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# “The Asian EMS” Could Be a Real Breakthrough for Crisis Prevention”<sup>1</sup>

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## **Introduction**

The Asian currency crisis in 1997 was “the wake-up call” for the Asian countries. Now the people in Asia who are earnestly working to promote Asian Integration commonly talk about “remembering the Asian crisis”. In other words, the distress from the crisis signaled the people and governments in Asia to seriously promote Asian Integration. In this sense, I think we should recognize the two key words at this 10<sup>th</sup> anniversary of the Asian crisis and the 10<sup>th</sup> anniversary of the establishment of the “ASEAN+3”(APT), “Lessons from the Asian Crisis” and “the Need for Promotion of Asian Integration”.

As repeatedly mentioned in the documents<sup>2</sup> in the “ASEAN+3” and its Track 2 Framework of the Network of East Asian Think-tanks (NEAT)<sup>3</sup>, the goal of community building in East Asia should be to promote the welfare and well-being of the people and to realize the East Asian Vision of Peace, Prosperity and Progress. Establishing crisis prevention mechanisms in the region leads to the goal of the East Asian community building. And, the most important element of crisis prevention in Asia is to achieve de-dollarisation within the region.

### **1. The Achievements of Asian Integration by “ASEAN+3” so far and Their Assessment**

We, in Asia, have been aiming at an East Asian FTA (EAFTA) within the framework of “the ASEAN+3” as one of nine medium and long-term concrete measures<sup>4</sup> as mentioned in the Final Report of EASG in November 2002. The FTA within ASEAN became effective at the beginning of 2002, and three “ASEAN+1” FTAs have almost been completed (see Table1). The ASEAN+China FTA was signed for goods and trade in November 2004, and was signed for services trade in January 2007. The ASEAN+South Korea FTA was signed in May 2006. Japan has concluded bilateral EPAs<sup>5</sup> with six

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<sup>2</sup> See East Asia Study Group (2002), NEAT (2006) and NEAT (2007). The 9 medium-term and long-term concrete measures in the EASG Final Report is shown in Attachment 1.

<sup>3</sup> NEAT was established in 2003 as a track 2 framework of think-tank network from 13 APT countries in an attempt to input policy recommendations to “the ASEAN+3” Summit, following the recommendations of the East Asia Study Group (EASG) which is the most formal document for Asian Integration to date. The EASG is the governmental framework which consists of representatives from all 13 APT governments. In November 2002, the EASG published the Final Report and proposed 9 medium and long-term concrete measures in it, as shown in Annex 1 of this paper. Establishing the NEAT is defined as one of 9 medium and long-term concrete measures. As a member of the Japanese Delegation, I participated at the 5<sup>th</sup> Annual Conference of the NEAT Meetings at Meritus Mandarin Hotel in Singapore, 20-22 August 2007.

<sup>4</sup> See Yamashita (2007b), p.38, Box 1

<sup>5</sup> EPA is Economic Partnership Agreement which is roughly FTA plus investment agreement.

ASEAN countries, and signed an EPA agreement with ASEAN 10 as a whole in November 2007.

If Japan, China and South Korea can reach an agreement on FTA or EPA, it will be possible for an EAFTA with 13 countries to be concluded. The Chinese Prime Minister Wen Jiabao proposed an FTA with South Korea when he visited Seoul on the 10<sup>th</sup> of April 2007, as a result of the FTA agreement of US-Korea reached on the 3<sup>rd</sup> of April 2007. Moreover, South Korea entered the FTA negotiations with the European Union (EU) on the 6<sup>th</sup> of May 2007. ASEAN agreed to begin FTA negotiations with the EU in May 2007, as well. As a reflection from these recent movements, there are some calls emerging in Japanese business circles for FTA agreements with the United States and the EU.

I do not think that seeking FTAs with the outer-world is desirable for Asian Integration, since it may be harmful to enhancing cohesion which is most important for the promotion of regional integration. In reality, however, it is a possibility that the United States and the European Union could be mediators for an FTA among the North East Asian three countries, Japan, China and South Korea, irrespective of American European willingness and regardless of whether this is good or bad for Asia. After all, I think that the realization of EAFTA and even the EAIA (East Asian Investment Area)<sup>6</sup> by “ASEAN+3” with 13 countries will be possible in the not-too-distant future, although many difficult problems still lie ahead.

But, the EAFTA should not be the end of the integration process in Asia. If it will end at the EAFTA, it is not so meaningful, because FTA is just the first stage of economic integration under the Bela Balassa’s Theory of 5-Staged Economic Integration (1961)<sup>7</sup>.

On the other hand, the Chiang Mai Initiative (CMI), which was agreed to in May 2000, is now considered as the first formal regional framework in East Asia, entered its second stage by the agreement made at “the ASEAN+3” Finance Ministers’ Meeting in Istanbul in May 2005. The CMI has been improved substantially in the second stage, but is still not sufficient as a crisis prevention measure. Especially, as Vietnam still does not have any Bilateral Swap Agreement (BSA) with Japan, China or Korea under the framework of CMI<sup>8</sup> (Chart 1). We have learned a very important

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<sup>6</sup> Japan has been promoting EPAs which include FTAs and Investment Agreements with ASEAN countries. If this could extend to China and Korea, the EAIA will be completed with the EAFTA at the same time.

<sup>7</sup> Bela Balassa (1962). See Yamashita (2007b), Box 2, regarding Balassa’s 5 Staged Economic Integration. The Balassa’s 5 Stages are ①FTA, ②Customs Union, ③Common Market, ④ Economic Union = ③+Common Economic Policy, ⑤Complete Economic Integration.

<sup>8</sup> The swap agreement currently available for Vietnam is only the Swap Agreement among ASEAN 10

lesson from past experiences to the effect that rapidly growing middle income LDCs are facing the highest risk of being involved in the debt crisis. Vietnam is going into that stage of economic development. The three North East Asian countries should promptly have a Bilateral Swap Agreement with Vietnam.

