SPEECH

Financial literacy and monetary policy transmission

Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the 2025 Mais Lecture at Bayes Business School

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According to our latest public opinion survey, more than 90% of respondents are aware of the European Central Bank.[1][2] But when asked about our tasks, only 43% said they know that the ECB is responsible for maintaining price stability, despite inflation continuing to be the most important issue for European citizens.[3]

These findings are part of a broader societal phenomenon: the widespread lack of financial literacy.

Financial literacy is the ability to understand and apply basic financial concepts. It empowers individuals to make informed financial choices, mitigate investment risks and make provisions for old age.

In my lecture today, I will argue that financial literacy also matters for the transmission of monetary policy. I will show that financially literate individuals react more strongly to interest rate changes, are more willing to take on risk and are more forward-looking when forming inflation expectations.

Together, these factors suggest that greater financial literacy tends to strengthen the transmission of central bank policies to the real economy. Therefore, it can make monetary policy more effective in achieving its objectives and lower the sacrifice ratio – that is, the cost of reducing inflation in terms of lost output or higher unemployment.

For this reason, central banks, including the ECB, have increased their efforts to foster financial literacy. Such initiatives strengthen trust in central banks and support broader policy goals, including progress on the European savings and investment union.

Financial literacy varies widely across socio-economic groups

In 2021 G20 finance ministers and central bank governors recognised financial literacy as an essential skill for empowering people and supporting individual and societal well-being.[4] It is defined as the ability to understand and effectively use basic financial concepts to take personal financial decisions.

Such decisions are taken at various stages of life. People have to decide how much of their income they want to spend and to save, how to best invest their savings, how to finance big purchases like an apartment or a house, and how to make provisions for old age or emergencies. This requires an

understanding of how interest rates and inflation affect the return on various financial products and the cost of borrowing.

The sharp economic fluctuations over the past few years have underscored how important financial literacy is for the well-being of households. The surge in inflation in the aftermath of the pandemic and the sharp rise in interest rates after a decade of low rates have highlighted the need for individuals to properly understand and react to a changing inflation and interest rate environment.

Economists Annamaria Lusardi and Olivia Mitchell developed the “Big Three” financial literacy questions, which have become a widely used measure of financial literacy (Slides 2 to 4).[5]

These questions assess basic knowledge in three areas that are of key importance for households’ financial decision-making: the concept of compound interest, the importance of inflation for the purchasing power of savings, and the benefits of diversifying a portfolio across different assets.[6] People are usually considered to be financially literate if they can answer all these three questions correctly.

Numerous surveys collect information about the level of financial literacy across various countries and socio-economic groups, and the ECB has contributed to this effort by including questions on financial literacy in its consumer expectations survey.

These surveys show that many people struggle to answer all three questions correctly. In the euro area, less than half of respondents, around 48%, managed to get all three questions right (Slide 5).

Moreover, financial literacy varies widely across socio-economic groups.

First, financial literacy is lower for younger people. Those aged below 50 display below-average financial literacy, which could negatively affect their ability to build up long-term wealth or their decisions about major purchases.[7]

Second, women have on average significantly lower financial literacy than men. This could lead to a higher risk of financial hardship and could explain why women are more often at risk of old-age poverty.[8]

Third, financial literacy increases with educational attainment and income, potentially reinforcing inequality as, on average, financially literate people take better financial decisions.[9]

Finally, there is considerable variation across countries, also within the euro area. Financial literacy tends to be higher in northern European countries.

Financial literacy matters for monetary policy transmission

These differences have important implications for individuals, but they may also have an impact on the effectiveness of macroeconomic policies.

Monetary policy is a case in point. The effectiveness of monetary policy relies on the smooth transmission of policy decisions – especially changes to key policy rates – to financing conditions and, from there, to economic activity and inflation.

