CEINEX Quarterly No. 3 · China Capital Markets Access

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Editorial

Dear Ladies and Gentlemen,

China was the first country to be affected by the COVID-19 pandemic and the first country to start re-launching its economy. The world is now watching very closely how and when China will recover from the crisis and what impact it will have on the future development of the Chinese economy.

This is the guiding theme throughout this newsletter in which you can learn about the latest developments, trends as well as new perspectives in the Chinese financial and capital markets.

When will China recover? »Only after the pandemic is really contained« is the clear answer by LIAO Qun from CITIC Bank International in Hong Kong. Looking forward, the potential to recover is unstoppable--despite the possibility of a decoupling between China and the US plus the trend of shifting supply chains out of China. To achieve this potential the market opening needs to be continued. Read more about the why and how this can be achieved in the Macro View.

In the Policy Update Dr. XU Bin, Professor and Associate Dean at the leading China Europe International Business School, summarized the five key take aways from the recent National People's Congress. It is promising news. On top of impressive numbers such as the 20,000 newly registered businesses per day postulated by Premier LI Keqiang for the future, the NPC also gave us an outlook on the upcoming 14th Five-Year Plan. This will likely see a shift from strict targets in terms of numbers towards a more strategic goalsetting with an emphasis on infrastructure and domestic innovation to lead to more cross-border commerce.

Especially in the financial and capital markets we have seen a committed movement towards further opening and co-

operation in the past years, which, of course, is also key to our mission of building a bridge between the European and Chinese capital markets here at CEINEX. Market participants closely watch any progress in this respect.

HSBC's Florence Lee in her capacity as Head of China Business Development in London guides you through the latest regulatory changes for international investors in this edition's Talking Point. Both, in terms of better access into the Chinese market for international financial services firms and its enormous potential of clients, but also by easier access for foreign money to participate in the still highly attractive cash and derivatives markets in mainland China. The bond market alone saw an increase of over 30% of invested foreign capital in the past twelve months – and still foreign ownership is at under 3% of the total Chinese bond market. Opening up and reform also account for the crude oil futures market in Shanghai, which already sees strong involvement from international investors and in a very short time established itself as the third largest oil futures benchmark globally. Read about how it fared during the high-tide of the Covid-19 crisis and what else to expect from this market in the Exchange Markets report by the Shanghai International Energy Exchange INE.

Better accessibility presents a great opportunity for the international asset management community. And not only for the big firms, but also the »boutiques« such as the Scottish asset manager Baillie Gifford, who lets you in on its business credo in the Speakers' Corner: There are still many untravelled (investment) paths for international investors to track down and many »raw diamonds« to find – but you have to look beyond the beaten paths and become one with the market.

Opening up is often considered a question of rules and regulation. But it may be much more crucial to change ones perspective regularly. We hope this newsletter will inspire you once again to do so.

One important change in perspective is the fast growing importance of »sustainability«. CEINEX is proud to be a partner of the Future Europe Sustainability Conference on July 1 and 2 on the occasion of Germany's presidency of the European Council. This virtual global conference will also feature renowned speakers from China. More information to follow soon.

Yours sincerely,
CEINEX Corporate Communications

Talking Point

Chinese Capital Market Opens Up To Global Investors – What Changed, Who Benefits?

by Florence Lee, Head of China Business Development, HSBC Securities Services, London

For years, China's capital markets have been under the spotlight in the investment community. China is currently the second largest economy in the world. Likewise, both its stock markets' capitalisation[1] (Shanghai Stock Exchange and Shenzhen Stock Exchange combined) and bond market size[2] are the second largest in the world. However, unlike many of its peers, the foreign ownership of these assets is relatively low. As of Q1 2020, the foreign ownership in the China A-share market was about 3.1%[3], while the foreign ownership of Chinese bonds in total was less than 2.5% and the foreign ownership of Chinese government bonds slightly higher at 8.7%[4].

