FINANCIAL LITERACY OR LESSONS FOR LIFE?

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ABSTRACT

The interest of this paper lies within financial literacy & education. Principles such as diversification of investments, exploitation of the power of interest compounding, taking advantage of tax-favored assets or employer matches are fundamental. Asteriou & Siriopoulos dictate the prevalence of vocational education, through which various financial skills emerge. How to be less vulnerable to financial fraud, use debt responsibly, runs a business efficiently, knowledge of interest compounding and numeracy are the strongest predictors of planning and economic growth. Any saving plan requires the ability to calculate present values, and an understanding of the advantages of starting to save early in life that can benefit every investor.

Keywords: Information and Market Efficiency (G14).

INTRODUCTION

PISA (2018) defines financial literacy as the knowledge and understanding of financial concepts and risks, and the skills, motivation and confidence to apply such knowledge and understanding in order to make effective decisions across a range of financial contexts, to improve the financial well-being of individuals and society, and to enable participation in economic life. Surveys show that a majority of workers are unaware of the risks they have to face, and even if they are aware of them, they have neither the sufficient financial knowledge nor the skills to manage such risks adequately (OECD, 2019).

Several studies have documented poor debt behavior and its link to financial literacy. Moore (2003) reported that the least financially literate are more likely to have costly mortgages. Lusardi & Tufano (2015) showed that the least financially savvy incurred high transaction costs, paying higher fees and using high-cost borrowing methods. In their study, the less knowledgeable also reported excessive debt loads and an inability to judge their debt positions. Mottola (2013) found that those with low financial literacy were more likely to engage in costly credit card behavior, and Utkus & Young (2011) concluded that the least literate were more likely to borrow against their 401(k) and pension accounts. Other studies have confirmed the positive association between financial knowledge and household financial decision-making. Stango & Zinman (2007) show that those who are unable to correctly calculate interest rates out of a stream of payments end up borrowing more and accumulating lower amounts of wealth. Lusardi & Tufano (2008) find that those who severely underestimate the power of interest compounding are more likely to experience difficulties repaying debt. Agarwal et al. (2007) show that financial mistakes are most prevalent among the young and the elderly—demographic groups that display the lowest levels of financial knowledge and cognitive ability. Hilgerth, Hogarth & Beverly (2003) also document a positive link between financial knowledge and financial behavior. Campbell (2006) further demonstrates that many investors failed to refinance their mortgages during a period of falling interest rates. This finding is consistent with lack of literacy, as those who failed to refinance were investors with disproportionately low education.

Those investors also seem less likely to know the terms of their mortgages, including the interest rates they pay (Bucks & Pence 2006; Moore 2003). Moore also shows that borrowers who took out high-cost mortgages display little financial literacy.

Discussion on Youth

Financial literacy is globally acknowledged as an essential life skill. Targeted financial education policy is considered to be an important element of economic and financial stability and development. G20 leaders also recognize that this requires lifelong learning that starts in childhood, as indicated by their call for core competencies on financial literacy for young people and adults (OECD & PISA, 2018). People form habits and behaviors starting at a young age, learning from their parents and others around them, indicating the importance of early interventions that help shape beneficial behaviors and attitudes. Early investments in children's education can provide the pedestal for a stronger economy and a better skilled labor force (Siriopoulos & Kassapi, 2019). Financial literacy has taken a place among the basic universal needs of today, possibly as life changing as basic literacy. Even though young people do handle the latest financial technology products very well in their everyday life in a promising way, fintech cannot in any way substitute for financial literacy (Lusardi, 2019).Younger generations are not only likely to face more complex financial products, services and markets but, they are more likely than their parents to have to bear more financial risks in adulthood. It is unlikely that young people may learn beneficial behaviors or gain sufficient knowledge or information from their friends and family unless they work in related fields. Efforts to improve financial knowledge in the workplace or in other settings can be severely limited by a lack of early exposure to financial education and by a lack of awareness of the benefits of continuing financial education (PISA, 2018). About one third of the global population is familiar with the basic concepts that underlie everyday financial decisions (Lusardi, 2019).

Effective Decision-Making

Financial literacy importance for planning is basically supported by the more financially knowledgeable who are much more likely to have planned for retirement. (OECD, 2019). Having a lot of money, does not prevent you from making bad decisions and lose it all if you don't know what to do with it. 70% of lottery winners end up bankrupt after a few years. Financially literate consumers are less likely to react to market conditions in unpredictable ways and protect their assets managing any risks transferred to them. Higher levels of financial literacy are also related to debt management, with the more financially literate individuals opting for less costly mortgages and avoiding high interest payments and additional fees (Lusardi & Mitchell, 2014).

