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Full Length Research Paper

Implications of financial literacy in developing countries

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This paper is an effort to establish the financial sector in the developing countries to promote financial literacy of customers and make them have access to finance and savings, which in turn support livelihoods, economic growth, sound financial systems, and participate in the economy. The main objectives of this paper is to enhances bank's visibility in the communities it serves, contributes to a larger customer base, increases access to depository institutions by educating consumers about available products and services, and enables consumers to make better-informed choices in the financial market. The final result is not to create financial experts; it is more important to equip individuals with sufficient knowledge to make sense of financial activities, seek out appropriate information, feelable to ask relevant questions, and be able to understand and interpret the information that they subsequently acquire. The primary goal of this paper is to create consumer groups, community-based organizations, schools, colleges/universities, financial institutions, other interested organizations and individuals to expand the process and enhance the level of financial literacy of the public at all levels of the society.

Key words: Banking knowledge, credit line, information and behavior.

INTRODUCTION

It is important to stress the financial literacy program is not designed to make people financial experts, rather, the aim is to empower individuals with sufficient skills and knowledge to form financial decisions and allow them to be more in control of their circumstances. Financial literacy can help these consumers to understand their financial options, make the most of these new opportunities, and manage traditional relationships with moneylenders as well as other financial obligations. Financial literacy is first and foremost about empowering and enlightening consumers so that they are knowledgeable about finance in a way that is relevant to their lives and enables them to use this knowledge to evaluate products and make informed decisions. As a consequence of the changing structure of an economy, financial knowledge has become not just a convenience but an essential survival tool. A lack of financial knowledge can contribute to the making of poor financial choices that can be harmful to both individuals and communities.

Mounting evidence shows that those who are less financially literate are more likely to have problems with debt, are less likely to save, are more likely to engage in high-cost mortgages, and are less likely to plan for retirement. Without a certain level of financial literacy, consumers might not purchase the financial products and services they need and might be ill-equipped to fully appreciate their rights and responsibilities as financial consumers, and to understand and appropriately manage the variety of risks.

Overall, these results suggests that individuals may underestimate the interest rate at which they are borrowing, confirming the evidence reported in Stango and Zinman (2008) that individuals are systematically biased toward underestimating the interest rate out of a stream of payments.

Financial literacy is a broad concept that includes both information and behavior; it is relevant for all consumers regardless of their wealth or income. Banks in the developing countries must promote financial literacy to their customers because of the positive direct impact this can have an access to finance and savings, which in turn support livelihoods, economic growth, sound financial systems, and poverty reduction. Financial education programs cover topics such as budgeting, saving, managing credit, and learning to negotiate. Each of these is effective in communicating information, but the most effective financial literacy programs is to empower individuals so that they are able to evaluate their options in the financial marketplace and then take appropriate actions in their own self-interest. Billion people in the world particularly in the developing or emerging economy don't have the ability to obtain credit and build a credit history, to get insurance products, or to save their money safely which could have a tremendous impact on their economic future. Financial literacy can help these consumers to understand their financial options, make the most of these new opportunities, and manage traditional relationships with moneylenders as well as other financial obligations. Most importantly, in a survey of Washington state residents, Moore (2003) indicates that people frequently fail to understand terms and conditions of consumer loans and mortgages.

The purpose of this paper is to offer guidance on assessing the outcomes of financial education in promoting (1) improved financial knowledge, skills and attitudes; and (2) financial behaviors that lead to improved financial outcomes and, ultimately, increased assets for poor people in developing countries. At this early stage in the development of financial education for poor people in developing countries focus is primarily on generating information that can be useful for improving the design and delivery of financial education programs for this new target group (Sebstad et al., 2006). Financial literacy helps build the capacity of the poor to gain control, become proactive, and use information and resources to enhance their economic security. It also enables them more effectively use financial services and reduces their vulnerability to over-zealous retailers or fraudulent schemes. Poor consumers need to have the opportunity to be educated and informed about the product choices becoming available to them, and for regulators of financial services, helping people make informed financial decisions is central to protecting consumers, promoting public awareness and maintaining market confidence. If financial service providers have not a significant information advantage over consumers with res-pect to the financial products and services offered this can weaken financial markets. Consumers more than ever need a certain level of financial understanding in order to evaluate and compare the increasingly voluminous and complex information available on different financial products, such as bank accounts, saving products, credit and loan options, investment vehicles, insurance coverage, etc. A survey of Washington State residents by Moore (2003) indicated that people often do not understand the terms and conditions of consumer loans and mortgages. Mitchell (1988) examined worker knowledge of pension provisions and showed that a substantial percentage of employees were unable to identify key features of their company retirement schemes, including early/normal retirement ages and how much their benefits would rise if they delayed retirement.

