talk money with Ecstra Foundation

# Finance facts: Saving

## Understanding savings

Most people can achieve their dreams by having a savings plan. A dream could be to save for a holiday, a car, a home, or just to have money in an emergency.

You might have already had a saving plan; you may have saved money each week to buy clothes, an iPhone or even for an end-of-school-year holiday with friends. There are many online tools, called 'budget planners' that help you keep track of your income and spending so you know how much you can save.

The importance of saving money is simple: having a saving plan can help you buy things—in the short term or the longer term. Setting money aside for a rainy day can also help you feel more secure. When you have money set aside, you feel less stressed when bills come or when something unexpected happens.

To make saving easier, you must have a clear goal or purpose for your money. If you haven't started saving, now might be the right time to start, particularly when you start working part-time and receive a regular income.

## Short and long term goals

Setting goals is a good way to focus your attention. Everyone's goals are different—they can include study, career, and travel goals—the list goes on.

### *How long will it take you to save for your goal?*

Depending on what you earn and what you desire, it could take six months to six years. For example, saving for a new phone or a small holiday break could take six months; this is a short-term goal. Saving for a home deposit or a new car could take many years. This is a long-term goal.

Some people even start to save for their retirement! This is a very long-term goal.

The earlier you start, the better you will be placed. People usually save for retirement in special accounts called 'superannuation' accounts. Money invested in these special accounts has the potential to grow in value, earning interest income over many years. Earning interest helps you grow your balance because you're not only earning interest on the original amount but also on the interest! This is called compound interest.

**Harnessing the magic of compound interest will help you achieve your goals sooner.**

## Bank accounts

There are many different types of bank accounts available. The best bank account will usually have some or all the following features:

- Wide ATM (automatic teller machines) network.
- No account-keeping fees, or an option to have the account fees waived.
- A range of different payment options available
- Monthly deposit conditions that are easy to meet (or none) to be awarded a higher interest rate on your savings
- A mobile banking app or internet banking portal to manage your account whenever you need.
- A linked savings account with a competitive interest rate.

### *Main types of bank accounts*

**Transaction accounts:** These accounts, also called cheque accounts, are for everyday transactions such as shopping, paying bills and depositing salary. Transaction accounts have monthly fees associated with them, depending on the types of service required. These fees and the number of transactions allowed per month vary according to the bank. Overdraft facilities are not automatic, and some banks may charge customers for using ATMs at other banks. Electronic banking facilities are generally available. Transaction accounts generally do not pay much interest on the balance in the account.

**Savings accounts:** These accounts are interest-bearing. The amount of interest earned depends on the account balance; however, there may be a minimum balance required to earn interest. Savings accounts can also be used for everyday banking needs, such as deposits and withdrawals. Some accounts pay higher interest rates if no withdrawals are made over a certain period.

**Term deposit accounts:** Higher interest rates are paid on these accounts compared to savings accounts. However, a minimum balance is generally required, and money must be left in an account for a certain amount of time—known as 'the term'. Interest rates are usually fixed, and interest is paid at the end of this term. If you break the term by withdrawing your money, you will miss out on interest for the month or for a certain period.

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### Case study: saving for a car and compound interest

Marley has her heart set on buying a second-hand car in two years. She wants to buy one for **$3,400** but she only has **$2,000** now. Marley opens a savings account with one of the banks for two years. The savings account offers **5% interest**. The interest is **compounded each month**, which means that each month the interest earned on the balance in the account for the month is calculated and added to the account.

We can calculate the compound interest earned on Marley's deposit a few different ways:

- Multiply the balance by 5% each month and add this to the new balance for the next month.
- Use a compound interest formula:
  $A = P * (1+r)^n$
  *where*
  A = ending balance
  P = starting balance (or principal)
  r= interest rate per period as a decimal
  n= number of time periods
- Use an online compound interest calculator tool, like the MoneySmart compound interest calculator.

When we calculate how much $2,000 will earn over two years at an interest rate of 5% per year, compounded monthly, the interest amount is $210.

$A = 2000 * (1+0.00417)^{24}$

Marley decides she can add another $50 each month each over the two years. When this extra money is added in, she will reach her goal and have $3,469 in total. This includes her original $2,000 deposit, $1,200 in additional deposits and $269 from compounding interest.

Compound interest and regular savings helps people to reach their financial goals sooner.

### Did you know?

How often the interest is 'compounded' matters; the more frequent the compounding the more your money will grow (because interest is earned on the balance, which includes past interest payments). That's why bank loans often compound interest *daily*, so they can get the most interest income from their borrowers.

## Glossary

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| **Budget** | is a plan to decide how you will spend your money and helps you to make sure you have enough money to pay for things you need and want. |
| **Interest** | is the additional money earned then you deposit money into a savings account and leave it untouched for several months or years. The money won't just sit idly in his account because the bank will use it to lend money to borrowers. The bank will earn interest by lending money out but will also pay interest to you as the holder of the saving account. |
| **Compound interest** | is the interest earned on both the money you have saved and the interest you earn. |
| **Overdraft facilities** | is an overdraft facility allowing you to borrow money through your transaction account by taking out more money than you have in the account. There is usually a charge for this. |

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ASIC Moneysmart Budget Planner

ASIC Moneysmart compound interest calculator



talkmoney.org.au
1800 651 636
talk@talkmoney.org.au