EUROPEAN ECONOMIC PERSPECTIVES

Centre for Economic Policy Research

Collective Action

How should the private sector be involved in the resolution of financial crises? A new Report argues that collective action clauses should be a priority in reforming the international financial architecture.

Since the Asian crisis of 1997/8, there has been extensive debate about how to strengthen the 'international financial architecture'. A broad measure of consensus has emerged on crisis prevention, what is needed to limit the frequency and severity of financial crises. Specifically, there is widespread agreement on the need for greater transparency on the part of market participants, stronger prudential supervision and regulation, international standards for sound financial management, and appropriate policies towards exchange rates and the capital account.

Crisis management is more controversial and one of the most difficult issues is the best way of securing 'private sector participation'. This is the polite expression for measures to ensure that investors 'take a hit' and do not escape all losses as a consequence of multilateral assistance for crisis countries. Private sector participation is essential, most commentators agree, in order to prevent IMF rescue packages from creating 'moral hazard', encouraging investors to lend without regard to the risks and hence undermining market discipline and the stability of the international economy.

In a new CEPR Report, published jointly with the International Centre for Monetary and Banking Studies in Geneva, Barry Eichengreen assesses the main proposals for reducing the moral hazard caused by IMF bailouts. He criticizes several fashionable approaches to reform, arguing that it is not feasible for the IMF to make its assistance conditional on commitments by private investors to restructure existing loans, roll over maturing issues or provide new money. Often the holders of debt securities cannot even be identified, much less compelled to act collectively. More fundamentally, an IMF promise to stand aside if investors refuse to cooperate is simply not credible. The costs of inaction – a severe economic contraction, an extended interruption to capital market access and a lengthy and difficult restructuring – are too painful for the official community to bear.

One alternative to large-scale financial rescues is imposing a standstill on payments. This is appropriate if the root cause of the crisis is investor panic, Eichengreen suggests, allowing a cooling-off period in which investors can collect their wits. He also draws attention to new evidence from corporate bond markets in 24

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countries, which suggests that such a measure does not automatically raise borrowing costs. Unfortunately, empowering the IMF to impose or endorse a standstill raises a host of difficult practical issues that would not be easily overcome.

In any case, many crises are the result of deeper problems of inconsistent policies and disappointing economic performance. With these crises, debt restructuring has to be part of the solution. So while there may still be a case for a standstill provision to provide an umbrella for restructuring negotiations, the key innovation must be a measure that facilitates restructuring, specifically the introduction of 'collective action clauses' into loan contracts.

In a financial crisis, collective action clauses facilitate debt restructuring, offering an alternative to IMF bailouts

Such clauses are already widely used, Eichengreen notes. Bonds governed by English law typically include provisions enabling the bondholders to call an assembly that can pass resolutions relating to defaults and other aspects of the original agreement subject to majority consent. This contrasts with American law, which allows so-called 'vultures' to hold up restructuring. Pursuing this alternative means promoting their more widespread use. The IMF has already taken a first step in this direction by citing the use of collective action clauses as one factor in determining whether countries qualify for its Contingent Credit Line.

Eichengreen points out that more than 40% of all international bonds issued between 1990 and 2000 were subject to English law. If such instruments were even more widely used, the market would have a mechanism with which to restructure problem debts and there would be an alternative to relying on IMF bailouts. And contrary to the claims of some market participants, adding collective action clauses to bond contracts does not necessarily raise capital costs for emerging market borrowers.

As always, reforms should be prioritized, Eichengreen concludes. And doing so means making a judgment about the predominant cause of crises. Most observers take the view that the majority of crises reflect problems with fundamentals, not simply investor panic. They will be inclined to believe that reforms that increase reliance on market forces and limit reliance on the IMF are the best approach and more likely to attract political support. This suggests that collective action clauses, not standstills, should be the priority for those seeking to strengthen the international financial architecture.

This article summarizes 'Can the Moral Hazard Caused by IMF Bailouts be Reduced?', *Geneva Reports on the World Economy Special Report* I by Barry Eichengreen (University of California, Berkeley, and CEPR).

Winners and Losers from Regional Integration

Do regional integration agreements (RIAs) promote convergence or divergence of per capita income levels among their members? It all depends on whether the countries involved are high or low income, according to new theoretical research by Tony Venables – 'Winners and Losers from Regional Integration Agreements', CEPR *Discussion Paper* No. 2528 (August 2000). His analysis indicates that the forces of trade creation and trade diversion systematically produce an outcome in which RIAs among high-income countries lead to convergence of income levels while RIAs among low-income countries cause divergence. This may explain such observations as the success of the European Union in narrowing per capita income differentials among its members and the comparative failure of the old East African Common Market, the Central American Common Market and the Economic Community of West Africa.