The multi-lateralization of the CMI was agreed to at the “ASEAN+3” Finance Ministers’ Meeting in Kyoto at the beginning of May 2007. This is a very important step forward for crisis prevention, as well as for the promotion of Asian Integration. The main thrust of this agreement is to gather foreign exchange currencies from the member states and to manage them in an integrated fashion.

## **2. What Should Be Done Next after the EAFTA and EAIA?**

The problem is what we should aim for after the completion of the EAFTA and EAIA. I think we in Asia should aim at creating a customs union (“the East Asian Customs Union, EACU”) next, although there are virtually no cases that an FTA has evolved into customs union so far. If Asian Integration stops at the first stage of EAFTA, it is not as meaningful as a regional framework. Establishing a customs union is certainly a very challenging task, since all the member countries have to give up their sovereignty over the international trade negotiations including the Multi-lateral Trade Negotiations (MTNs) within the framework of the World Trade Organization (WTO). However, it is worthwhile for Asian countries to have it as an important step in the process of promoting Asian Integration.

Just a half century ago in March 1957, Europe aimed at establishing a customs union with the EEC Treaty (the Treaty of Rome), and completed a customs union on the 1<sup>st</sup> of July 1968. The customs union is a foundation of the EU and an essential element in the functioning of a single market.

Mercosur (Mercado Comun del Sur)<sup>9</sup> in Latin America started as a customs union in January 1995. The EU started its economic integration with a customs union as defined by Balassa’s 2<sup>nd</sup> stage, and now it is in the process of completing the 4<sup>th</sup> stage of an economic union according to Balassa’s Theory, although the deepening of the EU has not necessarily been developing in accordance with Balassa’s Theory of 1961. Mercosur is now aiming at establishing a common market in accordance with the 3<sup>rd</sup> stage of Balassa’s Theory. In addition, Latin American countries are now attempting to establish the Union of South American Nations (Union de Naciones

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countries with 2billion dollars in total. That is quite insufficient for the country like Vietnam.

<sup>9</sup> The full members of Mercosur are now Argentina, Brazil, Paraguay, Uruguay and Venezuela, and its associate members are Bolivia, Chile, Colombia, Ecuador and Peru.

Suramericanas, UNASUR)<sup>10</sup> which includes all South American countries. In order to enhance the cohesion within the region, it is extremely important to clarify its differences from the outer-world. A customs union which has common tariffs with the outer-world would be able to show the differences between the countries in the region and the outer-world.

ASEAN and Korea are seeking FTAs with the outer-world. In this circumstance, we need to differentiate the intra-region from the outer-world. Although the word “open regionalism” looks beautiful superficially, in fact the word itself is contradictory. Actually we are not able to promote regional integration by open regionalism. It is apparent that enhancing cohesion within the region is the most important thing to promote regional integration. The creation of the East Asian Customs Union must be extremely conducive to enhance cohesion within the region.

Another major benefit of a customs union would be significant administration cost savings and efficiency gains. Michael Holden said, “Countries with an established customs union no longer require rules of origin, since any product entering the customs union area would be subject to the same tariff rates and/or import quotas regardless of point of entry”<sup>11</sup>. To maintain rules of origin requires extensive documentation by all FTA member countries. Therefore, establishing the East Asian Customs Union (EACU) could bring tremendous benefits to East Asia, while every member country has to lose its independent international trade policy. The EACU could be the foundation for further Asian integration, such as a single market and an intra-regional monetary system in the longer perspective.

In any event, however, we should not forget that the final target in terms of crisis prevention as well as Asian Integration is to realize de-dollarisation within this region.

### **3. Is There Anything to Expect from the IMF?**

What can we in Asia expect from the IMF? I sensed through the discussions with participants from the affected Asian countries including Dr. Thanong Bidaya<sup>12</sup>, the

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<sup>10</sup> In “the Margarita Declaration” at the 1<sup>st</sup> South American Energy Summit held on the Island of Margarita in Venezuela on April 17<sup>th</sup> 2007, 12 Latin American countries agreed to change the name of their regional framework to the UNASUR from the South American Community of Nations (Comunidad Suramericana de Naciones, CSN). It is said that they are contemplating establishing the Permanent Secretariat of the UNASUR in Quito in Ecuador, and the Bank of the South in Brasilia, Brazil.

<sup>11</sup> Michael Holden (2003). This is a part of the document made by the Economics Division of the Canadian government.

<sup>12</sup> He was the Finance Minister of Thailand at the time of the Asian Crisis in July 1997.

former Finance Minister of Thailand and Dr. Jussuf Anwar, the former Finance Minister of Indonesia at this conference, that Asian countries were determined never go to the IMF any more even if they would be in a very difficult situation again. The IMF lost its credibility among Asian countries at the time of the Asian crisis, because the Asian crisis proved the IMF's incapability in solving the problems. Moreover, inappropriate IMF policies made the situation even worse in some countries, particularly in Indonesia.

Although the IMF has been trying to reform itself after the Asian crisis, I do not think they could accomplish far reaching reforms. The root cause behind the IMF comes from its very "pre-modern structure" of governance. It is required to obtain more than 85% of voting share for deciding the most important agenda in the IMF executive board meetings<sup>13</sup>. Since the voting power of the United States in the IMF is currently 16.83%, the US has virtually a sole veto in IMF policy-making. In this sense, the US is like a "feudalistic lord" in the IMF. In other words, it is as if the IMF is a "family concern" owned by the US. The governance of the IMF is much more unfair than even the United Nations Security Council in which each of the five permanent member countries has a veto. Inherently, an 85% of qualified majority voting (QMV) in a principal international institution is extremely anachronistic and really shameful in the modern world of the 21<sup>st</sup> Century. The QMV in the IMF must be reduced to around 70% or two thirds.

The IMF desperately needs to alter this governance structure completely. Otherwise, it is impossible for the IMF either to achieve far reaching reforms or to regain credibility among Asian countries. If the US would agree to give up its feudalistic privilege of exorbitantly high percentage of the QMV in the executive board meetings, we could expect much from the IMF. The IMF reform must get to the heart of the problem. Unless the IMF would commit a substantial change in the QMV, we could expect nothing important from the IMF.

