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Japanese Approach to Transition Economies

Masahiro Taguchi

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Lecturer at the Graduate School of Humanities and Social Sciences, Okayama University and Institute of Social Sceince, Tokyo University. E-mail: taguchi@cc.okayama-u.ac.jp

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Summary

The paper presents economic policy of the Japanese government to support the developing countries and transition economies, behavior of Japanese FDI in these countries, and effectiveness of the approach.

Globalization (marketization and monetary liberalization) isn't always favorable for the developing countries. Therefore the support that the developing countries can get over structural weakness is required. For example, supporting priority sectors, training enterpriser and employee, transforming technology are very important issues to enhance the competitiveness for these countries. Reducing unemployment, building safety-net are also the central task for stabilization and development of these countries.

The IMF's reform measures for the Asian currency and financial crisis in 1997-98 weren't fully satisfied for Asian countries. This is why the Japanese government wants to establish the Asian Monetary Fund (AMF). There are critical opinions that this alternative approach, which was quite different from the neo-classical approach recognized widely, may weaken the expected effects of typical macro-stabilization policy. Because the fund would fill up the monetary shortage caused by the restrict policy.

This paper presents the economic policy of the Japanese government for the support of developing countries and transition economies. The Japanese government has kept to a pro-globalization approach in domestic economic policy. On the other hand, Japan has been criticizing international financial institutions and the United States for their pro-globalization approach in development assistance policy. Although Japan appears to maintain a similar stance in macroeconomic policy, it will often adopt a development assistance policy quite different from the international financial institutions and the United States, especially toward Asian nations. This is the reason why the economists and the policymakers in the world wonder whether Japan has a clear idea regarding its economic policy. In this paper, I try to describe the Japanese approach (the approach of the Japanese government) in relation to developing countries and transition economies and summarize the Japanese economic policy to assist development and transition (Section 1), while analyzing Japan's stance to democratization (Section 2) and chronologically introducing the efforts to establish an Asian Monetary Fund (AMF) (Section 3).

1. "Washington Consensus" vs. "Japanese Approach"

In the 1990s, the "Washington Consensus" (see Appendix 1) became a synonym for "neoliberalism" or "market fundamentalism", regardless of the meaning with which the term was initially used by Williamson (Williamson, 1999). This interpretation was convenient for the politicians and economists at that time. As a matter of fact, even though the "Washington Consensus" was not a full consensus even in Washington, it has had a huge influence on the economic policies of developing countries and transition economies in the last decade. Incontestably, the "Washington Consensus" accelerated globalization (marketization, monetary liberalization, etc.).

The Asian currency crisis, which started in 1997, gave us a lot of suggestions. The recipe applied by international financial institutions exacerbated the crisis in Asia. In particular, the excessive monetary restraint based on the "Washington Consensus" and large structural reconstruction demand heavily encumbered the Asian economies.

Globalization is not always favorable for developing countries. Therefore, support is required in order for developing countries to overcome their structural weaknesses. For example, supporting priority sectors, training employers and employees and transforming technology are very important issues needed to enhance competitiveness for these countries. Reducing unemployment and the building of a safety-net are also central tasks for the stabilization and development of these countries.

Japan has been gradually clarifying the differences in approach with regard to international financial institutions since the Asian crisis. As a matter of fact, there is neither a "Japanese approach" that has been officially declared by the Japanese government, nor is there a widely accepted "Japan program". Moreover, there is no consensus on Japanese development support or on transition economy support within the government, between the government and private financial institutions, the think tanks, or among economists in Japan. However, there is something akin to a common term or a greatest common divisor. A certain kind of common recognition has arisen based on the experience gained in dealing with the Asian financial crisis after 1997. It can be summarized as follows (with main emphasis on Asian issues). It is of interest to compare this with the "Washington Consensus"):

