Credit in America

CHAPTER 16

TERMS TO KNOW

credit
capital
collateral
finance charge
line of credit
deferred billing
open-ended credit
annual percentage rate (APR)
closed-end credit
service credit
loan sharks
usury laws
pawnbroker

Consider This. . .

It was two days before the spring festival, and Promys still hadn't purchased the supplies she needed in order to make her costume. She had been saving her money for four months and was still $50 short of her goal.

"I'll just have to borrow the rest," she told her friends. "Otherwise, I won't be able to get the costume completed and that means I'll have let down the team. I really wanted to pay cash and not go into debt, but in this case, it can't be helped. Credit is serious because it's money I'll have to pay back in the future. I probably should have used credit a little sooner. Now I'll have to work all night in order to get this costume completed. I learned an important lesson. There's a time and a place for using credit."

What Is Credit?

Goals
- **Describe how credit developed in America.**
- **Define basic credit vocabulary.**
- **Discuss the advantages and disadvantages of using credit.**

DEVELOPMENT OF CREDIT

When you borrow money or use a charge account to pay for purchases, you are taking advantage of the most commonly used method of purchase in the United States: credit. Over 80 percent of all purchases in the U.S. are made with credit rather than cash. **Credit** is money borrowed to buy something now, with the agreement to pay for it later.

In the Past

The need for credit arose in the United States when the country grew from a bartering and trading society to a currency exchange economy. During the 1800s, items were first manufactured for sale. People no longer produced everything exclusively for their own use. With their earnings, they bought the things they used to make themselves. Soon the need developed for sources of credit to help families meet their financial needs. Consumer credit had begun.

One of the earliest forms of credit was the account at the general store. Wage earners or farmers would pick up supplies and put the amount due "on account." When the borrowers received a paycheck or harvested the crop, they would pay their account in full, and the charging process would begin again. The store rarely charged interest. Credit was a convenience that store owners provided for customers they knew well and trusted. The customers paid off their accounts as soon as they could.

As the use of credit expanded, individual purchasing power also increased. Because credit increased people's ability to buy more goods and services, the American economy grew at a healthy pace. People bought luxuries as well as necessities with the help of credit, and the average American's standard of living rose. Businesses and consumers benefited from credit.


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Why in recent years have so many people declared bankruptcy?

Between 1920 and 1990, buying on credit became the American way of life. No longer was credit saved for emergencies. Many different forms of credit developed to meet changing consumer needs and wants.

In the 1990s, record numbers of people declared bankruptcy. Overuse of credit cards was the main reason. With the economic prosperity of the decade, people were optimistic and willing to spend their income well into the future. But this overspending brought enormous credit debt.

Credit Today

Credit today is a way of life. Merchants encourage consumers to use credit to buy all kinds of goods and services. Banks and stores offer credit in the form of cards, loans, lines of credit, and all manner of short-term and long-term financing. Some transactions are difficult to make without a credit card, such as reserving a hotel room or making an online purchase. It's no longer "How can I get credit?" but "How can I wisely manage credit?" Unfortunately, credit trouble remains all too common as well.

THE VOCABULARY OF CREDIT

Certain terms are commonly used to describe credit, its availability, and its cost. When you borrow money or use credit, you are a *borrower* or *debtor*. The person or company who loans money or extends credit to you is the *creditor*.

To qualify for credit, you must have the ability to repay the loan. Having a job is important. Creditors may also expect you to have some capital. **Capital** is property you possess (such as bank accounts, investments, and other assets) that is worth more than your debts. Having capital tells the creditor that you have accumulated assets and are on your way to being a responsible citizen.

You will probably want to pay for large purchases with credit. For large sums, creditors often want more than just your promise to repay. They want collateral. **Collateral** is property pledged to assure repayment of a loan. If you do not make your loan payments, the creditor can seize the pledged property. For example, when you buy a car on credit, the car serves as collateral. If you do not repay the loan, the car can be *repossessed*. Ownership of the car would revert back to the lending institution.

Once you have completed the credit purchase, you owe money to the creditor. The *principal* (amount borrowed) plus interest for the time you have the loan is called the *balance due*. You generally will make monthly payments until you repay the balance due in full. The payments include both principal and interest, and with each payment, the amount you owe is reduced. The **finance charge** is the total dollar amount of all interest and fees you pay for the use of credit. It is the price you pay for the privilege of using someone else's money to buy goods and services now.

Credit statements usually specify a *minimum payment*. This is the least amount you may pay that month under your credit agreement, though you may pay more to further reduce your debt. All credit payments are due by a specific *due date*. Typically, you will be given 10 to 20 days from the date you receive a bill in which to pay. If you do not pay within the time allowed, you are likely to be charged a *late fee*, which is added to the balance due.