Today I will focus on three key channels through which financial literacy can influence the transmission of our monetary policy: the interest rate channel, the risk-taking channel and the inflation expectations channel.[10]

Financially literate households react more strongly to interest rate changes

In standard macroeconomic models, monetary policy works mainly through the *interest rate channel:* an increase in interest rates shifts intertemporal trade-offs in the direction of higher savings and less consumption due to a substitution effect. Higher interest rates dissuade firms from investing and households from purchasing houses or durable goods.

Policymakers frequently use these models to derive policy prescriptions, thereby implicitly assuming that households react in an optimal way to changes in interest rates by adjusting their borrowing and saving.

However, a lack of financial literacy in part of society could be one reason that not all people behave in the way that models with rational expectations assume. Consequently, policymakers may make mistakes in predicting household behaviour, affecting the way monetary policy is transmitted to the real economy.[11]

For example, survey evidence suggests that financially literate households are more responsive to changes in interest rates.

On the one hand, this reflects the fact that these households are more attentive to interest rate developments. Among financially literate households, 62% report paying “some”, “much” or “a great deal” of attention to the level of interest rates. For households with low financial literacy, this share is only 49% (Slide 6).[12]

On the other hand, a financially literate person has a better understanding of how interest rate changes will affect their financial situation and how they should best respond.

The experience of recent years is a good example. When the ECB raised its policy rates in 2022 to fight inflation, financially literate individuals understood that this created more beneficial conditions for saving and less attractive conditions for borrowing, strengthening policy transmission. By contrast, less financially literate people reacted much less strongly to the dramatic change in the interest rate environment (Slide 7).

In other cases, the impact on transmission is less clear.

Households with high levels of financial literacy preferred fixed-rate loans when interest rates were low, but less so when interest rates were high (Slide 8). This behaviour tends to slow down policy transmission, as it insulates these households from changes in the interest rate environment. By contrast, less financially literate households did not significantly adjust their preferences when interest rates increased sharply.[13]

The financial literacy of borrowers and depositors may also affect how swiftly and strongly banks pass through changes in policy rates to financing conditions. This is a key step in monetary policy transmission.

The more attentive households are to interest rates, the more likely they are to search for the best possible interest rate for both loans and deposits. Indeed, according to the consumer expectations survey, financially literate households are more likely to “shop around” for the best terms of debt products (Slide 9, left-hand side).

The same is true for deposits. During the recent hiking cycle, banks had to increase deposit rates to prevent a deposit flight as depositors shifted from low-yielding deposits to higher-yielding investments.[14]

Such behaviour is likely linked to financial literacy. In fact, during the recent tightening cycle, cash accounts of corporates, which are managed by finance professionals, received higher interest rates for both overnight and term deposits than those of households (Slide 9, right-hand side).

Higher funding costs for banks then also translate into higher bank lending rates, strengthening the transmission of policy rates to financing conditions.

Financial literacy increases risk-taking and stock market participation

A second important transmission channel of monetary policy operates through investors’ risk appetite. This is the *risk-taking channel*.

Monetary policy influences people’s willingness to take risks, with looser monetary policy being associated with greater risk-taking, as investors have an incentive to switch from safe assets to higher-yielding alternatives.[15] Increased risk-taking, particularly through greater stock market participation, amplifies the aggregate effects of monetary policy adjustments.[16]

Research indicates that financial literacy plays a crucial role in determining the extent to which households engage in risk-taking by investing in the stock market or other risk assets.[17] Financially literate households are much more likely to invest in stocks or mutual funds, thereby strengthening monetary policy transmission (Slide 10, left-hand side).

Differences can also be found in the mortgage market.

