

Economic Survey of Korea, 2005

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Summary

Korea's rapid economic development has lifted its per capita income from one-third to two-thirds of the OECD average during the past two decades. The economy is changing profoundly as a result of the structural reform programme launched after the 1997 crisis and increasing integration with the world economy. However, the delayed recovery of domestic demand from the 2003 recession has created concern about Korea's growth prospects over the medium term. Although there are signs of a rebound in domestic demand, sustaining high growth requires further progress in structural reform to boost productivity gains, as well as appropriate macroeconomic policies.

Macroeconomic policies should promote stability and balanced growth

The medium-term inflation target should remain the focus of monetary policy. Market-friendly policies should be used to deal with real estate price increases in some areas, while keeping the short-term policy rate low until there is a sustained recovery in aggregate demand. With foreign exchange reserves surpassing \$200 billion, more than three times short-term foreign debt, the reduction in foreign exchange market intervention since the beginning of 2005 is appropriate to promote more balanced demand growth. The plans for fiscal stimulus, including public-private partnerships for infrastructure investment, should be pursued cautiously. The priority should be to limit increases in public spending and debt, given that population ageing is projected to be the most rapid in the OECD area. Reform of the public pension system is thus urgent to ensure its sustainability and limit the necessary rise in contribution rates.

This Policy Brief presents the assessment and recommendations of the 2005 OECD Economic Survey of Korea. 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.

Improving the relationship between levels of government is important to increase the efficiency of the public sector

First, there should be a clear division of responsibility and an upgrading of the capacity of local governments to enable them to exercise more power. The general local governments should have more influence on education, while providing more support, through stronger linkages with the local education authorities, with a final aim of merger. *Second*, the complicated local tax system should be simplified, while reducing the large role of property transaction taxes, and local tax revenue should be expanded, while increasing local governments' tax autonomy. *Third*, the shift from earmarked to block grants should continue, while simplifying the formula for the Local Share Tax. *Fourth*, increased autonomy at the local level should be accompanied by measures to ensure fiscal soundness. *Fifth*, the concerns about balanced regional development should be met through well-designed and transparent transfers, while addressing externalities due to concentration in the capital region through market-based instruments.

Upgrading the innovation framework is a key to faster productivity growth

A number of reforms are needed to make sure that Korea obtains full value for money from its relatively large investment in R&D and education.

- The R&D system should be upgraded by enhancing links between business, government, academic and foreign research institutes, with universities playing a greater role. Flexibility in allocating R&D funds is important to avoid excessive emphasis on areas identified as future growth engines. Market-friendly policies should be used to encourage the risk capital market and the venture business sector.
- Competition should be strengthened, particularly in the service sector – where labour productivity is only about half of that in manufacturing – to encourage the development and diffusion of innovation.
- The tertiary education sector should be restructured based on increased competition between institutions, including those from abroad, to improve its quality. Funding for education needs to be rebalanced between levels to upgrade the quality of tertiary education, which has fallen during its period of rapid expansion.

Policies to improve the functioning of the labour market are essential, while encouraging greater labour force participation

The rising share of non-regular workers, who account for a third of employees, raises both equity and efficiency concerns. Relaxing employment protection

for regular workers and improving the coverage of the social safety net, especially for non-regular workers, would enhance flexibility and reduce labour market dualism. Family-friendly measures to boost the relatively low participation rate of prime-age women are key to coping with rapid population ageing. It is also important to raise the effective age of retirement of employees from around 50, in part by reforming the seniority-based wage system and replacing the retirement allowance with a company pension system.

Further restructuring of the corporate and financial sectors is required to increase efficiency

While the large business groups (chaebol) have improved their soundness, it is important to increase competition, further implement the new corporate governance framework and improve financial supervision to strengthen market forces and prevent corporate misconduct. Moreover, it is essential to remain open to foreign investment. The deteriorating performance of small and medium-sized enterprises (SMEs) makes the restructuring of this sector a priority, while reducing government lending guarantees. Addressing the problems in the non-bank financial sector, which is heavily exposed to SMEs, is also essential. Another priority is to encourage the development of the capital market, which would enhance growth in an ageing society. The privatisation of government-owned banks should continue. ■

What are the key challenges facing Korea?

