

THE CONSUMER IN TODAY'S ECONOMY
FEDERAL RESERVE BANKS OF DALLAS AND KANSAS CITY

TAKING CONFERENCE CONTENT BACK TO THE CLASSROOM

October 2, 2008
Dr. Anne Macy
Gene Edwards Professor of Finance
West Texas A&M University

Scarcity Meets Consumption

- ❑ More demands on our income than we can meet.
- ❑ Forces us to make choices – called budgeting.
- ❑ With each choice, we incur a cost – opportunity cost. What else could we have bought?
- ❑ Time frame: short versus long. Rename this trade-off as present versus future consumption.

Buyer Beware

- ❑ Consumers have to be good present day consumers in order to have enough for future consumption.
- ❑ Finance is in the details.
- ❑ Small amounts add up.
- ❑ Smart savers start as smart buyers.

On The Car Lot

- ❑ Car lot – 97 out of 100 people don't know the price of the vehicles.
- ❑ Edmunds.com has several search engines for finding the prices of used and new cars.
- ❑ Example: show the cost of the navigation system.
 - Ford Escape XLT: base price is \$21,700 but the navigation system is another \$2,600, or 12%.
- ❑ Notice how many options there are for lower priced cars. They add to the price but the vehicle seems cheaper because of the lower starting price.
- ❑ After-market add-ons.

Depreciation

- ▣ Edmunds.com or Kelly Blue Book (www.kbb.com).
- ▣ Compare the prices of a vehicle over time.
- ▣ Ford Escape XLT
 - 2009: \$25,000
 - 2008: \$23,000
 - 2007: \$14,000
 - 2006: \$12,000
 - 2005: \$10,000
- ▣ What happened between 2008 and 2007?
- ▣ What are things you should do before buying a used car?

Car Lot Tricks

- ▣ Video cameras on the lot.
 - Many people go after hours and look at the cars to see the inventory.
 - The salespeople review the tapes in the morning and note who was on the lot and at what cars they looked. They know which cars to steer you towards.
- ▣ Putting the phone on forward.
 - Really they are putting the phone on speaker and going to another office to listen to your conversation.
 - They know what things you like and don't like about the deal.

Trade-ins

- ❑ You usually get a higher price if you sell your old car yourself – called a private party transaction – then with the dealer trade-in.
 - If you sell the used car yourself, people will come to your house. Young women must be careful if they are home alone. Additionally, thieves use this excuse as a way to case your home.
 - Have the dealer price your trade-in to see how much they want your sale.
- ❑ Generally, dealers make more money (\$ and %) on used cars than they do new cars.

Packing

- ❑ True example from Sam Donaldson on Primetime Live.
- ❑ Woman bargained with a car salesman for several hours. Finally, they reached the price of \$19,600. The trade-in value of her old car was \$3,000.
- ❑ The car dealership offered her a loan of 9%, 60 months with a payment of \$407.
- ❑ How was she cheated?

Time Value of Money

Input	Solve for payment	Solve for present value
Future value	\$0	\$0
Payment	? = \$344.59	407
Present value	\$16,600	? = \$19,606.56
Interest per year	9%	9%
Number of payments	60	60
Payments per year	12	12

Packing, 2

- Woman was cheated on the trade-in.
- Various studies have found that over 50% to over 80% of car loans have some type of cheating.
- Because the numbers “look” correct, customer doesn’t see the problem.
- Are men or women more likely to be cheated?
- Can also be packed on the interest rate.

FICO Score and Interest Rate

- www.myfico.com
- Each day the website shows the current interest rate and payment on a loan based on the ranges of the FICO score.
- 36 month car loan of \$25,000:

FICO range	APR	Monthly Payment
720 – 850	6.196%	\$763
690 – 719	7.722%	\$780
660 – 689	8.843%	\$793
620 – 659	11.235%	\$821
590 – 619	14.667%	\$863
500 – 589	15.522%	\$873

Small Amounts Add Up

- \$780 versus \$793 is only \$13. Most people won't quibble over this amount.
- However, over 36 months, the total amount is \$468 (36 times \$13).
- Would you balk at the extra amount on the price of the car?
- So why don't people balk at the extra amount in the loan?

