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Economic Development and Financial Literacy

Remarks by

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Chairman

Board of Governors of the Federal Reserve System

at the

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The Greenlining Institute

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It's a pleasure to participate in your annual summit on economic development. Given the nature of the conference, I would like to focus on a matter of mutual interest--improvements in asset accumulation in traditionally underserved markets of our household and business sectors and the importance of access to the financing and information tools that promote and sustain this progress.

In our economy, the three principal means for household asset accumulation are through home ownership, small business ownership, and savings. As important as these are for the individual, they also represent distinct and important benefits to the broader economy and, therefore, play prominent roles in the operation of our financial markets and the priorities of our public policy.

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The choice to buy a home is a decision to plant a family's roots in a community with all the implicit incentives to make that community thrive. Where home ownership flourishes, it is no surprise to find increased neighborhood stability, more civic-minded residents, better school systems, and reduced crime rates.

Just as important is the effect of home ownership on a household's ability to accumulate assets. For most households, home ownership represents a significant financial milestone and is an important vehicle for ongoing savings. The Federal Reserve's 1998 triennial Survey of Consumer Finances indicates that home ownership represented 44 percent of gross assets for families earning $50,000 or less annually. Further, investment in residential property has been generally more stable than other types of investment, and it is perceived to be largely permanent.

With these important benefits, an increased rate of home ownership has been chosen by our society as a national priority, with many public- and private-sector resources devoted to achieving this goal. Indeed, measurable progress has been made toward this end, with the overall rate of home ownership reaching 68 percent, a new high, in the third quarter of last year. In assessing the opportunity for home ownership in underserved markets, the Census Bureau reports significant gains. The homeownership rate for blacks and Hispanics, between 1997 and 2001, grew at more than double the pace for the general population. Additionally, the homeownership rate among households earning less than the median income increased more than three times the pace for households with incomes above the median.

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Small business accounts for about half of private gross domestic product in our economy. It is an important vehicle for significant numbers of minority families to accumulate assets.

Recently released data from the Census Bureau, for example, indicate that, between 1992 and 1997, the number of minority-owned businesses grew more than four times as fast as the number of U.S. firms overall, increasing from 2.1 million to about 2.8 million. In addition, the Census Bureau estimates that during this five-year period the number of women-owned businesses increased 16 percent, to 5.4 million enterprises.

These data suggest that the increases in small business ownership and equity investment by traditionally underserved populations result, in part, from increased access to appropriate financing to fund the start-up and growth of businesses. It is essential that the opportunity to start an enterprise is open to anyone with a viable business concept. We must continue to seek ways to promote the creation and expansion of viable firms by lowering barriers to funding and financial services.

To the extent that market participants discriminate--consciously or, more insidiously, unconsciously--capital does not flow to its most profitable uses, and the distribution of output is distorted. In the end, costs are higher, less real output is produced, and national wealth accumulation is slowed. By removing the non-economic distortions that arise as a result of discrimination, we can generate higher returns to human capital and other productive resources. Investors and lenders need to understand that failure to recognize the profitable opportunities represented by minority enterprises not only harms these firms, it harms the lending institutions as well. Accordingly, we must make further progress in establishing business relationships between the financial services sector and the rapidly growing number of minority- and women-owned businesses.

Doing so is crucial since pursuing the obviously worthwhile goal of increasing home ownership in minority communities also increases the debt of homeowners in these communities. Debt cannot indefinitely be pyramided against home equity as the principal or sole asset. Developing non-home equity, largely through small-business ownership, not only enhances home ownership among business owners in minority communities, it more importantly offers a source of risk capital to budding entrepreneurs in that community.

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Household saving, of course, is a fundamental component for increasing financial capacity and serves as a starting point for the accumulation of future tangible assets, such as homes and businesses. It is also a source of funding for education, which can materially improve future earning capacity. In the 1998 Survey of Consumer Finances, the top three reasons for saving given by respondents were retirement, liquidity, and education. These survey data, once again, exhibit positive trends among lower-income and minority populations.

Some progress is being made regarding the ownership of financial assets by families in the bottom quintile of net worth and by those who are nonwhite or Hispanic. In addition, survey respondents in these two categories experienced the largest increases in the ownership of transaction accounts, an important indicator of financial progress because the accounts often serve as the point of entry into the financial services industry. Despite these gains, however, lower-income and minority families continue to represent a large fraction of families that do not possess a checking account or, for that matter, other assets.

