Conversations with Bill Kristol

Guest: Scott Lincicome, International Trade Attorney
Senior Fellow, Cato Institute

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I: The Threat of Inflation (0:15 – 23:32)

KRISTOL: Hi, I'm Bill Kristol. Welcome to CONVERSATIONS. I'm very pleased to be joined again by Scott Lincicome, who is a Senior Fellow in economic studies at Cato Institute and a regular contributor, newsletter writer for our friends at The Dispatch. A must read, you should read it despite its slightly cutesy name, Capitolism, but it's nonetheless an excellent newsletter. And Scott, the last conversation we had was in January of 2021, January of this year, about 11 months ago, where we agreed that there were a ton of lessons to be learned from the success of the vaccine, including the case for globalization, free trade, for the free movement of capital, for immigration. And I noticed that no one has actually learned these lessons that we stressed.

LINCICOME: Not at all. But being a libertarian and writing about free market economics, you become accustomed to people not listening —

KRISTOL: Yeah. Well, hopefully this one —

LINCICOME: — in Washington at least.

KRISTOL: This one they'll listen to more.

LINCICOME: Yeah. [Laughter]

KRISTOL: So Scott's going to explain to us sort of where we stand as we exit, hopefully, the pandemic. In terms of the economy in general, but particularly this very interesting question of the supply and demand, supply chains, inflation and so forth.

But I do actually want to begin just with one other thing. It just occurred to me in the last 24 hours, we're speaking here, what are we, a week before Thanksgiving? I mean, if you really step back to 30,000 feet — this maybe is just me being crotchety when I see everyone complaining — isn't this sort of an amazing, I don't know, success story, may be too strong, but if you had said to us that the whole world economy was going to shut down almost two years ago because of this terrible pandemic, something that we haven't really seen in decades, maybe in a century almost, and that we would make it through.

I mean, leave aside the terrible, the deaths and the illnesses, which partly is due to apparently bad governance and partly is just what happens in a pandemic. But the economies would be where they are, GDP about where it was before the pandemic, unemployment at whatever it is in the US now, 4.5% or something. The world economy kind of moving along with the same problems and challenges, but I think we would've said, “That's kind of amazing. I mean, isn't this going to be more like the financial crisis where it takes years to recover or other kind of big shocks?” And I guess, am I wrong to think that people don't appreciate the strength and resilience of the world, of the US economy? Or am I just being too whatever contrarian or something?

LINCICOME: No, I think you're actually very much correct. If you recall from say May of 2020, give or take, there were all these debates about, “were we going to have a V-shaped recovery or an L-shaped recovery” or whatever. And the V-shaped idea that we would go straight down and bounce straight back was a minority view. And that's basically what we've had. Especially again, when you compare it to the Great Recession, which was such a slow, long slog back to normalcy. So yeah, I think in the kind of grand historical perspective, certainly we are blessed to be complaining about the little things.

Now, there are lot of little things. And like you said, there's a lot of really tragic death and so forth. But yes, in the broader context, it's been pretty good.

KRISTOL: And am I wrong that the US is actually doing better than most countries? Again, and we're going to spend the bulk of this discussion on problems and the granular and the supply chains and all that, and inflation and those may lead to bigger problems, so I'm not being Pollyanna, I don't think. But the US is sort of ahead of most countries I think in GDP or household income recovery.

LINCICOME: Oh, sure. In terms of economies snapping back, in terms of life returning back to normal, the United States is near the top. It really has disproven this idea that was, again, quite prevalent that the US response was a global laggard. That not only the policy response, but then things like not just infections but lockdowns and reopening, and then some a-ha, the China's approach was the way to go. And now what we've seen is really COVID doesn't discriminate. It seems to get at everybody eventually. And the US response, for all its warts, has shown kind of the resilience of a free-market, rather flexible economy and the ability of our markets to bounce back.

KRISTOL: And I suppose, combined — a nod here to our liberal friends — with a big government intervention. But of a kind of, I won't say libertarian kind, but not of a big government kind, not of a fatal conceit, central planning kind, just throwing money at it.

LINCICOME: Yeah. And to me, if you were pained enough to go back through my Twitter timeline back in March of 2020, I was very much on Team “Send People Checks.” Right? I think there's a very strong libertarian argument that if the government is going to shut down your livelihood, well, it owes you just compensation, sort of an eminent domain idea. And so yeah, the US fiscal response in several ways was, I think, quite appropriate.

Now, that was in 2020. I think as we'll probably get into, the fiscal response in 2021, maybe not so much. And certainly, there have been problems. But yeah, I mean, it seemed pretty good, given the situation.

KRISTOL: Okay. So let's get to 2021 and some of the problems and challenges, I guess. What you want to begin with, demand or supply? We've poured a lot of money on the demand side.

LINCICOME: I think demand is a good place to start because we can talk about it then hitting that wall of supply. Yeah, if you go back — Now let's rewind to say February of 2020, when the Biden agenda was just being rolled out.

KRISTOL: 2021.

LINCICOME: Sorry, 2021. Excuse me, yeah.

KRISTOL: Years blur together when you're —

LINCICOME: It really does.

So you see the Democrats were really wedded to this American rescue plan. This was going to be two trillion, it was going to send checks and a lot of money. And it was also going to do other things: child tax credits and unemployment benefits and this. And back then, there were really only a few folks that said, "Maybe this isn't a great idea." And I should say, a few folks on the kind of center left side of things. There were certainly folks on the right. All of a sudden Republicans had fiscal discipline again, magically. It's amazing what an inauguration will do.

