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What Is Financial Literacy and Why Should You Care?

In celebration of Financial Literacy Month, we're featuring #FinLit-focused stories and tips to inspire readers.

By Mark Catanzaro, Senior Manager

With April being Financial Literacy Month, you may start to see a spattering of references to financial education all over the internet.

What is the definition of financial literacy? It means understanding how to earn, spend, save, manage and invest money. It also means understanding how the economy works.

If you're like me, you get really excited about financial literacy and the possibilities it can create for all of us.

With that being said, I fully acknowledge that many will not share my excitement in this area. Most articles on personal finance or financial literacy will go right into how to set a budget, the benefits of saving, and the impact of interest rates. At that point, the majority of individuals lose interest (pun intended) and move on to something else.

In an attempt to keep your attention, let's spend some time looking at the "**why**" of financial literacy, not just the "**how**."

Financial literacy is about improving your life

While this subject may not be as exciting to you as it is to me, hopefully we can at least agree that money can have a significant impact on our everyday lives. My personal belief is that money doesn't necessarily buy happiness; it isn't just about buying that brand new car or newest gadget. However, money can allow a person to have more flexibility, reduce stress and improve relationships.

Living beyond our means can contribute to bankruptcy, divorce and massive stress. Additionally, the burden of student loan debt can keep first-time homebuyers out of the market, thus putting a drag on the economy.

Meanwhile, living with minimal debt and a savings cushion can provide you with the peace of mind and security of being financially free. Therefore, financial literacy isn't just about getting better with money to buy more stuff—it's about getting better with money to improve many different aspects of life.

- Financial literacy to a child may mean teaching the basics of spending, saving and giving.
- To some adults, financial literacy may mean helping someone open up a bank account or preventing someone from engaging with a predatory lender.
- For others, financial literacy could be learning how to budget or track spending—allowing you to develop a savings cushion, invest in your company's pre-tax retirement account, or save up for a new vehicle.

As you can see, financial literacy is important at all ages. And beginning to teach these concepts to children can instill lasting habits: A study by Cambridge University researchers (PDF) showed that behaviors around money form in children as early as age 7. If you happen to be older than 7 (shout-out to all the loyal readers who are not), it's never too late to learn.

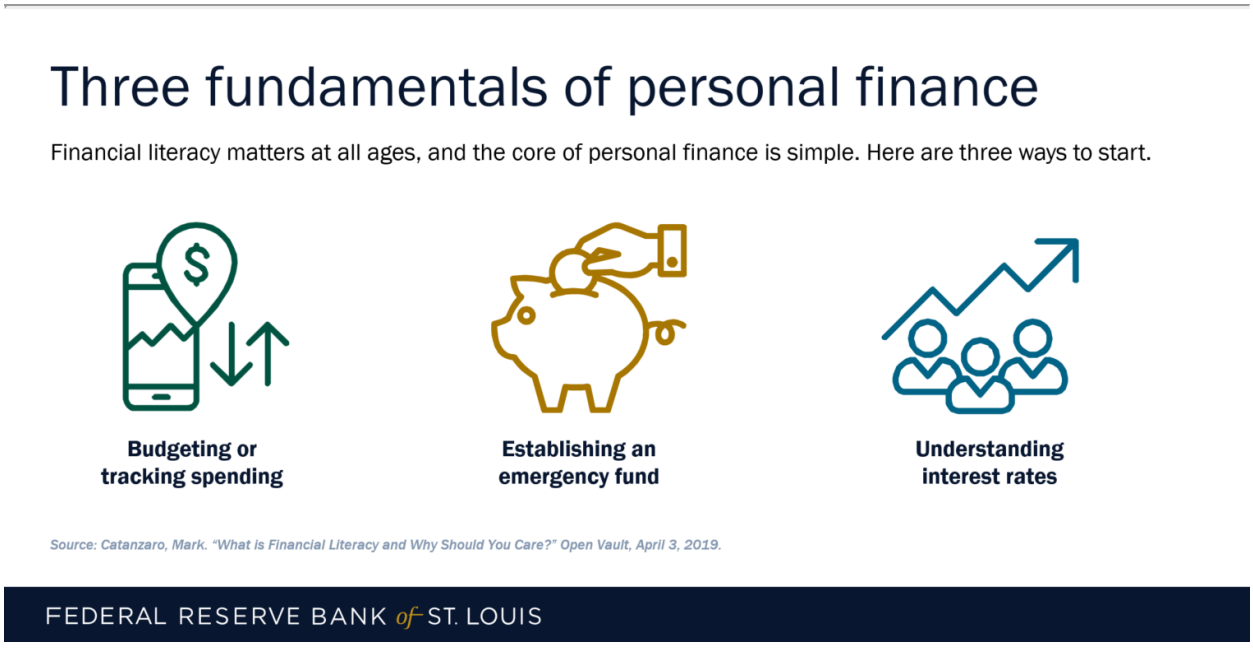
Three core principles for your personal finances

