CEINEX Quarterly No. 5 · China Capital Markets Access

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Ladies and Gentlemen,

anyone who has been dealing with economic relations between China and Germany over a longer period of time cannot help but develop a certain composure. As tempting as short-term excitement may sometimes be, it is important to take a long-term perspective on things.

Prof. Dr. Horst Löchel of the Sino-German Center at the Frankfurt School of Finance and Management does just that, analyzing the march of the Chinese government's five-year plan adopted at the beginning of 2021. He makes it clear that in the long run, it will become more attractive for European companies to invest in China and tap into the market - regardless of temporary challenges for individual sectors or companies.

YI Xiong is sounding the same horn. While the chief economist of Deutsche Bank in China sees the challenges that still lie ahead of the implementation of the investment agreement between the EU and China, he is optimistic that foreign companies will benefit greatly from the positive development and opening of the Chinese market.

We have two impressive examples of how China is continuously opening its markets to foreign market participants with the stock market and the bond market in China. Shanghai Stock Exchange's Harry FU explains how reforms are making the market attractive to foreign investors, using the Shanghai STAR Market as an example. And Michael Müller who is heading CICC's investment banking division in German-speaking Europe shows how much the bond market has gained in depth as a result of recent reforms - to the benefit of domestic issuers as well as foreign investors.

Some hoped-for progress may seem more arduous these days, or require a bit more time than first thought. But perhaps that may illustrate to us how worthwhile the progress we seek is. We are working on it.

Yours sincerely,

Niels Tomm	Dr. Chen Han
Co-CEO	Co-CEO

Talking Point

China's New Five-Year Plan: Opportunities and Challenges

by Horst Löchel, Professor of Economics and Co-Chairman of the Sino-German Center at the Frankfurt School of Finance and Management

The National People's Congress of China recently launched a new 5-year plan for the years 2021 to 2025. In terms of economic development, the plan contains six goals:

- Keep major economic indicators in an appropriate range
- Maintain above 7 per cent annual growth in Research and Development (R&D) and 8 per cent in Science and Technology (S&T) spending
- Keep the urban unemployment rate below 5.5 per cent
- Raise urban residents to 65 per cent of the population
- Increase the life expectancy of Chinese citizens by one year
- Promote green development

The first interesting point is the fact that the goals do not include anymore a quantitative growth target like in the previous plans. There are several reasons for that. Most importantly are unsustainable developments in the past, notably rising debt levels of companies and the public sector that together reached almost 300 per cent of China's Gross Domestic Product (GDP) in 2020. Obviously, the respective GDP growth targets of the past have been to a large extent reached by debt creation. This not only triggered unprofitable investment and overcapacities in the real estate sector, for instance, but also put the financial sector, especially the state-owned banks, under stress because most of the debt are bank credits.

Therefore, giving up an explicit growth rate can be interpreted as a way to deleverage China's economy and make growth more sustainable and the financial sector more stable. However, the consequences for the real economy have to been seen. A realistic expectation is an annual average GDP growth rate of around 5 per cent for the years to come. This also fits with China's long-term goal to double the GDP again until 2035 compared to 2020.

Despite these qualitative and quantitative indicators, the 5-year plan contains a new economic development strategy known as »dual circulation«. The term means that an economy is driven by two circuits, a domestic and an international one. The new strategy stresses the importance of the domestic circular flow without giving up the international. To put it in a nutshell: The implementation of the dual circulation strategy aims to make China's economy less reliant on cheap exports as well as high-tech technology imports.

Additionally, the strategy aims to strengthen domestic consumption. With a share of less than 40 per cent of the GDP, China still has one of the world's lowest consumption levels by private households. To change this, the government intends to raise disposable income through higher wages and an upgrade of the public social system. The latter is of particular importance. The so-called precautionary savings that compensate for the lack of a developed social system make up a large share of the overall saving ratio of private households of more than 30 per cent.

