How Much Money Do You Really Need in Your Savings Account

Bank savings accounts don't exactly earn you a huge return these days: in fact, most big banks are offering a fraction of a percent in interest on their savings accounts. However, savings accounts do serve an important purpose as a safety net. Should you run into some sort of crisis (losing your job, injuring yourself seriously and expensively, suffering a car breakdown, or so on) a well-funded savings account can get you through it while avoiding the drawbacks of going into debt. But how do you qualify "well-funded" in terms of a saving account?

Saving the bare minimum

The Federal Reserve Bank of New York holds a monthly Survey of Consumer Expectations in which it asks consumers various questions to determine their financial situation and expectations. One question on the survey asks whether the consumer would be able to come up with $2000 in cash if necessary. That's because the Federal Reserve Bank has determined that this is the average amount a consumer will need to resolve a crisis. Thus, $2000 is the minimum funding goal you should aim for with your savings account. That will be enough to get you through one average-sized crisis. Sadly, in the February 2017 edition of this survey only about 67% of Americans said they'd be able to scrape up that much money.

Going beyond the minimum

Having enough in savings to fund a single crisis is extremely helpful, but it may not be enough for safety. Some common crises may go well beyond the need for $2000. For example, if the primary breadwinner in your family loses his job and is out of work for a few months, $2000 wouldn't begin to cover what you'd need in order to get by. What's more, crises often seem to come in bunches; the car breaks down and then you get sick the very next week. If your savings account is only funded enough to take care of one crisis and you get hit by two in rapid succession, you'll be in trouble.

A better savings goal

How much you really need in your savings account depends on your lifestyle and circumstances. If you're single, have a stable job, and you have parents or other family members who can be counted on to help out in a pinch, you won't need to save as much as someone who is married with several young kids and doesn't have anyone else around for financial support. In the former situation, saving enough to get you through three months without any other sources of income should be enough. If your living situation is more precarious or other people are depending on you, aim for 6 to 12 months' worth of expenses in your savings account.

The risk of saving too much

On the other hand, it's possible to overfund a savings account. A highly risk-averse saver may choose to keep putting money into a bank savings account rather than directing it into more volatile assets, such as stocks. Unfortunately, that kind of investing strategy will end up costing this cautious saver money over the long term.

You see, historically, the average rate of inflation in the US is around 3%. That means that any long-term saving and investing strategy needs to realistically plan for a return of at least 3% just to keep from losing money. And while there have been periods when interest rates rose to the point where you could indeed get more than a 3% return on a savings account, these high-interest rate environments usually go hand-in-hand with high inflation rates. Thus, regardless of the base interest rate you're getting now, bank savings accounts will rarely if ever allow you to beat inflation, let alone make a reasonable return compared to your other options.

A good savings strategy with a caveat

Saving money is a high financial priority, but there's one financial priority that's even higher: getting rid of high-interest debt. The rationale is similar to the previous argument about inflation; if you're stuck with a debt on which you're paying 15% interest, then those interest payments will wipe out any possible returns from even the nicest investments. Thus, step one in a savings plan is to pay off any credit card or other high-interest debt. Once you've done so, the next step is to take the money you've been applying to credit card payments and drop it into your savings account instead until you've got a few months' worth of expenses covered.

When your savings account balance hits the goal you set for yourself, you can start funneling that money into a higher return investment -- typically the best choice at this point is some form of retirement savings account, since the investments in these accounts can grow unburdened by taxes. And with your savings account there to protect you in case of emergency, you won't risk falling back into expensive debt in the future.

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