

Promoting Financial Literacy Post-Crisis: Recommendations and Challenges

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Scheme of the presentation

- The state of financial literacy
 - How much do people know?
- What has the crisis taught us?
- A plan for financial literacy
- Recommendations and challenges

Collecting data on literacy

Most national surveys do not collect data on financial literacy

- **Need to measure state of financial literacy**
- **Who knows the least?**
- **What are the consequences of financial illiteracy?**

From yesterday's presentations

Where does money come from?

From a little factory close to the highway

Colombian child

Collecting data on literacy

We were able to add a small module on financial literacy in U.S. national surveys and also do ad-hoc surveys

➤ Financial Literacy

Do people know basic economics/finance?

➤ Do people know what they do not know?



Measuring Financial Literacy (I)

To test numeracy and understanding of interest rates, we asked:

“Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?”

- i) more than \$102;
- ii) exactly \$102;
- iii) less than \$102;
- iv) don't know (DK);
- v) refuse to answer.

Measuring Financial Literacy (II)

To test understanding of inflation, we asked:

“Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, would you be able to buy:”

- i) more than today with the money in this account;
- ii) exactly the same as;
- iii) less than today
- iv) DK;
- v) refuse.

Measuring Financial Literacy (III)

Finally, to test understanding of risk diversification, we asked:

“Do you think the following statement is true or false? Buying a single company stock usually provides a safer return than a stock mutual fund.”

- i) true;
- ii) false;
- iii) DK;
- iv) Refuse.

How much do young people know?

We analyzed the knowledge of people between the ages of 23 and 28 in 2007/2008:

Distribution of Responses to Financial Literacy Questions (%)

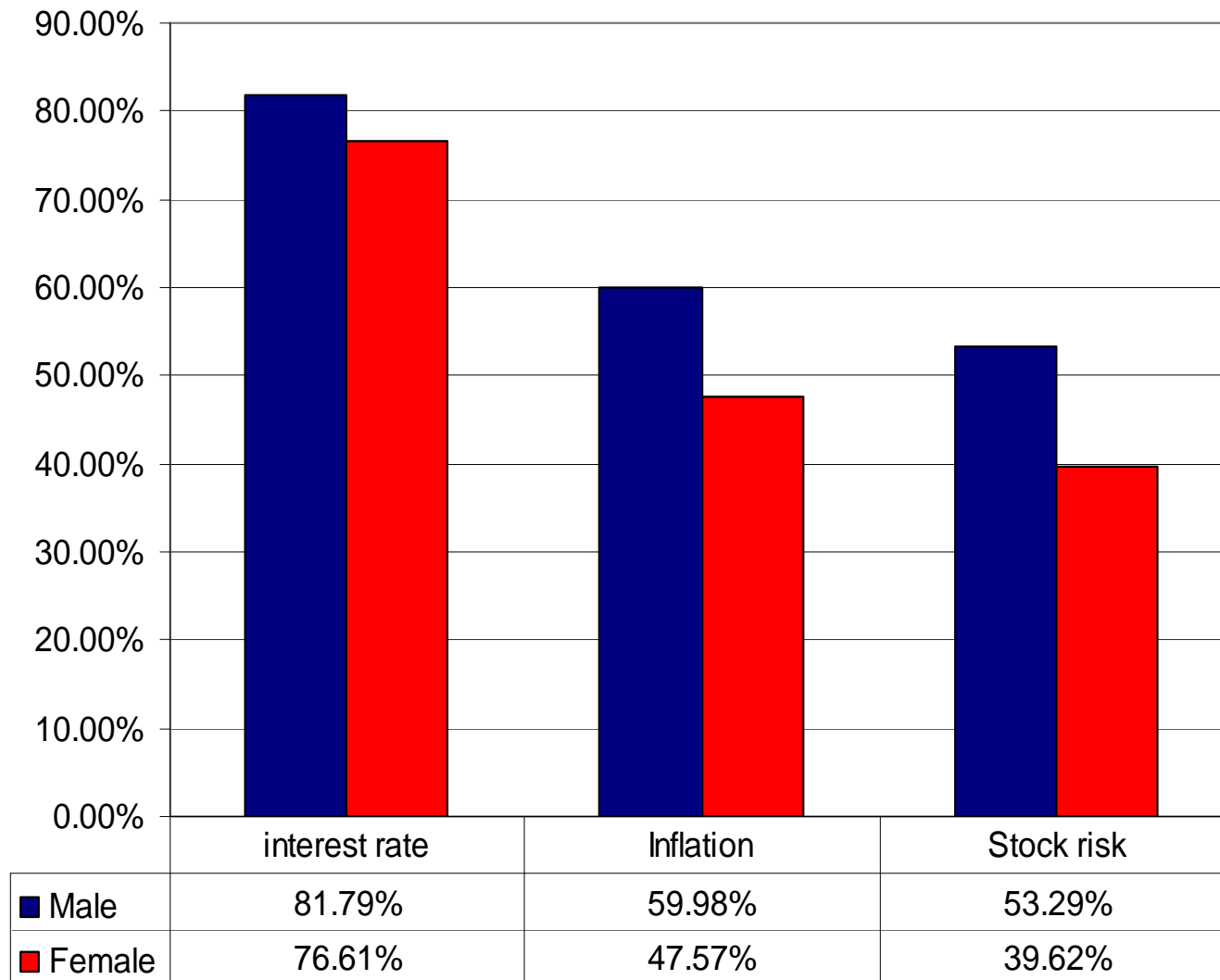
	Responses			
	<i>Correct</i>	<i>Incorrect</i>	<i>DK</i>	<i>Refuse</i>
Interest rate	79.24	14.76	5.87	0.12
Inflation	53.88	30.53	15.41	0.18
Risk diversif.	46.57	15.86	37.5	0.07

