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How Koreans Deal with Foreign Exchange Rate Risk: A Behavioral Law and Economics Perspective on the KIKO Forward Contract

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Abstract

Between 2006 and 2007, hundreds of South Korean export companies entered into what is called the KIKO (knock-in, knock-out) target forward contracts to hedge against the threat of appreciating Korean currency, Won. Buyers of these contracts were assured a pre-determined foreign exchange rate as long as the range of exchange rate fluctuation stayed within a narrow band. In 2008, however, the Korean currency depreciated enormously following the global financial crisis, forcing buyers of the KIKO contracts to incur enormous losses. Why were there both supply and demand for these contracts, and why did they become suddenly popular in Korea? This article employs a behavioral law and economics perspective to explain what transpired in the minds of the parties to the contracts. Psychological biases and cognitive limitations were perhaps at play, including herd behavior, investor myopia, information cascades, and optimism bias. Recognizing that these psychological factors could induce sub-optimal decisions of the contracting parties, it is argued that de-biasing should be considered an important policy goal in financial contracting. While the scope of this paper is limited to the KIKO contracts, the principles used to examine this case can be broadly applied. (A revised version will be published as "Contracting Foreign Exchange Rate Risks: a Behavioral Law and Economics Perspective on KIKO Forward Contracts," in European Journal of Law and Economics.)

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