On the other hand, in view of promoting Asian Integration, Asia does not expect anything from the IMF. In fact the IMF would do nothing for the promotion of Asian Integration.

#### **4. "The Asian EMS" Could Be a Real Breakthrough<sup>14</sup>**

As for the monetary field, I do not think that the ACU (Asian

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<sup>13</sup> See Yamashita (2004).

<sup>14</sup> This section is partly based on Yamashita (2007b) and Yamashita (2007d).

Currency Units) has the potential to be a breakthrough, although the “ASEAN+3” Finance Ministers agreed to study the ACU at the Hyderabad Meeting in India in May 2006. The ECU (European Currency Units) was introduced under the framework of the EMS (European Monetary System), and it had been used considerably as a denomination currency for bond issuance in the European capital markets, etc. However, the ECU was not capable of carrying out a significant role in view of changing the European monetary system within the EMS (European Monetary System). The German mark, not the ECU, actually became the intervention currency in EMS member countries since the mid-1980s, replacing the US dollar. This meant that the German mark became the reserve, exchange standard and key currency within the EMS. This happened due to the continuation of the intra-regional fixed exchange rate regime for almost 27 years within Europe under the frameworks of the EC Snake from April 1972 and its successor the EMS from March 1979 in Europe.<sup>15</sup> Thus, Europe accomplished de-dollarisation within the region which had been its dearest wish since “the Ansiaux Report”, the 5<sup>th</sup> attachment to “the Werner Report” in October 1970.

It is better for us to create the Asian Currency Units (ACU), but it could not be a real breakthrough for Asia in terms of achieving de-dollarisation. I think that the roles of artificial basket currencies like the ECU or ACU are limited. I understand that the EMS was as great a success as could be imagined. Europe maintained its intra-regional fixed exchange rate regime for almost 27 years, and from the beginning of 1999 the European monetary system finally succeeded in evolving into a unified currency which is the ultimate form of intra-regional fixed exchange rate regime. But, the ECU did not make a major contribution behind that success.

It should be noted that the market decided which one became the key currency within the EMS. There was no inter-governmental agreement on this matter at all. The strongest currency within the EMS eventually became the intervention currency, and then the key currency. If the French franc was the strongest among the EMS member country currencies, the French franc instead of the German mark would have become the key currency in Europe.

The reason why the DM became the key currency within Europe since the mid-1980s was the continuation of the fixed exchange rate regime for many years. Europe had been keeping the intra-regional fixed exchange rate regime for almost 27 years since the inception of the EC Snake in April 1972 until the birth of the euro at the

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<sup>15</sup> The reason why and the mechanism how the German mark became the intervention currency and eventually the key currency are mentioned in Yamashita (2006a), pp. 71-72.

beginning of 1999. The establishment of the EC Snake was the European answer to the Nixon Shock in August 1971 (see Box). Europeans thought that they did not follow floating exchange rates as an intra-regional exchange rate regime in Europe, although the global system monetary system might be obliged to turn into adopting floating exchange rates by the abrupt stoppage of the gold-dollar link by the US administration. The breakthrough in the European monetary system was not the ECU, but the continuation of the intra-regional fixed exchange rate regime for a very long period.

Facing the situation of the dollar's sharp decline after the Plaza Accord in September 1985, weak currency countries within the EMS needed to intervene in the foreign exchange market in an attempt to keep their currency's parity with the Deutsche mark which was always the strongest currency. However, if weak currency countries intended to intervene in the foreign exchange market by selling the dollar in exchange for buying their own currency, as they had done in the past, it would provoke an even further decline of the dollar. In other words, this method of market intervention could have invited further speculative selling of the dollar which would have made the situation worse. Therefore, weak currency countries intervened in the foreign exchange market mainly by selling the DM in exchange for buying their own currency from the mid-1980s. As a result, the DM became the exchange standard currency and intervention currency within the EMS from the mid-1980s, replacing the US dollar. At the same time, the DM naturally became the reserve currency within the EMS. This means that the DM finally became the key currency within the region at that time.

Another major accomplishment of the EMS was stabilizing the development of real effective exchange rates for its member country currencies.<sup>16</sup> This means that EMS member currencies were relatively stable against outside currencies. Although the global monetary system was very unstable because of the dollar's frequently sharp declines, the EMS was able to protect its member countries from the system's raging waves. In this sense, I call it "the EMS Hard-shelled Capsule"<sup>17</sup>. In sum, Europe was able to defend itself from disorder in the outer-world by maintaining an intra-regional fixed exchange rate regime and an ever closer economic integration which was achieved through the market integration. In other words, the EMS had a definite "the isolation effect".

As a result of the success of de-dollarization, the EMS has "the isolation effects" to the outer-world. Looking at the long-term movements of the real effective exchange rate (REER) of the major currencies, the contrast between the Deutsche mark

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<sup>16</sup> Yamashita (2006a), p.75

<sup>17</sup> Yamashita (2002), pp.237-240



(DM) and the Japanese yen was apparent (see Chart 2). While developments of the DM have been rather stable, the yen has a very strong upward trend and volatility, as well. This strong contrast in REER developments between the two currencies is a tragedy for the Japanese economy. I think the greatest reason behind the so-called “the Lost Decade and a Half of the Japanese economy” commencing on the beginning of the 1990s is large swings and volatility of real effective exchange rate of the Japanese yen after the Plaza Accord in September 1985. Japan should learn much from this most important lesson.

The greatest threat for Asia is the risk of the dollar’s free fall from now on. It is patently apparent that it is completely impossible to impose a balance of payments discipline on the United States, given the current floating exchange rate rates of the global monetary system with virtually only one key currency of the US dollar. In this sense, the current global monetary system has a fatal flaw<sup>18</sup>. We in the international community need to have a regime change, not just reforms, in the global monetary system itself. But, it takes a lot of time. Therefore, it is unfortunately inevitable that the international community will continuously face the threat of the dollar’s free fall. That is the reason why Asia needs to establish the regional monetary framework to protect themselves from the adverse effects of the dollar’s very large swings and volatility.

