INSIDE THE VAULT

An Economic Education Newsletter from the Federal Reserve Bank of St. Louis

Volume 11, Issue 2 Fall 06

Just Sign Here: Bottom-Line Personal Finance Myths

Consumers must make many financial decisions, from basic spending and saving to complex investment choices and retirement planning. What does an individual need to do or know to be financially literate? At a minimum, consumers must be able to keep track of their cash resources and all payment obligations, know how to open a savings account and how to apply for a loan, and have a basic understanding of health and life insurance. In addition, a financially savvy consumer knows how to compare competing offers and plan for future financial needs, such as paying for college, buying a car or house, and retiring.

Unfortunately, this type of financial knowledge is in short supply. A survey conducted in 2006 by the Jump$tart Coalition found that 12th-graders could correctly answer only 52 percent of the questions on a basic financial skills quiz. Although adults sometimes do better on tests like these, statistics indicate that U.S. households do not consistently demonstrate the basic skills of financial literacy. (See table at right.) This lack of basic financial knowledge often results in poor financial management, including such behaviors as using payday lenders or check-cashing services, incurring late fees on credit cards, or passing up employer-matching contributions to retirement accounts.

Being aware of some common personal finance myths—beliefs, rules of thumb or marketing pitches that are misleading or untrue—may help consumers make better-informed financial decisions.

Myth #1: "All that matters is your monthly payment."

When a consumer is financing a car or a house, borrowers are often assured that, despite the staggering sum of total interest payments, the only relevant question is, "Can you make the monthly payment?" Your monthly payment is not all you need to know about your loan, of course. The effective annual rate you are paying, the fees, the term to maturity, numerous contract contingencies and other details also matter a great deal. Borrowers who believe this myth may not understand all the costs involved in a loan, or they may not consider the trade-off they are accepting between less-burdensome early payments and more-burdensome later payments.

Myth #2: "Rising house prices make us all richer."

Over the past several years, house prices in many regions have increased significantly, perpetuating the "housing wealth" myth. To see the fallacy in this myth, imagine a simple economy with exactly two home-owning households. Suppose the "market value" of each house was $200,000 as of yesterday. Today, both households believe their houses have doubled in value. One household sells its house to the other for $400,000, pocketing a $200,000 capital gain—an apparent increase in the economy's housing wealth. But the first household needs somewhere to live, and the second household has an extra, empty dwelling. So, household one buys household two's original house at the inflated price of $400,000, generating a $200,000 gain for household two. Neither household has more cash or other assets than it had before, and each owns one house as before. What has changed? We can say that the housing wealth of the economy has doubled, but it has no economic significance—it is a myth.

Indicators of Basic Financial Literacy

Financial Behaviors	Percentage of consumers who engage in this financial behavior
Pay bills on time	88
Balance checkbook monthly	67
Have emergency savings	63
Track expenses	49
Use a spending plan or budget	46
Save for long-term goals such as education, car, home or vacation	39
Compare offers before applying for a credit card	35

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Q&A

Q. What is the automated clearinghouse (ACH)?

A. The automated clearinghouse (ACH) is an electronic clearing system for exchanging credit (payment applied to an account) and debit (payment subtracted from an account) transactions among participating depository institutions. The Federal Reserve banks operate an automated clearinghouse, as do private organizations.

Q. What types of transactions are usually made through ACH credit and debit transfers?

A. ACH credit transfers include direct-deposit payroll payments, Social Security benefits and tax refunds, and payments to contractors and vendors. ACH debit transfers include direct debits of consumer and business accounts for the payment of mortgages, bills and tax obligations.

Q. What is *Directo a México*?

A. *Directo a México* is a program that is offered by the Federal Reserve banks so that money can be transferred by Mexican workers in the United States to their homes in Mexico using ACH. Transfers are carried out to and from bank accounts chosen by the account holders. Money may be withdrawn by the recipient in Mexico at the bank, using a debit card at an ATM or by requesting additional cash back when making a purchase with a debit card.

Q. Why is using an ACH network a good way to send money to Mexico?

A. ACH is a very inexpensive and safe way to transfer money and is already in place in most financial institutions in the United States.

