# Topic 7

## The economic impact of personal financial choices

### Learning outcomes

After studying this topic, you will be able to:

- describe how good personal financial choices affect society; and
- explain how poor personal financial choices affect society.

### Introduction

Personal financial choices are a major part of everyone's life. In Topic 6, we saw how the spending and saving decisions that we make affect the economy, and in Topic 2, we saw how the national economy affects our own financial decisions. By the end of this topic, you will understand what good and poor financial decisions are, and the ways in which they affect society as a whole.

You may think that if you cannot pay your debts, for example, it affects only you and your family. In this topic, you will see that your choices affect different groups in society, as well as the economy as a whole. The idea that changes in one area of society affect changes in another is called 'interdependency'. When a lot of people make a particular financial decision, it can affect the economy. For example, if a lot of people decide that they want to buy a house, the price of houses will increase; if a lot of people decide to save money instead of spend it, then the profits of some businesses will fall and they may have to make staff redundant because they cannot afford to pay them.

### Did you know?

#### UK debt statistics

The Money Charity (2016) has published the following statistics.

**Table 7.1 Debt in the UK, 2016**

| | |
|---|---|
| £1.516 trillion | Total UK personal debt (Written out in full, this number is £1,516,000,000,000) |
| £56,153 | Average household debt, including mortgages |
| £3,821 | Average consumer credit borrowing per adult |
| £8.7 million | Value of loans written off every day by banks and building societies (These loans will never be repaid and are known as 'bad debts'.) |
| Every one hour and 34 minutes | Frequency with which a property with a home loan is repossessed (This means that the loan provider takes the property to sell so it can get some of its money back. The family that lived in the home must leave.) |

Managing your money is an important life skill.

Looking at these statistics, we can see how much debt is held by people (rather than companies) in the UK. This huge amount of personal debt is not a problem for the economy unless people are unable to repay it. These statistics show that loans which won't be repaid take £8.7 million out of the economy every day. This adds up to £2.88 billion in a year. Because the borrowers cannot repay this money, the banks have to use their own reserve money to replace it (because savers will want to withdraw their money at some point), which reduces their profits. The banks also lose money when people cannot repay their home loans.

As a result, banks cannot lend other people as much money as they could if all borrowers were to repay what they owe. So the amount of money that could be spent in the economy is reduced.

Personal finance is how you use your money – ie what you earn, and how you decide to spend and save it. This is known as ‘money management’. Being able to manage your money well is a responsibility, like those discussed in Topic 1. While we have the right to work and earn money in order to have a decent standard of living, we also have the responsibility to ensure that we use our money well. For many people, this means only borrowing what you can afford to repay and saving money for the future.

Managing your money effectively and making financial choices that help you to make the most of your money are the cornerstones of living well. We rely on money to help us to live a fulfilling life, and we benefit from putting money aside for the future or for emergencies. Having emergency money can give us peace of mind – knowing that, when times get tough, we will be able to pay our own way, at least for a while.

### Did you know?

According to Aviva’s *Family Finances Report* (Aviva, 2016), the typical UK family has savings of £3,150, although 25% of families save nothing at all.

Good money management entails many things. It means borrowing to buy items that will help us to reduce our living costs (such as a washing machine so that we don't have to buy new clothes all the time) and / or which are likely to increase in value (such as our own home), and being able to repay our debts on time. It means saving money to pay for goods and services in the future, and paying into a private pension so that we have more than only State Pension on which to live when we retire. It also means protecting our possessions, by buying insurance that replaces goods that are damaged by accident or stolen. Good money management also means planning for the future, while still living comfortably in the present (which we explore in more detail in Topic 11).

Poor financial choices are the opposite of these. Poor financial choices involve high risk and instability, leaving people without the means to survive when they run into difficulties, and with little or no security in old age. This, in turn, affects the economy as a whole, because these people will need help from the benefits system.