A higher share of financially literate households take out mortgages and other loans than is the case for households with low financial literacy, although the difference is quantitatively much smaller than for stocks (Slide 10, right-hand side). Changes in aggregate consumption in response to interest rate adjustments are to a large extent driven by households with mortgages.[18]

Higher risk-taking may also affect monetary policy indirectly by mobilising private capital for riskier and more productive investments. More risk capital should lead to higher productivity growth and hence a higher natural interest rate, r-star, giving central banks greater scope to stimulate the economy through lower interest rates due to a greater distance to the zero lower bound.[19]

The effects of higher risk-taking can be self-reinforcing. If a larger share of the population rebalances their portfolios by switching from savings products or bonds to stocks in response to looser monetary policy, this may encourage firms to make additional investments. The increase in investment leads to higher

aggregate income, in turn leading to more investment in the stock market.[20] Through this channel, stock market participation can magnify the investment response to monetary policy shocks.[21]

Wealth effects provide another amplifying channel, as looser monetary policy tends to go hand-in-hand with a better performance of riskier assets, increasing household wealth and fostering consumption, with important distributional consequences. However, as shown over the recent tightening cycle, asset prices may behave differently. Over this period, the dampening effect of higher rates on stock prices was more than offset by stronger risk sentiment, leading to a surge in stock prices. Such wealth effects weakened monetary policy transmission in the most recent hiking cycle.

Lastly, financially literate households have been shown to be more likely to build up precautionary savings, making them better able to cope with financial shocks and smooth their consumption.[22] This may slow monetary transmission, as these households can initially draw on cash buffers when the cost of borrowing increases through policy tightening. Hence, the impact of financial literacy on risk-taking may also go in the opposite direction.

Financially literate households are more forward-looking when forming inflation expectations

A third key transmission channel of monetary policy is the *inflation expectations channel*.

Since consumption and investment decisions as well as price and wage-setting processes reflect expectations about the future pace of price changes, household inflation expectations shape inflation dynamics. A growing body of research suggests that consumers' expectations matter greatly for the transmission of monetary policy, possibly more than those of financial market participants.[23]

Research by the International Monetary Fund shows that, over the recent inflation episode, near-term inflation expectations became an increasingly important driver of inflation in advanced economies (Slide 11, left-hand side).[24]

In turn, factors that can reduce the sensitivity of inflation expectations to actual inflation developments can contribute to bringing inflation down more quickly. And the lower the sensitivity, the lower the sacrifice ratio, allowing for swift disinflation without causing high unemployment or a deep recession.

It is therefore crucial that central banks understand how households form these expectations.

Research shows that policy tightening has a stronger dampening effect on near-term inflation expectations and inflation when a greater share of people in the economy are forward-looking (Slide 11, right-hand side).[25]

Forward-looking households form their expectations on the basis of a broader set of information, including central bank policies and their expected impact on the economy, while backward-looking households base their expectations to a larger degree on past inflation experience.

Therefore, a higher share of backward-looking households means that the central bank must tighten monetary policy more to achieve the same drop in inflation.

The degree to which households are forward-looking likely depends on their level of financial literacy.

Survey evidence indicates that households with higher financial literacy pay more attention to inflation.

52% of financially literate households pay “much” or “a great deal” of attention to inflation. This share stands at just 45% for the less financially literate (Slide 12, left-hand side). Higher attention also implies that these people are easier to reach through central bank communication.[26]

However, these data also suggest that even for financially literate people, almost one half do not pay much attention to inflation. This may explain why inflation perceptions are often very persistent, adapting slowly to actual inflation dynamics. While headline inflation in the euro area dropped by almost 8 percentage points from its peak in October 2022 until the end of 2023, inflation perceptions fell by much less (Slide 12, right-hand side).

Again, there is some difference of inflation perceptions across different levels of financial literacy: while the inflation perceptions of both groups were similar when inflation had reached its peak, those of financially literate people are now 1.6 percentage points lower than those of less financially literate people.

Inflation expectations paint a similar picture. The one-year ahead inflation expectations of financially literate households have dropped much more quickly than those of the less financially literate (Slide 13, left-hand side).

These two findings are linked and reflect the fact that individuals’ inflation perceptions have a substantial impact on their expectations of future inflation.[27]

Overall, the share of consumers with inflation expectations broadly anchored around 2% – meaning that three-year inflation expectations are between 1.5% and 2.5% – has fluctuated around a level of only 17%, indicating a low degree of anchoring.