KRISTOL: Larry Summers and the Conversation I had with him in February.

LINCICOME: Exactly.

KRISTOL: He was a skeptic about throwing quite this much money at it.

LINCICOME: Exactly. And so Summers, Olivia Blanchard, who was former IMF director and a few others, Jason Furman, former Obama Council of Economic Advisors, a guy who — Furman wasn't opposed but said, "This thing looks really big." And then again, you had others that were saying basically the same. That there was some fiscal policy needed, certainly government policy for COVID testing and for vaccines and the rest. But mailing off these massive checks, and they were. That's $10,000 a household when you finally add it all up. That was a lot of money to be pumping into an economy that even in February, you could see the green shoots. You could see the corner being turned. You could see vaccines rolling out. You could see economies sort of, kind of reopening. You could see a light at the end of the tunnel, at least the darkest parts of the tunnel.

And now fast forward to — And I should add, of course, that was on top of *trillions* in spending from 2020, the CARES Act and then another one in December. And of course, ultra-easy monetary policy, I mean, really kind of emergency monetary policy from the Federal Reserve. And so back then, those voices, Larry Summers and others, were mocked or really ridiculed. And then the rest of us were, of course, just ignored as being libertarian dogmatists or whatever.

So you fast forward to today, and now we're reaping a bit of the whirlwind, it sure seems. Where really, I think it’s undeniable at this point that there are inflationary pressures that are not just about COVID reopening. So it's not just hotels and used cars, rental cars, and that kind of stuff, which it was inevitably you were going to have some crazy price things going on there. And it wasn't just in supply chain stuff. Now we're seeing much broader based inflationary pressures that were supposedly, according to the Fed, according to Democratic policy makers, according to the White House, a lot of left-leaning economists, these price pressures were never going to exist, basically. We were going to jack up demand, we were going to have a transitory bout of inflation, which in the beginning was only supposed to be a few months. And then by the end of the summer things were going to settle down, supply was going to adjust and everybody was going to live happily ever after.

KRISTOL: I mean, it didn't seem ridiculous to me, at least. Coming out of a pandemic, there'd be all kinds of distortions and sectoral shortages and so forth.

LINCICOME: And worker issues, exactly.

KRISTOL: But you're saying that we are now — And we'll get back to those since those are quite interesting and important. But you're saying on the demand side, we've sort of gone beyond that and we now are in a more classic, actual inflation.

LINCICOME: The last two Consumer Price Index reports, and it's really important to look at these monthly because our year-over-year stuff is super wonky and distorted. And quite frankly, I get very annoyed when you see on Fox News or whatever that they're talking about, oh, “the largest annual increase ever.” Well, yeah, because it was like the depths of the Depression over last summer. But it doesn't matter. The month-over-month is concerning enough. Because what you see is in the spring and early summer, a spike in monthly inflation numbers. And that's, again, CPI, the other one, Personal Consumption Index, the Fed likes to use.

And then it started to moderate a little bit. We thought, “A-ha. Okay, maybe the transitory stuff is completely correct.” But now, it's trending back up again. And the problem is that, like I said, the early spikes were really isolated. They were mainly isolated in these COVID things. Again, I think rental cars is the great one. I mean, it went absolutely haywire and really screwed with the numbers. But now you're seeing it really across the board. And that's even if you remove things like energy, which can be very wonky, food which can be very wonky. I know removing energy and food is not realistic for normal humans, but for economists who of course are not normal humans, you need to do that because those things fluctuate so much.

KRISTOL: I think on the energy and food, just to interrupt for a second, the removal of those, I gather from the sort of things the economists talk about led to a kind of disconnect, apparent disconnect between the Biden administration saying, "It's not so bad." And everyone looking and saying, "Well, two of my major weekly expenditures are gas and food."

LINCICOME: Exactly. And I think I got into this a little bit in my newsletter this week, but the communication side of this is important. And saying things like, "Ah, inflation isn't bad if you remove food, energy, and some will even say housing." So if you remove everything you actually need, then inflation's fine. Right? Well, that's ridiculous.

But going back to what we've seen in the last couple months, now you're seeing core inflation and all these other alternative measures, that the Fed and other economists like to use to eliminate those wild fluctuations, are ramping up. And the last one from last week was really where I think people's toes started curling a little bit because this was a significant acceleration in those supposedly stable inflationary categories. And now you're seeing, hey look, Larry Summers and Blanchard are taking victory laps, because they were — I mean, look, and I get it, right? They were roundly ridiculed on Econ Twitter and so forth. And so look, it's inevitable human nature. You're going to dunk a little bit on that. But now I think Furman is the one that I like to focus on because he's clearly a Democrat.

KRISTOL: This is Jason Furman.

LINCICOME: Jason Furman, yeah.

KRISTOL: He's popular on Twitter if people don't want to read the 72 page, NVER papers and read the 280-character summaries.

LINCICOME: Exactly. So he's on Twitter, he's at the Peterson Institute and at Harvard. And so he was one of the guys that was cautiously supportive of the American Rescue Plan, but did say, "Hey, inflation might be a concern." Well now he's really been out I think in the front saying, "Look, we have an inflation issue. We're not looking at the 1970s. We're not looking at Zimbabwe. That's silly. But we really are seeing the potential early stages of a broader inflationary problem that isn't just a transitory thing."

And as I noted in my newsletter, the other thing that we need to note is that there are still a few shoes to drop here. The big one is housing because housing always tends to lag in the inflation indexes for all sorts of very boring reasons. But we've seen really substantial rent and house price increases. And housing is a big part of this index, of the indices that we look at. And those really are just starting to creep into the CPI figures and the PCE.

