What is financial literacy and why does it matter?

***Dr Vikas Kakkar** investigates a topic that affects us all – the skills and aptitudes that it takes to achieve lifetime financial security. What makes us financially literate and what kinds of behavioural biases lose us money?*

Financial literacy can be conceptualized as "the ability to use knowledge and skills to manage one's financial resources effectively for lifetime financial security". A growing body of academic research in recent years has documented that financial literacy levels around the world are alarmingly low. The Standard & Poor's Ratings Services Global Financial Literacy Survey is among the largest and most comprehensive studies ever conducted to measure financial literacy in over 140 countries. The survey, which assessed the general public's knowledge of four basic financial concepts, revealed that only 1 out of 3 adults worldwide are financially literate. While the concepts of numeracy and inflation were relatively well understood by the public, risk diversification was the least understood concept. Another concerning finding of the survey was that women's financial literacy levels are significantly lower than those of men. The results of many other country-level surveys are similar and confirm that these findings are fairly robust and not a mere statistical artifact.

Low levels of financial literacy are a cause for concern

These low levels of financial literacy are a cause for concern for policy makers and economists because financial products are gradually becoming more sophisticated and the responsibility for retirement planning and saving is increasingly shifting from governments and private companies to individual households. For instance, the employer-sponsored defined benefit pension plans that were previously the norm are increasingly being replaced by defined contribution plans. Although these new plans confer the benefits of more flexibility and mobility on workers, they also presume that workers are endowed with the necessary financial skills to make wise retirement-related decisions. Low levels of financial literacy imply that households do not possess the knowledge required to make sound financial decisions and hence their financial security and well-being may be significantly compromised. In stark contrast to conventional economic theory depicting rational individuals maximizing intertemporal utility via optimal asset accumulation over the life cycle, evidence suggests that many adults have no retirement plan and lack adequate savings for retirement.

What makes people financially literate?

The last couple of decades have seen a burgeoning of the literature exploring the measurement of financial literacy and how it potentially affects a wide variety of household financial behaviour. Broadly speaking, this literature shows that higher levels of financial literacy are associated with a host of desirable financial behaviours, including greater participation in equity markets, being better prepared for retirement and financial emergencies, and being more comfortable with using digital financial services and products. People with higher levels of financial literacy are also less likely to fall prey to financial fraud, default on their loans, or utilize high interest rate loans.

In a recent contribution to this literature, we utilize data from the first large scale survey of financial literacy conducted by the Central Council for Financial Services Information in Japan to investigate the relationship between financial literacy and wealth accumulation. In contrast to the bulk of the literature, which relies on a small number of questions to measure financial literacy, we measure overall financial literacy as the number of correct answers to 12 questions covering various dimensions of financial literacy. We also consider the possible impact of cognitive biases such as myopia and loss-aversion on wealth accumulation.

What are the effects of financial literacy?

Our empirical results show that overall financial literacy has an economically and statistically significant positive impact on wealth accumulation. We estimate that a one-point increase in overall financial literacy increases the financial asset balances of a Japanese household by JPY 3.26 million. It is noteworthy that a positive association between financial literacy and wealth could also obtain when causality runs from wealth to financial literacy. This is because wealthier households have more opportunities to acquire financial literacy via the process of investing and managing their wealth. It is therefore reassuring that our results are robust to the possibility of reverse causality.

In order to get a more nuanced view of which aspects of financial literacy have a greater impact on wealth accumulation, we also decompose overall financial literacy into five sub-components, comprising Deposits Literacy, Risk Literacy, Insurance Literacy, Debt Literacy and Inflation Literacy. Our results show that there are significant variations in the impact of these sub-components on wealth accumulation. Specifically, we find that Deposits Literacy, Risk Literacy and Debt Literacy have large economically and statistically significant impact on wealth accumulation. By contrast, Inflation Literacy and Insurance Literacy do not have statistically significant impact on the accumulation of wealth in Japan.

Behavioural biases lose money

Turning to the effects of behavioural biases on wealth accumulation, we find that higher levels of myopia are associated with lower levels of wealth. This implies that myopic investors, who are more concerned with relatively short-term results, might make poor long-term financial choices with adverse consequences for wealth accumulation. Loss aversion refers to the psychological phenomenon whereby losses are perceived by individuals as far more painful than the happiness generated by equivalent gains. The fear of losses looms so large as to cause investors to hold a losing stock too long and sell a winning stock too soon, thereby lowering overall returns. Consistent with this intuition from behavioral economics, we find that loss aversion has a significantly negative impact on wealth accumulation.

To conclude, our research shows that financial literacy has a positive and significant causal impact on wealth accumulation. However, it is important for policy-makers to distinguish between various types of financial literacies in the design of financial education and training programs because of their differential impact on our financial well-being. There is also a role for inculcating a greater awareness of common behavioral biases via financial education and training programmes.

Reference

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