Venables' argument is based on the comparative advantages of RIA members relative to each other and to the rest of the world. Suppose, for example, that countries differ in their endowments of skilled and unskilled labour, and that these differences form the basis of their comparative advantage. Take two countries that are abundant in unskilled labour relative to the rest of the world – say 'Uganda' and 'Kenya' – and suppose that Uganda, is also abundant in unskilled labour relative to Kenya. Uganda has an 'extreme' comparative advantage and Kenya an 'intermediate' one.

What happens if these countries form a RIA? The comparative advantage of Kenya relative to Uganda leads Kenya to export skilled labour intensive goods (say manufactures) to Uganda, which in return exports unskilled labour intensive goods (agriculture). The first of these flows is trade diverting: Uganda is getting its manufactures from Kenya rather than the rest of the world in line with comparative advantage within the RIA rather than global comparative advantage. But the second flow is trade creating: by increasing agricultural imports from Uganda, Kenya is trading with the lowest cost supplier in the world, not just within the RIA.

The general argument is that any country with an 'intermediate' comparative advantage will do better from a RIA than a partner with 'extreme' comparative advantage. Between two poor countries this unequal division of costs and benefits causes income divergence: the extreme country is the one with the least skilled labour, hence initially the poorest. But between two rich countries, the extreme country is the one with the highest ratio of skilled to unskilled labour. So exactly the same forces that drive income divergence in a RIA between Kenya and Uganda lead to income convergence in a RIA between, say, France and Spain. The implication is that developing countries are likely to do better in 'North-South' RIAs than in 'South-South' agreements.

Two Tribes

The emergence of two giant trading blocs centred on the European Union and the United States could lead to mutual antagonism. André Sapir analyses the transformation of European regionalism in the 1990s and calls for an ambitious agenda of 'global free trade in our time' to counter the threat of future trade conflicts.

The pan-European trading system could be characterized as a 'spaghetti bowl' of regional agreements

The last decade witnessed a huge upsurge in the number of regional trade agreements (RTAs). In the five years since the establishment of the World Trade Organization (WTO) in January 1995, it has been notified of 69 new RTAs. A total of 113 were in force as of December 1999, including 91 RTAs in goods notified under Article XXIV, the WTO rule that allows countries to form trading blocs as long as they do not become more protectionist towards outsiders.

The European Union (EU) is by far the most active WTO member in terms of RTA participation. It is party to 28 of the 91 RTAs in goods notified under Article XXIV. The EU, being at its heart a customs union, is itself a RTA under Article XXIV. In addition, it has 27 bilateral RTAs with third countries. This is a significant increase on the position of ten years ago when the EU was party to 18 RTAs in goods. It is also party to eight of the eleven RTAs in services. In contrast, the United States is only party to three RTAs in total while Japan belongs to none at all.

At the beginning of the 1990s, the EU's bilateral RTAs in goods fell into two distinct categories: reciprocal RTAs – customs unions or free trade areas providing reciprocal free access to both parties; and non-reciprocal RTAs – cooperation agreements providing duty-free access only for the non-EU partner. At the time, the implicit EU policy was that reciprocal customs unions and free trade areas were essentially reserved for potential EU members while non-reciprocal cooperation agreements were generally for countries outside Europe.

By the end of the decade, the shape and content of EU regionalism had been radically transformed. Not only had the number of RTAs increased substantially but the substance of the agreements had also changed dramatically. First, the fall of the Iron Curtain and the redrawing of Europe's political map resulted in the mushrooming of bilateral RTAs with the countries of Central and Eastern Europe. The second change was the decision gradually to eliminate non-reciprocal RTAs and set up reciprocal RTAs with countries outside Europe, which are highly unlikely to become EU members. In 1990, the EU had just one reciprocal RTA with a non-European country (Israel). By the end of 2000, five such RTAs will be in force (with Israel, Morocco, the Palestinian Authority, Tunisia and South Africa) and several others are already in the pipeline.