## Case study: Richard Baker's financial past

**Richard**

As soon as I got my first full-time job, I also got my first credit card. I bought whatever I wanted with it – clothes, video games, nights out and a watch. Before I knew it, I had a debt of £2,000. I could only afford to repay £100 a month. Even though I borrowed no more money on the credit card, it took me more than two years to repay that debt. The interest rate was 19% a year and I ended up paying £383 in interest charges.

Everyone I know has to borrow money to buy a car or to buy a home, so debt itself isn't a bad thing. But being unable to repay a debt is a worry, so now I make sure I can afford the repayments before I borrow.

## 7.1 Money management

How individuals manage their money is closely connected to the economic system as a whole. Both good and poor personal financial choices have particular effects on the economy and society.

✔ The main effects of good financial choices are:

- less 'bad debt' in the economy;
- less borrowing overall; and
- increased spending and increased saving, because when people borrow less, they repay less from their earnings.

This means that businesses make profits and the government has money to spend on services, because businesses and employees are paying taxes. Further, when people are feeling more secure about their future, they are more likely to spend their money rather than save it for an emergency. The movement of money around the system means both that fewer people are dependent on the state and that the government is able to afford to help those who need it.

✘ Poor financial decisions, on the other hand, can have the opposite effect:

- increased amounts of personal debt that cannot be repaid;
- more high-risk borrowing (ie borrowing money that has high levels of interest or which cannot be paid back); and
- less saving and less spending (because people use more of their earnings to repay expensive debt).

All of this leads to a less stable economy.

It is therefore important to examine what money management is, and the wider social and economic impacts of good and poor financial decision-making.

## Did you know?

### Debt can affect everyone

According to StepChange Debt Charity (2014), people who are working can have problems with debt. More than half of the people who contact the charity for help with debt are employed.

In order to understand the ways in which our personal financial choices affect the economy, it is necessary first to understand the idea of money management. 'Money management' refers to how we decide what to do with our money. Good money management involves being financially capable. One tool that we can use to manage our money is a budget (see Topic 2 in this unit and Unit 2, Topic 4). However, this is only one strategy for financial planning.

We all have particular needs and wants.

- Our **needs** are the things that are essential to our survival – food, water, shelter, clothing and warmth.
- Our **wants** are all of the things that we would like to have, but which are not essential to our survival – such as a car or telephone.

Some people might argue that, in our modern era, things such as transport and communication are essential to living. However, they are still not strictly necessary for us to stay alive.

When deciding what to do with our money, meeting our needs will usually come first. People try to make sure that they have food, somewhere to live and clean water, for example, before buying other items.

## Discuss

### Needs and wants

Some clothes are needs, because we must wear them to keep warm and dry. Other clothes, such as going-out clothes, are wants.

What do you think are the clothes that someone of your age, living where you live, needs? (Assume that your clothes are washed once a week.)

### 7.1.1 Individual decisions

There is no one correct way to manage money, because we all have different circumstances and attitudes. How each of us decides to manage our money depends on five areas: our goals, values, responsibilities, priorities and financial constraints. Each of these areas influences what we choose to do with our money.

We might first consider our goals in life. Some goals will require a certain amount of saving and planning for the future. For example, if one of your goals is to own your own home, then you will have to make particular financial decisions if that is to happen: you will have to save enough money for a deposit and then find a mortgage (house loan) that you can pay off over a period of time.

In addition, you might have short-term, medium-term and long-term goals that will affect how you manage your money. The extent to which you can achieve these goals might be affected by particular financial constraints, such as the size of your income or the amount that you have to put aside for expenses. This makes prioritising necessary. You may have to decide which of your goals are more important and make a trade-off – ie you might have to give up one thing to be able to afford something else.

#### Case study: Jacob's long-term goals

**Jacob**

I've been going out with my partner for a couple of years now, and one day we'd like to get married. We've also talked about buying a flat once we finish university, but we want to take a holiday first to celebrate our graduation. I still have a couple of years before I finish university and I'm not currently earning much money from my part-time job as a waiter.