KRISTOL: They've happened in real life, but they haven't been captured in the indexes for reasons I don't fully understand.

LINCICOME: Exactly. Yeah, it not worth it.

KRISTOL: Not worth getting into.

LINCICOME: And people have been saying, let's watch out for housing because if housing starts going up — It was up significantly last month. We keep seeing it creep up and accelerate. That's an issue. The other big ones to be on the lookout for are, we've seen substantial wage gains. Are those going to keep translating to higher prices, consumer prices? Import prices, so import prices have gone up a lot. Are those going to keep pushing — again, translating through the economy. It's a meat grinder. If you don't have a 10% import price gain, it doesn't mean a 10% price gain for a consumer. But these things do tend to creep through. The New York Fed just had a new paper on this.

So these are the things we're just kind of waiting for. So Furman and others are saying, look, we really, in retrospect, the fiscal response, the American Rescue Plan was poorly designed, it was too big. And oh, by the way, Fed policy has actually gotten *looser* in real terms, because when you account for higher inflation. And so, he's, and I think some others are saying, we really need to put on the breaks here a little bit. Not to go to a full-on contractionary Fed. The Fed shouldn't be jacking up interest rates to 5% or whatever, but we should, maybe we should be letting off the gas pedal for sure.

KRISTOL: So I want to get to the supply side in one second, but then get a little more granular on the stuff. You've done so much interesting work on the supply chains, and global shipping, and all. But just what you're saying is, you would suspect the Fed will be under a lot of pressure to at least modestly tighten over the next —

LINCICOME: Yeah, it's —

KRISTOL: I mean, that you can't avoid some monetary response, even if some of the cause is not simply monetary policy or —

LINCICOME: Exactly. Yeah. So the Fed is going to start tapering down its bond purchases. This is a quantitative easing side of things. So that's supposed to start next month and then it's going to start raising rates next year. Now the Fed right now says it's going to take this nice and slow. Maybe only one quarter point interest rate increase next year. The markets don't buy it anymore. The markets think that they're going to do at least two, maybe three. So, three quarter point increases and the, yeah, the Fed — So the Fed is independent, but it's still a political entity in the sense of that you're going to have to be called before Congress, Jerome Powell Fed Chair, Jerome Powell's term is up soon and he might —

So, there's a lot of stuff that the Fed is going to have to do deal with because the last thing the Fed wants and the thing it can't afford to do is to have inflation kind of go out of control, out of the Fed's control, where it's not able to just tweak things a little bit and get things to stabilize. And if things start really ramping up, if wages start demanding, if workers start demanding higher wages and then companies start raising prices, and this creates this wage price spiral thing, and the Fed has to slam on the brakes, well, that's how you get a recession because the whole economy contracts.

KRISTOL: When do you think, final thing on the inflation side, I guess, when do you think we would know or you would be able to guess with some reliability that things are kind of getting out of control or not getting out of control?

LINCICOME: Well, I think so the next two —

KRISTOL: Is this a January thing? Is this a March thing?

LINCICOME: Yeah. I think the next two reports for CPI and for the corresponding PCE, the next two inflation reports are going to be just massive in this regard. If things settle down again, then the Fed can breathe a sigh of relief, that they dodged a bit of a bullet. But if it's another month like this month or an even further acceleration, well, then, we're going to have some issues.

KRISTOL: And we're not used to dealing with rising interest rates. I mean —

LINCICOME: That's the other thing.

KRISTOL: — we have consumers and businesses who've never lived with this environment.

LINCICOME: Yeah. And you go back to the communications point. I mean, the communications point has been so ham-fisted about not just avoiding food and energy and all that kind of stuff, but that, “Oh, this is no big deal. We've got it under control. You should be grateful because you have these government checks we've given you and all this stuff.” And in the real world, that's just not how it works.

Americans, first of all, they've been living in a multi-decade period of low inflation, under 2%. It's actually been a bit of an economic problem, some people say. And so suddenly when you're looking at this year we're going to see 5% or 6% inflation. Furman said he expects next year to be 3% to 4% in the core inflation, but he said it might be 6%. He doesn't know. To his credit, he says, there's a lot of uncertainty.

KRISTOL: And you think about interest rates going up, I think has all kinds of unexpected effects that people just haven't dealt with in a long time, if you're small business. I mean, in just a million ways. You roll it over, your variable rate.

LINCICOME: Exactly. Exactly. A variable rate debt and all these types of things. And so that's what you don't want. You don't want to see the real economy say, well, the heck with it, inflation is going up. So we are going to adjust our interest rates, whether it's credit cards or banks or whatever. Well, that causes consumers to clench up and everybody kind of freaks out you. That's the last thing you want right now, because we're still, the economy is not fully recovered. We're still millions of jobs short. We've just come over the line in terms of recovering, just standard GDP. And of course, everybody knows that we have all these supply issues as well.

And that's, essentially, as we were saying, you have this tidal wave of demand that has hit kind of a wall of supply. Supply has increased. It just hasn't been able to increase as quickly as this demand spike.

KRISTOL: Now, if it did, it would relieve some of the pressure obviously.

LINCICOME: Oh yeah, of course. Yeah. If you —

KRISTOL: There are supply-side solutions to these things, as well as monetary and demand side.