Despite the still relatively low numbers overall there have been waves of capital flows into China most recently, largely driven by index inclusions. On the equity side, all three major index providers, MSCI, FTSE Russell, and S&P Dow Jones, have already included China A-shares into their flagship indices. On the bond side, the Bloomberg Barclays and JP Morgan indices both started the phased inclusion of China bonds which are due to complete by end of this year. FTSE Russell announced in September 2019 it will retain the Chinese market on its watch list for potential inclusion[5]. It is estimated that over the next five to ten years, foreign capital flows into China A-shares will grow by over USD 600bn and by about USD 300bn into the Chinese bond market because of the index inclusions[6].

1 Foreign ownership of China A-share market

Source: PBOC market research paper

Clear commitment to further opening

Chinese regulators have demonstrated their commitment to continuously open up the capital markets by introducing a series of new regulations and rules over the past few months. The Qualified Foreign Institutional Investor (QFII) and the RMB Qualified Foreign Institutional Investor (RQFII) schemes have been the traditional gateways for

investors to access China. In early May, the People's Bank of China (PBOC) and State Administraion of Foreign Exchange (SAFE) announced the regulation (the new SAFE rules) to abolish the quota system on QFII and RQFII scheme. Effective from 6 June 2020, investors only need to apply for the license with the China Securities Regulatory Commission (CSRC), then submit a simple registration form to SAFE to complete the foreign exchange registration process. This has greatly shortened the application timeline and made the process much simpler. The new SAFE rules also unified the funding currency to allow flexible choice of offshore Renminbi (RMB) and/or foreign currencies and simplified the profit repatriation mechanism to allow self-declaration on tax payments. These new requirements not only streamlined the administrative processes, but also laid the groundwork for the proposed consolidation of the QFII and RQFII schemes - eventually to be just one scheme.

The CSRC had proposed early in 2019 to merge the two schemes and include enhancement features to facilitate global investors' further participation in China's markets. One of the most anticipated new rules is to broaden the investment scope of R/QFII to include more products such as financial futures, commodity futures, margin trading, securities lending, private investment funds, etc. These proposed rules are welcomed by diverse types of investors as they would benefit through better risk management and be able to deploy more sophisticated investment strategies in China. While the market is waiting for CSRC to finalise the rules, investors have shown increasing interest in R/QFII schemes and the application numbers are growing.

Infrastructure enhancements in the fixed income market

There are also market infrastructure enhancements in the fixed income market. In March this year, the two central securities depositories in China, China Central Depository & Clearing Co. Ltd. (CCDC) and Shanghai Clearing House (SCH), announced they will provide two new settlement services. The Settlement Recycling Service enables counterparties to re-initiate the settlement within a certain period if settlement fails. The second service, the Flexible Settlement Cycle Service meets investor requests for settlement cycles that cater for special conditions such as public holidays. According to CCDC data, the investment of overseas institutional investors (OII) in the Chinese bond market totalled USD 298bn in May 2020 (May 2019: USD

2 Foreign ownership of China bond market

226bn), a year-on-year hike of 31%. This marked the 18th consecutive month that OII increased investment in Chinese bonds[7].

China has also opened up its asset management industry further to global asset managers. Effective from 1 April 2020, foreign ownership limits in fund management company (FMC) joint ventures were removed, meaning global asset managers can now tap into the massive China onshore retail fund market and are allowed to increase the control of those JVs. Immediately after the restriction was lifted, BlackRock and Neuberger Berman submitted applications for their wholly-owned retail fund management companies in China, and JPMorgan will acquire 100% of its FMC JV in China. To be able to continue providing competitive services to global asset managers, a few international custodian banks, including HSBC, were accepted by the Chinese regulators to apply for the local fund custodian licences in the same month.