I need to make a decision about what to do with my money, so I want to prioritise putting money aside for a deposit on a flat, because the other two goals can be adjusted slightly – you know, I can make a trade-off by having a cheaper holiday and wedding. I will, of course, have to talk about the impact of that trade-off with my partner!

You can easily see how your financial decisions can be affected by your priorities and the amount of money that you have available to you – but they can also be affected by other people in your life and what their priorities are. The values that you hold will also strongly affect your goals and priorities, and how you manage your money (as we saw in some detail in Topic 2).

If Jacob's partner were Muslim, for example, some of the couple's plans may change as a result of particular rules in Islam that guide how money should be used.

## Did you know?

### Islam and money management

Sharia (or Islamic) law explicitly forbids making money from money, so a Muslim cannot charge or pay interest. These values affect the ways in which Muslims manage their money, because they will not borrow money on which interest is charged and they do not want to get into debt. This has created a rise in Islamic banks, which offer particular types of loans.

Moreover, because one of the five 'pillars' of Islam is giving to charity, Muslims have particular responsibilities to consider charitable donations as a part of their financial planning.

## 7.1.2 The cumulative effect

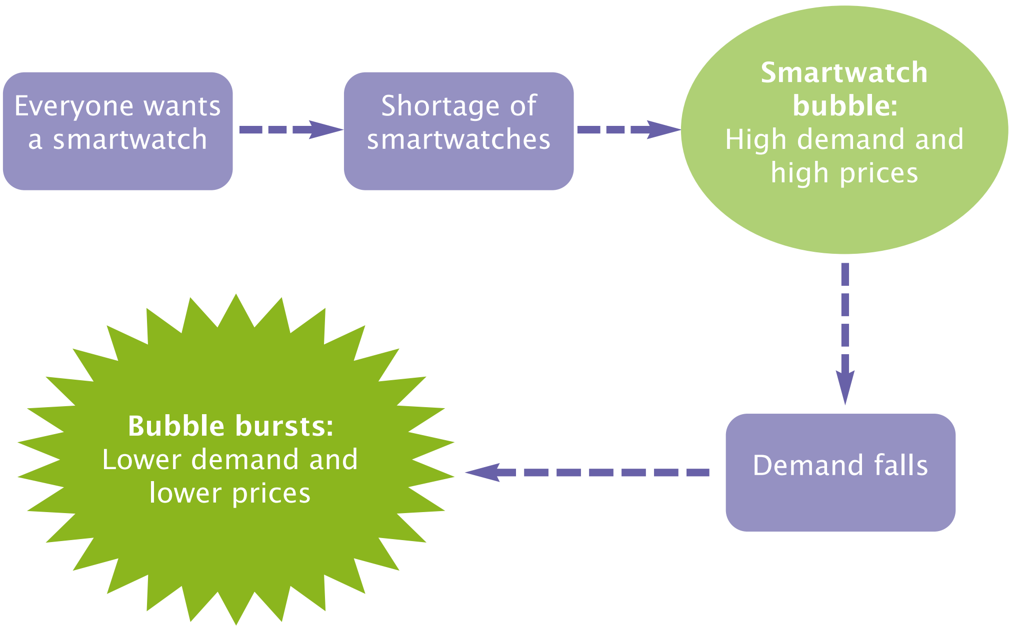
Individual decisions that are not necessarily positive or negative may have a cumulative effect. This means that there may be unintended consequences as a result of many people taking the same decision.

For example, suppose that everyone suddenly decides to buy a 'smartwatch'. The shops sell all of their stock and the number of smartwatches still available to buy in the market reduces. This leads to shortage of supply, compared with how many people want to buy them. This difference between supply and demand pushes up the price, because people will now be willing to pay more money to get a smartwatch.

These cumulative effects can sometimes result in a 'bubble'. This means that a particular economic condition is created (such as the demand for smartwatches) that will eventually 'burst' (ie people will stop wanting smartwatches) because the prices have become too high. When the bubble of high demand and high prices bursts, demand falls and so do prices, as shown in Figure 7.1.

