A Study of Diverse Conceptual Meanings of Financial Literacy: Literature Review

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Abstract

The research paper is an attempt to explain meaning of newly coined concept namely Financial Literacy. Various researchers, scholars and policy makers use this term 'Financial Literacy' to somewhat describe one's level of financial knowledge and skills to manage personal finances. Thus, it is observed that financial literacy has different conceptual meaning and diverse operational definitions. The current study tries to examine various definitions and measures of financial literacy. A clearer definition would help develop an accurate measure of financial literacy.

Introduction

Financial education and skills are required to manage personal finances. It has been observed that more people are growing financially independent. Also, financial markets are flooded with complex financial services and products. This has made it imperative for an individual to possess financial literacy. Various research has defined and measured financial literacy. Some measure financial literacy with basic few concepts like time value of money, compounding and inflation. While others take more comprehensive measure including diversification, equity, bonds etc. Thus, there is a need for much clearer definition of financial literacy.

Research Methodology

This is precisely a descriptive paper. It reviews various previous empirical research on Financial Literacy and tries to conceptualize it.

Literature Review

(Jelley 1958) The definition of financial literacy has been more complex and complicated with the dynamic changes in the economy of countries. By most of studies it was found that the definition of financial literacy includes the management of money. Some measure financial literacy at individual level and some as a whole aggregation by groups to form a macro point of view. A review based on a study conducted in the year 2000 it was found that the definitions of financial literacy could be classified into five classifications namely

- Level of knowledge on finance and its concepts
- Ability to grasp and present the financial concept
- Behavior towards managing one's money
- Expertise in making sound financial decisions
- Conviction in future planning of financial needs

Category 1: Knowledge of Financial Concepts

One of the most important concepts is to have adequate knowledge about the financial literacy. Management of money is said to be achieved only when one has sound know how about finance. As per National Foundation for Credit Counseling (2008) knowledge is defined as "the basic tenets of sound financial health and responsibility". The US Department of Treasury (2006) highlighted that it is a need for "the information, knowledge, and skills to evaluate options and identify those that best suit (a person's) needs and circumstances.

Category 2: Ability to Communicate about Financial Concepts Fox, Jonathan, Bartholomae and Lee (2005) are some of the authors who blended the concept of financial literacy with others. They believed that financial literacy can be defined as "crucial to effective consumer decision making" rather than just focusing on amount of information an individual has.

Category 3: Aptitude in managing finances

The authors believed to study the tendencies with which people manage their respective finances. As per Chen, Haiyang, and Ronald Volpe (2002), due to poor financial literacy Americans were said to have managed their funds appallingly. Definitions with a lengthier explanation one such given by Emmons (2005) elaborates special characteristics of financial literacy or some ways even suggested ways to measure financial literacy. The conclusion was financial literacy is way more than just having mere knowledge of it. Literacy is not only about managing money and handling it but also reflects one's potential to earn, retain and spend that money.

Category 4: Skill in Making Appropriate Financial Decisions

One of the most important factors in deciding about financial literacy is the decision-making skills. As per JumpStart Coalition for Personal Financial Literacy (2008), many scholars have described decision making as "successful financial decision making", Rhine, Sherrie and Toussaint-Comeau (2002) as "knowledge needed to make informed decisions" and "make smart choices" by Financial Fitness for Life (2008) are a few examples. Financial decisions are also affected by expansion of goods and services in the market and the insufficient resources available for the consumers. Several scholars have described financial literate as those who "successfully manage debt" (Stone 2008). As per Kozup, John and Jeanne Hogarth (2008) being financial literate means "a set of critical thinking skills to weigh and assess the pros and cons of a particular decision relative to one's own needs, values, and goals"

Category 5: Confidence to Plan Effectively for Future Financial Needs

As pe Koeing and Lori (2007) financial literacy are understood as "understanding about investing and financial planning". Financial literacy includes "responsible saving habits for future retirement." As per Wiseup (2008), a program conducted by the US department of labor. There has been a significant viewpoint of author when it comes to improved literacy and financial planning. On one hand where planning is considered to be important for development the other thinks that decisions can be made even if it is not well planned.

Other Dimensions Evident in Existing Conceptual Definitions

Other than the discussed five categories that have been explained above many scholars and authors have attempted to expand the typical definition of financial literacy and have included some other dimensions. Lusardi and Mitchell (2007) focused to maintain a global understanding. Whereas Hira and Loibl (2005) studied the role of individuals and their level of satisfaction at the work place. Some scholars found financial literacy to be that of a risky nature and also a means for defense against frauds. Stone (2008) have studied financial literacy as "basic financial knowledge about how to successfully manage debt." Similarly, Gross et.al. (2005) says that financial literacy is "basic information needed to function in our credit-based economy." Whereas several scholars are yet to define this concept.

