China Development Bank Financial Research Centre

Shanghai-Hong Kong as the Financial Centre of the World

by

Lawrence J. Lau

Working Paper No. 6

April 2012

Institute of Global Economics and Finance
The Chinese University of Hong Kong
13/F, Cheng Yu Tung Building, 12 Chak Cheung Street, Shatin, Hong Kong

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[1] Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong and Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University. This is a slightly revised version of the lecture presented by the author at Fudan University, Shanghai, at the Honorary Doctorate Degree Conferral Ceremony, 11th April 2012. All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organisations with which the author is affiliated.

1. Introduction

Definition of "financial centre of the World"

What is meant by a "financial centre of the World"? A financial centre of the World is a place where:

(1) enterprises and entrepreneurs come from all over the World to raise money in the form of either equity capital or debt, or anything else in between; and

(2) institutional and individual investors come from all over the World to make investments, to buy, sell and hold securities and other financial instruments, and to hedge financial risks.

In other words, a financial centre of the World is a place where both the World demand for and World supply of capital (financial assets) come together as their mutual **first choice**.

The demand for capital will go to wherever the supply of capital is expected to be the largest and the easiest available. The supply of capital will go to wherever the return is expected to be the highest, which is the same as where the demand for capital is expected to be the largest and where enterprises and entrepreneurs are expected to go first to raise money. A large capital market maximises the potential choices for both the demanders and suppliers of capital and simultaneously maximises the returns to capital to investors and minimises the cost of capital to capital users. Today, the economies of scale of a capital market are even larger, thanks to advances in the information and communication technology. Both the demand for and supply of capital will go first to wherever the capital market is expected to be the largest. Such expectations can be self-fulfilling and do not change easily once established.

Hong Kong and Shanghai are already separately international financial centres of China in their own rights. However, as the following two charts show, Shanghai or Hong Kong each going alone is not large enough to become the "Financial Centre of the World". Either Shanghai or Hong Kong by itself is smaller than both London and Tokyo (see Chart 1); even though they are larger than all the other stock exchanges in East Asia (see Chart 2). Neither of them have the necessary scale as yet to attract capital from all over the World.