The 'spaghetti bowl' can potentially lead to widespread discrimination and deter investment

In the meantime, the redrawing of Europe's political map has led to a veritable outbreak of intra-European RTAs. Today, there are dozens of RTAs in Europe. The European 'spaghetti bowl' could be characterized as containing three layers. The nucleus of the system would be the EU and its 20 or so bilateral European RTAs. The second layer would comprise the European Free Trade Area (EFTA) and its dozen bilateral intra-European RTAs. The last stratum would consist of the nearly 30 RTAs among European countries that belong to neither the EU nor EFTA.

The present pan-European trading system could be seen as suffering from three major weaknesses. The first and foremost is the potential for widespread discrimination. A country like the Czech Republic, for example, faces numerous different rules depending on whether it is trading with an EU member, an EFTA member, the Slovak Republic, its partners in the Central European Free Trade Area or various other countries and trade groupings.

One solution would be a pan-European free trade area of the continent's WTO members

The second problem is the investment-deterrent effect associated with 'hub-and-spoke' systems, where the 'hub' country has free access to all 'spokes' but each 'spoke' country has only free access to the 'hub'.

The last problem relates to EU enlargement and the status of RTAs between EU candidates

The EU and the United States could emerge as the 'hegemons' of two world trading blocs

and certain other non-EU countries. This issue derives from the fact that the EU is a customs union, which implies that its members cannot be parties to bilateral RTAs. Two situations may cause problems. One is that nearly all the 13 EU accession candidates participate in bilateral RTAs with other candidates that may join later than they do. The other is that some of the EU candidates are parties to bilateral RTAs with countries that are not (at least, at the moment) EU candidates.

A solution that I have proposed to these problems would be the creation of a Pan-European free trade area (PEFTA) incorporating all the countries of Europe that belong to the WTO. But obviously, given the central role of the EU in the system, such a solution cannot be envisaged unless, at the same time, the participants describe a clear vision of the pan-European political architecture. A possible model for the latter could run as follows. All the nations of Europe should belong to PEFTA if and when they become WTO members. And all the members of PEFTA fulfilling general criteria and willing and able to adhere to its aims would become members of the EU.

Establishing a global free trade agenda would reduce the potential for conflict

In this scheme, the EU would comprise three, instead of the current two, levels of integration. First, there would be the customs union, which would contain the current EU members *plus* the candidates meeting the required conditions. Second, there would be the single market, which would include the current EU members *plus* some of the present candidates able and willing to conform to the relevant EU legislation. And third, there would be the monetary union, in which membership would remain subject to meeting the convergence criteria.

Even without such a scheme, EU regionalism has clearly taken a new direction in recent years with its full-blooded RTAs with countries outside the European continent. And as a result of parallel initiatives by the United States, the world trading system now finds itself on virgin territory.

The EU and the United States have both implemented RTAs with neighbouring developing countries designed to 'lock in' their economic reforms and foster regional stability. Both have also taken important steps towards preferential trading agreements with countries outside their immediate vicinity that offer important market potential. At the same time, the EU is also considering establishing a series of RTAs with its traditional African, Caribbean and Pacific (ACP) partners with a view to fostering economic reforms and reinforcing traditional ties with potentially significant markets.

If the Free Trade Area of the Americas (FTAA) initiative and the idea of EU/ACP free trade areas are implemented, we could witness the emergence of two major 'hegemon-centred' trading blocs by the end of the first decade of the twenty-first century. One would be focused on an EU of 25-plus members, encompassing most non-EU European countries (including, perhaps at some stage, countries like Russia and Ukraine), African countries from the North to the South of the continent, and some countries in the Near East. The other, centred on the United States, would comprise the entire American continent.

The EU-centred bloc is, and would continue to be, a hub-and-spoke system of bilateral agreements; in contrast, the US-centred bloc is, under NAFTA, and would continue to be under the FTAA, a single agreement. The crucial point is that both blocs are, and would remain, free trade areas rather than customs unions. Free trade areas tend to require more costly rules of origin than customs unions.

WTO rules on regional trade agreements must be strengthened

It need not happen but it is certainly possible that the two emerging trade blocs could become closed to one another or even antagonistic. The best way to lay aside existing worries would be to undertake an ambitious agenda of 'global free trade in our time'. In the meantime, it is of the utmost importance that the EU and the United States, the two 'hegemons' of the system, agree to strengthen WTO rules on RTAs in order to minimize the discrimination they allow and maximize their potential for trade liberalization.

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Home Advantage

Equity markets are going global – or so we are told. But new CEPR research suggests that in certain cases, local knowledge can still lead to more profitable trading.

