**Chicago vs. Austria, Bitcoin, and More**
**Guest: Robert Murphy**
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**WOODS:** We're going to start off with Chicago versus Austrian School and specifically the debate that you had with David Friedman at PorcFest last year. Let me read you the exact question because we're talking here, especially for you newbies, we're talking about two schools of thought that are more or less associated with the free market: the Chicago School of Economics we associate with Milton Friedman, and the Austrian School we associate with Mises and Hayek and Rothbard and so on. Anyway, somebody asks, "I saw you Friedman/Murphy/Chicago/Austrian debate seemed like methodological quibble: principles, or principles plus data?"

He then follows up with, "Can such a difference explain hugely divergent policy recommendations and views on the Great Depression, etc.? Might there be another reason?" First of all, maybe you can state that in a more than 140-character format so people wil understand what's being asked, and then try to tackle that one.

**MURPHY:** Okay, I'll try to present my answer in the form of haikus if that's okay with you. But actually, yeah, let's not even do that. That's going to confuse people. Okay, so good question, especially the follow up. Let me deal with the stuff I can answer easily, and then we'll think about the trickier one. So, yes, I debated David Friedman, son of Milton Friedman, and I hate to say that because that's got to be a pain: no matter what the guy does, he's always the son of Milton Friedman. But just so people know who he is. We were actually supposed to debate two things at PorcFest. It was supposed to be the methodological issue between Austrian economics and Chicago School, and then the different foundations for anarcho-capitalism, meaning like a natural rights sort of perspective versus a utilitarian one. But there was a miscommunication, and so he thought we were just debating the methodology.

So if people watch the video, I just want to clarify that that's what happened. It was an honest misunderstanding in the beginning. As far as the methodological dispute, yes, I think it's important for people to realize, and a lot of people say, hey, why are you guys so particular about Austrian economics, and you want to do brand differentiation. Aren't you guys a free market school pretty much like the Chicago School, and so why do you need to go out of your way to distinguish yourselves? Why don't you all fight the Keynesians, the common enemy? And the reason we stress these things is that there are important differences, and I think the guy who tweeted this, Tom, may be on to something, that perhaps these methodological disputes, which to some people seem like mere philosophy, actually have policy conclusion relevance.

So as far as the methodological dispute, basically it's coming down to: how do you do economics? What does it mean to go do economics? What does it look like? And Milton Friedman had a famous exposition largely for the—well, it's readable by the layperson. I am not sure what his target audience was. He made this famous analogy to physics, saying we don't need realism if we want to come up with a model to explain—like if someone is playing pool, we can have a model for that and know the laws of physics and so on and predict that the expert pool player is solving complex differential equations in his mind when he lines up the cue stick and knows how much force to apply and knows the mass of the cue ball. And it's possible that actually a pool hustler from Chicago doesn't even know who Isaac Newton is. It's not that he knows the law of physics. It's just that we can model that system as if he knows the laws of physics because that gives us pretty good predictions.

So that was his approach, and so he said by the same token it doesn't matter whether actual entrepreneurs in the market economy are hyper-rational, and that they know all the things that in our economic models we assume they know, and that they can solve a complex calculus problem to find the equilibrium outcome of the profit-maximizing point from our models. We can treat it as if they do, because those are good enough approximations. Friedman goes on to say, how do you know whether a simplifying but false assumption is acceptable? And he said, well, you look at the outcome. If the predictions, the falsifiable, empirical predictions that your model shoots out, if you go check the data, and it's close enough, then your model is good enough. And actually, it's good if the assumptions are false because in order to make reality tractable you have to make simplifying assumptions.

That's the Friedmanite approach. The Austrians, at least in the tradition of Ludwig von Mises, have a completely different approach. They adopt what's called praxeology, saying you start from the action axiom, the idea that people act, they engage in purposeful behavior, they have subjective goals, and they use their reason to adopt means to try to achieve them, and then you logically deduce step by step implications from that. The nature of that enterprise is not going to give you quantifiable predictions, like saying GDP next quarter is going to rise by 2 to 2.5 percentage points with 95% confidence. That's not the kind of thing that's going to pop out of that framework. But actually Mises argues the stuff that does come out of that is far more useful, and that's what we really mean by economics.

