JULY 2006 Policy Brief

OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of Japan, 2006

oecd Observer

Summary

The economic expansion, which began in 2002, has enabled Japan to finally overcome the negative legacy of the collapse of the asset price bubble in the early 1990s. The upturn is projected to continue through 2007, underpinned by improving labour market conditions and accelerating exports, with inflation positive. However, as Japan emerges from a decade of economic stagnation, it faces a new set of challenges to sustain robust growth over the medium term in the context of rapid population ageing.

Successfully implementing a new monetary policy framework. The Bank of Japan should be cautious in raising interest rates, given remaining deflationary pressure. Although the announcement of the Board members' understanding of price stability enhances the transparency of monetary policy, the choice of a 0 to 2% zone does not leave an adequate buffer against deflation. The lower bound of the inflation zone should thus be increased. Avoiding an early and significant rise in long-term interest rates would be beneficial to economic activity, the fiscal situation and the banking sector. The financial soundness of the banking sector should be promoted by scaling back the role of public financial institutions and moving ahead with the privatisation of Japan Post.

Achieving fiscal consolidation. With gross public debt now above 170% of GDP, reducing the still-large government budget deficit is urgent. Continued spending restraint should be the priority, in part by reforming the social security system and further reducing public investment. However, expenditure cuts alone are insufficient in the context of population ageing, making revenue increases necessary, by broadening the income tax base, while some increase in the consumption tax rate may also be inevitable. It is important to maintain confidence in the government's fiscal consolidation programme by making the *Structural Reform and Medium-Term Economic Perspectives* a more detailed and binding plan of spending and revenue measures to achieve a primary budget surplus at least large enough to stabilise the public debt ratio by the early 2010s.

This Policy Brief presents the assessment and recommendations of the 2006 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.

Reducing income inequality and relative poverty. While population ageing is partly responsible for the rise in measured inequality and relative poverty, increased dualism in the labour market is another important factor. The growing use of non-regular workers should be reversed by a comprehensive approach, including reducing employment protection for regular workers. In addition, public social spending should be better targeted at vulnerable groups, such as single parents.

Upgrading the national innovation system to promote productivity growth. Raising productivity growth in the face of population ageing requires increasing the return on Japan's high level of investment in innovation by improving the R&D system and upgrading the education system. Greater mobility of researchers is needed to enhance links between government and private research institutions. Strengthening competition, particularly in the service sector and network industries, is a key to promoting the creation and diffusion of technology. Government science and technology policy should limit the risk of government failure caused by picking priority sectors and avoid focusing too much on manufacturing, while improving framework conditions to encourage business-sector R&D.

Strengthening the integration of Japan in the world economy. Japan remains relatively isolated in terms of import penetration, the stock of inward foreign direct investment (FDI) and the inflow of foreign workers. Making fuller use of foreign goods and services, FDI and foreign workers is important to boost productivity growth, as well as to cope with labour shortages in some sectors. Achieving this objective requires reducing barriers to FDI and imports, particularly in agriculture, and relaxing controls on inflows of foreign workers. ■

What are the main challenges facing Japan?

Japan has finally emerged from an extended period of economic stagnation following the collapse of the asset price bubble in the early 1990s. Factors that had weighed on activity – such as falling asset prices and declining bank lending – have been slowed or reversed, while corporate restructuring to reduce employment, capacity and debt has largely run its course. This has allowed the initial export-led upturn in 2002 to develop since early 2005 into a full-fledged expansion driven by domestic demand. The strength and duration of this upturn pushed some measures of inflation into positive territory in the first quarter of 2006 and business and household confidence have now reached their highest levels since the early 1990s. The government's reform measures have played an important role in laying the foundation for sustained and robust growth, in particular by strengthening the banking system. The positive trends in business investment and private consumption are expected to continue, making the current expansion the longest in Japan's post-war history, with output growing between 2 and 3% in 2006 and 2007.

However, sustaining the upturn over the medium term requires meeting a number of challenges:

- *Achieving a definitive end to deflation and successfully implementing an effective monetary policy framework.* A significant rise in market interest rates that is too early or too large would pose important risks to both economic activity and the fiscal situation.
- *Ensuring fiscal sustainability in the context of exceptionally rapid population ageing.* With gross public debt having risen to over 170% of GDP, measures to reduce the large government budget deficit are urgent.
- *Addressing emerging concerns about income distribution and poverty while containing the growth of government spending.* Rising income inequality and the increasing proportion of the population in relative poverty threaten to weaken the consensus for further economic reforms.
- *Upgrading the innovation system to help boost productivity growth.* With population ageing slowing labour inputs, increasing the return on investment in innovation is essential to achieve the faster productivity gains needed to sustain the rise in living standards.
- *Strengthening the integration of Japan in the world economy to benefit more fully from globalisation.* Accelerating productivity growth also requires making fuller use of goods, services, capital, technology and human resources from abroad.

