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I. Recent Developments

1. Real Economy

The recovery of the real economy has been gradually accelerating. First of all, the composite index of business indicators
continued to maintain its upward movement during the months of April and May. Along with the sustained favorable turn
in consumption and facility investment, exports and construction are also steadily improving.

The unemployment rate, which rose to as high as 8.7 percent in February, dropped to 6.5 percent in May influenced by the
decreased number of bankrupt firms and the active entry of new enterprises. The ratio of new start-up to bankrupt firms
has been rising steadily in the first half.

2. Prices

The second quarter saw the consumer price index rise by 0.6 percent over the same period last year. On the other hand,
the producer price index declined 3.3 percent.
These rather favorable figures are the result of a stabilized exchange rates and the economic recession which eased the
pressure on inflation. On top of these factors, the prices of agr., forest & marine products, which were quite unstable in the
first quarter, stabilized with their increased seasonal supply.

3. Money Supply and Exchange Rates

Since April the growth rate in the money supply has declined. The M2 supply, which had been on a sustained upward
growth path (based on average balance), dropped to 31.0 percent in May from 34.5 percent during the previous month. This
apparently resulted from the increased transfer of short-term deposits into savings-deposit accounts, thereby stemming the
growth rate in the M2 supply.

Reserve Money has remained at around 21 trillion won since March, thereby indicating that the money supply expansion
trend has actually come to an end.

Long-term interest rates, which temporarily rose in May due to the rapid recovery of the real economy and the widely held belief that the call rate had bottomed out, has once again regained stability.

In spite of the government? announcement of its policy to appropriately adjust foreign exchange supply and demand and account for the continued slide of the yen against the dollar, the value of the won against the dollar rose rapidly, influenced by the sustained surplus in the country? international balance of payments and increased influx of foreign exchange resulting from the sell-off of assets by restructuring-minded domestic enterprises.

On the other hand, the value of the yen against the dollar continued to slide, reflecting the concerted efforts of the Japanese government and the European Union to stem the appreciation of the yen. The value of the won against the yen appreciated to a new record level.

II. Outlook for 1999

1. Growth

Korea? economy, which registered a positive growth of 4.6 percent in the first quarter of this year from a year earlier, is expected to grow 6.2 percent in the second half of this year and 5.8 percent for the whole year.

By sector, private consumption and facility investment are likely to maintain their recovery trends. Nonetheless, the net export value (exports minus imports), which has propped up economic growth since last year, now appears likely to adversely influence overall economic growth. Inventories are likely to continue to decline for the time being. However, the sector is expected to positively contribute to economic growth through the expansion of inventories on an annual basis starting this year.

In the 2nd half of 1999, when the reactive effect against 1998? negative growth is expected to fade away, the quarter-to-quarter growth rate is expected to be less than 2 percent. It will then achieve a low growth rate of around 1 percent thereafter.

While it is likely that production activities will pick up along with an increased rate of economically active population stimulated by the gradual economic upturn that in turn will improve the employment situation, it is unlikely that the economy will recover this year to its pre-foreign exchange crisis level of late 1997.

The unemployment rate has been recovering since February (8.7 percent), and the number of employed workers topped 20 million once again in April but still remains short of the 21 million seen in 1997. The rate of economically active population still remains below the 62.2 percent mark registered in 1997.

The approximately 6 percent economic growth figure anticipated following the second quarter of this year is projected to be sustained for four consecutive quarters prior to declining to around 5 percent.
This forecast stems from the likelihood that a) the reactive effects from negative growth experienced in 1998 may disappear around the first quarter of 2000, b) the time-lag effect of the flexible monetary policy may fade away around the second quarter of 2000 and c) private consumption, which temporarily exceeded the average level in 1999, is expected to return to its long-term average in 2000.

In the facility investment sector, gradual recovery hereafter is anticipated. The picture is not yet clear insofar as the outlook for exports and domestic demand is concerned. Moreover, the restructuring efforts of enterprises in general are likely to be carried out mostly in the second half of this year, which does not translate into any fair prospects for increased facility investment this year.

The five major conglomerates that have spearheaded facility investments may also find it difficult to further expand their investments in view of their need to reduce their debt to equity ratio to 200 percent by the end of 1999. The top 64 major business groups also have among their number many enterprises singled out for work-outs on top of which they also find themselves hard pressed to restructure. This being the case, they can ill-afford to expand facility investments at this time.