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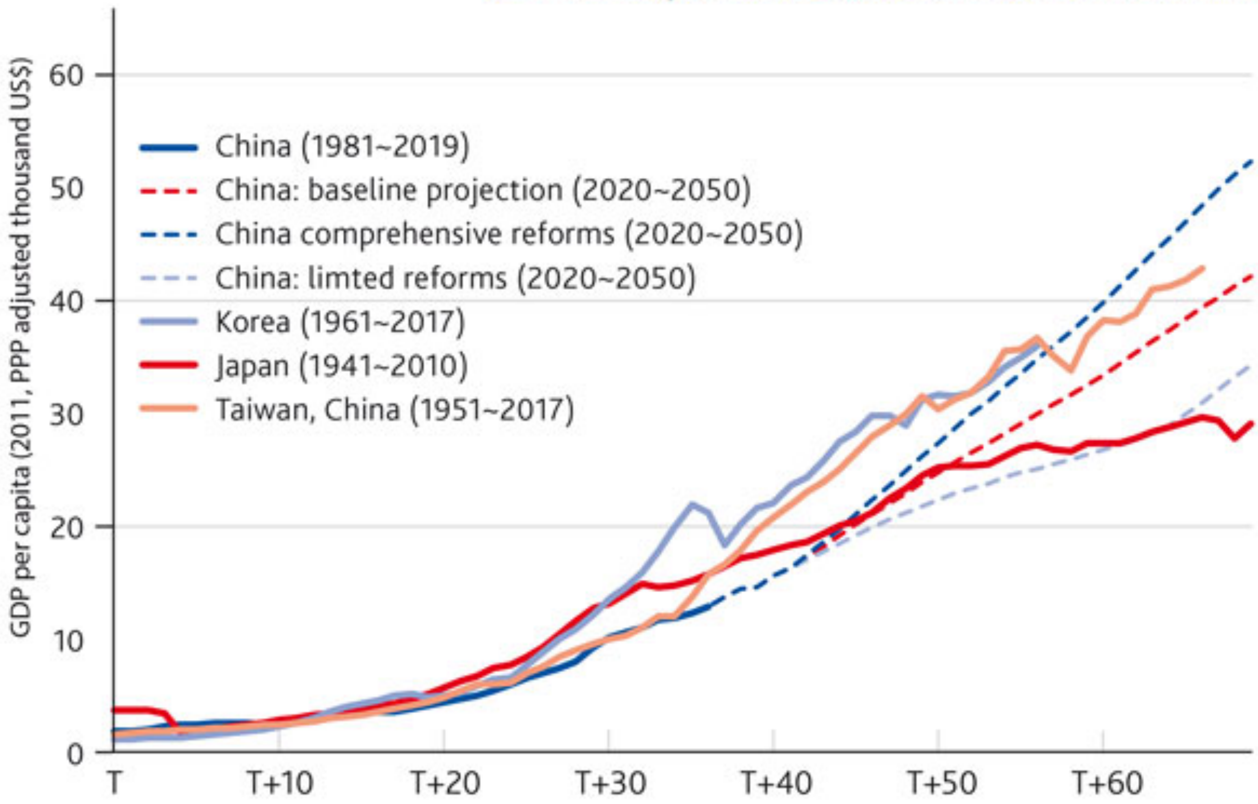
Development of China Towards a High Income Country:
GDP-Per-Capita as Distance from Start of Reforms



Source: EUCCC, European Business in China: Executive Position Paper 2020/2021, Sept 2020, p 13

The second element of the dual circulation strategy, the development of »self-reliance« in high-tech, is even more important, especially for foreign investors and companies. It is an extension of the »Made in China 2025« strategy that was already launched in 2015 to boost China's high-tech industry, pursuing the goal of global technological leadership until 2035.

This time the new 5-year plan focuses very much on the setup and development of self-reliance in frontier technologies such as AI, quantum information systems, semiconductors, neurosciences, and biotechnology among others. This can be interpreted as a reaction to the decoupling policy of the United States under former president Trump that, at least in economic terms, is continued under the Biden administration as well. High-tech exports from the US to China are still heavily restricted.

However, this is only one side of the coin. The aim for more self-reliance in high-tech is also driven by the attempt to avoid a middle-income trap in China and to become a high-income country comparable to western nations. Without a solid domestic high-tech industry that guarantees high value-added products as well as high productivity, this goal cannot be reached, as demonstrated in many regions of the world.

Of course, China's claim to reach technological leadership is a challenge for high-income countries. However, such kind of challenges are unavoidable in a competitive market environment. Protectionism should not be the answer. Instead, increasing the own competitiveness is the right way forward for companies and economies in high-income countries.

What does the new 5-year plan mean for European companies? This depends very much on the respective business models in terms of location and sector. For producers for China's retail market, domestically or abroad, the new 5-year plan is pretty favourable, given the goal to raise consumption over time.