3 Yearly R/QFII Quota Approval Comparison

Year	QFII (USD bn)	RQFII (USD bn)	Combined Scheme
2018	4.7	6.92	11.62
2019	10.34	6.92	16.96

Source: SAFE

2020 has been a volatile year so far with many challenges ahead for all of us. China's financial markets are mid-way through another year of positive changes and liberalisation and it is clear they are heading for further reform, with more announcements expected soon. Stay Tuned.

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Speakers' Corner

Creating Connections Is Key For Long-Term Investors In China

by Baillie Gifford, Edinburgh

With tens of millions of prosperous consumers buying from innovative and ruthlessly competitive companies, China is both exciting and daunting for foreign investors. For an asset manager it does not only make sense to weigh risk and reward in China but also to conduct in-depth research on the ground.

Over the next couple of decades, more and more of the world's innovation and its exciting new business models will emanate from China, as well as from Silicon Valley and Europe.

Some of the most highly regarded Chinese companies like e-commerce giant Alibaba, food delivery app Meituan-Dianping, internet giant Tencent, online travel agent Ctrip and fast-growing shopping app Pinduoduo are on the roster of many investors. But these household names in China are all listed outside the mainland.

With Chinese capital markets becoming ever more open to foreign shareholders, it is a huge opportunity for institutional investors from abroad to focus on local markets and the renminbi-traded shares on the Shanghai and Shenzhen stock exchanges. In order to be successful, committed on-the-ground expertise and research into rising Chinese companies is crucial. It is not enough to calculate fair values on the basis of a discounted cash flow model.

Since the country's 'reform and opening up' drive was launched in 1979, GDP climbed on average by a head-spinning 9.5 per cent a year to 2018. Now 80 per cent of the market capitalisation of more than half its key industry sectors is listed in local markets.

Looking for the best investment opportunities here is a question of looking behind the scenes. Staying away from the noise of financial districts is extremely helpful to think long term. Similarly one could argue that, as a long-term investor interested in Chinese domestic markets, you should shun financial districts and have a deeper look into neighbourhoods where companies are in sectors such as fashion, the automobile industry, spirits and luxury goods. There you hear the stories from the very core of the Chinese business community.

As an alternative to monitoring financial news and traditional financial analysis, it is important to use independent sources away from the noise of the common financial communities, but rather draw on insights from industry leaders, scholars and independent thinkers to learn more about their vision. As an example, founders and owners of the next generation of companies are going to transform entire industries. So, we should invest time with them to find out how they see that transformation – and China in general – developing in the next five to ten years. Then there is the academic perspective, which includes Chinese Government think tanks and writers. Also journalists and independent writers who have insights into companies that investment banks don't have. The most promising investment ideas of tomorrow cannot be found on today's stock lists, especially as many of them will remain non-listed for a long time.

It is crucial to put in the legwork to make first contact with China's often elusive domestically-listed and private companies. In China, connections do matter. For example, gene-sequencing is an area that will likely show huge growth in the future. In order to understand the respective industry in China it is important to look at companies like Berry Genomics or China National GeneBank in Shenzhen, a joint venture between the Chinese Government and Berry's competitors BGI. Due to their commercially sensitive data, both companies are – and will remain for the foreseeable future – domestically-listed. The gradual building of these relationships are essential for winning their trust in order to be a potential early investor for these companies in the future.

As China, its companies and markets attract more international investors, achieving a better understanding of the landscape matters more. Those scouting the horizon, looking beyond the streams of financial news and developing networks may be best able to secure long-term growth.