Financially literate consumers help to reinforce competitive pressures on financial institutions to offer more appropriately priced and transparent services, by comparing options, asking the right questions and negotiate more effectively. They also pressure government authorities to provide market standards and perform appropriate oversight of the financial system. Ultimately, financial institutions also stand to benefit, as informed clients pose less risk and constitute a market for sustainable financial services. Most of the people who are low levels of financial knowledge are not able to correctly calculate a percentage, compute compound interest correctly, and not understand interest rates or the terms of their investments. These findings are consistent with lack of financial literacy, in developing countries. These results are not promising, particularly the aging groups should have financial experience and retirement planning is relevant for this group. Lusardi and Mitchell (2006) find that older respondents display difficulty even in answering a simple question about interest rate, with the fraction of correct responses declining sharply with age. People who are financially literate are more likely to have planned for retirement. Other researchers have found that the effectiveness of financial education seminars is low, may not reach those who are most in need of retirement planning. Developing countries must have undertaken initiatives to enhance financial literacy, with the goal of enhancing retirement security. The information that this research produces on the level of financial literacy in different subgroups in the population will be useful for efforts aimed at providing financial education and improving financial literacy.

FINANCIAL LITERACY IS ESSENTIAL

Financial literacy involves both the understanding of basic financial concepts and the ability and discipline to use that information to make wise personal and financial decisions. These decisions include when to spend, when to save, effectively managing a budget, choosing the right financial products and readiness to address other life events, such as financing our own or our children's education and planning for retirement. Financial literacy is also helps to exercise a judgment when we are offered access to credit and possessing the wisdom to understand how much is enough—and how much is too much. Financial literacy is a mechanism that goes beyond political, geographic and socio-economic barriers, and it is widespread in developing countries. In its 2008 survey, the Jumpstart Coalition® found that U.S. high school seniors correctly answered only 48.3% of the questions posed to them that would evaluate their level of financial literacy. In 2005, the ANZ Banking Group conducted a survey of consumers in Australia and New Zealand and concluded that while respondents declared themselves to have a working knowledge of financial terms and calculations, only 28% were rated as having a “good level” of comprehension when faced with solving an actual problem (Jump$tart Coalition, 2008). The introduction of a national financial literacy program in all the developing countries is certainly needed particularly when the economy is doing very well, with prospects for continued strong economic growth and improvements in incomes. Financial literacy or financial education can broadly be defined as providing familiarity with and understanding of financial market products, especially rewards and risks, in order to make informed choices. Financial literacy goes beyond the provision of financial information and advice. The focus of any discussion on financial literacy is primarily on the individual, who usually has limited resources and skills to appreciate the complexities of financial dealings with financial intermediaries on a day to day basis. A large percentage of the population lacks a basic financial education, limiting their ability to make effective decisions regarding their financial future and exposing them to financial risks as well as potential market abuse. One example is offered by Hogarth et al. (2005), who demonstrated that consumers with low levels of education are disproportionately represented among the “un-banked,” those are lacking any kind of transaction account.

In developing countries, the growing number of consumers becoming involved in newly developing financial markets and newly liberalizing economies means that some level of financial literacy will be required if these markets and economies are to expand and operate efficiently. In addition, the growth of international transactions during the last decade, resulting from new technologies and the growing international mobility of individuals, makes the issue of improving financial literacy increasingly an international concern. This observation is consistent with research that finds consumers who are immigrants or members of a minority group have a greater reluctance to use formal financial institutions because of negative historical experiences and/or perceptions. Immigrants and minorities are more likely to have nontraditional borrowing and lending habits such as relying on family and friends (informal markets) to meet their financing needs (Rhine and Toussaint-Comeau, 1999). These programs is a pioneering initiative for the developing nations, and should lead the way in which the financial capability of its citizens.

Some of the developing countries have recently opted to provide savings for future generations, through such mechanism, in similar fashion the current situation demands a quantum change in personal economic behavior of the public, to ensure that current income gains are to have a sustainable impact on future personal welfare. While poor people recognize the negative consequences of poor money management and the importance of financial literacy, they tend to see “financial education” as accept changes – changes in their life styles, in their methods of production, health practices, etc thereby bring them to apply technologies and benefit from such interventions. The market research further confirms that people usually learn about managing money informally through personal experience and from family, friends and peers rather than formal education.