Chart 1: End of Year Market Capitalisation of Selected Stock Exchanges

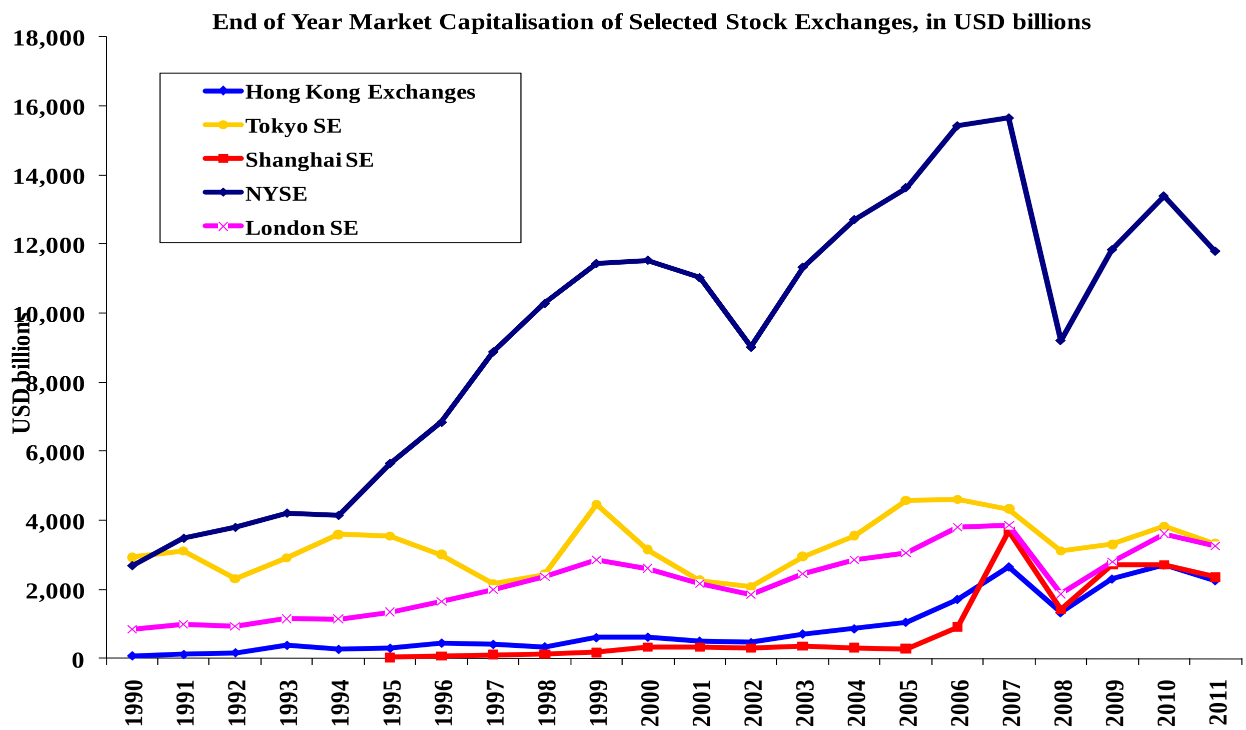
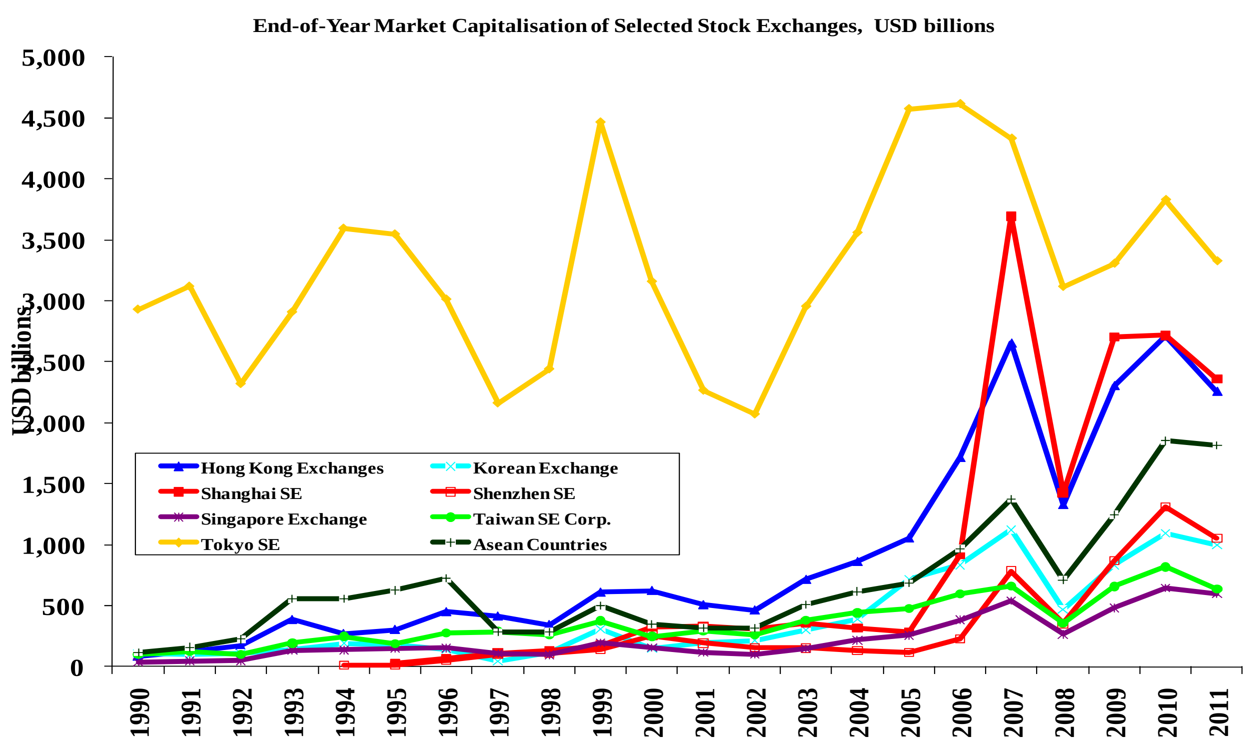
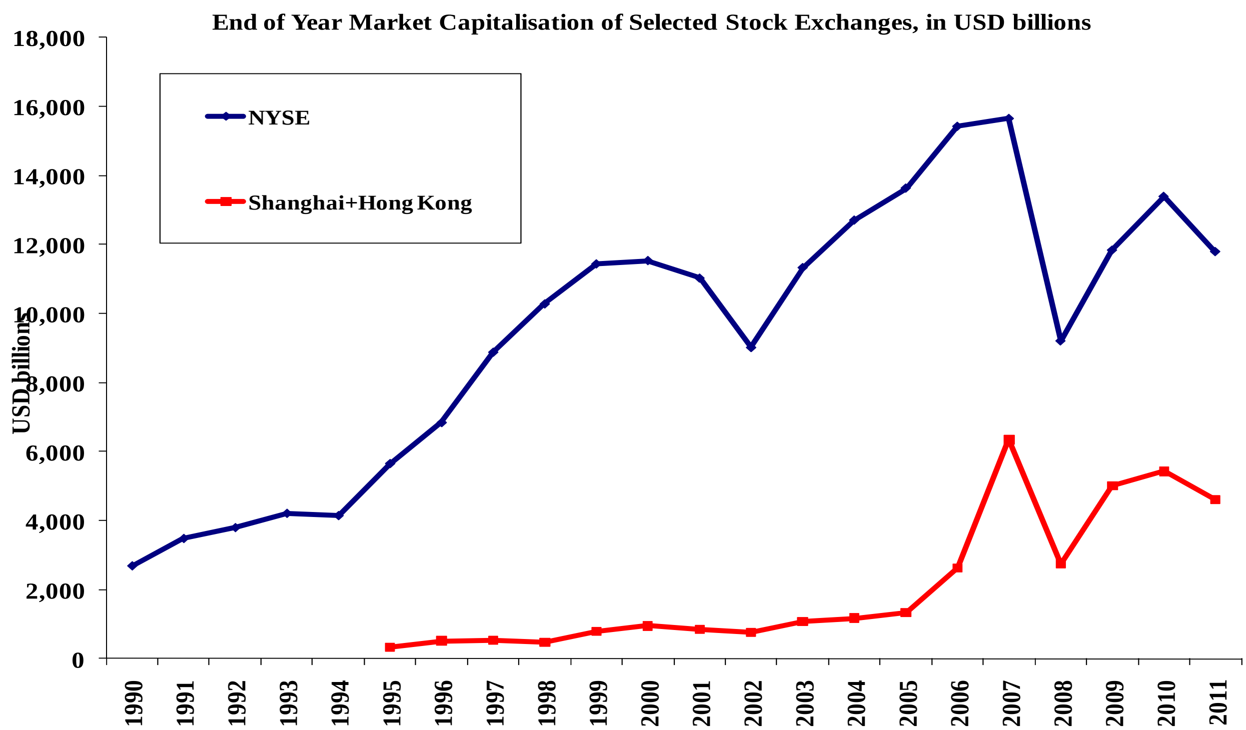


Chart 2: End of Year Market Capitalisation of Selected East Asian Stock Exchanges



But Shanghai and Hong Kong stock exchanges combined will be larger than either the Tokyo or the London Stock Exchange, behind in size only to New York. It then becomes more realistic and likely for a combined Shanghai-Hong Kong to surpass New York eventually than for either city going alone, recognising that both the demand for and the supply of capital are likely to go first to the capital market expected to be the largest.

Chart 3: End of Year Market Capitalisation of New York and Shanghai-Hong Kong Exchanges



For a market to have a chance at becoming No. 1, it is essential that everyone expects it to become No. 1. Thus, instead of competing with each other to become the international financial centre of China, Shanghai and Hong Kong should cooperate and together achieve the win-win outcome of becoming the "Financial Centre of the World". Given the advances in information and communication technology, they can transcend the geographical separation and become virtually an integrated financial centre. It will be the first such centre in the World.

