Personal Finance

Week 4:
It pays to save

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When interest rates rise again, savings accounts will pay off

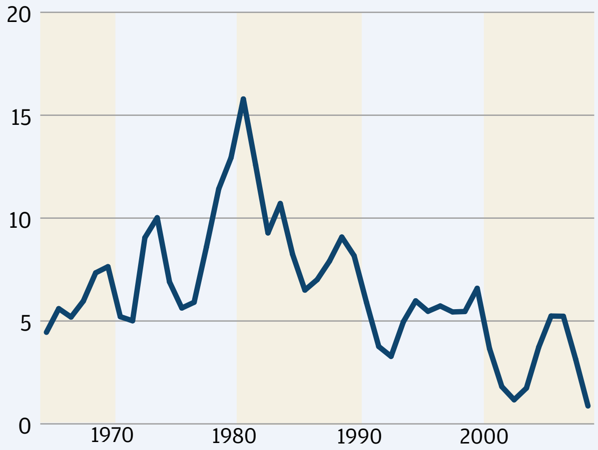
With interest rates on savings accounts at historic lows and the stock market seemingly in recovery, there may be little incentive to start or add to a savings account. The annual interest rate on most passbook savings and money market accounts is less than one-half of 1 percent. Current rates on one-year Certificates of Deposit are less than 1 percent. Extending the term to three years increases the rate to about 2 percent.

So, why bother saving at all? It is likely that the interest rates on savings will return to more normal historical levels, which will make savings more attractive. According to data from the Federal Reserve, the interest rate on six-month CDs averaged over 6 percent between 1965 and 2009. The annual rate has averaged below 5 percent in only nine of those 45 years; however, seven of the nine years have occurred since 2000.

So, why not wait until rates increase and then start saving? The sooner you start saving, and the longer your savings earn even a modest return, the greater the effect of compounding interest. Even with an average return of only 2 percent a year, $5,000 will grow to $6,100 in 10 years and about $7,400 in 20 years. However, $5,000 earning 5 percent interest a year will grow to $8,100 in 10 years. Allowed to grow for another 10 years, the original $5,000 will be worth $13,300. After 40 years, the initial $5,000 will have grown to $35,200.

This chart displays the average interest rate on six-month CDs as reported by the Federal Reserve.

Average interest rate on six-month CDs



Source: *http://www.federalreserve.gov/Releases/h15/data/Annual/H15_CD_M6.txt*

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