Conventional wisdom suggests location no longer matters for equity market trading

With new trading technologies providing non-discriminatory access to the world's leading equity markets from any geographical location, you might think that it no longer matters where a trader is based. Certainly, that is becoming the conventional wisdom in the international investment community.

But a recent CEPR *Discussion Paper* by Harald Hau indicates that in the case of Germany at least, locals still have an advantage. He has uncovered powerful new evidence that traders in German equities who are located outside Germany in non-German-speaking cities make significantly smaller profits on their proprietary trading than their German counterparts. But language and culture seem to be the key factors rather than geography *per se*: German-speaking traders do equally well wherever they are located.

Hau's research explores the relationship between a trader's geographical location and the informational advantages that may offer. For example, do traders in foreign countries underperform relative to domestic traders when it comes to proprietary trading of domestic equities? If so, do language barriers explain the performance differences? Do traders in a global financial centre like Frankfurt make more out of DAX stocks – the German blue chips – than traders in regional centres like Munich? Do traders in Munich do better than traders in Frankfurt with stocks where the corporate headquarters is in Munich? And do larger financial institutions with many traders outperform smaller institutions because of scale economies in the production of information?

These questions are related to what determines the distribution of equity holdings across the wider investment community. Empirical research has established that most portfolios are dominated by domestic equities, a phenomenon known as 'home bias'. This behaviour implies that investors forgo the benefits of better risk diversification that a truly international portfolio would confer. Initial explanations for this phenomenon focused on barriers to international investment, such as government restrictions on foreign and domestic capital flows, taxes, tariffs and fees. But recent evidence shows that even within the United States, investors tend to prefer the stocks of local companies. Local informational advantages seem to be the main explanation.

But the ultimate test of whether local information matters is superior trading performance, not simply portfolio bias in favour of more familiar stocks. Pursuing this idea, Hau has gathered data on more than 1,300 traders who use Xetra, the electronic trading system of the German stock market. He concentrates on the 451 largest traders; those that make at least 100 transactions in any of 11 randomly selected DAX stocks over a four-month period.

Yet in the German market, non-German-speaking traders underperform the locals

These large traders are located in 23 different cities and eight different European countries. Yet in spite of their wide geographical distribution, they all have equal access to the electronic trading platform. The absence of institutional discrimination makes Xetra data ideal for tracing differences in information – 'asymmetries' – across the trader community.

Hau measures the profitability of the traders over different time periods, adjusting for risk and differentiating between intra-day or high frequency profits, weekly or medium frequency profits and monthly or low frequency profits. This distinction is useful since the data spans only four months and intra-day profits can be observed more frequently than weekly or monthly profits. The high frequency profits therefore provide a more powerful statistical measure of informational asymmetries than lower frequency ones.

So what role does location play in determining individual trading profits at the three frequencies? The analysis reveals that a trader based in Frankfurt enjoys no comparative profit advantage over other German traders, which suggests that there are no special benefits from being located in a world financial centre. In contrast, being based in a foreign non-German-speaking city has a strongly negative correlation with profitability, a shortfall that Hau documents for intra-day, weekly

Relative quarterly underperformance is as much as 1.2 million D-Marks per account

and monthly profits. At the same time, foreign traders in other German-speaking countries – Austria and Switzerland – do not make significantly lower profits. This suggests that it is linguistic and cultural barriers rather than geographical distance *per se* that hold the key to the informational advantages identified in the data.

The underperformance by non-German-speaking foreign traders is not only statistically significant; it is also of considerable economic magnitude, averaging 20 D-Marks per market transaction. That is the equivalent of a relative quarterly profits loss of approximately 1.2 million D-Marks per actively traded account.

Language, culture and geography still influence how information is distributed across traders

Are there are informational advantages that derive from being physically close to the companies whose stocks are being traded? Hau examines whether traders operating no more than 100 kilometres from one of the nine corporate headquarters outside Frankfurt (two are in Frankfurt) have superior trading performance in those stocks. He finds that local proximity is positively correlated with intra-day profits, indicating local informational advantages. But the correlation is not significant at lower frequencies.

The data also reveal no evidence that large financial institutions have a better trading performance than smaller ones. There appear to be no 'informational scale economies' in proprietary equity trading.

Hau's findings, notably the profit difference between domestic and foreign traders, confirm that language, culture and geography continue to be important in determining how information is distributed across financial market participants. They suggest that market making in the equity business may be considerably less global than is often claimed.

