Swiss Institute
of Banking and Finance

University of St.Gallen

Foreign Currency Borrowing and Knowledge about Exchange Rate Risk

Discussion by Martin Brown

Swiss National Bank Workshop, November 2014

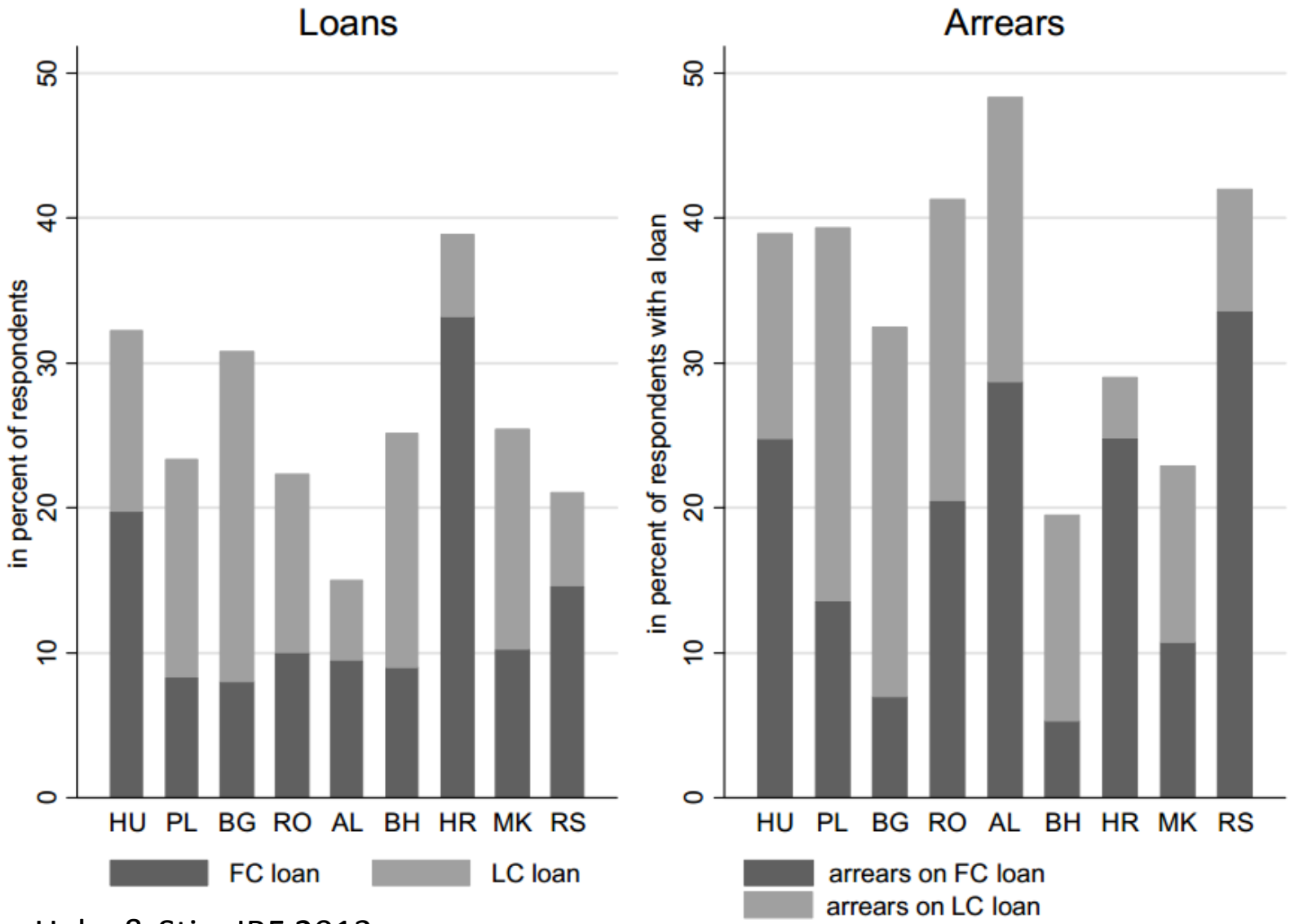
Research question, Methodology & Findings

- Is FX borrowing by households in South-East Europe driven by a lack of knowledge about exchange rate risk ?

- Relate household-level survey data on preferences for foreign currency loans to a new measure of exchange rate literacy
  - OenB Euro-Survey: 13’700 households in 8 countries in 2011/2013

- Find that exchange rate literate households are less likely to prefer FX loans … especially if they expect a depreciation of the local currency

We want to understand why households take risky loans



Fidrmuc, Hake & Stix, JBF 2013

Policy makers need to know whether literacy matters

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July 4, 2014 1:42 pm

Hungary acts on foreign-exchange loans

By Kester Eddy in Budapest

Hungary's parliament passed a law on Friday that will force banks to compensate borrowers for what the government says were "unfair" conditions applied to mostly foreign-exchange denominated loans issued in the years up to the financial crisis.

The same day, shares in Erste Group, the Austrian bank, fell as much as 15 per cent after it warned it would make losses of up to €1.6bn this year, partly because of the foreign-exchange loans made to Hungarian households.