To give a practical example of all this: in the debate, and this can get real heavy obviously, i said, look, David Friedman and the people here in the crowd, we all passionately believe in free trade, don't we? We are free traders. We think protectionism makes the country poorer.

But how did you come to adopt that belief? It wasn't because you looked at statistical regression before and after NAFTA was passed or something like that. No, you read Bastiat's "Petition of the Candlemakers." You read the clever little thought experiments that were written out in prose in three or four paragraphs of having to logically imagine a scenario, and we're seeing the inner logic of free trade. So it was a mental, logical deductive process. It was not an empirical verification of your tentative hypothesis. I was just trying to get them to see the core of what we all think of as economics is actually something you get using the method that Mises adopted or explained, and that the reason the Friedmanite approach seems so fashionable is that that is clearly what they do in the natural sciences, and since we want to be good scientists like physicists—that's why a lot of economists think, oh, we've got to do the same techniques, but actually, Mises pointed out that, no, what is correct in the natural sciences does not work in the social sciences.

**WOODS:** Let me put myself in the shoes of the person asking the question. Let's take the best-known example of a difference between the Austrians and the Chicago people. That would be monetary policy. How do you think this approach to doing economics yields you such divergent views on the subject of monetary policy? Is there a connection?

**MURPHY:** I am not sure if there is, and by that, that's not like my weasel way and polite way to say he's wrong. I really have not thought about it that carefully on that particular question. Just to make sure your listeners know what he's talking about: Milton Friedman and Anna Schwartz famously revised the professional economics mainstream opinion as to what made the Great Depression so long. The standard Keynesian view had been that you had demand collapse because of the stock market crash and bank failures and so on. The Federal Reserve and other central banks tried to inflate in the early 1930s, but they were pushing on a string. That was the famous metaphor, saying that once the interest rates had fallen to rock-bottom levels, the central banks were impotent, and that's why you needed the government to come in and engage in deficit spending. So the analysis was quite similar to what somebody like Paul Krugman would say since 2008. And so it was Milton Friedman and Anna Schwarz in their *Monetary History of the United States* who came along decades later and said, no, actually the Federal Reserve didn't do enough, that what happened is the public was taking their money out of commercial bank accounts because they wanted to hold the actual currency, and then if you understand how fractional-reserve banking works, when the public takes money out of the banks, that actually shrinks the overall quantity of money as measured by M1, for example. So Friedman was saying, yeah, the Fed did try to inflate, but they didn't do enough. They should have inflated a lot more on their end so that the money held by the general public ended up not falling because by that measure, M1 did fall by like a third from 1929 to '33.

So there you have a stark example in the difference in the policy recommendations between the Austrians and the Chicago School monetarists. The Austrians say, if you want to understand what the Fed had to do with the Great Depression, it was that the Fed inflated too much in the ’20s that caused an unsustainable boom. A crash was inevitable. And then, of course, Hoover and FDR just added all sorts of bad things on top of it and made the adjustment to the new reality agonizingly long. Whereas Friedman was saying no, the problem was the reason there was a stock market crash in ’29 is the Fed for some reason chickened out and stopped pumping in money in the late 1920s, and that that was the policy mistake, and then once the crash did happen, they also were very inadequate in inflating. So that’s a clear-cut policy difference, and so if the question is the methodological dispute—does that have something to do with it? I think it does. At least in this respect. Economic history, there’s so many moving parts; *ex post* I can tell you any story you want and give you some facts to buttress it. And that’s why Paul Krugman can look at the ’30s, and I don’t think he’s consciously lying. I think he honestly is seeing the facts jump out at him that, oh, my gosh, you idiots, look at how the gold standard tied all these governments’ hands, look at how they engage in inadequate deficit spending, and it was only the advent of the wartime spending and removing the gold standard when everything went back to normal.

