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The Plot Between Ignorance and Arrogance

By CATHERINE RAMPELL

Last Friday I attended a lunch with Carmen M. Reinhart and Kenneth S. Rogoff, authors of the wonderful new book, "This Time Is Different: Eight Centuries of Financial Folly."

Over lunch, the authors spoke of the two culprits behind nearly every financial crisis: ignorance and arrogance. That is, people are ignorant of their own sordid financial pasts and current risk exposure, and arrogant about their invulnerability to a new catastrophe. Transparency, historical analysis and education can therefore go a long way toward preventing the next crisis, the authors suggested.

As I see it, there's still a problem with this strategy: Sometimes a collective boost in investor savvy is *not* an unequivocally good thing. It is as if the twin vices of ignorance and arrogance have made a deal: A modest reduction in the former can result in a disproportionate, and totally counterproductive, increase in the latter.

Let me explain.

People are generally ignorant of their own country's history of financial crises and debt default. In the course of their research, Professors Reinhart and Rogoff found that even government officials were blissfully unaware of such basic information as their country's domestic debt records or recent housing market prices. In many cases, the authors (two veterans of the International Monetary Fund) said, national records simply do not exist.

Despite (or perhaps because of?) these huge memory lapses, both private investors and public officials, again and again, insist that the fundamentals of whatever financial bubble they happen to riding at any given time are sound, even indestructible.

When such hubris is eventually proven wrong, and whole economies are brought to their knees, investors finally realize how big their blind spots really were. In response they demand all sorts of new transparency rules, official investigations and investor protections — responses that eventually coax investors into a renewed feeling of omnipotence over the market, which again leads to a new underestimation of risk and, eventually, a new crisis.

In fact, until the current crisis, economists for years had been bragging about "The Great Moderation," the idea that technocrats had finally tamed the business cycle. New ways of

pooling risk in the form of snazzy financial products had virtually *eliminated* all risk — or so everyone thought before Lehman sought bankruptcy protection.

This pattern of events has a long history. Even back in 1929 there was a false sense of security over new-found mass financial "sophistication."

In their book, Professors Reinhart and Rogoff reprinted a gem of an archived advertisement. It tells, condescendingly, of the irrational exuberance that had plagued an earlier, more benighted species of investor:

FAMOUS WRONG GUESSES IN HISTORY
when all Europe guessed wrong

The date — October 3rd, 1719. The scene — *Hotel de Nevers*, Paris. A wild mob — fighting to be heard.

"Fifty shares!" "I'll take two hundred!" "Five hundred!" "A thousand here!" "Ten thousand!"

Shrill cries of women. Hoarse shoats of men. Speculators all — exchanging their gold and jewels or a lifetime's meager savings for magic shares in John Law's Mississippi Company. Shares that were to make them rich overnight.

Then the bubble burst. Down — down went the shares. Facing utter ruin, the frenzied populace tried to "sell". Panic-stricken mobs stormed the *Banque Royale*. No use! The bank's coffers were empty. John Law had fled. The great Mississippi Company and its promise of wealth had become but a wretched memory.

Then, the advertisement proudly promises:

Today, you need not guess.

History sometimes repeats itself — but not invariably. In 1719 there was practically no way of finding out the *facts* about the Mississippi venture. How different the position of the investor in 1929!

Today, it is inexcusable to buy a "bubble" — inexcusable because unnecessary. For now every investor — whether his capital consists of a few thousands or mounts into the millions — has at his disposal facilities for obtaining the *facts*. Facts which — as far as is humanly possible — eliminate the hazards of speculation and substitute in their place sound principles of investment.

The ad — for a company called Standard Statistics, whose address has since been turned into a Chipotle Mexican Grill — ran on Sept. 19, 1929, about a month before the market crashed.

Any of this sound familiar?

The Great Crash of 1929, like other subsequent financial crises, was followed by extensive economic research on what went wrong, plus sweeping new financial regulations. Which were ultimately followed by more financial crises, which were ultimately followed by more research and reform.

And so on.

Look, as a journalist (and moreover as a fancier of economics), I am genetically hard-wired to believe that additional public information is always a good thing. But for some reason, when it comes to additional *financial* information, mankind seems to have a problem correctly assessing the value of any new insight.

Contra Socrates, it seems the more we know about finance, the more we *think* we know about finance. As Malcolm Gladwell said, "Incompetence is certainty in the absence of expertise. Overconfidence is certainty in the presence of expertise."

So what's the solution for this perverse conspiracy between ignorance and arrogance? How do we give people information to make better financial decisions, but temper their resulting hubris?

I'm not sure. Perhaps it involves educating officials and the public — through books like "This Time Is Different" — about not only economics, finance and history, but psychology, too.

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