



## Economic Survey of Japan, 2009

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### Summary

In the context of the global economic crisis, the Japanese economy has fallen into its deepest recession of the post-war era. Output is projected to contract by around 6% in 2009, reflecting a plunge in exports and tighter financial conditions. Prompt action by the authorities to stabilise financial markets, cut the policy interest rate and implement large-scale fiscal stimulus is cushioning the blow and sets the stage for a mild recovery, against the backdrop of a projected sluggish rebound in world trade. With deflation entrenched, the Bank of Japan should keep the policy interest rate close to zero. As the stimulus packages fade and fiscal consolidation begins, sustaining the expansion will depend increasingly on private domestic demand, which requires economic reforms to create new drivers of growth. Reforms in the labour market, where rising dualism has constrained wages and private consumption, and the non-manufacturing sector, where productivity gains lag far behind manufacturing, are especially important. Policy reforms in a number of other areas are needed for robust and sustainable growth.

**Stabilising the financial market and improving its efficiency.** Emergency measures to steady the financial market and promote credit flows are proving effective. As an economic recovery takes hold, these measures should be phased out to limit their distortionary effects while improving the regulatory architecture to further reduce banks' equity holdings, enhance the transparency of securitised products and markets and improve the quality and fairness in the rating process of credit rating agencies. Reforms to increase efficiency and overcome chronic problems, notably the low profitability in the banking sector, particularly in regional institutions, are a priority to support Japan's growth potential.

**Achieving progress in fiscal consolidation.** The crisis and the stimulus packages are projected to boost the budget deficit to 10% of GDP in 2010 and gross public debt to 200%, calling for a detailed and credible medium-term fiscal consolidation plan to sustain the confidence of financial markets. Once a recovery is in place, such a plan should be implemented to put the public debt ratio on a downward path. This will require reversing the upward trend in spending, focusing on cuts in public investment. Additional revenues are also necessary, in part to finance

*This Policy Brief presents the assessment and recommendations of the 2009 OECD Economic Survey of Japan. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

the planned improvement in social welfare programmes. Revenue should be increased through a comprehensive tax reform that also limits the negative impact on economic growth.

**Reforming health and long-term care.** The health-care system has contributed to outstanding health outcomes in Japan while keeping expenditures below the OECD average. However, rapid population ageing and the plan to improve social welfare programmes will put upward pressure on health spending. It is important, particularly in light of the difficult fiscal situation, to introduce efficiency-enhancing reforms to shift long-term care out of hospitals to less expensive institutions and home-based care, expand the use of generic drugs and promote healthy ageing. Efficiency gains should be accompanied by measures to promote higher quality to address growing public dissatisfaction with health care. The keys are to improve access to new drugs, medical devices and advanced medical treatments, in part by allowing more mixed billing. Imbalances and shortages in the system reflect shortcomings in the current fee-setting system, which should adopt a more scientific approach. Finally, universal coverage requires improving compliance in paying premiums.

**Addressing global warming.** Japan has introduced a wide range of policies aimed at achieving its Kyoto Protocol target of reducing greenhouse gas emissions. Nevertheless, emissions have risen, indicating the need to introduce more binding, market-based mechanisms to achieve its targets for 2020 and 2050 in a cost-effective manner. Japan should shift from its voluntary emissions trading system to a mandatory system that covers the entire economy, including transport, drawing on the lessons from other countries and Japan's voluntary system. In addition, the emissions trading system should be linked to those in other countries and Japan should make greater use of a well-functioning Clean Development Mechanism as it is already relatively energy-efficient. Policies to promote the development of renewable energy sources in the short run should be based on transparent and efficient instruments. ■

## What is the economic outlook for Japan?

The export-led expansion that began in 2002 ran out of steam in late 2007 in the context of slowing world trade. Output began to contract from the second quarter of 2008, even before the global financial crisis intensified in September. Although Japan was not at the epicentre of the crisis, its export-dependent economy was vulnerable to the collapse in world trade, which resulted in its most severe recession of the post-war era. Exports and industrial production each fell by around a third in volume terms between September 2008 and February 2009, leading to a rise in unemployment to unprecedented levels by mid-2009 and to a decline in wages. Financial market conditions deteriorated as credit conditions tightened and the capitalisation of the Tokyo Stock Exchange fell by half. By March 2009, the confidence of large manufacturing firms had plummeted to its lowest level since 1975, causing a major retrenchment in their investment plans. Headline inflation has turned negative and by mid-2009 prices were down around 2% year-on-year. Output is projected to drop by around 6% in 2009, following a 0.7% decline in 2008.

