Peter Thiel Used Neoclassical Theory to Argue for Trump's Tariffs

Deborah Dsouza

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Venture capitalist Peter Thiel shocked Silicon Valley when he threw his support behind Donald Trump during the 2016 presidential campaign. And while he doesn't seem as exuberant as he once did, Thiel still believes President Trump is doing a better job than "the alternatives," Hillary Clinton or Bernie Sanders, would have.

Last month during an event advertised as "Luncheon with Peter Thiel" at the Economic Club of New York and during an interview that aired on Fox Business, the Facebook Inc. co-founder and outspoken libertarian was asked about his take on Trump's policies, specifically the tariffs announced on steel and aluminium imports. (See also: *Peter Thiel Is Breaking Up With the Tech Industry*)

Thiel supports the tariffs because he believes bilateral trade relations that are asymmetric should be fixed. He highlighted what he believes is a sign that today's trade dynamics are "strange" and used it to justify the tariffs.

Capital Flow

According to a neoclassical economic model, since developing countries like India or China have lower capital to labor ratios, investors can expect higher returns on the capital they invest there. If capital is assumed to be mobile, this means that logically capital should flow from richer to poorer nations.

However, this theory hasn't been supported by reality in the last few decades.

Thiel argued that capital not flowing in the direction it is expected to is a sign that all is not right with the world economy, we don't live in a "healthy globalized world" and Trump's tariffs are therefore not a violation of free trade principles but simply the right decision in a system where everything is wrong. "Even if free trade is good in theory, and that's what you want to get to, I think the way you get there is perhaps by being not too dogmatic and too doctrinaire," he said. (See also: *The Basics of Tariffs And Trade Barriers*)

"Capital should be flowing from the U.S. to invest in China, and China should have trade deficits that offset the flows," he said during the Fox interview with anchor Maria Bartiromo, who also conducted the other interview. "The U.S., the slower growing economy, has the trade deficits and the investments are flowing from poor people in China into the U.S. economy. It's completely backwards. That tells us something is very strange in terms of the trade dynamics."

Thiel spoke at the New York Economic Club of the "relatively open, free trade world" of the early 1900s when the UK had a current account surplus of 4% of GDP and capital got exported to Russia and Argentina.

"That's the way globalization is supposed to look," the former Trump adviser said. He thinks capital flowing the wrong way should push U.S. policymakers to ask questions like, "Why does nobody in China not want to buy anything from the U.S.? Why are our goods so undesirable? Are there policies that skew things too much towards consumption in the U.S. and more toward investment in other places and should we be rethinking that? Or are there intellectual property things that are not being enforced?"

Thiel on Fox directly linked the "uphill" flow of money to trade deficits. He said, "The reason it's happening is because of these enormous trade deficits. There is far more Chinese investment in the U.S. than U.S. investment in China." To which Bartiromo responded, "That makes sense."

The Lucas Paradox

The 1995 Nobel Prize winner in economics, Robert Lucas, a libertarian himself, identified in a much-celebrated paper that capital should be flowing one way but isn't according to the data. This phenomenon, which Thiel called the other side of trade deficits, was later known as the "Lucas Paradox" or "Lucas Puzzle."

However, there have been many multiple theories from economists, including Lucas, to explain this paradox. Factors that cause capital to flow the wrong way may be differences in human capital, infrastructure and institutional quality, credit risks etc. The theory Thiel cites doesn't take into consideration that emerging and developed economies have other differences than the cost of labor.

"Our results suggest that policies aimed at strengthening the protection of property rights, reducing corruption, increasing government stability, bureaucratic quality and law and order should be at the top of the list of policy makers seeking to increase capital inflows to poor countries," said a paper by economists from the Harvard Business School and the University of Houston.

Interestingly, economists at the IMF mentioned in an article that rising protectionism, a risk to developing countries, could in fact further push investments in the "uphill" direction in the future.

The time Thiel speaks of when capital flowed from countries like the UK to the developing world was during the time of the gold Standard system when economies "did not pursue any active monetary policy, did not accumulate meaningful currency reserves, did not interfere with foreign exchange markets and in international markets private not public funds were invested," as an article in the Central European Review of Economics and Finance journal points out.

Economists also say that current account surpluses of emerging economies, which lead to the "uphill" flow of capital, are caused by savings behavior rather than trade policy.

"China has a current account surplus largely as a result of its high savings rate – both corporate savings and household savings are high, for a variety of reasons. The surplus does not primarily result from unfair trade practices or protectionism by China, even though those are genuine problems," said Andrew Kenningham of Capital Economics. "Conversely, the U.S. has a deficit largely because it saves so little – particularly households, also the government." He also pointed out the example of capital flowing from Nigeria to London because of corruption, not protectionism.

Jeffrey Miron, the director of economic studies at the Cato Institute, said, "The Lucas Paradox is interesting because one might assume that poor countries should be borrowing now (and investing) so that their incomes would be higher in future. Yet, they have high savings rates, so end up being exporters. But that is not because of our trade deficits. It’s because of their savings behavior."

Thiel was asked about the U.S. trade deficit with Germany towards the end of the conversation about tariffs at the ECNY, at which point he stated that surpluses in other countries partly exist because they are oriented more toward investment than consumption.

Tariffs: Trade War or Shift Toward Golden Age of Globalization

Ninety percent of the 71 economists surveyed by Reuters recently said that they were concerned the Trump administration's tariffs would lead to a trade war.

Forty leading economists surveyed by The University of Chicago, including Nobel prize winner Richard Thaler, said they disagree with the notion that imposing new U.S. tariffs on steel and aluminum will improve Americans’ welfare.

"It is not necessarily a problem that the U.S. runs a trade deficit with China," said Kenningham. "The U.S. would be better off worrying about its overall current account deficit than the bilateral balances with individual countries. The Trump fiscal stimulus will lead to a wider current account deficit, probably exacerbating the China-U.S. bilateral imbalance too."

Bartiromo asked Thiel at the ECNY event if he was worried about the "hair on fire commentary about a trade war." He responded it is quite unclear to him where China can reciprocate on the tariffs because the U.S. is exporting so little and "there's no Chinese response possible."