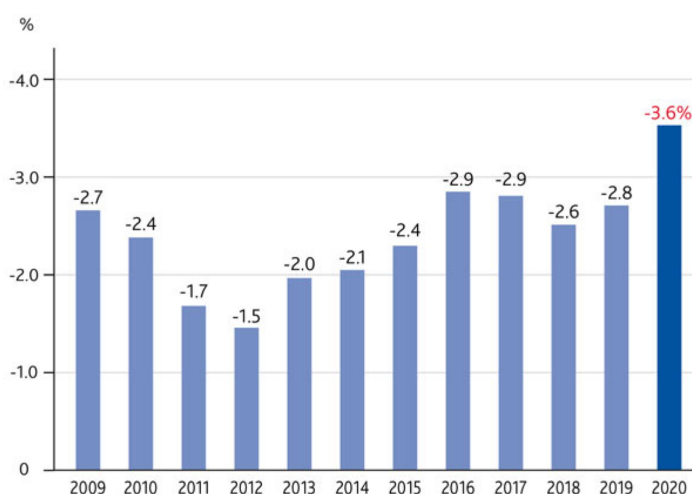
Policy Update

Five Key Learnings From The National People's Congress

by Dr. XU Bin, Professor of Economics and Finance, Associate Dean (Research), China Europe International Business School (CEIBS), Shanghai

The annual meeting of the National People's Congress (NPC), China's top legislative body, concluded on May 28. The meeting was delayed from March to May due to the Covid-19 pandemic. This is China's most important annual political meeting where the government announces key economic policies for the current year and points out the direction for future years. This year's meeting also provided a window for the outside to learn about the measures the Chinese government will take to speed recovery from the pandemic-caused economic downturn--which featured a 6.8% drop (year-on-year) of first quarter gross domestic product (GDP)--and the plans China is formulating for the post-pandemic era as the country will start its 14th Five-Year Plan in 2021.

In this article, I highlight five aspects that are worth everyone's attention.



Source: National Bureau of Statistics, China

First, despite not setting a GDP growth target for the current year, the Chinese government will strive for a growth rate much higher than the IMF forecast of 1.2%. The Work Report delivered by Premier LI Keqiang did not specify a GDP growth target set for 2020, which was interpreted by many observers as indicating that China is moving away from this GDP-focused practice. In my view however, this would be a misinterpretation. The truth is, while the Chinese government did not set an explicit growth target, the policies announced in the meeting reveal that the government would not accept a GDP growth rate lower than 2% for the current year and that it will make all the efforts to achieve an implicit growth target of around 3%.

Second, the meeting reveals that China will use a large dose of expansionary fiscal policy to achieve this implicit GDP growth target. Premier LI announced that the government is increasing the budget fiscal deficit to an all-time high of 3.6% of GDP, much higher than the 2.7% in the global financial crisis year 2009 and the 2.8% of last year (see chart). According to the report, there will be an increase of RMB 2tn (USD 281bn) of special treasury bonds this year for investments in "new infrastructure" such as 5G networks and new energy vehicles (NEV) charging stations. Moreover, the government will use various measures to provide a relief of RMB 2.5tn (USD 351bn) in total this year for the corporate sector. China's monetary policy will accommodate the fiscal policy. In an interview during the meeting, central bank governor YI Gang said that the central bank will ensure sufficient liquidity and maintain the growth rates of the money supply as well as total social financing, which is China's all-included measure of liquidity, at significantly higher levels than in 2019.

Third, the meeting sent a clear message that China will increase its effort in building its own technological innovation capacity. China's Research & Development (R&D) intensity, measured by R&D expenditure as percent of GDP, increased from 0.89% in 2000 to 2.19% in 2019 (see chart). In recent years however, the pace has been slowing down and China is on its way to miss the 2.5% target set in the 13th Five-Year Plan (2016-2020). In the Work Report, Premier LI vowed that the government will push enterprises to increase investment in R&D, support the development of private R&D institutions, strengthen intellectual property protection, and introduce an open competition mechanism to select the best candidates to lead key research projects. These words indicate clearly that, in the coming 14th Five-Year Plan (2021-2025), the Chinese government will place a greater weight on supporting indigenous technological innovation by Chinese enterprises.