Advanced financial literacy also matters for financial decision-making. Van Lusardi, (2009) use questions they designed for a module on financial literacy for the Dutch DNB Household Survey to show that financially sophisticated households are more likely to participate in the stock market. They address the argument that participation in the stock market or success in investing may also influence financial knowledge by relying on individuals' financial knowledge in the past and prior to investing in the stock market. Those who were literate when young are more likely to invest in stocks, showing an independent effect of literacy on stock market participation.

Unfortunately all this education is not taught in schools so one has to do it by one's self. Financial education though goes against conventional wisdom and might not be ok for most people.

Sayings like "*money doesn't grow on trees",* "money is the root of all evil" and other clichés keep people from getting financially educated. The negative connotation towards debt, which is not that bad if you know how to use it unless of course you don't have the appropriate education, is also very strong. One needs to develop a different mindset beyond the paycheck and a mindful approach towards money. As you make financial decisions every day, here are the 5 core competencies you should develop and use as building blocks regularly:
Earn money coming from many sources of income. **Spend** money wisely following the 50/20/30 rule prioritizing fixed expenses, savings and pleasure accordingly, operating under a budget. **Save** money starting early. **Invest** money with all the financial knowledge available and let compound interest lead the way. Risk diversification of the investment portfolio is key to profit making. **Borrow** money to make profit of it and make sure that borrowed money will be turned into assets. **Protect your** money with insurance coverage from frauds and scams and effective risk management plan.

Composing a questionnaire that can be used to make sure these concepts are comprehended by everyone like the "*Big Three*" that have been extensively used in questionnaires of many surveys would make a difference.

<table>
<tr><th colspan="5">Table 1
THE "BIG THREE" FINANCIAL LITERACY QUESTIONS.</th></tr>
<tr><td colspan="5">1) 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?</td></tr>
<tr><td>More than $102**</td><td>Exactly $102</td><td>Less than $102</td><td>Do not know</td><td>Refuse to answer</td></tr>
<tr><td colspan="5">2) Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account?</td></tr>
<tr><td>More than today</td><td>Exactly the same</td><td>Less than today**</td><td>Do not know</td><td>Refuse to answer</td></tr>
<tr><td colspan="5">3) Please tell me whether this statement is true or false. "Buying a single company's stock usually provides a safer return than a stock mutual fund."</td></tr>
<tr><td>True</td><td>False**</td><td>Do not know</td><td colspan="2">Refuse to answer</td></tr>
</table>

Source: Lusardi & Mitchell (2014). **Correct answers.

The first question measures the capacity to do a simple calculation related to compounding of interest rates. The second measures understanding of inflation, again in the context of a simple financial decision. The third question is a joint test of knowledge about 'stocks' and 'stock mutual funds' and of risk diversification, since the answer to this question depends on knowing what a stock is and that a mutual fund is composed of many stocks. Accordingly, it is important to understand knowledge of the stock market as well as differentiate between levels of financial knowledge and the behavior of investors and how they take risks. (Karyofyllas et al, 2017) (Lusardi, 2014).

Summary

Without being financially literate it is impossible to live and operate efficiently. As with reading and writing, the objective of any policy designed to promote financial literacy should be basic knowledge. While it may not be feasible to transform financially illiterate people into sophisticated investors, it may be possible to teach them a few principles. One should acquire the knowledge of complex mechanisms of money and capital and not rely solely on basic numeracy (Siriopoulos, 2020) the effect of asymmetry in the relationship of financial literacy and effective decision-making could be exploited by the more knowledgeable, either buyer or seller. (Tsagkanos & Siriopoulos, 2015). As the results from the econometric analysis for the country of Greece tell us, it appears like one should calibrate the channels knowledge transmission to the needs of the market and the trends for the future for a more integrated approach to being financially literate, which remains to be analyzed further in the future (Kassapi, 2016).

If people with low literacy make mistakes, who should pay for these mistakes? Themselves or society at large? If taxpayers will be called upon to support those who have made mistakes, a need for regulation and for implementing "*mandatory*" programs arises. One such program could be to require people to obtain some basic financial knowledge (CEDEFOP, 2009). A "financial license" could be required before individuals contribute to their pensions, invest their pension assets, or borrow to buy a house. In this way, individuals may learn about some basic financial concepts, reduce their reliance on random advice and avoid adverse selection on their own behalf.

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