1. Role of government: In the high-growth period of Japan, the government greatly contributed to its economic development. Now, the government is struggling to create an efficient, competitive free-market system in Japan. However, Japan is not requesting the other countries in transition to stop intervention in the market at once. In the economically weak countries, the efficient concentration of resources becomes difficult when the government weakens; and when the government weakens, the dynamics of economic growth decline. Of course, it is necessary to create a free-market system in the long run; however, a strong government which is able to design and create the free market, supervise the rules of transactions and control the market performances is required for this.
2. "Translational implementation" (Maekawa, 2000) of a global system: In each country, there is a so-called "base society", with roots deeply grounded in the culture, tradition and history (Ohno, 1996, pp. 61–92). This "base society" does not "jump".[1] Therefore "translational implementation" is necessary for the introduction of an international system to a country in the first stage of adjustment, though it is necessary to move to a free-market economy in the future.
3. Limitation of the range of conditionality: The present IMF's conditionality constitutes too wide a sphere. It covers almost the whole economic system. In transition economies and developing economies, there is neither enough capital nor are there sufficient human resources to create a complete, advanced free-market system within a short term. It is necessary to limit the range of conditionality.

[1] Ohno ironically expresses his idea in contrast to the title of Jeffrey Sachs' book, the *Polish Jump to the Market Economy* (Cambridge: MIT Press, 1993).

4. "Good governance": The Japanese government has officially declared that democratization is an element of great importance for development (see Section 2). In practice, the Japanese government is still very cautious about adding the democratization issue to economic assistance packages. This does not mean that the Japanese government neglects the significance of good governing practices. A lot of careful opinions are voiced in Japan concerning democratization. Therefore, the policy of the Japanese government is to provide "technological support" in areas such as improvements in the judicial system, the system of central and local government, etc.
5. Structural reconstruction: The contents of the structural reconstruction (privatization etc.) roughly correspond to the policies of the IMF and the World Bank. However, it is necessary to pay close attention to the timing, so as to decide whether the structural reconstruction should be done during the monetary crisis or when the emergency has passed.
6. Micro-financing: Fiscal and financial restrain strike first of all small and medium scale enterprises. Starting a sustainable small loan program is important to support domestic production and to avoid acute depression.
7. Trade financing: If severe monetary restraint is maintained and trade liberalization is rapid, trade financing is reduced and exports, which are the engine of economic recovery, will decline. In such cases, trade financing must be supported.
8. Problem of sequencing: Both trade liberalization and the liberalization of capital movement improve the efficiency of the domestic market. Thus, the introduction of the regulation of capital movement and the control of foreign exchange impart a negative influence to trade, and lead to the poor performance of the entire economy. However, many have argued as to whether or not trade liberalization and the freeing of capital transactions need to be done simultaneously in cases such as the Asian currency crisis. The liberalization of capital transactions requires mid- and long-term preparation. It is necessary to create a solid domestic financial system and to establish a control system to manage the enormous amounts of short-term capital which flows in (or flows out) rapidly to (out of) a country in the nascent stage of transition.
9. System stabilizer: The systems peculiar to the high-growth period of Japan, which are thought to have caused economic stagnation (government intervention in industry and the financial system, main-bank system and the cross-shareholding of stocks) are being reformed. However, such systems are sometimes useful at a certain level of development in order to maintain stability and the sustainable growth of the domestic market.

10. Exchange system: A currency basket system provides for exchange rate flexibility, thereby preventing the overvaluation or undervaluation of the currency.
11. Improvement of the condition of financial institutions: It is necessary to improve the condition of the financial institutions to prevent a monetary crisis and to persist in risk management (see Section 3).
12. Improvement of the level of education: The important factors for the production of internationally competitive industrial goods are technology and quality control. Establishing an education system and a skill formation system are key factors for industry. Long-term development assistance must be concentrated on consolidating the general education system to offer a bottom-up social education level and on creating retraining institutions to avoid employment mismatches in transition economies.
13. Building infrastructure: The enhancement of the infrastructure (communication networks, traffic, etc.) becomes an important factor for foreign direct investment.
14. Creating a safety net: The transition process expands income differentials at the first stage (the Kuznetz curve). Globalization brings another shock. The lack of a safety net quickly destabilizes a society. Thus, the improvement of weak labor market institutions, establishment of a formal safety net for workers and pensioners and the correction of income differences through budgetary and tax reform are necessary in order to ensure the stable development of the economy and society.

