Unit 3 Lesson 18

Credit Management

Introduction

Economics Credit transactions are important to buyers and sellers. Sellers usually are not concerned about whether buyers use ready cash or borrowed money to pay for goods or services. Buyers need to be concerned about credit, however, because borrowed money is costly, and the costs vary depending upon the type of credit instrument used.

Reasoning Credit enables consumers to "buy now and pay later." It is a popular option. According to the Federal Reserve System, as of December 2023, consumer debt in the United States totaled about $17.5 trillion. That is a large sum, obviously, but by itself it does not mean that buying on credit is a bad thing. For some consumers in some cases, the advantages of the credit option outweigh the added costs. For others, however, the decision to buy on credit is shortsighted. Consumers who understand various credit instruments and the real costs that come with them are more likely to use credit well and avoid shortsighted decisions.

Concepts

- Choice
- Debt
- Economic wants
- Income
- Interest
- Secured debt
- Unsecured debt

Objectives

Students will:

1. Include the cost of credit in weighing the expected costs and benefits of a purchase.
2. Calculate and use the real interest rate in determining the cost of credit.
3. Identify possible credit alternatives for use in purchasing goods and services.
4. Integrate short- and long-term perspectives and goals in credit purchase decisions.
5. Appreciate the benefits of financial freedom.

Content Standards

- Effective decision making requires comparing the additional costs of alternatives with the additional benefits. Most choices involve doing a little more or a little less of something; few choices are all-or-nothing decisions. (NCEE Content Standard 2)
- People respond predictably to positive and negative incentives. (NCEE Content Standard 4)
- Prices send signals and provide incentives to buyers and sellers. When supply or demand changes, market prices adjust, affecting incentives. (NCEE Content Standard 8)
- Money makes it easier to trade, borrow, save, invest, and compare the value of goods and services. (NCEE Content Standard 11)

Lesson Description

This lesson is designed to help students make good consumer-credit decisions. Although using credit is beneficial at times, it often carries higher costs than many people realize. This lesson discusses the costs of credit in a manner that helps students calculate those costs and integrate them in short- and long-term decisions.

Time required: 60 minutes

Materials

- Visuals 1, 2, and 3
- Activity 1

Procedure

1. Tell the students that the main purpose of this lesson is to help them think clearly and act prudently when they use credit. Display Visual 1, but reveal only the words *advantages* and *disadvantages*. Tell the students that you want to discuss their thoughts about buying goods and services on credit. (Credit in this exercise includes borrowing money with collateral [i.e., secured credit, such as a car loan] or using credit cards [i.e., unsecured credit].) After noting the students' comments, reveal and discuss all the points on Visual 1.
2. Display Visual 2. Ask the students to comment on the information it provides. Discuss their responses.
3. Remind the students that people who make good choices attempt to weigh the expected costs of a decision against expected benefits. Consumer choices regarding credit should include consideration of the cost of credit. Tell the students that they are about to make recommendations to various people as to whether they should buy a desired good or service now, wait and buy it later, or not buy it at all.

4. Refer the students to Activity 1. It describes three people making purchasing decisions. Each student's task is to identify the costs and benefits of the listed alternatives and to make a recommendation. Once individual students have completed the activity, direct them to pair up with a neighbor and discuss each other's recommendations. Have each pair answer one basic credit-management question: When is the use of credit an appropriate way to pay for a purchase? Discuss the teams' answers.

   (The general answer is a simple one. Credit is appropriate when the expected costs are less than the expected benefits. Reinforce the idea that using credit provides both benefits and costs. Decisions about the costs and benefits involved should include a time frame that includes the longer term.)

Possible answers to Activity 1:

Case One

Katie has a difficult choice to make. As is so often the case, the benefits of looking good don't come without costs. Even at 50 percent off, the skirt will cost $137.50. This translates into $62.50 coming out of Katie's savings. Remember that she is saving for college — the source, potentially, of a huge long-term benefit. If Katie opens a credit-card account at the store, she will reduce her out-of-pocket expenditure to $123.75 minus $75.00, or $48.75. She would have to pay this amount out of her savings when the bill arrives — or pay a minimum payment plus an interest charge. The usual 5 percent minimum payment or $10 (whichever is larger) would mean that next month she will have a 68 cent interest charge. If she misses the payment deadline, she will also incur a $35 late fee.

Case Two

Willie's situation would probably be familiar to many new college graduates. Being close to graduation is very much like being graduated, and few college grads believe they will fail to find employment. Walking away from the situation would certainly solve the money issue for the moment, but remember that Willie expects to buy a car very soon anyway. If he waits, he might forfeit a good deal and have to pay more later. If he buys the expensive Honda, he gains the benefits of the rebate and will have a smaller out-of-pocket cost in the long run. A major issue is whether he will get a job that pays enough to cover the new car — plus his student loans and his basic living expenses. The more expensive car's real cost is calculated by subtracting the rebate of $2,500 and the $500 discount (leaving $26,500) and adding 6 percent, or $1,590, plus an average $150 license fee. The total is $28,240. The cheaper car would cost $20,661. Note that these figures do not include effects related to the duration of the loan selected. Real interest needs to be considered as a benefit, since inflation allows purchasers to use cheaper dollars in paying off their debts. The real interest rate for the first year of the 48-month contract is –1.1 percent; for the 60-month contract it is +3.9 percent.