In sum, Japan needs to implement monetary and fiscal policies appropriate to its unique macroeconomic situation while advancing on a wide range of economic reforms necessary to sustain growth.

Policymakers face the challenge of managing a "double exit strategy", with monetary policy exiting from zero interest rates, while fiscal policy exits from unsustainably high budget deficits. Finding the appropriate pace and policy mix for this exit strategy is a difficult task and macroeconomic conditions have to be taken into account. Deflationary pressures are not fully overcome, although the real economy has strengthened considerably. Furthermore, medium-term inflation expectations have to be anchored at the desired level in order to prevent an excessive rise in long-term nominal interest rates. ■

How can monetary policy help meet the macroeconomic objectives?

Inflation turned positive in the first quarter of 2006, with the core consumer price index (the OECD definition, which excludes food and energy) rising by 0.2% year-on-year. However, the continued decline in other price measures, notably the private consumption and GDP deflators, suggests that some deflationary pressures remain. In March 2006, the Bank of Japan ended the quantitative easing policy introduced in 2001, which had supported the economic expansion by keeping the short-term interest rate at zero and long-term rates at low levels, while forestalling financial-sector instability by providing enormous liquidity to banks. With the end of quantitative easing, the central bank unwound the run-up in reserves since 2001 and then started to move away from a zero short-term interest rate with a 0.25% hike in July 2006. The Bank plans to continue purchasing long-term government bonds at an unchanged rate, which is likely to help maintain financial-market stability. The Policy Board also announced that 0 to 2% is its understanding of what constitutes price stability in the medium to long term, the first time that it has specified an inflation range.

The exit strategy from quantitative easing and zero interest rates is a special challenge for the Bank of Japan. While the announcement of the Board members' understanding of price stability enhances transparency, the fact that the inflation range will be reviewed each year makes it less useful as a guide for market expectations over the medium term. The framework announced in March also allowed considerable flexibility to the Bank in moving away from zero interest rates in order to limit long-term risks. Given uncertainty about the rate of potential growth and the size of the output gap as the economy emerges from deflation, the Bank should be cautious in raising interest rates. It needs to be sure that inflation is sufficiently positive to minimise the risk that a negative shock could push Japan back into deflation. Although the Bank ended the zero short-term interest rate in July, waiting until inflation moves further above zero – such as a 1% rate of increase in the core consumer price index – before raising interest rates further would also support the expansion. This suggests that the Bank should review the understanding of price stability and increase the lower end of the range to give an adequate buffer against deflation, as the zero floor is too close to deflation for comfort. Such an approach to monetary policy would reduce market expectations of interest rate hikes, which helped to drive up the long-term interest rate from 1.6% when the quantitative easing policy ended in March to 2% in May, accompanied by exchange rate appreciation. Avoiding a premature rise in long-term interest rates while the GDP deflator is still declining is also important for progress in fiscal consolidation.

Avoiding a substantial, premature rise in the long-term interest rate would also be beneficial to banks, whose holdings of long-term government bonds increased significantly during the quantitative easing period. Maintaining the improved financial health of banks is important to sustain the upward trend in bank lending, which recently turned positive for the first time since 1996. There has been considerable progress in reducing the non-performing loans of the major banks. The supervisory authorities should maintain pressure on the banking sector to strengthen its capital base and encourage the regional banks to continue reducing non-performing loans. While regional banks play an important role in lending to small and medium-sized enterprises, the government should avoid moral hazard that would create additional non-performing loans. In addition, the profitability of the banking sector would be improved by scaling back the role of public financial institutions. Perhaps the top priority is the privatisation of Japan Post, the largest financial institution in the world. The authorities should achieve a complete divestiture of the government's holdings in Postal Savings and Postal Life Insurance by 2017 at the latest. A level playing field with private financial institutions should be established before restrictions on the activities of Postal Savings and Postal Life Insurance are removed. The rationale for public financial institutions, whose lending amounts to almost one-fifth of that of private financial institutions, should be carefully examined and their activities should be reduced and subjected to clear budget constraints. Such an approach would reduce unfair competition with private financial institutions, while helping to cut wasteful government spending. ■