The guidance for and the criteria of the Japanese approach are expressed in "Japan's Official Development Assistance Charter" (Cabinet Decisions: June 30, 1992). This Charter says that

> Japan attaches central importance to support for the self-help efforts of developing countries intended to lift their economies. Japan will therefore use the ODA to help ensure the efficient and fair distribution of resources and "good governance" in developing countries by developing a wide range of human resources and socioeconomic infrastructure that will include domestic systems and by supporting basic human needs (BHN), thereby promoting the sound economic development of the recipient countries (MOF, 1992).

Japan's ODA is extended on the basis of requests from recipient countries. It stresses the importance of cooperation for the improvement and dissemination of technologies, assistance to human resources development and infrastructure improvement. Japan's ODA will pay full attention to efforts for promoting democratization and introduction of a market-oriented economy, and the situation regarding the securing of basic human rights and freedoms in the recipient country, but will be provided in accordance with the principles of the United Nations Charter (especially those of sovereign equality and non-intervention in domestic matters) (MOF, 1992). Thus, on the one hand, the Japanese government recognizes the importance of market liberalization, but on the other hand, it carefully avoids involvement in political issues, and tries to concentrate on the "technical" matters.

Supporting "good governance" is the key effort of Japan's ODA. Japan has experience in legislation, the system of government and the parliamentary system. Japanese experts will use their experience, gained in Japan, in the training of personnel, who will then be able to create their own economic policies and national plans. This technical cooperation to establish "good governance" is undertaken in the fields of management, administration control, financial policy, monetary policy, industrial policy, manpower development, protection of the environment, social security, farming policy and regional development. This form of assistance has been given in Poland (industrial policy), Vietnam (legal system), Uzbekistan (training of personnel), Jordan (industrial policy) and Cambodia (law maintenance). However, the advice is limited to "technical content" and intervention in politics is carefully avoided.

2. Democracy and development

One of the most characteristic approaches of the Japanese government is its stance with regard to democracy and development. Generally, there are two kinds of ideas. One is the idea that democratization promotes economic development. Another is the idea that economic development promotes democratization.

The former is an idea to assure fair competition through democratization, which promotes the creation of a healthy market. The major international financial institutions as well as those of the United States are mainly based on this idea. Democratization also promotes the entry of FDI to a transition country, which contributes to its economic development. In the latter approach, economic development causes an increase in the urban population, the improvement of the level of education, an increase in the number of professional workers and the size of the middle income group, which leads to the collapse or "meltdown" of an authoritarian regime or a dictatorial system. In addition, in the case where the government fails to achieve economic development under an authoritarian regime, a popular protest movement opposed to the political power may emerge, which becomes a democratic movement. As a result, the authoritarianism leads to democratization, even if the authoritarian regime fails.

Both opinions have their adherents. There is a stereotype that the Japanese government supports the latter one. Japanese government often adopts a development aid policy different from that of the United States toward Asian nations, including China and Vietnam, which is sometimes incomprehensible to the Americans. It is said that Japan has two faces. It means that the Japanese have their traditional philosophy, which is quite different from the western philosophies, but after the Second World War, Japan had to play a role of a champion of "western" democracy, hand in hand with the United States. Moreover, Japan has profited enormously from democracy, not only in social terms, but also economically. Japan has suffered from the stance it presents to the world and its internal reality. Japan has shown a vague attitude and has been criticized for having no philosophy or ideas pertaining to the support of development and transition economies. However, in practice, the Japanese government does not always overemphasize development and neglect democracy. There are many cases where the Japanese government has held to a policy of promoting democratization. For instance, it is availing itself of every opportunity to press for democratization and human rights improvements under the present regime in Myanmar. The Japanese government does recognize the significance of democratization.

Then, when does the Japanese government give priority to a democratization policy and when to development aid? It is widely accepted in Japan that democracy is a very important value in social life, which greatly contributes to development.

Amartya Sen describes clearly the importance of democracy (Sen, 1999b; see also Sen 1999a):

1. Political and social participation has intrinsic value in the lives of the citizens. Exercising civil and political rights is a crucial part of a citizen's existence in society and influences living standards.
2. Democracy has an important instrumental value in enhancing the consideration that people get in expressing and supporting their claims to political attention (including claims of economic needs). This is a strong incentive for politicians to response in good faith to the people's requests.
3. Under the democratic system, the process of public discussions and exchange of information helps society to form its values and priorities.

