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Overconfidence, Stability and Investments*

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Abstract

The available evidence from numerous studies suggests that overconfidence varies significantly across countries. We develop a model that endogenizes these differences and examines their economic consequences. A crucial determinant of differences in overconfidence is the degree of expected stability of the environment, with greater changefulness giving rise to more overconfident beliefs. When stability is endogenized, multiple equilibria can emerge, “dynamism” and overconfidence reinforcing each other in one case, stability and realistic self-assessment in another. Evidence from 38 countries is consistent with this relationship. Our model also sheds light on differences in overconfidence across individuals. We conduct a large-scale survey in China and find evidence consistent with the model’s cross-sectional implications.

Keywords: Self-confidence, investment, cultural differences, cultural transmission.

JEL Classification: Z1; D03; D83

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