

THE INFLUENCE OF ECONOMIC FACTORS ON PERSONAL FINANCIAL PLANNING

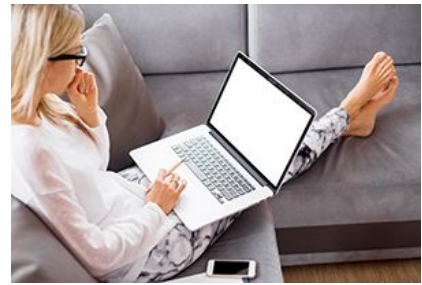
Assess economic factors that influence personal financial planning.

Daily economic activities are another important influence on financial planning. In our society, the forces of supply and demand play an important role in setting prices. **Economics** is the study of how wealth is created and distributed. The economic environment includes various institutions, principally business, labour, and government, that must work together to satisfy our needs and wants.

MARKET FORCES

Prices of goods and services are generally determined by supply and demand. Just as a high demand for a consumer product forces up its price, a high demand for money pushes up interest rates. This price of money reflects the limited supply of money and the demand for it.

At times, the price of an item may seem to be unaffected by the forces of supply and demand but, in fact, at such times other economic factors may also be influencing its price. Although factors such as production costs and competition influence prices, the market forces of supply and demand remain in operation.



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FINANCIAL INSTITUTIONS

Did you know?

A basket of goods and services that cost \$100 in 1914 cost \$2,173.33 in 2017. And what you could buy for \$100 in 2000 cost \$137.99 in 2017.

SOURCE: Bank of Canada, www.bankofcanada.ca.

Page 15 Banks, trust companies, credit unions, insurance companies, and investment companies are the financial institutions with which most people do business. Financial institutions provide services that facilitate financial activities in our economy. They accept savings, handle chequing accounts, sell insurance, and make investments on behalf of others.

While various government agencies regulate financial activities, the Bank of Canada, our nation's central bank, has significant responsibility in our economy. It is concerned with maintaining an adequate money supply. It achieves this by influencing borrowing, interest rates, and the buying or selling of government securities. The Bank of Canada attempts to make adequate funds available for consumer spending and business expansion while keeping interest rates and consumer prices at an appropriate level.

On Personal Financial Planning

"Spend less than you earn" is the foundation of long-term financial security, according to financial planner Ellen Rogin.

Although it sounds simple, most people do not follow this basic requirement for financial planning success. Ms. Rogin has been advising people about their money for more than 12 years. While the typical clients of her company range in age from 30 to 50, some are younger or older. Most of her clients are professionals and executives who have a common concern: a secure retirement. But Ms. Rogin is quick to point out that she works with people with a variety of needs, life situations, and investment philosophies. She has even advised a lottery winner, although she doesn't recommend counting on winning as a steady path to long-term financial security!



Ms. Rogin believes the availability of information is the most significant change in the financial planning marketplace in recent years. With the Internet, television programs, and an extensive number of magazines and books, people can be better informed regarding personal finance topics and investments. However, Ms. Rogin warns that people must assess the validity of the information. She suggests "avoiding specific investment advice from magazines and other sources that may not be appropriate for your individual situation."

When planning your own financial direction, Ms. Rogin recommends three actions:

1. Set specific financial goals.
2. Reduce your debts.
3. Save for retirement.

Even if someone else is managing your finances, Ms. Rogin encourages you to be involved. Be aware of your personal economic situation and the financial marketplace. Communicate your money views, risk acceptance, and financial priorities. Never let a financial planner, your spouse, or another family member have complete control.

GLOBAL INFLUENCES

The global marketplace also influences financial activities. Our economy is affected by both the financial activities of foreign investors and competition from foreign companies. Canadian businesses compete against foreign companies for the spending dollars of Canadian consumers.

When the export level of Canadian-made goods is lower than the level of imported goods, more Canadian dollars leave the country than the dollar value of foreign currency coming into Canada. This reduces the funds available for domestic spending and investment. Also, if foreign companies decide not to invest their dollars in Canada, the domestic money supply is reduced. This reduced money supply may cause higher interest rates.

ECONOMIC CONDITIONS

Newspapers and business periodicals regularly publish current economic statistics. [Exhibit 1–7](#) provides an overview of some economic indicators that influence financial decisions. Your personal financial decisions are most heavily influenced by consumer prices, consumer spending, and interest rates.