The authorities responded quickly to the crisis. In the financial sector, policies are aimed at sustaining credit flows and stabilising markets. The government revived a scheme to inject public capital in depository institutions, encouraged lending to small and medium-sized enterprises (SMEs), took steps to stabilise the stock market and launched a programme to provide emergency loans to firms. Additional support was provided by the Bank of Japan, which launched a major scheme to facilitate corporate financing, increased purchases of government bonds and started buying commercial paper and corporate bonds. Both the central bank and the government resumed purchases of equities from banks to support their capital base. In addition, the Bank lowered the policy interest rate from 0.5% to 0.1% by the end of 2008. These measures have improved credit conditions and have flattened the yield curve. On the fiscal front, the government has launched four crisis-driven stimulus plans since August 2008, amounting to 4.7% of 2008 GDP, above the average of 3.9% for OECD countries adopting stimulus programmes. Increased spending, at 4.2% of GDP, accounted for the bulk of the stimulus in Japan. As a result of the stimulus and the severe recession, the government budget deficit is projected to reach 10% in 2010.

The first green shoots of recovery appeared in the second quarter of 2009 with gains in exports and industrial production, while financial conditions improved, reflecting a rebound in the stock market. Output is projected to continue increasing in the second half of 2009, thanks primarily to fiscal stimulus. However, the pace of recovery is likely to be restrained by subdued export growth, as world trade picks up only gradually and the appreciation of the yen over the past year reduces Japan's market share. Consequently, output growth is projected to remain below 1% during 2010, resulting in entrenched deflation and a continued rise in the unemployment rate. While a stronger pick-up in world trade could lead to a faster rebound in Japan, there are a number of downside risks, particularly from the deteriorating labour market and possible negative second-round effects from the financial sector. In addition, Japan's huge public debt makes it vulnerable to a rise in long-term interest rates. ■

## What are the keys to sustaining growth over the medium term?

As the impact of the stimulus packages wanes and the focus shifts to fiscal consolidation, sustaining growth will depend increasingly on private domestic demand. The 2002-07 expansion, the longest in Japan's post-war history, was driven primarily by the export-oriented manufacturing sector and failed to spark strong domestic demand growth. The result was an unbalanced upturn that

exacerbated gaps between sectors, regions and small and large firms. Creating a new growth model depends on reforms to boost domestic demand. The previous government's *Medium to Long-term Fiscal Policy and an Economic and Fiscal Policy Outlook for the Next Ten Years* recognised the importance of "pursuing economic growth through reform in the medium to long-term". It is important to implement reforms promptly, given that their benefits often take considerable time to materialise. Indeed, OECD experience shows that key reforms are most often implemented during deep recessions. Reform, focusing on the labour market and the non-manufacturing sector, should be a top priority for the new government.

### ***How can the labour market be improved?***

The rise in the share of non-regular workers, from 20% in 1990 to 34% in 2008, has put downward pressure on wages and private consumption, as they are paid substantially less than regular workers. The increasing proportion also has negative implications for long-term productivity as firms invest less in training non-regular workers. Equity problems are a concern as well, given that the difference in productivity between regular and non-regular workers is much smaller than the wage gap. In short, the dualistic labour market traps a large proportion of the labour force, especially youth, in low-paying jobs with little employment security and limited access to training. Moreover, non-regular workers receive only limited coverage from the social insurance system. Reversing dualism requires addressing the factors that encourage firms to hire non-regular workers, notably the savings in labour costs, in part due to lower social insurance contributions, and enhanced employment flexibility. A comprehensive approach is necessary, including increasing the coverage of non-regular workers by social security insurance schemes, reducing employment protection for regular workers and upgrading training programmes to enhance the job prospects of non-regular workers. At the same time, it is important to raise female labour force participation by reducing or eliminating aspects of the tax and social security system that discourage full-time work by women, providing more attractive job opportunities and encouraging flexible working arrangements, including by expanding the availability and quality of child care. Such changes would make for a better "work-life balance" and could help end the downward trend in the fertility rate.