Fourth, China will see further development of new forms of businesses in the digital economy. In response to the Covid-19 pandemic, new forms of business such as online shopping, express delivery services, and teleworking are booming. In the meeting, Premier LI set the goal for the number of newly registered businesses to be at about 20,000 on an average day and he considers this figure as an important indicator to gauge the economic vitality of China. In the 14th Five-Year Plan (2021-2025), China is expected to make great efforts in building "new infrastructure" such as 5G networks to facilitate Internet-plus initiatives and expand the digital economy.

Fifth, expecting to face an adverse international environment, China will look for new growth momentum from within. In the meeting, Chinese leaders repeatedly emphasized the enormous potential of China's domestic demand. Indeed, consumption has surpassed investment and net exports as the main driver of the Chinese economy in recent years, now accounting for about two-thirds of China's GDP growth.

Overall, this does not mean however that China will move towards a closed economy. On the contrary, China will seek more openness to the outside. Premier LI stated that China will continue to nurture the global supply chains and keep them stable. In the 14th Five-Year Plan, China will set the agenda to engineer a new round of opening-up in the areas of cross-border e-commerce and trade in services. China will provide policy incentives for foreign investment in high-tech manufacturers and high-end services. While China will be prudent with regard to financial opening, the government has in its agenda to reform domestic financial markets, improve financial infrastructure, and promote RMB internationalization.

5 China's R&D expenditure in % of GDP

Source: World Development Indicators, World Bank

Macro View

China Economy After Covid-19: Back To Potential

by LIAO Qun, Chief Economist, China CITIC Bank International

A widespread concern has arisen in the market with regards to whether China's economy will return to normal or enter into a new normal after the Covid-19 pandemic. My response, which is intended to be clearer and more straightforward, is that the Chinese economy will return to its deserved potential after the pandemic is really contained.

A record economic downturn in Q1 hit by Covid-19

The Covid-19 pandemic has hit China severely and resulted in a record quarterly economic downturn. GDP growth in Q1 2020 turned out as negative as -6.8%, the worst on record. This was really shocking for a country such as China which has enjoyed a Compound Annual Growth Rate (CAGR) of 9.4% over the past 41 years.

As in other countries, this downturn was a direct and inevitable result of the unprecedented nationwide lockdowns of regions, factories and various kinds of businesses as well as other ultra-harsh measures to contain the pandemic. The downturn was across the board, with the three major sectors of manufacturing, services and agriculture on the supply side and the three growth engines of consumption, fixed assets investment and exports on the demand side all posting a deeply negative growth in Q1.

Domestic demand to recover step by step towards its potential, supported by reinforced policy easing and deepened reforms

Relaxations of the lockdown began in most regions of China around mid-March as the Covid-19 pandemic was largely put under control domestically, followed by a step-by-step easing of other pandemic containment measures. As a result, domestic demand has been recovering since March with the majority of activity indicators registering slower contractions in April and posting stronger rebound in May.

The recovery is poised to gather pace going forward as the pandemic vanishes domestically and subsides globally, supported by reinforced policy easing by the Chinese government. While the pace may not soon meet what the market expects given the uncertainty of the pandemic, it can be realistically expected that growth in domestic demand will turn around from negative to positive from Q2 on and turn positive for 2020 as a whole.

More importantly, it is believed that »revenge consumption and investment« will emerge once the pandemic is really contained both domestically and globally and hence the domestic recovery will keep accelerating until its growth potential is reached. This belief is built firstly on conventional wisdom that a full recovery from sickness is normal for a young patient and secondly on the judgement that the Chinese economy it is still an emerging and developing

economy with per capita GDP being about one quarter of that of developed economies and thus has plenty of potential to grow and upgrade further. Meanwhile, it is expected that deeper institutional reforms on many under-reformed areas in the country will help unleash the potential in a significant way. The SOE (state-owned enterprise) reform will accelerate to make the state-owned enterprises more market oriented; the financial reform will deepen in order to modernize the capital market and banking system so as to better serve the high-tech companies as well as the SMEs (small and mid-cap enterprises); plus, the regional development reform will gain further momentum to foster and strengthen »City Clusters«.

