POLICY BRIEF

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What are the key challenges facing Korea?

What is the economic outlook?

How can monetary and exchange rate policies support the economic expansion?

What is the appropriate stance of fiscal policy?

How can the sustainability of public finances be ensured?

How can the problems in the labour market be overcome?

What reforms are needed in the corporate and financial sectors and in the real estate market?

How can the KFTC be made more effective?

How can competition be strengthened in the service sector and in the network industries?

How can Korea become more open to trade and foreign direct investment?

For further information

For further reading

Where to contact us?

Summary

Korea has been one of the fastest growing economies in the OECD area over the past five years, with an annual growth rate of about 6 per cent. Such rapid growth, which has lifted per capita income to two-thirds of the OECD average, reflects Korea's underlying dynamism and its progress in implementing a wide-ranging reform programme in the wake of the 1997 crisis. However, the recession in 2003 – which was due in part to structural problems in the labour market and in the corporate and financial sectors – indicates that the reform agenda is unfinished. Sustaining rapid growth over the medium term as the contribution from inputs of labour and capital slows requires further progress in structural reform, particularly in the labour market and in the corporate and financial sectors, accompanied by appropriate macroeconomic policies.

Monetary policy should focus on the newly established medium-term inflation target. Putting a stop to foreign reserve accumulation would limit the need for higher interest rates over the business cycle and tend to promote a more balanced expansion over the medium term. Given the pressure for increased public expenditure due to population ageing and the development of the social safety net, as well as the potential costs of economic co-operation with North Korea, fiscal policy should aim at a balanced budget, excluding the social security surplus, over the business cycle. Anchoring spending decisions in a medium-term framework and increasing the efficiency of the public expenditure system would also help contain spending pressures. In addition, fundamental reform of the

This Policy Brief presents the assessment and recommendations of the 2004 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.

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pension system is essential to ensure its sustainability in the context of exceptionally rapid population ageing. Reform should aim at expanding the effective coverage of the public pension system and developing private-sector saving for retirement.

A comprehensive reform package is needed to increase employment flexibility, create more co-operative industrial relations and reduce the extent of dualism in the labour market, which creates equity concerns. Relaxing employment protection for regular workers and improving the coverage of the social safety net, especially for non-regular workers who account for about a quarter of all employees, would enhance flexibility and reduce labour market dualism. The government should promote an industrial relations framework in which workers and management settle their disputes autonomously. Active labour market policies should be improved while limiting deadweight costs. Over the longer term, boosting labour force participation rates, focusing on older workers and women, is essential to cope with rapid population ageing.

Further progress in implementing the new corporate governance framework, combined with improved financial supervision and strengthened competitive pressures, are important to effectively discipline chaebol behaviour and guide corporate restructuring. The 2003 accounting scandal demonstrates the need to improve auditing procedures to enhance transparency. In the financial sector, the privatisation of the commercial banks should continue. It is also necessary to promptly resolve the problems in the non-bank sector, notably in the credit card companies, which have impinged on private consumption, and in the investment trust companies. Shifting financial supervision to a more pre-emptive and risk-based approach would help avoid future problems in the financial sector.

Competition policy should be strengthened by granting the Korea Fair Trade Commission compulsory investigative powers, making the threat of individual sanctions more credible and removing exemptions from the competition law. The benefits of increased competition are likely to be strongest in the service sector, where productivity levels are significantly lower than in the manufacturing sector. Competition should be strengthened by removing barriers to large retail outlets and eliminating unnecessary constraints on professional services. Simplifying land-use regulations, which are governed by 112 laws, may also reduce entry barriers. It is also important to accelerate efforts to expand the scope of competition in network industries through privatisation and the unbundling of their activities. Another key to competition is the establishment of sectoral regulators that are independent of the ministries responsible for promoting the development of network industries. Foreign competition should be increased by further reducing barriers to imports while addressing features, such as labour market problems, that tend to discourage inflows of direct investment. ■

What are the key challenges facing Korea?

Korea stands out as one of the fastest-growing OECD countries over the past five years, with an annual growth rate of around 6 per cent. This very good performance has sustained the convergence process, lifting per capita income to two-thirds of the OECD average. The return to high growth rates following the 1997 crisis was based in part on Korea's progress in reforming its economic framework to correct some of the weaknesses that had made it vulnerable to the Asian crisis. Rapid growth also reflects the country's underlying economic dynamism, particularly in the information and communications technology (ICT) sector. Korea has also benefited from strong demand from China, which has emerged as its biggest trading partner. Korea's outstanding performance is underpinned by large inputs of labour and capital, reflecting still-rapid population growth, rising labour force participation rates and a high level of investment.

