

---

Discussion of “Piecing Together a Portfolio  
Puzzle:  
Accounting for Why Households Borrow High and  
Lend Low

Federal Reserve Bank of Boston  
July 25, 2006

Annamaria Lusardi  
Dartmouth College & NBER

---

# Main point of this paper:

- Borrowing High Lending Low (BHLL) is not an important puzzle
  - Cost of BHLL is low for majority of households

---

# Some considerations

- Reasons for why households may want to hold a demand deposit balance and a credit card balance:
    - Credit cards and demand deposits are not perfect substitutes. Reasons to hold demand deposits:
      - demand for liquidity
      - precautionary demand for liquidity.
    - Most demand deposits require minimum balances. There are overdraft penalties.
    - Financial management reasons: exploit low rates on credit card balances transfers, strategic default.
-

---

# Cost of BHLL

## ■ What is the cost of BHLL?

- Calculations are (inevitably) crude and should be interpreted as such (sometimes are upper or lower bounds).
  - SCF data may not report accurately credit card balances (Gross and Souleles 2002). The average number of credit cards per person is 6 and hard to collect data for each card.
  - Holding credit card balances is not the only way in which households borrow high.
-

# Assessing the finding about the cost of BHLL

- The (unadjusted and adjusted) cost of BHLL is low for majority of households:
    - Would like to see distribution among specific groups: those with low education, young people, single-earner families.
    - Why waste money? Paying off credit card debt first is a good financial practice.
    - Are people indeed doing these cost calculations (and acting accordingly)?
-

---

# Doing calculations

- Financial illiteracy is widespread among the population (see surveys by National Council on Economic Education, Jump\$tart Coalition, and the Health and Retirement Study).
  - Households have difficulties making very simple economic calculations (Lusardi and Mitchell 2006a, 2006b).
-

---

# 2004 HRS: Economic Literacy/ Calculations

- If the chance of getting a disease is 10 percent, how many people out of 1,000 would be expected to get the disease?
  - If 5 people all have the winning number in the lottery and the prize is 2 million dollars, how much will each of them get?
  - Let's say you have 200 dollars in a savings account. The account earns 10 percent interest per year. How much would you have in the account at the end of two years?
-

# Financial Knowledge and Literacy Among Early Baby Boomers (age 51-61)

<i>Question Type</i>	<b>% Correct</b>	<b>% Wrong</b>	<b>% DK</b>
Percentage Calculation	83.6	13.2	2.7
Lottery Division	56.4	34.1	9.5
Compound Interest	17.9	78.6	3.1



---

# Bankruptcy rates

- The number of families going bankrupt has increased three-fold during the expansion of credit cards.
  - While not all bankruptcy are mistakes, some may be a sign of mismanagement of personal finances.
-