Analysis of the Effect on Consumption of the Uncertainty of Income and Asset Prices

The Recent protracted sluggishness of consumption together with decreased facilities investment constrains recovery of the Korean economy. Many point out that this is mainly attributable to structural problems such as the widening gap between the rich and the poor, excessive household indebtedness and serious youth unemployment. However, the idea is gaining grounds that this lackluster consumption is partly due to the uncertainty of domestic and overseas economic conditions. Just as the focus of corporate investment shifted, after the financial crisis in the late 1990s, from achieving growth in terms of scale to improving profitability and security, households are getting more cautious when making investment and becoming more sensitive to uncertainty.

In this context, this paper sets out to analyze the influence of uncertainty on consumption. Although there exist numerous economic and non-economic uncertainties in a real economic situation, this paper deals exclusively with economic uncertainties, and those concerning income, borrowings and asset prices, in particular. The prediction error of income, calculated using sentiment index, and the conditional heteroscedasticity of incomes and asset prices are used as indexes for representing uncertainty.

According to the results of the analysis, income uncertainties, as well as economic factors such as income, assets and interest rates, have a significant influence on consumption. In particular, it is found that consumption has been getting more sensitive to income uncertainty since the financial crisis, and it is assumed that this is because economic agents, having already experienced and learned from the past crisis, now revise their expectations in accordance with changing economic conditions and modify their economic activities.

Furthermore, it is found that uncertainties concerning asset prices and borrowing conditions also have a negative impact on consumption. Notably, a rapid fall or rise in asset prices including housing prices together raises the overall level of uncertainty together, and accordingly, it may weaken the wealth effect following a rise in asset prices or accelerate the pace of decrease in consumption in the case of a fall in asset prices.

This study suggests that not only changes in purchasing power but also rapid changes in the consumption environment including income, asset prices and borrowings increase uncertainty and may consequently affect consumption. In this respect, in order to achieve steady and stable growth in consumption, it is necessary to improve the stability of those economic variables, such as income and asset prices, that affect consumption.