

Economic Survey of the Russian Federation, 2009

What explains the strong growth in Russia from 1999 through mid-2008?

Why did the global crisis hit Russia so hard?

What has been the policy reaction to date, and how should it evolve?

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Summary

The global crisis has put a sudden end to the strong recovery of the Russian economy since the financial crisis of 1998. A slowdown was becoming increasingly likely, given the erosion of favourable factors such as undervaluation of the rouble and spare production capacity and labour resources, but the severity of the crisis is a function of overlapping internal and external factors:

- Collapsing prices of oil and other commodities have resulted in a sharp turnaround in the terms-of-trade, which no longer support domestic demand.
- The drying-up of access to international capital markets hit some Russian banks and corporations hard, and a sudden deterioration of Russia-specific and more general emerging market risk premia increased financing costs steeply.
- The sharp depreciation of the rouble against the dollar in particular (related to falling oil prices and the deterioration in the private capital account) greatly increased the burden of foreign currency corporate debt, which has risen considerably in recent years.

The government and central bank responded swiftly to the onset of the crisis, providing liquidity and capital to the banking system and seeking to boost aggregate demand. The government is ready to accept a large fiscal deficit in 2009 and can do so because of accumulated reserves saved in better times. *Aggressive fiscal stimulus should aim at maximising the multiplier effect on domestic demand. Such stimulus should be cast in a credible medium-term framework, to safeguard fiscal sustainability. Monetary policy in the short term should make financial conditions as easy as possible, which means inter alia not resisting fundamental pressures for depreciation of the rouble. Maintaining the functioning of the banking system is of prime importance, but that is consistent with allowing considerable consolidation of the sector.*

This Policy Brief presents the assessment and recommendations of the 2009 OECD Economic Survey of the Russian Federation. 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.

Looking beyond the crisis, a broad-based and comprehensive policy package is needed to put in place a more robust growth model. This Survey makes recommendations in four important areas where co-ordinated reforms promise considerable synergy effects:

- *Economic rents from natural resource extraction should be captured and mostly saved by the government, but without unduly discouraging exploration and development, and the tax structure should be further reformed to enhance economic efficiency (without worsening equity – equity concerns will be addressed in more detail in the forthcoming OECD Labour Market and Social Policy Review).*
- *There should be a gradual switch to inflation targeting in order for monetary policy to complement fiscal policy and create a sound, price-stability oriented macroeconomic policy framework which also allows Russia to resist Dutch Disease pressures.*
- *The banking system should be made more efficient and less crisis-prone. Making prudential supervision counter-cyclical, facilitating effective competition by allowing further consolidation of the sector and reducing the state's role as an owner of banks would be important steps to that end.*
- *Product markets are overly regulated, hampering competition, innovation and productivity growth. Pervasive state involvement should be reduced, barriers to entry eliminated and public administration reform stepped up. Russia could also benefit from lower barriers to foreign direct investment and reduced levels and dispersion of import tariffs. ■*

What explains the strong growth in Russia from 1999 through mid-2008?

Between the financial crisis which struck Russia in August 1998 and the global crisis which broke out in earnest in September 2008, Russia had the strongest decade of growth in its history, with real GDP nearly doubling. This strong increase in output, coupled with the vigorous real appreciation of the rouble, driven mainly by the surge in energy and raw material prices, meant that nominal GDP measured in US dollars rose almost 7-fold during that period, more than in any other major country. A wide range of other economic and social indicators also saw dramatic improvements during those ten years. Total factor productivity grew strongly, real wages soared, and unemployment and poverty rates fell sharply. Strong current account surpluses, combined with a swing in the private capital account from large net outflows to even larger net inflows, pushed international reserves to nearly USD 600 billion, behind only China and Japan. The transformation of the government finances was particularly marked. After defaulting on part of its debt in 1998, the federal government ran a string of surpluses and almost extinguished public debt while building up foreign assets amounting to 13% of GDP by end-2008. The picture for inflation was more mixed, but for most of the past decade inflation was on a trend decline, falling from 85% in late-1998 to single digits by mid-2007. At that time, a combination of surging international food and energy prices and very rapid money supply growth in Russia pushed inflation back up to 15%, before it began to fall again in late-2008 as energy and commodity prices collapsed and money supply growth came to a sudden halt.