For European companies of high-tech products, the situation is different. Over time, obviously, it will be more favourable to produce in China instead of exporting high-tech products. However, China's industry still lacks international technological competitiveness to a large extent and this will not change overnight. The Chinese Ministry of Commerce (MOFCOM), for instance, just recently issued a notice that outlines strategies to attract more foreign direct investments to China, especially in the field of innovative industries.

In a certain sense, China's new 5-year plan follows the US model of consumption and innovation driven domestic growth. There is not much reason to believe that China's economy – the second largest in the world with a share of more than 30 per cent of global growth – will not be successful in the future as well, given the experiences of the past. Regardless of temporary challenges for individual industries and companies, this is good news for business and the financial markets in China as well as abroad.

SSE STAR Market, a new arena for innovation companies to cluster

by Harry FU, Managing Director of Global Business Development Department, Shanghai Stock Exchange

In order to build a standardized, transparent, open, dynamic, and resilient capital market, China is implementing a new round of comprehensive reforms in order to further deepen its capital markets. The registration system reform is the key project of this round of capital market reforms. In this regard, we adhere to three principles, i.e., drawing on international best practices, reflecting Chinese characteristics including the features of the pilot registration system on the STAR Market, and then implementing the registration system reform on ChiNext. Based on these principles, the registration system reform has achieved a major breakthrough as it has generally withstood the market test with market operations remaining stable and the market vitality being further stimulated. This was a joint effort by all parties involved.

The construction of the STAR Market of the Shanghai Stock Exchange (SSE) in particular has achieved the expected results, attracting technology and innovation companies and thus forming a respective cluster.

The Shanghai Stock Exchange launches the STAR Market and the pilot registration system

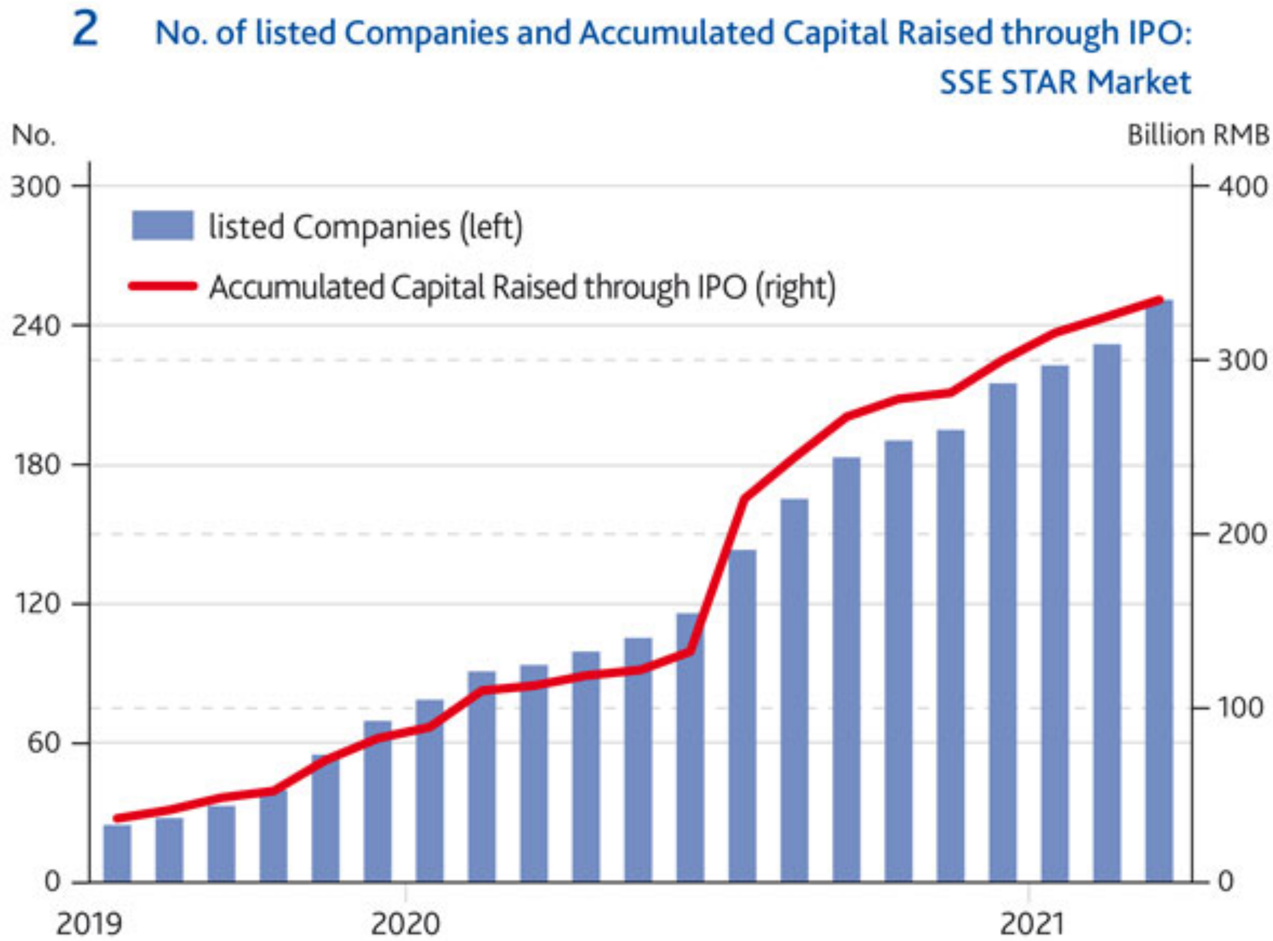
The STAR Market mainly serves technology and innovation companies that are in line with China’s economic development goals and have a competitive edge in key technologies and as well as a high market recognition. Therefore, the STAR Market focuses on supporting high-tech industries and strategic emerging industries such as new-generation information technology, high-end equipment, new materials, new energy, energy storage, environmental protection, and biomedicine. With information disclosure at its core, the STAR Market aims to

