

FINANCIAL LITERACY BRIEFING 1: WHAT IS FINANCIAL LITERACY?

SUMMARY

Financial literacy has often been defined purely in terms of ‘personal financial education’. Concern is frequently expressed about the capability of individuals in managing their own finances and avoiding levels of debt which they are unable to repay. Given the number of people who get themselves into serious financial difficulties this is an important social objective. Schools have their part to play in equipping young people to avoid these problems. However, this approach to financial literacy appears to lay all the responsibility for financial problems on to individuals. In the light of successive financial scandals and the financial crisis of 2008 this is a difficult position to take. There is, therefore, an argument for extending financial literacy to include knowledge and understanding of bank and government behaviour as well as personal financial management. This brief introduces a framework for a broader definition of financial literacy.

BACKGROUND

Financial Literacy remains in the political spotlight in the UK, not least through the role of the All Party Parliamentary Group on Financial Education for Young People (<http://www.pfeg.org/policy-campaigning/pfeg-and-parliament>). The designation of PSHE in England has been changed to incorporate financial education in the ‘E’ for Economic element: (<http://www.education.gov.uk/schools/teachingandlearning/curriculum/b00223087/pshe>). The Welsh Assembly has more detailed guidance for financial literacy in Wales (<http://wales.gov.uk/topics/educationandskills/publications/guidance/financialeducation/?lang=en>). Education Scotland provides guidance for Scottish schools at: (<http://www.educationscotland.gov.uk/learningteachingandassessment/learningacrossthecurriculum/responsibilityofall/numeracy/financialeducation/index.asp>). Available assessments for financial literacy are on the increase. The next PISA assessment includes a section on financial literacy, but countries can choose whether or not to include this part of the assessment. The UK has chosen not to take part. The OECD’s page on PISA and financial literacy can be found at: (<http://www.oecd.org/finance/financial-education/oecdpisafinancialliteracyassessment.htm>).

A BROAD FRAMEWORK FOR FINANCIAL LITERACY

Table 1 sets out a broad framework for financial literacy which includes understanding of the behaviour of the financial sector and government. The three columns ‘individual’, ‘financial services’, and ‘government/country’ refer to different actors in financial interactions. Previous definitions of financial literacy have focused exclusively on individuals. These definitions of financial literacy restrict their scope to the problems faced by individuals (e.g. in managing personal debt and assets). One consequence of this limited focus is that it creates the impression that financial problems are always and only a personal responsibility. This perspective rules out any reference to the financial crisis since 2008, systemic contexts for personal finance or national financial policies. The framework in Table 1 takes a different standpoint. It assumes that financial literacy should address the context for action by governments and financial services which is created by the understanding, skills and attitudes of the median voter. It is based on the idea that the median voter’s misconceptions about the financial system (and in particular about the role of the government within that system) may create a dysfunctional

context for government action in a democratic society. The median voter who believes it is perfectly possible to increase government spending, reduce taxation and reduce national debt creates a difficult problem for a government seeking re-election.

Table 1 A framework for financial literacy

Sustainability and Ethics in Interaction and Outcomes	Individual	Financial Services	Government/Country
1 Short Term e.g. income, spending, Liquidity, Borrowing and Saving	A Budgeting weekly/monthly; maintaining liquidity; Variation in saving and borrowing constraints for people on low and high incomes	B The interest rate margin between lending and borrowing; Financial Services judgements on the liquidity problems of individuals and businesses; Bank liquidity problems, how they may arise and how they are resolved.	C The Government Budget; Government Debt and Interest payments; Relationships between Taxation, Spending and Debt; Multiplier effects; Welfare payments and poverty; Government lending to and borrowing from banks
2 Longer Term e.g. Wealth, Debt, Interest, Time preference, Inflation, Risk and uncertainty	A Real and nominal values; general and personal inflation; Income and Expenditure forecasts; Borrowing risks; information problems about providers	B Real and nominal interest rates; Security in Lending; Bad debts; Lending risks, asymmetric information; bank lending, investment n industry and economic growth	C Lending to the government: how safe is it; The current 'financial crisis'; Defaults and their effects between countries; Low inflation as a policy; Inflation and National Debt

The framework distinguishes between short-term financial decisions/ interactions and long-term financial decisions/ interactions. A distinction is made between issues associated with short-term balance between income and spending (e.g. additions to assets or debt and liquidity) and issues associated with long-term (e.g. time preference, risk and expectations about inflation and interest rates). In each of these two rows it is suggested that similar questions may be asked in the contexts of the individual, financial services and government. However, financial literacy

requires an understanding that differences between these contexts mean that the answers to these questions need to take account of profound differences between these contexts. The misconception that government finances operate in the same way as household finances is deeply problematic.

The horizontal blue arrows are included to convey the idea that financial problems and decisions can be viewed in two ways. They can be viewed as a problem facing a particular actor (e.g. an individual, a bank or a government) and framed in terms of the consequences for that actor of a decision they might take. This way of looking at financial problems and decisions takes for granted an existing set of regulations, norms and wealth distribution. Alternatively, financial problems and decisions can be viewed as arising from a system which sets a particular context for interactions between individuals, financial services and government. Debates about the level of financial regulation, welfare payments, private provision for pensions all belong within this second perspective. The framework suggests that education for financial literacy should include this perspective. The horizontal blue lines are included to express this proposal.

The grey vertical lines indicate relationships between short and long-term problems and decisions facing any particular actor. Financial Literacy may be judged according to understanding of short-term problems, understanding of longer-term problems or understanding of relationships between short and longer-term problems.

We are grateful to each of the schools and the teachers who have helped in our development work in financial literacy. Anyone interested in finding out more about this framework or other aspects of our work in financial literacy should contact Lily Ilic at the School of Education, University of Birmingham, UK, email Lilic@bham.ac.uk.