**Figure 7.1 The cumulative effect in action: A 'smartwatch' bubble**




This may not seem like a huge problem for smartwatch sales, but when you are talking about higher-cost assets such as houses, the drop in prices makes a difference to people wanting to sell and to those wanting to buy. For example, if you were to buy a house for £200,000 and then prices were to fall by 50%, your house would be worth only £100,000. If you then had to sell your house, you would lose a huge amount of money.

The financial decisions that we make take place within a wider social, political and economic context. As we saw in Topic 6, the interdependency that exists between our personal financial choices and the economy means that all of these decisions, and the reasons why we take them, have a significant impact on the economy as a whole. If a person makes good financial choices (see section 7.2), then the impact on the economy and society will be positive, whereas if a person makes poor personal financial choices (section 7.3), the impact on the economy and society is likely to be negative.

## 7.2 Good personal financial choices

Making good personal financial choices means living within your means, borrowing only money that you can afford to repay and putting money aside for emergencies or future needs. The Financial Services Authority (FSA, 2006) – now replaced by the Financial Conduct Authority (FCA) – identified five components of financial capability or good financial management, as follows.

1. **Staying within a budget** – This is sometimes referred to as 'making ends meet' and means that you do not spend more than you get in income.
2. **Keeping track of personal finance** – Also known as 'budgeting', this means knowing how much income you have and how much your expenses are.
3. **Planning ahead** – This could mean saving money for emergencies or putting money aside to ensure that you have a stable income on retirement.
4. **Choosing financial products wisely** – This involves looking at interest rates and understanding the 'small print', ie whether there are any extra fees.
5. **Staying informed about financial matters**.

Abiding by this guidance leads an individual towards good financial choices. These kinds of decisions are not only beneficial for the individual, but also for society. If individuals try to make sure that they borrow only money they can afford to repay, for example, there will be less 'bad debt' in society as a whole.

Bad debt is debt that is never repaid. As we saw at the start of this topic, this is harmful for society because if debt is not repaid, lenders do not receive the money that they need to run their businesses. This has a double effect: because there is less money available to lend to people, those people may have less money to spend in the economy; this could then lead to job losses as businesses shrink, resulting in an economic downturn (as discussed in Topic 2). In addition, if people lose their jobs, they may need to rely on government benefits and will not have any money to spend in the economy. Therefore reduced bad debt may mean that the economy is able to remain stable.

### Discuss

Does the reason for borrowing money make the debt 'good' or 'bad'?

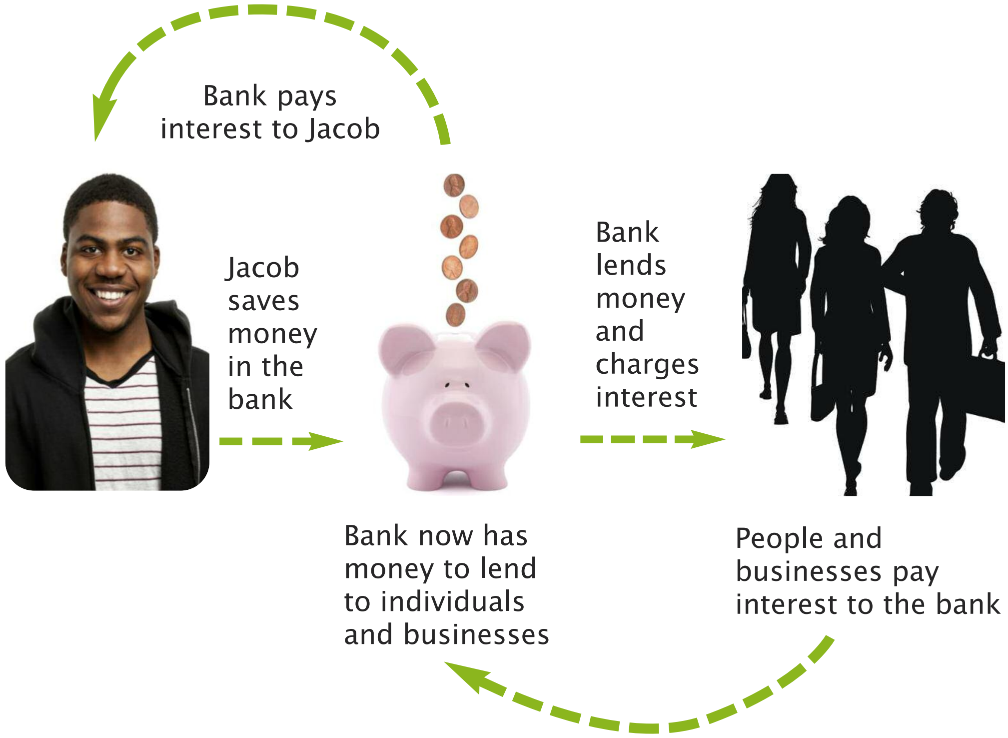
Consider Figure 7.2 on the next page. How do these types of borrowing affect the individual concerned and the economy as a whole?