Thus, Asia has a culture different from Western Europe and the United States and even in those cases where the modern democracy system cannot be accepted, democracy remains a value in itself which must be pursued. It seems that Sen's stance on democracy is not too far removed from the views of the Japanese government. The problem is not whether democracy is necessary or not, but how we can achieve democracy and by what means we can support democratization.

Yasuhiro Takeda, associate professor of International Relations at the National Defense Academy of Japan, describes clearly the difference of diplomatic approaches to the promotion of democracy between Japan and the United States. He points out that Japan places much more emphasis on an incentive approach, which provides benefits for promoting democracy. On the other hand, the United States tends to use the sanction approach, which deprives a country of benefits if that country does not democratize (Takeda, 1997). He stresses that

> Japan, in particular, does not automatically apply a uniform response to countries that act in ways that are undemocratic. Japan decides its response after considering the country's circumstances and the relationship between Japan and the country, being very cautious when it comes to applying sanctions. The United States, on the other hand, is quick to cut off support to any country guilty of suppressing human rights or democratization movements under the Foreign Assistance Act. In addition, Congress, which is sensitive to issues of human rights and democratization, frequently presents bills for sanctions against countries considered guilty of violations of human rights and this limits the government's ability to apply its own diplomatic judgment (Takeda, 1997).

Takeda does not come out in favor of one or the other of these positions. Each approach has its merits and demerits. It is important to establish common rules, because the difference between the two countries could lead to a conflict. Japan may conduct an advantageous policy with respect to a country, using a carrot approach; at the same time, however, the United States cannot use its whip approach effectively precisely because Japan does not take a common stance. According to Takeda the rules should be as follows (Takeda, 1997):

1. If Japan has substantial interests in a country, combined with a strong intent and the ability to provide the benefits promised, the effectiveness of the incentive approach is high. On the other hand, if the US has interests in a country it has threatened with sanctions, the credibility of the threats of sanctions seems less effective (the China case). In this case, the incentive approach is more viable.
2. It is reasonable to choose the sanction approach when the probability of success in achieving democratization is high and to choose the incentive approach when it is low. It is very rare for a monolithic and unified ruling elite to yield to foreign pressure and accept democratization, especially in the case when democratization would seem to lead to the

abandonment or weakening of the present regime. In this case (when the probability of success is low), the incentive approach is more effective for promoting democratization.

3. When an authoritarian regime is seriously fractured internally, it would be effective to use sanctions to prevent armed suppression or to control mass movements that may trigger armed suppression.
4. The sanction approach has a certain level of effectiveness in checking a significant retreat from democracy, but it is not so effective in promoting democracy. When sanctions are carried out after deterrence fails, it is not the ruling elite, but rather the public that suffers most. In this sense, the sanction approach mistakes the means for the end. Sanctions to punish a significant retreat from democracy should only be implemented after specifying the time limits of the sanctions period and the level of the sanctions.

Takeda's conclusions are not the official consensus between Japan and the United States. However, such an approach is not too distant from the current diplomatic practices of the Japanese government in the area of support for transition economies.

3. Asian Monetary Fund

Japan takes initiatives concerning the international monetary system. In August 1997, a Japanese plan was announced for a monetary fund of USD 100bn to prepare in case of a relapse of the monetary crisis. It was put forward as the "Asian Monetary Fund" (AMF) plan. Each country of ASEAN and South Korea agreed with the AMF plan. However, the United States was critical of it. The IMF took the position that "the support plan in an Asian region that does not correspond to the support plan of the IMF will create a moral hazard in the realization process of the monetary policy". China also showed a passive attitude to the plan.

