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THE SIGNIFICANCE OF FINANCIAL LITERACY

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ABSTRACT

A trend in stockownership in Pakistan has changed drastically over the short span of time. There were very few people who intend to participate in stocks. But now this picture has changed as the number of individual investors has increased in financial markets. For many these financial products are difficult to understand. The question is individual investors well-equipped to make financial decisions? Do they possess ample financial knowledge to enter in the risky and complex stock trading? At the other end for those who are relatively financially literate how much they understand stock market behavior? For many people, especially people unfamiliar with finance, the stock market is not intrinsically different from a card game (Guiso, Sapienza & Zingales 2005).

Lusardi and Mitchell (2006) suggest that financial literacy is required to establish a measure of financial competence, i.e., to stay knowledgeable about financial matters. These literate people are more participating in financial market because they know financial matters. Authors found that financial illiteracy is widespread and particularly acute among specific groups of the population, such as women, the elderly, and those with low education. Further a study on the OECD (Organization for Economic Co-operation and Development) by Lusardi and Mitchell (2007) review the evidence on financial literacy across countries and show that financial illiteracy is a common feature in many other developed countries, including European countries, Australia, and Japan. These findings are reflected in the work of Christelis, Jappelli and Padula (2007) finds that most respondents in Europe score low in participation due to a low financial literacy index.

The work by Stango and Zinman (2007) shows that those who are not able to correctly calculate interest rates end up borrowing additional amount and accumulating lower amounts of capital gains. Agarwal, Driscoll, Gabaix and Laibson (2007) further show that stock participation errors are prevalent among the young and elderly, who are more likely to have the lowest amount of financial knowledge.

As financial markets have great impact on any country's economy. Therefore, the importance of financial markets can not be neglected. In financial markets it's all about participation of investors.

Our study analyses the importance of financial literacy in stock exchange participation and how financial knowledge helps the stock participants in their decision. Do they earn more return than financially illiterate investors? In this research, we considered "Financial Literacy Index (FLI)" and "Substitutive Market (SM)" as independent variables and "Stock Participation Index (SPI)" as dependent variable. Regression analysis has been used to examine any significant relationship among them. The data is collected through a questionnaire from 290 stock market participants. Our questionnaire is classified on age group, income level, educational level, and business type of the individual participant in stock exchange to test the hypothesis whether financial literacy has any impact on the stock exchange participation or not. The following model is estimated…

$$\mathbf{SPI = \alpha + \beta_1\, FLI + \beta_2\, SM + \epsilon}$$

Hypothesis:

H_o: The beta is insignificant => $\beta1, \beta2 = 0$

H_1: The beta is significant => $\beta1, \beta2 \neq 0$

α is the SPI intercept, β_1 is the coefficient **financial literacy index and β_2** is the coefficient for **substitute market, ϵ is the error term**.

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