THE IMPORTANCE OF FINANCIAL LITERACY

Address by Mr Keith Hall, Assistant Governor (Banking and Payments), to the Conference on Deepening Financial Capacity in the Pacific Region, Sydney, 25 August 2008.

Let me first of all take this opportunity to welcome you to Sydney and to the Reserve Bank's Training Centre here at Kirribilli – a centre named after the RBA's first Governor, HC (Nugget) Coombs, who was both a passionate believer in the importance of financial education and a good friend of Australia's Pacific neighbours. So it's fitting that we should be here today. Let me also take the opportunity to thank the multilateral agencies – the ADB, IFC, IMF, UNDP and the World Bank – for combining to organise this Conference; it bodes well for its success that we have their combined weight behind us. And finally, let me single out for particular thanks, Susan Adams, Director of the Pacific Financial Technical Assistance Centre, who I know has been a driving force behind this gathering.

Over the next two days, the Conference will be exploring various ways of deepening financial capacity in the Pacific region – by which we mean ways of developing the financial infrastructure so that individuals and communities have better access to a suitably wide range of financial services. These are services that extend well beyond the provision of credit, to the availability of well-tailored savings and investment products, to insurance, both life and general, and of particular importance to many countries in this region, access to appropriately priced money transfer services or remittances. In my remarks this morning I want to emphasise one particular point, which is that efforts to deepen financial capacity will have a far better chance of succeeding if they go hand-in-hand with efforts to raise financial literacy. We need to be sure, in other words, that we are providing individuals and communities with the level of financial education needed to grasp both the benefits and pitfalls of their easier access to financial services. Delia Rickard of the Australian Securities and Investment Commission, who is our next speaker, will expand on the recent initiatives here in Australia to lift financial literacy. For my part, I want to set the scene by making a number of generalised observations about financial literacy and why financial education is so important. In doing so, I am very conscious that these observations will be drawn from a financial system that in some cases will be very different to your own, but hopefully they are still worth sharing.

What Do We Mean by Financial Literacy?

When we talk about financial literacy we are usually referring to a set of skills that allow people to manage their money wisely. As a minimum, these skills include the attainment of basic numeracy so that rates of return on savings and borrowings can be readily calculated and compared. They also extend to some understanding of essential financial concepts, not least an appreciation of the trade-off between risk and return. And not to be overlooked is the capacity to understand when the time may have come to seek professional financial advice and where you need to go to find it. Broader concepts of financial literacy also assume that people will make better judgments about their financial affairs if they understand the relationship between their own finances and the wider economy. I want to touch very briefly on this broader definition later on.

Why Financial Literacy Matters

Financial literacy matters at many levels. From a social welfare perspective, it obviously matters greatly whether or not people are able to manage their financial affairs wisely and live within their means. But the benefits of financial literacy extend well beyond stronger household balance sheets to the promotion of a more resilient financial system and, ultimately, to the more efficient allocation of resources within the real economy.

The Importance of Financial Literacy for Individuals and Families

For individuals and families, the *benefits* of financial literacy – which using shorthand we can describe as 'being good with money' – are well understood. The financially astute recognise the wisdom of sound financial planning from an early age and, by doing so, improve their chances of achieving their financial goals. These goals commonly include the purchase of a family home – usually by combining savings and a sensible amount of mortgage debt – putting enough money to one side for the education of children and, importantly, making suitable provision for old age. If you wanted to single out the one characteristic that signifies a financially astute person – in Australia, at least – I suspect that it would be their awareness of the need to save for retirement from an early age. This is not immediately obvious to those who are new to the workforce, who face many competing and what seem to be more appealing uses for their money. As a result, saving for retirement is routinely postponed until late, sometimes too late, in the life cycle – an observation that in Australia led to the phasing-in of a compulsory superannuation system from the early 1990s onwards. Nonetheless, even with this compulsion, it remains the case that the financially educated are quick to appreciate the importance of making additional personal contributions to their superannuation – at least if they want to live comfortably in retirement.