In August 1998, the devaluation of the ruble in Russia hit the world market. Stock prices fell sharply worldwide and the exchange rates simultaneously became unstable. The international monetary market was confused. People were beginning to realize that the prescriptions of the IMF were not cure-alls. In October 1998, the framework of the government fund assistance was announced. The Japanese government aimed to support the reconstruction of the economies of Asian nations that were suffering from the monetary crisis. This was called the "New Miyazawa Initiative" (A New Initiative to Overcome the Asian Currency Crisis) (see Appendix 2). The total amount involved was USD 30bn. The Export-Import Bank of Japan's (now operating as The International Cooperation Bank) would provide the financing and yen loans under a medium- to long-term support plan (supporting corporate debt restructuring in the private sector, making financial systems sound and stable, strengthening the social safety net, stimulating the increase of employment, facilitating trade finance and assisting small and medium-sized enterprises) in South Korea, Thailand, Indonesia, the Philippines, and Malaysia. The AMF plan had been reversed by the United States. This time, the Japanese government proposed a plan based on bilateral support. In this way, the plan received the understanding of the United States.

In May 2000, a Finance Ministers Meeting was held in Chiang Mai in Thailand, and "ASEAN+3" (Japan, China, South Korea, and ASEAN nations) adopted the "Agreement on currency swapping" which would accommodate foreign currency in case of foreign financing difficulties.•This was called the "Chiang Mai initiative". It aimed to ensure the smooth accommodation of foreign currency reserves – mainly the US dollar reserves – and to prevent a financial crisis that would be triggered by rapid capital outflow from the country. This system lead to the AMF plan.

In January 2001, the Asian Currency Basket Plan, in which the base currencies were the US dollar, yen and the euro, was adopted at the 3rd Finance Ministers' Meeting held in Kobe within the framework of ASEM (Asia-Europe Meeting). The participants came to the conclusion that a possible solution for many emerging market economies would be a managed exchange rate whereby the currency would move within a fixed range whose center would be aligned to a basket of currencies.

4. Concluding remarks

The IMF's reform measures for the Asian currency and financial crisis in 1997–8 were not fully satisfactory for Asian countries. This was one of the reasons why the Japanese government wanted to establish the AMF. There were critical opinions that this alternative approach, which was quite different from the widely recognized neo-classical approach, might serve to weaken the expected effects of a typical macro-stabilization policy because the Fund would fill up the monetary shortage caused by the restrictive policy.

However, the AMF plan was not proposed as a means to escape from IMF's severe financial restraints. Introduced simultaneously, the IMF's restraint policy and the AMF's financial support policy may cancel out each other's effects. However, financing debt restructuring in the private sector, strengthening the social safety net, stimulating the increase of employment and assisting small and medium-sized enterprises will also aid to restore macroeconomic balance. It is important to work out the cooperation guidelines to create multiplicative effects.

The Japanese government does not always overemphasize development and neglect democracy. Democratization is one of the most important issues in Japan's ODA. However, a sanction approach in achieving the democratization of a transition economy is not always enough. An effective combination involves a mix of a sanction approach and an incentive approach.

Appendix 1: The "Washington Consensus" (Williamson, 1994, pp. 26–28)

Fiscal Discipline: Budget deficits, properly measured to include those of provincial governments, state enterprises, and the central bank, should be small enough to be financed without recourse to the inflation tax. This typically implies a primary surplus (i.e., before adding debt service to expenditure) of several per cent of GDP, and an operational deficit (i.e., disregarding that part of the interest bill that simply compensates for inflation) of no more than about 2 per cent of GDP.

Public Expenditure Priorities: Policy reform consists in redirecting expenditure from politically sensitive areas, which typically receive more resources than their economic return can justify, such as administration, defense, indiscriminate subsidies, and white elephants, toward neglected fields with high economic returns and the potential to improve income distribution, such as primary health and education, and infrastructure.

Tax Reform: Tax reform involves broadening the tax base and cutting marginal tax rates. The aim is to sharpen incentives and improve horizontal equity without lowering realized progressivity. Improved tax administration (including subjecting interest income on assets held abroad – flight capital – to taxation) is an important aspect of broadening the base in the Latin context.

Financial Liberalization: The ultimate objective of financial liberalization is market-determined interest rates, but experience has shown that, under conditions of a chronic lack of confidence, market-determined rates can be so high as to threaten the financial solvency of productive enterprises and government. Under that circumstance a sensible interim objective is the abolition of preferential interest rates for privileged borrowers and achievement of a moderately positive real interest rate.