So how could anyone but an ideologue who works for the Heritage Foundation not see that evidence screaming out at you? So the point is, you can always pick and choose facts that buttress your case. Part of it is because there’s no controlled experiments in economics. If two physicists are arguing over something that involves a charge on an electron, they can do a controlled experiment in the lab and perhaps see who is right and who is wrong, at least tentatively, but you can’t do that with—we can say, oh, geez, the Obama stimulus package, they passed it, and then unemployment was worse with the deficit spending than they projected it would be if they did nothing, so we win, right? And they said, no, no, the economy was worse than we realized. The point is, they’re not lying when they say that. They could be right in their own world. I think that’s part of Milton Friedman’s approach, and that was part of Mises’ critique of that whole enterprise of trying to come up with falsifiable predictions and then go and check them against the data to see whether what you said is true or not. But that’s not a very good way to learn basic economic laws or principles, the way you can uncover the laws of physical nature using that technique.

**WOODS:** Well, are we saying, then, that everybody except the Austrians is at some level doing anti-theoretical economics? Is everybody just looking at empirical data and pulling out what they want to see from it? They have some theoretical apparatus, don’t they ?

**MURPHY:** They do, and this also, for those of you who want to go look at that, if you go to YouTube and say Bob Murphy, David Friedman PorcFest Debate, it’ll come up.

**WOODS:** We’ll put it in the show notes for this episode. This episode is September 30, 2014, so when you look in the archives, that’s where you’ll find it. I’ll link to it there.

**MURPHY:** Okay, yeah, so it's true that David Friedman was getting visibly irritated with me thinking I was setting up a straw man, and he was saying no, no, we have theory, too. By the same token, there are certain things, like, let me give you an example. I think we can *a priori*, logically deduce Austrian business cycle theory, and we can also deduce that raising the minimum wage causes unemployment so long as you raise the minimum wage legally above where the market-clearing level would have been. I think we can get those results without referring to empirical evidence. But then if you ask me, why was the unemployment rate so high in 2010? To tease out the different implications and say, well, was it because they raised the minimum wage, which they did do, or was it because of the lingering effects of the housing bubble—that's something I do think you would need to go look at there. You couldn't just *a priori* know those sorts of things. So the two camps are actually closer in practice than they think if you just listen to the methodological arguments.

By the same token, I think a lot of the Chicago School guys are very good economists, but again, where I think they really shine in their brilliance is in their *a priori* stuff. I even pointed out that one of the best arguments for free trade I've ever encountered, David Friedman invented—he has it in his book *Hidden Order,* I think, and Steve Landsburg reproduces it. Just to give it to you quickly: there's two ways that we can make cars in the United States, two technology functions, two production functions. One way is to send steel and rubber and whatever to factories in Detroit. That's one way of making cars. Another way is farmers grow wheat, put it on a ship, send it across the ocean, and then six months later it comes back as Toyotas. And that's another way of physically producing cars. When you think about it like that, you can see the silliness of using tariffs to protect U.S. automakers, that really you're not helping foster U.S. job creation. You're just putting it in one sector versus another. You're helping Detroit auto workers at the expense of Iowa farmers if you put in a tariff on foreign cars. My point was that's not an empirical thing. That's a logical thing. Once you grasp that, boom, now all of a sudden you see the logic of free trade. That particular argument came from David Friedman. So I think what happens in in practice is a lot of these guys want to dress up what they do in practice and explain it or codify their technique to make it look like they're doing what they think the physicists do, because they know, oh, physics is the ultimate science, and we want to be scientific like those guys because they are so smart, and the public loves them, and we want to be like that. But in practice I think they're not understanding what it is to do good economics.

**WOODS:** All right, let me pause to note that I have a little mini-course that I did with Jeff Herbener on the differences between the Chicago and Austrian Schools. It goes through a bunch of points, and then you and I did one on the Great Depression. That's available to some of the folks over at the supporting listeners page—supportinglisteners.com.

