Recent Household Consumption Trends and Structural Stagnation

Kim, Jaechil*

As the Korean economy has recently shown signs of recovery, some have raised the 2017 economic outlook for Korea. However, no substantial improvement has yet been reported in household consumption, a significant element dragging down Korea's economic recovery for the past few years. Especially, stagnant household consumption in this business cycle seems serious even considering Korea's slowed potential growth. In the path of stabilizing household debt, the burden of principal and interest repayment has weighed down consumption. A significant part of household income is spent to accumulate less-liquid retirement assets, and to afford exorbitant housing expenses. Those factors are structural and less likely to change in a short run. Although the signs of recovery are more than welcome, whether or not the household sector fully rebounds remains to be seen.

The Korean economy has recently shown some signs of improvement. As exports outperform expectations, production and investment are picking up. Amid the rebound of retail sales that had declined for three consecutive months before February 2017, there are growing expectations for rising consumption. Given those conditions, the Bank of Korea announced that it would raise Korea's 2017 economic outlook by 0.1 percentage point from 2.5% to 2.6%, right after its monetary board meeting on April 13. Subsequently, Korea Development Institute and the IMF also followed suit, revising their growth projections from 2.4% to 2.6%, and from 2.6% to 2.7%, respectively. Although cautions are necessary to interpret those figures, they certainly indicate a positive shift in those institutions' view on the economy. Going forward, however, it is

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* Ph.D., Senior Research Fellow, Fund & Pension Department, Tel: 82-2-3771-0663, E-mail: jckim@kcmi.re.kr

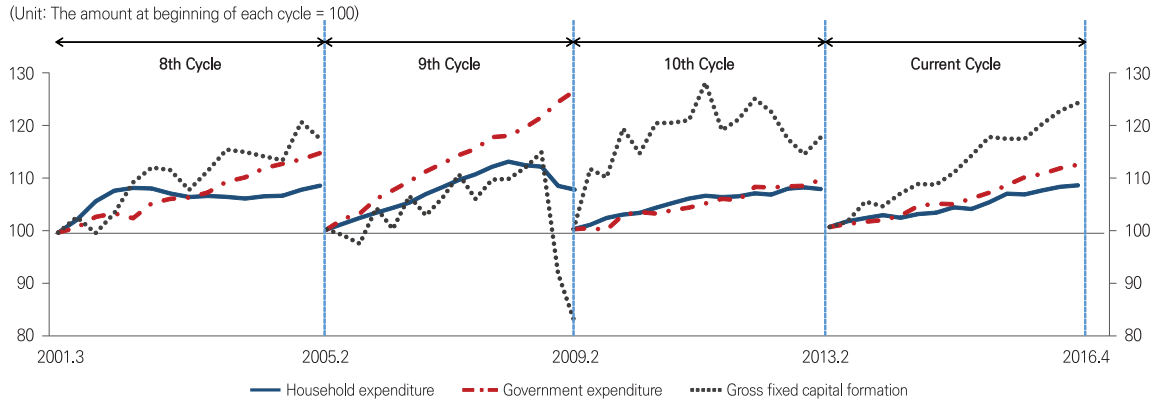
important to pay attention to whether or not private consumption, household consumption in particular, will rebound and stop being such a drag on the economy.

Household consumption: The mid- to long-term trend

It is hard to accurately grasp the change in consumption based on the monthly retail sales data alone, which is short-term statistics. The 3.2% increase in February from the previous month is surely encouraging as it came after the downward trend for three consecutive months. However, there were a few upswings in 2016, all of which failed to last. To see whether or not household consumption will improve substantially requires a comparative look at long-term data on the characteristics of household consumption.