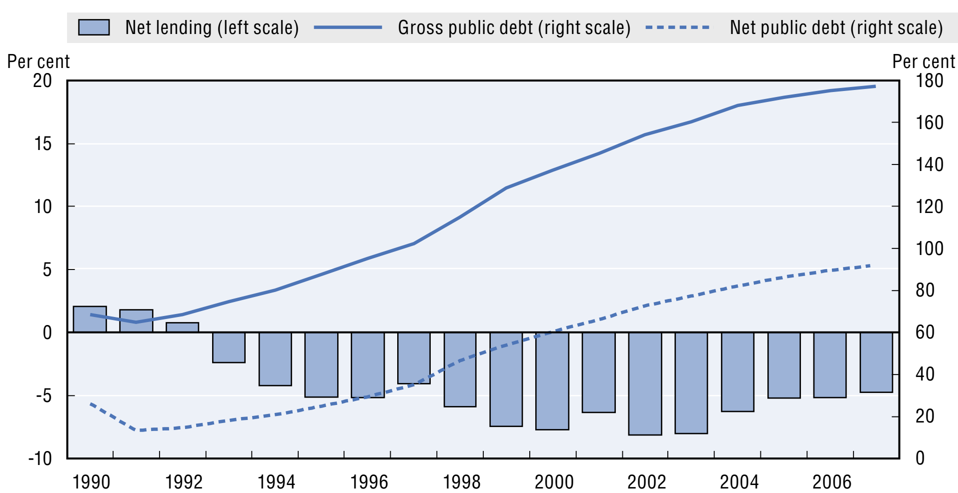
How can public finances be put on a sustainable path?

Limiting the growth of government spending is the priority in addressing the serious fiscal problem. The FY 2001 *Structural Reform and Medium-Term Economic and Fiscal Perspectives* set an objective of freezing public expenditure at 38% of GDP through FY 2006, and this target is likely to be achieved. Such spending restraint, which was achieved in part through cuts in public investment, aimed at the goal of a primary budget surplus for the combined central and local governments in the early 2010s. On a general government basis, the primary budget deficit has fallen from 6.7% of GDP in 2002 to an estimated 4% in 2006, with about half of the decline due to structural factors, and the rest accounted for by the economic expansion.

Figure 1.

THE FISCAL SITUATION IN JAPAN

For general government, as per cent of GDP[1]



1. OECD estimates for 2005, 2006 and 2007.

Source: OECD Economic Outlook 79 database.

The *Reference Projection* for the FY 2005 *Reform and Perspectives* shows a primary budget balance for the combined central and local governments in 2011. However, a balance would not be adequate to stabilise the level of public debt relative to GDP in the long run if the nominal interest rate on government debt exceeds the growth rate of nominal output. While the economic expansion and an end to deflation may push the nominal growth rate above the interest rate in 2006, assuming that growth remains higher would not be prudent for setting a medium-term fiscal objective. Indeed, population ageing will tend to slow output growth while possibly increasing the interest rate. In sum, stabilising the public debt to GDP ratio is likely to require a primary budget surplus for the general government of between ½ and 1½ per cent of GDP. To achieve this target by the early 2010s would require that the pace of fiscal consolidation accelerate somewhat to around 1% of GDP per year. Achieving such a target would stabilise the public debt ratio sooner and at a lower level. Moreover, it would help maintain public confidence in the government's fiscal consolidation efforts, thereby limiting the possibility of a rise in the risk premium and preventing a substantial deterioration in the budget deficit.

A credible medium-term plan is also important to sustain public confidence. A number of steps should be taken to improve the *Reform and Perspectives:*

- *Adopt a ceiling for the government expenditure level through the early 2010s in accordance with the latest Reference Projection. Set specific spending targets by category to show how the ceiling can be achieved.*
- *Make the spending targets more binding on the government's actual annual outlays and introduce a feedback mechanism that shows how the plan will evolve if outcomes diverge from those targets.*
- *Ensure the sustainability of the social security fund. The Reform and Perspectives' target for central and local governments should not be achieved through a deterioration in the social security account.*

Furthermore, continued efforts are needed to increase the transparency of the budgetary system, thereby enhancing fiscal discipline and achieving consolidation.

