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Psychological Factors affecting Financial Literacy: A Review

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Abstract

As the world is progressing towards a more globalised economy, more and more emphasis is being given on characteristics of human beings that affect financial processes. A paradigm shift in the way these processes were though to function can be seen in the way modern researchers are trying to define these processes. Earlier, these were thought to be governed with simple economic principles. However, if this were true, no one would make economically unsound decisions. But this, as we all are aware, is far divorced from the reality. Thus, modern researchers started studying the role that factors such as culture, cognition, personality, social norms etc. play in determining these relationships.

The present article is a review-based paper which discusses the personality and cognitive factors that affect the levels of Financial Literacy that a person possesses.

Keywords: Financial Literacy, Personality, Cognition

Introduction

As revealed by the work of Daniel Kahneman on Financial Decision Making (Kahneman and Tversky, 1979), the importance of personal factors gets highlighted. Since then, umpteen number of studies have happened in the area which came to be known as Behavioural Economics eventually.

In the year 2024 the Nobel Prize in Economics was conferred upon Daren Acemoglu, Simon Johnson and James A. Robinson for studies on how institutions are formed and affect prosperity.

With more and more people having bank accounts and having access to formal financial institutions, Financial Literacy of those people holds utmost value.

Definitions

Financial Literacy is the ability to comprehend and apply information relevant to one's finances. (Huston, 2010**)**

Lusardi and Mitchell (2011) defined Financial Literacy as people's awareness and knowledge about financial institutions, products and concepts linked to daily decision making.

OECD (2014) defined Financial Literacy as "a knowledge and understanding of financial concepts and risks, and the skills, motivation and confidence to apply such knowledge and understanding in order to make effective decisions across a range of financial contexts, to improve the financial well-being of individuals and society, and to enable participation in economic life."

Financial Literacy is the ability to make informed financial decisions based on sufficient knowledge about financial concepts and instruments. (Agarwal et. al., 2010)

Based on these definitions, it can be concluded that Financial Literacy is a skill which is acquired and is important for the well-being of a person, society and nation at large.

Psychological factors affecting Financial Literacy

Just as with any other skill, Financial Literacy is also affected by Psychological Factors. There is ample evidence to support the claim that psychological concepts such as cognition and personality have profound impact on the level of Financial Literacy of people.

Zimmerman (2000) elucidated the importance of psychological factors in reducing financial wastage. They also have an impact on financial decisions.

According to Farell et. al. (2016) self-efficacy aids the successful management of personal Finance.

Cole et. al. (2009) focused on the role of cognition in determining the level of Financial Literacy that a person possesses.

They posited that people’s limited capacity to think causes low demands for financial products, which stagnates an economy.

Similarly, Huston (2010) emphasized on cognitive factors. According to him Financial Literacy is the ability to comprehend Financial Knowledge and its successful application. This highlights the important role of cognition.

Building the premise of the study on self sufficiency theory, Hong et. al. (2022) attempted to relate the financial abilities of less earning people with Financial Literacy.

It was revealed by the result that Financial Attitude and Financial Behaviour were correlated to perceived financial constraint and financial hope.

Emotions also act as a deciding factor in determining Financial Literacy.

Skagerlund et. al. (2018) opined that the Financial Literacy is made up of numeracy and emotions towards numbers.

Prasad er. Al. (2014) in their study found that when certain emotional factors are there, people do not employ practical and logical approach in financial decision making.

Widjaja and Pertiwi (2020) concluded that emotions, Financial Literacy, materialism and risk perception have a role to play in indebtness, which is considered to have stemmed from poor Financial Literacy.

Nga and Yen (2013) concluded that some traits of personality- Conscientiousness, Openness to Experience and Agreeableness influence avoid taking risks, cognitive biases and investment which is socially responsible in nature.

The impact that personality has is greater than that of demographic factors such as gender.

Bertoni, Bonfetti, Celidon, Crema and Dal Bianco (2019) in a study found that personality traits have a significant relationship with participation in stock market.

Moreover, if a woman is head of household financially, her level of agreeableness and neuroticism have a positive correlation with indebt proneness.

Rzeszutek M et al. (2018) reported that people who are extroverted, adventurous and open to new experiences make financial decisions which are practical and logical. Such decisions have a rational basis to them.

Gladstone J and Barrett J A M (2023) studied the relationship between cognitive ability and debt and found that they have an inverted U-shaped relationship.

This means both the sample groups, i.e. who have high cognitive abilities and those with low cognitive abilities, hold lesser debts and those with average intelligence held highest debts.

The relationship between cognitive ability and indicators of wealth was linear for most of the people. However, it becomes non-linear at higher end of the cognitive ability spectrum.
Finally, they concluded that concluded that higher the cognitive ability, lower the financial stress, meaning that they are negatively correlated.
Bongomin G O et. al. (2018) studied the moderating role of cognition in the relationship of Financial Literacy and Financial Inclusion in rural Uganda. They found that cognitive ability significantly moderated the relationship between the aforementioned variables.

Discussion
Financial Literacy is of utmost importance in today's day and age as more and more people are joining the workforce, are earning and are contributing to the economy.
Financial Literacy is not only a mere ability to successfully manage one's finances but is responsible for a household's overall well-being (Nyarko, 2022) and even female empowerment. (Swamy, 2014)
A lot of factors can have an impact on something as complex and multifaceted as Financial Literacy, Cognition and Personality being two of them.
It can be well concluded from the studies that both these factors play crucial roles in determining the level of Financial Literacy of an individual. Gender differences were also noted.

Direction for Future Researches
Cognition and Personality are two such phenomena that affect a lot of psychological, mental and social processes.
The studies considered in this review paper more often than not have built the premise of their research on the BIG-5 Model of Personality by Costa and McCrae.
This model is widely accepted as a reliable construct. However, it will be an exaggeration to say that this is the one that captures every aspect of as intricate an entity as Personality. So, studies can be planned employing some other conception of Personality, especially if there is any such tool available which has its roots in local/regional understanding of personality as opposed to a global, more cosmopolitan approach.
As for Cognition, it can be observed that studies focus only on one socially/ culturally uniform group at a time, which does not provide us the bigger picture of the relationship as the society is not homogeneous and lot of intermingling of different and varied bunches of people occur to give rise to elaborate social processes. Moreover, in this era of globalisation, not only two or more groups interact but in fact the arena of finance has gone multinational.
Hence, studies in the future can focus on the cultural and national differences and nuances in light of locally held beliefs about finance and its management to develop a better understanding.

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