- improve the transparency of listed companies,
- set up diversified and inclusive listing conditions,
- establish prudent investor suitability requirements,
- strengthen the responsibility of market entities,
- increasing the penalties for violations,

in order to promote a continuous charge towards improved quality, efficiency, and impact.

From November 5, 2018, when President Xi announced the establishment of the science and technology innovation board and the pilot registration system in his speech at the opening ceremony of the first China International Import Expo, to July 22, 2019, when the first 25 companies were officially listed and traded on the STAR Market - the Chinese capital market has ushered in a brand new board, marking the implementation of the major reform task of establishing the STAR Market and the pilot registration system in the Chinese capital market. As a market for new listings, the STAR Market is the first market to implement the pilot registration system, opening up a new chapter of reform in China's capital market.

After the first batch of companies listed on the STAR Market, the STAR Market has gathered outstanding technology and innovation companies. Within the first nine months, 100 companies were listed on the STAR market, another 100 followed suit within the next nine months. The STAR Market has shown an obvious clustering effect for industries such as integrated circuits and biopharmaceuticals. By attracting more and more leading companies, the STAR Market continues to empower technological innovation. As of March 31, 2021, there were 251 listed companies on the board, raising RMB 338 billion (USD 52 billion) in total.



In order to timely reflect the performance of the securities listed on the STAR Market and provide the market with investment targets and performance benchmarks, the Shanghai Stock Exchange and the China Securities Index Co., Ltd published the STAR 50 Index in July 2020. Currently, the STAR 50 Index ETF is becoming a more and more important vehicle for domestic and foreign investors to invest in the STAR Market and share the fruits of China's economic and technological development. As of March 31, 2021, more than ten domestic STAR 50 ETFs have been listed, and several STAR 50 ETFs have been launched in overseas markets such as the United States, Hong Kong, and Japan, with the range of offered products still expanding.

Looking Ahead

The year 2021 is the first year of China's 14th Five-Year Plan. China will continue to deepen the reform of the capital market, focusing on key tasks such as fully implementing the registration system for stock issuance, further developing the business with institutional investors, and opening up the capital market to the outside world in an ever-growing depth. In recent years, the SSE has launched the Shanghai-Hong Kong Stock Connect, the Shanghai-London Stock Connect, the China-Japan ETF Connectivity and other mechanisms, as well as jointly establishing the China Europe International Exchange in Frankfurt with Deutsche Boerse and China Financial Futures Exchange (CFFEX) as an important overseas complement to the domestic capital market, continuously promoting the high-standard two-way opening up of the capital market. As of the end of 2020, we have achieved net inflow of foreign investment for three consecutive years, and foreign investors' holdings of A-Share assets have exceeded RMB 3 trillion, and there is still a lot of potential in the Chinese market in the future. We welcome foreign market participants to pay more attention to the Chinese market and participate more extensively and deeply in the Chinese capital market.