Financial literacy is a set of skills that serve as the entry point to basic financial knowledge. It contains a set of skills through which individuals and eventually the society in general make all–round development and actively participate in the development process through the acquisition of more knowledge, skills, capabilities and attitudes. One of most urgent development challenges of the 21 century is, therefore, the inadequacy of better information on finance and economic terms. Information and education empower people to make changes for the betterment and improvement of their social, cultural, economic and environmental conditions. Knowledge is becoming an essential commodity for mankind, a basic raw material which is indispensable for development and even for mere survival (UNESCO, 1997). Learning is an internal process of empowerment, an indispensable key to personal and social improvement and a development of an all-time and life-long resource and the ability to read and write allows people to acquire new knowledge, raise their level of awareness about their surrounding and understand their rights. It enables them to claim their individual and collective rights to participate in society, and participation is an important factor in development.

LOW FINANCIAL LITERACY DELIVERS POOR CHOICES

As financial markets have become increasingly complex in recent years in both developed and developing countries, more products and providers and consumers have greater responsibility for critical financial decisions such as planning for retirement (Miller, 2009). The very poor people also face an increasingly complex financial environment, due to the growth of microfinance, remittance networks, branchless banking, and micro-insurance to name just some of the financial services now available down-market. Financial literacy and basic education should be made relevant and useful to peoples’ daily lives and development activities. Financial literacy must have adequate financial support to bring a substantial change in the society, and illiterates in developing countries share those attributes that are common among peoples with high level of illiteracy: they are mostly poor and marginalized, the females being the most deprived of all the groups. The coincidence of illiteracy with poverty and deprivation is a phenomenon long realized by experts (Roy – Sing, 1990). The unskillful are the sector of the society that are denied their rights to education and most excluded from information and knowledge sources and opportunities. Financial illiteracy can contribute to the making of poor financial choices that can be harmful to both individuals and communities. Without an appreciation of money concepts and an understanding of financial options, people are likely to pay more than they have to for financial services, fall into debt, damage their credit records, and over-invest in some financial products while under-investing in others. Low-income families that lack basic financial skills become more vulnerable to sudden economic shocks such as health emergencies or unexpected job losses. Decreased family stability, increased foreclosure risks, and disinvestment in homes and local businesses challenge already disadvantaged lower-income communities (Jacob et al., 2000). As a consequence of these changes, financial knowledge has become not just a convenience but an essential survival tool. At the same time, responsibility for financial well being is increasingly being placed on the shoulders of individuals.

IDENTIFYING FINANCIAL ILLITERACY

Financial literacy is an active process in which communicating information is only the beginning: empowering consumers to take action to improve their financial well-being is the ultimate goal. The issue of financial education is to be directly connected to the debate on access to finance, the lack of knowledge on money issues and misunderstanding the banks role. The primary focus is the provision of basic information about money and the benefits of having a relationship with a formal banking institution.

Besides, financial education can contribute to a more efficient and more proactive use of scarce financial resources by current clients of banks, through a better understanding of the opportunities and options banks has to offer. It is also important to enable customers, especially the most vulnerable ones, to protect themselves from abusive financial practices and prevent them from being overburdened by debt. All in all, the end objective should be to empower people to achieve their own goals through enhancing their financial capabilities. The US Financial Literacy and Education Commission define financial literacy as “the ability to make informed judgments and to take effective actions regarding the current and future use and management of money” (Basu, 2005).

Today’s financial products and services are increasingly complex and accessible from a growing number and type of providers. It is hard to navigate the financial marketplace, compare products, and understand their relative benefits and risks. At the same time that financial products and services have increased in number and complexity, large numbers of consumers are entering financial markets for the first time, both because income is growing in developing countries and because new financial institutions, such as microfinance providers, and new technologies, are making it easier for consumers to participate in financial markets. Financial literacy is especially important today for several reasons. The financial crisis will reduce access to credit and increase its cost in many developing-country markets, just as it already has in the United States and Europe. In a world of escalating financial complexity, there is an increasing need for financial knowledge and at least basic financial skills (Morris 2001). Financial literacy can help to prepare consumers for tough financial times, by promoting strategies that mitigate risk such as accumulating savings, diversifying assets, and purchasing insurance. Financial literacy also reinforces behaviors such as timely payment of bills and avoidance of over-indebtedness that help consumers to maintain their access to loans in tight credit markets. Bernheim (1998) surveys several studies and shows too that workers display little financial literacy. Financial literacy can help these consumers to understand their financial options, make the most of these new opportunities, and manage traditional relationships with moneylenders as well as other financial obligations.

WHY DOES FINANCIAL LITERACY MATTER?