The key long-term challenge is to continue the rapid convergence to the average income level in the OECD area by accelerating productivity growth as inputs of labour and capital slow. The government's emphasis on maintaining high growth is reflected in the recently established goal of doubling per capita income from $10 000 to $20 000, although the time frame is unspecified. With labour productivity (per hour worked) at around one-half of the OECD average, there is considerable scope for convergence to sustain high growth, all the more so given the positive effect stemming from the rising education level of the workforce. With some pick-up in total factor productivity gains, Korea may be able to sustain growth at around 5 per cent over the medium term. However, achieving such an outcome will require polices to:

- Maintain macroeconomic stability in the face of spending pressures stemming from exceptionally rapid population ageing, the development of a social safety net and the potential cost of economic co-operation with North Korea.

- Ensure that the labour market functions effectively by encouraging more co-operative and harmonious industrial relations, enhancing employment flexibility and limiting dualism in the labour market, which has negative implications for equity.
- Further improve the corporate governance framework and accounting transparency to boost efficiency in the corporate sector, while ensuring better supervision of the financial sector.
- Strengthen competitive pressure by overcoming the legacy of extensive government intervention in the economy, upgrading competition policy and continuing the opening to international trade and foreign direct investment.

In short, it is essential to continue the reform agenda launched after the 1997 crisis. ■

What is the economic outlook?

Indeed, remaining weaknesses in the economic framework contributed to the economic recession in the first half of 2003, which slowed growth for the year to around 3 per cent. Private consumption was negatively affected by the liquidity and solvency problems of the credit card companies following the sharp rise in the delinquency rate in the wake of the credit boom to the household sector. Lending by the credit card companies to households has fallen by a quarter from its peak. The 1.4 per cent decline in private consumption in 2003 despite continuing household income growth also indicates that the household sector had become over-indebted. The instability in financial markets resulting from the problems of the credit card companies was aggravated by a serious accounting scandal that caused the failure of SK Global. The negative impact on business investment was magnified by the deterioration in already difficult industrial relations and labour strikes at major firms. In addition to these structural weaknesses, Korea was hit by a series of external shocks, notably SARS and the North Korean nuclear issue, which weakened confidence.

The recession in 2003 continued the pattern of volatility experienced in recent years. The ICT-led expansion in 2000 and the credit card boom in 2002 were followed by marked slowdowns in 2001 and 2003. The rebound in exports, at 16 per cent in volume terms in 2003, led to an economic recovery beginning in the second half of the year. China continues to exert a strong positive effect, with its imports from Korea rising at a 50 per cent year-on-year rate. The conflicting signals given by buoyant export growth and sluggish domestic demand make it exceptionally difficult to project the path of the economy. Nevertheless, robust export growth should stimulate sluggish business investment and private consumption, resulting in growth in the 5 to 6 per cent range in 2004 and 2005 that would absorb the excess capacity in the economy. The unemployment rate, 3.4 per cent in the first quarter of 2004 (seasonally-adjusted), is about the same as the average of the past three years, while core inflation (which excludes petroleum-based fuels and non-grain farm products) has remained around the midpoint of the medium-term target range of 2.5 to 3.5 per cent, despite the economic downturn. ■

How can monetary and exchange rate policies support the economic expansion?

With the economy gaining momentum, *monetary policy should enhance macroeconomic stability by focusing on the medium-term inflation target introduced in 2004*. The increased independence that was granted to the central bank under the revised Bank of Korea Act that came into effect at the beginning of the year should facilitate the shift in emphasis to the medium term. In an effort to stimulate sluggish domestic demand, the central bank reduced the overnight call rate to a record low of 3¾ per cent in July 2003, a rate only slightly above the 3.6 per cent rate of headline inflation in 2003. *Maintaining stability over the business cycle will likely require some withdrawal of monetary stimulus*, leading to higher real short-term rates, as the economy accelerates. However, given the run-up in household debt from 56 per cent of GDP in 1998 to 74 per cent in 2003, higher interest rates may slow the recovery in private consumption.