Korea has achieved an annual growth rate of 5½ per cent during the past five years, thanks in part to progress in restructuring its economy and strong external demand, particularly from China. The wide-ranging reform programme adopted following the 1997 crisis and the further opening to international competition is transforming the economy. Nearly half of the major business groups have disappeared, while foreign ownership of listed companies has increased from 15% to 42%. Rising foreign direct investment includes an important foreign presence in the banking sector. With rapid growth, the convergence process has continued, lifting Korea's per capita income to two-thirds of the OECD average.

However, the stagnation of domestic demand since the end of 2002 and slowing inputs of capital and labour have raised concerns about Korea's growth prospects. Sustaining the potential growth rate near its current level of 4½ to 5% requires meeting a number of challenges.

- Maintaining macroeconomic stability and sound public finances in the face of spending pressures stemming from exceptionally rapid population

ageing, the development of a social safety net and the potential cost of future economic integration with North Korea.

- Effectively implementing the fiscal decentralisation programme to enhance efficiency in the context of the government's objective of promoting balanced regional development.
- Upgrading the innovation system to promote faster productivity gains by improving the R&D framework, strengthening product market competition and restructuring tertiary education.
- Enhancing labour market flexibility to cope with rapid structural change and reversing the trend toward increasing dualism, while promoting greater labour force participation.
- Resolving persistent remaining weaknesses in the corporate and financial sectors.

In sum, it is essential to complete the transformation of the economic framework that was launched in the wake of the 1997 crisis, while addressing emerging challenges, in order to sustain high growth. ■

What is the appropriate monetary policy strategy?

Structural factors have contributed to the weakness of domestic demand since the 2003 recession. Households have reduced consumption following the run-up in debt during the credit card bubble of 2001 and 2002, while the corporate sector has been reluctant to expand investment despite a high level of profits. The acceleration of real export growth to a historical high of 20% supported output growth of 4.6% in 2004. However, with exports slowing significantly in the first half of 2005, due in part to weaker demand from China, output growth will fall short of the government's goal of 5% for the year. Although there are some signs of a pick-up in domestic demand, output growth may slow to around 4% for the year, with faster growth in 2006 as domestic demand strengthens.

The central bank should maintain low interest rates until aggregate demand is on a sustained recovery track in the context of the medium-term inflation targeting framework introduced in 2004. The Bank has supported demand by keeping the short-term policy rate at a record low of 3¼ per cent since November 2004. With the core consumer price index rising almost 3% year-on-year in the first half of 2005 – near the midpoint of the inflation target of 2½ to 3½ per cent – the real short-term rate is close to zero. The impact of low interest rates has been partially offset by the rising exchange rate, which gained 12% on a trade-weighted basis between the first quarters of 2004 and 2005. This appreciation occurred despite significant foreign exchange market intervention, which boosted reserves to \$205 billion by early 2005,

the fourth-highest in the world. With reserves now more than three times larger than Korea's short-term foreign debt, there is little rationale for further reserve accumulation. *The apparent scaling back of intervention since the beginning of 2005 should thus continue.* Moreover, a stronger won has the positive effect of re-balancing the composition of growth from exports to domestic demand. *It is important to carefully monitor the new schemes created to manage foreign exchange resources – such as the Korea Investment Corporation – so as to avoid losses.*

The Bank of Korea is under pressure to raise interest rates to stabilise the upward trend in real estate prices in some parts of the country. Prices of apartments in certain districts of Seoul rose 10% in the first half of the year, although on a nation-wide basis, prices are up less than 4%. However, interest rate hikes are a blunt instrument for influencing real estate prices and would be harmful to the nascent recovery in domestic demand. The economic impact of rising real estate prices in specific regions is likely to be limited, although it may raise equity issues about the distribution of wealth. *Such concerns should be addressed by targeted measures, such as ensuring that the capital gains tax is adequate to achieve the desired level of redistribution. Policies to deal with real estate prices should be market-friendly. In particular, the authorities should end the stop-and-go pattern of imposing regulatory measures aimed at stabilising prices, and then periodically removing such measures to boost the construction sector.* ■

Is additional fiscal stimulus necessary?

