

ECONOMICS

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In the school yard of personal finances, watch out for the economic bullies

For many people, economics falls into one of two categories: confusing or boring. Perhaps both!

Think back to your school days and the different groups of kids: the cool kids, the geeky kids... oh yes, and the bullies. Rather than paralleling economics with some of the bullies from my own school days, let's pick a school setting that we're all familiar with. The school is set in the town of Springfield and as we walk down the corridor we hear the words, "Don't have a cow man!"

That's right; you've just met the cheekiest member of The Simpsons family – Bart. If you've spent time in their living room, like a billion other TV viewers, there's a chance you'll also know Bart's best friend Milhouse. He's the gullible, loyal friend whose extreme nearsightedness often leads him into trouble. Milhouse is often the butt of the joke (literally) as wedgies are dished out by the school yard bullies Nelson, Jimbo, and Kearney.

Whether you picture your financial self as a Bart or a Milhouse you're still at risk of being over-powered by the economic version of Nelson, Jimbo and Kearney. Your personal financial success is constantly under pressure from economic

bullies and they'll beat you up if you let them. So who are these bullies and how do you protect yourself from them?



Interest rates

Let's start with the noisiest and most obvious bully, Nelson Muntz. Nelson is well recognised for his infamous and well timed "Ha Ha!" and is a terror

to Bart and Milhouse. In economic terms the most obvious bully is interest rates.

In New Zealand interest rates are managed by the Reserve Bank and are increased and decreased to help to manage the economy. When you see the Reserve Bank on the news it's almost always linked to an announcement about the Official Cash Rate (OCR). The easiest understanding of the OCR is that it is the benchmark that all banks use to set their interest

rates for the public. A more technical explanation is that the OCR is the rate that banks borrow money at, normally over short terms like overnight, to manage their liquidity. When the OCR goes up, mortgage rates go up, when it goes down, mortgage rates go down too.

Recently the only direction interest rates have been heading is up, which impacts most families negatively. But to be honest with you, that's the point the Reserve Bank is trying to achieve.

When mortgage rates go up the loan payments rise accordingly, which takes money out of the pockets of people who have home loans. This gives them less to spend day-to-day, which restricts inflation and the health of the economy is maintained (in the eyes of the Reserve Bank I might add!). So you can see why interest rates can be a "bully" to New Zealand families, with less money to spend on the family's needs.

The problem though, is that many families poke tongues at this bully, teasing him and asking for a beating. How? By borrowing to their absolute limit to buy the dream house they want. This leaves no room in the budget to allow for increased loan payments. As a result, when the mortgage rates do rise, they suffer by sacrificing their lifestyle, or in many cases the necessities of life are foregone so that the house does not get taken off them.

Surely there's a safe way to own a house without having to live in fear of interest rates rising? Of course there is. The problem is not the rate of interest, but rather the rate of repayment. You see, when the home owner borrows to their absolute maximum budget they are forced to pay most of their payments in interest. Not much goes to paying off the loan itself. And, with no room for increased payments, the danger of financial destruction lurks in the shadows.

The key to living safely with mortgage debt is to keep the loan at a manageable level and have a safety net of income if the interest rates do rise. It could be easy for you to repay the loan at an interest rate of 8 per cent, but could you handle payments if the interest rate rose to 12 per cent?



The exchange rate

One bully usually encourages another bully. On The Simpsons, Jimbo Jones is the lanky, long-haired lout with the beanie and black T-shirt. In economic terms let's link this bully to the exchange rate.

A long-haired lout linked with the price of the New Zealand dollar? When partnered with Nelson, Jimbo is worse. So too are the interest

rates linked to the strength of our dollar. When interest rates rise it not only affects the mortgage rates but also the term deposit rates that banks offer to investors. This is great when you have surplus cash to invest. New Zealand, however, is not a country renowned for surplus cash, but many other countries are. When the term deposit rates rise in New Zealand this attracts the attention of many wealthy countries with surplus cash to invest. For example, Japanese investors might only receive 1 per cent interest on their savings in a Japanese bank, but they look at New Zealand and see they can earn 8 per cent and decide that this is the place to invest.

To invest their money here they must buy New Zealand currency. It would be like you going to the foreign exchange shop and changing your twenty dollar note for Aussie money. Well, they do the same thing, but with a huge amount of

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money. With these investors buying large amounts of New Zealand currency it increases the demand and makes our currency more valuable. This increases the strength of the New Zealand dollar. Have you ever seen the news report that the dollar has strengthened against other currencies? Well this is one of the ways that this happens. More demand for our Kiwi dollar sees it grow stronger, with the exchange rate going up.