External headwinds more challenging but to be weathered with a more selective market opening-up

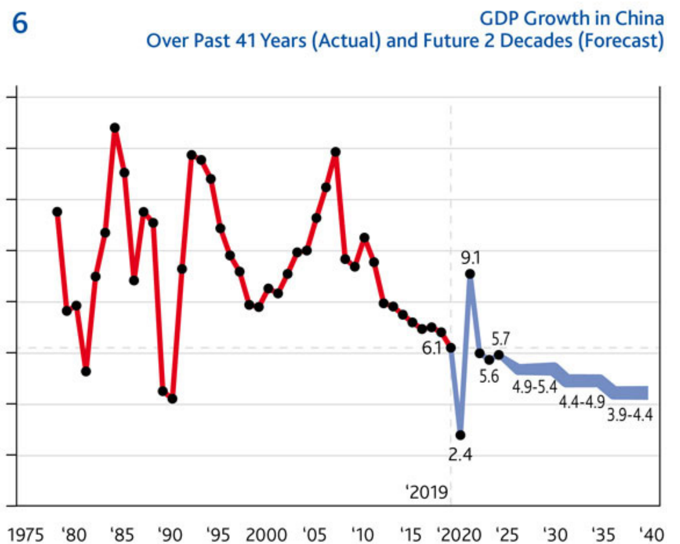
Admittedly, external headwinds will be more challenging for China in the post-Covid-19 period. The two biggest while also related issues are a possible China-US economic decoupling and a sharper trend of the global supply chain moving out of China.

It is true that China--US relations have been worsening rapidly in recent months and are poised to further deteriorate going forward, which is indeed a severe challenge for China after the pandemic. Having said that, however, the deteriorating may not necessarily lead to a full China--US decoupling as many worried, since it would be disastrous to both countries given that the China-US coupling is highly mutually beneficial.

It is also possible that the trend of global supply chain moving out of China will sharpen in the post-Covid-19 period, with more foreign companies relocating their factories from China back to their home countries or other cheaper and less politically-sensitive countries. It is worth noting, however, this trend in fact started about ten years ago. But China's exports of goods and value-added output of manufacturing as percentages of global exports of goods and value-added output of manufacturing have increased from 9% and 17% to 13% and 31% respectively in these ten years, indicating that the trend has actually been far less sharp than many had expected. The critical success factor of China in this regard is the international competitiveness of its labor force which is well balanced between cost and quality. This success factor is poised to continue prevailing in the foreseeable future, and as a result the expectation of a sharp change in the global supply chain after the pandemic would prove untrue again.

These two headwinds are therefore not something unmanageable. To weather them, the Chinese government is believed to resort to a more selective approach for the country's opening-up, aimed to re-define and spot the markets and entities for opening-up in various dimensions of country/region, industry, enterprise group, product and project, which is expected not only to mitigate their impacts but also to turn them into new opportunities.

6 GDP Growth in China Over Past 41 Years (Actual) and Future 2 Decades (Forecast)



Source: Actual data: National Bureau of Statistics, China
Forecast data: China CITIC Bank International

Back to potential – mid & high growth

With the domestic demand returning to potential levels and the external headwinds largely weathered, the growth potential of China's economy will return next year if the pandemic is fully contained. Even if a full China-US decoupling and the sharp change in the global supply chain take place, the return of the growth potential may be postponed but cannot be stopped.

So what is the growth potential for China's economy in the next stage? Having experienced a high growth of above 9% per year for over 40 years, the Chinese economy is entering a period of mid & high growth with the potential growth rate ranging between 4-6% per year for the next two decades. The slowdown from the high growth reflects a fated growth pattern at a certain stage for any developing economy to emerge from underdeveloped towards developed according to the Theory of the Stages of Economic Growth. And the settling to the mid & high growth stems from the strength of fundamentals of the Chinese economy determined by its competitive labor force.

