WHY ECONOMICS?

CONCEPT #5- FINANCIAL LITERACY

What students should know about economics and why: 6 Key Ideas

#5 The Economics of Financial Decision Making

Financial literacy includes:

- mastery of benefit/cost analysis to facilitate informed decision making.
- development of skills, knowledge, experience and personal characteristics necessary to set and achieve goals
- understanding of one's role in and preparation for successful participation in the 21st century economy
- application of the above to earning, spending, saving, investing , risk management, and money and credit management

Economics provides the analytical tools that allow people to make informed decisions about financial planning and managing money. But, what is money? Many people mistake money for the real thing. For most of us, the real thing is our human capital. Skills, knowledge, experience, and personal characteristics to a large extent, determine the kind of life people can live. Money is simply a tool that allows people to exchange their human capital for the goods and services and saving that they desire. People take their human capital to work, get their paychecks (money), and use that money to buy things and save. Money allows people to exchange resources they own (usually human capital) for goods, services, and saving that they desire. So, in most cases, money is embodied human capital.

Financial literacy requires an understanding of economic principles and their application to personal finance. Three major areas of economics should be applied to personal finance.

The first is benefit/cost analysis. Economics teaches us that we choose because we can't have everything we want and that every choice involves a cost—opportunity cost. Economics provides a method (benefit/cost analysis) that helps organize information for better decision making. Youngsters can use benefit/cost analysis when deciding how much and what type of human capital to acquire. Some students use school as an opportunity to develop their human capital and some don't. Generally speaking, those who do will have greater earning potential than those who do not. Selection of a career – and the training needed for a chosen career - is another major financial decision for students. Once a worker is earning an income, she will make decisions such as how much to save, how much to spend, and how much to give. Should she gain additional human capital? Using the *Pyramid of Risk*, she will decide in what form to keep her saving. What kind of insurance and how much should she buy? What kind of retirement plan should she have? What role will credit play in her purchasing decisions? Should she rent or buy a home? If she buys, what type of mortgage should she get? All of these decisions and more are made more effectively if the decision maker is using benefit/cost analysis and always remembering that every choice has a cost.

The second analytical tool that is essential in making well informed personal finance decisions is supply and demand analysis. If people understand markets, they can make better decisions about purchasing, planning careers, and making credit purchases. They will be able to answer questions such as:

- Why do housing prices differ dramatically in different parts of the country? How much should the housing price differential influence my decision about where to live and work?
- Why do some careers see faster growth and higher earnings? Am I willing to pay the opportunity cost to prepare for and work in those higher paying careers?
- Why are some industries and careers fading away and what does that imply for my future? Have I insulated myself from changes in the labor market?
- Why are credit card rates so much higher than mortgage rates? What do the higher rates tell me about the use of credit cards?
- What determines the value of the dollar against other currencies and what does the value of the dollar mean to me as a buyer of foreign goods, a seller of goods overseas, or a purchaser of foreign stocks and bonds?

Finally, it is impossible to understand the present or plan for the future without an understanding of how our national economy works (macroeconomics.) With this understanding one is better able to consider the following questions:

- How will a looming recession affect my employment outlook and what can I do to prepare for it? This is particularly important for students about to enter the labor force, but also for those most vulnerable to layoffs.
- How will actions of the Federal Reserve affect interest rates and therefore the cost of borrowing money to buy a house or a car or a washer/dryer or refrigerator?
- How will inflation affect the purchasing power of my paycheck? How will deflation affect the value of my mortgage payments?
- How will diversification reduce the risk associated with a fluctuating economy?

Economics is essential to one's ability to manage money and prepare for the future.   With the framework provided by economics, personal finance becomes an organized body of analysis, knowledge, and critical thinking rather than a series of isolated decisions or unrelated facts.

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