Let's go on to a question that comes up a lot, and we might as well just answer it now. I know you've answered it in writing quite a bit, and that's the old Bitcoin question, the question that will not go away. Somebody wanted to know where Hans Sennholz would have stood on Bitcoin vis-a-vis his book *Money and Freedom*, but I am less interested in the specific issue of Sennholz than I am in the question of Bitcoin and Austrian economics and the regression theorem problem. Do your best to explain these concepts like why it is that this would demand an explanation in the first place, and then tell me if you've got one.

**MURPHY:** The standard way Austrians would teach monetary theory, and I did this when I was a college professor at Hillsdale, I did it writing the study guides to *Human Action* and *Theory of Money and Credit* and so on, so this is standard stuff, and I am not criticizing it, is to say that—the first point is, we don't need to assume there was a wise king or a political ruler or some chief of the tribe who suddenly grasped the idea of money and then imposed it on everybody. We can explain using the narrative that Menger taught us and that Mises refined. We can explain how money spontaneously would have been adopted by a community that originally started out in barter. We can go through and tell that story, and Mises in several places says words to the effect that there's a historical element when it comes to money that is not true in other areas. We can value a capital good without knowing anything about its purchasing power. We can just say, well, this machinery, this hammer would help me with these nails to make a doghouse, and I know how much I would value a doghouse effectively so now I can figure out how much I value the hammer and the nails as means to an end. We don't need to rely on market prices to make that sort of judgment. But when it comes to accepting something intending to use it as a medium of exchange, we necessarily need to know what is the purchasing power of this thing because otherwise how would we know how to value it as a means to acquiring further goods? If you didn't have any clue as to how much it could buy you, and just to motivate that: suppose you went into a coma, and then you woke up and people revived you in the year 2080, and they said, hey, how's it going. You're from the past. This is great. We'd love to have your story, and we have this publisher here who wants to buy the rights to you—the guy who just woke up after a coma for 50 years—and we're going to give you two million dollars for the rights to that.

Does that sound like a good deal? And in the year 2080, you'd say, wait a minute. I don't know how much two million dollars buys right now. Let me go look at the prices first before I answer you, because for all you know, a loaf of bread is $6,000. So it's the same sort of thing in general. And Mises says that it's unthinkable to imagine a good becoming a medium of exchange without it first having a history of being valued in the marketplace for its own, let's just say, intrinsic qualities—that's a bit misleading, but the point is, something had to be useful in trade before it became the medium of exchange before people could then extrapolate, and sort of piggyback the medium of exchange value on top of the fact that it was an original commodity. So gold and silver, tobacco, other things that have historically served as money in different communities in a different times, those all you can explain why they were valued originally before they became a medium of exchange.

Okay, so that's the standard stuff, and it seemed unassailable logic, and I used to teach it. The problem, then, is how do you fit Bitcoin into that narrative? It seems like Bitcoin was developed to be a money in the first place. It's not that it did something else, and then people later said, oh, we can also use it as a medium of exchange. No, it was designed from day one to be a medium of exchange or a money, and so that's the superficial problem. You had some Austrian fans saying, when Bitcoin first came out, and some to this day will say, end of story: Bitcoin is not money. It will never be money. It can't be because if it is, then Mises is wrong, and we know Mises isn't wrong. And then you have other people saying Mises is wrong: Bitcoin violates the regression theorem, and so there you go: some people make mistakes sometimes, even giants like Mises.

**WOODS:** And then you have people who will say Mises was right, and Bitcoin does not in fact violate the regression theorem. Is that the Murphy view?

**MURPHY:** I'm not sure. Let me state what I am sure of first, and then I will get into murkier territory. For sure I would say it is incorrect for people to claim that because of the regression theorem empirically Bitcoin will never get adopted by enough people for us to say, okay, it really is a money at this point. The reason for that is if you go and read Mises carefully and think of the logic of what he's saying, he wasn't merely saying something could never become money—that means it's widely accepted as a means of exchange. He was saying something can't even get off the ground to be a means of exchange, period, even to have one person accept it not because of what he was going to do with it, but because he was going to trade it away.