Much of the spending restraint to date has been achieved by cutting public investment from 8.4% of GDP in 1996 to 5% in 2004. Given that it still remains significantly above the OECD average of around 3% of GDP, there appears to be scope for further reductions, which should be accompanied by a better allocation of investment to enhance its productivity. However, the rising cost of maintaining existing infrastructure is crowding out new growth-enhancing public investment. It is important therefore to develop a comprehensive plan, in the context of a declining population, to close less useful infrastructure. The government plans to reduce expenditure by cutting the number of central government employees over five years as a first step to halving their total compensation during the next decade. Given the inefficiency of across-the-board cuts, budget savings should instead be achieved by reducing low priority activities and using market testing to determine which tasks can be better performed by the private sector. In addition, increasing efficiency in the public sector, in part by relaxing the rigid employment system, could generate savings. The efforts to reduce spending should be extended to include local governments, public enterprises and government-affiliated organisations, which account for more than 80% of public-sector employment. In any case, the scope for expenditure cuts may be limited by the fact that public-sector employment per population in Japan is well below the level in other major OECD economies, suggesting the need to achieve spending reductions in other areas as well.

Population ageing raises pressure for increased outlays on pensions and healthcare. The FY 2004 reform is expected to keep pension payments constant at around 9% of GDP through the end of the decade by allowing the replacement rate to fall from 59% to 50%. Any slippage from this spending target should be met by a hike in the pension eligibility age, rather than by a further rise in the contribution rate, which is to be increased from 13.6% in FY 2004 to 18.3% by FY 2017. A rising contribution rate risks further boosting the evasion rate, which at 33% for those not part of the employee pension system, is already well above the level assumed in the government's projections. As for healthcare, a large cut in medical fees and the introduction of a new insurance scheme for those over the age of 75 is expected to help keep spending at around 5½ per cent of GDP through 2010. Much of the expected spending restraint, however, depends on reducing the demand for healthcare by preventing lifestyle-related diseases. Given the difficulty of achieving such savings, additional reforms are needed. The key to achieving higher quality and greater efficiency in healthcare, as well as in long-term nursing care, is to make greater use of the dynamism of the private sector, in part by allowing companies to manage hospitals and nursing homes.

Even with these reforms, it will be difficult to reduce government spending as a share of GDP, in part due to rising interest payments. Consequently, achieving the necessary improvement in the government budget position – around 5% of GDP – will require additional revenue. Given that less than one-half of wage earnings are taxed and only one-third of corporations pay income tax, broadening tax bases is important to raise additional tax revenue, while enhancing economic efficiency and growth. In addition, measures to increase tax compliance, such as a taxpayer identification number, would enhance efficiency and fairness, while increasing tax revenue. A hike in the consumption tax rate may also be necessary to achieve fiscal consolidation. ■

How can the rise in inequality and poverty be reversed?

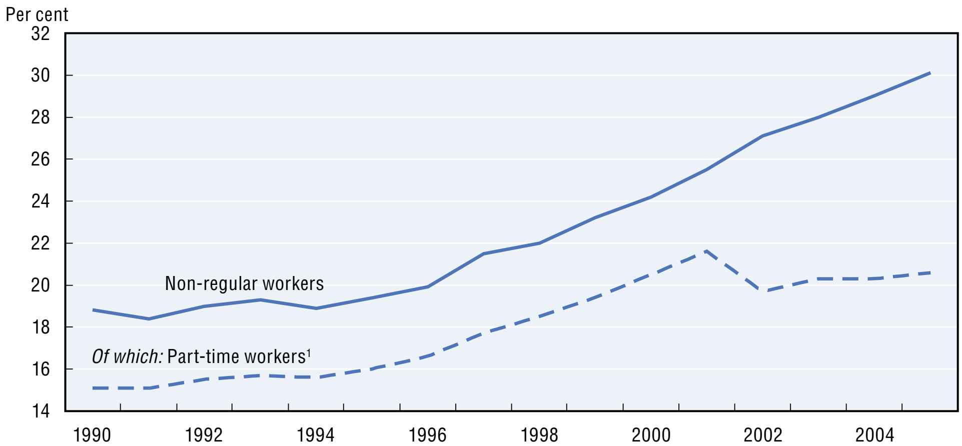
Reform of the tax system should take into account its potential impact on income distribution, which has become more unequal for the working-age population in recent years. Indeed, the Gini coefficient measure has risen significantly since the mid-1980s from well below to slightly above the OECD average and the rate of relative poverty in Japan is now one of the highest in the OECD area. Population ageing is partly responsible for boosting inequality as it raises the proportion of the labour force in the 50 to 65 age group, which is characterised by greater wage variation. However, the key factor appears to be increasing dualism in the labour market. The proportion of non-regular workers has risen from 19% of employees a decade ago to over 30%. Part-time workers earn on average only 40% as much per hour as full-time workers, a gap which appears too large to be explained by productivity differences. Although the increase in non-regular workers has been partly caused by cyclical factors, there is a risk that labour market dualism will become entrenched, given that thus far only a small proportion of non-regular workers have become regular workers. One important key to reversing the rise in inequality and poverty is to reduce labour market dualism. This requires a comprehensive approach including reducing employment protection for regular workers and thereby weakening the incentives of firms to hire non-regular workers. In addition, it is important to increase the coverage of temporary workers by social insurance and to enhance the employment prospects of non-regular workers.