Figure 7.2 Reasons why people might borrow money


A further probable effect of good personal financial decisions is more responsible spending. This is because people will be managing their money well, so will potentially have the money available to purchase the items that they want (or to prioritise, as discussed in section 7.1). When people are able to spend money, they can help to stimulate the economy by buying goods and services, and thus providing money to businesses. Businesses use that money to pay their employees, who in turn have money available to spend. This cycle was discussed in detail in Topic 6.

Although people may spend more, with good financial decision-making they may also be able to save more. This is illustrated in Figure 7.3.

Figure 7.3 The benefits for the economy of saving




### Interest on savings vs interest on borrowing

Perhaps you have noticed that the amount of interest charged on bank loans is always higher than the amount of interest you get for any savings? This is because the bank's profits are calculated as the amount of interest that the bank charges on its lending minus the interest that it pays to its savers.

The more money that people save in the bank, the more money there will be for others to borrow. As long as people are borrowing only an amount that they can afford to pay back, this means that there will be more money moving around the economy.

## 7.3 Poor personal financial choices

Many of the outcomes of poor personal financial choices are the direct opposite of the results of good personal financial choices. Poor financial choices leave individuals with large debt repayments every month, and less money to use for their wants or needs. Poor financial choices mean that an individual will increasingly be in debt, with little or no ability to pay it back.

## Did you know?

### Her Majesty's Treasury

Individuals are not the only ones who need to budget and to be careful about how much money they borrow; so too do organisations and governments. The Office for Budget Responsibility (OBR) is an official independent body that checks the UK government's official annual Budget.

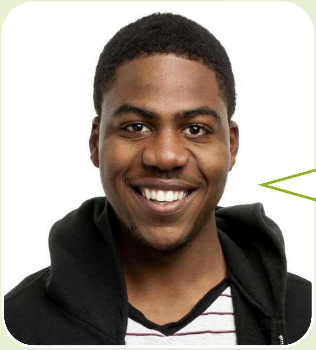
The OBR has five main roles:

- to produce forecasts for the UK economy;
- to evaluate the financial risks in these forecasts;
- to judge the government's performance against the financial targets it sets itself;
- to check HM Treasury's tax and spending figures in the Budget; and
- to report on the long-term sustainability of public finances.

Decisions such as using a credit card to its limit need to be carefully considered, because this type of borrowing attracts a high rate of interest that must be repaid. There is no fun in paying back a loan over many years for something that may give only momentary pleasure. An overdraft facility can also be less useful than it seems: you really have extra money only the first time you use it; after that, you are behind by the overdrawn amount every time you are paid, until you are in a position to pay it back.

Poor financial choices have many effects on the economy and society as a whole. We have discussed the consequences of bad debt on the economy; poor financial choices can also have a significant social impact, in terms of increased stress, health issues, marriage breakdown and even suicide. Although some of these will occur in only the most extreme cases, this illustrates the importance of financial capability to all aspects of life, not only the economy.