In this sense, we in Asia are not in the same boat with the United States. At Elysee Palace in Paris on the 27<sup>th</sup> of August, 2007, the French President Nicolas Sarkozy<sup>19</sup> who is known much more pro-US than his predecessor Jacques Chirac said in his first major foreign policy speech since taking office in May 2007, “Although Europe should be allied to the United States, its interests would not always be aligned”<sup>20</sup>. I think it should be applicable to Japan and Asia, as well.

I believe that “the Asian EMS” could be a real breakthrough. In the medium and long term, I believe we in Asia should aim at an “Asian EMS” or an “Asian ERM (Exchange Rate Mechanism)”. If we accomplish an “Asian EMS” of intra-regional fixed exchange rate regime, East Asia could succeed in isolating itself from the outer-world’s disorder, and in particular, the large swings in the value of the dollar which can be anticipated from now on due to the unsustainable huge and ever increasing US current account deficits. We in Asia must protect ourselves against disturbances which come from the US economy.

However, the member countries in the intra-regional fixed exchange rate

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<sup>18</sup> See Yamashita (1996) in details.

<sup>19</sup> He is sometimes bantered as “Sarko the American”.

<sup>20</sup> The web version of “France 24”, 28 August 2007 and “Financial Times”, 28 August 2007

regime need to have their own freely convertible currencies. At present, however, there are only three freely convertible currencies in East Asia. Those are the Japanese yen, the Singapore dollar and the Hong Kong dollar. However, I think that the Taiwan dollar, the Korean won and the Malaysian ringgit could become freely convertible currencies if the respective governments make this determination. Therefore, I think we in Asia should aim at establishing an intra-regional fixed exchange rate regime with these six countries/areas first. The Chinese yuan (RMB) and the Thai baht should be able to join the club several years later. The most important thing for the Chinese yuan is to obtain its free convertibility with the hard currencies, and not to move to floating exchange rates as the country's foreign exchange rate regime which the US has been strongly demanding of China for years. Apparently there is no relationship between floating exchange rates as an exchange rate regime and a freely convertible currency.

Although Hong Kong and Taiwan are not the member of the "ASEAN+3", we in Asia need to include both of them in the economic regional framework. Otherwise, the Asian economic regional framework could not be completed. On the other hand, we are not able to wait for all the members to prepare to join the regional currency framework. We should aim at "the Asian EMS" with six countries/ areas first, utilizing the "ASEAN Minus X Formula" which allows the ASEAN for a "differentiated integration" in a particular field. This formula was agreed within the ASEAN in July 2002. And, several years later it is going to be possible to run "the Asian EMS" with eight countries/areas including China and Thailand.

By adopting this monetary system "the Asian EMS", Asian countries would benefit from the disciplinary effect as well as the isolation effect, which the EMS members had. If Asian countries will continue this intra-regional fixed exchange rate regime for many years, the strongest currency in the region would eventually become the key currency in Asia. It is not needed to have any inter-governmental agreement on the central currency of the Asian EMS in advance. It should be recognized that "the Asian EMS" would become the core of crisis prevention mechanisms in East Asia.

I would like to add some comments on the Chinese RMB. The Chinese monetary authority proclaimed that they adopted "Managed Float" since July 2005. However, in fact the current Chinese foreign exchange rate regime of the RMB should be recognized as "the Multi-currency Basket Based Crawling Peg System" rather than "Managed Float". It is a very short-stroke crawling peg with the daily revision of the central rate. It seems to me that "Multi-currency Basket Based Crawling Peg System

“ is appropriate for China at this point, but the contents of the currency basket<sup>21</sup> should be more simplified, and changed more suitably to the current Chinese economic relationship with the world. Particularly, the dollar’s weight in the basket should be much smaller.

## 5. Polarisation of the World

There are some arguments supporting the sustainability of US current account deficits of balance of payments. The central figure of this argument is Michael Dooley of University of California Santa Cruz. However, their arguments are not persuasive, because they do not show the reason why<sup>22</sup>.

The US current account deficits as a percentage of GDP are now running around 7% which is just twice as large as that before the Plaza Accord in September 1985. Approximately 3.5% current account deficit as a percentage of GDP before the Plaza Accord was the largest ever for the US at that time. I can not believe it could be sustainable. The dollar’s free fall would be the greatest threat to Asia, as well as the world economy as a whole. Since the dollar’s sharp decline may come at any time in the future, presumably it could not be in time for us to establish “the Asian EMS” before the next one. But, we in Asia must prepare for the one after the dollar’s next sharp decline.

After the dollar’s sharp fall for several times to come, presumably the American economy will substantially decline. In other words, the key word in the global governance in the future is likely to be “polarisation” rather than “globalisation” based on the US unilateralism. Asian Integration should also be recognized as a part of this tide in the world, as well as a historical inevitability. The global governance in the future is likely to be the tri-polar system consisting of the US, the EU and Asia with some sub-poles, such as Russia, the Latin American Unasur and the GCC (the Gulf Cooperation Council) countries in the Middle East. The global governance based on the tri-polar system could be much more stable rather than the current uni-polar system which has been continuing since the collapse of the Cold War in 1989. The reason why is that the functioning of checks and balances each other could work well under the tri-polar system, and bring a competitive equilibrium into global governance in terms of economics as well as politics.

I would like to point out that the US external imbalance could only be solved

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<sup>21</sup> Although the composition of the basket is not disclosed, it is said that it includes 10 currencies or more in the basket of the RMB since July 2005.

<sup>22</sup> Michael Dooley, David Folkerts-Landau and Peter Garber (2003)

by the dramatic increase in US savings rate, in other words substantial decreases in US consumption, as well as substantial lowering of the Americans' living standard. Everyone have to live within his or her arms. That is an old proverb, but still a very basic principle of human life. After all, the United States could not be different from any other deficit country as far as curing its very serious balance of payments position. "The argument of surplus countries' responsibility" for the adjustment of the global imbalance never functions well, because it leads to "exports of moral hazard (discredit exports) from deficit countries to surplus countries. Consequently, the only healthy way to solve this problem is to substantially increase US domestic savings. The ball definitely lies in the court of the deficit country with the greatest outstanding external debt in the world.