Furthermore, the government had earmarked 20 trillion won for release in the first half of this year out of its 1999 budget for facility investments totaling 30 trillion won. In view of this, government requests for two supplementary budgets in the second half of this year notwithstanding, increased facility investments and outlays for support of economic recovery through government expenditures will have limited effects.

2. Prices

The growth rate in the consumer price index, which has been gradually decreasing since the first quarter of 1998, is likely to be around 1.5 percent on average in 1999. This stems from the likelihood that a) in 1999 the won will continue to appreciate slowly but steadily against the dollar, b) international market prices of raw materials, wages and other cost-push factors will remain stable, c) overall demand pressure will not be conspicuous, and d) the size of GDP, excluding inventories, will remain at the 1998 level this year and the ?DP gap will tend to function as deflationary pressure.

3. Foreign Trade and Balance of International Payments

Thanks to last year? greater-than-anticipated trade surplus, it was possible to achieve a current account surplus of US$40 billion at year? end. Nonetheless, the first quarter of this year witnessed a current account surplus of no more than US$6.78 billion, due to lagging exports and increasing imports. Thus, the current account surplus for the whole year may be reduced to US$20 billion. Consequently, the ratio of the current account balance to GDP will drop from 12.5 percent in 1998 to 5.0 percent in 1999.

Overall imports this year are likely to witness a growth rate of 20.1 percent, mainly influenced by the minus 36.6 percent growth and decreased inventories of 1998. On the other hand, Korea? exports will see limited growth this year, due to the gradual appreciation of the won against the dollar, and delayed economic recovery in Japan, China, and other countries in Southeast Asia.

The deficit in the invisible trade sector including services and unrequited transfers, which declined markedly last year, is expected to expand sharply this year to register US$3.8 billion this year versus US$1.13 billion last year.

4. Interest Rates and Exchange Rates

The interest rate (yield of corporate bonds, 3yrs.), which had dropped to around 7 percent until recently, is now likely to remain stable in the second half of this year. With a narrowed margin between domestic and foreign interest rates, however, there are now misgivings that the domestic interest rate will become more vulnerable to changes in international interest rates hereafter.

Ever since September of last year, Korea? financial policy authorities have been pursuing a money supply expansion policy, but its inflationary pressure has been almost negligible. This being the case, when and if the monetary authorities concerned implement a flexible credit supply policy, the market interest rates will be maintained at around the 7-8 percent level--or the nominal growth rate.

Appreciation pressure on the won-dollar exchange rate is expected to eased following the government? announcement of a policy to appropriately manage the supply and demand of foreign exchange. Nonetheless, the gradual appreciation of the won against the dollar is likely to remain unabated due to the maintenance of a current account surplus and a sustained influx of foreign capital into the Korean Stock market.

A review of the real effective won-dollar exchange rate as calculated by our institute shows that the real effective exchange rate as of the end of last May stood at around 1,212 won per dollar but the prevailing exchange rate in June was around 1,160 won per dollar, thereby indicating that the won was then overvalued by around 4-5 percent.

The announced government plan to issue US$4 billion worth of foreign exchange stabilization bonds is expected to ease the pace of the won? appreciation against the dollar. Nonetheless, no less than US$50 billion is expected to be added to Korea? current foreign exchange holdings this year, including US$20 billion in the current account surplus, US$25 billion in foreign direct investment and investment in the Korea Stock Exchange, and $4.3 billion to be borrowed from the IMF and other international financial agencies. Thus, Korea is likely to face a foreign exchange surplus for the time being.

III. Policy Issues & Suggestions

1. Policy Issues

Thanks to a sustained low-interest policy since the second half of last year, it has been possible to stimulate the recovery of the stock market and other asset markets, which in turn brought about the recovery of the real economy.

Provided that the current economic recovery path is maintained, it will be possible to attain economic growth of over 6 percent this year--far exceeding the earlier forecast. At the beginning of the year, a number of economic institutes predicted annual growth rates of around 2.0-4.0 percent, but they have now come to revise their projected growth rates to around 6 percent.

Influenced by the higher-than-anticipated economic growth rate for this year, the government has also come to shift its basic economic policy from a growth oriented to a stabilization-oriented policy.