Can these two cities, which are almost 1,000 miles apart (974 miles or 1,568 kilometers, to be exact), join together to become the “Financial Centre of the World”? While the geographical distance between the two cities cannot be changed, the cyber-distance, cultural distance and the psychological distance can be significantly reduced. On the internet, the two cities, indeed, the two stock exchanges, can be virtually next to each other, with trades initiated in one city executed in the other instantly and vice versa. Given the advances in telecommunication, through the use of dedicated trunk lines, telephone calls between the two cities can become local calls, with the parties being able to see each other visually if desired. Through the use of video- and tele-conferencing facilities, the two places can be virtually integrated as one. In fact, the link between Shanghai and Hong Kong, can be indifferent from the link between Pudong and Puxi, or the link between Hong Kong and Kowloon.

There are many Shanghai natives and their descendents resident in Hong Kong—some of them came to Hong Kong more than 60 years ago. Similarly, there are also many Hong Kong natives resident in Shanghai today. Shanghai used to be the most internationalised Chinese cities before 1949, even more so than Hong Kong at the time. Hong Kong is today Asia’s World City. The cultural and psychological distances between the two cities can be readily bridged.

Even with a combined Shanghai-Hong Kong stock exchange, the market capitalisation is still less than approximately 40 percent of that of New York (see Table 1). Thus, a great deal of work remains to be done for Shanghai-Hong Kong to become the “Financial Centre of the World”. Shanghai and Hong Kong will have to make good use of their own unique advantages

Table 1: Year-End Market Capitalisation of New York and Shanghai-Hong Kong Stock Markets

Year-End Market Capitalisation of New York and Shanghai-Hong Kong Stock Markets

	2010	2011
	US$ trillions	
New York Stock Market	13.4	11.8
Shanghai-Hong Kong Stock Markets	5.4	4.6

What Shanghai-Hong Kong has going for it is that the value of their combined initial public offerings (IPOs) has exceeded that of New York for every year since 2006 except 2008, the year of the failure of Lehman Brothers (see Chart 4). Similarly, the average annual rate of growth of the market capitalisation of the Shanghai-Hong Kong exchanges has also significantly exceeded that of New York over the past decade (see Chart 5).

Chart 4: Annual Value of IPOs of New York and Shanghai-Hong Kong Stock Exchanges

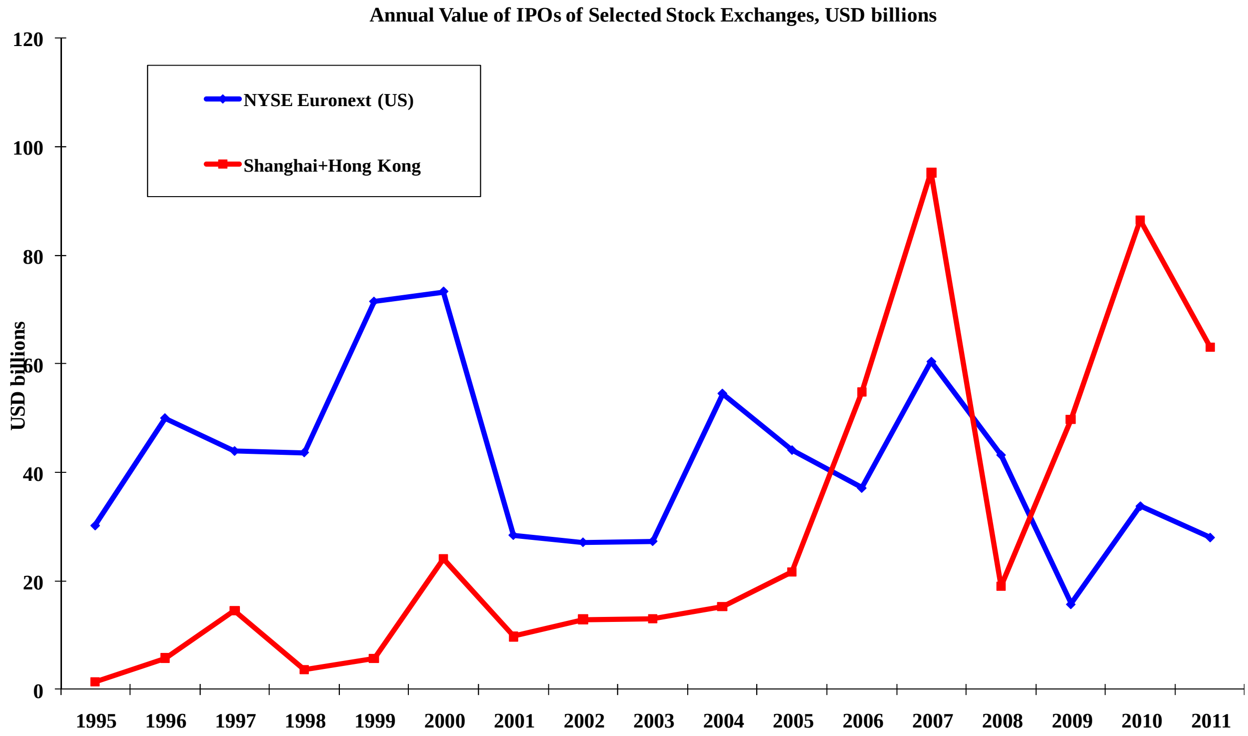
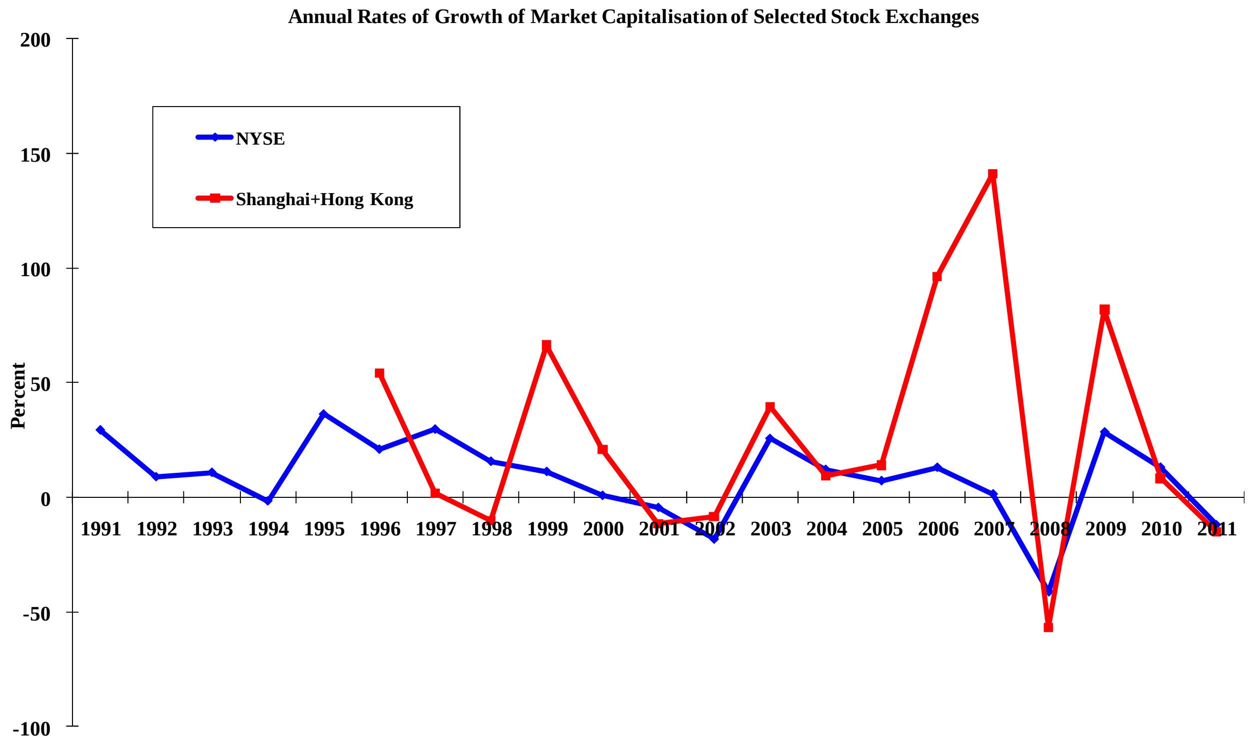


