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.
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:

<table>
<thead>
<tr>
<th>Distribution of Responses to Financial Literacy Questions (%)</th>
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</thead>
<tbody>
<tr>
<td><strong>Responses</strong></td>
</tr>
<tr>
<td>Interest rate</td>
</tr>
<tr>
<td>Inflation</td>
</tr>
<tr>
<td>Risk diversif.</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate</td>
<td>81.79%</td>
<td>76.61%</td>
</tr>
<tr>
<td>Inflation</td>
<td>59.98%</td>
<td>47.57%</td>
</tr>
<tr>
<td>Stock risk</td>
<td>53.29%</td>
<td>39.62%</td>
</tr>
</tbody>
</table>

- Male responses for interest rate: 81.79%
- Female responses for interest rate: 76.61%
- Male responses for inflation: 59.98%
- Female responses for inflation: 47.57%
- Male responses for stock risk: 53.29%
- Female responses for stock risk: 39.62%
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
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

<table>
<thead>
<tr>
<th>Credit card payment</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5 years</td>
<td>3.8</td>
</tr>
<tr>
<td>Between 5 &amp; 10 years</td>
<td>12.4</td>
</tr>
<tr>
<td>Between 10 &amp; 15 years</td>
<td>21.6</td>
</tr>
<tr>
<td>Never (correct)</td>
<td>35.4</td>
</tr>
<tr>
<td>Do not know</td>
<td>21.7</td>
</tr>
<tr>
<td>No answer</td>
<td>5.1</td>
</tr>
</tbody>
</table>
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

The graph shows the percentage of correct answers and “do not know” responses 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
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!