LINCICOME: There are. It's great to see all of my left-leaning friends suddenly become supply side. All of a sudden —

KRISTOL: Right. I was thinking about this myself, that I mean the initial supply side insight, it got kind of complicated. A lot of it had to do with marginal tax rates obviously and so forth. But it was sort of the sense that you can't just be a demand person, either a Keynesian or Friedman-ite demand person, if I can speak in shorthand, and I don't fully understand this, but I mean, yeah, you had to really be careful. Yeah. The supply chain mattered.

LINCICOME: Yeah, no, exactly. And we're reaping the whirlwind of sorts, right? That the prevalent view from many folks on the left back earlier this year was that we can just crank up demand. We can cut all of these checks. The government can —and just to be clear, it wasn't just stimulus checks. It was child tax credits. And there was a loan forgiveness and a lot of rent forgiveness and so forth.

And so all of that of course gives consumers more disposable income. Of course you also had pent up savings. And so the idea on the left was that this is fine because the supply will adjust. Producers will produce more. Workers will return to the market. Everything will be okay. And we're just not seeing that. There are these supply side constraints.

Now, some of that is COVID, some of it is psychology. Maybe people just don't want to get back to their old lives. There's this anti-work movement and stuff out there. People retired. They just said the heck with it because they have higher home values and the rest. But a lot of it is policy related.

II: Supply Chain Issues (23:32 – 1:02:13)

KRISTOL: So let's talk about it. So there are shortages of workers, shortages of dishwashers apparently, containers stacking up in Long Beach, but let's go to the sort of more, maybe we'll get to workers a little bit later, which is an interesting question I think ultimately because — But what accounts, why are there containers stacking up in Long Beach? Why are people ordering dishwashers and they can't come for three months. There can't be a massive increase in demand for dishwashers, for God's sake. Americans haven't just decided they all have to have three of them or something, you know?

LINCICOME: Well, it's funny you say that. So certainly there is, demand is way up and more importantly, demand for goods is way up. So we have, so COVID caused a shift in American consumption patterns. Some of this was just because of the lockdowns and the nature of COVID. So when you're stuck in your house, you are not going to consume many services. You are going to consume more goods, to the extent you're consuming much of anything.

KRISTOL: You have a lot of money just sitting around in your bank account.

LINCICOME: Exactly. So if you're not taking those vacations, if you're not getting that occasional massage or whatever, you have more money and you're sitting in your house and you're thinking, oh, these walls are ugly or that couch has, finally I'm going to replace that couch with a hole in it, whatever.

And so Americans shifted their consumption patterns, but they seem to have continued that shift longer than I think a lot of people expected. Most people expected that goods consumption would trend back down. As countries get richer, certainly it has happened in the United States, we tend to shift our budgets. We tend to consume more services and fewer goods relatively, right? So you're not stopping to eat. You're not not eating anymore. But relatively, you make more money. You tend to — more of your budget's going to go to services. Well, that again, that's shifted. So, and also you have a lot of money to spend. And some of that is from higher wages, but again, a lot of it is government stimulus.

And so that hit a supply chain that was already struggling with COVID. So, the supply chains, global supply chains are kind of a delicate dance of sorts. They are essentially based on pretty predictable supply and demand patterns around the world. Ships have to of course arrive at certain times and they have to stack containers. Those containers get filled. They move to a port. They are offloaded. Trucks are waiting there. This whole kind of dance that the supply chain does is based on a relatively predictable pattern of consumption and production and operating hours at ports and having workers of course to unload things and produce things and transport things in the rest.

So COVID threw a wrench in all of that. You had economies opening and closing at different times. You had, of course, workers getting sick or dying. You had plants closing, factories closing, ports closing, all this type of stuff. So that threw this well choreographed dance off. And that's part of the issue. Simply a matter of how do you deal with these weird patterns? Because you ended up at one point, for example, you had the US economy was reopening, but a lot of economies overseas were still pretty closed down. They didn't have vaccines and so forth. So we, again, we had this new appetite for goods. We had a new comfort with e-commerce, and so we're pointing and click, we're pointing and clicking here, and the containers are arriving. That's fine.

But the problem is we're not sending anything abroad. So because again, other economies aren't consuming our exports. Contrary to popular belief, we export a lot of stuff. The United States is the second largest exporter in the world. And so that's a big problem. So what happens, you have empty containers start stacking up. And you have the inability to clear the ports after the imports arrive. So that was a bit of the imbalance.

But the other issue we have in the port system and in the supply chain is that we have a very inefficient port system in the United States. If you look at the global rankings for port efficiency, for example. I know everybody out there you're very into this stuff. Clearly, it's light reading at night.

KRISTOL: I was just looking at them last night. [Laughter]

LINCICOME: Yeah. Right. Right. Well, so the United States, not a single port in the United States ranks in the top 50, in terms of efficiency. The biggest ports complex we have out in Los Angeles in California is almost the bottom. And this is not just, this is like 350 ports around the world, in developing countries and Western economies and everywhere. LA Long Beach are around 335 out of 350. Our most efficient ports, which are on the East Coast, were in the 80s. So nobody is really doing well.

Well, when you have inefficient ports —

KRISTOL: Why is that? I mean.

LINCICOME: Oh, well, so the reason very much so is a lack of automation at these ports and a lack of modernization pushed by very powerful longshoreman's unions. So the longshoreman union on the West Coast basically controls all West Coast ports. So when they have a strike, half the economy, the global economy, can kind of shut down. So they have immense leverage. They also, of course, have political backing from state and Federal politicians and the NLRB and the rest.

And so they've negotiated contracts that essentially prohibit fully automating ports. And the East Coast ports have essentially the same situation with the union out there. And so when you look at the ability of US ports to process containers, we're very low on the list. And it's not just versus China. If you look at a place like Rotterdam, fully automated, they do great. Ports in Japan and a lot of —

KRISTOL: These are not, yeah. So social welfare states that are not full of, that are not under extreme capitalism.