Chart 5: Annual Rates of Growth of Market Capitalisation of Selected Stock Exchanges



2. The Existing Economic Environment

The Chinese savings rate is among the World's highest, approaching 50 percent at times (see Chart 6), and it is even higher than the investment rate. China, especially Mainland China, is a major source of surplus savings, which can be utilised by the rest of the World. Thus, the supply of capital will be ample in Shanghai-Hong Kong, backed by the high Chinese national savings rate. By comparison, the developed countries of the West are short of capital because of their relatively low national savings rates, the depressed state of their economies, their huge public debts relative to their GDPs and the need for their financial institutions to de-leverage.

Chart 6: Savings Rates of Selected Asian Economies (since 1952)

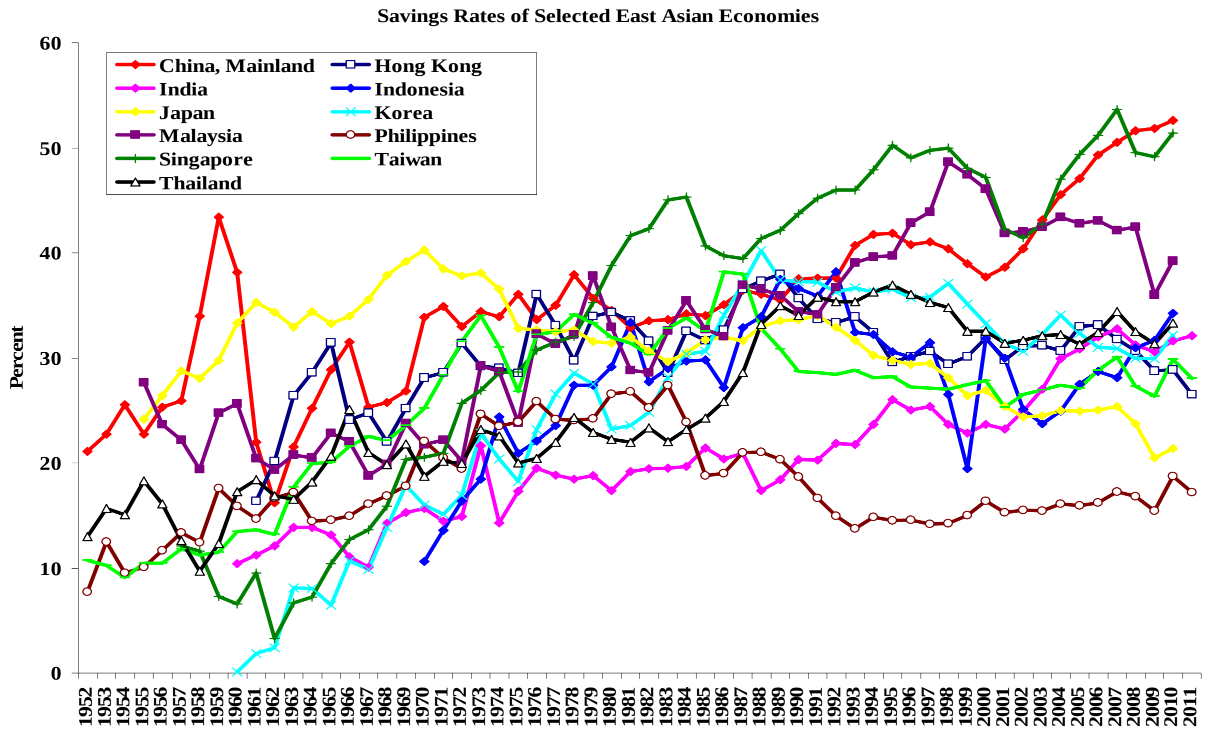
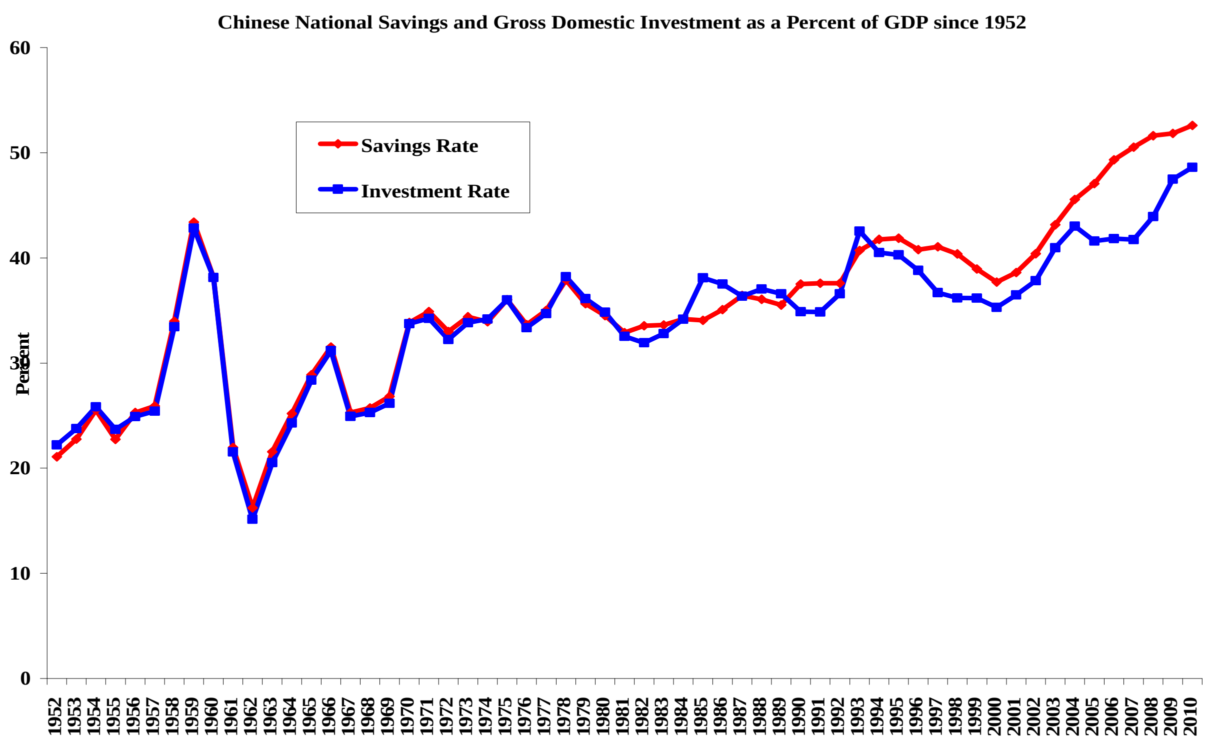