The easing of monetary policy has been accompanied by a mildly expansionary fiscal policy stance in 2004 and 2005. The consolidated central government deficit – excluding the social security surplus and the cost of financial restructuring – is projected to rise in 2005 from ½ to 1% of GDP. This reflects a 1 percentage point cut in income tax rates and the elimination of special excise taxes on some luxury items. In addition, nearly 60% of expenditures were frontloaded in the first half of 2005, which may result in a decline in government outlays in the second half of the year in the absence of a supplementary budget. However, spending by state-owned enterprises and private-sector investment in infrastructure will increase in the latter half of the year. Given the recent upturn in domestic demand, *additional fiscal stimulus appears unnecessary. The priority should be to achieve the medium-term framework's objective of a balanced budget, excluding the social security surplus, by 2009.*

To boost fixed investment, the government recently launched a public-private partnership plan, which aims at attracting private-sector participation in the provision of infrastructure under a "build-transfer-lease" approach. The government and private sector are expected to

agree on total spending of 6 trillion won (0.8% of GDP) in 2005 and a cumulative 24 trillion won by 2007. The private sector is projected to spend 0.5 trillion won on these projects in 2005. Given that these projects will take up to four years to complete, *the programme should not be pursued as a countercyclical policy. Instead, joint public-private projects should be selected on the basis of their long-term economic benefits and the programme should be anchored in the medium-term framework. Moreover, contracts with firms need to be carefully crafted to control the government's expenses and contingent liabilities.* Limiting increases in public debt should be a top priority, given the spending pressures, particularly for population ageing. Indeed, Korea's elderly dependency ratio, the third-lowest in the OECD area in 2000, is projected to be the third-highest by 2050. ■

How should the public pension system be reformed?

Given the rapid ageing, fundamental reform of the public pension system is urgent. Under the current parameters – a contribution rate of 9% and a benefit replacement rate of 60% – the National Pension Scheme (NPS) would run deficits by 2036 and its Fund would be exhausted by 2047. Ensuring the sustainability of the NPS would require a contribution rate of around 20%, which would likely have a negative impact on the labour market. *Korea needs a more systemic reform of the pension system to ensure its sustainability, while providing adequate coverage.* In 2004, 12.4 million persons – a little more than half of the labour force – paid contributions to the NPS. In addition, there appears to be a considerable under-reporting of income by the self-employed. *The authorities should immediately adjust the parameters of the earnings-related public pension to sustainable levels, which implies lower benefit rates. Furthermore, the tax-financed means-tested social programme, which currently has limited coverage, should be gradually transformed into a universal basic pension, with a relatively low flat rate. The scope of such a two-tier system depends on the availability of fiscal resources and may require measures to reduce the basic pension benefit to the wealthy. Given the small number of persons currently receiving public pensions, it is essential that the means-tested programme be adequate to lower the relatively high incidence of poverty among the current elderly population as well as those entering retirement before the introduction of the basic pension.* ■

How can relations across different levels of government be improved?

One aspect of maintaining a sound fiscal position is to ensure the accountability of local governments, which

account for almost half of total government spending in Korea. With the abolition of the system requiring central government approval of each local government bond issue, *fiscal rules need to be adequate to ensure sound financial management. This should include increased transparency concerning contingent liabilities, particularly in regard to public corporations, while reducing the reliance of local governments on borrowing from the public sector.*

Fiscal responsibility of local governments should also be enhanced by increasing their taxing powers through a broad reform of the local tax system.

