

7.1: Introduction

Financial management is about managing the financing for consumption and investment. You have two sources for money: yourself or someone else. You need to decide when to use whose money and how to do so as efficiently as possible: maximizing benefit and minimizing cost. As with all financial decisions, you also need to think about the strategic consequences for future decisions.

You can use your own money as a source of financing if your income is at least equal to your living expenses. If it is more, you have a budget surplus that can be saved and used as a source of future financing while earning income at the same time. If your own income is less than the expenses, you have a budget deficit that will require another external source of financing—someone else's money—that will add an expense. Ideally, you want to avoid the additional expense of borrowing and instead create the additional income from saving. The budgeting techniques discussed in Chapter 5 are helpful in seeing this picture more clearly. Your ability to save will vary over your lifetime, as your family structure, age, career choice, and health will change. Those “micro” factors determine your income and expenses and thus your ability to create a budget surplus and your own internal financing. Likewise, your need to use external financing, such as credit or debt, will vary with your income, expenses, and ability to save.

At times, unexpected change can turn a budget surplus into a budget deficit (e.g., a sudden job loss or increased health expenses), and a saver can reluctantly become a borrower. Being able to recognize that change and understand the choices for financing and managing cash flow will help you create better strategies.

Financing can be used to purchase a long-term asset that will generate income, reduce expense, or create a gain in value, and it may be useful when those benefits outweigh the cost of the debt. The benefit of long-term assets is also influenced by personal factors. For example, a house may be more useful, efficient, and valuable when families are larger.

Macroeconomic factors, such as the economic cycle, employment, and inflation, should bear on your financing decisions as well. Your incomes and expenses are affected by the economy's expansion or contraction, especially as it affects your own employment or earning potential. Inflation or deflation, or an expected devaluation or appreciation of the currency, affects interest rates as both lenders and borrowers anticipate using or returning money that has changed in value.

Financial management decisions become more complicated when the personal and macroeconomic factors become part of the decision process, but the result is a more realistic evaluation of alternatives and a better strategy that leaves more choices open in the future. Financial management decisions, however, are difficult not because of their complexity, but because the way you can finance your assets and expenses (i.e., lifestyle) determines the life that you live. The stakes are high.

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