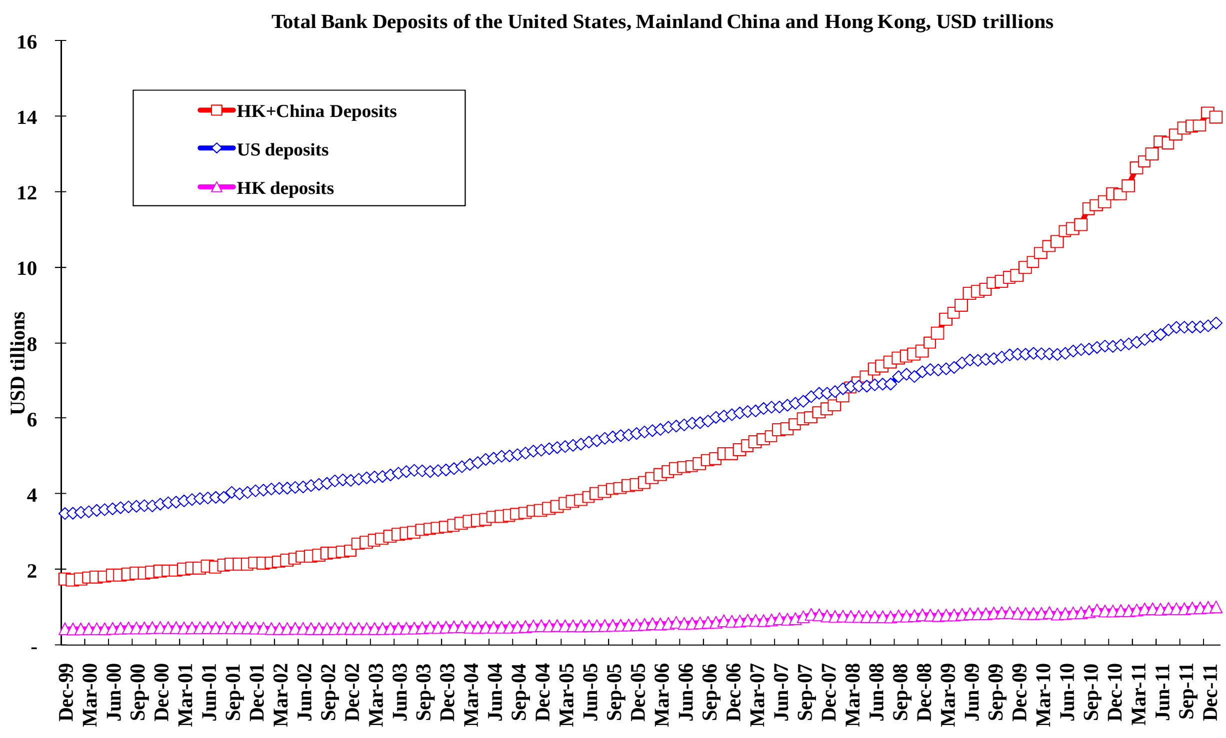
Chart 7: Chinese National Savings and Gross Domestic Investment as Percents of GDP



Chinese enterprises, both state-owned and private, now have the desire to diversify their investments and businesses, and also invest abroad. Similarly, with limited domestic options for financial investments, Chinese portfolio investors also desire to diversify their portfolios beyond China, if given the opportunity. Direct and portfolio investors worldwide all want to invest in the fast-growing economies of Asia, in particular, China and India. Shanghai-Hong Kong provides the ideal entry point.