- *The current system, which includes 16 different taxes, should be simplified by eliminating those that generate minimal revenue but increase complexity and administrative costs.*
- *Local governments should be encouraged to exercise their existing power to change tax rates, which has been little used despite being allowed for 11 local taxes.*
- *The high level of taxes on property transactions, which account for 40% of local government tax revenue, should be reduced as they create lock-in effects, thus reducing the efficiency of land use, and are only loosely related to the demand for local government services.*
- *The government should accelerate its plan to boost the effective tax rate on property holdings from 0.1% at present to 1% by 2017 by bringing the tax base closer to market levels, as this would discourage speculative activity and encourage efficient land use.*

The net effect of reforms should be to increase local government tax revenues through higher property holding taxes and, if necessary, other taxes that achieve the objective of enhancing local autonomy and accountability.

However, increasing local government reliance on tax revenue is likely to aggravate regional imbalances, given that per capita tax payments in the capital region are about 60% higher than in the rest of the country. *Achieving the second objective of limiting regional imbalances requires that the devolution of taxing power be accompanied by sufficient transfers from the central to poorer local governments to ensure adequate public services throughout the country. The formula currently used to calculate such transfers should be made more transparent and simple, while reducing arbitrary adjustments. The central government should make clear that local government efforts to boost tax revenues will not be offset by decreased transfers.*

The government should transfer responsibilities to local governments to increase efficiency and enhance the capacity of the public sector to meet the needs of local citizens. Effective decentralisation requires

establishing a clear division of responsibilities between levels of government. *The capabilities of local governments, which have been limited to acting as agents of the central government, should be expanded to handle greater responsibilities.* Currently, there exist separate local governments responsible for primary and secondary education. *The general local governments should have more influence on education, while providing more support, through stronger linkages with the local education authorities, with a final aim of merger. Autonomy should also be expanded by changing earmarked transfers to block grants, where appropriate, and relaxing the conditions attached to earmarked transfers to allow greater flexibility for local authorities.* ■

How should Korea deal with congestion and pollution in the capital region?

Developing more dynamic and autonomous local governments may have a positive impact on the government's goal of achieving more balanced regional growth. Despite the measures to reduce concentration in the capital region by regulations limiting new construction, the region's share of population and economic activity has risen to nearly half. The easing of these regulations on small and medium-sized enterprises (SMEs), venture businesses, foreign-invested companies and advanced-technology firms is appropriate as it allows firms to follow through on investment plans. At the same time, *it is necessary to increase reliance on economic instruments aimed at offsetting externalities resulting from concentration in the capital region, notably congestion and pollution.* With air pollution in Seoul among the most severe in the OECD area, *the government should follow through on the introduction of a cap-and-trade system in 2007 to limit industrial emissions.* In addition, the government launched a "regional innovation plan" aimed at creating clusters of government research institutes, firms and universities in various locations outside of the capital region. *The location of such clusters should be chosen transparently on the basis of clear criteria. Given the importance of innovation in sustaining growth, policies to promote innovation should focus primarily on the objective of fostering national productivity growth rather than on regional development.* ■

How can Korea's innovation framework be improved?

Korea already makes a large investment in R&D, with such outlays amounting to nearly 3% of GDP. It is

important to maximise the benefit from this investment by upgrading the R&D system.

- *Linkages between business, university and government research institutes should be strengthened. The performance-based evaluation system of public-sector R&D should be further developed, taking greater account of its relevance to the business sector.*
- *Incentives for R&D in the universities, which are currently underutilised, should be strengthened.*
- *The government should maintain flexibility in setting research priorities in order to limit the risks inherent in focusing on sectors identified as future growth engines.*
- *Policies should aim at increasing the international integration of Korea in R&D activities.*

The authorities have also been active since the 1997 crisis in developing a risk capital market and a venture business sector. *Government involvement in this area should be re-focused on leveraging private-sector participation by improving transparency and disclosure requirements. The government certification system for venture businesses should be phased out as planned.* The government also offers relatively generous tax incentives to encourage private-sector R&D. *The effectiveness of these incentives should be evaluated to ensure their efficiency and the results should be compared with the potential gains from supporting other activities. In addition, while intellectual property rights have been strengthened, better enforcement would encourage innovation activities.*