Financial literacy is the combination of consumers’/ investors’ understanding of financial products and concepts and their ability and confidence to appreciate financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being. Financial education, like all types of education, is about empowering individuals so that they are better equipped to analyze diverse (in this case, financial) options and to take actions that further their goals. Mounting evidence shows that those who are less financially literate are more likely to have problems with debt, are less likely to save, are more likely to engage in high-cost credit, and are less likely to plan for the future. Financial literacy enables people to make better financial decisions, to appreciate their rights and responsibilities as consumers of financial products, and to understand and manage risk. More financially literate consumers increase the demand for, and responsible use of, financial services, help to underpin financial market stability, and contribute to wider economic growth and development. A common response is to borrow money on very unfavorable terms, resulting in over-indebtedness and erosion of assets (Sebstad et al., 2006).

Thematic area examples of current behaviors and desired behaviors are:

1. Budgeting
i. Live day-to-day
ii. Reactive financial behaviors
iii. Lack of forward financial planning
iv. Plan ahead for expenditures

v. Make a budget
vi. Use a budget to manage money

2. Savings
i. Wasteful expenditures
ii. Irregular savings
iii. Savings not linked to goals
iv. Avoid unnecessary spending
v. Have a savings plan
vi. Save regularly

3. Debt management
i. Borrow for emergencies
ii. Over-indebtedness
iii. Borrow with little understanding of terms and consequences of delinquency
iv. Maintain an emergency savings account
v. Make a plan to reduce debt
vi. Avoid excessive debt
vii. Borrow with full understanding of terms and conditions

4. Financial negotiations
i. Weak negotiating position in business relationships
ii. Limited control by women over own earnings
iii. Negotiate for what you want in business transactions
iv. Take an active role in decisions over own earnings

5. Bank services
i. Limited knowledge of bank services
ii. Limited use of bank services
iii. Know about financial options and their terms and conditions
iv. Use bank services to support financial goals
Assessing the Outcomes of Financial Education: Working Paper #3 - 2006

CHALLENGES ASSOCIATED WITH FINANCIAL LITERACY

Banks of the developing countries has to face with challenges of contributing to the improvement of living conditions, supporting the local economic development and building greater social cohesion at local level is an integral part of their identity and one of their distinctive features amongst financial players. Financial education is indeed part of savings banks' wider commitment to the communities in which they operate. Banks should have a specific emphasis on the direct impact and concrete benefits on their customers by having a bank account or improving the management of one's budget or financial planning is a means to translate a theoretical presentation into a personalized, real-life case for the customers, is also defines as a financial coach for any project such as buying a home, car and a motorcycle).

Poor people are like everyone else they are at a disadvantage because they lack access to many formal financial institutions such as banks, insurance companies, and government systems of social protection (Rutherford, 2000; Lund and Srinivas, 2000). This proves useful not only to provide very concrete illustration about savings, but also to disseminate basic information about responsible consumption and the risks of (easy) credit. Given that a high proportion of lower-income consumers are un-banked, there is added concern that these consumers are inadequately prepared (lack of experience and information about personal finance and consumer education concepts) to make informed financial decisions (Hogarth and O'Donell, 1997).

The ability to make well-informed financial decisions plays an important part in the ability of individuals to manage their financial affairs. The outcomes of financial decisions have significant implications for an individual's financial security and standard of living. A person with a good level of financial literacy is likely to be better placed than someone without those skills and knowledge to manage their financial affairs prudently; all else being equal, they are more likely to budget effectively, invest wisely and manage their debt level in a sustainable manner. By contrast, poor financial choices, possibly based on a lack of understanding of financial matters, can result in a number of negative outcomes, including a lower level of financial wealth and imprudent debt levels. Knowledge is becoming an essential commodity for mankind, a basic raw material which is indispensable for development and even for mere survival (UNESCO, 1997). Learning is an internal process of empowerment, an indispensable key to personal and social improvement and a development of an all-time and life-long resource. Levin (1989) testifies that: "There will be no break-through in agriculture and industry, no progress in community health, and indeed, no change in living conditions without the right to learn."

Financial literacy and basic education has been suffering from neglect that originates from lack of political will on the part of the government. As a consequence, financial literacy and basic education remained peripheral to financial institutions policies and the resources allocated to it have been kept to the minimal. Improving financial capability through education is a major undertaking. People's abilities and needs are diverse and complex and reaching them at key points in their lives poses a huge challenge. There are other trends that highlight the potentially negative ways that consumers are handling their finances. Some households are choosing to lease automobiles rather than own them, which results in fewer household assets and never-ending car payments. Also, many families are beginning to take out mortgage or home equity loans to make major purchases. This means that more homes become at risk as people attempt to pay off their debts and families must wait much longer to build up home equity (Jacob et al., 2000).