And, it should be noted that there are movements of shifting the reserve currency from the US dollar to the others in many countries. Nowadays, we can see these important movements in Russia, China, the Scandinavian countries, the Persian Gulf oil exporting countries and Latin America.

We should particularly pay attention to China's Sovereign Wealth Fund (SWF), the China Investment Corporation (CIC) which was established by the Chinese government in late September 2007. CIC is likely to be modeled after the Government of Singapore Investment Corporation (GIC) Private Limited<sup>23</sup> rather than TEMASEK Holdings in Singapore. The GIC is an institution peculiar to Singapore. It is said that the CIC began its operations using about 200 billion US dollars out of China's total foreign exchange reserves of 1.43 trillion US dollars at the end of September 2007. The CIC could have a major impact on the world economy<sup>24</sup>.

First, we have to take into consideration the impact on the structure of the international flow of funds. From the beginning, the size of CIC is almost equivalent to that of the California Public Employees' Retirement System (CalPERS) which is the world largest as a public pension fund. CalPERS's total portfolio is 254.6 billion US dollars at the end of September 2007. Since China's foreign exchange reserves are increasing by more than 200 billion US dollars every year, there is a possibility that other new huge funds equivalent to CalPERS would emerge every year. And, all these funds will be managed completely by the Chinese government.

Secondly, in the longer perspective it could be a trigger of regime change in

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<sup>23</sup> GIC was established in 1981, and its chairman is the former Prime Minister Lee Kuan Yew and Deputy Chairman are the current Prime Minister Lee Hsien Loong and the former Deputy Prime Minister Tony Tan Keng Yam. The GIC is centered on overseas investments, while TEMASEK Holdings is mainly focused on domestic investments. The GIC's total portfolio is now well over 100 billion US dollars in more than 40 countries.

<sup>24</sup> See Yamashita (2007c) in details.

the global monetary system which is related to the international flow of funds as mentioned above. The birth of the CIC could spur the recent movements of diversifying international reserve currencies all over the world. In other words, the birth of the CIC might be the beginning of the annoying problem of “the dollar balances” in the very longer perspective. It reminds us the very annoying problem of “the sterling balances” from the 1940s through the 1960s. In any event, the international community will have to face the very annoying issue of the dollar balances eventually, and it has to overcome that very difficult issue in the future.

## 6. The Roadmap to Asian Economic Integration<sup>25</sup>

Finally I would like to show a complete picture of my roadmap to Asian Economic Integration. Basically, I think we should aim ultimately for an “Asian Economic and Monetary Union (AEMU)”<sup>26</sup> or “Asian EMU” in three stages, as follows (see Table2).

In the first stage, East Asian countries excluding Japan should adopt a triple currency basket -based fixed exchange rate regime, so that they are able to minimize any adverse effects from the volatility among the three major international currencies which contain the dollar, the euro, and the yen<sup>27</sup>.

According to my estimates, the weight of the nine major East Asian countries/areas<sup>28</sup> comprehensive economic relationship with the three major economic poles, including international trade, foreign direct investment (FDI), indirect investment and Official Development Aid (ODA), was “Japan: US: EU = 4: 3: 3” immediately before the Asian Currency Crisis in 1997. In other words, this shows that the optimum currency basket weight for these nine East Asian countries/areas as a whole is “yen: dollar: euro = 4: 3: 3”. Consequently, East Asian countries should first adopt this system to peg their own currency to the triple- currency basket with this weighting. By adopting this system, East Asian countries will always have the anchor fixed at the average level of the three major currencies, without being affected by any volatility among them. Hence, this will contribute tremendously to stability among currencies within the region.

In the second stage, we should have an intra-regional fixed exchange rate

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<sup>25</sup> This section is largely based on Yamashita (2006a), p.79.

<sup>26</sup> The details of my idea about the AEMU are shown in Yamashita (2002), pp. 259-260.

<sup>27</sup> See Yamashita (1999b) in details.

<sup>28</sup> They include Malaysia, Thailand, Indonesia, the Philippines, Singapore, Hong Kong, Taiwan, South Korea, and China.

regime which consists of East Asian currencies including the yen. In other words, we should aim at an EMS-type fixed exchange rate regime. But, we should seek a smaller group with which to start this common currency system, considering that many ASEAN countries are still in the very early stages of economic development. I think that this group should consist of eight countries/areas, such as Japan, South Korea, China, Hong Kong, Singapore, Taiwan, Malaysia, and Thailand. By adopting this currency system, East Asian countries would benefit from the disciplinary effect and isolation effect (the Hard-shelled Capsule Effect), which the EMS members had.

When the member countries' economies have sufficiently developed and converged, the time will be ripe for East Asia to formulate a plan for a unified regional currency. This will be the third stage which I have termed "the AEMU" or "the Asian EMU".

**Table 1 : FTAs and EPAs in ASEAN Plus Three**

|               |   |
|---------------|---|
| (ASEAN)       | AFTA : Jan. 2002 effective  |
| (ASEAN+China) | ACFTA for Goods : Nov. 2004 signed<br>ACFTA for Services : Jan. 2007 signed   |
| (ASEAN+Korea) | FTA : May 2006 signed   |
| (ASEAN+Japan) | EPA Framework Agreement : May 2007<br>EPA : November 2007 signed  |
|               | Japan/ Singapore EPA : Jan. 2002 signed<br>Japan/ Malaysia EPA : Dec. 2005 signed<br>Japan/ the Philippines EPA : Sep. 2006 signed<br>Japan/ Thailand EPA : Apr. 2007 signed<br>Japan/ Brunei EPA : June 2007 signed<br>Japan/ Indonesia EPA : Aug. 2007 signed |

