

# A Focused Approach to Financial Literacy

BY JOHN A. WEINBERG

An article in this issue of *Region Focus* begins with an observation on the difficulties many adults have in answering basic questions about key aspects of financial decisionmaking. Indeed, systematic research has revealed large gaps in knowledge about such things as compound interest. These findings suggest that many people would have difficulty assessing the trade-offs involved in even the simplest financial decisions. Even more so, then, people must struggle with the really big decisions we all face at some time in our lives — decisions about the acquisition and financing of education, or about homeownership, or about saving for retirement.

The demonstrably high level of financial inefficiency in many parts of the population also presents a challenge for economic analysis, since our understanding of the aggregate behavior of households is based on a model that assumes individuals are capable of making the decisions that lie at the heart of household finance. If grasping the essential trade-offs is difficult for many individuals, then can we trust a model based on an assumption of sophisticated decisionmaking to give a good representation of the data? Perhaps surprisingly, there is evidence that at the aggregate level, or looking broadly across the population of households, such models do reasonably well at describing consumption and savings decisions.

Does the fact that models of sophisticated consumers do well at capturing aggregate economic behavior imply that the problem of financial inefficiency is small, and that resources dedicated to financial education would not yield large improvements in peoples' well-being? I don't think so. It is certainly possible that errors in decisionmaking, relative to a standard model of household choice, are not systematic enough to show up in aggregate behavior but that such errors still have large consequences for individuals. This is especially true of the large decisions that households must make — decisions that can have lasting consequences.

These most consequential decisions tend to be associated with major phases of an individual's life cycle. Early on, people must make choices about education — choices that may imply delaying labor market participation and, thus, delaying earning income — in order to accumulate further human capital after secondary school. This can have a large impact on both an individual's lifetime earnings ability and financial position in early adulthood, as the delay in earnings and the cost of education may need to be funded by debt.

Another early decision may be whether to purchase a

home. This may not alter the actual housing services enjoyed so much, but it does have significant implications for the household's balance sheet and to what risks it is exposed.

Finally, as a household enters its peak earning years, plans for retirement become important. Savings and the accumulation of wealth through financial or real estate assets become key financial tools for such planning.

These decisions not only involve basic trade-offs between consumption now and consumption in the future, but they all bring with them a choice among financing strategies or instruments — how much debt to incur, what kind of loan to take on, what kind of savings instruments to use. And they

are decisions that can have lasting effects on well-being, as well as having important implications to how exposed a household is to economic shocks. Ill-informed decisionmakers are not only prone to make mistakes, but they also become more vulnerable to abusive financial practices.

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I think it's also important to note here that, while what may appear to be ill-informed financial decisions indeed often are, that is not always the case. Individual circumstances that cannot be observed by outsiders may lead households to make decisions that, in fact, are rational. If one's future income stream is highly variable or unstable — for instance, if a person is self-employed in the first case or faces a potential layoff in the second — then it very well may make sense for that person to act differently than what we would normally perceive as optimal. That person may wish to save less now for long-term purposes such as retirement — especially, perhaps, in tax-preferred vehicles that can carry significant penalties for early withdrawal — in order to remain relatively liquid and better weather those more immediate financial shocks.

That said, I do not wish to downplay the importance of financial education. It seems likely that such efforts, targeted at people who are close to critical decision points in their lives, could have substantial implications for individuals' well-being, even if the overall effects on the macroeconomy are not large. Indeed, effective financial education could be the single best strategy for consumer financial protection. While there may be a role for regulatory oversight and legal recourse, such as in the case of fraud, giving consumers the tools to better understand the financial choices before them should also help make unfair and misleading practices less profitable. **RF**

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