The financial assets of Chinese households have grown enormously over the past decade. For example, bank deposits have increased by leaps and bounds in Mainland China, currently standing at US$13 trillion, compared to US$8.4 trillion for the U.S. and less than US$1 trillion for Hong Kong (see Chart 8). A combined Shanghai-Hong Kong will have access to the "deep pockets" of the Chinese savers, who will be able to supply the capital for the market, a potential recurrent supply that may exceed that of the U.S..

Chart 8: Total Bank Deposits of the U. S., Mainland China and Hong Kong



Chinese private enterprises will increasingly rely more for their financing on the capital markets, both at home and abroad, than on loans from the state-owned domestic commercial banking sector. This development has the potential of creating another large and growing source of demand for capital in Shanghai-Hong Kong.

For good reasons, China still maintains controls on both capital inflows and outflows, whereas Hong Kong has no controls whatsoever. Although it is likely that China will relax controls on long-term capital inflows and outflows, short-term capital flows will probably continue to be controlled at least for a while because of their potential in disrupting the foreign exchange market and de-stabilising the exchange rate, thus adversely affecting the real economy. Shanghai and Hong Kong working together can thus provide great flexibility for China. Short-term capital flows can be routed through Hong Kong whereas long-term capital flows can be routed through Shanghai.

Finally, Shanghai-Hong Kong can have some advantages in the area of regulation compared to New York. For example, the Sarbanes-Oxley Act, which imposed very significant costs on publicly listed companies in the U.S., has been totally ineffective in preventing the occurrence of the 2007-2009 financial crisis. Financial derivatives such as credit default swaps are totally unregulated and did major damage to the bond market. Neither is high-speed computerised trading. Shanghai-Hong Kong can adopt regulations that make the capital market fairer, safer, and more transparent as well as more stable.

3, The Complementarity of Shanghai and Hong Kong

Shanghai and Hong Kong are similar in many ways—they share the following commonalities:

First, both are active international financial centres;

Second, both are centres of international trade and logistics;

Third, both have world-class research-oriented universities such as Fudan University and Shanghai Jiaotong University in Shanghai and the University of Hong Kong and the Chinese University of Hong Kong in Hong Kong;

Fourth, both have well-educated labour forces and a tradition of internationalism;

Fifth, both have an entrepreneurial environment. and

Sixth, both are in the same time zone.

However, Shanghai and Hong Kong are also different in many aspects. And these differences mean that they can complement each other.

First, Shanghai is backed by an ample supply of capital because of China's high national savings rate. Hong Kong's savings rate is much lower. In addition, Hong Kong's GDP is only a small fraction of the Chinese GDP.

Second, China still maintains control on capital inflows and outflows and the Renminbi is not yet fully capital account convertible. The Renminbi exchange rate determination mechanism is a managed float. Hong Kong has a completely convertible and stable currency, pegged rigidly to the U.S. Dollar, completely free capital mobility and has long maintained large active markets in the major foreign currencies.

Third, geographically, Shanghai is centrally located in East China; and Hong Kong is located at the junction between Mainland China and the ASEAN region. Hong Kong has also in the past served as a safe haven for capital from Southeast Asia, especially in the 1950s and 1960s. Shanghai and Hong Kong serve different hinterlands.

Fourth, there is ease of travel, residents from the majority of the world's countries and regions can enter Hong Kong without visa. Academic freedom and freedom of information in Hong Kong, facilitates its being a capital market for both capital users and capital providers and a hub for deal flows where investigation and due diligence can be readily carried out.

Fifth, Hong Kong has low corporate and individual income tax rates, and no tax on bank interest, capital gains and cash dividends. China has much higher progressive corporate and individual income tax rates, as well as taxes on bank interest and cash dividends.

Sixth, there is in Hong Kong a well-functioning, efficient, transparent and credible judicial system, which facilitates contract enforcement and adjudication of claims.

Seventh, Hong Kong has an experienced and seasoned labour force in international finance. Shanghai has been also been catching up rapidly.

4. The Division of Labour, Specialisation and Collaboration

How can Shanghai and Hong Kong divide their responsibilities, specialise and collaborate to make Shanghai-Hong Kong the “Financial Centre of the World”?

Some high-quality securities can be listed dually in both Hong Kong and Shanghai. Dual-listing enlarges the total market for the securities of an enterprise and leads to increased trading volume, greater liquidity and better pricing. It also allows overseas investors to buy and sell Mainland Chinese shares without having to move capital into and out of Mainland China. Foreign investors can buy and sell Mainland Chinese shares in Hong Kong or Chinese depositary receipts for the same shares in Shanghai; domestic Chinese investors can buy and sell not only Chinese shares but also non-Mainland shares dually listed on Mainland Chinese stock exchanges.

Securities for cross-listing will be subject to the approval of the regulators of both the primary listing and the secondary listing markets. Regulation and supervision of enterprises of such matters as disclosure and corporate governance should be left to the respective regulator for the primary listing. The local regulator and supervisor will be responsible for enforcing compliance with the rules of market conduct, such as the prohibition of insider trading or stock manipulation. The secondary listing can be in the form of ordinary shares or depositary receipts. Depository receipts have the advantage that trading can be done in the local currency by domestic investors without any foreign exchange conversion and hence disruption of the foreign exchange market is minimised. The trading of shares (including depositary receipts) on the Shanghai Stock Exchange can be done in Renminbi; the trading of shares (including depositary receipts, if any) on the Hong Kong Stock Exchange can be done, in principle, in multiple currencies (Hong Kong Dollars, U.S. Dollars, or Renminbi).

It is expected that the International Board will be launched in Shanghai, attracting major non-Mainland-listed (including foreign-, Hong Kong-, Macau- and perhaps even Taiwan-listed) enterprises to dual-list in Shanghai, with trading in Renminbi. The introduction of the International Board will allow major foreign firms such as Boeing and Microsoft to raise funds by issuing shares (Chinese depositary receipts (CDRs)) in Renminbi in Shanghai. It will also provide Chinese institutional and individual investors much wider investment choices. Non-Mainland enterprises can also issue Renminbi-denominated debt in Shanghai. The Renminbi funds so raised can be used within China or converted into foreign exchange and remitted out of China for use elsewhere.