The extent of the rise in interest rates needed to keep inflation in the medium-term target zone depends to some extent on exchange rate developments. By December 2003, the exchange rate of the won relative to Korea's 41 major trading partners had fallen 6 per cent below its year-earlier level. This may have contributed to the acceleration of exports, though possibly weakening domestic demand by reducing the purchasing power of Korean households and firms. The fall in the won took place in the context of continued large accumulation of foreign exchange reserves, which rose by $34 billion during 2003 to reach

$155 billion, the second highest level in the OECD area, thus reducing Korea's vulnerability to crisis. However, there is some risk associated with intervention to limit the upward pressure on the currency, which generally has limited effectiveness except in the very short run. At the same time, the opportunity cost of holding such a large amount of reserves is significant. *Therefore, now that Korea's reserves are almost three times larger than its total short-term foreign debt, there is no need for continued foreign exchange accumulation.* Although this may allow more upward pressure on the exchange rate, with a moderating effect on exports, it would have some offsetting positive effects, including a real income gain for households and firms. In addition, it would reduce the burden of companies' foreign debt. In sum, these factors may promote a more balanced expansion over the medium term. ■

What is the appropriate stance of fiscal policy?

A monetary policy focused on the medium term should be accompanied by a fiscal policy anchored in a medium-term framework to ensure fiscal sustainability. Such a framework would allow automatic stabilisers to function in order to limit volatility. However, such stabilisers are relatively weak in Korea, reflecting the small size of government and the early stage of development of the social safety net. In 2003, two supplementary budgets in the latter part of the year boosted total government spending, after adjusting for special factors, by 6½ per cent, slightly faster than nominal output growth. However, government revenue grew even faster, at 8 per cent, due in part to large tax receipts from corporations on their profits in 2002. Consequently, the consolidated central government balance (excluding the social security surplus, the cost of bringing part of the financial-sector restructuring programme into the budget and privatisation revenues) was in balance in 2003 for the first time since the crisis. The elimination of the small deficit, which was ¼ per cent of GDP in 2002, suggests that the stance of fiscal policy was slightly contractionary in 2003.

The fiscal stance for 2004 is uncertain. While comparing the initial budget to the outcome in 2003 shows an 8 per cent rise in spending – in line with expected nominal income growth – the frequent use of supplementary budgets may lead to higher expenditures. Moreover, tax cuts have recently been introduced to encourage private consumption and job creation. The recovery projected during the course of the year, though, would negate the need for fiscal stimulus. *The authorities should aim to keep the consolidated central government budget (excluding the social security surplus) in balance over the business cycle once the process of bringing the costs of financial-sector restructuring into the budget is completed in 2006.* ■

How can the sustainability of public finances be ensured?

Maintaining a sound fiscal position in the face of the pressures for increased outlays would be facilitated by an effective medium-term expenditure framework that anchors annual spending decisions and provides discipline for policymakers. *The National Fiscal Management Plan, which is currently under discussion by the cabinet, has many positive features, and should be used to bind annual budgets as from 2005.* This should be accompanied by a comprehensive reform of the budget structure aimed at:

- *strengthening aggregate spending control and enhancing transparency by making the budget less compartmentalised and fragmented;*
- *increasing efficiency by strengthening accountability for results and relying more on market mechanisms in supplying publicly financed services;*
- *improving inter-governmental fiscal relations.*

Similarly, on the revenue side, it is important to minimise the distortive effects of the tax system by reducing generous allowances and tax credits in the personal income tax system and broadening the base for corporate and value-added taxes. The negative features embedded in the tax system should be removed before boosting government revenues to accommodate growing expenditure resulting from the development of the social safety net, economic co-operation with North Korea and population ageing.

The fiscal impact of ageing will be large in Korea given the rapid pace of demographic change. Indeed, the share of the population over age 65, which is projected to double from 7 to 14 per cent between 2000 and 2019, is increasing substantially faster than in other OECD countries. Although the law requires changes in the pension system every five years to ensure its long-run sustainability, the proposal in 2003 to raise the contribution rate gradually and to cut the replacement rate from 60 to 50 per cent was not approved by the National Assembly. Maintaining the current benefit replacement rate would require a rise in the contribution rate, currently set at 9 per cent, to nearly 20 per cent, which would have a significant impact on the labour market. *An overhaul of the pension system is essential to ensure its sustainability, while providing adequate coverage*. At present, around a quarter of those who are supposed to participate in the National Pension Scheme, notably the self-employed, do not contribute. *There is thus a need for measures to include more of the self-employed and encourage them to report their income more accurately. Private sources of retirement income should be further developed, notably by creating a corporate pension system. In addition, it is important to raise the age of retirement of regular workers, which is typically around age 55, and ensure that the pension system does not discourage older persons from working. Given the small number of persons receiving public pensions at present, it is essential that the social safety net be adequate to limit poverty among the elderly*. ■

How can the problems in the labour market be overcome?

