Commentary on 2013 Roepke Lecture Financial Literacy in Context

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Commentary

I am going to make an admission in beginning my comments: that Gordon Clark's article is outside of my normal field of expertise. I do economic geography, in a more conventional sense, and I do not have, as perhaps Clark might say, a high level of "financial literacy." And I personally have not done much research on finance or capital markets or on social insurance schemes and on the welfare state in general. So that is the caveat.

I also had to struggle with the organization and style of the article. The article is set up as a set of Russian dolls: arguments within arguments within arguments. It took me a long time to realize that its principal object is to critique global movements toward financial literacy, testing, and education. Gordon Clark says that societies are pushing financial literacy as a way of enabling their citizens to cope with a world of woefully growing financial complexity and risk. These citizens are faced with a decline in the ability of social protection systems to assure them long-term security, something which was promised to them with the rise of strong welfare states in the middle of the 20th century. Since Clark's was the Roepke Lecture in Economic Geography, I expected the article to analyze the geographic differentiation of financial risk, geographic differentiation in levels of financial literacy, and geographic variations in financial reasoning. But geographic differentiation is marginal as a concern of the article.

The main concern of the article is to critique the financial literacy movement and its theoretical justifications. The principal justification that Clark takes aim at is behavioral economics. Clark admits that behavioral economists have taken on the economics and financial establishment for their model of universal rationality. So why does he not like behavioral economics? Behavioral economists argue that the model of rationality is flawed because it ignores the ways in which people make decisions in real contexts. Similarly, geographers have long been interested in contexts that are environmentally, humanly, and socially constructed. Thus, it may seem that

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behavioral economists and geographers would both be on the side of critiquing the notion of a single universal rationality.

Instead, Clark claims that the behavioral economists have merely invented yet another newfangled version of formalism and that the particular brand of contextualism that lies at the heart of behavioral economics—because it is formalized and its insights are said to be universal—is just the wolf of universal rationality in the sheep's clothing of context and difference. So Clark wants to construct a radical critique of behavioral economics.

Along these lines, Clark objects to some of the key claims of behavioral economists. Let us consider one known as the "money illusion." The money illusion concept emerged from powerful experimental results that show that people attach value to the index number of how much money they have and systematically do not discount for inflation, deal with opportunity costs, or consider alternative investments. Yet, according to Clark, the money illusion is *not* universal. The extent to which the illusion is understood or stronger or weaker depends on people's particular circumstances, institutionally, economically, or geographically. This is, as I noted earlier, a radical claim. One would like to have seen cases and statistics to demonstrate its veracity.

Let us return to the central concern of the article: the financial literacy movement. Clark argues that the movement is unlikely to help people to pursue their goals in a world of complex financial markets, and this critique is plausible. It is absurd to think that ordinary people, even reasonably well-educated ordinary people, can use financial management courses to plan their financial lives so as to achieve the level of risk they desire. Even the great supposed geniuses of the finance world failed miserably to manage risk in 2007 and 2008.

In discussing these issues, I expected the article to draw on the distinction first made by Frank Knight in 1921 in his book *Risk, Uncertainty, and Profit*. Risk exists as a set of fluctuations for which we can make a meaningful probability estimate; by contrast, uncertainty exists when no such effective probability estimates can be made. This distinction has been the basis of models of financial market fluctuation since the 1930s. The latest generation of such models, such as Black-Scholes, claimed to have overcome uncertainty for a wide range new types of investments and financial market interactions, claiming to have tamed their uncertainty and thereby transforming it into manageable risk. But as we learned in 2007, they were wrong. That's how Lehman Brothers and AIG went down. The system is fundamentally uncertain, as Alan Greenspan admitted publically, with great pathos, in Congressional testimony after the crisis hit. He admitted that that the "rational markets hypothesis" was fundamentally flawed.

Since then, we have learned that the problem is not just about the *theory* of uncertainty. It is also institutional. Many of the big financial institutions have a reason for not being overly interested in whether the system is protected from true uncertainty; when they make mistakes that are really huge, taxpayers will save them. Even today, without having fully recovered from the terrible recession caused by the financial crash, our financial markets are overheating again, and as of today, there are six bills in Congress to eliminate the restrictions that we put on derivatives just two years ago. The Securities and Exchange Commission, under a Democratic president, supports allowing foreign jurisdictions to determine the level at which derivatives will be regulated, effectively encouraging a new wave of geographic regulatory arbitrage.

So if the great financial powers believe that it does not matter whether they fail or not and that the system will be saved by public policy, what about ordinary people? They will not be saved, of course. The underwater homeowners, as well as the tens of millions of people who lost their jobs and the many millions who depleted their life savings and whose retirement funds declined precipitously in value, were not saved. No amount of

financial literacy will help them because, as I noted earlier, even the experts are not "literate." The system is now engineered to be so opaque that its various elements cannot be understood. It is a breeding ground for new "black swans."

Clark seems to agree with this point of view, but then the article takes a curious twist. It cites at length the example of Revolution Foods in Oakland, California, where, Clark says, employees are given practical and easy-to-understand savings and investment options, which help them plan for their futures. These indeed do seem like sensible and progressive company policies. But are they going to protect people from financial collapse in the face of the system dynamics I just mentioned? Obviously not. What would save me, for example, if the real estate market crashed again and this time it crashed really hard? Many of our personal assets are in our homes. Or what if there were to be rampant inflation? What would happen to me, or my retirement fund, if the stock market crashed again and the Federal Reserve no longer had enough market credibility or funds to sustain another 10 years of quantitative easing? In this light, the overall recommendation of Clark's article, which is to reaffirm certain kinds of social insurance regimes, would not save us. Many pension funds in places like the United States are essentially large stock funds. That is the University of California retirement system on which my future will ultimately depend. So financial literacy, sensible company policies, and social insurance are all probably good things. But without public policy to reshape the world of finance so that its products are risk-based and not creators of huge quantities of fundamental uncertainty, no amount of financial literacy education will suffice to protect people. Somehow, in the Russian dolls of the article, I think Clark would agree with this point, but it is a bit hard to tease it out.