

The Economic Importance of Being Educated

INSIDE:

Early Childhood Education

Consumer Finance

Mortgage Counseling

PLUS:

Q&A with Laurence Meyer

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



The views expressed in Forefront are not necessarily those of the Federal Reserve Bank of Cleveland or the Federal Reserve System. Content may be reprinted with the disclaimer above and credited to Forefront. Send copies of reprinted material to the Public Affairs Department of the Cleveland Fed.

Forefront
Federal Reserve Bank of Cleveland
PO Box 6387
Cleveland, OH 44101-1387

forefront@clev.frb.org
clevelandfed.org/forefront

FALL 2010

Volume 1 Number 3

CONTENTS

-
- 1 President's Message
-
- 2 Reader Comments
-
- 4 Upfront
Battling the next phase of the housing crisis
-
- 6 Stop Investing in Stadiums... Start Investing in Kids
Interview with Art Rolnick
-
- 10 Mortgage Counseling, Plain Language, and
Financial Education: What Works?
Highlights from the 2010 Community Development Policy Summit
-
- 14 Five Big Ideas about Consumer Finance Education
Observations of a Federal Reserve researcher
-
- 18 Overextended, Underinvested:
The Debt Overhang Problem
Economists explain how debt kills investment
-
- 22 Interview with Laurence Meyer
Former Federal Reserve governor on the state of macroeconomics
-
- 28 Book Review
The Big Short: Inside the Doomsday Machine
-

President and CEO: Sandra Pianalto

Editor-In-Chief: Mark Sniderman,
Executive Vice President and Chief Policy Officer

Managing Editor: Robin Ratliff

Editor: Doug Campbell

Associate Editors: Amy Koehnen, Michele Lachman

Art Director: Michael Galka

Designer: Natalie Bashkin

Web Managers: Stephen Gracey, David Toth

Contributors:

Dan Littman

April McClellan-Copeland

Filippo Occhino

Anne O'Shaughnessy

Andrea Pescatori

Jennifer Ransom

Editorial Board:

Ruth Clevenger, Vice President, Community Development

Kelly Banks, Vice President, Community Relations

Stephen Ong, Vice President, Supervision and Regulation

James Savage, Vice President, Public Affairs

Mark Schweitzer, Senior Vice President, Research

James Thomson, Vice President, Research

About Jeanne Hogarth



Jeanne M. Hogarth is a native of Northeast Ohio. She earned a bachelor's degree in education at

Bowling Green State University in 1971 and then taught high school in Olmsted Falls. She left the area in 1981 after earning a master's degree and a doctorate in family and consumer economics from the Ohio State University.

Today Hogarth manages the Consumer Education and Research Section of the Division of Consumer and Community Affairs at the Board of Governors in Washington, DC.

During the 2009–10 academic year, Hogarth was a visiting professor at Iowa State University. She is a member of the Association for Financial Counseling and Planning Education and the American Council on Consumer Interests.

“One of the most interesting things I’ve learned is that a lot of financial education isn’t about economics—and that might be heresy!” Hogarth said. “It’s really about psychology; it’s about how people think and feel.”

Behavioral economists have explored how psychology affects whether people participate in 401(k) plans. The optimal choice for a worker’s financial well-being is always the same: to participate. But studies have shown that when companies make “opting in” automatic—meaning that workers must actively decline 401(k) participation—more people participate. That’s the sort of result that traditional economists might not have predicted.

This realization has encouraged Hogarth to think about how to help people deal with the psychological issues they confront when they make home loans and retirement and investment decisions. “Your risk tolerance is not a financial thing; it’s a psychological thing. And yet it has a huge impact on what happens. Because if you’re not tolerant of risk, you’re not going to get a very high rate of return,” she says.

Financial Education Seems to Work

Hogarth’s faith in financial education has grown over the years, thanks to some of her own research. In 2003, Hogarth and two of her colleagues at the Board of Governors, Casey Bell and Dan Gorin, began studying the effectiveness of a two-day financial education program for military personnel at Fort Bliss in El Paso, Texas. Staff from the San Diego City College taught the course, which covered budgeting, credit, consumer awareness, car buying, insurance, and retirement savings.

For the study, the soldiers were split into two groups—those who took the financial education course and those who did not. Both groups had to come from the same population and had to be tracked over many years; these are hard-to-satisfy requirements in natural experiments. To determine the effect of financial education, the researchers monitored 13 positive behaviors (such as comparison shopping and starting an emergency fund) and 15 negative behaviors (such as paying bills late). They found that soldiers who participated in the financial education group showed more positive behaviors and fewer negative behaviors than those who did not.

Hogarth has been generally pleased with the study and its findings. “Financial education did seem to have an effect on specific financial management behaviors,” she wrote in a paper presented at the 2009 Federal Reserve System Community Affairs Research Conference.

“The bottom line is that we want good financial outcomes for consumers,” Hogarth said. “We want them to have financial security. We want them to feel comfortable about managing their money.”

The Earlier the Better

Not only should consumers have access to financial education programs, but the earlier the better. In a 2006 paper, for example, Hogarth cited a study (Bernheim, Garrett, and Maki) that showed that consumers who graduated from high schools in states with mandated financial education averaged higher savings rates and higher net worth.¹

The benefits also persisted over time. The research on soldiers stationed at Fort Bliss showed that those who had bank accounts when they were growing up became better money managers as adults, as did those whose parents talked with them about family finances early in life.