The content for Q & A was compiled by Billy Britt, economic education specialist at the St. Louis Fed's Little Rock Branch, and was largely adapted from Directo a México Frequently Asked Questions *at www.frbservices.org/Retail/pdf/DirectoMexicoFAQ.pdf.*

Economic Snapshot

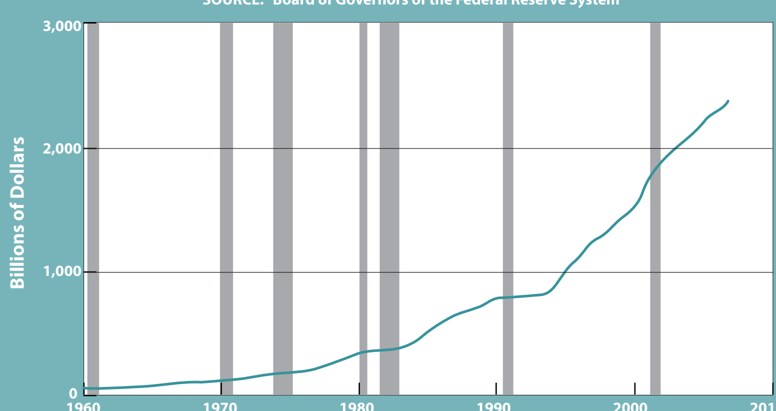
Third Quarter 2006

	Q4-05	Q1-06	Q2-06	Q3-06
Growth rate — Real Gross Domestic Product	1.8%	5.6%	2.6%	1.6%*
Inflation rate — Consumer Price Index	3.2%	2.2%	5.0%	2.9%
Civilian Unemployment Rate	4.9%	4.7%	4.6%	4.7%

** Advance Estimate*

Total Consumer Credit Outstanding

SOURCE: Board of Governors of the Federal Reserve System



Shaded areas indicate recessions as determined by the National Bureau of Economic Research

What do the shaded areas in the graph indicate?

The shaded areas indicate recessions as determined by the National Bureau of Economic Research (NBER). A recession is a significant decline in economic activity spread across the economy, lasting more than a few months and normally visible in real GDP, real income, employment, industrial production and wholesale-retail credit. For additional information about the criteria NBER uses to determine recessions, visit www.nber.org/cycles/recessions.html.

What types of credit are included in the consumer credit data?

Both revolving and non-revolving credit are components of these data. Revolving credit allows borrowers to use or withdraw funds up to a pre-approved credit limit. The amount of credit available to borrowers decreases as funds are borrowed, and the amount of credit available to borrowers increases as funds are repaid. Borrowers may repay the borrowed amount in full at any time. Borrowers may also repay over time; the repayment is subject to minimum payment requirements. Examples of revolving credit include credit cards and lines of credit.

Non-revolving credit involves a contract agreement in which a down payment or trade-in is usually made. A predetermined amount is paid periodically until the entire debt is paid. Finance charges are added to the price and are included as a portion of the payment. Examples of non-revolving credit include home mortgage loans and automobile loans.

With the exception of the recession that occurred from March 2001 through November 2001, what do you observe about consumers' use of credit during recessions?

During most recessions, growth of consumer credit tended to flatten out, which indicates that consumers' use of credit did not increase at as a great a rate as it did during expansions.

June 18-22 and 26-27, 2007

Making Sense of Money and Banking

Federal Reserve Bank of St. Louis

This is a seven-day, three-credit course open to elementary and secondary teachers and other educators interested in integrating money and banking topics into social studies, language arts and math. The course will feature guest speakers from the Federal Reserve Bank of St. Louis, as well as tours, hands-on activities, simulations for classroom use and breakout sessions for elementary and secondary teachers. Registration through either Southern Illinois University at Edwardsville or the University of Missouri-St. Louis is required. **Three hours of graduate credit** will be awarded to educators completing the course.

To register for **ECON 500B-501** through SIU-E, contact Mary Anne Pettit at 618-650-2583.

To register for **ECON 5055**: Money and Banking through UM-St. Louis, contact Barbara Flowers at 314-516-5561. Ask about scholarships for practicing teachers in Missouri.