### ***How can productivity in the non-manufacturing sector be increased?***

During the export-led expansion beginning in 2002, labour productivity growth accelerated to more than 7% per year in manufacturing while remaining below 2% in services. As services account for 70% of value-added and employment in Japan, boosting productivity in this sector is essential to sustain output growth and narrow the gap with the top OECD performers. The weak productivity performance in services highlights the importance of strengthening competition through a number of policies:

- Competition policy should be further upgraded by reducing exemptions to the Anti-Monopoly Act, increasing administrative fines and phasing out the special treatment of SMEs, which play a dominant role in services.
- Regulatory reform should be accelerated, focusing on reducing entry barriers, as international comparisons indicate that starting a business in Japan is relatively

complicated, costly and time-consuming. In addition, the reforms introduced in the special zones should be expanded nationwide.

- International competition should be enhanced by reducing barriers to service imports and encouraging inward foreign direct investment (FDI). Increasing inflows requires removing barriers to FDI and product market regulations that discourage potential foreign investors.

In addition, competition in key service industries, such as retail, energy, transport and business services, needs to be strengthened through wide-ranging reforms. In particular, an independent sectoral regulator should be established for both the electricity and gas sectors and more consumers should be allowed to choose their supplier. Finally, reform of agricultural policies would bring significant benefits to consumers as the high level of assistance to farmers boosts the average price received by agricultural producers to a level nearly twice as high as the world price. Market price supports, which distort trade and production decisions, should be replaced.

### *What reforms are needed in the financial sector?*

Reforms should also include the financial sector, where the focus at present is appropriately on emergency measures. These encompass increasing guarantees on loans to SMEs, expanding loans by public financial institutions, purchasing equities from banks and regulatory forbearance. Once a recovery takes hold, these measures should be withdrawn to limit distortions. It is also necessary to improve the regulatory architecture. While this is part of an international initiative, a number of priorities stand out for Japan. *First*, banks' equity holdings should be further reduced. The experience of 2008 demonstrates once again that corrections in the stock market threaten banks' capital adequacy and their ability to lend. *Second*, the transparency of securitised products needs to be enhanced to promote the stability of financial institutions and to revive this market. *Third*, quality and fairness in the rating process of credit rating agencies should be improved, in part through rules that prevent conflicts of interest, while progressively removing their ratings from financial regulation.

Another priority is to introduce reforms to enhance the efficiency of the financial sector and address chronic problems, notably the low profitability of the banking sector, particularly in regional institutions. It is important to accelerate the privatisation of public financial institutions to reduce distortions in resource allocation and to facilitate banks' entry into financing sectors, such as agriculture, that remain relatively closed to them. The authorities should reduce preferential regulatory treatment of regional institutions, which leads to distortions and moral hazard problems, and encourage the rationalisation of this sector. To increase efficiency in the context of an ageing population, obstacles to the use of reverse mortgages need to be removed, thereby reducing liquidity constraints on the elderly. ■

### **How can monetary policy support a recovery?**

In addition to promoting financial market stability and facilitating corporate financing, the Bank of Japan should support economic growth by keeping the policy interest rate close to zero, given entrenched deflation and downside risks to economic activity, while taking into account the risk of financial imbalances in the medium term. Once deflation has been overcome, the central bank's Policy Board should revise the understanding of price stability as inflation between