While stronger macroeconomic policies and structural reforms both contributed importantly to the good economic performance through mid-2008, a good deal of the impetus to growth came from transitory factors, as was outlined in the 2006 *Economic Survey of Russia*. Initially, there was the 50% real depreciation of the rouble at the time of the 1998 crisis, which sparked a recovery driven by import substitution and facilitated by substantial underutilisation of capital, allowing rapid growth to occur without high rates of investment. Then, both during 1999-2000 and to an even greater extent from 2003 to mid-2008, the terms of trade improved sharply, driven mainly by a rising oil price. The loosening of conditions in international capital markets, with declining spreads for emerging market borrowers and rising net inflows combined with low interest rates in advanced countries, gave a further impulse to the strong increase in domestic demand in Russia.

The contribution of transitory factors to growth in recent years increasingly raised questions about the sustainability of the expansion, particularly as some of the favourable factors (such as oil prices and the compression of borrowing spreads for emerging markets) exceeded or approached record levels. Although investment grew robustly, it remained low in relation to GDP compared with other rapidly catching-up economies, and the economy began to show signs of overheating as capacity utilisation rates rose and labour shortages emerged. Real GDP growth was increasingly driven by booming domestic demand, while the balance of payments and the government budget both became increasingly reliant on oil, with non-oil current account and fiscal deficits rising steadily. There is wide agreement, including within

the government, that a shift to a new more self-sustaining growth model is needed. The government's Russia 2020 growth strategy, which aims for innovation-driven growth and reduced reliance on the production of raw materials, was developed in 2008 while oil prices were still high and rising, but the crisis struck before that strategy could even begin to be translated into concrete policy actions. It is therefore important to return to the structural reform agenda both within the context of anti-crisis measures and beyond. ■

Why did the global crisis hit Russia so hard?

The continuation of rapid growth had certainly become increasingly vulnerable to a decline in oil and gas prices, but a normal oil price downturn would probably have been consistent with merely a growth slowdown rather than the severe recession which is now under way. The size and speed of the decline in oil prices that began in July 2008 were greater than any previous episode, and the effects were exacerbated by similarly extreme falls in the prices of other export commodities. Financial turmoil, including the disruption of emerging market access to international capital markets, was also exceptionally severe. At the same time, world demand collapsed in the last quarter of 2008, dramatically shrinking world trade, which hit the volume as well as the price of Russian exports of metals and natural gas. The impact of these external shocks on the Russian economy was aggravated by domestic vulnerabilities, including fragile confidence in domestic banks and the currency.

The strategy for Russia in tackling such a big economic crisis needs to be broad-based, including a range of fiscal and monetary policy measures to support aggregate demand and maintain the functioning of the banking system. As in other countries, policymakers in Russia should seek measures that maximise the immediate demand effect; minimize distortions; protect macroeconomic stability and fiscal sustainability via a clear exit strategy from stimulus measures; and, where possible, yield longer-term efficiency gains while achieving short-term demand management goals. Designing a response that best conforms to these principles, including finding the right balance where there are trade-offs between them, is the overarching near-term policy challenge. ■

What has been the policy reaction to date, and how should it evolve?

The authorities' reaction to the onset of the crisis was broadly in line with that of many OECD economies, although the response in Russia was unusually rapid and large, reflecting in part the substantial resources available to the authorities after years of fiscal and balance of payments surpluses. Liquidity and capital were provided to the banking system, deposit insurance limits were increased, and a number of expansionary fiscal measures were announced. All told, quantifiable announcements in the first months of the crisis were equivalent to about 13% of GDP. These measures were initially thought to be more than adequate to address the consequences for Russia of the global financial crisis, but it has become increasingly clear that Russia is facing a deeper and longer downturn than was imagined a few months ago. As the stock of available resources has dwindled while

the cost of some initial measures has risen (notably the combination of limiting depreciation of the rouble while providing ample liquidity to banks) new measures are being more carefully weighed, especially with respect to possible risks to fiscal sustainability.