## Discuss



**Jacob**

I'm going to buy a new phone. I could buy a phone outright for £250, and use 'pay as you go' deals to pay for my calls, texts and internet usage. Or I could get the same phone on an 18-month contract, paying £23 a month for 600 minutes of calls, unlimited texts and unlimited internet.

Jacob has to decide whether he should pay less for the phone, but have to pay higher phone charges, or pay more for the phone, but pay only for the calls that he makes. Before he makes a decision, he has to consider how much he uses his phone and for what purposes, as well as whether he will be able to make the monthly repayments for an 18-month period.

Which option would you choose and why?

Poor financial choices can also lead to an unstable economy. High levels of personal debt can lead to overspending. Increases in demand for consumer items and large purchases can push up prices, as sellers and businesses try to make more profit from the high levels of demand. These rising prices may lead to a recession, as banks find it difficult to get the large amounts of money needed to meet the high demand for borrowing. This is because overspending means that people are saving less money. (If you look back to Figure 7.3, you can see that if there is no money going into banks, they will not be able to afford to finance loans.)

In Topics 2 and 6, we outlined the economic climate and how the economy works in more detail. As a result of the interdependency of the system, personal financial hardships caused by overborrowing or unexpected expenses – such as a rise in mortgage rates or high interest rates causing increased repayments – can have a negative impact on the whole economy. This is discussed further in Topic 8.

# Summary

Finally, we can recap what we have learned in this topic.

- This topic has explored money management, and the broad social and economic outcomes that are possible through either good or poor personal financial choices.
- A major point is that the economy and our personal finances are interdependent. This means that any changes in one area will affect changes in other areas.
- Topic 2 looked closely at how the economy and political decisions of government can affect our financial decisions. This topic has reinforced some of the underlying factors that are present in our money-management decisions and has also shown that our personal financial choices can affect the workings of the economy.
- Good financial choices are about living within your means and not having levels of debt that you cannot repay. Good money management means that people are financially capable. The financial capability of its citizens is important to a country as a whole.
- Good personal financial choices have a positive impact on the economy, including reduced bad debt, less borrowing overall, an increase in spending and increased savings (because less money is being used on repaying debt), and more money available for the banks to lend and for the government to give to those who need it.
- Poor financial decisions, on the other hand, are heavily linked to high levels of personal debt. The types of issue that lead to spiralling debt are high-interest loans and people taking out loans that they cannot afford to repay. This results in high levels of bad debt, more high-risk borrowing and an unstable economy, built on ever-increasing debt and, ultimately, the threat of recession.

## Thinking points

- What steps do you think banks should take to make sure that borrowers can repay the money that they lend to them?
- What do people save up to buy?
- How do you find a balance between spending now and saving so that you can spend in the future?
- Ask your older relatives about debt. How have attitudes about being in debt changed over the last 40 years or so?

## Key terms

**Bad debt** – debt that can never be paid off.

**Capital** – the money with which a business starts or the original amount of debt taken out.

**Credit** – an arrangement by which you obtain money now that you promise to pay back in the future. (Confusingly, however, a 'credit balance' on a current account means the amount of money that you actually have at a particular time.)

**Credit history** – a person's previous history of debt repayments.

**Debt** – the total amount of money that someone owes at a particular point in time.

**Default** – the situation in which a borrower is unable to repay a debt.

**Financial capability** – an individual's ability to manage their money well.

**Financial Conduct Authority (FCA)** – an agency that regulates financial firms and services.

**High credit risk** – someone who may not be able to repay a loan.

**Interdependency** – the situation in which changes in one area affect changes in another area.

**Money management** – making decisions about using your money.

**Needs** – the things that we require to survive, such as food, water, shelter, warmth and essential clothing.

**Overdraft** – a service provided by banks that allows a person to withdraw more money than they actually have in their bank account. The extra money is borrowed from the bank and must be repaid with interest.

**Payday loan** – a short-term loan offered at a high interest rate that is designed to financially assist someone until they are next paid.

**Trade-off** – the act of giving up something in order to have something else.

**Wants** – the things that we would like to have, but which we do not need to stay alive, such as a car or a mobile phone.

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