**WOODS:** Right, and the reason for that is that it doesn't have a pre-existing array of prices in terms of itself. There wasn't a Bitcoin price for, well, I won't pick a pizza entirely at random, a pizza or anything else. There was no existing array of prices, so therefore, how would you know how valuable it was? How could you start offering it in exchange for things if you don't know what the array of Bitcoin prices is, and since there is no existing array of Bitcoin prices, how can it get off the ground? Yet it did get off the ground, and that does seem *prima facie* to contradict at least this strong Misesian claim.

**MURPHY:** Right. I guess I'm partly warning people, too, that don't say this can never be a money because that would mean Mises is wrong, because I think you're setting it up for the possibility that Mises is going to be "disproven" because it already got past the hurdle of being a medium. Bitcoin right now clearly is a medium of exchange. Some people are accepting it intending to trade it away, again, for other goods and services, and so it's already surpassed that hurdle. What does that mean, then? Is it actually that Mises is right, and we can reconcile? There have been attempts to do that by saying, well, people were accepting Bitcoin as a payment system or technology. I don't quite like that because, again, I think this is the same problem: what good is it to have a payment technology for something that's worthless? Or how do you know how much to value the payment infrastructure, the fact that you can almost instantly and cautiously send payment to somebody in Africa so long as he's got an Internet connection. I don't see how would you value the ability of having access to that infrastructure if you didn't know anything about the purchasing power of the coins involved.

**WOODS:** Exactly. So let me clarify this. A way that I have indeed seen people try to deal with this problem is to say what you're saying, which is that Bitcoin is not just a currency, it's also a payment system. And since the payment system is something that's valued, then Bitcoin does have a starting value of some sort that helps to get the thing started, but you're saying the payment system itself can't be valued unless you can put some kind of value on Bitcoin as a currency. So this just pushes the problem back a stage.

**MURPHY:** Right, exactly. Yeah, because you could know, oh, yeah, I definitely want to accept Bitcoin and have that in my portfolio because I can buy things with it so easily, but it's still, if you say, okay, so someone wants to buy my car for Bitcoin. How many should I ask for? The fact that you know that it's a great payment system—that doesn't answer the original problem because you need to know, well, okay, how much, what kind of things can Bitcoin buy in the marketplace to know whether my car should be sold for 800 or 2. So what I think happened is, and whether you want to say it's a violation of Mises or like a loophole in what he said is I think—because clearly what did happen, and there's no ambiguity about it is, the original Bitcoins were sold for—they had very little purchasing power. The first real transaction was some people bought a pizza from somebody and gave them a large number of Bitcoins for it, and so I think way back then it was more of a novelty and people were just—people do all kinds of silly things like to trade playing cards, you have pictures of their sci-fi heroes or whatever, and so I think back then it was sort of like a nerdy thing to do and people understood the technology and whatever, and maybe they had some inkling that wow, if this thing took off, these would be good things to hold. So there could have been a speculative element, and so there's a lot of stuff packed into there. But for sure somebody gave up a pizza in exchange for things that had no prior purchasing power. But why did Mises see that? Well, because they were extremely weak. The guy just gave up a pizza. It's not like he sold his house.

So I think that's what happened, and then once you start getting some objective prices in line, it could form as a foundation, then it's just bootstrapped on top of that. So the way I would say it is, and let me put it to you this way, just to be honest. I think if you had told me what Bitcoin was in 2005, and then said do you predict that will ever take off, I'm not sure, but I think I might have said, I don't think that's going to work. How could that get off the ground? I might have said that. It's hard for me now to think back then knowing what I know, but it wouldn't surprise me if I said no, that's impossible. And so clearly, let me put it to you this way, people who studied the regression theorem may have had views about what was possible that were too restrictive.