Demand-support measures will be less effective to the extent that the financial system is not operating smoothly. This implies that maintaining the functioning of the banking system is of prime importance. While liquidity shortages did trigger turmoil at the onset of the global crisis, the main threat to credit growth now appears to be solvency problems, arising from the declining capacity of borrowers to repay bank loans. Banks risk breaching regulatory capital requirements if, as expected, the downturn brings an upsurge in non-performing loans. Such capital shortages can force deleveraging as banks shrink their balance sheets to meet capital adequacy requirements. Banks may also be unwilling to lend as credit risks on new lending rise in an environment of negative real GDP growth both domestically and abroad. The challenge is to maintain capital adequacy and prevent a sharp curtailing of lending flows financing new activities, while minimising moral hazard and the cost to taxpayers.

Just as monetary conditions during the period of strengthening oil prices were too easy, as balance of payments strength fed through to money supply growth via the central bank's exchange rate-oriented monetary policy, so they risk becoming too tight in a context of falling oil prices and capital outflows. Intervention to support the rouble in the months following the onset of the crisis meant sharply falling reserves, and this was accompanied by a large fall in M2 since September 2008. Real interest rates are becoming positive for the first time in years just as aggregate demand is collapsing due to adverse external shocks. In addition, the resistance to depreciation delayed a compensatory stimulus for non-oil tradable when the oil price fell. The stepwise widening of the exchange rate band allowed some breathing space for firms with heavy foreign currency liabilities and possibly prevented a sharper weakening of confidence in the rouble and, thus, a run on deposits. But the costs were heavy, as expectations of further depreciation encouraged capital flight. The central bank's communication policy should foster the recognition that the real exchange rate eventually has to move in line with large swings in fundamentals such as oil prices. This episode revealed the weakness in the monetary policy framework and illustrated that holding to a fixed exchange rate or managing a float for an extended period is difficult, as serious conflicts with fundamentals are likely to arise sooner or later, particularly in a commodity-dependent economy.

The main short-term challenge for fiscal policy is to maximise the fiscal multiplier while managing moral hazard and risks to long-term fiscal sustainability. *The former tends to suggest expenditure measures, possibly in the form of transfers to low-income households or lower levels of government, rather than general tax cuts.* Temporary measures, such as one-off transfers or temporary tax rebates, can be one effective way of maximising the short-term demand impact. Measures that are hard to reverse, such as raising entitlements or

cutting tax rates, could undermine long-term sustainability. The current crisis is increasingly looking like a more extended downturn than originally foreseen, which may make infrastructure spending more attractive than otherwise, particularly since there is evidence that the fiscal multiplier is highest for such spending. The threat to fiscal sustainability would appear to be less of a problem in Russia than in many OECD countries, given low levels of gross public debt and substantial public financial assets. Nonetheless, the federal deficit will be very large in 2009, and is likely to remain at high levels for several years. Moreover, Russia faces underlying negative demographic trends and particularly serious environmental degradation problems, which could entail major fiscal costs in the future. As in other countries, therefore, *it will be important for Russia to set its stimulus efforts in a medium-term context that credibly charts a return to a sustainable public debt path.* ■

Looking beyond the crisis, how can a better growth model be put in place?

At some point the crisis will end, and oil prices will probably recover sooner rather than later. In the medium term, Russia will face the challenge of putting in place a healthier model for sustained catch-up growth. This should be one based on innovation, investment, the accumulation of human capital and coherent implementation of the rule of law within a well regulated and competition-enhancing market economy, rather than one largely driven by strong but temporary improvements in the terms of trade and the increasing reliance on state corporations with inadequate governance structures as well as *ad hoc* support of selected banks and corporations. To this end, there is considerable scope for major progress in a wide range of areas. For example, education performance is mediocre; the healthcare system is deficient in a number of respects; innovation policy does not get the most from Russia's considerable potential; administrative reform is needed to improve the efficiency of the public service; and some important prices, notably for natural gas, remain distorted, making the economy more energy-intensive than it should be. Many of these topics have been addressed in past *Economic Surveys*, and remain valid. Particular challenges discussed in this *Survey* include macroeconomic management, including the priorities for monetary and fiscal policy, the development of the banking system, and product market regulation reforms to widen the scope for competition. ■

What needs to be done to prepare for a successful adoption of inflation targeting?