The serious fiscal problem limits the scope for boosting social spending to reduce relative poverty. It is necessary, therefore, to reallocate social spending to increase the share received by low-income households, while taking care to limit the creation of poverty traps and work disincentives. About three-quarters of social spending is allocated to the elderly. More than half of single working parents were in relative poverty in 2000, compared with an OECD average of around 20%. Moreover, Japan had a higher poverty rate for single parents who work than for those who are not employed. In 2002, the government reformed the single parent allowance to provide work incentives. Significant poverty among single parents is a factor boosting the child poverty rate to 14% in 2000, well above the OECD average. Given the relatively high proportion of education costs borne by the private sector, it is essential to ensure that children in low-income households have adequate access to high-quality education to prevent poverty from being passed to future generations. The increasing stratification in educational outcomes in Japan found by the PISA study should be addressed. ■

Figure 2.

THE SHARE OF NON-REGULAR WORKERS IS RISING

As percentage of total employed persons



1. The significant fall in the number of part-time workers in 2002 and the rise in the other categories is thought to be due to a change in the questionnaire.

Source: Ministry of Internal Affairs and Communications.

How can the education system become more effective?

Improving the overall quality of the education system is essential to accelerate productivity growth through the generation and diffusion of innovation. In recent years, the performance of Japanese students on international standardised tests has declined despite increasing expenditures on private institutes for after-school tutoring. Giving more autonomy to local governments and individual schools in hiring teachers, setting wages and determining the curriculum could enhance competition and help reverse declining levels of performance. Reforming the entrance examination systems for secondary schools and universities would also encourage more diversity in the curriculum. Improving quality at the tertiary education level by strengthening competition is also essential. This could be accomplished by allowing more flexibility in the management of universities, enhancing transparency in evaluating performance and further reducing regulations, including those that prevent foreign universities from entering Japan, while ensuring high quality education. ■

How can productivity in the service sector be increased?

One aspect of improving the return on investment in innovation is to promote the use of existing technology, particularly in the service sector, where average labour productivity fell from 88% of the US average in 1993 to 84% in 2003. One key to encouraging the diffusion of technology is regulatory reform to strengthen competition, particularly in network industries. In order to ensure pro-active *ex ante* regulation, a necessary condition for introducing competition in markets dominated by strong incumbents, the establishment of sectoral regulators independent of the government should be considered if the current approach through the government ministries does not work sufficiently well. The Special Zones for Structural Reform introduced in 2003 also have the potential to be effective in removing unnecessary regulations, which requires focusing on nation-wide reform rather than simply on regional development. This focus could be re-enforced by strengthening organisational links between the offices for special zones and regulatory reform. In addition, reforms allowed in the zones should be generalised nation-wide in a limited time period, avoiding unduly long periods of evaluation. ■

How can the national innovation system be improved?

In addition to education and regulatory reform, it is important to upgrade innovation-specific policies. One priority should be to strengthen links between research institutes in government, academia and business sectors. This requires greater mobility of researchers, given that the average number of job changes by researchers during their career is less than one in Japan. Increasing the portability of pensions and reforming the system of retirement allowances at public research institutes would reduce disincentives that discourage job changes. Moreover, expanding the use of open competition in hiring, performance-based pay, fair and transparent evaluation systems and fixed-term contracts, and providing more information on job opportunities, would also encourage mobility.