Exhibit 1–7 Changing Economic Conditions and Financial Decisions

Economic Factor	What It Measures	How It Influences Financial Planning
Consumer prices	The value of the dollar; changes in inflation	If consumer prices increase faster than your income, you are unable to purchase the same amount of goods and services; higher consumer prices also cause higher interest rates.
Consumer spending	The demand for goods and services by individuals and households	Increased consumer spending is likely to create more jobs and higher wages; high levels of consumer spending and borrowing can also increase consumer prices and interest rates.
Interest rates	The cost of money; the cost of credit when you borrow; the return on your money when you save or invest	Higher interest rates make buying on credit more expensive; higher interest rates make saving and investing more attractive and discourage borrowing.
Money supply	The dollars available for spending in our economy	Interest rates tend to decline as more people save and invest but higher saving (and lower spending) may reduce job opportunities.
Unemployment rate	The number of people without employment who are willing and able to work	People who are unemployed should reduce their debt level and have an emergency savings fund for living costs while out of work; high unemployment reduces consumer spending and job opportunities.
Housing starts	The number of new homes being built	Increased home building results in more job opportunities, higher wages, more consumer spending, and overall economic expansion.
Gross domestic product (GDP)	The total value of goods and services produced within a country's borders, including items produced with foreign resources	The GDP indicates a nation's economic viability resulting in employment and opportunities for personal financial wealth.
Trade balance	The difference between a country's exports and its imports	If a country exports more than it imports, interest rates may rise and foreign goods and foreign travel will cost more.
S&P/TSX composite index and other stock market indexes	The relative value of stocks represented by the index	These indexes provide an indication of the general movement of stock prices.

CONSUMER PRICES

Inflation is a rise in the general level of prices. In times of inflation, the buying power of the dollar decreases. For example, if prices increased 5 percent during the last year, items that cost \$100 then would now cost \$105. This means it now takes more money to buy the same amount of goods and services.

Page 17 The main cause of inflation is an increase in demand without a comparable increase in supply. For example, if people have more money to spend because of pay increases or borrowing but the same amounts of goods and services are available, the increased demand can bid up prices for those goods and services.

Did you know?

To find out how fast prices double, use the rule of 72. Just divide 72 by the annual inflation rate (or interest rate). For example, an annual inflation rate of 8 percent means prices will double in nine years ($72 \div 8 = 9$).

Inflation is most harmful to people living on fixed incomes. Due to inflation, retired people and others whose incomes do not change are able to afford smaller amounts of goods and services. Inflation can also adversely affect lenders of money. Unless an adequate interest rate is charged, amounts repaid by borrowers in times of inflation have less buying power than the money they borrowed. If you pay 10 percent interest on a loan and the inflation rate is 12 percent, the dollars you pay the lender have lost buying power. For this reason, interest rates rise in periods of high inflation.

Did you know?

Canadian households spent an average of \$82,697 in 2015, including \$60,516 on goods and services.

SOURCE: Statistics Canada, "Survey of Household Spending, 2015."
<http://www.statcan.gc.ca/daily-quotidien/170127/dq170127a-eng.htm>

The rate of inflation varies. During the 1970s and early 1980s, the annual inflation rate was in the 10 to 12 percent range. In the early 2000s the cost of living increased by approximately 3 percent annually.

More recently, the annual price increase for most goods and services as measured by the consumer price index has been under 2 percent. The *consumer price index* (CPI), published by Statistics Canada, is a measure of the average change in the prices urban consumers pay for a fixed "basket" of goods and services. For current CPI information, go to <http://www.statcan.gc.ca>.

CONSUMER SPENDING

Total demand for goods and services in the economy influences employment opportunities and the potential for income. As consumer purchasing increases, the financial resources of current and prospective employees expand. This situation improves the financial condition of many households.

In contrast, reduced spending causes unemployment, since staff reduction commonly results from a company's reduced financial resources. The financial hardships of unemployment are a major concern of business, labour, and government. Retraining programs, income assistance, and job services can help people adjust.

INTEREST RATES

In simple terms, interest rates represent the cost of money. Like everything else, money has a price. The forces of supply and demand influence interest rates. When consumer saving and investing increase the supply of money, interest rates tend to decrease. However, as consumer, business, government, and foreign borrowing increase the demand for money, interest rates tend to rise.

Interest rates affect your financial planning. The earnings you receive as a saver or an investor reflect current interest rates as well as a *risk premium* based on factors such as the length of time your funds will be used by others, expected inflation, and the extent of uncertainty about getting your money back. Risk is also a factor in the interest rate you pay as a borrower. People with poor credit ratings pay a higher interest rate than people with good credit ratings. Finally, we must always take into consideration the role played by personal income taxes with respect to the interest income we earn and the interest expense we pay. Every dollar of interest we earn must be added to our taxable income. Therefore, if our income tax rate is 30 percent, we have only 70 cents of after-tax interest income. On the other hand, we can deduct the interest that we pay on certain types of loans. In that case, the true cost of one dollar of interest paid is only 70 cents. We will discuss the issue of before- and after-tax investment income and borrowing costs in further detail in [Chapter 3](#).

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CONCEPT CHECK 1–3

1. How might the uncertainty of inflation make personal financial planning difficult?

2. What factors influence the level of interest rates?