The effective coverage of the social safety net should also be expanded to ensure adequate support for unemployed persons. Although the legally-mandated coverage of the Employment Insurance System has been progressively increased since its establishment in 1995, less than one-fifth of the unemployed in 2003 received unemployment benefits, reflecting in part the low effective coverage of the System. The recent changes to expand the coverage, in particular by including more non-regular workers – who account for at least a quarter of employees and are paid about 20 per cent less on average than regular workers – are commendable but enforcement needs to be further improved. *There may be scope for greater use of active labour market policies, such as training for the unemployed and job placement services to overcome mismatch problems, provided they are subject to rigorous cost-benefit analysis.* However, as wage subsidies are generally associated with high deadweight costs, measures are needed to minimise such effects.

Measures to expand the safety net and improve active labour market policies should be part of a comprehensive package addressing labour market problems. Such a package should also include steps to improve industrial relations, enhance employment flexibility and raise labour force participation rates of women. Unstable industrial relations appear to be one of the obstacles to a sustained economic recovery. *The government should develop an environment more conducive to harmonious industrial relations and avoid getting involved in individual disputes.* More co-operative industrial relations may facilitate more employment flexibility, while it is also necessary to reform the labour law. Although it was revised in 1998 to allow collective dismissals of regular workers for managerial reasons, this has not created enough flexibility in practice, given the constraints on management wishing to take such actions. *Reducing the employment protection provided to regular workers is important to reduce the incentives to hire non-regular workers, thus limiting the extent of dualism in the labour market, while enhancing labour market flexibility.* ■

What reforms are needed in the corporate and financial sectors and in the real estate market?

Greater flexibility in the labour market is essential to cope with rapid structural change in the corporate sector, which is driven by technological advances and Korea's increasing integration in the world economy. Another important element is effective corporate governance to guide investment decisions and prevent abuses by controlling shareholders and management. Significant improvements have been made in the corporate governance framework since the 1997 crisis. However, the failure of SK Global as a result of accounting fraud suggests that there is a lack of transparency and a need for better auditing practices. *The measures recently introduced to require the certification of financial reports by CEOs and CFOs, prohibit loans or collateral for major shareholders and executives, and strengthen protection for whistle-blowers should be effectively implemented to prevent such abuses. In addition, the steps introduced to ensure the independence of auditors should help enhance transparency. However, it is also necessary to increase the number of auditors significantly. The government should also encourage firms to adopt the recently introduced OECD Principles of Corporate Governance*. Finally, the decision to allow class action suits to protect shareholders of the largest firms – about 80 in number – from fraudulent practices related to securities is already influencing managerial behaviour. *Expanding the coverage of such suits to cover related party transactions should be considered to further reduce the scope for managerial abuses*.

Such abuses have created financial-market instability. In particular, the investment trust companies (ITCs) were vulnerable to liquidity pressures in 2003 after the collapse of SK Global and were also affected by the problems in the credit card companies. Credit card use expanded by a factor of eleven between 1998 and 2002, preceding the development of adequate expertise in the credit card companies and in the supervisory authorities. The rise in the delinquency ratio from 5 to 14 per cent and in the amount of rescheduled loans from 7 to 29 per cent of total credits led to serious liquidity and capital problems in this sector. In response, the government has encouraged related companies to roll over the debt of the credit card companies, although such a strategy tends to weaken market discipline. The authorities co-ordinated a rescue of the largest credit card company, fearing that its collapse could lead to a systemic crisis. However, this may increase moral hazard by suggesting that the "too big to fail" approach is still valid. In addition to the need for better supervision to cope with the rapid expansion of the credit card sector, the pace of the expansion of bank lending to households, which increased more than 40 per cent in 2002, raises concerns about risk analysis capabilities in the financial sector. *These problems demonstrate the need to develop a pre-emptive and risk-based approach to the supervision of financial institutions. In the banking sector, the privatisation of the government's holdings should continue. Finally, improving the health of the ITCs, in part by privatising the two large institutions that were restructured using public funds, is a priority to promote the development of the corporate bond market and provide more secure saving instruments for households*.

The development of long-term saving vehicles would help households prepare for retirement and reduce the concentration of their savings in real estate. Concern about persistent upward pressure on real estate prices, which resulted in a one-third rise in housing prices over the past three years, has led to a wide range of policy initiatives. Following through on measures to raise holding taxes and enhance the supply of housing should help alleviate such pressures. The plan to move the capital from Seoul to the middle of the country could also alleviate the concentration of activity in the capital region, where price increases have been largest. Given that Korea's population density is one of the highest in the world, achieving an efficient use of land should be a priority. Complicated land regulation, which is governed by 112 laws, is one of the key factors hindering investment by foreign and domestic companies in Korea. *Simplifying regulations on land use, should, therefore be a top priority.* ■

How can the KFTC be made more effective?

