Financial Literacy: A Catalyst to Financial Inclusion

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Abstract

Financial activities have attained greater importance as it is a medium that ensures development and prosperity. As far as the developing world is concerned, financial inclusion is the need of the hour as it retains the potential for the economic uplifting of the people. Having access to a bank account and the capacity to use it are the key to this. However, due to the lack of awareness people are reluctant or ignorant in making use of the opportunities available to them. Financial Literacy, as a means to empower people to have greater access to financial services, is vital in making financial inclusion a reality. Although not an absolute state, financial literacy can be a crucial element in making people aware of the possibilities and risks associated with financial management decisions. This paper assesses the present situation in the developing world and the importance of financial literacy as a catalyst for financial inclusion.

Keywords: Financial literacy, Financial inclusion, Financial awareness, Indicators of financial literacy, and Measuring financial literacy

Introduction

Finance and the activities associated with it have attained greater importance ever since it has been recognized as a vital element for development and growth (Jain, 2015). This can be achieved only by making finance and the services associated with it available to all who need it. Having access to banking services is vital in making people beneficiaries of the development that takes place across the world. Financial Inclusion, which generally denotes as the access to basic financial services by everyone with affordability and convenience, do involve benefits to all who need it. It is also an important policy instrument that can accelerate sustainable development goals (Klapper et al., 2016). Financial Literacy, as a means to empower people to have greater access to financial services, can potentially be of great importance in making financial inclusion a reality. However, it is a matter of serious concern that in spite of the manifold attempts to make the financial market accessible to the world population, it still lacks access to finance and its services contrary to what is envisaged. According to Findex data 2014, about 2 billion adults remain unbanked and the number fell to 1.7 billion by 2017, still making it approximately 40 % of the world's adult population (Demirgüç-Kunt et al., 2017).

Credible financial inclusion can be associated with the financial depth, proximity to access centers, low cost of access, and sound legal system(Allen et al., 2016). However, it seems workable that a functioning financial system not only needs physical infrastructure but also informed customers which means customers with reasonable financial literacy. They can make better financial decisions and ultimately support for an effective financial system that demands financial inclusion (Grohmann et al., 2018).

Financial Inclusion

Financial Inclusion, in broad terms, refers to the delivery of financial services, including banking services and credit, at an affordable cost to the vast sections of disadvantaged and low-income groups who tend to be excluded from the financial activities (Chhabra, 2015). It takes into account the involvement of people who are hitherto out of the purview of mainstream financial services based on their access to various financial services (Sing, et al., 2014). Access involves convenient and responsible service delivery, which is both affordable to the customer and sustainable for the provider with the result that financially excluded customers use formal financial services rather than existing informal options (Jong-Hee, 2016). Reserve Bank of India defines Financial Inclusion as "the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low-income groups at an affordable cost" (Rangarajan, 2008). In general, financial inclusion is the pursuit of making financial services accessible to all individuals and businesses at affordable costs, irrespective of net worth and size.

The assessment of the level of financial inclusion is mainly on the basis of three criteria such as Banking Penetration, Service Availability and Usage of Services (Martinez & Garcia, 2018). However, a more accurate picture of financial inclusion can be assessed not from the number of account holders but of the regular usage of it. According to the Findex database, globally, 13 percent of adults, or 20 percent of account owners, are considered to have inactive accounts, with no deposit or withdrawal — in digital form or otherwise — in the past 12 months. Considering a developing nation like India, its flagship financial inclusion program, *Pradhan Mantri Jan Dhan Yojana (PMJDY)*, has been able to make universal access to a bank account a near reality, but the level of usage of accounts remains quite low. Almost 48 percent of the accounts are inactive which is highest in the world and about twice the average of developing economies (Demirgüç-Kunt et al., 2017).

As per a global survey by Standard & Poor's Financial Services LLC (S&P) (Klapper et al., 2015) the level of adult financial literacy among South Asian Countries is below 25%. As far as India is concerned, although it home around 17.5% of the world's population, the word 'financial literacy' is yet to become a priority as it staggers below 24% in the level of financial literacy. It means 76% of its people have no basic financial education. For making successful use of financial services, people need to be literate enough to understand the basics of money management. This skill is known as financial literacy.