Mainland enterprises listed in Shanghai can also issue shares in the form of Hong Kong depositary receipts (HDRs) with trading in Hong Kong Dollar or U.S. Dollar or even Renminbi. This allows non-Mainland institutional and individual investors to invest in Mainland enterprises the option of not having to use Renminbi, facilitating subsequent exit. The foreign exchange funds so raised by the Mainland enterprises can be used outside the Mainland, for example, for direct investment in other countries. They can also be converted into Renminbi and remitted back to the Mainland if needed. Note that the capital inflow or outflow that occurs when depositary receipts are created is only a one-time flow and does not create a continuous demand for Renminbi conversion.

Opposition to dual-listing (and to the International Board in Shanghai), mostly by securities brokers in the primary listing market, is based on the mistaken notion that what should have been their business is being taken away by securities brokers in the secondary listing market. What they fail to understand is that the pool of potential investors is now enlarged, and that there will be additional new demand for the securities and increased liquidity, and that in the absence of the new demand from the secondary listing market, the additional share issuance may not have taken place at all.

Opposition to dual-listing (and to the International Board in Shanghai), mostly by investors in the secondary listing market, is based on the mistaken notion that there is a fixed total demand for securities in the market and that the introduction of new supply (in the form of dually-listed shares) will drive down the average price level in the market and devalue their existing investments. What they fail to understand is that the new supply of securities will attract new investors and enlarge the overall market demand.

While the International Board in Shanghai will be able to attract major multinational companies to dual-list in Shanghai, Hong Kong can focus on attracting major companies from the ASEAN region (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) to list in Hong Kong, making use of its long-standing close relationship with businesses, especially ethnic Chinese-owned businesses, in the region. More recently the Hong Kong Stock Exchange has also listed Russian, Italian and Mongolian enterprises. However, Hong Kong has unique historical advantages when it comes to attracting ASEAN enterprises.

The time is ripe for the development of a unified East Asian stock market in which the shares of the major firms in every East Asian country or region can be traded in the form of depositary receipts. A unified stock market allows the East Asian savings to be deployed more efficiently and the cost of capital to East Asian enterprises to be lowered. Hong Kong is the ideal location for such a stock exchange, as well as for a unified East Asian bond market trading bonds issued by East Asian entities denominated in either local or international currencies. For East Asian enterprises and investors in East Asian enterprises, liquidity and ease of potential entry and exit are more important considerations than capacity (scale). That is why Hong Kong may be a better location than Shanghai.

The provision of venture capital is different from other types of financing. Typically, the amounts involved are not large, but the assessment requires proportionately much greater efforts. Also, the chance of success is relatively lower for venture capital. Hong Kong, because of its open travel policy, its complete freedom of capital flow, its freedom of information access, is the preferred place to become the centre of venture capital in not only Greater China but East Asia as a whole. Its low tax environment is also an advantage. The judicial system in Hong Kong is also ideal for the protection of property rights, especially intellectual property rights. Venture capital needs the protection of intellectual property very much.

There is now sufficient insurance (including casualty, property and life) business generated in and sufficient risk-bearing capacity provided by Greater China and East Asia that consideration should be given to the establishment of a centre for insurance and re-insurance in Greater China or East Asia so as to reduce the dependence on London and Zurich and the net cost of insurance in the process. Shanghai and Hong Kong can collaborate to make it happen--with Hong Kong administering the insurance policies and adjudicating the insurance claims, making use of its efficient, fair, transparent and credible courts and with Shanghai mobilising the risk capital necessary to sustain the insurance pool. (If casinos in Macau can do such a thriving business, there must be sufficient risk capital to be tapped!)

Long-term cross-border direct and portfolio investment can be beneficial to both the investor and the investee countries. However, they are frequently discouraged because of the instability and unpredictability of exchange rate movements over such a long time horizon. A typical direct investment has a lifetime exceeding five years. During that time, the exchange rate could have changed so much that the investor might have profits in the investee country currency but a net loss in terms of the investor's home country currency. Long-term currency hedges are not generally available; beyond twenty-four months, the market for currency hedges is extremely thin. Moreover, these hedges are expensive and subject to counter-party risks as well.

Unhedged, an investor is subject to "mark to market" rules, and the net value of the direct or portfolio investment in the investor country currency may fluctuate wildly, affecting its income and loss statement as well as its balance sheet. Moreover, to the extent that the revenue from the investment is in the investee country currency, there is potentially a currency mis-match in the assets and liabilities.

One way to reduce the currency risk is for the investor to borrow in the investee country currency to make the direct portfolio investment. The investor will acquire assets in the investee country with the loan proceeds. Thus, the assets and liabilities are matched in terms of currency. Fluctuations in the exchange rate will, to a first approximation, have little impact on the balance sheet— appreciation or devaluation of the investee country currency relative to the investor country currency will raise or lower the value of both assets and liabilities held by the investor in the investee country. Under this arrangement, marking to market will have little impact. Here it is assumed that the revenue from the direct investment is mostly in the investee-country currency. (If the revenue is mostly in the investor-country currency (for example, through exporting back to the investor country), then there is no currency mis-match problem.)

Most foreign long-term investors are not experts on exchange rates and hence they would prefer this natural hedge of matching the assets and liabilities in the investee-country currency. It is of course possible that the foreign direct investment project may fail. Thus, in order to prevent moral hazard, the loan must be either guaranteed by the foreign direct investor's parent company in the home country, if the latter's credit is good, or be backed by a deposit of cash or cash-equivalent in the investor-country currency otherwise. It should be borne in mind that in time, the foreign direct investor will have used the investee-country currency loan to make fixed investments or portfolio investments which can in turn be used as collateral against the investee-country currency loan, thus releasing part or all of the cash deposit. However, Shanghai and Hong Kong will have to work together to make this cash-deposit-backed loan concept work as the cash deposit in the investor-country currency will remain outside the Mainland and the loan will be disbursed inside the Mainland. The arrangement described above can be applied to inbound investment to Mainland China as well as to outbound investment from Mainland China. In the latter case, the cash deposit will be in a Chinese bank whereas the loan will be disbursed outside of Mainland China (in Hong Kong).