For particularly expensive purchases, you may have to sign an *installment agreement*, wherein you agree to make regular payments for a set period of time. At the end of that time, you will have repaid the entire debt. This is a type of *secured loan*, because the goods you purchased with the loan serve as collateral for the money loaned.

ADVANTAGES AND DISADVANTAGES OF CONSUMER CREDIT

Some people use credit extensively while others pay cash as much as possible. Many people get into trouble each year by not using credit carefully. Credit can have several advantages for you, but you must not lose sight of its disadvantages.

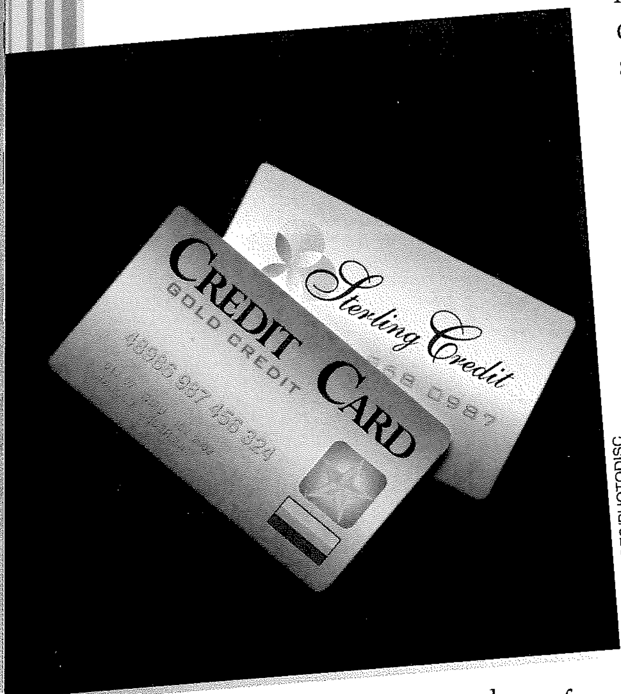
Advantages of Credit

Used correctly, credit can greatly expand your purchasing potential and raise your standard of living. For example, credit allows you to purchase expensive items now that you do not currently have enough cash to buy, and then pay for them over time. As a result, you can enjoy items like furniture and a car earlier in your life than you otherwise could. Making your payments on time then helps you establish a good credit record that will help you get loans in the future.

Credit can also provide emergency funds. A sudden need for cash can be solved by a **line of credit**, which is a pre-established amount that can be borrowed on demand with no collateral. To establish a line of credit, you fill out the application with a lender. Lenders examine your income and financial position and approve an amount that they believe you can repay. With a line of credit, money is always available should you need it.

Credit is convenient. Credit customers often get better service when they make a purchase because they can withhold payment until a problem is resolved. Regular charge customers receive advance notices of sales and special offers not available to the public, such as deferred billing. **Deferred billing** is a service available to charge customers whereby purchases are not billed to the customer until later. For example, merchandise purchased in October might not be billed until January, with no payment due until February.

The proof of purchase provided by a charge slip is usually more descriptive than a cash register receipt and helps in making adjustments when merchandise is returned. Finally, carrying a credit card is safer than carrying large sums of cash.



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What are some advantages and disadvantages of consumer credit?

Disadvantages of Credit

Use of credit also has disadvantages. For instance, credit purchases may cost more than cash purchases. Merchants must pay the credit card company for using the card in transactions, and they often pass this cost on to customers in the form of higher prices. In addition, an item purchased on credit and paid for over time costs more because of finance charges. A finance charge of 18 percent a year is 1½ percent a month. On a $1,000 balance, the finance charge would be $15 a month. The larger your balance and the longer you take to pay it off, the greater the finance charges.

When you use credit, you tie up future income. You have committed to making payments, perhaps for several years. Over that time, those funds are not available to you for buying other products you may need. This situation can put a strain on your budget.

Buying on credit can lead to overspending. You can get into trouble with credit if you buy more than you can pay back comfortably. At the end of the month, when the bills come in, you may be surprised at how much you have really spent. Using credit too much can result in debts so high that you can never pay them off, and may even lead to bankruptcy.

Global View

Traditionally, consumers in Thailand preferred to use cash when purchasing goods and services. This conservative attitude toward cashless transactions hindered consumer credit expansion. As of 2002, it was estimated that only 10% of the Thai population owned a credit card. Major card issuers then began aggressive marketing campaigns and promotional offers to entice new customers. With extensive incentives for consumers and a low minimum income threshold for credit card eligibility, many issuers witnessed considerable growth in their customer numbers.

Think Critically: What consumer benefits as well as problems might result from the boom in credit card use in Thailand?

Check Your Understanding

1. Compare the use of credit today to its use in this country's early years.
2. Why is it important to make credit payments by the due date?
3. For you, what is the greatest advantage and greatest disadvantage of credit?