References

- Japan/ Mexico EPA : Sep. 2004 signed  
Japan/ Chile EPA : March 2007 signed  
Korea/ US FTA : April 2007 signed
- Japan/ Korea FTA negotiations : Dec. 2003 started  
Japan/ GCC FTA negotiations : Sep. 2006 started  
Japan/ Vietnam EPA negotiations : Jan. 2007 started  
Japan/ India EPA negotiations : Jan. 2007 started  
Japan/ Australia EPA negotiations : April 2007 started  
Korea/ EU FTA negotiations : started in May 2007  
ASEAN/ EU agreed to begin FTA negotiations in May 2007  
Japan /Switzerland EPA negotiations : May 2007 started  
India/ EU FTA negotiations : July 2007 started

**Table 2 : The 3 Stage Asian EMU Plan  
(Initiated by Yamashita)**

Stage I : Triple-currency Basket-based Fixed Exchange Rate Regime for Asian Countries except Japan

\*triple-currency = the dollar, the euro and the yen

Stage II : "the Asian EMS" ( Intra-regional Fixed Exchange Rate Regime)

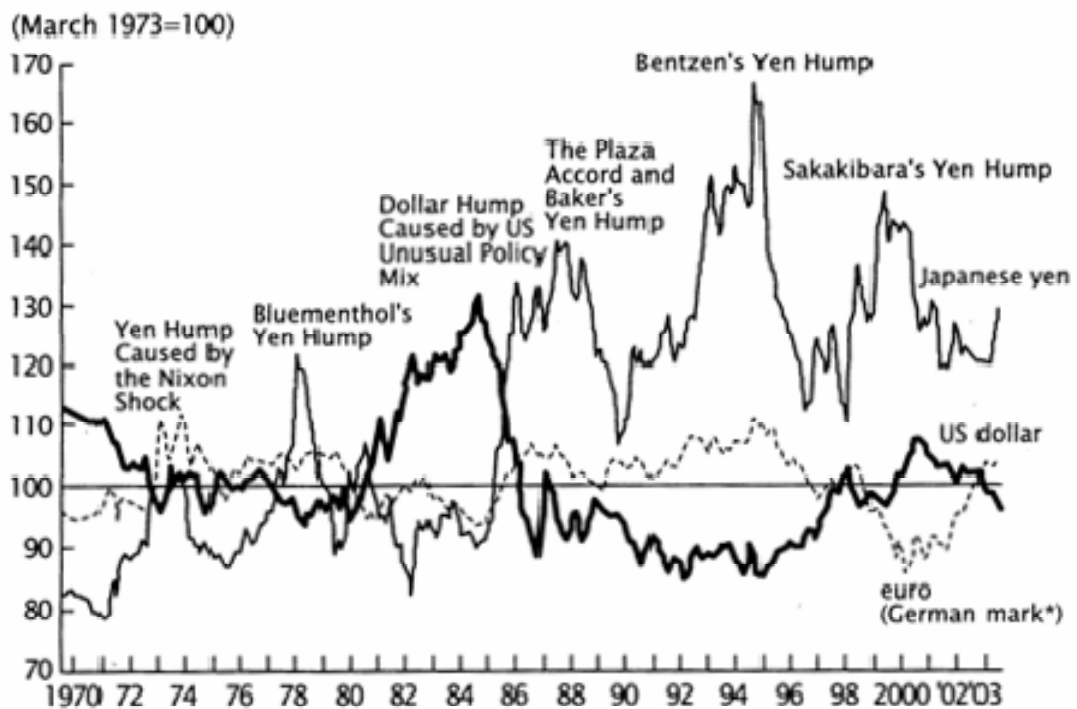
• • • initial start by 6 countries/ area (Japan, Singapore, HK, Taiwan, Korea, Malaysia)

Stage III : a unified Asian currency = "the Asian EMU" ("AEMU")

Source: Yamashita (1998), (2002), (2006a)



Chart. Real Effective Exchange Rate of the 3 Major Currencies  
(1970~2003, Quarterly Data)



\* The German mark until the fourth quarter 1998, from then on the euro.  
Source: Bank of Japan. The literal expressions in the chart have been made by the author.

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"The Promotion of Asian Integration by Learning from the European Experience: Establishing a Sino-Japan Core-Partnership as the Key"

**Box. External Factors Affecting the Promotion of European Integration**

| <u>External Factors</u>  | <u>Developments of European Integration</u>   |
|--|---|
| The Cold War after the World War II<br>→ The Necessity of Cohesion in the West Led by the U.S.   | → The Schuman Plan (May 1950) ... Reconciliation between Germany and France<br>→ Establishment of the ECSC (July 1952)  |
| Oct. 1960 The First Dollar Crisis (Gold Price Hike)  | → Re-valuation <sup>(of)</sup> the German mark and the Dutch guilder against the Dollar (Mar. 1961)<br>... European Concern about the Bretton Woods System<br>→ the Van Campen Report (Apr. 1962) & the Hallstein Initiative (Oct. 1962)<br>... The First EMU Plan (Never Realized) |
| Aug. 1971 The Nixon Shock  | → Basic Agreement on the Inter-regional Currency System at Brandt & Pompidou Summit (Dec. 1971)<br>→ the Establishment of the EC Snake (Apr. 1972)  |
| 1977~78 Malign Neglect Policy of the Dollar by the Carter Administration   | → EMS Proposal by the German Chancellor Schmidt (Feb. 1978)<br>→ Aachen Franco-German Summit (Sep. 1978)<br>→ The Establishment of the EMS (Mar. 1979)  |
| The Latter Half of the 1980s<br>Dollar Talk-down Policy by the Reagan Administration after the Plaza Accord & Threat by the Rise of the Japanese Economy | → The Delors Report = EMU Plan (Apr. 1989)  |
| 1989 The End of the Cold War (→ The Possibility of the German Re-unification)  | → Kohl & Mitterrand Summit (Apr. 1990)<br>→ Agreement of the Maastricht Treaty (EMU Treaty) (Dec. 1991)<br>→ Establishment of the EMU = The Birth of the Euro   |

Notes: This box has been made by the author.