LINCICOME: Exactly. Yeah. This is not —

KRISTOL: I mean, they have some problems there too, right? There's a backup and so on.

LINCICOME: Well, they are, but they are more easily able to clear the docks and get things. Basically, an automated crane, first of all, doesn't ever get sick. But beyond that, it can work 24/7. But beyond that, the ability of these automated systems to kind of just adapt, right? If one ship is taking longer, they can quickly kind of move to another crane system and so forth. And we have one pretty automated port out in Virginia, and it's a smaller port granted, but they're having almost no bottlenecks and problems.

And the thing that, and so beyond the automation though, the unions have negotiated very strict rules on shifts. They, of course, are making tons of money. They're very expensive, these workers. So what happens? Well, the entire system doesn't work 24/7. Truckers and warehouses and the rest are, essentially they're just not going to be as efficient and flexible as possible. And it's certainly not the only issue, but those ports, I think it really starts at the ports.

KRISTOL: You think that's really key? I mean, so what about when you read about dishwashers and stuff? That's not a — Is that just a more standard supply chain, stuff is coming from 20 different countries kind of issue?

LINCICOME: Well, so that's certainly part of it as well. Right? So we put microchips in everything and the chip industry, we have a global chip shortage of sorts and that's mainly just COVID stuff. You'll hear, “oh, that's because we don't make a lot of chips.” But we actually make a lot of semiconductors here in the United States too. About half of all chips that American companies consume are made here in the United States.

But the problem is that during the start of the pandemic, a lot of major chip consumers, particularly automakers, canceled their contracts. So these chip companies, they shut down their production or they signed new contracts, particularly with things that everybody was starting to consume like video game consoles and PCs, we all were working from home. And then all of a sudden the auto companies realized that, oh my gosh, people are actually buying cars. They're not just buying cars, they're buying more cars. So they wanted to get back into these contracts. And the chip companies were like, “we don't have any supply available for you.”

KRISTOL: Some of this is just the sorting out of a post pandemic situation.

LINCICOME: Exactly. Yeah. And I —

KRISTOL: Even the docks, I'm thinking, I mean, of course there were the same union rules five years ago and nothing was piling up so presumably —

LINCICOME: And that goes again, import consumption is way up. So the docks are basically having to deal with actually additional volumes. So yes, if you're not getting your dishwasher or you're waiting a year for a sofa, a lot of that is just, again, these kind of supply chain things. Because supply chains, because of amazing technology and the ability to map out production in multiple countries, have it assembled in another place and then shipped across the world. So the production is very fragmented.

The other thing of course, is that companies, to save money and save and deliver benefits to consumers, adopted a very lean inventory system. So they just weren't carrying a lot of inventory. Now, that's great for consumers in the good times, it means that you can get customized products, you get lower prices. But look, in a pandemic, if a factory ends up getting shut down because of COVID and you don't have a lot of inventory and you need that to produce other stuff because you're a link in the supply chain, well that is going to redound, it's going to ripple through.

So certainly some of the supply chain stuff is just the pandemic doing pandemic stuff, but I think, and I'm going to pound the table on this a lot, is that it's been exacerbated substantially I think by a lot of bad policy.

KRISTOL: Well, there's sort of a global supply chain problem. So presumably it's exacerbated by bad policies everywhere. Or is the US such a big part of the market that bad policies here have a global effect?

LINCICOME: Well, I think it's both. Certainly other countries have their share of dumb policies, but we're especially dumb in a lot of ways because if you look at, it's like a death by a thousand cuts, I think is the way to put it. Because if you look at all of the different little impediments that keep popping up, at the end of the day, you're going to find in almost all cases, not all, but in almost all cases, there's some silly policy that was put in place that's causing the issue.

And so you take the California ports, for example. So we had all these containers piling up, well, why are the containers piling up? We talked about that imbalance, but why can't ports move these to other places? Well, it turns out that zoning laws in the LA Long Beach area prevent the stacking of containers above two high because people who live there lobbied and won zoning restrictions that simply kept containers at that level. Well classic kind of NIMBY-ism, Not In My Backyard issue. And that was a major contributor to port backlogs, which again, redounds through the system.

We have a trucking shortage or problems in the trucking sector, because it's certainly not just the ports. Well, it turns out that we put tariffs of 200% on chassis —which are what trucks hook up to, you drop the container on the back — from China, which is the largest supplier of chassis. Now maybe putting tariffs on chassis from China is a good idea in non-supply chain crisis times, but our laws don't — which again have been drafted by kind of domestic constituencies, the steel industry and others —our laws don't allow our administering agencies to maybe pause those tariffs for a minute.

So we implemented these tariffs literally in the middle of a supply chain crisis. The preliminary ones when it came out last fall, and then the final ones came out in May. So that, of course, when the supply in the United States and elsewhere can't keep up, we don't have sufficient domestic production for that. And what do you have? Well, you have a chassis shortage. So that's a problem.

We also have prohibited Mexican trucking companies from operating in the United States, which is a direct violation of our NAFTA commitments. And these companies have —

KRISTOL: Is it a violation of that new law that —

LINCICOME: Oh, the USMCA? Well, that's a good point. So Trump's USMCA tightened the clamps a little bit, but the Department of Transportation could still approve Mexican trucking companies to operate here under the new USMCA rules.

