Universität St.Gallen

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“Financial literacy. Making better financial decisions.” Author: Prof. Dr. Martin Brown, Professor of Banking, Swiss Institute of Banking and Finance (s/bf-HSG), www.sbf.unisg.ch

Link: https://youtu.be/fQfmkdrw_HY

Shortlink to the series: http://bit.ly/littlegreenbagshsg

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Financial literacy: Making better financial decisions.

Got enough pocket money to buy 10 chewing gums? Lease a new car or buy a used one? And how to provide for old age?! We all make financial decisions – some of them are easy, many others are complex. Choose a mortgage with fixed or variable interest rates? Amortize or pay interest only? And what term is best: five, ten or twenty years?

Many people struggle with such questions and end up making decisions that aren't in their best interest. For example: they take out mortgages which they can afford now, but don't consider that the interest rate may rise in the future. The result can be an unbearable debt burden, social humiliation or even the loss of their home.

This is why it is so important that adults are able to correctly assess their financial situation. And why universities, public authorities, international organizations and banks engage in the field of “financial literacy“.

But what is financial literacy?

Financial literacy is the ability to make sound financial decisions. It consists of three components:

First: knowledge. Financially literate people understand financial concepts. For example: they are familiar with the concepts of interest, inflation and risk diversification.

Second: skills. Financially literate people can apply their knowledge. For example, they are able to do the maths required to calculate an interest rate.

Third: attitude. For example, financially literate people consider the long-term consequences of today's financial decisions – and don't succumb to short-term incentives.

Academic research shows: despite the fact that we all deal with money on a regular basis, financial literacy is astonishingly weak among the general population. Only one in three people understands the concepts behind interest, inflation and risk diversification.

How come?

Numerous surveys have revealed that adults with a low level of education and low income often lack the knowledge required to make good financial decisions. Also, women generally possess a lower level of financial literacy then men.

So do less money, less schooling and fewer Y-chromosomes simply result in a lower degree of financial literacy?
Hardly.

One reason for the different levels of financial literacy lies in people's upbringing: parents can teach their children how to manage money by giving them some pocket money at an early age.They also pass on important values such as "Never spend more than you earn".

Moreover, the social environment has an impact on our financial literacy: where money and consumption are symbols of prestige and freedom, teenagers are more likely to consume spontaneously – and make rash financial decisions. Research shows that girls are especially prone to such peer pressure.

In adulthood, incentives play a decisive role:
people who earn more and have significant wealth have stronger incentives to acquire financial knowledge – or to seek expert advice. And people who think more about their financial future are more likely to be aware of the importance of financial knowledge, skills and attitude.

The low levels of financial literacy documented by academic research have triggered various financial education initiatives and experiments in many countries: there are courses for secondary school students in Germany, there's counselling for mortgage borrowers in the U.S., and in South Africa soap operas experiment with financial topics.
But will these efforts really serve to improve financial literacy and – even more so – change people's financial behaviour?

Yes, they can. Research findings indicate that some financial education programmes do improve participants' financial literacy. Apparently it does help when budget problems are made the subject of discussion in TV soap operas. Yet unfortunately, not all programmes are equally successful. Mandatory consultation for vulnerable mortgage borrowers in the U.S only had one effect: clients tried to avoid the consultation sessions at all costs.

Time for a quick wrap up:

First – financial literacy is the ability to make sound financial decisions. It includes knowledge, skills and a certain attitude towards money.

Second – only one in three people is financially literate.

Third – some financial education programmes have demonstrated that financial literacy can be improved.

Great, so where do we go from here?

Academic research is now trying to find out which programmes are best suited to reaching different target groups. Because, to significantly improve financial literacy, educational programmes must be accessible to those who are likely to benefit most – people with low incomes and low levels of education.

The end of this research journey is marked by an ambitious goal: to find solutions which enable as many people as possible to make financial decisions which are in their best interest.

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