Financial Literacy

In simple terms, financial literacy refers to a set of skills that allow people to manage their money wisely along with some understanding of essential financial concepts. It is the ability to understand basic financial concepts and the accumulation of knowledge, skills, and experience necessary to make informed decisions basing on proper planning taking stock of the available resources. In other words, it's about understanding how to acquire or generate, spend, invest or save our resources by making the optimum use of it in order to maximize benefit and enhance wealth. Also, it helps to facilitate increased decision-making skills (Jang et al., 2014)

The working definition of OECD on financial literacy considers it as "a combination of awareness, knowledge, skill, attitude, and behavior necessary to make sound financial decisions and ultimately achieve individual financial well-being" (OECD, 2013). The definition used in the Programme for International Student Assessment (PISA) speaks about financial literacy as motivation and confidence for wise behavior in managing personal finance (OECD, 2013). Adult Financial Literacy in Australia survey broadly defines financial literacy as the ability to make informed judgments and to take effective decisions regarding the use and management of money (ANZ, 2011).

Attaining financial literacy gathers vital importance as financial transactions and various other services become increasingly complex and banks and financial institutions compete with each other in bringing out financial products that suit the needs of the prospective investors. Ignorance on the above could lead one into a deep financial crisis as they might end up subscribing to unsuitable products or service providers. As some analysts opine that financial ignorance carries significant costs and those clients who do not comprehend the concept of interest compounding are likely to spend more on transaction fees, run up bigger debts, and incur higher interest rates on loans (Lusardi & Carlo de Bassa, 2013; Lusardi & Tufano, 2015). It is also argued that people with financial literacy can do better in job planning as well as savings for retirement (Lusardi & Mitchell, 2014; Behrman et al., 2012). Besides financially informed investors are more likely to diversify risk by allocating funds across various ventures (Abreu & Victor, 2010). In view of the deficiency of proper awareness, people subscribe to various financial products or services without adequate planning and give up midway because they don't have the ability to carry it forward. Aggressive pushing of products by various financial institutions may leave the financially illiterate in a vacuum and lead them into confusion.

Indicators of Financial Literacy

In order to effectively measure financial literacy, we need to have not only financial literacy index but also indicators that can be used to compare what consumers need to know to effectively do the management of their financial resources. Generally, four aspects are monitored (Mihalcova et al., 2014; SRC, 2008)

i. Management of finances – measuring the ability to create a family budget and monitor income and expenses
ii. Planning of financial income and expenses – incorporation of future contingencies in the budget
iii. Choice of suitable banking products – the ability to analyze and choose the most appropriate products and services from the financial markets
iv. Information on suppliers of services – having fair knowledge of the service providers and the way to approach them.

Level of Financial Literacy worldwide

According to the S&P Finlit survey (Klapper et al., 2015), although about 65 percent or more adult population is financially literate in economically advanced countries, only 33% of the world population can be considered literate among which women and young are more vulnerable and are in need of special focus. A survey by (Atkinson & Messy, 2012; L. Xu & B. Zia, 2012) finds that developing economies have the lowest general level of financial literacy as it is to the general literacy level. World over ethnic, racial, regional, personal, demographical characteristics can influence the level of financial literacy as it is shown in different researches (Annamaria & Olivia S., 2011; SRC, ANZ, 2015; Natoli, 2016).

Characteristics of Financial Literacy

From the inferences made by various researches in this area (SRC, 2008; SRC,2011; SRC,2015; OECD, 2013; Kiliyanni & Sivaraman, 2016) it can be seen that financial knowledge is interconnected with gender, age, country of birth, marital status, employment, education, income, etc.

Gender: According to a few researchers (Goldsmith & Goldsmith, 1997; Heaney et al., 1997; Chen & Volpe, 2002) women are less knowledgable with regard to financial understanding which significantly affects their ability to achieve financial security.

Age: The ability to take financial decisions declines as one advances in age from adulthood. (Finke et al., 2017). It is also found that the quality of decision on financial matters reduces considerably after 65 years of age (Choi et al., 2014).

Domicile: It has also been highlighted by various studies that the financial conditions of the country of birth have a significant impact on making one financially included or not (Atkinson & Messy, 2013).

Education Level: Education is an important factor in acquiring knowledge. (Lusardi & Mitchell, 2014) points out that a relatively low level of education results in a low level of financial literacy. However (Kiliyanni & Sivaraman, 2016) argue that a high level of literacy does not necessarily mean a high level of financial literacy. Functional literacy is the keyword here which is the ability to use printed and written material to fulfill one's different needs at home, to function in society, to achieve one's personal and professional goals, etc. (Mihalcova et al., 2014).

Marital Status: There are researches that establish a connection between marital status and financial literacy as married people are relatively more financially literate than single people. This finding has been confirmed by several researchers (Taft et al., 2013; SRC, 2015; Volpe et al., 2002).

Employment: Individuals in professional employment or in the organized sector are more financially literate compared to that of manual or menial workers (SRC, 2015). Studies also show that low-level employment often corresponds to low-level financial literacy (Lusardi & Mitchell, 2014).