But of course, who doesn't want that? Well, the Teamsters have lobbied for years to prevent that, even though Mexican trucking companies have been qualified by US regulators as being safe and clean and so forth because they have to follow US rules. So these trucking restrictions not only prevent Mexican truckers from operating on US roads, but they also suck up trucking supply because what does a Mexican truck have to do when it's traveling from say somewhere in Mexico to Chicago? Well, it actually has to drop the containers at the border and then an American trucker has to come and pick them up. So that American trucker that could maybe be hauling freight out of Los Angeles and Long Beach, or from the port of Savannah is instead at the Texas border picking up containers.

Now again, maybe in the good times that makes perfect — Who cares? It's a penny or two for your t-shirts or washing machines. Well, in the bad times, though, when there's a crisis, you don't have that flexibility. You don't have that capacity available. And then, I mean, I can go on and on.

The other one you have to mention is the Jones Act. So the Jones Act restricts maritime, well coast wise shipping. So you can't ship from a US port to another US port using anything other than an American made, American owned, an American crewed ship.

Well, this, as you can imagine, makes shipping from say, let's say you want to ship oranges from Florida to Massachusetts to Boston. It prohibitively costly, even though container shipping is by far the most efficient process. So we don't do that. Well, that adds additional burdens on our trucks and trains that are now of course over capacity.

So all of these little things build and when in the good times when demand isn't that high, when you have a little excess capacity in the system, it's fine. But when you have, again, this wall, this tidal wave of demand through both COVID and non-COVID and policy related reasons hitting a sclerotic supply chain that is constricted by policy, well, here you go. The inevitable result is the problems we're seeing today, higher prices and empty store shelves. —

KRISTOL: So domestic regulations, tariffs, et cetera, these are all things that could be changed, but there hasn't been that much focus on them. And I suppose the administration's not inclined to take on some of these political fights anyway.

LINCICOME: No. And that's, yeah, and that's really the disappointing thing. And I would say to Senator Mike Lee's credit, he's introducing a bill I think today I just saw that actually is trying to get at some of these supply side things. But generally yeah, the focus is not at all on easing, at least in the long term, the regulatory impediments.

Now California did ease those zoning restrictions I mentioned. And apparently they just increased regulatory limits on truck weights again, to allow for more, to getting more product away from the ports. But yeah, in general, you don't see any focus from the Biden administration on these types of supply side policy related restrictions.

And in fact, unfortunately, this new infrastructure bill that was just passed and granted is a bipartisan endeavor, but contains a lot of the very same things that in the past have gummed up the work. So for example, buy American restrictions that notoriously bogged down construction, infrastructure projects and make them more expensive. Well, they're in there. Then we have this thing called the National Environmental Policy Act, NEPA, that has been shown to delay projects, not just by a few months, which is of course regulatory environmental review, fine, but by years, years. And that apparently will be another impediment for any of these infrastructure projects coming out. And so it, yeah, the unfortunate thing is that while it seems that individuals policy makers are acknowledging the supply side restrictions, they don't seem to be willing to focus on the policy related capacity restrictions.

KRISTOL: How about labor? So everyone now knows that it's very hard to hire people, especially, well at all levels, I guess, but I mean, it's striking how much restaurants and so forth, the hotels, people are strapped and they're hiring people they might not have hired before. And they're just understaffed at this point. And I mean, we can get to immigration in a second. One of my favorite obsessions and yours too, that if you shrink immigration by what have we shrunk it by over the last three years, partly a COVID thing and partly a policy thing, if you shrink it by —

LINCICOME: Millions.

KRISTOL: By millions. Yeah.

LINCICOME: Yeah. So that's the big head smacker of the group, but I mean, yeah, we're in the middle of a worker shortage of sorts even though companies are paying higher wages and significantly higher wages in some respects, we are still four to five million workers short of our pre-pandemic trend. Labor participation rate is still pretty depressed, still in kind of pandemic era levels. And we expected this to bounce back and it really hasn't.

So that of course adds additional pressures throughout the supply chain and also additional inflationary pressures. Now why is that? Well, some of it is COVID. As morbid as it is, hundreds of thousands of workers are permanently removed from the labor force. And certainly not all COVID deaths, because there were of course a lot of older people and so forth, but you're looking at a few hundred thousand people gone.

You add to that retirements. So I mentioned earlier that a lot of workers in their fifties and maybe early sixties just looked at the situation and said, “to heck with this.” And of course asset prices are way up, homes, 401ks. And they said, “you know what, that's it, I'm done.” And so we are one and a half million or so workers above trend in terms of retirement. And so that is of course a big chunk as well.

The other thing that of course we have to mention is government policy. And for rightly or wrongly we have given households a lot of money and have lowered their expenses either through student loan forgiveness or rent forgiveness or just rent pauses. And so some of that's going to clear out. And so anyway, when people have this extra money, maybe they decide they're just not going to work. And there is some evidence that that's having a bit of an effect on the labor force, at least right now, maybe they're going to come back as they start to spend down that savings. We just don't know.

I would caution though, with those folks that there does seem to be a shift in sentiment among some households, two earner families where maybe they said, “You know what? We actually want to homeschool our kid. We're sick of the public school system. We like this new arrangement.” Or maybe the breadwinner, the primary earner actually got a big raise, and you're getting this nice new child tax credit, by the way, “We're going to make this work with a single earner family.” Or again, some people are just saying, “To heck with it, I'm just not going to work at all.”

KRISTOL: Which might be fine, I always tell people, I mean, it's not a bad thing if you step back. For people to retire a couple years earlier if they can afford to, it's not a bad thing, for people to stay home, but as you say, it creates a labor shortage.