The third Science and Technology Basic Plan, which covers the period FY 2006-10, contains a number of positive changes from the preceding plans. However, there remain a number of areas for improvement as well as concerns about the programmes of the Ministry of Economy, Trade and Industry (METI) to promote new industries:

- *Focus on increasing efficiency in R&D spending rather than on meeting a specific spending level,* which risks encouraging wasteful investment. The third Plan states that government R&D investment should be 1% of GDP each year between FY 2006 and FY 2010.
- *Avoid mixing national innovation policies with measures aimed at promoting balanced regional development.*
- *Increase further the share of competitive grants in the allocation of public R&D funds to enhance the efficiency of spending.* In FY 2005, competitive grants accounted for only 13% of the total.
- *Maintain flexibility in allocating public R&D funds, thereby limiting the risks of government failure inherent in concentrating R&D in the sectors identified as priority areas.* For example, the third Basic Plan identifies four priority areas and four promotion areas.
- *Attach greater importance to the non-manufacturing sector in the allocation of public R&D funds.*
- *Focus support for R&D on new start-ups rather than on existing companies as is now the case.*
- *Expand the work of the Council on Science and Technology Policy beyond purely scientific issues to include measures to improve framework conditions for innovation.*
- *Strengthen international links.* According to data on patents, foreign ownership of domestic inventions in Japan and domestic ownership of foreign inventions are both the lowest in the OECD area. ■

How can Japan become better integrated in the world economy?

Along with innovation, strengthening Japan's links to the world economy is essential to boost productivity growth. Indeed, the stock of inward FDI, import penetration and the proportion of foreign workers in the labour force in Japan are each the lowest in the OECD area. Although the stock of inward FDI tripled between 1998 and 2002, the pace of inflows has slowed during the past few years. The government's recently announced target of doubling the stock of FDI as a share of GDP by 2010 should spur ministries and agencies to improve the environment for foreign investors. Most importantly, the market for mergers and acquisitions (M&As) should be fully opened to foreign firms by allowing them to use their own shares to finance mergers and granting them the same tax deferrals that are available in the case of domestic M&As. In addition, while most discriminatory regulations on FDI inflows have been removed, it is important to make further efforts to facilitate FDI inflows, particularly in the service sector and network industries, by accelerating regulatory reform in product markets, notably to reduce entry barriers to both domestic and foreign firms.

Improving the environment for inflows of FDI may also help expand international trade. Despite the marked increase in trade with China during the past decade, import penetration is significantly below the expected level, even after taking account of factors such as country size, transport costs and per capita income, although there may be other economic factors. It is important to further reduce tariff and non-tariff barriers, which appear to be higher than in other major trading regions in the OECD area, according to some measures. Trade liberalisation should be pursued through multilateral trade negotiations, the preferred approach to reducing barriers, and participation in WTO consistent regional trade agreements. Although Japan has been a latecomer to the worldwide surge in such agreements, it is now engaged in negotiations with a number of countries. However, the high level of agricultural protection appears to be an obstacle to both multilateral and regional trade agreements. It is important to reduce the level of protection for farmers in Japan, in part through a further opening of the rice market, which would provide significant economic benefits to Japanese consumers. Aspects of multifunctionality in agriculture, as well as income support for farmers, can be better dealt with through carefully targeted policy measures that minimise trade distortions.

Increasing the number of foreign workers is a major issue in regional trade agreements, given that some Asian countries wish to see improved opportunities for their nationals to work in Japan as part of such agreements. Currently, foreign workers, both legal and illegal, account for about 1% of employment in Japan, the lowest ratio in the OECD area. The number of sectors in which foreign workers are allowed should be expanded to include non-technical areas, such as caring for the elderly. In addition, the range of foreign qualifications that are valid in Japan should be expanded. Increasing immigration should help meeting emerging labour shortages, particularly for long-term nursing care, where demand is growing rapidly due to population ageing. In addition, a liberalisation of restrictions on the employment of skilled foreign workers would be positive for productivity. ■

How can female labour participation be increased?

While increased inflows of foreign workers would be beneficial, they will not be large enough to offset the projected decline in Japan's working-age population by nearly one-fifth over the next 25 years. Removing disincentives for female labour force participation would be more effective in limiting the falling proportion of workers in the total population. While the relatively low participation rate of prime-age women reflects a number of private-sector practices, such as seniority-based wages, the government should reduce or eliminate aspects of the tax and social security system that discourage women from working full-time. In addition, it is essential to increase the availability of childcare facilities and to encourage the take-up of parental leaves and the creation of more family-friendly workplaces. Such policies would also be likely to boost the fertility rate from 1.3 children per women, one of the lowest rates in the OECD area. ■

For further information

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Economic Outlook No. 79, May 2006.
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10 2006 13 1 P4