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Financial literacy: The importance of a new field

Annamaria Lusardi Olivia S Mitchell / 8 Sep 2023

Global inflation has once again taken centre stage for households and policymakers, stressing peoples' finances, undermining their savings patterns, and threatening long-term financial security. This column examines how much financial literacy, including knowledge of inflation, drives people's financial decision-making. Simple measures which have been used around the world confirm strikingly low levels of financial literacy, with consequences for how people manage their personal finances. It is becoming increasingly important to focus on the new field of financial literacy, not only for research

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well people understand basic financial concepts (Lusardi and Mitchell 2011). Table 1 lists these questions along with answers, using the most recent data available from a national survey of consumer finances.

Table 1 The ‘Big Three’ financial literacy questions and answers

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?
- More than $102**
- Exactly $102
- Less than $102
- Do not know/Refuse to answer

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?
- More than today
- Exactly the same
- Less than today**
- Do not know/Refuse to answer

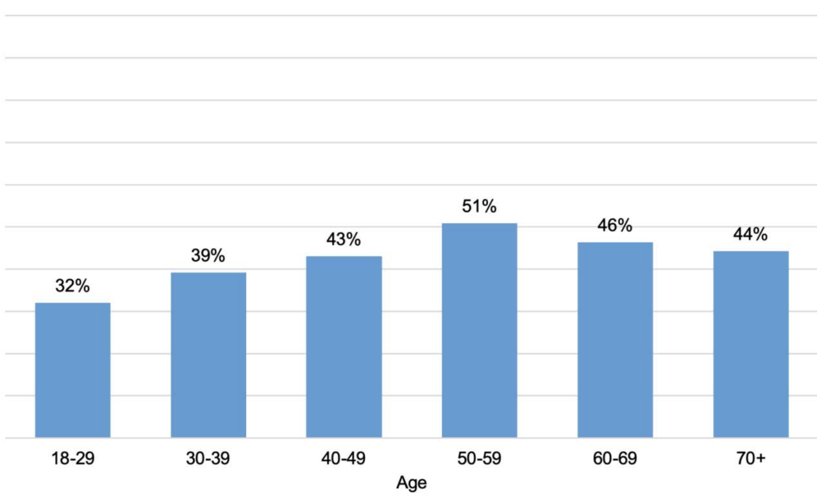
3) Please tell me whether this statement is true or false. "Buying a single company's stock usually provides a safer return than a stock mutual fund."
- True.
- False**
- Do not know/Refuse to answer

***Note*: Correct answers indicated with two asterisks.The Big Three questions, designed by Lusardi and Mitchell, have been used in numerous international comparisons of financial literacy**

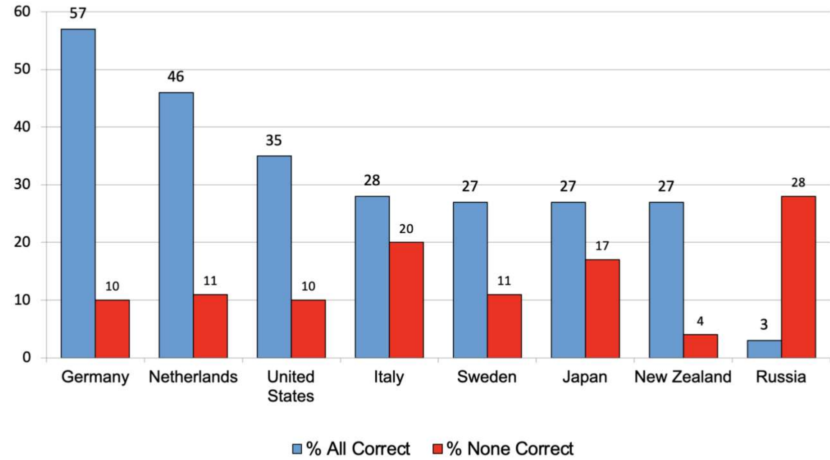
***Source*: The Big Three originated with Lusardi and Mitchell (2011a).**

Despite the fact that these questions were intended to assess knowledge of the ABCs of personal finance, fewer than half of the respondents queried in this nationally representative survey in the US got all three correct, even among older persons having already made numerous financial decisions over their lifetimes (Figure 1). Our Big Three includes a question about inflation, a timely economic concern of late, and we have found that a substantial fraction of the population – especially the young – does not understand how inflation erodes purchasing power.

Figure 1 Percent of respondents answering all Big Three questions correctly, by age



Source: Authors' calculation, US Survey of Consumer Finances ([illegible])



***Source*: Lusardi and Mitchell (2011)**

We have also extended our measure of financial literacy to incorporate other relevant financial concepts. These extended measures of financial literacy, including our Big Five measures, cover additional areas of financial decision-making, and they confirm most of our earlier findings using the Big Three (Lusardi and Mitchell 2023).

Financial literacy matters

This topic is important since the more financially literate engage in savvier financial behaviours than do their counterparts. For example, they are more likely to save for the short and the long term, invest in stocks, earn higher (risk-adjusted) investment returns, and can better manage their debt (Lusardi and Mitchell 2023). We have also shown that financial literacy, when seen as a form of human capital investment, can be incorporated into traditional economic models of saving under uncertainty. Its relevance cannot be overstated: financial literacy accounts for 30-40% of observed retirement wealth inequality (Lusardi et al. 2017).

Another way to assess the importance of knowledge is to look at the effects of financial education. A recent meta-analysis covering the most rigorous programmes (randomised controlled trials, or RCTs) in 33 countries across six continents yielded three major conclusions (Kaiser et al. 2022). First, financial education has important positive effects on both financial knowledge and behaviour. Second, its impact is three to five times larger than reported in prior studies. Third, financial education programmes are financial literacy have been adopted across the world, and they are proving to be good predictors of financial behaviour. The Big Three have been included in over 40 studies in Europe, Latin America, and Asia, and versions of these questions have been included in a global financial literacy survey (Klapper and Lusardi 2020). We have also shown that financial literacy can be incorporated into standard intertemporal models of consumer behaviour. Indeed, not doing so limits understanding of the determinants of wealth. Accordingly, incorporating financial literacy into standard economic models of consumption and saving is essential if researchers wish to incorporate a key explanation for observed large differences in wealth near retirement.

In addition, the critical role of financial literacy skills has now been recognised by colleges and universities. Motivated and guided by our research findings, we began offering personal finance courses at our own universities, starting in 2013. Just as aspiring chief financial officers (CFOs) regularly learn corporate finance in college and business schools, regular consumers also need rigorous training to manage their money, save, invest, and avoid running out of money in retirement.

Our research also provides insight into what such courses should teach. In the US, national standards for financial literacy have been established, outlining what should be covered in personal finance courses in school. We have extended those standards in our courses, drawing on both theory and empirical evidence on financial literacy.

Regarding policy, over 80 nations have established committees to design and implement national strategies for financial literacy. The European Commission in its capital markets union action plan has added financial literacy as a key objective for empowering citizens. More recently, the Commission has issued a report on financial literacy data collected in 2023 across the 27 EU nations, using questions similar to the Big Three.

Countries should add measures of financial literacy to their national statistics; research has shown it is linked to many indicators of financial well-being.

Additionally, the fact that so many people lack financial knowledge not only limits their ability to use their resources to the fullest but also contributes to macroeconomic problems and financial instability. For example, people who do not understand inflation may do a poor job of budgeting. Additionally

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