LINCICOME: In almost all of these cases, I'm passing no judgment on lifestyle decisions, right? This is not about welfare queens or anything like that. This is really just about labor decisions.

KRISTOL: Some of it's even a sign of prosperity and of people living arguably healthy or more pleasant lives if they can quit at 63 instead of working till they're 68 in a job they don't much like or it's quite onerous and burdensome. But that’s a reason therefore why we want immigrants to take some of these jobs.

LINCICOME: Yeah. There are macroeconomic implications of having fewer workers and having a ton of demand. And like you said, I think the elephant in the room here is immigration. It depends on what stat you use, but I think pretty much everybody says we're at least a million immigrant workers short if you just look at the pandemic. But if you actually take out trends, so if you actually look at how immigration was trending and so then instead of just drawing a flat line and saying, oh, we have a million, if you actually then take the trend up as it was going, well, we could be three million. So we'll just be nice and say we're about two million potential immigrant workers short.

KRISTOL: And that includes Trump restrictions plus the pandemic effect.

LINCICOME: Correct. Right. Plus the pandemic. And Biden has not been quick to resolve this. And some of this of course requires Congress, but some of it just is unilateral action: processing visas, reopening consulates, reopening borders, and the rest. And to allow for again, lawful immigration, we're not talking about floods of undocumented immigrants coming through or whatever.

KRISTOL: And all these green cards that haven't been for example processed, right?

LINCICOME: Exactly, exactly. The number that my Cato colleagues put together was that just in green card processing, it was about a million lawful —

KRISTOL: People who have filed, and I gather, been even qualified.

LINCICOME: Yeah. Been processed.

KRISTOL: Been processed.

LINCICOME: So they're good. They're stamped. They're ready to roll. Just sitting on the sidelines, not part of contributing to the economy, and of course their own lies. But then the other — We have a backlog of millions more.

Contrary to some popular belief, as you well know, I'm sure, the process for getting a visa and actually getting to the United States is brutal. And so certainly that's — We have millions more. I think the number I saw is nine million more people who want to come here. They have lawfully applied and they're just sitting, waiting in line. Well, if you have a labor market that is short several million workers, and you have a line of people willing and able to come and work here, makes a lot of sense. But of course, that's one of the intractable problems in Washington right now.

KRISTOL: Yeah. The immigration thing is kind of infuriating on so many levels, I would argue, but whatever.

On the global side, so get away from the US policy failures, how worried — You're sort of a pro-globalization, pro-global supply chain guy, generally, with the obvious caveats for maybe some national security and stuff, but have you had to rethink it? Have you rethought it? Do you still hold to that, pretty much? Have you rethought that? Is there a global problem of all just global — What's that called? Instant, non-inventory-type manufacturing and so forth?

LINCICOME: Hindsight is 2020, and I think that the reliance on these very lean inventory systems and the reliance on these very stretched supply chains, reliance on single sources for products — China being the obvious one, but not just China — those types of things, in retrospect, look like bad decisions.

But again, where I haven't changed my view is I don't see much role for the government to fix things here. Now, of course, that's unsurprising coming from a libertarian. Cato might fire me otherwise. Right? But more seriously, if you look at what multinational manufacturers have done since the start of the pandemic is they have adapted. So you're now seeing, for example, just today, Ford signed a new deal with a global semiconductor manufacturer that has operations in the United States, because they want more onshore semiconductor production. What a crazy idea, right?

KRISTOL: So the system is adapting.

LINCICOME: Exactly. And you're seeing more air freight come online because manufacturers don't want to deal with the ports. They don't want to deal with this. So you're seeing a new air freight system evolve. You're seeing some domestic production come online as investors see opportunities for, again, this kind of nearshoring of manufacturing. Contrary to popular belief, we are a massive manufacturing nation. But again, large multinational manufacturers think, "Huh. Maybe it's a good idea if I have a little more sourcing nearby. If not in the United States, then in Mexico or Canada or wherever."

And so when you put it all together, you see that the supply chains are adapting. Inventories are building. Diversification of suppliers is occurring and all of the rest. As I've written, and this is of course very Hayekian, but by the time policy makers get involved, the emergency that existed in April of 2020 has evolved like five times. And it's going to evolve again by the time any of these policies are implemented.

So I think the best thing that policymakers can do is focus on these supply-side constraints. Where is government policy restricting the flexibility and dynamism of the supply chain? Where is it inhibiting that adaptation that we want, that we need? And there's a million bodies buried all throughout state, local, Federal government. Hopefully there will be some attention to those things in the future.

I would add, importantly, that our domestic supply chains are having the same problems our global ones are. If you look at food production, for example, about 80% of everything we consume food-wise is actually made domestically. And that makes perfect sense. We're a massive agricultural producer. Food manufacturing is a huge business here in the United States. I live in North Carolina. There's tons of food manufacturing here. But the food supply chains are having very similar issues with trucking shortages and warehouse capacity and COVID outbreaks at meatpacking facilities; you name it.

So simply trying to onshore all of our domestic production to somehow fix these global problems, it's really just trading one vulnerability for another. Instead, again, the best thing you can do is diversify your supplies and ensure that that supply chains can adapt when there are these stresses, because COVID is a hopefully once-in-a-generation or longer thing, but supply chain shocks happen every couple years. I mean, you think of, for example, Japan and the Fukushima situation. That was a massive shock to the Asian supply chain. Supply chains adapted after that. They're adapting again now.

