

REASONS FOR THE INCREASE IN PRIVATE CONSUMPTION

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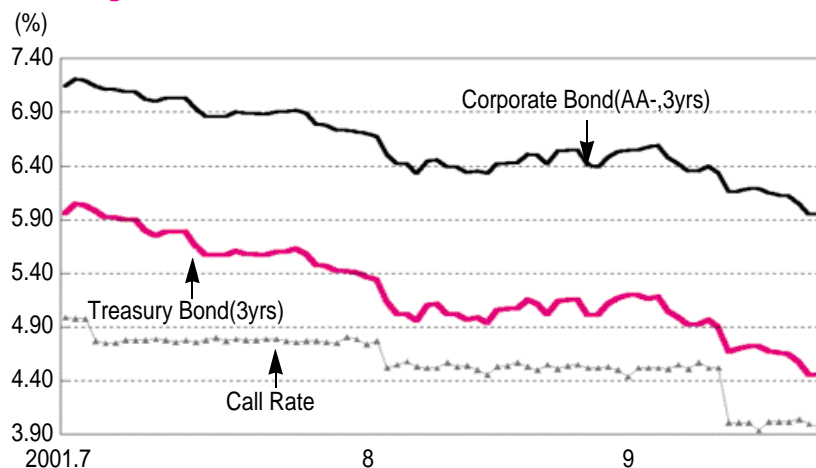
Compared to advanced countries such as the US, Japan, and Europe, the Korean economy has shown relatively strong growth in recent months. During the third quarter of 2001, Korea's real GDP growth rate was higher than expected at 1.8%, in contrast to the negative growth rates seen in the US and Japan.

This favorable growth rate was based on increases in construction investment and private consumption spending. Construction investment increased in the form of buildings such as schools and commercial buildings, as well as facilities such as generators and ports, to result in annual growth rate of 7.3%. Although this increase in construction investment does have the qualities of a technical rebound from a year-long decline, the increase is also backed by heightened construction demand.

Consumption growth due to low interest rates?

Unlike the increase in construction investment, the factors behind the increase in private consumption are somewhat unclear. During the third quarter of 2001,

Figure 1. Market Interest Rates in Third Quarter of 2001



private consumption increased 3.4% year-over-year, and some observers thought that this was due to the government's low interest rate policy. The market interest rate actually did fall continuously from April to October, and as a result bank interest rates also went on a downtrend.

However, there is a problem in the view that the increase in private consumption was caused by the low interest rate trend. In the Korean financial market, there are currently two channels through which low interest rates can result in an increase in private consumption. First, a fall in the interest rate can cause bond prices to rise, leading to an increase in private assets. Also, an interest rate cut can cause a reduction in bank lending rates, which would lead to a reduction in financing costs for households.

An increase in private assets due to a bond price increase can be a reason for increased private consumption. However, participation of individual investors in the domestic bond market is very low, with institutional investors as the main market participants. Therefore, a rise in bond prices would not have much effect on private consumption. In addition, if the explanation of higher consumer spending caused by capital gains in the bond market is valid, losses in the stock market should lead to lower consumption. This did not seem to apply for the domestic stock market, in which individuals account for about 90% of daily sales and purchases, and which has been in a downtrend during the third quarter.

Now let's examine the possibility of private consumption increasing through bank lending. During the third quarter, the products that saw the highest consumption growth were wholesale medical and pharmaceutical products, telecom equipment, and electrical equipment, and auto sales also rose by about 20% year-over-year. Since it is unlikely that hospitals and pharmacies took bank loans to buy supplies on the wholesale market, there was probably a good deal of auto purchases through installment payments. However, because credit card companies occupy a large share of the auto financing market, bank loans probably didn't account for many of the auto loans. Even acknowledging the influence of lower bank rates on private consumption, another factor is needed to explain the 3.4% annual increase of consumption.

Relation of consumption to income increases

Here, it may be helpful to reverse the meaning of the consumption function. Consumption is usually seen as a function of income, so an income boost, whether present or future, will result in a consumption increase. Unlike predictions that household income would decrease due to the stagnant economic conditions, a look at income levels for urban workers in the third quarter of 2001 show that private income has clearly increased, with the average monthly income of an urban worker's household at 2.73 million won in the third quarter, a 12% increase from 2.44 million a year earlier. This seems to be the cause of the higher consumption level seen in the third quarter.

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Reasons for private income growth

In the last quarter, besides the male's earnings, income from female labor increased 10.9% and income from other sources increased by 14%.

Even if a boost in income is claimed as the reason for higher consumption spending, the question remains of how the income of urban workers can increase during the current economic slump.

The most realistic answer would be that household income sources have diversified. Until recently, the main income source for urban workers' households has been the adult male's work income. However, in the last quarter, besides the male's earnings, income from female labor increased 10.9% and income from other sources increased by 14%. This shows that the worsened economic conditions have led wives and children to participate in the workforce in part-time or temporary positions, and that the source of income has spread from the head of the household to include the wife and children.

Average Monthly Income for Urban Workers

(unit : ten thousand won, annual change, %)

	Third Quarter 1999		Third Quarter 2000		Third Quarter 2001	
	Amount	Change	Amount	Change	Amount	Change
Income	225	8.5	244	8.6	273	12.0
Ordinary Income	217	10.1	228	5.1	253	10.9
Earned Income	197	9.8	209	5.7	230	10.0
Breadwinner	162	9.4	170	4.8	186	9.5
Spouse	20	5.7	21	9.8	24	10.9
Other Members	16	20.2	17	10.0	20	14.0
Other Income	20	13.1	19	-0.7	23	20.5
Business, Side job	9	16.8	9	3.1	11	15.6
Assets	5	12.5	4	-10.4	5	13.6
Transfer	6	8.5	6	1.5	8	32.8
Irregular income	8	-22.1	16	105.1	20	26.5

The 1.8% growth of GDP was due to the increase in construction investment and higher household income and consumption resulting from wider participation in the workforce.

Source: Korea National Statistical Office

Therefore, it can be concluded that the 1.8% growth of GDP during the third quarter of 2001, despite stagnant facility investment and exports, was due to the increase in construction investment and higher household income and consumption resulting from wider participation in the workforce. **VIP**