NB: Only **about one quarter (27%)** correctly answer all 3 questions.

Who are the most literate young adults?

- Male
- Whites
- Those whose parents (particularly mothers) have college degrees
- Those whose parents had stocks and retirement savings when respondents were teen-agers.

Correct responses (young adults): By Gender



Financial Literacy in other surveys

- These questions have now been added to many other surveys in the US
 - HRS (age 50+)
 - Rand American Life Panel (all age groups)
- These questions have been added to many surveys abroad
 - The Netherlands
 - Italy and Germany
 - Russia
 - New Zealand



Financial Literacy related to Debt

- Together with Peter Tufano (HBS), I designed questions about *debt literacy*
 - *Relevant given sharp increase in debt*
- We engaged a market research firm (TNS) to provide timely data
 - Representative sample of the US population



TNS Survey: Paying off credit cards

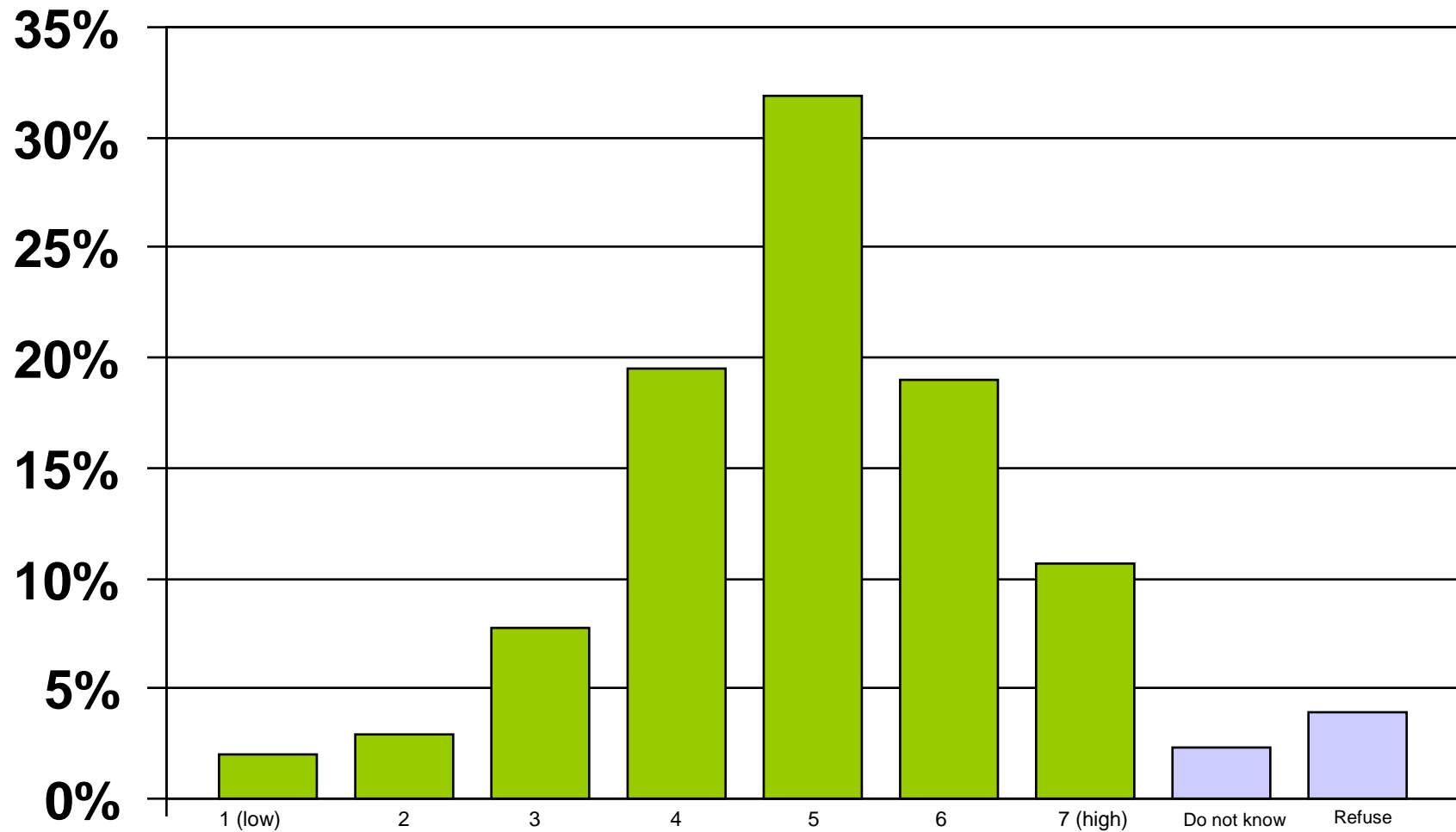
We tested participants' understanding of the impact of paying of credit cards:

Suppose you owe \$3,000 on your credit card. You pay a minimum payment of \$30 each month. At an Annual Percentage Rate of 12% (or 1% per month), how many years would it take to eliminate your credit card debt if you made no additional new charges?

- Less than 5 years
- Between 5 and 10 years
- Between 10 and 15 years
- Never
- Do not know
- Prefer not to answer

Credit card payment	Percent
Less than 5 years	3.8
Between 5 & 10 years	12.4
Between 10 & 15 years	21.6
Never (correct)	35.4
Do not know	21.7
No answer	5.1

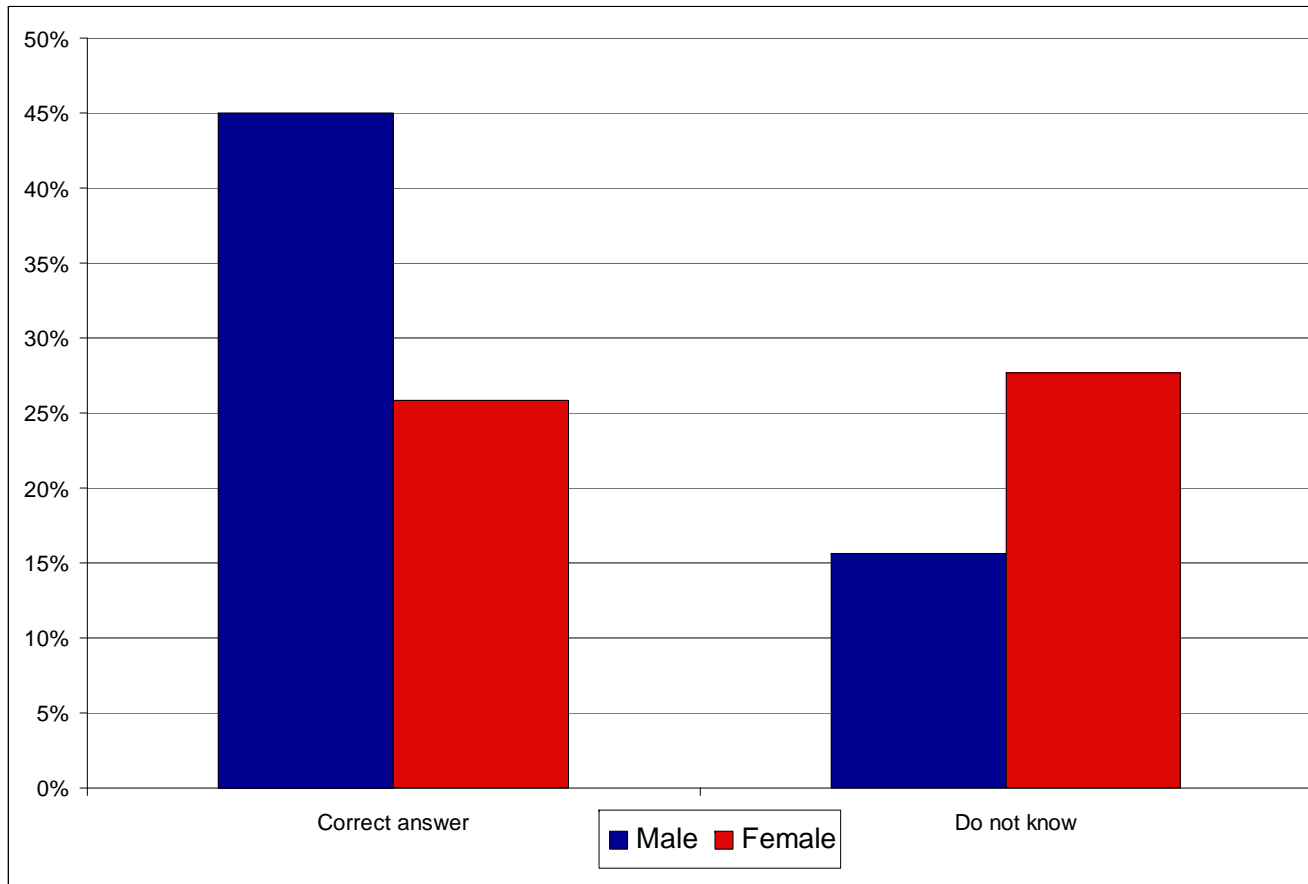
Self-reported financial knowledge



Who has lower financial literacy?

The debt literacy question showed marked differences between men and women:

Percent answering credit card question correctly or “do not know” by gender



Two Takeaway Points

- Financial illiteracy is widespread
- Financial literacy varies widely among demographic groups.
 - Gender
 - Age
 - Race
 - Economic background

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The financial crisis has shown us

- Financial mistakes have devastating consequences
- There are societal costs in addition to individual costs
 - Role for public initiatives
- People are paying attention
 - This is an ideal “teachable moment”
 - No crisis should be wasted!

Academic research: The cost of financial illiteracy

- High cost debt



- Poor investing



- Lack of saving

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A plan for financial literacy

- The need for a (national) financial literacy strategy
- The need for a baseline survey that measures
 - Financial capability of population
 - What is done already
- The need for appropriate funding and evaluation of how effective programs are
 - A Latin American Fund?

Where to start?

- The importance of financial education programs in schools
- The importance of financial education programs in the work-place
- Other initiatives

The Importance of Financial Education in Schools

- Individuals need to be knowledgeable *before* they engage in financial contracts
- Equalizing opportunities:
 - Not everybody have parents/peers to learn from
- The scientific basis of financial literacy
 - Teach the law of gravity and the law of interest compounding!
- Limitations of learning by doing (we only retire once) and learning from previous generations (the world has changed)

What to teach?

- What should we teach in school?
 - How to balance a check-book?
 - How to price options?
- We should teach the basics of economics and finance
 - Grounded in theory
- The objective is to equip people with basic tools not to make them professional experts

Financial education in the work-place

- A lot of people are already out of school