One of the effects of this is that the goods we import from other countries don't cost us as much. Examples include TVs, cars, clothing and computers – when the exchange rate goes up prices on these items come down. This isn't so great when buyers are falsely enticed into thinking they can afford these items.

You see, the way some bullies work is to entice you into a weak position by giving you a false sense of strength. In the same way cheaper overseas goods have the potential to leave you with a sore head.

If you've planned and saved to buy a new big item, then by all means enjoy taking advantage of the lower price. But spending money on unplanned purchases of a major kind robs families of their financial strength and often leaves them with no reserves. Let me give you two examples of how families can be let themselves be bullied like this.

The Pineapple family go for a walk one Sunday afternoon and see plasma TVs on special. They decide that they can now afford it because it's cheaper, and use all their savings to purchase the TV for cash. Unfortunately the car fails its WOF the following month and needs four new tyres. With no savings, the Pineapple Family are forced to buy the tyres on

credit and pay a high amount of interest. They would have been wiser to set the TV as a goal and save for it, while also allocating funds to an emergency fund.

In the second example the Peach family happen to see a great deal in the junk mail and go quickly to the store to take advantage of it. The big screen LCD TV is not only on special, but it's interest free and there are no payments for 12 months. The Peach family have no immediate need to worry about paying for the privilege. But consequences do arrive. When the request comes for the monthly payments to start there's a small problem. Since the purchase of the TV there has been an interest rate rise and their mortgage payments are now an extra \$200 per month. The extra money the Peach family thought they had is now being sucked up in the mortgage. Suddenly the TV is not looking like it was such a great deal.

Making the mistake of spending future income is very dangerous and should be avoided at all times.

Like the other economic bullies there's no way any of us can control the exchange rates. But we can control our own buying behaviour. If you've been saving up for the item, go ahead and enjoy the better deal. But if you're just being mesmerised by the shiny new toy at a lower price, consider the impact on your financial strength and the reserves you should have stored away. Also remember that the prices are lower because the exchange rate is high, and that's because interest rates are high, which in general means less in our pockets to begin with.



Inflation

Bullies travel in packs. At the beginning I mentioned that Nelson and Jimbo had a friend called Kearney. Kearney Zzyzwicz is an oversized oaf with oversized attitude. He's the big bully with the bald head and the dog collar wristbands, and the only kid at school that shaves! The third bully in our economic pack is inflation.

In New Zealand our government's economic policy is built around measuring and managing inflation to keep it as steady as possible. In the most basic of explanations I would term inflation as the amount that the cost of living increases each year. Have you noticed that a bottle of milk now costs over \$4? And petrol... don't get me started!

Kearney is an oaf and only does what he's told to. In the

same way inflation is merely a measurement and reflection of what we as consumers have been spending in the economic world. The point here is that we can't point the finger at inflation and say it's the problem, when we caused it – that would be like blaming the speeding ticket on the car and not the driver.

When we spend more as a nation, inflation increases. When inflation increases it's a sign that the things we like to buy are getting more expensive. This means it costs us more to have the same level of lifestyle that we are accustomed to. And, just like the speeding ticket, we cause our own pain.

When inflation increases the Reserve Bank notices and tries to keep the economy healthy by managing inflation,

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increasing and decreasing interest rates. In the case of rising inflation, interest rates get pushed up to decrease the excess money we have available in order to try and restrict spending. As a nation we've caused this problem by silly overspending and buying stuff with money we don't have.

Sometimes I wonder if the person being bullied has created the situation. I know that when I was at school I encouraged attention by being cheeky, kind of like a Bart Simpson. And there are certainly plenty of Milhouses that put themselves in the wrong situation time and time again, inviting punishment at the hands of bullies. Just like families that rob their own financial strength with unplanned big ticket items, or who max out their mortgage with no breathing room for interest rate rises.

Whether you picture yourself as a Bart or a Milhouse you're still at risk of being over-powered by the economic version of Nelson, Jimbo and Kearney. In the economic world your personal financial survival and success are constantly under pressure from interest rates, exchange rates and inflation.

If you are being bullied ask yourself if your own choices made it worse. But, more importantly, what decisions are you going to make to protect yourself from being beaten up by these bullies in the future?