Enhancing competition is a key to improving productivity growth. Indeed, markets with high concentration ratios tend to have higher mark-up ratios, which reduce consumer welfare and distort the allocation of resources. *Given the large potential gains, promoting competition should take priority over government interventions aimed at accelerating growth in certain sectors. In particular, the authorities should avoid undue emphasis on the ten areas identified as future growth engines.To enhance competition, the power of the Korea Fair Trade Commission (KFTC) should be expanded by strengthening its investigative powers. Boosting the level of sanctions to the levels in other member countries and establishing a credible threat of individual sanctions would increase the deterrent effect of competition policy. The scope for private legal actions should be expanded, while the special treatment provided for particular sectors, such as small and medium-sized enterprises, should be scaled back*. The emphasis on "fair trade" and concern about the power of the chaebol has led the competition authority to devote substantial attention to an enforcement programme to limit shareholdings and debt guarantees and control aspects of ownership structure. This may compete with the attention given by the KFTC to enforcement against other fundamental competition problems. The combination of improved corporate governance, more independent financial institutions, upgraded financial supervision and the increased role of foreign investors – who now own more than 40 per cent of listed Korean companies – is reducing the scope for abuses by managers of chaebol companies by strengthening market mechanisms that impose discipline on the groups. *Supervisory functions related to transactions that amount to misuse of corporate assets should be concentrated in regulators responsible for financial and securities matters, while transactions that have an exclusionary or distorting effect on product market competition in particular cases should still be subject to competition-law control*. ■

How can competition be strengthened in the service sector and in the network industries?

The potential gains from enhanced competition appear to be largest in the service sector, given its lower level of productivity. Therefore, facilitating competition in the service sector through market opening and regulatory reform is one of the most urgent tasks for the Korean economy. One priority should be the *retail sector*, which is characterised by a large number of outlets and a high number of employees. *It is important to simplify the application process for opening large retail stores and make it more transparent, while removing obstacles to foreign direct investment. Deregulation of zoning laws would also facilitate the development of large stores with higher productivity. Restrictions on entry in some professional services should also be relaxed, while avoiding the delegation of powers by the government to professional associations. Regulations that limit foreign competition by restricting commercial presence should be relaxed, while recognising the qualification standards of other countries would be beneficial*. As for prices, the Omnibus Cartel Repeal Act of 1999 made collusion over fee-setting illegal in nine professional services. *Similar action should be taken in other areas where exemptions from the Monopoly Regulation and Fair Trade Act allow cartel activity*.

The authorities should also intensify efforts to expand the scope of competition in network industries, notably electricity, natural gas and telecommunications. *One key to competition is the creation of independent sectoral regulators, which is the norm in other OECD countries*. The ministries' role in promoting the development of these sectors conflicts with the objective of encouraging competition. *In electricity and natural gas, it is important to spell out detailed liberalisation plans in order to encourage new entry in these sectors and to accomplish the planned privatisation of the electricity-generating companies*. This would help ensure the independence of the generation companies from the transmission system, a prerequisite for competition. *In addition, price distortions that favour agriculture and industry should be corrected by ensuring that prices reflect costs. In some sectors, notably telecommunications, an appropriate framework for interconnection and local loop unbundling is needed to promote competition. Other measures, including an easing of entry requirements and the extensive adoption of number portability, would also be beneficial in telecommunications*. ■

How can Korea become more open to trade and foreign direct investment?

Reducing barriers to imports is an important aspect of strengthening competition. *The relatively high tariff rates in Korea should be reduced, while ensuring that standards do not hinder imports. Trade barriers in the highly protected agricultural sector should be cut by transforming support for farmers into direct payments. Protection for agriculture should be lowered; the total support provided to farmers by Korean consumers and taxpayers amounted to 3½ per cent of GDP in 2003, according to the OECD. The liberalisation of agricultural barriers will contribute to the success of multilateral trade negotiations, as well as facilitate Korea's participation in regional free trade agreements, which would allow it to benefit from the economic dynamism of Asia*. Stepping up inflows of foreign direct investment (FDI) has been a major government objective since the crisis and large inflows were recorded at the end of the 1990s. While the declining trend in inflows since 2000 may be primarily due to external factors, *it is important to remove remaining impediments to FDI. Perhaps most important for attracting inflows of FDI is improving aspects of the Korean economy that discourage foreign investors, particularly problems in the labour market*. ■

For further information

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