- The work-place is an ideal venue because:
 - This is where a lot of adults can be found
 - Changes in pensions (from DB to DC)
 - Interest of employers that workers make good financial decisions so they can retire
- Economies of scale in delivering financial education in firms

Other initiatives

- Other initiatives to reach other members of the population
 - Video-games to teach low income women (Doorways to Dreams, USA)
 - TV programs (including soap operas)
 - Link financial education to programs fostering entrepreneurship
 - Comics, tales, videos to teach financial literacy concepts

In their own words : A Dartmouth College employee



- Ron Whitcomb works in Facilities Operations & Management's Custodial Services. He has been with the College for fourteen years.
- Topics discussed:
 - Hopes for Retirement
 - Parents as Role Models
 - Why I Save
 - Ron's Recommendations
 - Planning for the Future

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Current financial education programs

- Many current programs do too little to address such widespread financial illiteracy
 - One seminar on retirement planning is unlikely to affect behavior
- Returns of financial education is in the long-run
 - Few institutions have such horizon

Evaluation of financial education

- Few financial education programs are rigorously evaluated
 - Financial evaluation has to be built in the program, not be an afterthought
- It is essential to do evaluation
 - Need to allocate (scarce) resources to what works
 - Need accountability
 - Need to give credibility to the work that is done

The role of central banks to promote financial literacy

Role of central banks is crucial:

- Central banks have economic expertise
- They have the attention of the public: When a central banker speaks, the public listen
- They can afford to have a long horizon
- They are independent from the financial industry
- Common objectives: Financial literacy promotes participation in financial markets, strengthens financial decisions, it promotes stability

Financial education and the financial industry

- Word of caution: there is a conflict of interest between educating and selling financial products
- Involvement of financial industry can undermine the credibility and trust in a program
- Need to think hard about how to find a way to collaborate

Financial education around the world

- There are a lot of countries/central banks/institutions that have done or are financial education programs
- We need to know what is effective
- No need to reinvent the wheel
 - Very useful to learn from other initiatives
 - Cut costs and time
- The OECD can provide very useful guidelines

What can financial education deliver?