Figure 1 compares domestic consumption from the third quarter of 2001 to the fourth quarter of 2016 (the 8th through 11th business cycles), by setting the quarterly, seasonally-adjusted amount of real household expenditure, government expenditure, and gross fixed capital formation at the beginning of each business cycle as 100. This shows how fast and to what extent each component of domestic consumption recovers in each business cycle.[1)]

Figure 1. Domestic consumption by business cycle: Household/government expenditure, gross fixed capital formation



Note: The figure compares domestic consumption among expenditures in GDP. It sets the quarterly, seasonally-adjusted, real amount at the beginning of each business cycle (the bottom) as 100. The official business cycle consists of a bottom, a peak, and another bottom that are measured monthly. A new business cycle starts at the bottom which is equal to the end point (bottom) of the previous cycle. Business cycles in Figure 1 are based on quarterly data. For analytical tractability, the new cycle's starting point (bottom) is separated from the end point (bottom) of the previous cycle, which creates subtle differences from official business cycles. The end point (bottom) of the 11th business cycle starting from March 2013 (noted as the second quarter here) has not been fixed yet.

Source: Data compiled from BOK statistics on expenditure to GDP

1) The peak and the end of the 11th business cycle have not been officially fixed yet. Hence, it is possible that we are going through either the 11th or 12th cycle at present. This article, however, assumes that we are currently in the 11th cycle that began in the second quarter (March) of 2013.

Except for the 9th business cycle hit by the global financial crisis, gross fixed capital formation and corporate investment expenditure drove Korea's economic recovery in the 2000s. The recovery of gross fixed capital formation was fast and sizable. During the 5th through 7th business cycles between the late 1980s and the early 2000s, the pace and size of the recovery in household expenditure were similar to those of gross fixed capital formation. But since the 2000s, household expenditure recovered much slower than investment expenditure, and the size has been insignificant to revive the overall economy. Especially since the 10th business cycle right after the global financial crisis, the recovery in household expenditure has become remarkably slower and smaller.

In the current 11th business cycle, household expenditure has shown a slower and smaller recovery, even compared to the 10th business cycle that saw a dramatic cut in household expenditure dynamics. If household expenditure at the beginning of the 10th cycle is set at 100, household expenditure two years later stood at 106.9, with the peak reaching 109.4. However, household expenditure in the 11th business cycle reached only 103.7 two years after the cycle began, and topped at 107.9 in the fourth quarter of 2016. This is a trend consistently found in the Household Income & Expenditure Survey by Statistics Korea (see Table 1). What are the causes behind the serious decline in household expenditure in the post-crisis era, especially, in the current business cycle that began in the second quarter of 2013?

Causes behind stagnant household consumption

Household consumption is in general affected by many compounding factors. Hence, it is not easy to pinpoint exact causes behind today's slow consumption. This article discusses potential culprits based on the Household Income & Expenditure Survey, and the Survey of Household Finances and Living Conditions released by Statistics Korea.[2)]

The first and foremost factor is income stagnation. Year-on-year increases in monthly average income from the first quarter of 2003 to the fourth quarter of 2016 confirm a serious slump in the income increase in the current 11th business cycle. Although the average income increase rate during the 9th and 10th business cycles stood at 1.62% and 1.88%, respectively, that of the

2) The Household Income & Expenditure Survey compiled and released by Statistics Korea is a quarterly survey (1st quarter of 2003 to 4th quarter of 2016) that offers useful data on Korean households' monthly average income and expenditure. The Survey of Household Finances and Living Conditions is an annual panel survey (2012 to 2016) for Korean households' nominal assets, liabilities, income, and consumption trends.

11th business cycle was only 0.95%. Income stagnation was even more drastic in households without salary and wage earners, e.g., the self-employed. The income increase rate of those households was highly volatile across business cycles, reaching 0.28% in the 11th business cycle. However, the income increase rate in wage and salary earners' households remained stable in this cycle after a major setback in the 10th cycle. This suggests that income stagnation especially among non-wage and salary earners has been a primary factor putting household consumption in this cycle on a standstill.

Table 1. YoY increases in monthly household income and expenditure

(Unit: %)

	9th Cycle Average (Feb. '05~Jan. '09)		10th Cycle Average (Feb. '09~Jan. '13)		11th Cycle Average (Feb. '13~Apr. '16)	
	Income	Expenditure	Income	Expenditure	Income	Expenditure
All households	1.62	1.06	1.88	1.52	0.95	0.20
Salary & wage earners' households	2.14	1.76	1.27	1.42	1.22	0.46
Other households	0.46	-0.23	2.57	1.30	0.28	-0.40

Note: The timing of the beginning of each business cycle is adjusted for quarterly data. The end of the 11th business cycle has not been fixed yet.