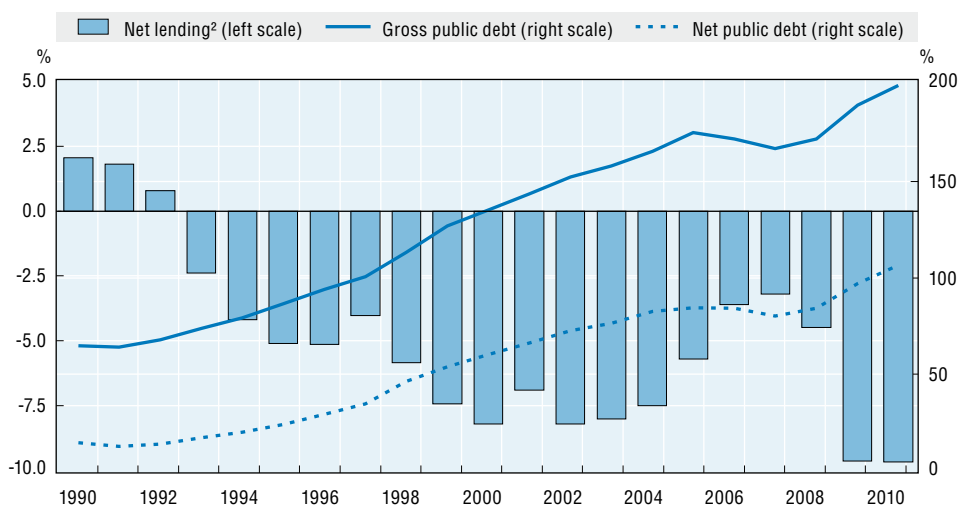
0 and 2% by increasing the lower end of the range to ensure an adequate buffer against renewed deflation. The course of monetary policy will need to take into account the pace of economic growth and the evolution of inflation, which will depend in part on progress in fiscal consolidation. ■

**What should Japan do to resolve its fiscal problem?**

The reduction in the budget deficit – from 8.2% of GDP (excluding one-off factors) in 2002 to 3.2% in 2007 – is rapidly being reversed, putting the target of a primary budget surplus for central and local governments by FY 2011 out of reach. Gross government debt is projected to rise to 200% of GDP in 2010, and to 100% in net terms, raising serious concerns about the sustainability of the fiscal situation. It is essential, therefore, to develop a credible and detailed medium-term fiscal consolidation programme to maintain the confidence of financial markets and to implement it once an economic recovery is firmly in place. The December 2008 programme to upgrade the social welfare system would make fiscal consolidation even more challenging as it implies increasing public social spending from its current level, which is below the OECD average, making the required rise in revenues even larger.

In June 2009, the government set out new targets for fiscal consolidation: stabilising the public debt ratio by the mid-2010s and putting it on a downward trend from the early 2020s. This was to be accomplished by halving the primary budget deficit of central and local governments by FY 2013 and achieving a surplus by FY 2019. It is essential that a more ambitious fiscal consolidation objective be adopted to limit the run-up in debt and the risk of higher interest rates. Japanese interest rates have remained surprisingly low and stable despite rising public debt, reflecting abundant domestic saving, significant home bias and consistently large purchases of government bonds by financial institutions in a context where attractive domestic investment opportunities are limited. Looking ahead, the conditions fostering low interest rates are likely to weaken. For example, the new Japan Post Bank and the national pension funds may expand

**Figure 1.**  
**THE DETERIORATING FISCAL SITUATION IN JAPAN**  
For general government, as per cent of GDP<sup>1</sup>



1. OECD estimates for 2008-10.  
2. Excludes one-off factors related to the transfer of pension funds, the privatisation of highway corporations and transfers from the FLF Special Account.  
Source: OECD Economic Outlook No. 85 Database.

their investments in other assets. An effective fiscal consolidation programme is thus essential to limit the risk of a substantial rise in interest rates. Moreover, given the objective of reducing the public debt ratio, it is important to shift the focus of consolidation from the primary to the overall budget balance.

### ***Is there scope to cut spending?***

Cutting expenditures should play an important role in achieving the fiscal targets. After falling from 39% of GDP to 36% during the 2002-07 expansion, public spending is projected to reach 42% in 2010. The decline in public investment, from 8.4% of GDP in 1996 to 4.0% in 2008, was partly reversed by the fiscal stimulus packages. Unwinding this increase would reduce total spending by almost 1% of GDP. Cuts in investment should be accompanied by better allocation to enhance its productivity. The cost of maintaining existing infrastructure is projected to exceed new investment by 2011 and completely crowd it out by 2022. Maintaining scope for productivity-enhancing public investment thus requires closing under-utilised infrastructure, based on strict cost-benefit analysis in the context of a declining population. There is also room for further cuts in the government wage bill as hikes in public-sector salaries have far outstripped those in the private sector during the past 15 years. Efforts to scale back the wage bill should be focused on local governments, public enterprises and government-affiliated organisations, which account for more than 90% of public-sector employment. In any case, the scope for expenditure cuts in this area is limited by the small size of Japan's public sector relative to other major OECD economies.