Financial Literacy Doesn't Always Mean Financial Capability

But being knowledgeable about financial management does not guarantee that people will put that knowledge to good use. Hogarth pointed out that educators have spent a lot of time and effort trying to distinguish between financial literacy and financial capability without reaching a consensus.

Hogarth has her own take on the difference: “I think that literacy connotes a certain level of knowledge,” she said. “Capability takes it one step beyond knowledge to actions. I might know intellectually how to play baseball, but if I’ve never gotten onto a field and tried to swing a bat at a ball, I wouldn’t necessarily be capable. But when I actually get out there and start practicing, my capability kicks in. That’s how I differentiate literacy from capability.”

“The bottom line is that we want good financial outcomes for consumers,” Hogarth said. “We want them to have financial security. We want them to feel comfortable about managing their money.”

Focus Future Research on Behaviors and Outcomes

Hogarth has seen research nail down a connection between consumers’ knowledge and behavior — if you know more, you do better. But another question looms large for Hogarth and others who study consumer behavior. Sometimes people exhibit all the “correct” financial behaviors, but their outcomes are underwhelming.

Hogarth illustrates the point with an example: “Let’s say I max out my 401(k) every year. With the recent decline in stock market values, I’ve actually lost money. I’m doing all the right things, but my outcome isn’t so great.

“Sometimes the outcome isn’t caused by the things you do or don’t do,” she explains. “It’s because of external factors such as unemployment or a decline in housing values. The struggle for researchers is connecting behaviors to outcomes while also controlling for external factors. I don’t know that we’ve figured out how to do that.”

Hogarth acknowledges that it is difficult to track financial outcomes five to 40 years in the future. She points to the Social Security Administration, which has set up three centers for financial security research. The Financial Literacy Research Consortium, as the centers are collectively called, will create innovative materials and programs for Americans at various phases of their lives. For example, mid-career professionals and near-retirees will be helped to understand the role of Social Security benefits and to plan for retirement.

“I think the centers will really help financial educators provide evidence-based research to policymakers,” Hogarth said. “There are many, many projects that have been funded through the three centers that will bring some fresh insights on the links between financial knowledge, financial capability, and financial outcomes.” ■

1. Bernheim, B. Douglas, Daniel M. Garrett, and Dean M. Maki. 2001. “Education and Saving: The Long-term Effects of High School Financial Curriculum Mandates.” *Journal of Public Economics* 80(3): 435–65.

Q&A with Jeanne Hogarth

Interviewed by Jennifer Ransom,
Community Relations and Education

Forefront: *Do you think the field of behavioral economics is helping to marry psychology and economics?*

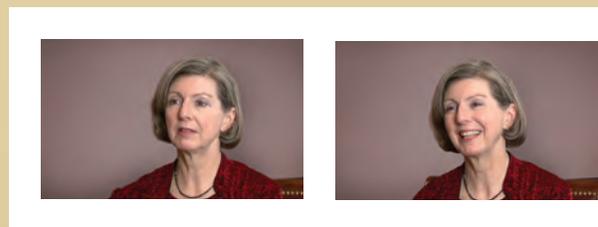
Hogarth: Behavioral economics has been tremendously important in raising our awareness of how people operate, what they're thinking, what they're doing. But we also know that default options can be set up. One of the classic ones, the major tenet of financial management, is pay yourself first. The idea of using payroll deductions to save into a retirement or savings account is good behavioral economics. You get automated savings; you build up your emergency fund, your college fund, your new car fund, or whatever it is; and you use some of the "out of sight, out of mind" psychology to the help your economic situation.

Forefront: *Can you talk about the tension that can arise when banks or other private-sector firms want to go into schools to help educate students about finance?*

Hogarth: There's an interesting conflict here. Research shows that kids who have bank accounts while they're growing up are better money managers as young adults. It's obviously very important for kids to open accounts, but the question is how to do that without coming across as a giant marketing attempt by a bank. I don't know if there's a really good answer to that. You could partner with multiple banks in your community. Or you could work through your local bankers' association or trade association to raise awareness in the schools, and then invite the students to do some comparison shopping for a bank account.

Forefront: *What's your thinking on the highest and best role of the Federal Reserve System in helping to achieve good financial outcomes for consumers?*

Hogarth: In marketing, there's an interesting model for creating awareness and then creating comprehension,



Jeanne Hogarth discussed her research during a visit to the Federal Reserve Bank of Cleveland in June. Watch video clips of our interview at www.clevelandfed.org/forefront.

and having that feed into decision-making. I think that's actually a pretty good model for the Federal Reserve System. In many of our initiatives, we're at the awareness level. We're just trying to alert people that there's something out there that they might want to be paying attention to. The Fed also has a lot of resources that can help people deepen their comprehension. But in the end, you have to realize that most people's decisions are personal. ■

Published works



Jeanne Hogarth's webpage, which includes published works, at the Federal Reserve Board of Governors.

www.federalreserve.gov/research/staff/hogarthjeannem.htm

Q&A



Watch clips of our interview with Jeanne Hogarth.

www.clevelandfed.org/forefront