The *costs* of financial illiteracy – of 'being bad with money' – are equally apparent. Those who go through life making poor financial decisions will inevitably end up with a far lower standard of living than was otherwise achievable. Unfortunately, the opportunities for making poor financial decisions come thick and fast through life. Many of these – particularly for the young – are associated with easy access to credit and the 'buy now, pay later' marketing of many retailers. For some people, this fuels poor spending habits – indiscriminate and compulsive spending behaviour – which leads on, in turn, to spiralling debt problems. And as we all know – hopefully only anecdotally – it's no easy matter to get out from underneath a heavy debt burden. But even those individuals and families who budget carefully and spend wisely can still fall into costly financial traps. It is often astonishing to learn just how easily otherwise sensible people can be parted from their hard-earned money. This usually occurs in one of two main ways. Some people fall prey to straight-out financial 'scams' or frauds – offers that 'seem too good to be true' and are. Others – especially in a low-inflation, low-interest rate environment – are tempted to go off in search of investments offering far higher returns without fully understanding that these higher returns are likely to go hand-in-hand with much more risk. We have all too many examples in Australia of personal investors, often retired couples, losing their life savings by investing in property-related ventures where the returns were high but so was the underlying risk, which was, admittedly, often quite well camouflaged.

While financial literacy has always been important, the need for financial education has assumed greater urgency in many countries as an ever wider range of financial products and financial services have been marketed to consumers. There was a time in Australia, for example, when a new customer had to do little more than choose between a couple of basic bank products – a cheque account and a passbook account, both easy to open and easy to maintain. When the customer had established a suitably long savings record – and not a moment before then – the same bank might deign to offer a housing loan of a fixed term and at a standard variable interest rate. Those days are long since gone. Now there are a bewildering number of banking products for a customer to select from: on the deposit side, there are accounts with fees that pay interest; those with no fees and no interest; those with no fees but with limits on the number of transactions per month – and so on. On the loan side, borrowers can now shop around, courtesy of a broker, to find not only the cheapest mortgage but one that provides them with maximum flexibility in terms of use, drawdown and repayment. And credit cards these days come in a dazzling array of permutations.

While all of these developments are to be welcomed from a consumer choice perspective, there is no doubt that they are simultaneously increasing the complexity of decision-making around even the most basic of financial products. Financial literacy is very much about empowering individuals so that they can master this complexity and take full advantage of the benefits that flow from financial innovation and new financial products.

Equally important, especially for countries with remote and isolated communities, is the revolution in the way that financial services are now being, or will soon be, delivered. In countries such as Fiji, the Solomon Islands and Tonga, mobile banking units have made an appearance. While in others, like Australia and New Zealand, you need not visit your bank at all. Your bank comes to you, so to speak, via the internet or through your mobile phone. These electronic services are increasingly available to customers across the Pacific region. While they open up enormous potential in terms of access to financial services, they do require that customers are properly schooled in their use and understand their limitations.

The increase in the number of people accessing a greater range of financial services also imposes important obligations on financial institutions. The sheer variety and greater complexity of financial products make it imperative that fees and charges are sufficiently transparent so that consumers can make informed decisions. I know that a number of countries represented at this Conference have gone some way towards ensuring improvements in this area. Tomorrow, Governor Mafi from the National Reserve Bank of Tonga will provide an account of efforts towards ensuring greater disclosure by financial institutions in her country. And the decision of the Australian and New Zealand aid agencies to fund the development of a remittance-comparison website for the South Pacific region is a very welcome initiative from a transparency perspective.

I doubt it will surprise you to hear that the lowest levels of financial literacy – and, hence, the greatest need for financial education – are generally to be found among the most vulnerable members of our society. A study funded by the Commonwealth Bank in Australia in 2004[1] showed that there was a definite lack of financial skills and knowledge among people with certain demographic characteristics. The results of the survey showed that 10 per cent with the lowest financial literacy tended to be younger people, males, students, people with lower levels of education, the unemployed and those on lower incomes. Older people also displayed lower financial literacy skills, suggesting that literacy is not just a function of age or experience. Lower financial literacy was also found to have an impact on an individual's general health and to be significantly related to problems in paying off mobile phone, credit card and utility bills.

