

Financial Education and Financial Stability

**Conference on
Financial Education and Financial Awareness:
Challenges, Opportunities, Strategies
Central Bank of the Republic of Turkey
Istanbul, March 10, 2011**

**Hans-Helmut Kotz
Center for Financial Studies
Goethe University, Frankfurt**

02-25-2011

1

Issues

- Financial crises – consequence of financial illiteracy?
- Financial education – micro-perspective
- Financial (and economic) education: macro angle
- Conclusion: Fostering capacity to judge/agency

02-25-2011

HHK, Panel Renner Institut

2

Crisis causes

- Obviously, financial education only part of crisis prevention (severity, incidence/frequency)
- Causes of crisis – multiple, remedies as a corollary therefore also
- However: Ultimately, it's always the same: too much leverage
- FE would foster micro stability (living within one's means)
 - subprime mortgages, credit card debt
 - realistic assumptions about retirement income
- F(E)E could also contribute to macro financial stability

03-10-2011

HHK, Panel CBRT, Istanbul

3

FE – micro perspective

- OECD work on financial literacy, financial education
 - issues of knowledge (illiteracy) , overconfidence
 - financial capacities income dependent
- ...need for financial literacy in two (three) areas
 - household debt management
 - pension provision (defined contribution)
 - participation in public debate
- Public policy issues
 - asymmetric information – market failure – consumer protection
 - private under-provision of unbiased information
 - merit goods dimension

03-10-2011

HHK, Panel CBRT, Istanbul

4

Information requirements

- Knowledge about historical returns and risks of different asset classes
- “Irrational optimism” – return expectations too high – (Dimson et al. 2004)
- Accounting for complete range of possible outcomes (time diversification, Burtless 2000)
- Data and capacity to interpret/process information
- statistical quirks – and “commerce de promesses”
 - small sample bias
 - selection/survivorship bias

03-10-2011

HHK, Panel CBRT, Istanbul

5

Capacity to judge and implement

Classical Finance

- CAPM etc. (Weber 2007)
 - You cannot beat the market (and you must not try it!).
 - Stocks are risky – also in the long run (diversification vs. shortfall risk, geometric mean vs. absolute level of assets)

Behavioral Finance

- Expected utility maximizers?
- Behavioral biases
 - **overconfidence**, (own capacities, control illusion) – irrational optimism
 - **loss aversion** (too much trading), **disposition effect** (referencing)
 - **procrastination**

03-10-2011

HHK, Panel CBRT, Istanbul

6

FE – macro-angle

Crisis resolution

- Response to crisis and public discourse
- ...policies strongly influenced by public debate
- ...bail-out (asset-buyouts, recapitalization, guarantees), timing
- ...long-lasting consequences of crisis for public debt
- Trade-offs

...prevention

- Fallacy of composition: individual/collective rationality: macro-prudential dimension
- Capital requirements (level, risk-weighting, leverage ratios, dynamic provisioning, pro-cyclicality)
- Illiquidity buffers: endogeneity
- Too-big/interconnected too fail (SIFIs, resolution), systemic in a herd

03-10-2011

HHK, VT Renner Institut

7

Conclusion: Fostering agency

- Kantian approach: “Aufklärung ist der Versuch...”
- Consumer protection and unbiasedness of information
 - data provision
 - research and publication program
- Merit goods and “nudges”
- Current policy issues
 - level of capital/liquidity requirements?
 - bank levy?
 - financial transaction tax?
- Importance/usefulness of enlightened public debate
- Healthy skepticism, listen to (disinterested) academic scribblers (group think)
- ...and organize/contribute to agency – as CBRT does!

03-10-2011

HHK, Panel CBRT, Istanbul

8