Both Shanghai and Hong Kong are destined to play a leading role in the internationalisation of the Renminbi. They are already major centres of international trade and logistics of China. As the use of the Renminbi for trade settlement becomes more and more common, they will become the major centres of Renminbi finance, one onshore and one offshore. Moreover, the direct exchange between the Renminbi and other currencies, especially East Asian currencies, without going through a third major reserve currency such as the U.S. Dollar, will also become more common. Shanghai and Hong Kong together can jointly operate a unified single market for each of these currencies in terms of the Renminbi. Direct exchange with the Renminbi can save transactions costs and reduce the exchange rate risks for all exporters and importers involved in Chinese international trade.

5. What Need to be Done?

In order for Shanghai and Hong Kong to work together smoothly, the rules on market conduct should be aligned as much as possible, so as to avoid "market shopping" on the part of the investors on dually-listed shares (and depositary receipts). It is too much to try to align the listing rules but both Shanghai and Hong Kong already subscribe to the best practices for corporate disclosure and governance.

If the laws and regulations on taxation can be aligned, it will make the two markets look more like a single market. However, it is not realistic to expect complete alignment. Income tax rates are different and tax treatment of bank interest and cash dividends are also different. And they will continue to be different for quite some time. More work is required to rationalise the system so that the goal of a single price in both markets can be eventually realised.

On the margin, some measures can be and are already taken. For example, enterprises listed in Hong Kong but with their principal operations on the Mainland have begun to withhold income tax on cash dividends paid. The use of the real-name system of security ownership (which is already required by anti-money laundering laws), will permit distinguishing investors of different countries and regions, enabling separate tax treatments as necessary.

China already has close to 100 double-tax agreements with various countries and regions, including all of the major countries such as the United States and Australia, to avoid double taxation on businesses and individuals with cross-country income. At the present time, Hong Kong has slightly more than 20. Hong Kong needs to step up its efforts to enter into double-tax agreements with as many countries and regions as possible if it is to serve effectively as a base for outbound investment from the Mainland.

Before the complete elimination of capital controls, especially short-term capital controls, it may be necessary to authorise one or more entities to be arbitrage specialists with the mission of narrowing the premia and discounts of dually-listed shares between the Hong Kong and Shanghai stock exchanges and between the two stock exchanges and the other stock exchanges in the World. These entities will be granted a quota of Renminbi and foreign exchange so that they can perform the arbitrate transactions. Arbitrage profits, if any, should be returned to the two stock exchanges. Persistent price differentials in the same shares in different markets are indicative of fundamental supply-demand imbalances in that particular share, the causes of which ought to be investigated in a timely manner and remedial action taken if possible.

Finally, it may be necessary for there to be a special arrangement between Shanghai and Hong Kong so that Renminbi balances can be transferred between the two cities freely between authorised financial institutions in either direction without further approvals from either the State Administration of Foreign Exchange or the Hong Kong Monetary Authority.

6. Towards Capital Account Convertibility

Even when the Renminbi becomes capital account convertible, Shanghai-Hong Kong collaboration will continue to be beneficial to both cities. Together they will be responsible for maintaining unified markets in all currencies against the Renminbi, helping to determine the exchange rates every day.

The Renminbi has actually been current account convertible since 1994. It has also become long-term capital account convertible, including not only foreign direct investment but also foreign portfolio investment and long-term foreign loans for quite a while. The only outstanding issue is that of short-term capital account convertibility. (Individual Chinese citizens can remit up to US$50,000 per person overseas each year, with few questions asked.)

The theory of comparative advantage shows that two economies trading goods and services with each other voluntarily will both benefit, although possibly to varying degrees. This is the intellectual basis for supporting international trade, and in particular, free trade. It is also well demonstrated that foreign direct investment undertaken voluntarily in the absence of special privileges will always benefit both the investor country and the investee country. The same argument applies to foreign portfolio investment. However, there is no similar argument in favour of short-term speculative international capital movements. It is simply an article of faith that the freer the cross-border movement of capital, the better.

Moreover, short-term non-trade-related capital inflows that can be withdrawn at short notice do not really benefit the destination country and on the contrary may do significant harm, as the East Asian currency crisis of 1997-1998 demonstrated. Short-term capital inflows cannot be usefully deployed in the destination country and when they are used to finance long-term investment they invariably lead to trouble because of the maturity mismatch in addition to the currency mismatch. It is also not clear what good short-term capital outflows do to the origin country except perhaps benefitting the banks handling the currency conversion and transfer.

The principal remaining target of capital control is therefore short-term speculative inflow (and outflow)—hot money—which does not bring any benefits to the destination country but on the contrary disrupt the foreign exchange market and de-stabilise the exchange rate and thereby adversely affect the real economy. But how can long-term and short-term capital flows be distinguished? It is not easy. One possible solution is to impose a Tobin tax (named after the late Nobel Laureate in Economic Sciences Prof. James Tobin) on all conversions of foreign exchange, into or out of Renminbi, above a certain threshold, say RMB one million Yuan, into or out of the Renminbi, of say 0.5% or 1%, with an exemption for all international trade-related transactions.

For long-term direct and portfolio investors, the Tobin tax can be amortised over a period of time and is therefore almost nothing. For short-term speculators, the Tobin tax can amount to a tax of 6 or 12 percent per annum, which lowers significantly the expected returns to short-term currency speculation. The Tobin tax can be imposed any time the Renminbi is exchanged for another currency through the commercial banks unless it is trade-related or below the threshold. The banks can be given the responsibility for collecting the tax. Banks that fail to collect the tax should be prohibited from dealing in Renminbi.

7. Concluding Remarks

In conclusion, Shanghai and Hong Kong, by collaborating together, can surpass New York, London and Tokyo to become the "Financial Centre of the World". This is win-win for Shanghai and Hong Kong and optimal for China.