Case Three

With a new child, Mr. and Mrs. Jones will find it very helpful to have a washer and dryer. But the new child also will cause a reduction in income for a period of time. If Mrs. Jones goes back to work outside the home, child-care expenses will add to the financial burden. If Mr. and Mrs. Jones buy the $579 combo, their first payment will be approximately $29; after that they will pay 21 percent interest on the unpaid balance. The first payment on the $849 combo will be approximately $43, and the interest rate on the unpaid balance will be 21 percent. The extended warranty may reduce future repair costs, but that is an unknown. The silver service sounds like a nice extra, but Mr. and Mrs. Jones need to decide whether they would ever really use it.

5. Display Visual 3. Discuss each of the guidelines. Ask the students to look back at the recommendations they made in Activity 1. In arriving at those recommendations, did they use some or all of these guidelines? Will they be able to use the guidelines in future decisions of their own? Why or why not?

CLOSURE

Assign the students the task of describing the personal benefits associated with achieving financial freedom. Television advertisements, talk-show topics, and magazine articles often address the problems caused by using too much borrowed money. These discussions refer to objective problems that may follow from the overuse of credit, such as losing one's home or car, and to less tangible problems including the embarrassment or emotional trauma that sometimes accompanies steep debt or bankruptcy. Financial freedom can help people to avoid such problems. But what is financial freedom? Is it simply being rich? Students should consider their own understanding of the concept; they also should seek other people's opinions about it and do additional research about the benefits of using credit wisely or being free of debt altogether. Then the students should write a one-page essay describing how it feels to be in a good financial position.

(The purpose of this essay is to help young people grasp the point that financial self-restraint — including not buying, in some cases, and thus not going into debt — does have advantages.)

Multiple-Choice Questions

(correct answers shown in bold)

1. People should avoid buying too many goods or services on credit because:

   A. High interest charges increase the item's price.

   B. Credit-card debt reduces discretionary income levels.

   C. High credit use reduces one's opportunity to get an automobile or home loan.

   D. All of the above.

2. Current information about the use of credit suggests that:

   A. People are beginning to reduce their use of credit.

   B. Many people actually have a negative savings rate.

   C. Credit delinquency rates are falling.

   D. American Express holds the largest consumer debt.

3. People who use credit wisely will borrow money to:

   A. Deal with an emergency.

   B. Take advantage of a very low price on an item they plan to buy in the very near future.

   C. Take advantage of a low interest rate in comparison to price-level changes.

   D. All of the above.

Essay Question

Write a two-part answer describing, first, a situation in which it would be a sound economic decision to use a credit-card loan at a 15 percent interest rate, and, second, a situation in which using a credit-card loan at a 15 percent interest rate would be a poor economic decision.

(Using a credit-card loan in an emergency — perhaps to handle an unexpected car repair — is probably a good economic decision. Using a credit card loan to purchase frivolous items — soda and chips for a party — or for impulse purchases is probably not a good economic decision.)

Unit 3, Lesson 18
Visual 1

WHY USE CREDIT?

ADVANTAGES

- Use a good or service today and pay for it later.
- Acquire assets such as a college education or a home.
- Help with an emergency.
- Take advantage of a unique opportunity to buy.
- Pay back with cheaper dollars in a time of inflation.

DISADVANTAGES

- Loans have to be repaid with interest.
- Convenient credit might encourage impulse buying.
- People may use too much credit in relationship to their income.
- Poor credit use can harm credit ratings and make credit more expensive in the future.

Unit 3, Lesson 18
Visual 2

Consumer Credit Information

The following information about consumer credit will help people to make better decisions regarding its use:

- Credit cards enable people to obtain instant loans from banks, gasoline companies, department stores, and other retail businesses.
- Most credit cards come with limits as to how much a person can borrow.
- Most credit cards allow for cash advances, and most charge a fee (*up to 4 percent*) for cash advances.
- Interest charges on credit-card debt can be as high as 36 percent.
- The owner of a credit card is liable for up to $50 for unauthorized charges.
- Credit cards are usually valid for a period of 12 to 36 months.
- Most credit cards offer unsecured loans; the issuer relies on the credit user's promise to pay.
- Affinity cards connect credit-card use to special benefits such as frequent-flyer miles or automobile discounts.
- The real interest rate being charged credit users is the posted rate minus the inflation rate.
- The average delinquency rate for credit-card debt is on the rise.
- According to a recent issue of *U.S. News and World Report*, the typical American has an average of four credit cards and owes credit-card balances of approximately $8,000.
- Most Americans save very little, if any, of their disposable income.

Unit 3, Lesson 18
Visual 3

CONSUMER CREDIT GUIDELINES

- Don't think you will save money by borrowing more.
- Don't impulse buy.
- Pay off high-interest credit-card balances.
- Start an emergency fund savings plan.
- Avoid joint obligations with people who have questionable spending habits.
- Charge only those items you can reasonably afford with your basic income.
- Create a realistic budget and stick to it.
- Find alternatives to spending money.
- Realize that the over-spending culprit is YOU.
- Calculate the cost of using credit before you decide to buy.
- Ask: "Can I pay for this credit purchase if I lose my job?"
- Ask: "What will happen if I don't make my credit payment on time?"
- Ask in each case: "All things considered, do the expected benefits from a credit purchase outweigh the costs?"