What is a Good Score?

- Median FICO score is 723.
- Anything above 700 is viewed as good.
- A score below 600 indicates high risk and the chance of obtaining a loan is low.
 - The interest rate increases quickly at rates below 600.
- Obtain your free credit report annually.
- But the credit score must be purchased.

What is in a Score?

- **Your payment history – about 35% of a FICO score**
 - Have you paid your credit accounts on time? Late payments, bankruptcies, and other negative items can hurt your credit score, but a solid record of on-time payments helps your score.
- **How much you owe – about 30% of a FICO score**
 - FICO scores look at the amounts you owe on all your accounts, the number of accounts with balances, and how much of your available credit you are using. The more you owe compared to your credit limit, the lower your score will be.
 - Be careful about closing unused accounts. It will lower your available credit without lowering the amount you owe, which will increase the percentage that you owe.

What is in a Score?, 2

- ▣ **Length of your credit history – about 15% of a FICO score**
 - A longer credit history will increase your score. However, you can get a high score with a short credit history if the rest of your credit report shows responsible credit management.
- ▣ **New credit – about 10% of a FICO score**
 - If you have recently applied for or opened new credit accounts, your credit score will weigh this fact against the rest of your credit history.
 - FICO scores distinguish between a search for a single loan and a search for many new credit lines, in part by the length of time over which inquiries occur. If you need a loan, do your rate shopping within a focused period of time, such as 30 days, to avoid lowering your FICO score.

What is in a Score?, 3

- ▣ **Other factors – about 10% of a FICO score**
 - Several minor factors also can influence your score. For example, having a mix of credit types on your credit report – credit cards, installment loans such as a mortgage or auto loan, and personal lines of credit – is normal for people with longer credit histories and can add slightly to their scores.

Others Have Access

- ❑ Other firms can check your score, which can decrease your overall score.
- ❑ Why is there so much activity in your account?
 - Insurance companies.
 - Employers.
 - Your bank. Example – 14 times in one year. Looking to raise rates on loan.
 - Credit card company.

Inflation

- ❑ Inflation looks like a little amount but it adds up over time.
- ❑ This is why the Federal Reserve focuses more on inflation than on unemployment.
- ❑ Saving for retirement. How does 1% change your retirement?
- ❑ Example: You plan on inflation averaging 3% while you are saving for retirement. But what if inflation is 4%?

Inflation Effects

	3% Inflation	4% Inflation
Future value	? = \$71,347.73	? = \$101,144.24
Payment	\$0	\$0
Present value	\$25,000	\$25,000
Interest per year	3%	4%
Number of periods	420 (35 years)	420
Payments per year	12	12

What Does This Mean for a Retiree?

- \$25,000 becomes \$71,350 at 3% inflation. If inflation is 4%, the \$25,000 becomes \$101,145 – an increase of 42%. This is just to maintain the same purchasing power.
- Just for year one of retirement, a person must save an extra \$30,000. Imagine the extra amount for a 25-year retirement.
- The retiree probably also has to try to earn a higher return, which means more risk.

Insurance on Durables?

- ❑ Is buying the extra warranty on durables a good idea?
- ❑ Very expensive.
- ❑ The price usually adds 10% to 25% to the price.
- ❑ Self-insure.
- ❑ Why is the store selling you something that you have to insure? What is the return policy?

Smart Buyer

- ❑ Save the cash leakages and use this money as the money to start saving.
- ❑ Build up a reserve fund of 3 to 6 months. The average duration of unemployment is 3 to 4 months so make sure you can ride out a bump.
- ❑ Bumps can become hurdles if there is poor planning.

Personal Finance Is

Sucking quarters out of the air with
your giant, personal vacuum
cleaner.