Macro View

The EU's Business Interest in China

by Yi Xiong, Deutsche Bank Research, Chief Economist, China, Hong Kong

China and the EU have become the world's biggest bilateral trade partners in 2020. Their bilateral trade flows have, for the first time, surpassed EU-US trade flows. But Europe's business interest in China goes far beyond trade. Take Volkswagen as an example: China accounted for more than 1/3 of Volkswagen's car sales and profits worldwide. 3.8 million Volkswagen cars were sold in China in 2020, generating an annual operating profit of EUR 4.4bn for the Volkswagen Group. Most of these cars are not counted as EU exports to China because they are assembled and sold by Volkswagen's two Chinese joint ventures (JVs).

European companies have more than 4,000 EU subsidiaries in China's manufacturing sector, according to Eurostat's Foreign Affiliates Statistics (FATS). A striking fact is that EU companies are already selling more goods through their Chinese subsidiaries than through exports. In 2017 (the latest year data was available), subsidiaries of EU manufacturers in China reported EUR 209bn in revenue, EUR 30bn more than EU goods exports to China. In addition, subsidiary sales were growing faster than exports: subsidiaries grew 9.3 per cent per annum between 2010 and 2017, while exports grew only 7.5 per cent per annum.

While European businesses have grown rapidly in China, they are becoming dissatisfied with the lack of improvement in the business environment. This is evident from the EU Chamber of Commerce's annual business confidence survey. On the one hand, market competition is becoming fiercer, owing to not only stronger domestic players but also lower trade barriers. On the other hand, China's opening up to foreign investment made limited progress in much of the 2010s, and its regulatory environment and market openness for foreign investors has not kept pace with the rapidly developing economy.

Nevertheless, China's efforts in opening up to foreign investment have now accelerated. China's new »dual circulation« strategy, which will guide its economic policymaking in the coming decade, envisages China's domestic market to become more open to foreign investors. In fact, »opening up« was a standalone section in China's 14th five-year plan. Foreign investment can greatly help China's goals of enhancing technological capability and building a large, competitive, and fair domestic market. Positive spillovers from Foreign Direct Investments (FDI) is evident over the past four decades. China's manufacturers, from shoemakers to smartphone makers, have continuously benefited from their business relations as well as from the competition with foreign companies.

The EU-China Comprehensive Agreement on Investment (CAI), which has been agreed in principle and is awaiting ratification, is a good proof of China's policy intentions. China's commitment comes with »only very limited exclusions« and »would match the EU's openness«, according to the EU. The removal of a JV requirement in the auto and other manufacturing sectors could help significantly improve European manufacturer's competitiveness in China. China also promised to explicitly ban any form of forced technology transfers, protect confidential business information, and enhance transparency and predictability in authorizations and administrative measures.