**WOODS:** Okay, that's fair enough. Now, I want to hurry up because I don't want to take all day with you. I want to do one of them really quickly. What do you say to anti-gold people who say that other countries would come claim their gold if the dollar was backed by gold? Well, of course, you and I would favor going beyond just the gold standard. We just want the government out of money altogether. But wouldn't the answer to that be that we would just define the dollar in terms of gold so that all the outstanding claims to gold could be met? Wouldn't it just be a definitional question?

**MURPHY:** Right, exactly, it's not that they would define it in such a way that it would be vulnerable to a run. That's kind of the point. It also, those other countries right now can—if they think the dollar is not a safe currency to hold, and they would want to—it was kind of weird to say, oh, right now they're content to hold the dollar—it was backed up by nothing, but all of a sudden if it's backed up by gold legally, they're going to say, oh, I don't want these dollars. Get them out of here. That doesn't make any sense. That would make—

**WOODS:** It would make the dollar stronger, you're saying.

**MURPHY:** Right, that would make foreigners right now who are holding dollar-denominated assets more willing to hold dollar-denominated assets, including actual currency, if all of a sudden it's backed up by something. So we wouldn't need to worry about making it stronger and sturdier all of a sudden and then saying, ugh, get rid of these green pieces of paper.

**WOODS:** That's a good answer. All right, the last one I want to leave you with has to do with an episode that I did sometime this month where I answered somebody's question about my own academic experience—just what I went through in getting the Ph.D. and everything. But you have a totally different story because you went to NYU, which was, at that time anyway, heavily Austrian. You had Israel Kirzner there, I think— he was still there when you were there, wasn't he?

**MURPHY:** He was.

**WOODS:** And Mario Rizzo was there, and so you had that kind of influence. Even though you did learn mainstream economics, you had a lot of support there. And then Hillsdale College where you went as an undergrad you had a lot of intellectual support. So in other words, going into college you must have already known what you believed. How did that happen?

**MURPHY:** I know we're under the gun here with time, so I'll do the short version.

**WOODS:** Well, it's your time we're under the gun with. I have all day. (laughs)

**MURPHY:** I read *Human Action* cover to cover in high school. I'm not saying I understood all of it, but I knew, okay, this is what I want to do. I want to be an economics professor. I thought I was going to be teaching at a college my whole life. I went to Hillsdale College precisely because they had Mises' personal library there. Richard Ebeling was there, and he taught courses explicitly in Austrian economics. So I just said that I've got to go there. So that's why I went to Hillsdale with an econ major, and then I did apply to several schools—Chicago among them—the University of Rochester and a few other ones. But partly why I went to NYU was, number one, they accepted me and gave me good funding, but also they did, as you say, have a very strong Austrian tradition there. I should clarify, though, that it was—there were no such—there wasn't like a class in Austrian economics that I ever took at NYU. I took a history of economic thought class that Israel Kirzner taught, and so of course when he touched on the Austrians, he could give more flavor than somebody else would have, but it's not like he would lecture on J.B. Say from an Austrian perspective. It was a standard course. And they did have a weekly Austrian colloquium there, so that was great, but again, that was just something on the side that I did because of my fellowship or just because it was there. It wasn't like an official course. So I went to the standard—I had to take the field exams and all that stuff, and I majored in game theory—not that the major means anything, but that was my field was in theory, which meant game theory.

So I did all that stuff. I had to do papers that were mainstream stuff. My dissertation was in Austrian theory because you had more flexibility with what you wanted to do your dissertation on, but in terms of the reports that I did at NYU, that was the only explicitly Austrian thing that popped out, was my dissertation, which is a big chunk of it. So it's true that there was the Austrian tradition there. Israel Kirzner has since retired. NYU is, if you can handle the math, and people want to go there, a great school, but it's more—it equips you to know what the mainstream people are doing, so when guys like Krugman or whoever refer to general equilibrium models, and they start throwing around equations and things, you don't have to be intimidated. You can actually read it and know exactly what they're saying. Whereas I think some people who go to other schools—they actually don't know exactly how those models work, and so they are kind of at a loss. But then again, they've learned other things instead of learning that for three years like I did at NYU. So there's an opportunity cost.