The drivers for growth will be consumption on the demand side and services on the supply side at the macro level as well as the so called »strategic emerging industries« led by the new generation of information technology at the sectoral level.

It can also be expected from the Theory of the Stages of Economic Growth that the potential growth rate will be higher for the next decade than that of the following one. Hence, the Chinese economy is expected to grow by 5-6% per year in the next five to ten years. With an exemption for 2021, in which growth may be as high as 8.9%, jumping from the trough with an expected 1.9% in the pandemic-hit 2020.

Exchange Markets

Shanghai Crude Oil Futures Playing An Increasingly Important Role In A Volatile Market Environment

by Shanghai International Energy Exchange (INE)

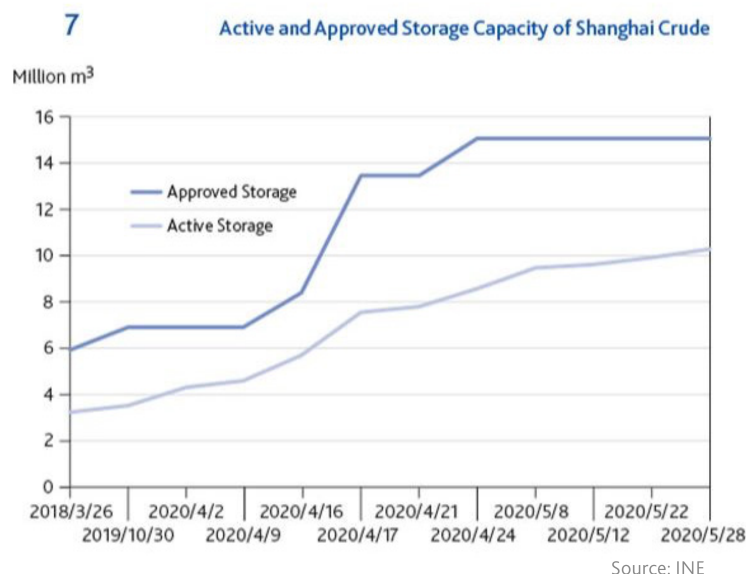
With the spread of Covid-19 worldwide and the impact of uncertainties over a production cut on oil supply and demand, the price of global crude oil futures has fluctuated sharply. On 20 April, WTI crude for May delivery plunged over 300% to USD -37.63/barrel, closing in negative territory for the first time in history. Brent crude also slumped. Against the backdrop of extreme prices globally, Shanghai crude, the world's third largest crude oil futures benchmark after WTI and Brent, is also under huge pressure and challenges.

In such a volatile market environment, Shanghai International Energy Exchange (INE) takes risk control as its first priority and manages risks properly. Faced with huge price fluctuations, INE raised the price limit and the trading margin rate in order to release market risks and ensure the smooth operation of the market. Meanwhile, in order to prevent any delivery risks, INE increased the storage capacities for crude oil futures since this year. Up until early June, the number of delivery storage sites has been increased to 14 with an active storage capacity of 10.4 million cubic meters.

During the pandemic, the open interest of Shanghai crude increased rapidly to record highs. From the beginning of 2020 to 29 May, the average daily trading volume of Shanghai crude reached 162,000 lots and the average daily open interest reached 108,000 lots, which was more than two times the number of 2019. In April alone, Shanghai crude recorded an average daily trading volume of 216,000 lots with a year-on-year increase of 52% and surpassing Brent crude during the Asian trading hours. On 20 April, the open interest of Shanghai crude hit a record high of 188,400 lots; the trading volume reached a record high of 494,800 lots on 19 May. At the same time, the smooth operation of Shanghai crude has attracted more and more overseas clients. From the start of 2020 to 29 May, the average daily trading volume and the average daily open interest of overseas clients in proportion to all market players increased by 1% and 6% respectively compared with that of 2019.