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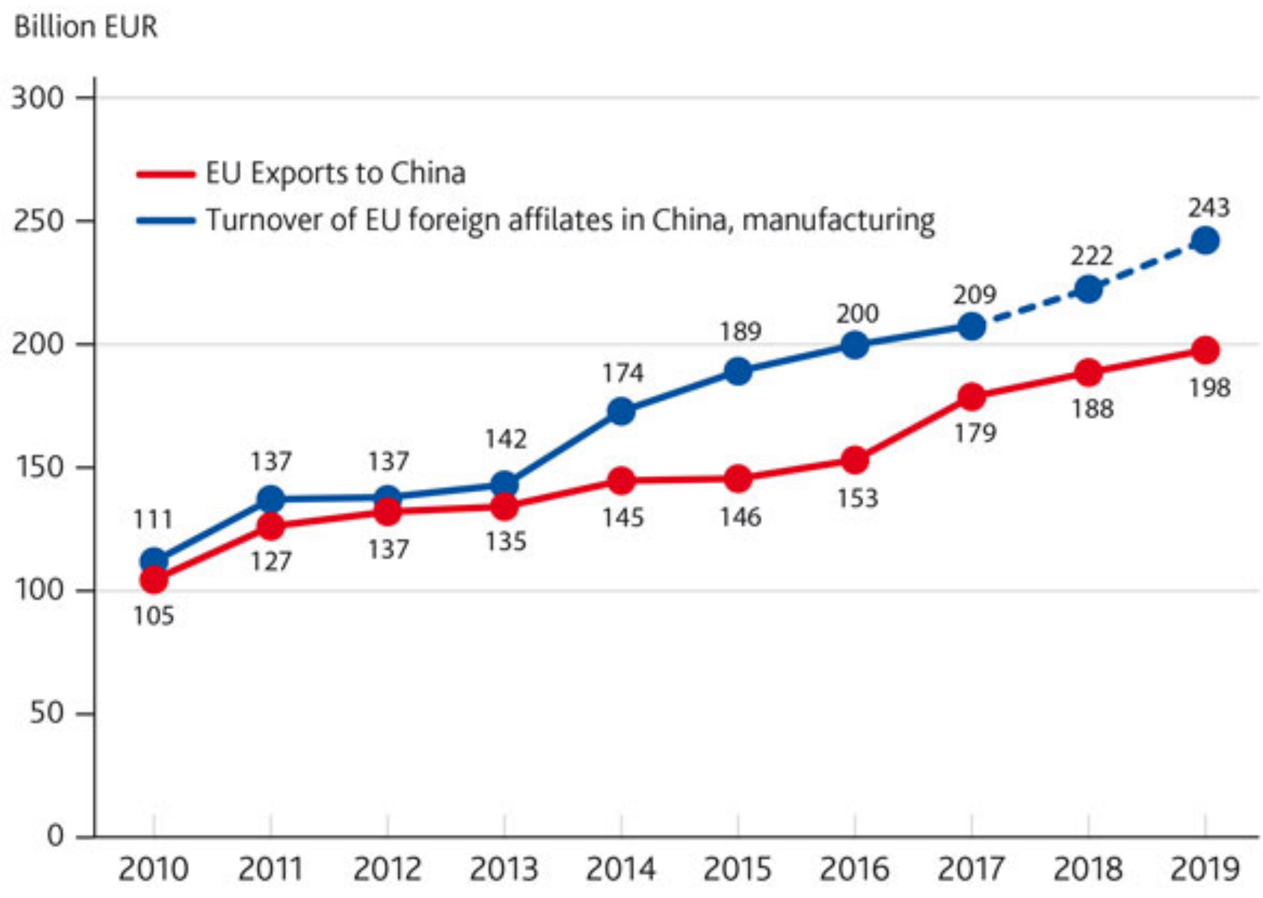
EU manufacturing subsidiaries in China sold more goods than EU exports to China



Perhaps even greater growth prospects can be expected for the services sector. EU services companies are underrepresented in China's economy. Their services sector revenues in China (excluding wholesale and retail) was only EUR 31bn in 2017, which accounted for only 3 per cent of their global revenues. The sectoral breakdown in services revenues suggests China's entry barriers were likely an important obstacle. Although financial services accounted for 34 per cent of EU companies' services revenues in China, the sector was still lagging behind as globally, financial services accounted for 45 per cent of the EU's total services revenues from abroad. Similarly, the share of information and communication services was 16 per cent in China, compared to 19 per cent globally. These happen to be the services sectors in China that have high entry barriers.

The good news is China has become more transparent in the opening up of its services sector in recent years. From 2017, China started to publish annually a foreign investment negative list, which largely deals with the services sector. The length of the list was reduced from 63 items in 2017 to 33 items in 2020, of which 24 items are in the services sector. China agreed to further open up financial and IT services to European investment, and will also open up promising services sectors such as environment and health services. These commitments will likely be reflected in the 2021 version of the negative list.

Furthermore, China has agreed to take steps to address some long-standing issues with State-owned enterprises (SOEs) and government subsidies. SOEs will act in accordance with commercial considerations and will not discriminate in their purchases and sales of goods or services. China also promised to publish its services sector subsidies on a public website annually, and to provide additional information upon request. The CAI's dispute resolution mechanism allows EU companies to raise concerns about SOE behaviors and government subsidies that could negatively affect their interests.

Admittedly, there are still many unknowns with the CAI. The agreement has yet to be finalized and ratified, and the initial implementation of the agreement may prove challenging and not without frictions. Despite these short-term uncertainties, the longer term trend is clear: China's domestic market will grow bigger in the next decade. Foreign companies will benefit from China's growth not only through increasing exports to China, but more importantly through investing and expanding their operations in China.