The government has dropped its policy of lowering the call rate to 4.75 percent or less per annum. Instead it has now set the prevailing call-loan rate as the minimum level and is set to adopt a flexible interest rate system, geared to effectively cope with any changes in the economic situation.

However, we should not overlook the fact that the recent economic recovery trend has not been triggered so much by the restructuring of enterprises and financial institutions as by the government? policy of expanding liquidity and other related financial policies.

In fact, the government in July 1998 dropped its high-interest rate policy that had only stimulated the bankruptcy of enterprises. Instead the government wasted no time and spared no efforts in eliminating once and for all the vicious cycle of high interest rates => increased financial cost for enterprises => increase in bankruptcies => worsening of financial conditions due to tight credit control => higher interest rates.

Simultaneously, the Korean economy also benefited from the low-interest rate policy of the United States and other advanced countries that helped subdue the worldwide financial crisis and helped facilitate the stabilization of the domestic economy.

Thanks also to the low-interest rate policy of advanced countries, domestic enterprises steadily assumed a course of overall economic recovery beginning with a sharp reduction in financial costs, influx of adequate liquidity into the stock market to prop up share prices, recovery of capital and asset markets, abatement of foreign exchange panic that gripped enterprises and other economic agents, recovery of domestic consumption demand, and gradual recovery of the overall economy.

There is no denying the fact that the recent economic recovery is due in no small part to the restructuring efforts of enterprises and financial institutions that began last year. However, it is no less important to

acknowledge that there still
exist a number of problems which need to be addressed.

In fact, the restructuring efforts of our financial institutions and enterprises thus far have contributed to improving their
image with foreign investors in Korea. Nonetheless, a closer look into such efforts indicates that they may have been
merely interested in impressing potential foreign investors rather than demonstrating their earnest intent to reform their
industrial/financial structures.

This view is supported by a) lagging progress in their negotiations for so-called ?ig deals, b) lack of sincere efforts to
dispose of their excess facilities, and c) unfavorable developments in their subsidiaries designated as ?ork-out firms, not to
mention the stalemated negotiations for the sell-offs of Korea First Bank and Seoul Bank.

Therefore, it is obvious that the recent economic recovery stems from a low-interest rate policy that reduced the financial
cost for enterprises which in turn helped facilitate recovery of capital/asset markets and helped restore enterprises
confidence, and thus boosted private consumption.

All in all, this leads to the conclusion that the current economic recovery trend represents a technical reaction to changes in
major economic factors. Thus, it is rather difficult to assert that the recent recovery of the real economy resulted from the
successful restructuring of financial institutions, enterprises, and public and labor sectors, which were identified as the major
culprits for the foreign exchange crisis that brought about the IMF-era in late 1997.

In fact, we need to realize that we have been able to overcome the foreign exchange crisis and resulting IMF-era to a
certain extent thus far thanks chiefly to the low-interest rate policy of advanced countries adopted in September 1998.
Therefore, we should not spare any effort to successfully cope with the advent of another economic crisis, which is quite
probable if and when the international financial situation seriously deteriorates.
2. Policy Suggestions

A. Maintenance of Low-Interest Rate Policy

Dissension has erupted among government ministries over the sustained implementation of the current low-interest rate
policy. The Ministry of Finance and Economy asserts that the current interest rate level of 4.75 percent should be
maintained. On the other hand, the Bank of Korea insists that the current interest rate

should be readjusted upwards,
noting rapid increases in the prices of shares, real estate and other asset markets.

It is the opinion of our institute, however, that Korea? interest rate policy should be set and maintained at an optimum level, taking into consideration economic status and the future outlook as well. In view of the fact that our economy has undertaken structural renovations in general. We should adopt a low interest rate policy on a long-term basis.

The so-called Golden Rule stipulates that an optimum level of interest rate should represent the combined figures of the economic growth rate and consumer price index growth rate. Therefore, when and if it is properly assumed that our potential economic growth rate is 5 percent and that anticipated consumer price index growth this year is 3 percent, then the long-term optimum interest rate would be around 8 percent and should be maintained at that level. If Korea is to follow the Taylor principle, one of the criteria used by the FRB of the United States to adjust its short-term interest rates, then Korea? optimum short-term interest rate should be set at around 7.65 percent.