Sparse holdings of financial assets may, in part, be due to lack of access to savings vehicles such as individual retirement accounts and 401(k) retirement plans. Recognizing this possible link, community organizations have collaborated with their partners in government and the private sector to design innovative mechanisms for saving. One such vehicle is the individual development account, which state and federal government agencies have embraced as a means for facilitating saving for low-income households. Through tax benefits and matching funds, this instrument helps individuals earmark funds to achieve longer-term financial goals, such as purchasing a home, starting a business, or pursuing higher education or job training. Besides providing a structured account that offers a high incentive to save, individual development account programs require participation in financial training to help individuals continue on the path of economic betterment.

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Structural changes in the financial services industry, in recent years, have heightened competition, encouraging market efficiencies that continue to help drive down costs and to foster the emergence of increasingly diverse and highly specialized organizations. These organizations--which range from firms that offer their services through electronic delivery mechanisms to local partnerships that provide one-on-one counseling and financing arrangements--provide consumers with increased access to various credit and savings instruments.

Community-based organizations have contributed in this evolving marketplace by helping to ensure that traditionally underserved populations and geographic areas are able to achieve gains in asset accumulation. And, as in the broader economy, market-driven innovation has advanced community development, enabling community-based organizations to more effectively respond to the needs of the communities and families they serve. Community development organizations working in partnership with financial corporations and governments have created new intermediaries--community development corporations, micro-business loan funds, and multibank and investor loan pools, among them--to provide financial opportunity for lower-income individuals and families. These innovators have succeeded in developing new approaches for engaging disadvantaged participants in the economy in the same manner that any successful organization does--by assessing need, evaluating risks, managing costs, and developing appropriate products.

Educational and training programs may be the most critical service offered by community-based organizations to enhance the ability of lower-income households to accumulate assets. Indeed, analysts have shown that a comprehensive understanding of basic principles of budgeting and saving, at the start, increases household wealth in later years.

Education can also increase economic opportunity by enabling individuals to overcome their reluctance or inability to take full advantage of technological advances and product innovation. As market forces continue to expand the range of financial services, consumers will have more choice and flexibility in how they manage their finances, and they will seek instruction in the use of the new technologies to help formulate better decisions. Financial education can equip consumers with the fundamental knowledge required to choose among the myriad of products and providers in the financial services industry. It can also help to inculcate individuals with the financial knowledge necessary to create household budgets, initiate savings plans, and make strategic investment decisions. Such financial planning can help families meet near-term obligations and maximize their longer-term well being and is especially valuable for populations that have traditionally been underserved by our financial system.

Community-based organizations have an integral role in disseminating information that can assist lower-income families in exploiting financial opportunity. Because of their local focus, these organizations can develop educational and training programs tailored to the markets they serve. Through homeownership counseling programs, they offer families information that is fundamental to obtaining and maintaining mortgage credit. (A recent study conducted by one of the leading purchasers of home mortgages found that homeownership counseling can effectively reduce delinquency rates by as much as a third.) Community organizations are also using financial literacy campaigns to help prevent vulnerable consumers from becoming entangled in financially devastating credit arrangements. The campaigns are important in addressing abusive lending practices that target specific neighborhoods or vulnerable segments of the population and can result in unaffordable payments, equity stripping, and foreclosure.

Similarly, training programs for microenterprise development provide information on the fundamentals of starting a business, such as developing a business plan and financial statements, that allow lenders and investors to evaluate risk.

Community groups are not alone in the effort to provide life-long financial education. Some school systems have introduced financial management curricula, and some employers have taken up the challenge. At the Federal Reserve Board, for example, our Consumer and Community Affairs staff recently hosted several well-attended educational programs for Federal Reserve employees, providing information on qualifying for a mortgage and managing debt. The Community Affairs and Public Information offices at the twelve Federal Reserve Banks also have joined together, with the strong support of Governor Gramlich, to promote both local and national financial literacy and economic education programs.

The Community Affairs Offices help financial institutions, community organizations, and local governments increase economic opportunity in distressed neighborhoods through strategic partnerships. The offices provide information on innovative funding strategies for community economic development. And they seek new ways of measuring the effectiveness of financial literacy programs. In our call for papers for the Community Affairs Research Conference scheduled for the spring of 2003, we have asked for studies that evaluate the effect of such education initiatives. Measurement of the quality and long-term success of these efforts will be particularly useful to the Federal Reserve System as we develop and distribute financial and economic literacy products.

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In conclusion, I encourage community groups such as those represented here to continue productive partnerships and activities that have yielded much progress in increasing the assets of their constituencies. With your continued commitment and market-driven product innovation, the prospect for increased economic opportunity for traditionally underserved markets remains promising.