The good news is that the same study suggested that increasing the level of financial literacy among the 10 per cent of Australians who are least financially literate would raise their incomes and help reduce the number of unpaid bills. The study estimated that over a period of 10 years these benefits would add $6 billion a year to GDP and create over 16 000 new jobs. In other words, money spent on financial education would be money very well spent.

The Importance of Financial Literacy to the Financial System

If we accept that financial literacy has a role to play in promoting stable household balance sheets – and small business balance sheets for that matter – then it isn't too much of a stretch to see the benefits that can flow through from better financial education to the stability and efficiency of the financial system.

The existence of a stable financial system has much to do with the prudent management of risk by financial institutions, particularly credit risk – which is the risk of financial loss arising from the default of customers and counterparties. Of course, credit loss can never be eliminated completely, but good systems and controls can certainly help contain it. Nonetheless, history tells us that financial institutions are quite myopic in their lending behaviour – they will tend to be quite liberal with credit when the economic times are good, only to repent of their generosity and tighten lending standards when times turn bad. This 'procyclicality' in lending behaviour can spell danger for over-leveraged borrowers and, by extension, for the financial institutions themselves, especially if the economic downturn is sharp or prolonged. In a financially educated society, however, borrowers will be less likely to take on more debt just because credit is cheap and freely available. As a result, they will have a far better chance of riding out an economic downturn without defaulting on their debt repayments – which, in turn, will help minimise the bad debt experience of financial institutions and, by doing so, help bolster the stability of the financial system.

The importance of households being able to manage their debt bears repeating. One of the objectives of financial deregulation and financial sector reform is to ensure that businesses and households have easier access to credit; and in many countries households, in particular, have been very quick to take advantage of this. As a result, financial deepening often goes hand-in-hand with a sharp rise in household indebtedness. In Australia, for example, household debt,

1 *Commonwealth Bank Foundation (2004), 'Improving Financial Literacy in Australia: Benefits for the Individual and the Nation'. Available at <http://www.commbank.com.au/about-us/download-printed-forms/FinancialLiteracy_KeyFindingst2004.pdf>.*

mainly in the form of mortgage debt, has risen from below 100 per cent of disposable income at the beginning of the decade to well above 150 per cent. This has raised some questions about the ability of households to service their higher levels of debt in a harsher economic environment. But so far, even though mortgage interest rates have risen by around 150 basis points over the past year, there has been only a slight increase in household default rates. This suggests that most households have been borrowing quite prudently – which, in turn, would seem to vindicate the efforts being made by the Australian Government and, importantly, the banks themselves to improve the standards of financial education in Australia.

There is also a view that financial literacy can bolster financial stability by enhancing market discipline within the financial system. By market discipline, we mean the process by which customers can collectively influence the behaviour of financial institutions for the better, so that they are more likely to operate in a safe, sound and efficient manner. Certainly, if there is enough transparency in the financial system so that customers are both knowledgeable and well-informed, it does seem reasonable to predicate that they will direct their business away from riskier, poorly run financial institutions to those that are better managed. Our colleagues in New Zealand place particular emphasis on the role of disclosure and market discipline in safeguarding financial stability. But it also forms an important part of the New Basel Capital Framework – to which many countries subscribe – which recognises that market discipline has the potential to reinforce capital regulation and other supervisory efforts designed to promote the safety and soundness of banking systems.

The Importance of Financial Literacy to the Economy

What is good for individual households is often good for the economy as a whole. As I noted earlier, financial literacy is very much about encouraging individuals and families to use their money wisely – both their own hard-earned income and that borrowed from financial intermediaries. But encouraging households to save, for example, is not just good for them, it is also very much in the longer-term national interest. Economic development is very much about the successful channelling of domestic savings into productive investment opportunities.