YAMASHITA (2006), p. 69

“The Promotion of Asian Integration by Learning from the European Experience: Establishing a Sino-Japan Core-Partnership as the Key”

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**【Attachment 1】**

**EASG Final Report in 2002**

**9 Medium-term and Long-term Concrete Measures, and Those That Require Further Studies**

- Form an East Asian Free Trade Area (EAFTA)
- Promote investment by small and medium enterprises
- Establish an East Asia Investment Area (EAIA) by expanding the ASEAN Investment Area (AIA)
- Establish a regional financing facility
- Pursue a more closely coordinated regional exchange rate mechanism
- Pursue the evolution of the ASEAN+3 Summit into an East Asian Summit (EAS)
- Promote closer regional marine environmental cooperation for the entire region
- Build a framework for energy policies and strategies, and action plans
- Work closely with NGOs in policy consultation and coordination to encourage civic participation and state-civil society partnership in tackling social problems

Source : East Asia Study Group (2002)

## **【Attachment 2】**

### **Chronology of Asian Regional Integration**

- Sep. 1985~ Unusually Sharp Appreciation of the Japanese yen after the Plaza Accord  
→ Japanese firms' massive FDIs in ASEAN countries
- Dec. 1987 "The Manila Declaration" at the 3<sup>rd</sup> ASEAN Summit  
→ ASEAN Countries shifted their policies towards export-oriented and FDI-friendly ones.  
ASEAN, BBC (the Brand-to-Brand Complementation) Scheme introduced
- Dec. 1990 EAEG Initiative by Mahathir bin Mohamad**
- July 1991 India adopted the New Economic Policy (NEP)
- Jan. 1992 ASEAN, "the Singapore Declaration" agreed to accomplish AFTA within 15years
- Jan./ Feb 1992 Deng Xiaoping's "the Southern Speech" ("Nanxun Jianghua") calling for accelerating the Chinese reform and open policy
- Jan. 1993 ASEAN, CEPT (Common Effective Preferential Tariff) introduced
- July 1994 Establishment of ASEAN Regional Forum (ARF)
- Sep. 1994 ASEAN agreed to advance the target year of accomplishment of AFTA to 2002 from 2007.
- July 1995 Vietnam joined ASEAN. → ASEAN 7
- Mar. 1996 The 1<sup>st</sup> ASEM Summit in Bangkok . . . virtual start of "ASEAN+3"
- Nov. 1996 ASEAN, AICO (ASEAN Industrial Cooperation ) Scheme effective
- Mar. 1997 ASEAN, SEANWFZ effective
- July 1997 Occurrence of the Asian Currency Crisis in Thailand**
- July 1997 Laos and Myanmar joined ASEAN → ASEAN 9
- Sep. 1997 AMF Initiative deadlocked**
- Dec. 1997 The 1<sup>st</sup> "ASEAN+3" Summit in Kula Lumpur**
- Summer 1998 The Triple Currency Basket Based Exchange Rate Regime for the Asian EMEs advocated by Japanese economists, etc.
- Aug. 1998 ASEAN, AIA (ASEAN Investment Area) Framework Agreement
- Oct. 1998 "the New Miyazawa Initiative" for the Asian countries in crisis (30 billion dollars)**
- Dec. 1998 Kim Dae Jung proposed East Asia Vision Group (EAVG)

- Dec. 1998 ASEAN, “Vision 2020” adopted
- Apr. 1999 Cambodia joined ASEAN. → ASEAN 10
- Nov. 1999 The 1<sup>st</sup> Japan, China and Korea -Trilateral Summit in Manila
- Nov. 1999 “ASEAN+3” Summit, “the Manila Declaration” by the joint communiqué for East Asian cooperation**
- (Nov.-Dec. 1999) (Breakdown of the Seattle WTO Ministerial Meeting against the background of very strong anti-globalisation movements)
- May 2000 “ASEAN+3”, the Chiang Mai Initiative (CMI) agreed**
- Nov. 2000 ASEAN, IAI (initiative for ASEAN Integration) agreed at the 4<sup>th</sup> Informal ASEAN Summit in Singapore in an attempt to reduce the differences among ASEAN countries
- Nov. 2000 Zhu Rongji proposed “ASEAN+China” FTA to ASEAN in Singapore.
- May 2001 “ASEAN+3”, CMI effective
- (Sep. 2001) (9.11 Terrorism)
- Nov. 2001 “ASEAN+3”, EAVG Report finalized**
- Nov. 2001 ASEAN-China FTA (ACFTA) agreed to start negotiations to aim at the completion within 10 years**
- (Dec. 2001) (China joined the WTO after 15 years negotiations)
- Jan. 2002 Prime Minister Koizumi’s Singapore Speech proposed “the Enlarged East Asian community” including Oceania
- (May-June 2002) (2002 FIFA World Cup jointly hosted by Japan and Korea)
- June 2002 Inauguration of ACD (Asia Cooperation Dialogue) in Thailand
- July 2002 ASEAN, “ASEAN Minus X” Formula agreed
- Sep. 2002 “ASEAN+3”, announcement of the Asian Bond Market Initiative (ABMI)
- Nov. 2002 ACFTA Framework Agreement between ASEAN and China
- Nov. 2002 East Asia Study Group (EASG), “Final Report” presented to “ASEAN+3” Summit in Phnom Penh**
- Nov. 2002 Zhu Rongji proposed the China, Japan and Korea FTA.
- Jan. 2003 “Okuda Vision” by the Japanese Keidanren, calling for “Japan should be determined to live within Asia.”, and proposed to establish “the East Asian Free Economic Zone” by 2020 at latest.
- (Mar. 2003) (Outbreak of War on Iraq)
- May 2003 The 1<sup>st</sup> East Asia Think-tank Network (NEAT) Meeting in Beijing
- June 2003 Executives’ Meeting of East Asia-Pacific Central Banks (EMEAP), Establishment of Asian Bond Fund (ABF) announced



