

It's raining; perhaps you should spend your rainy-day fund

It is common advice. Build an emergency fund equal to between three and six months of take-home pay in case of unexpected expenses. Often also known as “rainy-day funds” because money is set aside for unfavourable conditions, they are the bedrock of personal financial planning



Spending your rainy day-fund

For many, unfavourable conditions have arrived. It's raining. Work and income have dried up. Many people face not only a Covid-19 crisis but a liquidity crisis. The liquidity crisis can be reduced by taking money from the rainy-day fund. That's what it is there for.

But there are four problems with this.

First, nobody can be sure how long this crisis will last. We don't know the rainy-day fund needs to last.

Second, there is a presumption that many people have rainy-day funds. Survey evidence suggests few people have a sizeable emergency savings buffer.

Third, there is a presumption that a key motive for why people save is as a precaution against income shocks. Hence the technical term “precautionary savings”. But studies of why people save are ambivalent about whether many save due to uncertainty about future income, this may not motivate many savers. If so, those who have savings may not be willing to reduce them in the current circumstances.

Fourth, a noticeable percentage of those who have savings will be reluctant to reduce them because they are more emotionally wired to save rather than to spend. These people will find it difficult to reduce savings.

No umbrella

Suggesting people spend their rainy-day fund makes little sense if many do not have money put aside for emergencies. Many cannot shelter from the rain, or can only do so for a short time.

Surveys consistently show that personal and household finances in many countries are fragile. Our own ING International [Surveys](#) have consistently shown for many years that around three in ten people across Europe have no savings at all. Of those who do, only about four in ten have three months or more of take-home pay available, meeting the generally accepted rule-of-thumb for good financial management.

About half across Europe, the US and Australia say they run out of money at the end of each pay period occasionally or most of the time. Even small unexpected expenses can cause trouble. The US Federal Reserve [reports](#) that four in ten could not cover a \$400 emergency expense using cash or its equivalent (i.e. a credit card that would be paid off in full in the next payment period).

Why people save

A further twist on this concern is that studies of saving behaviour prevaricate on whether people save as a precaution against income volatility, at least in a strong form. A 2015 [paper](#) based on survey data from a representative sample of Dutch households found “strong precautionary motive in the saving behaviour of the households in our sample.” However, a 2017 [survey](#) of the literature on precautionary saving found “most of the reviewed works find evidence of precautionary motive for saving, there is not a consensus on the magnitude of the precautionary saving and some works conclude that this motive is nearly irrelevant.”

Nevertheless, there appears to be agreement that there can be a variety of responses in the way households react to income shocks, such as being experience now. A 2019 [paper](#) based on survey data from Dutch households found significant differences in reactions to hypothetical income shocks. Those with liquidity constraints (i.e. limited access to credit or savings) cut spending more. But even those not constrained cut back.

If rainy-day funds are typically small and also, income uncertainty or variability may not be the main reason people save, suggesting that people dip into those savings may make little sense to them.

Unpredictable forecasts

Usually, rainy-day funds are set up to meet emergencies that have a known cost. For example, the cost of an urgent car repair is likely to be known with some accuracy so can be accommodated by

a given rainy-day fund. The current situation is less predictable. The rain may last for some time.

Given this, the best way to use rainy-day funds is unknown. But that is not an excuse to avoid making a plan. Figure out your and your household's spending priorities. Any plan under current circumstances is likely to be inexact. However, as John Maynard Keynes said: "It's better to be roughly right than precisely wrong."

You may as well make this plan now. Do not put it off. Procrastination has been [shown](#) to lead to financial problems. To offset the temptation to procrastinate, [research](#) suggests enlisting others to do the task with you can help. It's a form of commitment device.

Tightwads and spendthrifts

Even if people have saved for uncertain events, they may find spending those savings emotionally difficult. It may be that those who save tend to be cautious. Some may even find spending difficult, to the point that they spend less than they would ideally like to spend. They are emotionally conflicted by spending. Such people can be called "tightwads". On the other hand, there are those who spend more than they would like. These people can be called "spendthrifts".

A 2007 [paper](#) studying spending attitudes among around 13,000 people in the USA found that most (60 per cent) people are not conflicted by their spending behaviour. They are neither tightwads nor spendthrifts. However, 24 percent recorded as tightwads and 15 per cent as spendthrifts. Tightwads outnumber spendthrifts by a ratio of 3:2. There were differences in the extent of 'tightwadism' across the different samples in the study, but the lowest percentage was 19%. Reluctance to spend appears to be a noticeable occurrence.

The paper did not trace these groups to saving behaviour. Nevertheless, there is evidence that about one-in-five people are reluctant to spend. If so, spending their rainy-day fund will be difficult.

Waiting out the rain

How people will react to the current situation is as unpredictable as the outcome of what we're going through. We should not assume people will run down their savings. They may simply wait to spend again once the rain is over.