Let's face it, there's a lot of conflicting information out there about personal finance. But the better educated you are about finances, the better decisions you'll make. The core of personal finance is simple: ~~Save more~~ Spend less than you earn and then invest the difference.[1]

The doing is the hard part.

It can be tough to go out and make a higher income when you're barely able to scrape by on your current paycheck. Even with a higher income, slowly paying down debt requires a lot of discipline when spending beyond our means is a constant temptation. Finally, investing can be confusing with so many options in the marketplace. I know this may be challenging depending on income level, amount of debt, or other life situations that come up. We are all on a different path on our financial journeys, which is why it's called *personal* finance.

Not sure where to get started? Here are three core financial literacy principles that may help improve anyone's personal financial situation.



1. Budget or track your spending

I know what you're thinking: "See, I *knew* you would talk about budgeting!" Yes, there is a reason why almost every discussion on financial literacy focuses on budgeting or tracking your spending. If you don't know where

your money is going, then how can you make improvements to your financial situation? Budgeting is where you plan out your expenditures ahead of time.

For those who may not want to budget, simply tracking your spending after the money is spent can give you a snapshot of where your money is going. It's amazing how those random $10 or $20 purchases can add up when left unchecked.

Some of you may already be on a tight budget; others may be able to cut out unnecessary expenses and use that money to pay down debt, build savings or invest. Below are a few resources from the Federal Reserve if you're looking to get started.

- Budgeting 101 Online Course for Consumers
- Piggy Bank Primer: Saving and Budgeting Lesson for Grades 2-4
- Katrina's Classroom

2. Establish an emergency fund

Now that you are budgeting or tracking your spending, hopefully you can find a little cushion to save up an emergency fund of $1,000 to $2,000. The Federal Reserve Board issued a report on the economic well-being of U.S. households indicating that 40 percent of Americans could not cover a $400 emergency expense without selling or borrowing something.

Establishing an emergency fund is a critical step to help with the unexpected costs that always seem to come up. A flat tire, leaking toilet or unexpected medical expense can be right around the corner. An emergency fund can significantly reduce the stress of these unexpected situations. Ideally, you'll want to work your way up to having three to six months of emergency savings to protect yourself or your family in case of a job loss, significant medical event or other large and unexpected expenditure.

3. Develop an understanding of interest rates

Last year I wrote a post on the power of compound interest. Compound interest is known as the "eighth wonder of the world" because investing even a few hundred dollars per month in your 20s can leave you a millionaire by the time you retire. On the other hand, high interest loans could cripple a person for years. While there is a time and place for debt, not having a plan to get out of high-interest debt can lead to financial turmoil.

I remember a point in my life where the basics of interest rates were very confusing. The difference of a 3 percent interest rate on a money market account versus a 3 percent interest rate on a car loan wasn't clear. Interest rate percentages are used interchangeably and, at least to me, it wasn't obvious the positive or negative effect that interest rates had on an investment or debt.

According to a working paper from the National Bureau of Economic Research, less than one-third of young adults possess basic knowledge of interest rates, inflation and risk diversification. Financial literacy can help you understand these topics, allowing you to make better financial decisions.

First individuals, then families, then the economy

Personal finance is as much behavioral as it is about the numbers. Having a strong understanding of financial literacy will allow you to make better financial decisions that can hopefully improve your day-to-day life. At the macro level, financial literacy can result in stronger family balance sheets, which lead to a stronger overall economy (PDF).

While the concepts of personal finance are simple, research shows there is a long way to go in spreading financial literacy. Take time this April to educate yourself or a friend on personal finance-related topics. The St. Louis Fed's economic education team has a variety of resources that can assist you or someone else on the journey to becoming more financially literate.

Notes and References

[1] Editor's note: This language was updated for accuracy.