Similarly, promoting the sensible and prudent use of credit is both good for individual households and for the wider economy. Used wisely, access to credit can provide households with a number of important economic benefits. In particular, it allows them to purchase goods and services, notably a home, much earlier than they could by relying on just their own income. This will help boost economic activity. But there are many other benefits: auto finance, by helping households buy a car, assists the mobility of labour within the economy; and student loans to fund further study can make an important contribution to raising a country's intellectual capital. For anyone wanting to start up a small business – and a thriving small business sector is often the key to a vibrant, expanding economy – access to credit is vital.

Finally, it's worth noting that any market economy will function much more effectively if the population is knowledgeable, forward-looking and financially literate. An efficient economy is one in which participants maximise their risk-adjusted returns so that resources flow to their most productive use relative to risk, leading to higher longer-term growth rates. When participants misjudge the risk-return trade-off, the consequences for the economy can be quite damaging.

We have a very good example of this just now in the United States in the form of the sub-prime mortgage crisis. It is quite clear that many of the users of US sub-prime mortgages – loans made to borrowers unable to qualify for a traditional mortgage – never fully understood the risks of borrowing this way. It is equally apparent that the investors who ultimately funded this lending by buying securities backed by this sub-prime debt also failed to recognise the underlying risks. As you all know, the fall-out from these misjudgments has been very costly for the US economy and for the global financial system. As a result, one of the questions now being asked in the wash-up is whether a better level of financial education might have helped borrowers and investors to avoid the pitfalls of embracing new financial products so wholeheartedly.

These problems may seem very distant from the ones you currently face in your own financial systems, but I hope you can identify with the underlying theme here – that financial education can help safeguard against some of the risks that inevitably attach to financial innovation.

Financial Literacy and Monetary Policy

Having spent most of my time extolling the virtues of financial literacy, it may surprise you that I want to finish off by noting the limitations around financial education: that no matter how good our financial education programs, they will never do away with financial hardship within our communities. Unfortunately, in every society there will always be some individuals and families who fall on hard times, often through no fault of their own: jobs will be lost, serious illness may strike and, in some cases, families may find themselves the innocent casualties of a breakdown in law and order. Nevertheless, while some level of financial hardship may be inevitable, public policy can certainly do much to contain it. In a well-managed economy there will be fewer job losses; a decent medical system can do much to promote public health; and an effective policing and judicial system will promote law and order.

Of course, central bankers like to believe that they too are playing an important role in minimising financial hardship. And I doubt it is much of an exaggeration to say that sound monetary policy and the maintenance of low inflation is one of the foundations of a prosperous society – one in which everyone has a decent shot at achieving a good standard of living. This takes me back to that broader definition of financial literacy that I mentioned earlier – one in which financial literacy includes an understanding of the intersection between household balance sheets and the broader economy. Central banks would like to think that this extends to an understanding of why inflation matters and why central banks sometimes need to take the unpopular decision of raising policy rates. As the Reserve Bank tightened monetary policy in Australia over the last year or so, we sometimes felt we were struggling to effectively communicate our actions to the wider general public, not least because we lacked support from some sections of the popular press. Internally, this has prompted us to consider whether there are ways in which we could improve our contribution to financial education. In late 2007, the Bank decided to release a short statement following each monthly Board meeting whether or not the cash rate was changed. The minutes of these meetings are also now made public, with a delay. This increase in information is complemented by a website that seeks to explain our policy role and a number of community programs, including the sponsorship of a university economics competition and the hosting of numerous school visits to our museum. But there is clearly much more we could do and we are giving some thought to how we might better get our message across.

Conclusion

Financial literacy matters on many levels. It helps people manage their financial affairs and improve their standard of living. But it also makes an important contribution to the soundness and efficiency of the financial system and to the performance of the economy.

So the point that I want to leave you with today is that, as you contemplate ways of improving financial capacity in the Pacific region, don't overlook the importance of financial literacy and financial education. Like the proverbial 'horse and carriage', efforts to improve financial capacity and to raise financial literacy best go together; it makes for an easier and more successful journey. This Conference is an important step in that journey.