### ***What should be done to raise government revenue?***

Given the limited scope for spending cuts, achieving the fiscal targets will require additional revenue, preferably through a fundamental reform of the tax system, as outlined in the *2008 Survey of Japan*. Such a reform should boost revenue, while limiting the negative impact on Japan's growth potential, addressing concerns about income inequality and relative poverty and improving the local tax system. The key elements of such a reform would include:

- A hike in the consumption tax rate should be the main source of additional revenue, as it limits the negative impact of higher taxes on economic growth.
- Broadening the corporate tax base, thereby lowering the proportion of firms that do not pay tax, would provide scope for cutting tax rates, which would spur economic growth.
- Broadening the personal income tax base would also raise needed revenue, given that less than half of wage income is taxed and the self-employed under-pay taxes. Reform of the income tax should include the introduction of an earned income tax credit to address the issues of income distribution and relative poverty.
- Improving the local tax system, which is exceptionally complicated with 23 taxes, and allowing more fiscal autonomy to local governments would be beneficial.

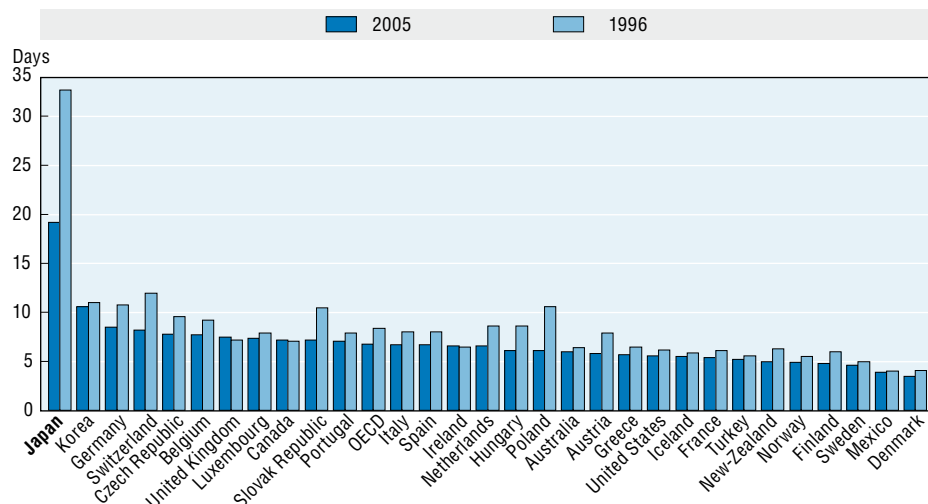
The previous government proposed to allocate all consumption tax revenue to social security. Although earmarking may make it politically easier to raise the consumption tax rate, it could also limit flexibility in spending.

Controlling public pension spending in the face of rapid ageing is essential to reduce the public debt ratio. The 2004 reform aims at ensuring the sustainability of the pension system for 100 years by introducing “macroeconomic indexation”. This is projected to reduce the benefit replacement rate from 62% to around 50%. It also involves raising the contribution rate from 13.6% in FY 2004 to 18.3% by FY 2017 and increasing the government contribution to the basic pension from one-third to one-half in FY 2009. As the long-run projection is sensitive to economic and demographic assumptions, additional reforms may become necessary in the future. In that case, rather than further raise the contribution rate or lower the replacement rate, the best option would be to further increase the pension eligibility age, which under current plans will reach 65 by 2025 for men and 2030 for women. Other reforms are needed to limit the negative impact of the pension system on labour supply. In particular, the exemption from contributions to the pension system, as well as for health and long-term care, for second earners in households with an income below a certain threshold encourages them to restrict their working hours. ■

**What reforms are needed to improve the health-care system?**

Reform of the pension system should be accompanied by changes in the health and long-term care systems. Japan’s health-care system is outstanding in a number of respects, contributing to the excellent health status of the Japanese, which is near the top of the OECD in a variety of indicators, while holding spending as a share of GDP below the OECD average. In addition, it provides universal access in principle to all medical institutions in the country. Nevertheless, it faces a number of important challenges. *First*, despite a 7½ per cent cut in medical fees and prices since 2000, health spending has risen significantly in recent years, which has weakened the fiscal position as more than 86% of health care is publicly financed. Under the current framework and utilisation patterns, health-care spending is projected to rise by around 2% of GDP by 2025, owing to rapid population ageing. *Second*, there is growing dissatisfaction with the quality of health care, which culminated in the 2008 decision to upgrade social welfare programmes. *Third*, the system faces a number of imbalances by region and by type of care. *Fourth*, universal coverage requires improving compliance in paying premiums.

