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Information and consumer credit in Central and Eastern Europe

Akos Rona-Tas [a,*], Alya Guseva [b]

[a] Department of Sociology, University of California, San Diego, 401 Social Science Building, 9500 Gilman Drive, La Jolla, CA 92093-0533, United States
[b] Boston University, Department of Sociology, 96-100 Cummington Street, Room 260, Boston, MA 02215, United States

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ABSTRACT

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We present a critique of Behavioral Economics, the dominant approach to reforming the regulation of retail credit, and propose a new approach to managing uncertainty in consumer lending. This new approach draws on a different model of decision-making, Distributed Cognition, to improve contract origination, and it takes inspiration from the Legal Theory of Finance with respect to contract enforcement. We develop a set of stylized arguments about information-related problems and their possible solutions in Central and East European markets, discussing separately measures to protect lenders, such as requiring collateral, collection, screening and data sharing, and those to protect consumers, including disclosure, data privacy and regulation of automated individual decisions. Then we move to enforcement and using the empirical case of the Hungarian foreign exchange mortgage crisis we illustrate the importance of elasticity of law. *Journal of Comparative Economics* **41** (2) (2013) 420–435. Department of Sociology, University of California, San Diego, 401 Social Science Building, 9500 Gilman Drive, La Jolla, CA 92093-0533, United States; Boston University, Department of Sociology, 96-100 Cummington Street, Room 260, Boston, MA 02215, United States.

1. Introduction

The three central postulates of the Legal Theory of Finance (LTF) developed by Pistor (2013) are the hierarchical nature of finance, the role of law in both ensuring and subverting the stability of credit markets, and the differential enforcement of laws (elasticity) with the core afforded much more consideration than the periphery. The need for elasticity follows from true uncertainty, and the way elasticity is distributed is related to the power each actor wields. The source of this power can be structural position in the hierarchy of finance, political influence or both.

In this paper, we apply some of the ideas of LTF to an area that is at the bottom of the hierarchy of finance in not one but two ways. Consumer credit in Eastern Europe is situated on the periphery both geographically, as the rules of international finance are written far away from Budapest, Moscow or Warsaw, but also because retail lending and individual borrowers are on the outer edges of the world of finance dominated by stock exchanges, currency markets and government debt. In fact, retail customers are at the bottom of the pecking order facing the hardest liquidity constraints. We will illustrate Pistor's theoretical arguments with empirical data from East European credit card markets, and then point to their limitations offering a set of complementary ideas.

* Corresponding author.
E-mail addresses: aronatas@ucsd.edu (A. Rona-Tas), aguseva@bu.edu (A. Guseva).

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The LTF treats law as an independent variable that explains how financial actors that are faced with an impending crisis attempt to enforce or renegotiate contracts that underlie credit transactions. We want to broaden the problem by stepping back in time, from contract enforcement to the point of contract origination. We frame the contract as a solution to a series of uncertainties experienced by the lender and the borrower. We discuss enforcement as an extension of the uncertainty problem.

As developed by Pistor, LTF is a macro-level theory that approaches finance as a field with an overarching goal of explaining systemic failures. Our starting point of looking at contract origination necessitates that we zero in on the lender–borrower dyad, and requires that we complement LTF with a micro-level theory of economic action – a perspective that would account for our particular markets on the double periphery better than the ones currently on offer. Our first concern is how to construct a consumer loan contract that when signed best protects both lender and borrower. In consumer credit markets, legal contracts are typically written in a one-sided fashion: banks are contract-makers and consumers are contract-takers, who sign with little possibility of negotiating (and often without reading through or fully understanding the "fine print").

Yet, problems of uncertainty are too deep to be fully resolved at the point of origination. Contracts, therefore, need to provide a certain amount of flexibility to adjust for later changes. Contracts with appropriate flexibility minimize risk not just to the two parties but they also reduce systemic risk. Nevertheless, there can be situations, where more is needed and the regulator must intervene by directly loosening obligations because unforeseen developments generate externalities and risk is no longer contained between the two parties but becomes systemic. Then, as the LTF posits, there is a need for elasticity in the enforcement of those contracts even if they seem optimal at the time.

In what is to follow, we present a critique of behavioral economics (BE), the theoretical approach that currently dominates new thinking about the regulation of consumer credit that focuses on contract origination. Then we develop a set of stylized arguments about information-related problems of consumer credit markets and their possible solutions drawing on another approach to decision-making – distributed cognition (DC) – that was developed by cognitive scientists in the 1980s, but gained in popularity only recently (Hutchins, 2001). We look at the solutions to those problems in East European markets focusing separately on measures to protect lenders and those to protect consumers. Then, with help from LTF, we move from origination to enforcement of these contracts using the empirical case of the Hungarian foreign exchange mortgage crisis.

2. The theoretical framework

2.1. The trouble with behavioral economics

Recently, much of the new economic thinking about consumer credit on the micro-level has taken behavioral economics (BE) as its point of departure. The Directorate General of the EU for Health and Consumers, the department of the European Commission responsible for reforming financial services has a special webpage on BE with useful links to studies on the topic deploying ideas from BE.[1] The influence of BE on the new Financial Consumer Protection Agency in the US is also hard to miss.[2] The popularity of BE is based on the conviction that the main problem with traditional economics is that it built its rational choice theory (RCT) on unrealistic ideas of how humans make decisions and act (Camerer et al., 2003; Kahneman and Tversky, 2000). BE is expected to supply a more realistic individual psychology for our understanding of the economic world. Its research program aims at finding universal behavioral patterns, decision-making flaws and mental shortcuts that can replace the overly cerebral, autistic and amoral *homo oeconomicus*. Spearheaded by cognitive psychologists, BE earned its scientific stripes by conducting experiments, a revered scientific method that economics, having embraced the general philosophy of positivist scientific thinking, could not ignore. Its most famous achievements are cleverly contrived experiments, usually set up in a lab, where it can be shown that people deviate from rational thinking as depicted in RCT under the artificial circumstances presented to subjects by experimenters, and the pattern extracted from these experiments can be deployed as plausible explanations for some economic phenomenon in real life. BE is quite powerful demonstrating the limitations of the self-interested rational actor model. Moreover, as many works of (social) psychology, it supplies us with great stories to tell.

Yet moving beyond criticism, BE becomes as vulnerable as its arch nemesis. Take any of the discoveries of BE and you can think of countless exceptions (Kahneman et al., 1991; Cachon and Camerer, 1996). Default bias claims that we have a tendency to stick with the *status quo*, but while certain people in certain situations do let the default rule dictate their choices, other people, or the same people in other situations, want to make their own decision. If default reigned supreme why are divorce rates on the rise, what would one make of converts to new religion, and why would anyone buy risky stocks or become an organ donor?[3] The theory of loss avoidance contends that given a loss and a gain of the same amount and likelihood, people will prefer avoiding the loss to pocketing the gain. Yes, it happens, it may happen often, but if this were to be a universal truth, no one would play the lottery. And the list goes on. BE is powerful because it is liberating compared to the prescriptive straightjacket of the RCT. In addition, its psychological approach makes the existence of the phenomena it describes available to quick and easy validation through introspection. What these experiments show us is that under certain circumstances people

[1] http://ec.europa.eu/consumers/behavioural_economics/index_en.htm. See also Stark and Choplin, 2010.

[2] See http://blogs.wsj.com/economics/2011/05/11/behavioral-economist-heads-to-consumer-protection-agency/.

[3] Unlike some of the European countries, in the US "opt-in" system, the default is not to be a donor.