Exchange Markets

China Accelerates Its Opening-up Of The Bond Market

by Jianheng Chen, CICC, Global Head of Fixed Income Research; Michael Mueller, CICC, Head of Investment Banking, Germany, Austria & Switzerland

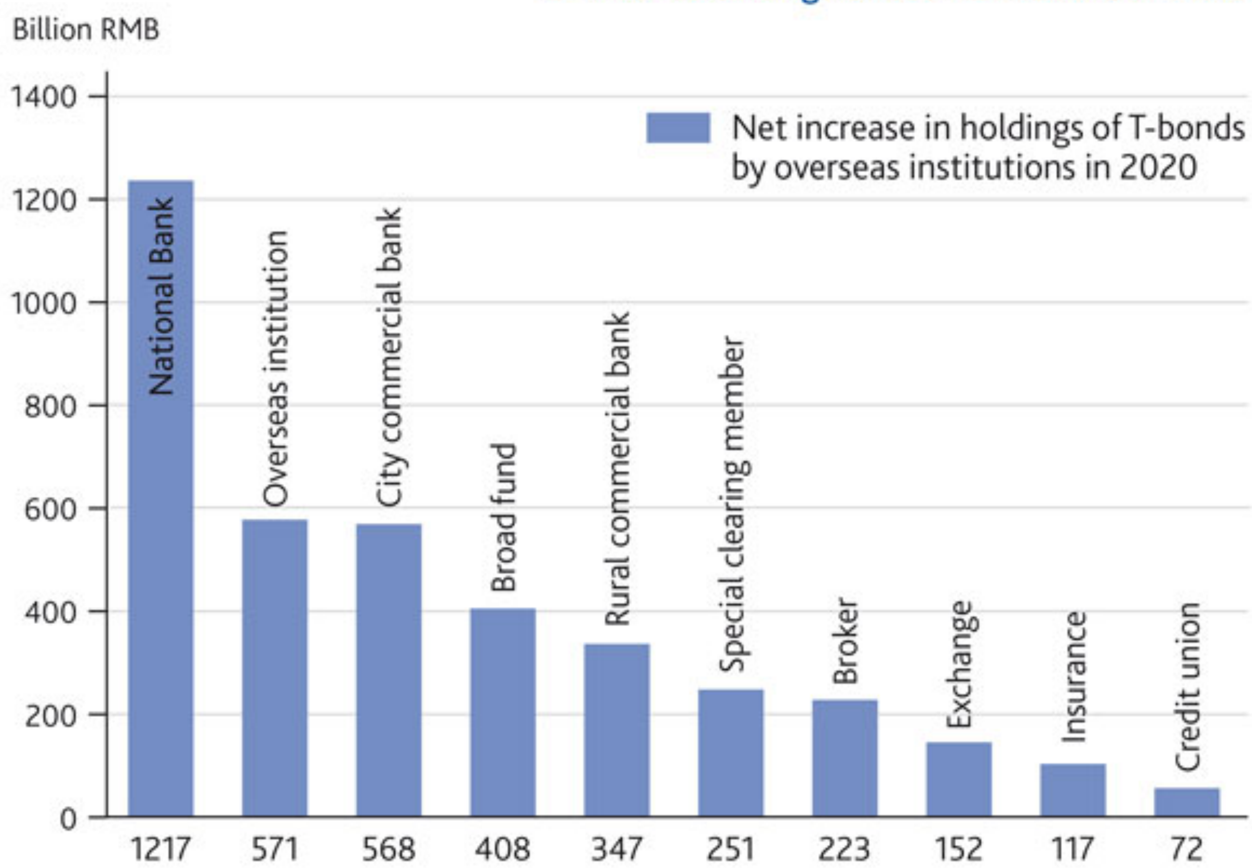
China's bond market has expanded along with its rapid economic growth over the past three decades, reaching RMB 117trn at the end of 2020 and ranking second in the world behind the US. China's bond market mainly consists of two markets: the interbank bond market with a balance of RMB 100.7trn and the exchange market with a balance of RMB 16trn. Among the exchange markets, Shanghai Stock Exchange (SSE) contributes the largest proportion, with a balance of RMB 13.2trn, followed by Shenzhen Stock Exchange, with a balance of RMB 2.8trn.