Root Meaning

One such approach is to study the meaning and concept of literacy levying the financial portion aside. There can be various definitions of literacy ranging from culture, finance, environment, and some other specific basis. Literacy in the most layman terms is one's potential to read write and speak. Understanding the root meaning of literacy also reminds that communication skill is also necessary for financial literacy. Ability to perform calculations and knowing some common economic ideas is also necessary to understand financial literacy. Managing finances whereas is considered to be a difficult task as compared to the basic reading, writing, and speaking concepts.

Nominal concept

Some scholars argue that without the required skills and potential one cannot utilize its gained knowledge. Johnson et.al (2007) have defined financial capability as "Participation in economic life should maximize life chances and enable people to lead fulfilling lives; this requires knowledge and competences, ability to act on that knowledge, and opportunity to act. Ability and skills go hand in hand with a given opportunity. The most fascinating alternative names suggested for the phrase financial literacy has been empowerment (Jekwa and Sizwekazi 2007), One scholar described financial literacy as "a form of regulation by which the state holds individuals accountable for aspects of market governance and social security that it used to provide" (Williams and Toni 2007). The U.S. National Strategy for Financial Literacy speak to empowerment as "Financial literacy can empower consumers to be better shoppers, allowing them to obtain goods and services at lower cost. This optimizes their household budgets, providing more opportunity to consume and save or invest". There were many alternative names given but none of them seemed to be an appropriate and sufficient substitute for financial literacy. Empowerment, economic understanding and other such terms implies to deeper consequences that would be difficult to achieve through the present traditional training and communication programs.

Suggested Definitions

Earlier studies have emphasized on the requirement of more stable and consistent definition of financial literacy concept. The understated amalgamated definition of financial literacy brings together important concepts like: Hilgert and Hogart (2002) understanding of important financial topics and potential of managing their own finance keeping in mind the dynamic economic environment around. To be concise, it is not just the understanding of finance which is important, but its practical implementation makes one more capable. Hence, along with awareness of financial concepts, experience is required to develop aptitude in finance. Practical experience builds up connection between knowledge & aptitude. Jump$tart & Coalition in Personal Financial Literacy (2008) defined financial literacy differently. His definition emphasizes on ability to implement financial knowledge and skills to manage personal finance. But this definition is said to have flaws as it does not focus on the fact that financial literacy is basically a concept that should be measured. The other flaw in this definition is that it does not directly state the various financial concepts which a person should know in order to be called financially literate.

Stone (2004) stated that financial literacy is the ability to understand, handle and pass on information about one's personal financial conditions. Noctor et. al. (1992) in their study defined it as capability to make enlightened decisions about money management. OECD INFE defined it as integration of recognition, comprehension, capability and behavior imperative to make better financial decisions.

Understanding Financial Literacy.

Lusardi and Mitchell (2007) found that many households are not even aware of basic financial or economic concepts. As a result, they are not sound in planning for retirement, saving and making any investment decisions.

Rooij et. al. (2011) further explains that the few people who possess knowledge of finance, just know about very few basic concepts like compounding, time value of money and inflation. Besides this they do not even know about diversification, shares, equity, bonds etc. He correlated their financial literacy with low level of investment in stock market.

Brown and Graf (2012) concluded that financial literacy is related directly to investment in financial market and saving for future retirement.

Monticone (2011) found in his studies that keeping other factors constant, a financial literate person is most likely to resort to professional financial advice. There seems to be a direct relation between financial literacy and chances of using advisor's services for financial decisions.

Behrman et. al. (2012) financial literacy together with schooling have linear relationship with accumulation of wealth. Eikmeier (2007) concluded that financial education is directly related to financial literacy which further makes one's attitude positive towards planning investment.

Segelken (2005) found in the studies that dynamic and complex financial markets have made it challenging for one to attain financial knowledge, confidence and skills required in today's world.

Conclusion

Scholars are using wide variety of definitions for financial literacy. Hence everybody has developed their own scale of measure for it. It is a need of today to be financially literate to deal with complex financial markets. To run various financial literacy programs or any such development. It has become more important to reach consensus and formalize a clearer and comprehensive definition of financial literacy.

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