Income: Several studies have identified a close association between low-level financial literacy and low-level income (SRC, 2015; Roy Morgan, 2005; Marcolin & Abraham, 2006; Astuti & Trinugroho, 2016).

Types of Financial Literacy

In its broad sense financial literacy can be termed as the ability of a population to rationally manage the finance of the households being aware of the circumstances of the financial market and its offering and also the legal legislation connected to financial transactions (Ivanova et al., 2017). Theoretically speaking financial literacy can be classified as Congenital, Acquired and Rejected (Vovchenko et al., 2018). Congenital literacy is the ability one acquires naturally to manage his/her financial resources from the experience of parents or close people. Acquired financial literacy is the ability and methods one obtains from the surroundings such as school, university, work, etc., to manage one's personal finances. Rejected Financial literacy is the rejection of knowledge as a result of psychological immaturity which results in some sort of unwillingness to enter into independent decision making. Methodologically speaking financial literacy can be categorized into two, viz., literacy as the possession of a basic tool in the area of financial relations and literacy as skills and competence to execute such relations (Vovchenko et al., 2018).

Measurement of Financial Literacy

Even though it is important to know the level of financial literacy of people, it is a difficult task to find out how much do they know about it. Any measurement of financial literacy has to have the potential to understand the basic conceptual knowledge of the people, general knowledge about the day to day financial decisions in a general manner, and it should not overburden people with a load of questions and queries.

There are mainly three types of queries that can assess the basic financial knowledge of the people. They are (Lusardi & Mitchell, 2014; Banks & Oldfield, 2007; Lusardi & Mitchell, 2007)

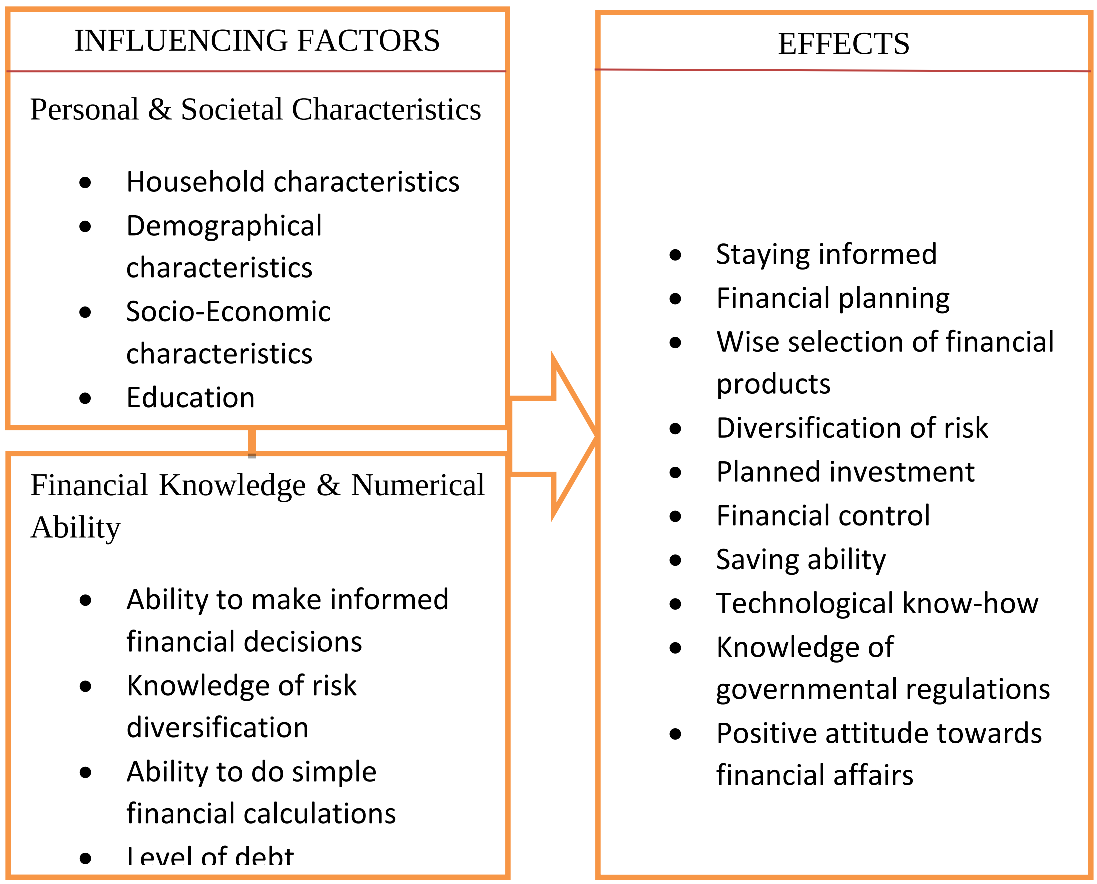
i) Understanding of interest compounding which measures numeracy or the know-how to do simple calculations
ii) Understanding of inflation which is based on the ability to do simple financial decisions
iii) Understanding of risk diversification which covers the knowledge of risk diversification by means of investing in stocks or mutual fund or any other