Again, there are notable differences in inflation expectations linked to financial literacy. The share of consumers with medium-term inflation expectations anchored around 2% is significantly higher for financially literate households. However, these households have also been more responsive to actual inflation developments, with the share of consumers with medium-term inflation expectations around 2% declining more sharply when inflation surged and rising more strongly when it came down (Slide 13, right-hand side).[28]

The observed differences in the formation of inflation expectations translate into lower deviations of individual one-year ahead forecasts from inflation perceptions at that time for more financially literate people, implying a lower subjective forecast error (Slide 14). In other words, households with higher levels of financial literacy tend to have more accurate inflation expectations.[29]

Financial literacy also affects household perceptions of real, i.e. inflation-adjusted, incomes, with implications for monetary policy transmission. Over the past three years, real private consumption has

increased more slowly than real disposable income. This can be partly explained by household misperceptions of their real income developments.[30]

While over 50% of households in the euro area experienced positive real income growth in 2024, only 11% *perceived* that their real income had increased (Slide 15, left-hand side). The net percentage of pessimistic households is highest for the bottom half of the income distribution, and it is also higher for households with low financial literacy (Slide 15, right-hand side).

This implies that lower inflation due to restrictive monetary policy generally had a weaker impact on consumption due to such misperceptions, dampening the recovery.

The need for enhanced financial education initiatives

The evidence presented explains why central banks have a keen interest in promoting financial literacy and improving financial knowledge.

In our 2021 monetary policy strategy review, we acknowledged that communication to broader audiences is key for monetary policy. That is why we have put more emphasis on explaining our monetary policy decisions to the general public in an accessible way.[31]

Since President Lagarde took office, the Governing Council has made significant progress in making communication more accessible. For example, the introductory statement to the press conference after our monetary policy decisions has been replaced with the monetary policy statement, which offers a more concise and compelling narrative, while significantly reducing the textual complexity of monetary policy announcements, thereby increasing readability (Slide 16). To reach audiences beyond experts, the statement has been complemented by highly accessible, visualised statements, available in all EU languages.[32]

When people understand how monetary policy works, they tend to trust central banks more.[33] And people's trust in the central bank and in its ability to maintain price stability has been shown to help anchor inflation expectations and increase the share of forward-looking people in the economy.[34]

Knowledge about the ECB is linked to financial literacy. Financially literate households tend to be significantly more knowledgeable about the ECB and its inflation objective (Slide 17).

This has implications for the ECB's credibility. In the most recent inflationary episode, the share of households with high financial literacy that trusted the ECB to maintain price stability over the next three years rose notably after the ECB had embarked on its hiking cycle and inflation had come down significantly (Slide 18).

By contrast, households with low financial literacy lost confidence in the ECB's ability to maintain price stability as interest rates rose. Even when inflation had already come down significantly, the share of households that trusted the ECB's ability to maintain price stability remained low. This is in line with recent

evidence from the United States, where 60% of survey respondents believe that high interest rates cause high inflation.[35]

Therefore, to maintain and improve their credibility, central banks should help people understand their policy actions and their economic effects through communication and enhance their efforts to improve financial literacy.[36]

At the ECB, we are taking active steps to do this. We have expanded our communication efforts towards the general public by offering explainers on YouTube (through our “Espresso Economics” channel), by speaking more frequently on TV, by engaging on social media and by producing regular podcasts.

Earlier this month, on International Women’s Day, the ECB took another step in promoting financial literacy by committing to five joint actions with national central banks, also aimed at closing the gender gap in financial literacy.[37]

These include raising awareness, establishing a central bank financial literacy network, collaborating with national authorities for consumer protection, developing a harmonised financial literacy dataset across Europe, and focusing communication efforts on key moments in life, such as early education, taking out a major loan or building a pension.