This article discusses research reported in 'Information and Geography: Evidence from the German Stock Market', CEPR *Discussion Paper* No. 2297 (November 1999) by Harald Hau. Hau is at ESSEC in Cergy-Pontoise and a Research Affiliate in CEPR's International Macroeconomics programme.

Follow the Bear: When Markets Move Together

Should investors reduce the 'home bias' of their portfolios by diversifying into overseas markets? The standard argument in favour of international investment is that it lowers risk without sacrificing return. Stocks and bonds traded in the same national market tend to move up and down together since they are affected in similar ways by the national business cycle, economic growth and interest rate movements. By diversifying overseas, an investor can hope to reduce some of that national market risk.

But there will only be benefits from international diversification if asset returns differ widely across markets, that is, if markets move independently of each other. Their degree of independence is measured by the correlation coefficient: zero implies total independence while one implies that market movements are perfectly synchronized. Over the last four decades, the correlation coefficients between the US equity market and other major markets have been 0.52 with the UK, 0.44 with France, 0.39 with Germany, and 0.27 with Japan. The correlation between two typical stocks in the same country is much higher, suggesting that there is room for successful diversification.

However, recent studies show that correlation is not constant but varies considerably over time depending on the relative importance of domestic and worldwide forces in national markets. In some periods, when there are no global economic shocks, equity markets are primarily affected by country-specific factors. But at other times, all markets are affected by the same global forces, for example, the oil shock of 1974, the Gulf War of 1990 and, in the late 1990s, the turmoil in emerging markets.

These studies have also linked correlation to market volatility, the idea being that markets are more synchronized in times of high turbulence, perhaps because the dominance of global factors is associated with volatile markets. New research by François Longin and Bruno Solnik – 'Extreme Correlation of International Equity Markets', CEPR *Discussion Paper* No. 2538 (August 2000) – questions these findings. These researchers argue that the standard technique for comparing asset returns across markets can give the impression that there is higher correlation during volatile periods than during tranquil periods even though the true correlation is constant.

Longin and Solnik believe that the key to determining whether correlation really increases during volatile periods is to focus on what they call 'extreme correlation' – the correlation between returns in either the negative or positive tail of the distribution of asset returns. Using monthly data on the five largest stock markets from 1958–96, they find that correlation is not related to market volatility *per se* but rather to the market trend. Correlation increases in bear markets but not in bull markets.

Down by Law

More than ten years after the fall of the Berlin Wall, it is becoming clear that there are three distinct trajectories of economic transition from socialism to capitalism. New CEPR research explains these trajectories in terms of the relationship between law enforcement and economic performance.

Law enforcement plays a key role in the transition from socialism to capitalism

Formerly planned economies making the transition to the market follow one of three trajectories, according to a recent CEPR *Discussion Paper* by Gérard Roland and Thierry Verdier. The first is the one followed by Poland, the Czech Republic and the other countries of Central and Eastern Europe, all of which began the transition process in 1990. In most of these countries, there was a strong political will to introduce reforms as quickly as possible and the strategies were typically 'big bang'. The main objective was to combine early price liberalization and stabilization with mass privatization of state-owned enterprises. After a significant initial fall in output, these countries have, with varying degrees of success, found the route to economic recovery and growth. They are now expecting accession to the European Union (EU).

The second trajectory is that of Russia. Here too, a big bang strategy of rapid reform was pursued in the early days, similar in most respects to the strategies of the Central and East European countries. Nevertheless, Russia has experienced a persistent and much greater economic decline since the beginning of transition, culminating in the devaluation and debt default of August 1998.

The third trajectory is that of China, which has followed a very different strategy from the European countries. Its 'gradualist' approach to reforms meant that they were 'sequenced' over a longer period of time. Furthermore, a 'dualist' approach led to the coexistence of an unreformed state sector, where the government keeps direct control over economic resources, and a liberalized non-state sector, which follows market rules.

Roland and Verdier explain these three trajectories by emphasizing the key role of law enforcement in transition. They argue that the vision of many transition experts, in which markets evolve spontaneously following liberalization, neglects another spontaneous evolution, namely criminal activity preying on private producers. The emergence of predatory behaviour naturally calls for law enforcement, but there are important coordination problems.

First of all, for a given level of spending on law enforcement, a strongly law abiding citizenry will ensure that enforcement is effective. If people are less law abiding, this will reduce potential criminals' expectation of getting caught and hence the disincentive to break the law. Coordination is also necessary to provide the public good of enforcement technology. This coordination problem is usually solved through tax collection though tax collection itself is likely to be weak in countries where law enforcement is weak.

