

**FINANCIAL LITERACY -
UNDERSTANDING FINANCIAL TURMOIL**

Even if you are not an investor or an avid financial newspapers reader, it is hard to ignore the current financial crisis. What is it all about?

The crisis started in the USA last year. Many financial institutions had lent money more aggressively to people who needed a mortgage to buy their houses. How were banks more aggressive? By lending to people who a decade ago would not have qualified for a loan, because their revenues were too low or unsure. Why did banks take such a risk? First, because they wanted to make up for the low interest rate on their loans: their returns were too low. Then, because as long as the housing market was up, this was fine... but the property market started going down. And as some loans had variable interest – the interest rates were going up after a few years, many borrowers could simply not pay back their loans; the banks got the house back as a security (to compensate for the payment default) and had to sell them (banks needed the cash), which made the property market go down too.

How did this crisis spread all over the world, even making countries like Iceland go virtually bankrupt? First, the payment defaults made money scarcer in the USA, and banks need money to run. Then, some banks or mortgage institutions had sold the loans as financial investments to investors in the US and abroad. This is how the crisis spread and some major banks and financial institutions either went bankrupt or were rescued by governments.

What is this “credit crunch” about: this means that there is less cash in the economy. The first reason is the default payments, but it is also due to the lack of trust or confidence of all the financial institutions: if bank A doesn’t really know how safe bank B is, bank A is not going to lend money to bank B...and the whole economy gets to a stand-still! Trust is also in question when we hear about some major frauds and scams, involving billions of dollars. No wonder ethics courses have started being introduced in some business schools!

So how can we react? First, one lesson about the crisis is to avoid having too much debt. Having a house is often a life dream: to realise it, make sure you first save for it and don’t borrow the whole purchase price of the house. Check the loan contract: how much you will have to pay back, now and in a few years’ time. What is the interest rate? Is it fixed or variable? Is it monthly or yearly? Can you get a better offer in another bank? Write a budget and calculate how much you can pay back every month, and keep money for daily living, yearly expenses and still saving for your other goals and emergency. Maybe your first house won’t be your dream house. It may be smaller. But you can sell it later and buy a bigger one. One step at a time. Make sure also that your house will be easy to sell: is the area good? Are there development plans in the area which could change the value of your house (either down or up)? Is the house in good shape?

If you have debt problem, don’t wait for your own bankruptcy: work on a plan with your lenders and gradually get out of it.

Another lesson from the crisis is about investment. You may have some investments and you are worried about their lower value. First, check how trustworthy the institution is and if it is backed by the government. Don’t sell in panic: as long as you have not sold, you have not lost money. Don’t forget investments are for the long term – 5, 10 years or more. Things hopefully will have

Financial Literacy

Because money is more than adding up figures

improved since then. If you need money for the short term, don't invest it; just leave it in a saving account.

May I suggest a few New Year resolutions: get out of debt, budget, stay focus on your goals and make the most of your money. Happy New Year!

If you have questions, send me an email: Sophie@aandbmake3.com , call 2151.2302 or read www.aandbmake3.com. **Enrich**, our not-for-profit partner in Hong Kong, gives courses on money matters (T: 2817.8928)