Of course, such efforts can only complement, not replace, much broader efforts needed from governments and the education system. And it requires a long-term effort, with progress likely to be incremental.

Financial literacy is also an important cornerstone of the savings and investment union, one of the European Commission’s flagship projects.[38]

Under its first pillar, it aims to encourage citizens to invest in capital markets, which can contribute to financing part of the massive investments needed for the green and digital transitions.[39] As I said before, financial literacy increases the willingness to make such investments. Therefore, an improvement in financial literacy is seen as essential to achieving the stated objectives. That is why the European Commission will adopt a financial literacy strategy, in line with the ECB’s efforts.

Conclusion

Let me conclude.

Financial literacy is an essential life skill that not only empowers individuals to make informed financial decisions but can also make monetary policy more effective.

Financially literate individuals respond more strongly to interest rate changes, are more willing to take on risk and are more forward-looking when forming inflation expectations. This tends to strengthen the transmission of central bank policies to the real economy.

However, significant differences in financial literacy across socio-economic groups highlight the need for continued educational initiatives.

Fostering financial literacy can support policy effectiveness, enhance public trust in central banks and help people make better financial decisions, ultimately contributing to a stronger economy and individual well-being.

As Benjamin Franklin, who spent more than 16 years here in London, once said, “an investment in knowledge pays the best interest.”

Thank you.

Annexes

27 March 2025

Slides

1.

I would like to thank Dimitris Georgarakos for his contributions to this speech.

2.

ECB Knowledge and Attitude Survey, 10th edition, 2024, internal report.

3.

European Commission (2025), Eurobarometer, EP Winter 2025 survey, March.

4.

G20 (2021), *Italian G20 Presidency Third Finance Ministers and Central Bank Governors Meeting Communiqué*. This was preceded by the publication of comprehensive recommendations by the OECD on how to improve financial literacy globally. See OECD (2020), *Recommendation of the Council on Financial Literacy*.

5.

Lusardi, A. and Mitchell, O.S. (2014), “The Economic Importance of Financial Literacy: Theory and Evidence”, *Journal of Economic Literature,* Vol. 52, No 1, March.

6.

The “Big Three” questions are the following: Interest rate question (numeracy): Suppose you had $100 in a savings account, and the interest rate is 2% per year. After five years, how much do you think you would have in the account if you left the money to grow? A) More than $102, B) Exactly $102, C) Less than $102, D) Don’t know; Inflation question: Imagine that the interest rate on your savings account is 1% per year, and inflation is 2% per year. After one year, would you be able to buy: A) More than today, B) Exactly the same as today, C) Less than today, D) Don’t know; Risk diversification question: Do you think the following

statement is true or false? “Buying a single company’s stock usually provides a safer return than a stock mutual fund.” A) True, B) False, C) Don’t know.

7.

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8.

Lusardi, A. and Mitchell, O.S (2008), “Planning and Financial Literacy: How Do Women Fare?” *American Economic Review*, Vol. 98, No 2, pp. 413-417, May. See also Hasler, A. and Lusardi, A. (2017), *The Gender Gap in Financial Literacy: A Global Perspective*, Global Financial Literacy Excellence Centre.

9.

Atkinson, A. and Messy, F.-A. (2012), “Measuring Financial Literacy: Results of the OECD / International Network on Financial Education (INFE) Pilot Study”, *OECD Working Papers on Finance, Insurance and Private Pensions*, No 15, OECD Publishing.

10.

Most of the results presented in this speech are descriptive without establishing causal relationships. Causal evidence is provided in some of the given references.

11.

Economists, including those at central banks, are increasingly using heterogenous agent (HANK) models, moving away from the representative agent assumption. Some findings discussed in the speech, such as the low responsiveness of some agents to interest rates, can be explained in such models.

12.

Baldassarri, L. Georgarakos, D., Kenny, G. and Meyer, J. (2024), “Monetary policy transmission to households: The importance of consumers’ attention to interest rates and financial literacy”, VoxEU, 26 September.