The central bank's welcome intention to shift over time to an inflation-targeting regime would address the tensions which have beset monetary policy in recent years. Inflation targeting has proved a successful framework for a wide range of countries, including those with a high degree of commodity dependence. Also, it has often worked well even when some factors, advanced as pre-conditions for making the transition to inflation targeting, have not been fulfilled. Nonetheless, there is a good case in Russia for taking a gradual approach to such a transition, as certain important conditions, some of which go beyond technical preparations on the part of the central bank, requiring political support, remain unfulfilled. Too little is yet known about the ability to forecast inflation and the response of inflation to changes in policy interest rates. To that end, *the Central Bank of Russia's recently introduced inflation reports, which are a welcome innovation, should be*

How should fiscal policy contribute to macroeconomic stability and sustained growth?

improved to become less descriptive and more analytical. Also, inflation targeting would undoubtedly work better if Russia had deeper financial markets and greater central bank independence. *The unexpected return to budget deficits should be used to issue more domestic government debt, providing banks with more paper for refinancing and establishing a benchmark for the financial sector.* ■

Reorienting monetary policy to achieving inflation objectives implies that insulating the economy from large fluctuations in oil prices will largely fall to fiscal policy, especially as regards the mechanisms for taxing and saving oil. During the recent period of high oil prices reserves of about 13% of GDP were accumulated in two funds, one to smooth oil-price-dependent revenue fluctuations and the other to provide for a stream of income to boost long-term national welfare. *In periods of oil price weakness, allowing the lower prices to be reflected in larger non-oil deficits financed by running down the Reserve Fund will offset part of the pressure for depreciation. Using fiscal policy to lean against real exchange rate pressures arising from oil price swings helps to insulate the non-oil economy from such swings and is welcome.*

Russia has made major improvements to the structure of its taxation and to tax collection. Tax bases have been broadened, rates cut, and compliance improved. Nonetheless, scope remains for further reform that could speed up convergence to advanced country income levels. *Oil and gas taxation should be adjusted to capture economic rents without harming incentives for exploration and development. In particular, export taxes on crude oil and oil products should be removed in the medium term. The government should address problems with VAT refunds directly, rather than bow to demands to cut rates, given that VAT is a relatively efficient tax. Russia has scope to increase the revenue share of property taxes, which OECD research suggests is the least growth-unfriendly form of taxation. Corporate profit tax, which is found to be particularly harmful for growth performance, is already at low levels after the most recent cut to 20% but, subject to satisfactory overall revenue collection, further reductions should not be ruled out. Economic efficiency would also suggest exploring ways of reducing the comparatively high tax wedge, which again is relatively growth-unfriendly. Apart from the possibility to further improve economic efficiency, considerable scope also remains to alleviate poverty, which despite some progress during the recent episode with exceptionally high growth is still far more prevalent than in OECD countries. This may require more redistribution than can be achieved at the moment with a flat tax rate for personal income, a regressive unified social tax and relatively low real estate and wealth taxation. This issue will be dealt with in the forthcoming OECD Labour Market and Social Policy Review.* ■

How can the banking system be made more resilient and efficient?

Russia's banking sector has suffered repeated crises since the start of transition. Policy makers face two broad regulatory challenges in seeking to improve the stability of the banking system: to converge on existing best practice as regards the implementation of prudential supervision and (a challenge shared with many other countries) to address defects in bank regulation which amplify economic cycles and give insufficient weight to

liquidity considerations. In the cyclical upswing Russian banks on average maintained but did not increase capital cushions above the minimum standard, and many therefore risk falling below the minimum as loan losses rise as a result of the recession, unless new capital can be found. As in OECD countries, there is a need for a more macro-prudential approach to financial supervision, which takes more account of systemic risks, in addition to focusing on bank-specific ones. *Capital requirements and/or provisioning rules should be made counter-cyclical and capital requirements should be allowed to vary across banks to reflect each bank's contribution to systemic risk. In addition, stress tests should include assessments of shocks which hit across the banking system.* There will be ongoing efforts to reform international rules to strengthen existing supervision approaches, and *Russia should actively participate in these discussions while proceeding with own reforms to bolster financial market stability.*

Russia's financial system, despite its recent rapid expansion, is still relatively underdeveloped, leaving considerable scope for financial deepening to contribute to long-term growth. A number of reforms would contribute to such deepening. First, although Russia has many banks, competition overall is weak, especially at the regional level. *Consolidation of the sector would help, as this would lift more banks above a minimum efficient scale, which is necessary to contribute to effective competition. Over the long term, competition and efficiency would be improved by streamlining the state's involvement in the sector.* Here, as with state-owned enterprises in other sectors, policy goals are mixed with commercial ones, mandates are unclear, and institutions with sub-optimal corporate governance arrangements are given major roles. *Beyond being boosted by competition, banking efficiency would benefit from improvements in the rule of law, faster convergence to international financial reporting standards, and measures to lengthen the effective duration of bank liabilities (notably, repeal of the Civil Code provision that allows withdrawal of all household deposits on demand regardless of their contractual term).* ■

How could Russia's product market regulation be made more growth-friendly?