Source: Data compiled from the KOSIS database on household income and expenditure

In the 11th business cycle, the cut in the expenditure increase rate was much larger than that in the income increase rate. This could deepen further if non-consumption expenditures such as tax, public pension, social insurance, interest payment, etc. rise substantially to cut consumption expenditures. In the 11th business cycle, the increase rate of non-consumption expenditure slowed significantly at 0.68%, compared to 2.71% in the 10th cycle. This figure alone cannot explain the impact of the non-consumption expenditure factor on slowed household consumption. However, what is missing in the Household Income and Expenditure by Statistics Korea is installment debt. To accurately grasp how non-consumption expenditure has changed requires a look at the trend of regular payments to repay installment debt in the Survey of Household Finances and Living Conditions by Statistics Korea. Table 2 demonstrates that the ratio of debt repayment to household disposable income rose between 9 percentage points to 15 percentage points for 2012-2016. Although this could have stemmed from the slow-paced income growth vis-à-vis the household debt increase, structural improvements in household debt during the period also played a role. More concretely, interest rates fell while the size of

debt per household rose substantially during the period, which possibly reined in the interest payment burden. In addition, a policy measure has taken into effect since 2011 to induce more debt to be repaid in periodic installments, rather than in lump-sum at maturity, which led to a substantial decrease in the share of households with lump-sum repayments at maturity. This could have presumably increased households' debt repayment burden, and at the same time cut their disposable income for consumption expenditure.

Table 2. Household debt: Structural improvement and repayment burden across income brackets

(Unit: %)

	Income Quintile (Low → High)	Time		
		March 2012	March 2014	March 2016
% of households with liabilities	Total	65.2	65.9	64.5
Households repaying in lump-sum at maturity to those with mortgage debt (%)	1	37.3	35.0	31.8
	2	42.3	41.9	27.2
	3	44.8	31.0	30.2
	4	41.0	34.1	26.4
	5	42.9	38.7	36.7
Debt repayment to disposable income (%) in households with liabilities	1	45.3	61.8	41.6
	2	26.1	36.6	40.9
	3	25.4	31.8	34.5
	4	21.4	25.4	35.4
	5	20.6	24.0	30.5

Source: Data compiled from the KOSIS database on the Survey of Household Finances and Living Conditions (2012-2016, annual data)

Lastly, it is worth looking at how disposable income is distributed to consumption expenditure, savings, etc. The Household Income & Expenditure Survey conducted by Statistics Korea releases the "surplus over disposable income (%)", the amount of disposable income left after household expenditures, which usually goes to savings and investments. During the 11th business cycle, the surplus over disposable income bottomed at 25.5% in the first quarter of 2015 before climbing to reach 30.3% in the fourth quarter of 2016. The steep increase in household financial assets is also confirmed by the flow of funds by BOK. This is a recent phenomenon observed amid the slowed increase in household income, and thus unlikely to imply that households accumulated savings after spending as much as they like. It is more likely

that households increased precautionary savings while cutting consumption expenditures to meet other financial needs such as retirement savings, abruptly risen housing rent, etc. This is partly evidenced by the continuous increase in the share of insurance and retirement pension savings in household financial assets. Because those assets are illiquid, they are hardly converted to household consumption.

Expectations for a rebound in household consumption

An economy is often likened to a living organism. Good signs could emerge all of sudden although all other conditions bode ill. If exports and production rebound to offer more to households, and if positive signs continue in the stock market and other financial markets, this could change household sentiment sooner than expected. However, it is not easy to expect a rebound given that the current slowness in household consumption could have stemmed from structural factors. Because it is inevitable for Korea to stabilize the excessive size of household debt for improving the debt structure, a substantial part of household income will be spent to repay the debt unless there is any significant decrease in the overall debt size. But such a decrease requires a long period. Furthermore, if interest rates begin to rise again, more household income should go to debt repayments. Also notable are other structural variables that could rein in household spending as much as household debt does, e.g., more illiquid savings for retirement assets, more savings for sharply risen housing expenses, etc. To sum up, although recent signs for recovery are more than welcome, whether the household sector, besides other sectors, will rebound or not remains to be seen.