13.

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15.

Bauer, M.D., Bernanke, B.S. and Milstein, E. (2023), “Risk Appetite and the Risk-Taking Channel of Monetary Policy”, *Journal of Economic Perspectives,* Vol. 37, No 1, Winter, pp. 77-100. See also Borio, C. and Zhu, H. (2012), “Capital regulation, risk-taking and monetary policy: A missing link in the transmission mechanism?”, *Journal of Financial Stability*, Vol. 8, Issue 4, pp. 236-251.

16.

Melcangi, D. and Sterk, V. (2024), “Stock Market Participation, Inequality, and Monetary Policy”, *The Review of Economic Studies,* June.

17.

Christelis, D., Georgarakos, D., Jappelli, T. and Kenny, G. (2024), “Consumer risk-taking and stock market investment: Insights using the CES’s consumer finance module”, *Research Bulletin*, No 119, European Central Bank, May. See also van Rooij, M., Lusardi, A. and Alessie, R. (2011), “Financial literacy and stock market participation”, *Journal of Financial Economics*, Vol. 101, Issue 2, pp. 449-472.

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Cloyne, J., Ferreira, C. and Surico, P. (2020), “Monetary Policy when Households have Debt: New Evidence on the Transmission Mechanism”, *The Review of Economic Studies*, Vol. 87, Issue 1, pp. 102-129.

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Filip, M.-D., Momferatou, D. and Parraga-Rodriguez, S. (2025), “Why a more competitive economy matters for monetary policy”, *The ECB Blog*, ECB, 11 February.

20.

Melcangi, D. and Sterk, V. (2024), op. cit.

21.

On the downside, this channel can also encourage excessive risk-taking, thereby endangering financial stability. Even financially literate households may not be immune to irrational exuberance, fuelling financial bubbles.

22.

The build-up of precautionary savings may also be beneficial for financial stability. See Lusardi, A., Schneider, D. and Tufano, P. (2011), “Financially Fragile Households: Evidence and Implications,” *Brookings Papers on Economic Activity*, Economic Studies Program, The Brookings Institution, Vol. 42(1), Spring, pp. 83-150.

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McMahon, M. and Naylor, M. (2023), “Getting through: communicating complex information”, Bank of England Staff Working Paper No. 1047. See also Reis, R. (2023), “Four mistakes in the use of measures of expected inflation”, *AEA Papers and Proceedings*, Vol. 113, pp. 47–51.

24.

See Chapter 2 of the IMF’s October 2023 World Economic Outlook. Similar results for the relevance of inflation expectations for aggregate demand and inflation dynamics had been found for the low inflation period preceding the COVID-19 pandemic. An exogenous increase in the inflation expectations of households from below target levels leads to increased consumption and ultimately to higher inflation. Households expecting stable prices have a lower propensity to buy durable goods than those expecting positive inflation. See Coibion, O., Gorodnichenko, Y., Kumar, S. and Pedemonte, M. (2020), “Inflation expectations as a policy tool?”, *Journal of International Economics*, Vol. 124, May. See also Andrade, P., Gautier, E. and Mengus, E. (2023), “What matters in households’ inflation expectations?”, *Journal of Monetary Economics*, Vol. 138, September, pp. 50-68.

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Bruine de Bruin, W., van der Klaauw, W., Downs, J.S., Fischhoff, B., Topa, G. and Armantier, O. (2010), "Expectations of Inflation: The Role of Demographic Variables, Expectation Formation, and Financial Literacy", *The Journal of Consumer Affairs,* Vol. 44, No 2, pp. 381-402. See also Burke, M.A. and Manz, M. (2014), "Economic Literacy and Inflation Expectations: Evidence from a Laboratory Experiment", *Journal of Money, Credit and Banking*, Vol. 46, No 7, pp. 1421-1456, October.

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36.

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38.

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39.

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