Need for Financial Literacy

As for a developing economy is concerned where there is an urgent need to improve financial literacy so as to accelerate the pace of financial inclusion, the following points are considered to be crucial (Sane, 2014):

i. *Increased life expectancy, Transfer of risk*: People do spend more time in their retirement as life expectancy is increased which makes financial planning imperative. Transfer of risk from government or employers to individuals, the introduction of new financial products that help one to plan for future such as insurance products, etc. make financial literacy a must-have capability.
ii. *The growing availability of financial service providers*: Consumers, at present, have a multitude of choices in their need for a particular service which also increases the possibility of getting trapped into fraudulent practices or people. Financial literacy insures the customers from all these to a great extent.
iii. *Technological advancement and innovation in the financial sector*: Innovation catapulted by the advancement of technology requires consumers to stay updated with the developments. With the introduction of various innovative financial services offered by almost all banks make financial literacy a need of the hour.
iv. *The entry of new financial firms and the introduction of multifaceted financial products*: Ever since the government initiated the privatization program along the line of globalization where entrepreneurs got access to the world market, there started the entry of a multitude of firms in the market. The financial sector too was no different and as a result, a flood of new and innovative financial products and services were made available to consumers. An avalanche of products, service or information - actual or fraudulent - deemed it necessary for people to have financial literacy in order to help them to make the right financial decisions.

Furthermore, financial literacy enables us to understand the value of money, it saves us from acquiring too much debt, helps to plan for emergency, guides into profitable investment and wealth creation, aids in boosting the economy of the country and finally it helps to impart knowledge to the younger generation and gives the privilege to help the less fortunate and marginalized (Ahrcelle, 2019).



A Framework of Financial Literacy

Source: Compiled by the author

Challenges in Implementing Financial Literacy

Many of our citizens find themselves in poor financial condition, with substantial debts and limited or no savings. One possible explanation for this could be a lack of knowledge of financial management. Practically, real-world skills set around personal finances were not necessarily emphasized in the academic curriculum in previous generations, but in recent years, financial literacy has moved to the forefront of discussions with hopes of addressing the gap in the current curriculum. Clearly, it is not just about counting coins and decimal places but we're at a point where not the creation of wealth but the management of it gain the focus. However, the road to the successful implementation of a financial literacy plan is not without jumps and jerks. Here are a few challenges (Vovchenko et al., 2018):

i. Inadequacy of the educational system to deal with financial literacy program: often the school curriculum offers only a fragmented nature of teaching the basics;
ii. Lack of clear and accessible training programs and educational materials for people
iii. Shortage of qualified specialists in imparting knowledge about financial literacy
iv. Lack of sufficient legislative support
v. Low awareness of the protection of consumers and pension rights of citizens
vi. Inadequate level of resources to support necessary programs and activities

Arguments Against Financial Literacy

There are also certain differing voices on financial literacy. According to a research by (Betti et al., 2007) that it is not necessarily the poor that are more indebted but, where there is wider access to credit, the younger, high-income consumers tend to be the most over-indebted which shows that access to credit and not the lack of financial knowledge is the cause of over-indebtedness. It is echoed by (Alsemgeest, 2015) when he says where the access to credit markets is less the possibility of over-indebtedness is also less.

Conclusion

Financial inclusion programs definitely can play a significant role in the economic development of the people and the nation at large. It empowers the citizens to decrease inequalities of information asymmetries between customers and financial intermediaries. Although not an absolute state, Financial literacy can play a vital role in making people aware of the possibilities and risks associated with financial management decisions. It is a continuum of capabilities subjected to demographical characteristics such as age, culture, family, education, domicile, etc. and also an evolving state of competency by which each individual responds to an ever-changing economic scenario (Mihalcova et al., 2014). The result of various researches conducted across the world, almost unanimously echo the mounting importance of financial education, no matter whether it's a developed nation or a developing one. As the governments across the globe are investing and willing to invest more in the area of financial education, the onus falls on each individual to get motivated to be trained so as to be a financially literate person and eventually a financially included individual.

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