it looks like a stage production of Peter Pan.

### ***CONCLUSION***

The system holds. But most Americans today are falling behind. Price inflation is now rising faster than wages are increasing. Add the income tax effect, and the worker is falling behind steadily.

Yet he spends. Lenders offer him money at rates that seem low, and he takes it. Every time he does this, he places another restriction on his economic mobility. He trusts the decision-makers to protect him from rising interest rates, yet the Federal Reserve's stated policy today is to raise interest rates.

The squeeze will continue unless the rate of price inflation falls. But if it does fall, then it is likely to take the economic recovery with it. With

respect to private sector employment, it is not much of a recovery.

The best investment strategy today is this one: "No strings attached." There may be exceptions, such as a fixed interest 30-year mortgage on a house that would easily rent for more than you are paying for mortgage, maintenance, and insurance. But there are not many of these for sale these days.

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