CONSUMPTION STIMULUS POLICY FOR ECONOMIC REVIVAL

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Need to pump-prime the economy

From the beginning of 2001 there have been worries of whether the economy will have a soft-landing.

The Korean economy, which recorded a 6.7% GDP growth in 1998 after the outbreak of the financial crisis, recovered to a rate of 10.9% in 1999. Until the first half of 2000, high growth continued at 11.1%. In the second half of 2000 however, the surge in international oil prices brought difficulty to Korea, which has a high external dependency for energy. In addition, prices for key Korean exports such as semiconductors fell, which compounded the difficulties. As a result, annual growth rates fell to 9.2% in the third quarter and 4.6% in the fourth quarter. Therefore, from the beginning of 2001 there have been worries of whether the economy will have a soft-landing, and some have argued that stimulus measures are necessary.

However, at the beginning of the year, many were against stimulus measures by the government, saying that they were against the principles of the restructuring that was pursued for the last several years. The main point of restructuring was to exit uncompetitive firms from the market, while stimulus efforts would extend the lives of such firms. In addition, stimulus efforts would worsen national debt (which is already at risky levels) to decrease financial soundness and become a long term obstacle to economic development.

In February, the government stated the need for economic stimulus through fiscal spending.

Although the government did not agree that stimulus measures would hinder restructuring or that national debt is excessive, the government did not even feel that stimulus measures were necessary. However, with the continued stagnation of key indicators such as consumption, investment, and exports during January and February, the government began to consider stimulus measures, and in February, the government stated the need for economic stimulus through fiscal spending. However, the government's proposed spending policies are geared to economic adjustment rather than economic stimulus. To prevent a sharp downturn in the economy, the government plans to spend 63% of this year's budget in the first half. This may have been to avoid criticism about budgetary soundness as well as prevent a sudden drop in the economy.

There are some arguments against stimulus (or adjustment) policies based on budgetary spending. Government spending has a crowding out effect on private consumption, and judging from the past, government spending had little effect on

—Table 1. Arguments for and against Stimulus through Fiscal Spending—

Main Arguments	Position on economic stimulus through expanded fiscal spending	
	Oppose	Support
Restructuring vs Economic Stimulus	(restructuring first) A forced stimulus policy would help borderline firms survive, which goes against the basic idea of restructuring.	(economic stimulus with restructuring) If the economic stagnation drags into the long term, healthy as well as borderline firms will go bankrupt.
Maintaining fiscal soundness	(national debt is excessive) Tax reduction or expanded fiscal spending will increase national debt and reduce financial soundness. · The unrecoverable public funds injected during restructuring or the insufficient portion of funds for social insurance can also be seen as national debt. If additional fiscal spending is pursued to stimulate the economy, financial soundness will be undermined and growth will be hindered in the long term.	(national debt is sustainable) Korea's current financial situation is sound and can absorb additional fiscal spending. · By IMF standards, national debt is only 23% of GDP, which is far lower than the OECD average of 70%. · The balance of national bonds at the end of 2000 was 14.8% of GDP. This compares to 71.2% in the US, 48.6% in Japan, 23.8% in Germany, and 36.2% in England.
Fiscal policy vs Monetary policy	(for monetary policy) Although there is a need for economic stimulus, monetary policy rather than fiscal policy should be used. · Looking at past experience, expanded fiscal spending does not have much effect on the economy and in the long run, has a negative effect on economic growth.	(for fiscal policy) Currently, stimulating consumption is essential, and it has been empirically confirmed that the effect of interest rates on household consumption is small. · The past studies of fiscal spending and economic growth were done when fiscal policies were not used for economic adjustment, so they can not be considered as cases of fiscal policy used for economic stimulus.

economic fluctuations. Therefore, some observers recommend monetary policy rather than fiscal policy. However, proponents of fiscal policy argue that monetary policy may not be effective in stimulating the economy because Korea's financial system is not as advanced as in developed countries. In addition, they say that it is invalid to point to past experience because fiscal policy was hardly used in Korea. Furthermore, they argue that the recent economic stagnation has contributed to a severe slump in consumption, and fiscal policy will be more useful in resolving this problem.