In light of the fact that there has been no tangible signs of Korea? consumer price index making a radical upturn, it is no exaggeration to say that the possibility of consumer prices taking such a route appears remote. Nevertheless, the very fact that Korea? wage level has been rising gradually but steadily draws our attention. In particular, we must not ignore signs of rising prices of shares and real estate, thereby raising capital gains, that are apt to result in increased awareness among our main economic agents about immediate inflation.

It is worth mentioning that the current interest rate is not low when compared with the one that prevailed prior to the advent of the IMF-era. Although the nominal interest rate is lower than its pre-IMF level, the current real interest rate is identical with that of the pre-IMF level.

B. Long-Term Approach Towards the Stock Market

The recent rapid increases in the prices of listed shares, along with the tendency of surplus liquidities to turn into speculative investment funds, appear to have caused some sort of misgivings. On June 23, the KOSPI closed at 888--up 58 percent from the end of 1998. The combined value of the listed shares also rose from 7.1 trillion won at the end of 1997 to 212 trillion won as of the end of April this year.

The bullish stock market is a positive factor inasmuch as it enables listed companies to directly raise funds to reduce their debt to equity ratio. On the other hand, the concentration of liquidlties into mutual investment funds being operated by investment firms affiliated with business conglomerates is apt to result in the concentration of economic power in the hands of conglomerates.

It is also possible that any dissension between policy-making government agencies over the concentration of liquidities is apt to disturb the market. Some government officials insist that the current bullish stock market does not represent a bubble market but reflects a genuine economic growth trend, while others maintain that it represents over-valuation of major stocks and therefore it is necessary to discourage operation of mutual investment funds being managed by investment firms affiliated with business conglomerates.

Nonetheless, there is no denying the fact that a sustained bullish stock market makes it easier for enterprises to raise much-needed funds to reduce their debt to equity ratios. Therefore, it is necessary to approach the stock market issue on a long-term, systematic basis in conjunction with the general structure of financial institutions.

Indeed, it is absolutely necessary to revitalize the stock market, if only to pave the way for cash-strapped enterprises to directly raise funds. Incidentally, it should be noted that in order to attain the target of reducing the debt to equity ratio of enterprises to the 200 percent level by the end of this year, it is necessary to issue new shares with consideration worth 57.9 trillion won.
Therefore, it is necessary to adopt measures stimulating indirect investments through mutual funds, beneficial bonds rather than more risky direct investments in shares by individual investors, as well as other measures designed to encourage investments in safe national pension funds, insurance funds and other long-term securities.

It would also be appropriate to consider at this time the implementation of a capital gains tax (tax on earnings from stock transactions) in consideration of taxes being collected on incomes from real estate and other financial transactions, including bank deposits. In particular, if progressive capital gains tax rates are assessed in favor of long-term stock transactions, it will be possible to help sustain a stable stock market on a relatively long-term basis.

C. Resolution of Unemployment and Unbalanced Income Issues

Since the advent of the IMF-era, the unemployment and unbalanced income issues have become more serious than ever before. The unemployment rate nominally dropped to 6.5 percent as of the end of May this year. However, the substantial unemployment rate is believed to be much higher if the people squeezed out of business due to the economic recession that come about in the wake of the IMF-era are taken into consideration. The index indicating the degree of income imbalance also deteriorated seriously since the outset of the IMF-era (see table below)

In order to minimize the unemployment rate, the government has been financing public works projects and supporting the establishment of venture enterprises and knowledge based businesses -- all of which are not expected to yield the projected results.

The public works projects have resulted in a social deadweight loss, while venture and knowledge based businesses have had little effects in boosting employment because of their innate nature.

In order to fundamentally resolve unemployment, it is necessary to create additional jobs. To this end, it is also necessary to create jobs in the private sector, while boosting employment opportunities in the construction and service sectors.

On the other hand, it is possible to create demand for labor by ensuring flexibility and diversification in labor markets.

In addition, it is necessary to raise labor? skills through the education of professionals in preparation for the development of knowledge industries as well as the software industry.

The government announced recently its plan to reduce labor income tax by as much as 1.4 trillion won a year so as to help the middle-class. Although the government fears that the plan may stimulate price inflation, it is believed that it will have little influence.

In as much as the wage earners who are subject to wage tax cutbacks have already suffered cutbacks in their permanent income, due chiefly to decreased nominal and substantial wages, it is highly unlikely that the projected income tax reductions will stimulate increased private consumption propensity and thus stimulate inflation.