Russia's law enforcement and economic performance have both been relatively weak

These coordination problems in law enforcement typically lead to a range of possible outcomes – what economists call 'multiple equilibria'. Such multiplicity may help to explain why countries with similar reform strategies may have such different outcomes in law enforcement. But what explains why some equilibria are selected and not others? The answer lies in assessing whether there are institutional mechanisms for eliminating the 'bad' equilibrium.

In the context of transition, Roland and Verdier identify two such mechanisms. The first is the dualism of the Chinese transition. Keeping direct state control over sufficient economic resources to deter predatory activity is a way to eliminate the bad equilibrium of low tax collection and weak law enforcement: the state has the resources to enforce the law and there are fewer targets for predators. This points to an important trade-off between the potentially high efficiency costs of maintaining state control over resources and the benefits of coordination.

State control of a significant element of the Chinese economy deters law-breakers

The second mechanism is EU accession, provided the accession country is small enough relative to the club it is joining. The channel through which this works relates to the coordination problem arising from the degree of law abidance. If EU accession is expected, citizens anticipate law enforcement in the future and conclude that they will be better off if they

choose to be producers rather than predators. This incentive can be sufficient to achieve law enforcement today even without a sufficiently effective apparatus of enforcement. From this point of view, accession without conditions of entry is the ideal mechanism since expectations of accession will be naturally higher. Attaching conditions to accession creates a coordination problem of its own, which can reduce the positive impact of expected accession.

The expectation of EU accession makes law enforcement easier in Eastern Europe

The researchers conclude that while the first mechanism explains China's success in law enforcement, the second mechanism may explain why Central European countries are faring much better than Russia in terms of law enforcement, and also in terms of the effects of enforcement on growth and economic performance.

This article summarizes research reported in 'Law Enforcement and Transition', CEPR *Discussion Paper* No. 2501 (July 2000), by Gérard Roland and Thierry Verdier. Roland is at ECARES, Université Libre de Bruxelles, and Co-Director of CEPR's Transition Economics programme; Verdier is at DELTA, Paris and a CEPR Research Fellow.

Self-Confidence: A View from Economics

Throughout history, the maintenance and enhancement of self-esteem has been identified as a fundamental human impulse. Philosophers, writers, educators and of course psychologists have long emphasized the crucial role played by self-image in individual motivation and social interactions. A recent CEPR *Discussion Paper* by Roland Benabou and Jean Tirole – 'Self-Confidence: Intrapersonal Strategies', No. 2580 (October 2000) – brings these concerns into the realm of economic analysis, where they have important implications in areas as diverse as education, career and investment decisions, and family and workplace relations. The paper is part of an exciting new research initiative for CEPR in the interdisciplinary field of economics and psychology.

Benabou and Tirole use the tools of economics to show that several puzzling examples of behaviour documented by psychologists can be quite rational. Their analysis is based on three premises about behaviour. First, we often have imperfect knowledge of our abilities and are uncertain of the long-run pay-offs of our efforts. Second, these self-perceptions affect our incentives to undertake or persevere in a variety of tasks. And third, our decisions exhibit a 'salience of the present' so we are tempted to seek immediate gratification at the expense of our long-term interests, to procrastinate and to give up in the face of adversity.

The danger that such myopia may damage our long-term interests creates strong incentives for the manipulation of self-knowledge. An individual's current 'self' has a vested interest in enhancing the self-confidence of future 'selves' so as to counter the natural tendency to procrastinate or give up too easily. Hence, good news about our abilities or expected productivity should make us less likely to procrastinate or give up. But the motivation benefits of confidence-maintenance must be traded off against the risks of overconfidence.

This interpretation of rational self-deception helps explain the phenomenon of selective memory, the tendency to remember successes more than failures. This, in turn, helps explain the widely documented prevalence of self-serving beliefs, where people have over-optimistic assessments of their own abilities and hence choose over-ambitious tasks in which they are sure to fail.

Benabou and Tirole show how this 'psychological immune system' can lead to a range of possible outcomes in people's cognitive strategies, self-confidence and behaviour. This suggests the value of benevolent outside parties, such as parents or therapists, to help people escape the 'self-traps' they create. Most importantly, they show that while 'positive thinking' and similar forms of self-deception can improve welfare, they can also be self-defeating so that it might be better always to be honest with oneself. The research also helps explain why people sometimes seek to lower their own self-confidence: defensive pessimism may reduce the temptation to rest on one's laurels.

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