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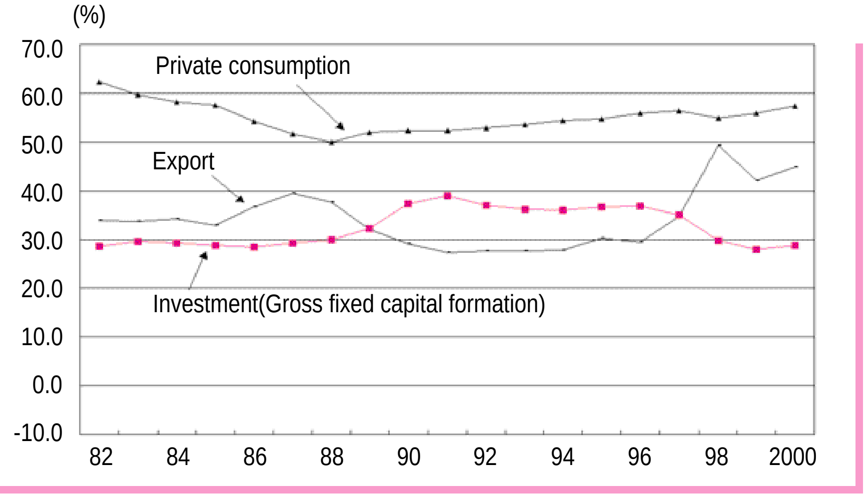
Currently, there is some consensus about the need for economic stimulus (or adjustment) policies. The rest of this article will examine which category to focus on and what policy approaches to use, considering the characteristics of the Korean economy.

Which category should be the focus?

In 2000, 28.7% of GDP was investment, while 57.3% was private consumption.

For economic stimulus, an ideal category would be one that has a large share in the domestic economy and has a large effect on other categories. Private consumption would be such a category, as it accounts for the greatest share of GDP. In 2000, 28.7% of GDP was investment, while 57.3% was private consumption. In addition, the share of private consumption in GDP is constantly increasing.

Figure 1. Share of GDP by Category



Consumption also has a low import promotion effect compared to other categories.

Consumption also has a low import promotion effect compared to other categories, and an increase in consumption has a positive effect for GDP growth [1]. While investment has a import promotion effect of 0.253, consumption has an effect of only 0.216. Although exports are an important category that accounts for 45.0% of

Table 2. Import Promotion Effect of Aggregate Demand Categories

	1990	1995	1998
Private Consumption	0.202	0.210	0.216
Investment	0.284	0.309	0.253
Exports	0.309	0.302	0.354
Total	0.245	0.254	0.261

Source: Bank of Korea, "1998 Industry Linkage Table Results", April 2001.

1) National Income(Y) = Consumption(C) + Investment(I) + Export(X) - Import(M) and a high import promotion effect causes economic growth to fall correspondingly.

GDP, the import promotion effect of exports is 0.354. In addition, exports are mostly affected by external conditions, and it is difficult to find an appropriate policy that increase exports without causing trade frictions.

The biggest reason that companies are currently unable to decide on investment is uncertain market conditions and lack of demand.

Meanwhile, consumption will have a positive effect on investment. Immediately after the financial crisis, the biggest problem for domestic companies was raising capital. However, the biggest reason that companies are currently unable to decide on investment is uncertain market conditions and lack of demand. According to a survey, firms consider the following as obstacles to investment: unclear prospects for the economy (27.6%), stagnant demand (21.2%), and difficulty in raising capital (14.4%)[2]. In addition, if households, which are the most numerous agents in the economy, expand their consumption, this will provide not only incentives for firms to invest but also improve overall sentiment in the economy.

Table 3. Economic stimulus through promoting consumption

consumption accounts for a large share of GDP	⇒	· consumption: 57.3%, investment: 28.7%, exports: 45.0%
low import promotion effect	⇒	· average: 0.261 · consumption: 0.216, investment: 0.253, exports: 0.354
Recent contraction in facility investment contributes to a fall in demand	⇒	· Results of survey on obstacles to investment uncertain economic prospects (27.6%), lack of demand (21.2%) difficulty in raising funds (14.4%), excessive facilities (15.4%)
High policy discretion	⇒	· Difficult for policy to affect other categories such as exports
positive sentiment can spread through the economy	⇒	· positive household sentiment on consumption can spread through the entire economy

Determining factors of consumption

Both an econometric model and a survey of individuals found that income was the most important variable affecting consumption.