**Figure 2.**  
**INTERNATIONAL COMPARISON OF AVERAGE LENGTH OF STAY IN ACUTE-CARE HOSPITALS**



Source: OECD Health Database (2008).

### ***How can the efficiency of health care be increased?***

The current strategy of cutting fees for physicians and hospitals and the prices of drugs and equipment is unsustainable, making it important to increase efficiency. One key area for reform is the length of hospital stays, which is four times the OECD average, reflecting in part the important role of hospitals in providing long-term care for the elderly. The introduction of long-term care insurance in 2000 has led to an expansion in long-term care facilities, but the shift of long-term care from hospitals to these lower-cost facilities and to home-based care needs to be accelerated by adjusting the fee schedule and improving the monitoring of patient classification. Reforms are also needed to reduce the length of hospital stays for acute care, which is about three times higher than the OECD average. In particular, it is essential to move away from a *per diem* payment scheme and toward a “diagnostic-related group” approach, which sets an overall fee according to the illness, while promoting the standardisation of treatment and length of hospital stay. Efficiency in the hospital sector should be promoted by abolishing the rule limiting the direction of hospitals and clinics to medical doctors and relaxing restrictions on equity finance. Encouraging the use of generic drugs, for example by moving towards making them the standard for reimbursement, would also reduce health spending. The government initiative to promote healthy ageing through medical check-ups and the provision of information should be supplemented by economic incentives, notably higher taxes on cigarettes.

### ***How can the quality of health care be improved?***

Concerns about quality have become more prominent as medical fees and prices have declined. One major issue is the “drug lag”; one-quarter of the world’s top-selling drugs in 2006 had not been introduced in Japan and half had become available on average six years after their global launch. The situation is similar for medical devices. It is necessary to shorten the drug and medical device lags by implementing the action plan for their speedy review by the relevant authority. This involves accelerating the review process by greater use of scientific measures, encouraging manufacturers’ efforts by reducing the cost of clinical trials in Japan and ensuring that reimbursement levels are appropriate. A second issue is the ban on “mixed billing”. Patients wishing to combine a new medicine or treatment that is not included in the prescribed treatment in the health insurance package with services that are included must pay not only the cost of the additional treatment but also the cost of services that would normally be covered by health insurance, although some treatments that are deemed to be safe and effective are exceptions to the ban on mixed billing. In effect, this regulation discourages patients from choosing new drugs and treatments that are not listed in public health insurance. Allowing more mixed billing would increase patient satisfaction by facilitating their access to new health services, while potentially easing the burden on public finances. However, an increase in the use of drugs and treatments that are not covered by health insurance should not be allowed to erode the quality of the health insurance package, which should include all essential treatments.

The health-care system faces shortages in some areas, notably for emergency care and paediatricians, reflecting problems in setting prices. The fees for the thousands of medical treatments covered by insurance and the prices of more than 10 000 drugs are revised every two years by the government, in line with

the basic policy set by an advisory board and the result of discussions between the health insurers and health-care providers, subject to a constraint on total spending imposed by the government. A more rigorous approach should be adopted that sets prices based on cost studies showing, for example, the time required for medical personnel to perform each treatment.

