

“Revisiting the Effects of More, Yet Imperfect, Information”

Most economists would agree that ideal economic outcomes can evolve when complete and perfect information is available. Nobel Laureate Friedrich Hayek constructed arguments for realizing optimal outcomes using less than complete information (see “The Use of Information in Society” in *The American Economic Review*, September 1945; pp. 519-530)—he did not elaborate extensively on information quality.

Let’s revisit situations and related outcomes when investors/employers have more, yet imperfect, information.

The first case is the current financial crisis. Improvements in media communications and the proliferation of personal computers facilitated the widespread coverage and observation of the crisis. While we all learned that there was a problem, in most cases, the information that was provided was far from complete.

Armed with knowledge that asset-backed securities based on subprime loans were a problem, investors began to shy away from firms that owned these securities. The volume of information had the effect of reducing investors’ uncertainties about that information—apparently, convincing investors that “most” subprime-based asset-backed securities were worthless. Consider that there was little precise reporting on actual subprime loan default rates or on the proportion of firms’ portfolios that were subprime loans. Nevertheless, investors drove down stock market capitalization by \$4 trillion from October of 2007 to October of 2008 partly due to the subprime loan “crisis” and the media’s reporting of it.

Deeper analysis revealed that defaults on subprime loans, while well above traditional norms, were not ubiquitous. The media’s reporting of Black Americans’ defaults on subprime loans were also overblown.

It turns out that with less than an overall 20 percent default rate, financial institutions that own these assets are unwilling to sell them cheaply. Why should they sell these assets for 40-to-60 cents on the dollar and permit a purchaser to earn a 20-to-40 cents return on the dollar. This must partly explain why the U.S. Treasury Department decided to change its strategy for solving the financial crisis.

Now consider that financial institutions, also affected by more, yet imperfect, information, virtually stopped lending. The information provided by the media apparently convinced banks that they couldn’t trust each other because their balance sheets were likely fraught with worthless subprime mortgage-based asset-backed securities. Banks also slowed considerably their lending to nonfinancial firms and to consumers.

We’ve had financial crisis before, and we’ll likely have them again. But the harm done by the additional information provided by the media can be summarized partly by the increase in stock market volatility. During the most traumatic period of the Savings and Loans financial crisis from the late 1980s to the mid-1990s, a scale-free measure of dispersion—the coefficient of

dispersion—for the Dow-Jones Industrial Average’s (DJIA) daily closing value was 90.58.¹ Compare that value with the coefficient of dispersion for the DJIA daily closing value during the current crisis of 121.97.² Is the nearly 35-percent increase in volatility between the two crises commensurate with the difference in magnitude and scope of the two financial crises? Notably, stock market volatility during the current crisis is over 300-percent greater than during the period surrounding the stock market crash of 1929 when reporting and observation of the crisis was sparse when compared with today.³

The second case is the election of Barack Obama. Let’s consider two aspects of this outcome. President-elect Obama is light skinned and tall. His election—at a minimum, the margin of victory—may be attributed, in part, to his skin color. No question about it, we received lots of information about his skills and abilities during the campaign and we were perpetually reminded that he is light skinned and tall. Will the nation’s employers use these signals to hire more light- versus dark-skinned Black Americans in the period ahead? There is good evidence that light complexion among Black Americans already carries heavy employment and income premiums (see William Darity, Jr. and Patrick Mason’s “Evidence on Discrimination in Employment: Codes of Color, Codes of Gender” in the *Journal of Economic Perspective*, Spring 1998; pp. 63-90).

In addition, we must inquire whether, in the immediate period ahead, there will be a sizeable boost to the employment and income premiums that accompany height (see Samuel Bowles and Herbert Gintis’ “The Inheritance of Inequality” in the *Journal of Economic Perspectives*, Summer 2002, pp. 3-30).

Just as there is no credible evidence that there are differences in intelligence between Whites and Black, there is no evidence that light-skinned Blacks are intellectually superior to dark-skinned Blacks. The same conclusion applies to intellectual and ability differences between tall versus short persons.

All of this is to conclude that, while we may bask in the knowledge that we received near continuous news coverage of the financial crisis and the presidential elections, we cannot say that we had perfect information.

However, for the economy and for the ordinary citizen, what we have now is an economy that has fallen into a slump that might have been less deep and a situation where dark-skinned Black Americans and short persons are likely to incur adverse outcomes relative to their light-skinned and tall counterparts.

Often, more is better. However, there are certainly situations where we might be better off with less information—particularly when it is imperfect and/or misleading.

¹ The coefficient of dispersion (the variance of a series divided by its mean) covers the period January 1, 1989 through the end of June 1995; a period when 747 savings and loans banks were closed or received assistance from the Federal government.

² The coefficient of dispersion covers the period July 1, 2007 through the end of October 2008.

³ The coefficient of dispersion for the 1929 stock market crash is 38.45; it covers the period September 3, 1929 (the pre-cash stock market peak) to July 8, 1932 (the trough).

B.B. Robinson, Ph.D.
11/18/08