For more information, contact Mary Suiter, manager of economic education at the Federal Reserve Bank of St. Louis, at 314-444-4662 or toll-free at 1-800-333-0810, ext. 44-4662, or e-mail mary.c.suiter@stls.frb.org.

NEW!

Federal Reserve Resources

Tips & Tools

Do you have a great idea for using a Federal Reserve publication in your classroom that you are willing to share? If so, visit www.stlouisfed.org/education/resourcetools. At this site, you can add a tip or tool that you want to share, and you can access tips and tools other educators have shared.

Fed Challenge

Federal Reserve Bank of St. Louis

Little Rock, Louisville, Memphis and St. Louis

Hot Topics in the News

For more information about these Federal Reserve Bank of St. Louis programs, go to www.stlouisfed.org/education or contact the economic education specialist nearest you. (See bottom of page.)

Are you looking for ways to bring real-world economics into your classroom? Consider these opportunities for fun and prizes by entering your high school students in one or both of these two programs held in Little Rock, Louisville, Memphis and St. Louis:

- Enter a team of five students in the **Fed Challenge**, a monetary policy competition in which students take part in a mock Federal Open Market Committee forum. A workshop for teachers, teams and coaches will be held at each of these Eighth District cities:
  - Jan. 30, 2007 – Louisville
  - Jan. 31, 2007 – Memphis
  - Feb. 1, 2007 – Little Rock
  - Feb. 6, 2007 – St. Louis
- Invite your students to enter the ***Hot Topics in the News*** **essay contest**. Essays are due:
  - Dec. 13, 2006 – Little Rock
  - Dec. 13, 2006 – St. Louis
  - April 3, 2007 – Louisville
  - April 3, 2007 – Memphis

Missouri Personal Finance Challenge

New for Missouri teachers: Enter a team in the first Missouri Personal Finance Challenge. Teams of four high school students will compete in written tests and a quiz bowl on personal finance. The regional competitions will be in Columbia, Kansas City, St. Louis and Springfield. The state finals will take place in May 2007 in Jefferson City. For details regarding competition dates and locations, as well as teacher workshop dates, see http://cas.umkc.edu/mcee/MPFC/MPFC_Index.htm.

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Compare this concept to automobile price changes. Do we feel richer when automobile prices rise? Probably not; in fact, many of us would feel poorer because we know we'll have to spend more to buy our next car. The point is that the value of a house or a car is derived solely from the housing or transportation services it provides.

Myth #3: "It's always better to buy than to rent."

The renting vs. buying decision is particularly important when households are purchasing housing services. In becoming an owner-occupier, a household effectively is a landlord renting a house to itself. Some of the critical considerations in making this decision include the following:

- A household with a steady income may be more suited to home ownership because it is better able to undertake the fixed financial commitment represented by a mortgage. A household with a highly variable income, on the other hand, may need to reduce housing expenses relatively rapidly if income declines significantly and may, therefore, be better off renting.
- Because the transaction costs involved in selling a house and moving to a new residence are high—probably about 10 percent of the value of the house, including sales commissions, financing-related fees and moving expenses—it may be better for a household that expects to move within a short period of time to rent rather than own.
- Owning a house provides a hedge against unexpected future increases in rent. A household that has a low tolerance for bearing the risk of future "rent shocks" will benefit more from owning a house than a household that is more tolerant of such risk.

Personal finance is becoming more complex every day; yet, the widespread belief in these myths shows that the average level of U.S. households' financial literacy is low. If consumers want to make informed decisions, they need to arm themselves with knowledge of basic economic and financial principles and to exercise smart spending and saving behaviors.

This article was adapted from "Consumer-Finance Myths and Other Obstacles to Financial Literacy," *written by Senior Economist William R. Emmons and published as a Federal Reserve Bank of St. Louis* Supervisory Policy Analysis *Working Paper 2005-03 in April 2005.*

Classroom Discussion

1. What are some details about a loan that a savvy borrower should find out?
2. How is it possible that an increase in the price of your house would not result in your being better off?
3. According to the table on Page 1, what are some conclusions that might be drawn regarding financial behavior? What could be done to improve financial behavior?

For a **lesson plan** to accompany this article, go to www.stlouisfed.org/publications/itv/default.html.

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