Managing debt while rates grow

Terry McBride , For Canwest News Service SASKATOON -- Canadians have taken advantage of extremely low interest rates to overextend themselves. The Bank of Canada wants to try to prevent inflation by raising interest rates to slow the economy down. How will debtors manage?

Inflation vs. deflation

Actually, debtors generally prefer inflation (when prices go up) because that can make it easier to repay a debt, which is a fixed dollar amount owing. Loan payments become more affordable when wages keep up with inflation.

Debtors usually fear deflation (when prices go down) because it becomes more difficult to repay an obligation when the fixed number of dollars can buy more. Deflation is already a major concern these days in Europe where some governments are raising taxes and cutting back on spending to tackle mushrooming public debts. Businesses there may be forced to cut prices and workers' wages to cope with the economic slowdown.

Debtors fear deflation. How can they handle debt payments after their wages are cut or they lose their jobs? Serious household debt management issues arise.

Mortgage term

If your mortgage is coming up for renewal, how do you choose the best mortgage term? If you have had a variable or floating rate of interest tied to the prime rate, should you take the safe route and lock in a fixed, usually considerably higher, interest rate for five years?

If your mortgage payments rise, then you will have to look at various ways to manage other debts.

Consolidate

One popular debt management strategy is to combine various loans into your mortgage or a line of credit. Consolidation can eliminate high-interest credit card debt. Free up some cash flow by reducing your interest costs.

Talk to a professional debt counsellor. Can you have a single monthly payment? You could continue to make the same level of payments on your consolidated loan as you did before consolidation. Aim to reduce your principal owing and cut interest costs.

Amortization

Knowing how amortization works will help you to understand how to properly manage your debts. Amortization is how long you are scheduled to repay an instalment loan.

If interest rates rise, consider stretching the repayment period on an instalment loan to reduce the size of your monthly payments. Making your payments smaller seems very attractive at first. However, by making payments over a longer time period you will eventually pay much more interest in the long run.

Debt snowball

Here is a strategy for cutting down your overall debt level:

Make a list of your debts. Add up how much you pay on each loan.

Pick the smallest debt to tackle first. Pay the minimum on all debts except for your target debt. Pay whatever is left on your target debt until it is paid off. Then, continue with the debt snowball strategy by choosing the next debt on the list as your target debt. Pay it off.

Borrow wisely

The next time you have to borrow, avoid buying something that drops in value. The only time you should buy something using debt is if it is something that will appreciate in value or generate additional cash flow for you.

As a general rule, if you are buying something with borrowed money, make sure that what you buy lasts longer than the debt. Don’t add to your debt burden by going on a vacation financed by credit cards.

Emergency fund

Do you have to borrow when you have an emergency? Instead you should build an emergency fund with cash held in reserve. You could use a Tax-Free Savings Account, the cash surrender value of a whole life policy or a Canada Savings Bond payroll savings plan, for example. Having cash available to pay for an emergency will give you greater financial security than an untapped line of credit