The contribution of this paper

- First paper to document the degree of exchange rate literacy among households across Eastern Europe

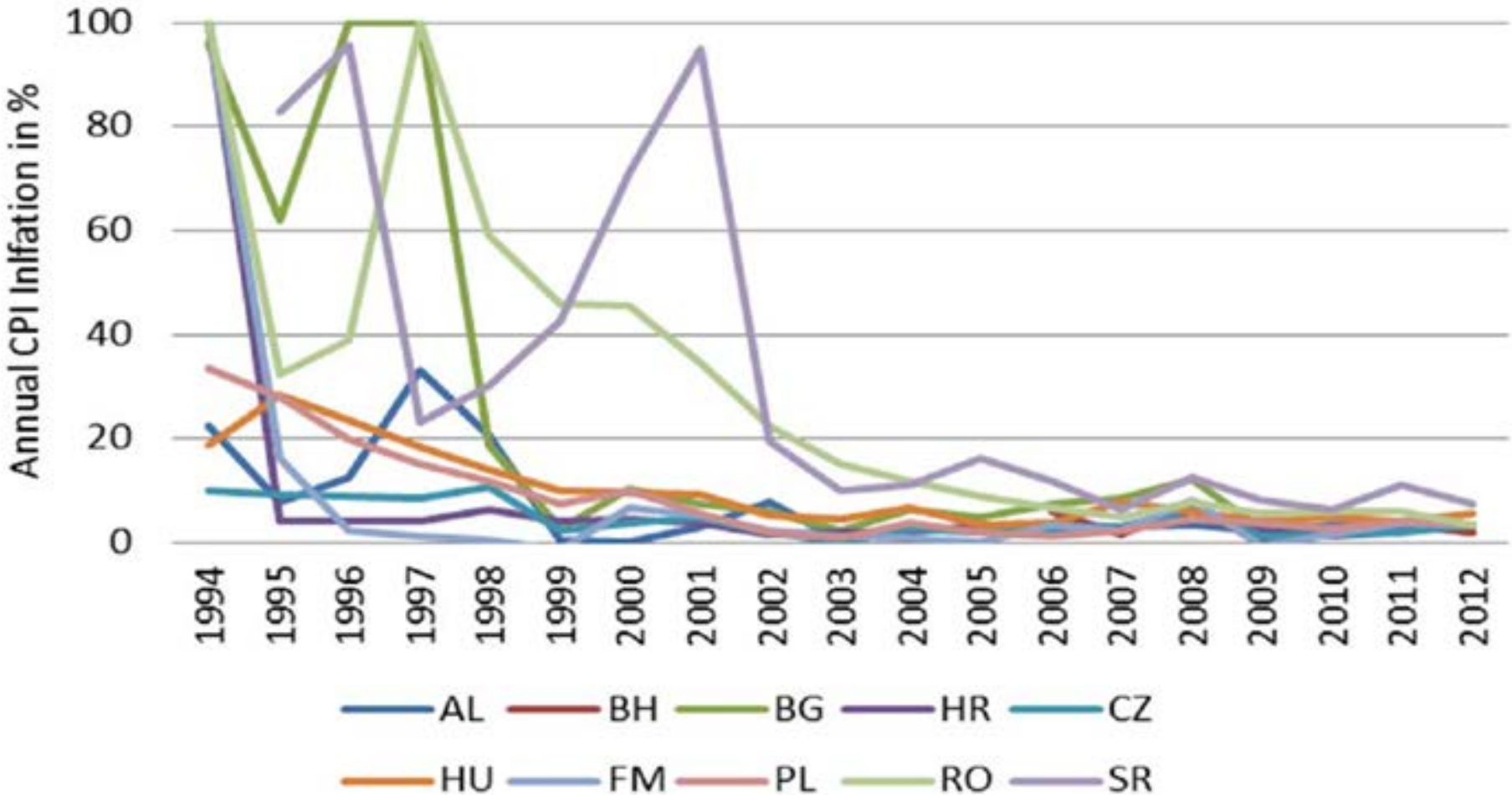
- First paper to relate exchange rate literacy <u>and</u> indvidual exchange rate expectations to FX borrowing

….. and from the broader perspective of loan contract choice and household risk management …..

- First paper to document the interaction of financial literacy and monetary expectations on household choice of (risky) debt contracts

Comment 1: Exchange rate & Inflation literacy

- Expand the analysis of the relation between crisis experience, exchange rate literacy <u>and</u> inflation literacy



Comment 2: Characterize FX borrowers

- Households which understand FX risk and expect a depreciation are (much) less likely to demand FX loans

…….. is this sufficiently informative for policy makers ?

- What share of FX borrowers are clueless about FX risk ?
- What share of FX borrowers understand FX risk

  .. but are (over-) confident about the local currency
- What share of FX borrowers understand FX risk and don't trust the local currency

  …. but are willing to take the bet because oflow leverage

  … or high risk tolerance

Comment 3: Household risk management

- Numerous papers study household mortgage choice from the viewpoint of household risk management

  e.g. Amromin et al. 2013; Ehrmann & Ziegelmeyer 2014

- Individual monetary expectations (and knowledge about their impact on loan installments) play a key role in theory

  … but i've not seen an empirical paper which can relate loan contract choice to individual expectations and literacy

- You have the potential for a more general contribution
  - but you would also need to discuss the interest rate risk attached to LC vs. FX loans…

Other comments

- Present bias vs. Financial literacy
- What about loan type and purpose ?
- Replicate the results using actual use of FX loans
- Do you need a selection model ?