KRISTOL: So it sounds like on the one hand, the bad news, I'm just thinking, is neither political party is really enthusiastic about — or only little small parts of either major party are enthusiastic about — the trade, immigration, and supply side agenda that you've outlined. So that's not great in terms of some of these reforms getting implemented. Now, we can presumably still get back to where we were, and as you say, live with some of these problems and pay some small economic price and other kinds of price for them. You can say more about that. But also then just more broadly, I guess I'm just curious.

So stepping back again — this is where we started — it sounds like you're pretty optimistic we make it through this non-disastrous sleep. What are the odds? How worried are you that we could really have a recession, but not even just a recession, but a real, serious one or stagflation or a real — I think people haven't, in 10 years since the financial crisis that had its own implications — people aren't ready after this pandemic now for a recession and what that could do. And psychologically, politically, I don't think most of it would be healthy in terms of letting people be more libertarian on that regulatory stuff. It'll lead to God knows what on the left and right, I think.

LINCICOME: Yeah. No, I agree with you. I think there's a significant, but not majority chance of that being the outcome; there being a real tightening. If I'm putting a number on it, I would say something like 15, 20%. So significant, and enough for me to be kind of concerned, but that's not my main, core view.

The reasons for that are a couple things. One is, I’m quite confident in the ability of the supply chains to adjust, and there does seem to be a light at the end of the tunnel in terms of the port and other situations. The Biden administration's going to take credit for it. They don't really deserve it, but it's far more about just demand patterns during the holidays and also China having a Lunar New Year Golden Week that will shut down the factories. That's going to allow some of these pressures to dissipate in early next year.

Also, there does appear to be some evidence that workers are returning to the market. Either they're spending down their savings, they find they're too bored with retirement, they're more comfortable with COVID being under control, and so that appears to be getting better as well.

I still am not a inflation hawk in the sense that I don't think we're just going to see 6% inflation next year, Jason Furman's worst-case situation. It looks to me like it's going to be kind of middling. Typical US; we're going to kind of muddle through this and be okay. But I am increasingly concerned — I think part of it being the political response. Inflation is such a potent political issue, and if we were to see 6% core PCE inflation, which PCE, that's supposed to be the moderate one, core, and that's supposed to be eliminating the volatile stuff. If we start seeing — What is the voter response? What is the political response?

KRISTOL: Yeah. I think that's really a key point. I mean, everyone still, if you're of a certain age or you've read a little history, you remember the happy story of the end of the inflationary era. Volcker, Reagan; demand and supply side responses, incidentally, that were quite dramatic, which really got rid of the problem for quite a long time to come. And I'd say, and not just in the US, there was some global equivalent. But if you step back and say we're in the equivalent of 1967 or ’68 with inflation ramping up, we have a very unhappy 12 years after that in terms of economic policy, with some really bad decisions made —

LINCICOME: Horrible. Wage and price controls. Really bad stuff.

KRISTOL: We could be looking at a decade of that before we get to the next Volcker-Reagan moment, right?

LINCICOME: Yeah. So I'm hoping, fingers crossed, that we see just silly things, like the Biden administration jawboning gas prices, right? "Oh, we're going to sic the FTC." Everybody does that. No problem. It's silly, but not harmful.

I'm worried more about the harmful stuff. So the hope is that things do settle down and that everyone remains calm. But look, I think it's important to say, we, that the Biden administration and the Fed, to a lesser extent, have put us in this situation that we really didn't need to be in right now. And that hopefully, we can pull the red flags out without too much pain.

KRISTOL: I guess, as you said, Hayek wouldn't be surprised that we overreacted and reacted more slowly and threw a huge amount of money. And it was bipartisan, I guess, to some degree, and then more Biden-driven in early 2021, but threw a huge amount of money when we should've been tapering down the money. And now, I mean, Manchin might be — People were just laughing at Manchin about this maybe two months ago. So we're talking late November, when he said, "I'm worried about this second social spending bill. It could be pretty inflationary." And it's like, "Well, inflation. What does that have to do with all this money? And anyway, we have to do it because it's good for various good causes." Which are good causes. And I guess he looks weirdly — I mean, not weirdly. I don't mean to insult him, but it's kind of interesting that Joe Manchin seems pretty prescient here. Right?

LINCICOME: Yeah. And *Bloomberg* had a good piece this week on looking at Manchin's voters, and these are older people on fixed incomes who really are sensitive to inflation. When you talk to your constituents and if that's the first thing that comes up, you're going to be acutely attuned to it.

So yeah, I do think that if things settle down a bit, we'll be able to ride through. But I also got to add, if you look at some of the stuff that the Biden administration is actively doing on the regulatory side with it, for freight rail and shipping, for example: just not helping matters. It seems that we want to expand the supply side, right? We want to unburden the supply side, and they're actually, in some ways, doing the opposite. So I think that's the other, again, the concern. If demand keeps up and supply actually gets further constricted, then we could have some issues.

KRISTOL: We need to reassemble. And what do you think? Spring, summer, we should have a real sense of this, I think.

LINCICOME: Yeah. Yeah. In fact, and again, I think, keep an eye on the next few CPI numbers. But we'll know a ton more in May or June or so.

KRISTOL: Good. Well, we will get back together. This has been a really interesting and enlightening conversation, I think, and this stuff is a little exotic. But it is, I think, very important, I think conceptually, even, to see that demand and supply are two different things, and you could be right in doing certain things in one area and certain things in another area, and then the combination has a real effect, is important.

LINCICOME: Exactly. Exactly.

KRISTOL: Scott, once again, thanks for joining me today. And thank you for joining us on CONVERSATIONS.

LINCICOME: My pleasure.

[END]