Exchange Rates: Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in traditional exports, and managed so as to assure exporters that this competitiveness will be maintained in the future.

Trade Liberalization: Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 per cent (or at most around 20 per cent) is achieved. There is, however, some disagreement about the speed with which tariffs should be reduced (with recommendations falling in a band between 3 and 1 years), and about whether it is advisable to slow down the liberalization process when macroeconomic conditions are adverse (recession and payments deficit).

Foreign Direct Investment: Barriers impeding the entry of foreign firms should be abolished; foreign and domestic firms should be allowed to compete on equal terms.

Privatization: State enterprises should be privatized.

Deregulation: Governments should abolish regulations that impede the entry of new firms or restrict competition, and ensure that all regulations are justified by such criteria as safety, environmental protection, or prudential supervision of financial institutions.

Property Rights: The legal system should provide secure property rights without excessive costs, and make these available to the informal sector.

Appendix 2: A New Initiative to Overcome the Asian Currency Crisis ("New Miyazawa Initiative") (October, 1998; summary)

I. Medium- to Long-Term Financial Support to Asian Countries (USD 15bn)

1. Need **for funds in Asian countries**: Asian countries affected by the currency crisis need medium to long-term capital to implement the various policy measures described below for economic recovery.
   (1) Supporting corporate debt restructuring in the private sector and efforts to make financial systems sound and stable;
   (2) Strengthening the social safety net;
   (3) Stimulating the economy (implementation of public undertakings to increase employment);
   (4) Addressing the credit crunch (facilitation of trade finance and assistance to small and medium-sized enterprises).

2. Measures **for financial assistance**: To meet these medium- to long-term capital needs of Asian countries, Japan will extend financial assistance to those countries making use of the various measures listed below. In doing so, due consideration will be paid to the better use of the Tokyo market to mobilize Japanese funds.
   (1) Providing direct official financial assistance
      i) Extending Export-Import Bank of Japan (JEXIM) loans to Asian countries
      ii) Acquisition of sovereign bonds issued by Asian countries by the JEXIM
      iii) Extending ODA yen loans to Asian countries
   (2) Supporting Asian countries in raising funds from international financial markets
      i) Use of guarantee mechanisms
         a) Utilizing the guarantee functions of the JEXIM
            - The JEXIM will guarantee bank loans to Asian countries.

- The JEXIM will guarantee sovereign bonds issued by Asian countries (legal amendment is necessary).

b) Providing export insurance to bank loans to Asian countries

c) Requesting the World Bank and the Asian Development Bank to step up their efforts to provide guarantees to bank loans and bond issuance by Asian countries

d) It is hoped that in the long run the establishment of an international guarantee institution with a prime focus on Asian countries will be seriously considered.

ii) Interest subsidies: Japan will establish an Asian currency crisis support facility backed by our funding. This facility will be used to provide interest subsidies to Asian countries that borrow funds from JEXIM or private banks in conjunction with loans from the Asian Development Bank.
This will be an open facility in which all countries are welcome to take part.

(3) Financial **support in the form of co-financing with multilateral development banks**: Japan will continue to provide co-financing with the World Bank and the Asian Development Bank to Asian countries. In particular, we will call for maximum financial assistance from the World Bank and the Asian Development Bank to support those Asian countries that are faced with huge capital needs in an effort to address the issue of corporate debt restructuring and the restoration of stability in the financial system. We are ready to provide co-financing with these two banks.

(4) **Technical assistance**: The World Bank and the Asian Development Bank will be requested to provide necessary technical assistance through Japanese special funds to Asian countries that are to implement a comprehensive approach to address the issue of corporate debt restructuring and the restoration of the financial system. Japan is prepared to contribute by means of providing technical assistance to these Asian countries, taking into account the respective situations in those countries.

II. Short-Term Financial Support to Asian Countries (USD 15bn)

Asian countries may face some needs for short-term capital in the course of making progress in their economic reform. To be prepared to meet these needs such as facilitation of trade finance, Japan will set aside USD 15bn in short-term funds which will take the form of swap arrangements.

Japan intends to cooperate closely with the multilateral development banks and the related countries, especially Asia-Pacific countries and G-7 countries, in implementing the new initiative.

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