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Interview with Kevin Murphy

by *John Cassidy*

Kevin Murphy is one of the best-known Chicago economists from the post-Lucas, post-Fama generation. In 1997, he was the recipient of the John Bates Clark Medal, which is presented to the best American economist under forty. Although he is primarily a microeconomist, Murphy has published articles on a wide range of subjects, including income inequality, the value of medical research, economic growth, and unemployment. He wasn't available to see me when I was in Chicago, but I subsequently talked to him on the telephone, and these are the notes of our conversation.

To what extent has the financial crisis and subsequent recession damaged the prestige of Chicago economics?

The Chicago straw man has taken a beating. The Chicago economist who says that markets always get things right and financial markets always work efficiently, he has taken a beating—no doubt. But the Chicago economist who I think about when I hear that phrase, he's in the same place that he was in a year ago.

So what is Chicago economics, if it isn't its media image?

I've always thought of Chicago economics as an approach to the subject—a way of doing economics. It's based on the belief that the tools of economic analysis are really useful for explaining things in the real world. When you approach problems in the real world, you use the same tools you use in doing economic theory. That has always been the test—a guy would give the same answer in a seminar to a question about the economy that he would give if somebody stopped him in the street. He wouldn't say, the theory is this but the actual answer is something else.

Is that attitude reflected in your own research and teaching? [Murphy teaches graduate courses on economic theory, with Gary Becker, and on the economic analysis of policy issues.]

Yes. *[Murphy explained that he sometimes teaches summer camps in price theory for Ph.D. students from other universities.]* Many of them say they have never been taught in that way, or done a course like ours. In tying theory to data when studying a range of phenomena in the real world, you are always trying to give an example. If you can't give one it is a problem.

It is also true in seminars. If you present a paper in Chicago, you don't get much of a chance to present. You have to defend. The type of paper where the presenter says, "Well, this assumption clearly isn't realistic, but I'm just going to ignore that for now and derive some results"—there isn't a whole lot of sympathy for that approach here in Chicago. You've got to be telling us something that is valuable and applicable to the real world. People like Friedman and Stigler really instilled that tradition in this place.

What about skepticism toward the government: Isn't that also a key part of the Chicago tradition?

Sure. You have to ask why would the government get it right. You can't just say, here's a market failure and the government needs to step in and address it. You have to look in detail at what the government might do, and compare the relative effectiveness of the two.

What about the efficient-markets hypothesis and the idea that speculative bubbles are very rare, or might not even exist? Is that the Chicago view?

I teach economics a lot. I teach in the economics department; I teach in the business school. I talk about house prices, and I think I've always raised the possibility that prices might get too high.

[Murphy cited the example of the Japanese real estate bubble in the late nineteen-eighties and early nineteen-nineties.]

I was looking at that, and I was thinking, "Geez, these prices are assuming that the returns from housing—the rental cost of housing capital—is going to be really high in the future. How realistic is that? Boy, it's really hard to justify these prices." During the Internet stock bubble, same thing. I looked at those prices and said, "Geez, can I rule out the possibility that investors are being irrational?" I think we believe that prices can depart from economic reality. The problem is that you can't see it in advance.

So is the efficient-markets hypothesis consistent with that idea—that prices sometimes depart from fundamentals?

It could be.

[Echoing what John Cochrane had told me, Murphy explained that there were two rival explanations for big movements in asset prices: attitudes to risk that vary over time, which are consistent with an efficient-market equilibrium, or irrational exuberance and bubbles, which aren't.]

Empirically, I don't see how you can distinguish between the two. It's become almost a matter of semantics. Do you call it time varying risk premiums or irrational exuberance?

But the fact is that much of the variation in the market is unpredictable. In finance research, it's a major victory if you can explain half of one per cent of the price variation with your model. The idea that you can't beat the market, or predict it—that part of the efficient-markets hypothesis is very much alive and well.

What about the rational-expectations hypothesis and the work of Robert Lucas? How does that fit in with your idea of Chicago economics, and the idea of tying theory to data? Surely the data rejected much of that work early on.

Well, I think that work does have empirical implications, but it is certainly a larger distance back from the theory to the data.

[At this point, Murphy defended Lucas's work, saying that it helped fill in an important gap in Keynesian economics, which couldn't explain the inflation of the nineteen-seventies. Going back to the nineteen-sixties, Milton Friedman and Columbia's Edmund Phelps had put forward the idea that, contrary to Keynesian ideas of the time, there was no long-run trade-off between inflation and unemployment—in the jargon of economics, the "Phillips Curve" was vertical. Lucas added a lot of rigor to that idea, Murphy said. He also brought up Lucas's work on the causes of economic growth, which date back to the nineteen-eighties.]

That side of his contribution is probably even more important, because it says that the questions of what we can do to keep creating growth is really critical. That gets us back to physical capital, human capital, and technical progress—and those are the things that really matter in the end. How do we do a better job of promoting physical investment, human capital investment, and technological progress? When you think that way, you have to always consider the long-run implications of short-term actions.

That takes us neatly back to the current situation. You have written skeptically about the Obama administration's stimulus package. Why are you so critical?

[Murphy referred me to a January 2009 presentation of his (pdf). The presentation analyzes the likely impact of the stimulus and concludes that it wouldn't do much good. The key to his negative result, Murphy explained, was two assertions: 1) that the taxes necessary to pay for the stimulus would act as a significant disincentive for people to work and for businesses to invest, and 2) that the government wouldn't spend the stimulus money wisely, and that much of it would be wasted.]

The reason I think it's neat is that it makes clear what really matters. You can say it's Keynes versus Friedman, but it's really a debate about bigger government versus smaller government. The whole question of what size the [fiscal] multipliers are—that's just part of the question.