In finding the best way to stimulate consumption, one must examine the variables that affect consumption. Income is by far the most influential variable, especially fixed income such as business income and wages. Both an econometric model[3] and a survey[4] of individuals found that income was the most important variable affecting consumption.

2) Korea Industrial Bank, "Prospects for Industrial Facility Investment in 2001"
3) Bank of Korea, "Trends and Factors in Recent Private Consumption", July 2000.
4) Hyundai Research Institute, "Characteristics of Recent Household Consumption", MVPR May 2001, March 2001.

Table 4. Factors in Consumption Decision and Results of Empirical Studies

			Relation to Consumption	Result of Empirical Studies
Macro Variables	Income		· main factor affecting consumption	· 54.2% of respondents stated "change in monthly fixed wages" as one of the factors that affect future consumption,(HRI survey). · Empirical analysis: After the 1990's, a 1% increase in income led to a 0.39% increase in consumption (Bank of Korea).
	Asset Prices	Interest Rate	· double effect of higher interest rates ⇒ savings↑, consumption↓ ⇒ asset value↑ ⇒ consumption↑ ⇒ debt burden↑⇒ consumption↓	· Empirical analysis: Interest rate and consumption had a negative relation, but the relation was not statistically significant (Bank of Korea).
		Stock Prices	· higher stock prices ⇒ asset value↑ ⇒ consumption↑	· 65.5% stated that stock prices had no relationship to consumption levels (HRI survey). · Empirical analysis: After the 1990's. a statistically significant, positive relation was found, but its influence was low (Bank of Korea).
		Real Estate Prices	· double effect of owning real estate	· 84.6% stated that real estate prices have no relation to consumption levels (HRI survey). · Empirical analysis: a significant, positive relation was found, but there are limits to choosing real estate as a variable (Bank of Korea).
	Other		· possibility of unemployment↑, prices↑ ⇒ consumption↓	· 14.0% indicated that employment was the most important factor in consumption (HRI survey). · A negative, statistically significant relationship was found with prices, and the relationship with the unemployment rate was not significant (Bank of Korea).
Other Structural Factors			· income distribution structure · household financial asset/debt structure · real estate ownership structure	· Propensity to consume is higher as income falls. · Non-consumer spending (interest payable and rent spending) was higher than asset income (interest and rent income). · Lower profitability of financial assets.

Fluctuations in asset prices affect consumption indirectly through a wealth effect on income. It is unknown however whether asset price fluctuations af fect consumption positively or negatively, and the effect is not too great. The effect of interest rate fluctuations on consumption was merely to redistribute income between asset holders and borrowers. The same holds for changes in real estate prices.

14.0% of respondents answered that employment expectations were the main factor in deciding consumption.

Meanwhile, the evaluations and forecasts of consumers also has a significant effect on consumption. The two most important factors in their evaluations are their expectations for unemployment and the price level. According to a survey, 14.0% of respondents answered that employment expectations were the main factor in deciding their level of consumption. This shows that consumers do not make judgements only with short term information, and will cut down on consumption if the employment situation becomes unstable. However, according to the econometric analysis, the influence was not statistically significant. Price fluctuations also affect consumption, and were found to have a negative and statistically significant relationship to consumption.

For Korean economy, stimulus through government spending is effective

Looking at the above, one can see that fiscal policy is more effective than monetary policy.Fiscal policy, by increasing income, directly affects consumption and has a strong economic stimulus effect. It is also possible to minimize side-effects such as price instability. Therefore, the current government stance to focus on fiscal rather than monetary policy is a positive development.

A certain level of government intervention to keep stock prices up may be needed for consumer sentiment to recover.

For income policies to lead to expanded consumption and a stimulated economy, other asset value variables should be considered. In the case of stock prices, the survey showed that they do not have a great effect on consumption, but the econometric analysis showed that after 1990, there was a positive relation between stock prices and consumption. In addition, with one-tenth of the population holding stocks, stock prices have become an important indicator for individuals in evaluating economic conditions.

Therefore, a certain level of government intervention to keep stock prices up may be needed for consumer sentiment to recover. In addition, considering that the average individual has debt amounting to 88% of disposable income, interest rate policy and policies to provide liquidity to households should be carefully adopted to prevent consumption from contracting due to debt. VIP