People's behavior when it comes to money is influenced by many different factors: culture, emotion, personal beliefs, knowledge and attitudes to name but a few. In particular, for adults, education is a choice – there is no obligation to engage with personal finance education. In considering means to improve the financial status of families, education can play a critical role by equipping consumers with the knowledge required to choose from among the myriad of financial products and providers. Financial education is especially critical for populations that have traditionally been underserved by our financial system. In particular, financial education may help to pre-vent vulnerable consumers from becoming entangled in financially devastating credit arrangements (Greenspan, 2002). One of the challenges is, therefore, to convince the government and financial institutions to attach high importance to the development of its financial literacy of its citizen and design policy, in collaboration with social partners and other stakeholders to promote basic financial literacy education.

KENYA'S STRATEGY FOR FINANCIAL LITERACY

The vision for a National Strategy for Financial Education of Kenya seeks to lay the foundation for a comprehensive program that: helps consumers make better and informed financial decisions; fosters effective use of financial services thereby promoting a thriving financial services sector; and advances consumer protection through a well articulated legislative agenda. To achieve this vision, a Financial Education Partnership (FEP) has been formed bringing a number of private and public sector organizations together to champion the cause. A taskforce has been selected from the larger partnership to drive the initiative forward. In 2007, the World Bank estimated that Kenya received about $1.3 billions in remittances. About half probably was used to meet family-related expenses, with the rest going into various investments, particularly in real estate. But the financial turbulence in the UK, US and other countries will likely lead to a decline in such remittances for the near future (Mary Kimani, 2009).

Kenya is a good example of the changes outlined above. A significant portion of its population is still un-banked, and a dynamic financial sector, led by Equity Bank, is moving into that market. After abandoning rural branches in the 1990s, banks are now expanding their rural presence with new branches, mobile banks and other touch points linked to mobile phones and point of sale devices. This new supply of services and products calls for financial education to help consumers navigate through the options. On the demand side, an interesting dimension of Kenya's need for financial education is the enthusiasm for investments. Kenyans are eager to participate in the stock market and other investment opportunities. Yet, their enthusiasm is not often matched with knowledge, resulting in a high vulnerability to fraud, as evidenced by widespread losses to pyramid schemes in recent years (Johnson and Nino-Aarazua, 2007). In order to gain a better understanding of how key initiatives to improve financial literacy can be developed, Financial Sector Deepening (FSD) held a workshop for participants from banks, semi and informal financial institutions, insurance companies, the central bank, ministries, the education sector and communications companies (Ferrand, 2008). The objective of the workshop was to talk to broadest group of stakeholders possible to develop ideas for a national financial education agenda.

UGANDAN'S FINANCIAL LITERACY

On the onset of the global economic recession, Ugandans' personal debt is increasing, and makes the importance of spreading financial literacy more urgent than ever before. During the 4th financial literacy week held at the Imperial Royale Hotel in Kampala, there was consensus regarding the need to step up financial education among all age groups across Uganda. "Many Ugandans do not understand their financial rights and obligations. So many households are saddled by debt, unaffordable lifestyles with little savings and poor business ethics," noted education minister Namirembe Bitamazire, who kicked-off the literacy week. "There may be a good number of you who have businesses alongside day jobs but are probably making losses daily because you are financially illiterate," she observed. Bitamazire was optimistic that financial literacy training promoted by investors and players in the financial sector was a first step towards the formal inclusion of financial literacy as an integral part of the school curriculum. Most importantly, she considered financial literacy as part of a life-long learning process (New Vision, 2009).

CONCLUSION

This article has argued that financial literacy is important at many levels. It is an essential element in enabling people to manage their financial affairs and can make an important contribution to the soundness and efficiency of the financial system, and to the performance of the economy. A low level of public financial knowledge can mean that inappropriate risk return decisions are being made, and that people are not necessarily aware of the risks they face in their day-to-day financial decisions. Improved financial literacy can benefit individuals and families by giving them more control over their money and helping them make better financial decisions. Good financial literacy skills will build the capacity to better understand and manage financial risk, and take advantage of increased competition and choice in financial sectors. Broadly speaking, the purpose of financial education is to teach people concepts of money and how to manage it wisely. The aim is to enable people to become more informed financial decision makers, develop awareness of personal financial issues and choices, and learn basic skills related to earning, spending, budgeting, saving, borrowing, and investing money. Financial literacy can help people set financial goals and optimize their financial options.

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