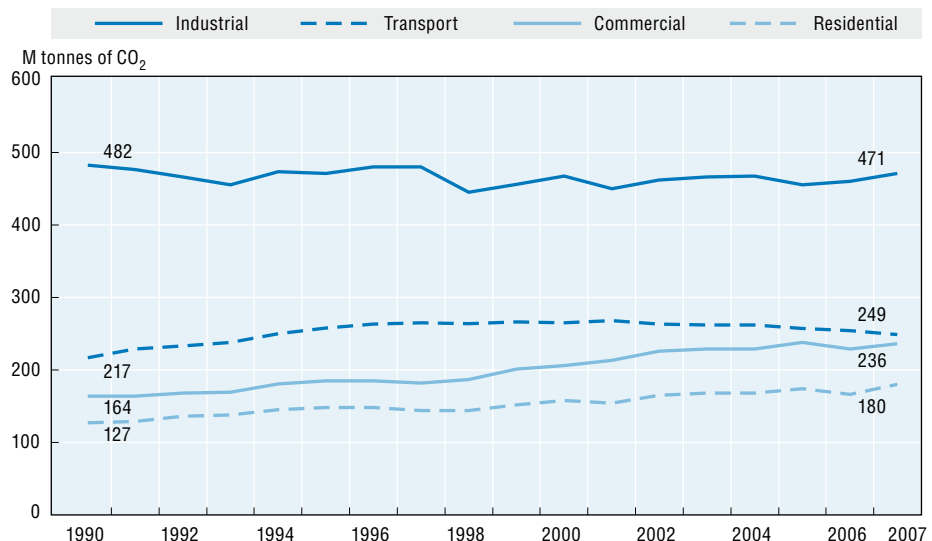
Another concern is the share of the population that does not pay health insurance premiums. By 2008, about 21% of households (8% of the total) that were covered by National Health Insurance (which includes primarily the self-employed, economically inactive and elderly) failed to pay the premium. Of this group, some (amounting to around 1.5% of total households) have to pay health costs out-of-pocket (these costs can be reimbursed but overdue premiums can be subtracted). It is important to reduce this share by improving compliance, as well as to include more non-regular workers in employer-based insurance. Another equity problem is that a significant portion of households limit their use of health care for financial reasons according to a 2007 poll. It is important to reduce the monthly ceiling on co-payments to ensure adequate health care, particularly for those with serious or chronic illnesses. ■

**How should Japan address climate change?**

Japan has been active in the global effort to limit climate change and increase energy efficiency. Under the Kyoto Protocol, it committed to reducing greenhouse gas emissions by 6% relative to 1990 over the period 2008-12 from an already relatively low level among advanced economies. However, emissions were up by 9% by 2007 and its emissions per capita have risen faster than the OECD average since 1990. Japan has relied primarily on voluntary measures, largely in the manufacturing sector, without binding commitments and price signals. In June 2009, Japan established a medium-term target of reducing emissions by 15% from the 2005 level by 2020 (through domestic reductions alone) as a step to its long-term objective of cutting emissions by 60% to 80% by 2050.

Achieving these targets requires changing the policy framework by introducing market-based instruments to reduce emissions in a cost-effective manner. Market

**Figure 3.**  
**CO<sub>2</sub> EMISSIONS FROM ENERGY USE BY SECTOR IN JAPAN**



Source: Institute for Environmental Studies and GHG Inventory Office of Japan.

instruments are efficient insofar as they equalise abatement costs across all emitters and, over the long run, provide incentives to develop new technologies that lower abatement costs. Japan should shift from its voluntary emissions trading system (ETS) to a mandatory system based on cap-and-trade that covers the entire economy, including transport, drawing lessons from the experience of other countries and Japan's voluntary system. Ideally, the initial permits should be allocated by auctioning, which would help generate much needed revenue. The scheme should include banking of permits, and possibly borrowing as well, to limit volatility, risk and uncertainty. Additionally, consideration should be given to applying a carbon tax to sectors not covered by the ETS. As Japan is already relatively energy-efficient, meeting the long-run target requires linking its ETS to those in other countries, which should substantially reduce the cost of emission abatement in Japan. Another option to reduce the cost is greater use of the Clean Development Mechanism (CDM), which allows countries to meet their emission targets through credits earned from projects that reduce emissions in developing countries. Greater use of a well-functioning CDM to utilise the vast low-cost abatement potential in developing countries is thus a cost-effective option for Japan. Financing CDM projects, though, should not lead to a decrease in Official Development Assistance (ODA) funds.

Price-based measures should be accompanied by other policy instruments in markets that are less responsive to price signals. Ideally, these should take the form of performance-based regulations that allow the choice of the most efficient technology. Moreover, price signals alone do not ensure adequate R&D and innovation, especially in the area of climate change. Public investment in R&D, particularly basic research, is important. Finally, transparent and effective instruments are necessary to accelerate the development of renewable energy in the short run while relying on market instruments in the longer run, which will minimise the cost of meeting emission reduction targets. ■

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