In addition to promoting the creation of new knowledge, it is at least as important to use the existing stock of knowledge more effectively. This is particularly true in Korea, given that its average labour productivity per hour is only 40% of the US level, suggesting a large scope for further convergence based on existing technology. *It is necessary to strengthen competition in order to encourage the diffusion of knowledge, as well as its creation. Reducing entry barriers and administrative opacity and improving the exit mechanism are needed to support the creation of new enterprises, a key to developing and adopting new technologies.* Given that services' share of value added is steadily increasing, boosting productivity in this sector is essential to sustain growth. *The priority should be to remove entry barriers in the areas of retail, business services, health care and social services. The complicated system of land regulation should be simplified and made more transparent to avoid hindering the entry of new firms.*

Ensuring the availability of highly trained human resources is of key importance for innovation. While Korea's substantial investment in primary and secondary schools, together with extensive private tutoring, has produced good results, the large increase in the number of students at the tertiary level

has been accompanied by a deterioration in quality. *Reversing the decline will require a rebalancing of expenditures away from primary and secondary schools, where age cohorts have already begun to decline, in favour of tertiary education, where funding per student is exceptionally low compared to other OECD countries. It is necessary to increase the availability of scholarships and loans to ensure that students from low-income families have access to tertiary education. Deregulation and stronger competition to drive the restructuring and consolidation of tertiary educational institutions would help reverse the decline in quality. Greater transparency about the performance of each university and increasing the scope for foreign institutions to operate in Korea would strengthen competition and efficiency in this area. At the same time, it is essential to increase opportunities for lifelong education given rapid structural change and population ageing.* ■

How can the labour force participation rate be increased while reducing dualism?

Population ageing also makes it crucial to boost the labour force participation rate. If participation were to remain at its current level, the labour force would decline by 15% by mid-century, thus increasing the burden of ageing. One key is to raise the participation rate of prime-age women, which is one of the lowest in the OECD area. *Increasing support to families for childcare and extending the length of publicly-financed maternity leave from one to three months would help to increase female participation.* It is also important to increase, or at least maintain, the labour force participation of persons over the age of 50, who will account for half of the working-age population by mid-century. *One priority is to extend significantly the age of retirement from companies beyond the current practice of around age 50.* Most workers leaving firms become self-employed workers, primarily in the service sector. Raising the effective retirement age from enterprises would limit the inflow of labour into this low-productivity sector. *The key is to transform the seniority-based wage system, which makes older workers relatively expensive, into a remuneration system more closely linked to productivity levels.* While wage systems in firms are decided by collective bargaining, the government should voice support in the Tripartite Commission for productivity-linked wage systems and introduce them where appropriate in the public sector. *In addition, the authorities should discourage the use of mandatory retirement ages in firms, which would increase pressure to reform the seniority-based wage system.*

Replacing the current retirement allowance system with a company pension system would reduce the incentive of firms to retire older workers, while

increasing private savings for retirement. The recently introduced framework for company pensions allows employers and workers in each firm to adopt a defined benefit or defined contribution system. *In order to facilitate labour market mobility, company pension systems based on defined contributions should be encouraged, while at the same time phasing out the traditional retirement allowance system.*

The government has increased subsidies to encourage the employment of older workers, as well as other groups. However, given the large deadweight costs of this approach, *employment subsidies should be reduced. Instead, the priority should be to bring the effective coverage of the Employment Insurance System, currently at about half of employees, more closely into line with the law, which mandates coverage for 85%.* Currently, only one in four unemployed persons receives unemployment benefits. *In addition, it is important to expand the coverage of work-based social insurance programmes, including health and pensions, to non-regular workers.*

Better coverage of non-regular workers by the social safety net would reduce the cost advantage that encourages firms to shift from regular to non-regular workers, who now account for one-third of employees. Perhaps as important, non-regular workers provide greater employment flexibility for firms. *Stopping or even reversing the rising share of non-regular workers, while ensuring overall flexibility in the labour market, requires increased employment flexibility for regular workers.* The 1998 reform to allow collective dismissals of regular workers for managerial reasons has not created enough flexibility in practice. *The Supreme Court decision specifying acceptable criteria for dismissal – including to prepare against future crises – needs to be incorporated into the law to ensure enhanced flexibility.* The effort to obtain a consensus among the social partners on reform of labour laws and practices has been frustrated by a difficult industrial relations climate. *The government should develop a more harmonious environment by implementing the roadmap to resolve remaining industrial relation issues.* In sum, a comprehensive package is needed that includes less employment protection for regular workers, greater coverage of non-regular workers by the safety net and an improved industrial relations environment. ■

How can the performance of the corporate sector be improved?