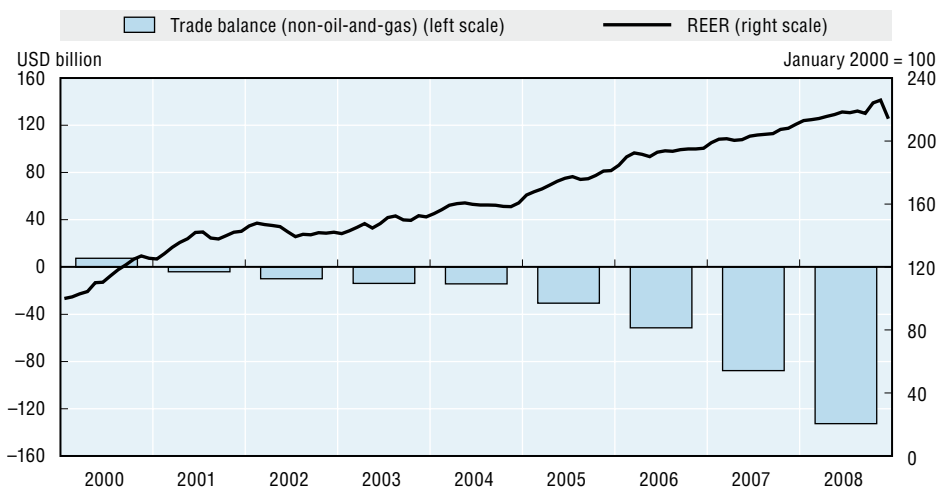
The OECD's product market regulation (PMR) indicator for Russia reveals that, despite liberalisation in some areas, such regulation is, on average, highly restrictive. The overall level of regulation is significantly higher and restricts competition to a greater extent than in any OECD country – including the emerging market economies within the OECD area. All three of the high-level sub-components of the overall PMR index are high in Russia relative to comparator countries, although there is considerable regulatory heterogeneity in lower-level sub-components.

Reflecting the legacy of the Soviet era as well as the backlash after the chaotic early years of transition to a new system, state control in the Russian economy is extensive, via both direct state ownership and control over economic activity. State-owned enterprises are found across a wide range of sectors and often occupy a dominant position in their industry. Furthermore, there is a pervasive blurring of the line between the public and private sectors, arising not only from the extensive role of state-owned enterprises but also by close ties between government (at all levels) and major private firms. One reflection of this phenomenon is the unusually important role of

current or former politicians and senior bureaucrats in business, which gives rise to multiple, distorting and costly conflicts of interest. Recent initiatives to strengthen the obligations for politicians and senior bureaucrats to publicise their incomes and financial assets are welcome. The special-status state corporations, most of which were established recently, are exempt from some reporting and monitoring obligations. *These exemptions should be removed. Furthermore, the extent of the problems posed by the unclear governance of these institutions, which are neither under full political surveillance nor privately owned, should be carefully monitored.* The PMR indicators also signal a high level of government involvement in the private business sector. In part, this reflects a prevalence of command-and-control-type regulation. *Significant benefits in terms of economic performance could be yielded by reducing political interference in the operation of state-owned enterprises (SOEs) and private sector firms. This should include separating the activities with non-commercial policy objectives of SOEs and consolidating them to the relevant government department; improving standards of transparency and disclosure in SOEs; imposing an effective firewall between public and private professional activities to avoid conflicts of interest; disposing of golden shares in SOEs and private firms; increasing the independence and accountability of government representatives and accelerating appointments of independent and accountable directors on SOE Boards; revitalising privatisation (once SOE corporate governance has been improved); reducing the list of strategic firms and sectors; and using regulatory alternatives to command-and-control regulation and direct intervention.*