The interbank bond market and the exchange market each have their own niche. The interbank bond market is a quote-driven OTC market, where deals are struck based on bid and ask prices negotiated between two trading counterparties. On the other hand, the exchange market is an order-driven market, where deals are struck based on tender prices. In addition, most government bonds have been issued and traded in the interbank bond market, whereas most corporate bonds have been issued and traded in the exchange market, including hybrid debt securities such as convertible bonds and exchangeable bonds that are only available in the exchange market. China's bond market has seen rapid growth in its size, trading mechanisms, and bond products over the past three decades and is, by now, much more in line with developed bond markets than ever before.

China has accelerated its opening-up of the bond market since 2002 at heightened velocity. In November 2002, qualified foreign institutional investors (QFII) were allowed to invest in China's exchange market, followed by Renminbi qualified institutional investors (RQFII), which were permitted in 2011. After that, China's regulatory authorities gradually eased restrictions on qualifications, investment quotas, and investment scopes. China also opened up its interbank bond market in 2005 and has so far provided three investment channels, including QFII/RQFII, CIBM Direct, and Bond Connect. At present, the interbank bond market is well poised to lift all restrictions on investment channels, quotas, scopes, and capital repatriation. China's government has been accelerating its opening-up of its capital market and bringing its infrastructure and trading mechanisms in line with international standards over the past several years, making it easier for foreign investors to invest.

Unlike other major bond markets, China is not inclined to introduce strong stimulus monetary policies. Therefore, China's bond yields have not fallen along with its peers and ranked among the top amid major economies. China's opening-up and appealing bond yields have made the bond market increasingly attractive to overseas investors. Between 2015 and 2020, overseas investors' net investments in China's bonds have increased 21-fold, with a compound annual growth rate (CAGR) of 84 per cent. Overseas institutions ranked second and third in a net increase in holdings of China's treasury bonds and policy bank bonds respectively and ahead of a variety of various domestic institutions in 2020 (s. graphic 2 and 3). With the inclusion of China's bonds in three major global bond indices (FTSE World Government Bond Index, Bloomberg Barclays Global Aggregate Index and JPM GBI-EM Global Diversified Index, tracked by around USD 6-10 trn of assets in total), global bond investors could increase exposure to China's bonds through index investments.

4 Overseas institutions ranked the second in net increase in holdings of T-bonds among various institutions in 2020



CICC has been providing comprehensive and value-added services for our overseas clients in participating in China's bond market for more than a decade. CICC ranks the top in QFII trading volume, ranks second among its peers in covering over 200 clients in trading via Bond Connect, and has been providing innovative, tailor-made, and comprehensive solutions for overseas clients in CDS and other derivative trading.

Looking forward, we expect China to continue to accelerate its opening-up of its bond market and explore to establish more trading infrastructures that provide more convenient access. We may see more opening-up of the exchange market in the near future, with Shanghai Stock Exchange as the primary pilot. Shanghai Stock Exchange has capitalized on its location advantage and accumulated experience in implementing the Shanghai-Hong Kong Stock Connect and the Shanghai-London Stock Connect. With its base in Shanghai, it has established itself as the renminbi cross-border receipt and payment center. We expect Shanghai Stock Exchange to roll out more innovative mechanisms, such as the eastbound business of the Shanghai-London Stock Connect, Shanghai-Frankfurt Stock Connect (planned), the German "D-Shares", launched with the Haier IPO in 2018, the connectivity of cross-border exchange bond markets, and the inclusion of corporate bonds and other credit bonds in major global bond index, among others. Meanwhile, with the opening-up plan of the exchange market and the interbank bond market to be announced and the interconnection of infrastructure across markets in progress, foreign investors would be able to trade bonds across markets, making it much easier to invest in China's bond market.

About CEINEX

China Europe International Exchange
China Europe International Exchange AG (CEINEX) is a joint venture established by Shanghai Stock Exchange (SSE), Deutsche Börse Group (DBAG), and China Financial Futures Exchange (CFFEX). It is the first dedicated trading venue for China- and RMB-related investment products outside of mainland China and considered a strategic project between China and Germany

Our vision
Establish a centralized marketplace for trading, risk management, and asset allocation for China-related or RMB-denominated exchange traded financial products in Europe.

Our mission
As a Sino-German strategic capital markets platform, CEINEX's mission is to support the real economic cooperation between China and Europe as well as promote RMB internationalization.

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