Rapid structural change in the corporate sector requires improved corporate governance as well as greater labour market flexibility. There has been marked progress among the remaining chaebol, which have reduced their debt-equity ratios below 100%.

However, there appears to be a reluctance to invest despite abundant cash holdings. To some extent, this more cautious behaviour is the desirable outcome of better corporate governance practices and the desire to increase financial soundness. *It is important to make further progress in improving corporate governance, enhancing transparency and ensuring that the market for corporate control is open to both domestic and foreign participants. With further progress in this regard, the phasing out of the 25% shareholding ceiling imposed on more than 200 chaebol-affiliated firms would be appropriate, which may have a beneficial impact on business activity. Finally, it is essential to remain open to foreign investment.*

In contrast to the large companies, the situation in SMEs has deteriorated. *It is important to streamline the diverse programmes to support SMEs, which have made them dependent on the government. In addition, the increase in government guarantees on bank loans to SMEs, which amount to 6% of GDP, should be reversed. The government's June 2005 plan to streamline programmes that support SMEs and to reduce government guarantees on bank loans to SMEs should be implemented. Banks should be encouraged to improve credit analysis in lending to SMEs. It is encouraging that the delinquency rate of SME lending fell from 2.3% in June 2004 to 2.1% a year later. However, the exposure of non-bank lending institutions to SMEs has boosted their non-performing loans (NPLs) and weakened their balance sheets. The Financial Supervisory Commission should remain vigilant in imposing prompt corrective action to limit potential problems in this sector. ■*

What are the major remaining problems in the financial sector?

In contrast, the commercial banks have managed to increase their profitability and capital adequacy ratios, while reducing their NPL ratios. *It is important to press ahead with the privatisation of the state-owned banks,*

which is boosting the foreign presence in the banking sector. While the banks appear to have overcome the aftermath of the credit card bubble, the large number of delinquent borrowers – 3.6 million or nearly one-tenth of the working-age population – continues to damp private consumption. Government policies that provide support for debtors without resolving the problem should be phased out, while avoiding additional schemes to help delinquent debtors in order to prevent moral hazard problems. Meanwhile, only a very small fraction of delinquents – around 30 000 – have used court-based personal bankruptcy procedures. The government should encourage the legal process to function actively, which requires increased resources for the judicial system. Discrimination against delinquent borrowers should be discouraged. Meanwhile, a new unified insolvency law, which is to be implemented in 2006, should be used to improve the exit mechanism in the corporate sector.

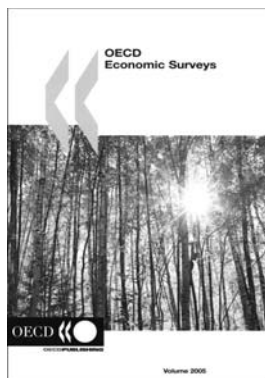
Compared to the banking sector, developments in the capital markets have been less favourable in recent years despite the acceleration of financial-sector liberalisation and an opening to international capital flows. A vibrant and strong capital market is important to the development of venture business as well as to provide appropriate long-term saving instruments needed in the context of population ageing. Recent trends in the capital market are encouraging. *It is important to promote the further development of the capital market through the issuance of government bonds with long-term maturity, limiting vulnerability to shocks and upgrading the financial infrastructure, including credit rating agencies. ■*

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- **Economic Outlook No. 77**, June 2005. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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Public Affairs and Communications Directorate.

They are published under the responsibility of the Secretary-General.

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