Russia performs well in some regulatory areas related to barriers to entry, including regulatory and administrative opacity and the system of licensing and permits. However, the administrative burden that the government places on entrepreneurs starting a new business, whether they are corporations or sole traders, is still very high and acts as an obstacle to new entry. This could be indicative of more widespread inefficiencies in government administration and reflect ongoing difficulties in reforming the public administration,

Figure 1.
NON-OIL-AND-GAS TRADE
BALANCE AND REER

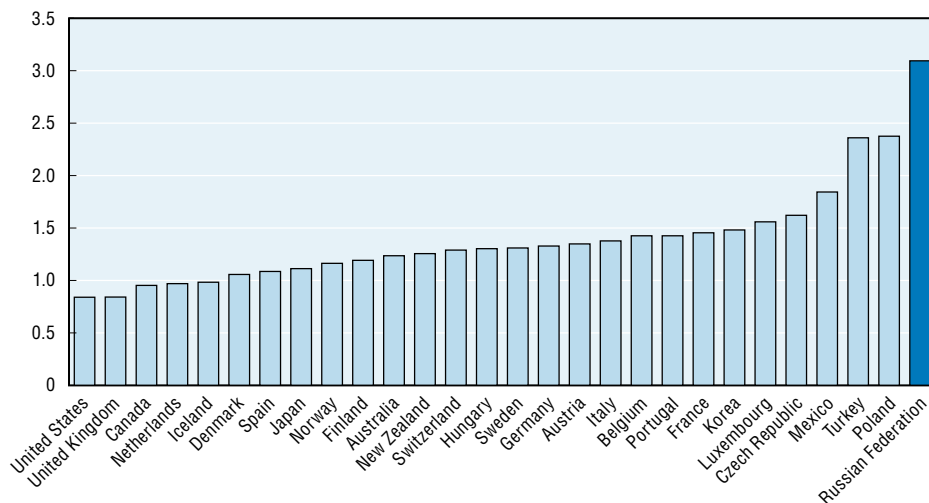


Source: OECD calculations based on Central Bank of Russia and JP Morgan.

creating new regulatory institutions and implementing market-orientated forms of regulation. Many measures could be taken to reduce barriers to entrepreneurship and increase competition, including: further public administration reform and cutting red tape; increasing the transparency and accountability of public administration; carrying out Regulatory Impact Analysis to assess significant new regulatory proposals; breaking the dependence of regional governments on a limited number of local firms for revenue raising; providing for more vigorous and uniform implementation of competition law; minimising uncertainty and the need for subjective decision making within the government administration so as to reduce corruption opportunities; and continuing work to make network industries more competitive, with stronger regulation.

Russia's average import tariff rate is somewhat higher than in most other middle-income countries and significantly higher than in OECD countries. Further, despite the implementation of a programme to simplify the rate structure in 2000-01, the dispersion in tariffs has actually increased since the beginning of the 2000s, indicating a less uniform structure. Lowering tariff protection and tariff dispersion to OECD levels would be both beneficial for economic performance and helpful in speeding Russia's accession to the World Trade Organisation (WTO), which has been under negotiation for more than 15 years. WTO membership would in turn exercise some leverage for making more progress with competition-enhancing reforms. As to foreign direct investment (FDI), inflows have, until recently, been robust, but barriers to foreign ownership are estimated to be high in Russia compared to OECD countries. In part, this reflects the enactment in May 2008 of the law on strategic industries, which defines 42 sectors in which control by foreign investors requires prior authorisation from a government commission. Although this law increases transparency and is less ad hoc than the previous regime, its sectoral coverage is broader and notification

Figure 2.
THE OVERALL INDICATOR
OF PRODUCT MARKET
REGULATION



Note: Index scale of 0-6 from least to most restrictive.

delays longer than OECD-recommended practice. The emergence of large state-controlled conglomerates with dominant market positions also acts as a barrier to FDI inflows. The scope for foreign investors to acquire equity in these conglomerates or participate in government procurement contracts in the sectors they occupy is strictly limited. Beyond explicit barriers to FDI, the overall regulatory environment in Russia is perhaps the most significant impediment to greater inflows of FDI. *The government should increase the openness and predictability of the foreign investment regime, review the list of strategic sectors and ensure a level playing-field between domestic and foreign firms with respect to government procurement and access to subsidies.*

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Economic Outlook No. 85, June 2009.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2009 edition.

More information about this publication can be found on the OECD's website at www.oecd.org/economics/goingforgrowth.

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