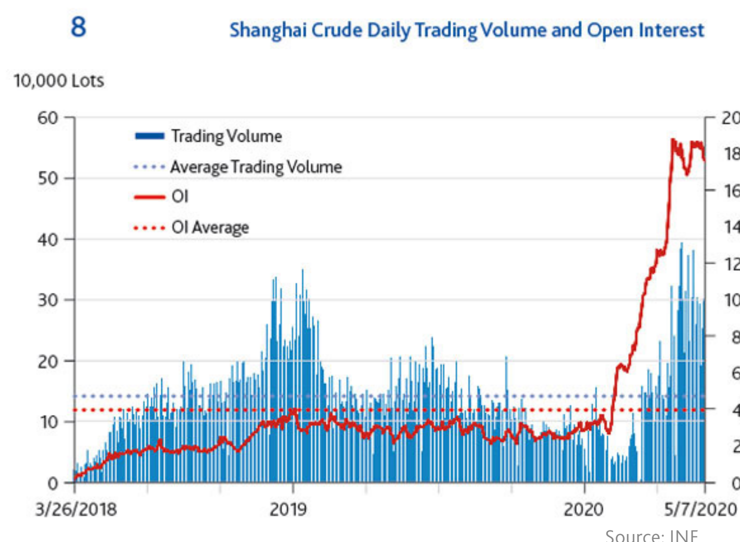
Since the launch of Shanghai crude, INE has inquired public opinions on many occasions and made several amendments to improve its rules, such as the introduction of market makers and the simplification of account opening procedures. Moving forward, INE will continue to improve its rules, and accelerate introducing trading at settlement (TAS), in order to provide highly efficient risk management tools for investors. INE will also explore overseas markets, and provide risk management and hedging tools not only for Chinese investors but also for global clients.

7 Active and Approved Storage Capacity of Shanghai Crude



Source: INE

8 Shanghai Crude Daily Trading Volume and Open Interest



Source: INE

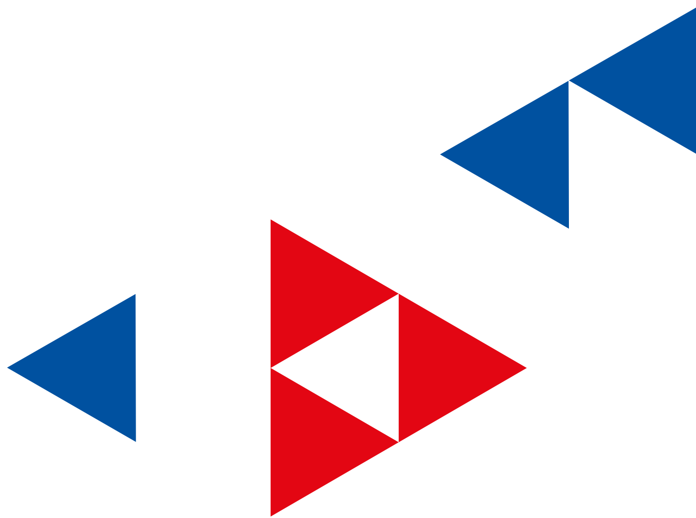
With the approval by the China Securities Regulatory Commission (CSRC), INE was established in Shanghai in 2013. It is a wholly-owned subsidiary of Shanghai Futures Exchange (SHFE). SHFE is one of the four futures exchanges regulated by the CSRC. According to FIA statistics, SHFE has been the world's largest commodity derivatives exchange by trading volume for four consecutive years. As the international platform of SHFE, INE is the forerunner in the globalization of SHFE and China's futures market. In March 2018, Shanghai crude oil futures were launched on INE as the first Chinese futures contract open to overseas investors, marking the start of the opening up of China's futures market. Apart from Shanghai crude, INE also listed TSR20 futures and plans to launch low sulfur fuel oil futures in the near future. INE also plans to launch a copper futures contract. All these products are or will be open to overseas investors.

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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