- Financial education does not (and should not) transform individuals into little George Soros
 - We do not teach Spanish at school so that everybody can write *One hundred years of solitude*
- The fact that a country offers financial education programs does not take away from
 - The importance of regulation of financial markets
 - The importance of supporting the most vulnerable groups in society
 - The importance of greatly simplifying financial decisions
- Financial education is a complement not a substitute to other programs (one example is default options)

Concluding remarks

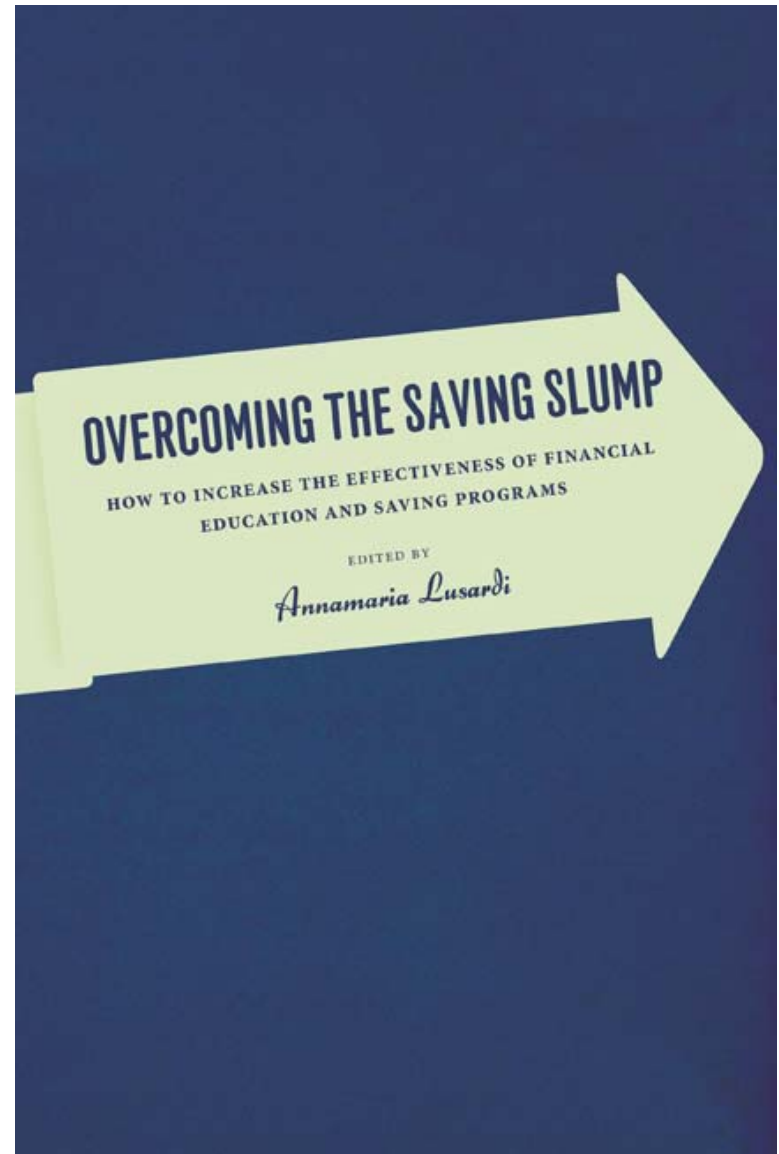
➤ Financial **Literacy**:

As it was not possible to live in a modern world without being able to read and write, so it is not possible to live in the current society without being financially capable.

➤ Financial literacy helps individuals make better financial decisions and improve their well-being and build a stronger economic system

If you want to do more readings

- I edited a book on how to increase the effectiveness of financial education programs
- It covers the experience of many countries



Research on financial literacy

For more information:

- Other papers I have written on this topic are available on my webpage:
<http://www.dartmouth.edu/~alusardi>
- I write a blog dedicated exclusively to financial literacy

Thank you for your attention!