|             |  |
|-------------|--|
|             | <ul style="list-style-type: none"> <li>• • • to invest 1 billion dollars in dollar-denominated government bonds issued by 8 East Asian countries/ area (ASEAN 5, China, Korea and Hong Kong)</li> </ul>  |
| June 2003   | ASEAN agreed to establish the ASEAN Economic Community (AEC) by 2020.  |
| June 2003   | China-India Joint Communique, the end of rivalry between the two countries since the boundary dispute in 1962 and agreed to strengthen their economic relationship   |
| Aug. 2003   | <b>“ASEAN+3” formally agreed the Asia Bond Market Initiative (ABMI) at the ministerial level.</b>  |
| Oct. 2003   | ASEAN agreed “the ASEAN Concord II” <ul style="list-style-type: none"> <li>• • • 3 pillars of “Security Community”, “Economic Community” and “Social &amp; Cultural Community” for the framework of “the ASEAN Community” defined</li> </ul>         |
| Oct. 2003   | China and India signed “the Treaty of Amity and Cooperation” (TAC) with ASEAN  |
| Dec. 2003   | Japan-ASEAN Special Summit, “the Tokyo Declaration” <ul style="list-style-type: none"> <li>• • • agreed to deepening East Asian cooperation toward establishment of “the East Asian Community” jointly</li> </ul>                                    |
| Dec. 2003   | Japan-Korea EPA, start of negotiations   |
| Jan. 2004   | China-Hong Kong CEPA (Closer Economic Partnership Agreement) and China-Macau CEPA effective  |
| May 2004    | Construction of “Asia Highway” agreed <ul style="list-style-type: none"> <li>• • • 140,000km from Tokyo via the Middle East through Europe by UN/ ESCAP</li> </ul>   |
| May 2004    | the Council on East Asia Community (CEAC) established in Tokyo <ul style="list-style-type: none"> <li>• • • track 2 framework of all Japan group consisting of representatives from political, bureaucratic, academic and economic fields</li> </ul> |
| July 2004   | Japan signed TAC with ASEAN  |
| (July-Aug.) | (young Chinese spectators shown very severe anti-Japanese behaviour at the soccer stadium of the Asian Cup)  |
| (Sep. 2004) | (Japan-Mexico EPA signed)  |
| Nov. 2004   | ASEAN-China FTA (ACFTA) signed for goods trade   |
| Nov. 2004   | Korea and Russia signed TAC with ASEAN.  |
| Apr. 2005   | ASEAN-Japan EPA, start of negotiations   |

- (Apr. 2005) (very intense Chinese anti-Japan demonstrations)
- May 2005** **“ASEAN+3”, strengthening of CMI agreed in Istanbul**
- May 2005 EMEAP announced the start of “ABF II”.
- • • to invest 2 billion dollars in local currency-denominated bonds issued by 8 East Asian countries/ area
- June 2005 Singapore-India Comprehensive Economic Cooperation Agreement (CECA) signed
- July 2005 Chinese RMB and Malaysian Ringgit, Multi-currency Basket-based Crawling Peg adopted
- Aug. 2005 Korea-Singapore FTA signed
- Dec.2005** **“The Kuala Lumpur Declaration” at the 9<sup>th</sup> “ASEAN+3” Summit**
- • • **“ASEAN+3” (APT) should be the main vehicle for the construction of “East Asian Community (EAC)”.**
- Dec. 2005 The 1<sup>st</sup>East Asian Summit (EAS) with 16 countries (APT + Australia, New Zealand and India) in K.L.
- • • “a forum for dialogue” and “a substantial role” for EAC building
- Dec. 2005 Japan-Malaysia EPA signed
- Apr. 2006 Japanese Ministry of Economy, Trade and Industry (METI) announced “Global Economic Strategy”
- • • Economic Research Institutes for ASEAN and East Asia (ERIA) and East Asian EPA by 16 countries proposed
- May 2006 “ASEAN+3” Finance Ministers’ Meeting agreed to study Asian Currency Unit (ACU) • • • “the Hyderabad Declaration”
- May 2006 ASEAN-Korea FTA signed
- Aug. 2006 “the Nikai Initiative” by NIKAI Toshiyuki, Minister of Japanese METI at “ASEAN+3” Economics Ministers’ Meeting in K.L.
- ① Establishment of ERIA by 16 countries
  - ② East Asian EPA by 16 countries
  - • • agreed to study
- Sep. 2006 Japan-the Philippines EPA signed
- Nov. 2006 Japan-Indonesia EPA Framework Agreement made
- Jan. 2007 ASEAN Summit on the Island of Cebu, the Philippines.
- ① agreed to advance the target year of ASEAN Economic Community to 2015 from 2020 at Jan. 2007
  - ② Blueprint of the ASEAN Charter by Report of the Eminent Persons Group (EPG) approved • • • It was mentioned that “the principle of

no interference in the domestic affairs” and “unanimity” will be revised.

- Jan. 2007 ASEAN-China signed ACFTA for services trade, and aim to complete free trade from the 1<sup>st</sup> of Jan 2010 on.
- Jan. 2007 the 2<sup>nd</sup> EAS in on the Island of Cebu
- Jan. 2007 Japan-India EPA, start of negotiations
- (Mar. 2007) (Japan-Chile EPA signed)
- Apr. 2007 Japan-Thailand EPA signed
- (Apr. 2007) (Korea-US FTA agreed)
- May 2007 Japan/AESAN EPA Framework Agreement made
- May 2007 “ASEAN+3” Finance Ministers’ Meeting in Kyoto, Multi-lateralization of CMI agreed**
- • • The thrust of agreement is to gather foreign exchange currencies from member states and to manage them in an integrated fashion.**
- (May 2007) (Korea entered the FTA negotiations with the EU.)
- June 2007 Japan-Brunei ETA signed
- Aug. 2007 Japan-Indonesia EPA signed
- Nov. 2007 ASEAN-Japan EPA signed
- Nov. 2007 “the ASEAN Charter” to be adopted at ASEAN Summit in Singapore**
- Nov. 2007 the 2<sup>nd</sup> Joint Communique for East Asian cooperation at the 11<sup>th</sup> “ASEAN+3” Summit in Singapore**

\* This chronological table was made by the author.