

Joint Committee on the National Security Strategy

Oral evidence: UK's economic security

Monday 29 January 2024

4.20 pm

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Members present: Dame Margaret Beckett MP (The Chair); Sarah Atherton MP; Lord Butler of Brockwell; Liam Byrne MP; Dame Diana Johnson MP; Baroness Fall; Richard Graham MP; Angus Brendan MacNeil MP; Stephen McPartland MP; Lord Robathan; Lord Sarfraz; Lord Snape; Viscount Stansgate; Lord Strasburger.

Evidence Session No. 1

Heard in Public

Questions 1 - 15

Witnesses

I: Agathe Demarais, Senior Policy Fellow, European Council on Foreign Relations; John Gerson, Visiting Professor, The Policy Institute, King's College London; Professor Dennis Novy, Professor of Economics, University of Warwick.

Examination of witnesses

Agathe Demarais, John Gerson and Professor Dennis Novy.

In the absence of the Chair, Lord Butler of Brockwell took the Chair.

Q1 The Chair: We now start our public session of evidence on the United Kingdom's economic security. We have three witnesses: Madame Demarais, Mr Gerson and Professor Dennis Novy. Could I ask you to introduce yourselves in turn? Madame Demarais, perhaps you would go first.

Agathe Demarais: Thank you very much. Good afternoon. I am a senior policy fellow at the European Council on Foreign Relations, a London-based think tank, and I work on geoeconomics, including economic security.

John Gerson: I am a visiting professor at The Policy Institute at King's College London. I worked for the Government for 33 years and for BP for a decade.

Professor Dennis Novy: Good afternoon. I am professor of economics at the University of Warwick in the economics department. I am affiliated with the London School of Economics in the Centre for Economic Performance. My area of specialty is international trade and international economics.

Q2 **The Chair:** Thank you. I will take the first question. You have probably seen that there is a large amount of ground to cover, so if you could make your answers as succinct as is necessary to cover the subject, that would be a great help. Economic security is a very wide subject, and I wondered if we might start by seeing if we can agree on a definition. Madame Demarais, would you like to start?

Agathe Demarais: Yes, absolutely. Thank you very much. I completely agree that it is very difficult to define economic security. Everyone would have a different definition of it, and I would be very keen to hear others'. From my perspective, there are two ways to look at economic security. I would start with security: it can be defensive and it can be offensive. The defensive side is all about protecting ourselves from our adversaries. The offensive side is about coercing our adversaries into doing the things that we want them to do.

When we apply the question to the economic field, we can take a look at a number of things. One is trade, which is all about having access to markets for our exports, which is obviously important, and about having the ability to import critical raw materials such as rare earth, which are important in a number of industries, or semiconductors, which are critical in a number of defence fields. In the economic field, we can look at economic security for technology. I mentioned semiconductors. Access to technology is a key determinant of economic growth these days, so it is tremendously important to retain access to critical technologies for economic security. Finally, there is the question of investment for domestic firms— investments abroad protecting technology so that it does not fall into the hands of adversaries, or conversely, foreign investment into critical infrastructure domestically. That would be my definition of economic security.

Obviously, the elephant in the room is China at the moment. I do not want to say it is all about China, but it is a lot about China, and to a lesser extent maybe about Russia. Sanctions are applicable in the economic security field, the offensive field, against Russia.

Finally, on the major players in the field, there are a lot of discussions about the US at the moment. We have moved away from decoupling. Now, it is all about de-risking, limiting the risks of economic reliance on China for trade and technology and not fuelling the rise of China in the military field. China of course is the other side of the coin. China has been doing economic security for a very long time, and has been decoupling or de-risking from western economies. Then there are other players such as the UK of course, and the European Union and Japan. That would be my definition of economic security.

The Chair: We have just done a report on ransomware. Would you include international crime in that sort of security defence against criminal attacks?

Agathe Demarais: From a narrow perspective in the economic field, I would limit the definition to trade, investment and technology. Of course, it is also extremely important to defend firms from ransomware and other attacks when we take a look at economic security from a defensive perspective. From a broader perspective, yes, anything that can defend economic interests is also to be included in economic security.

The Chair: Thank you. Professor Novy and Mr Gerson, do you want to add or comment?

John Gerson: I would define economic security as the preservation of our sovereignty and our prosperity, and our ability to promote that prosperity.

Professor Dennis Novy: I would define economic security as the ability of an economy, its people and its businesses to withstand and adapt to shocks and threats. Those shocks and threats can have a different nature. They can be of an economic nature. They can be of a political or international nature. Political institutions can break down. They can be of a technological nature. You mentioned ransomware, which would be an example of that. They can be of a military, environmental, climate or health nature, and all those issues are important. The aspect that I would stress is the rules-based international system and the issue of sovereignty, whatever that means—we might come back to that—which are absolutely essential to guarantee the economic security of the United Kingdom.

The Chair: Thank you. Are members of the committee happy with those definitions that are going to define this inquiry of ours? Are there any comments? Good, thank you, that is very helpful.

Q3 **Viscount Stansgate:** Good afternoon, and hello to all the witnesses. How have recent geopolitical trends and events affected both global and UK understandings of economic security?

The Chair: Who would like to tackle that? Professor Novy, you look pregnant with a reply.

Professor Dennis Novy: The obvious recent thing that comes to mind is military confrontation in Russia and the rising threat of military conflict in China and what that means for the UK economy. If you strip out the military implications of that—I am not an expert on the military at all, but I am an expert on the economy—what it means first and foremost for the UK is the risk to supply chains. It has become the view that we have to pay much more attention to political aspects of the international economic architecture. What I mean by that is that in the old days right after the Cold War was over it was clear that the international economic architecture was dominated by what you might call a transatlantic consensus. Nowadays, that has changed; we are dealing with autocracies

like China and Russia, and the old weapons that were sometimes deployed, such as sanctions, may no longer work in the same way as they used to work.

What has also changed, since the 1990s in particular, is the nature of international supply chains. We now have global supply chains, and the old view that we export things and then we import other things is no longer true. Trade in intermediate inputs is now the lion's share of international trade. Many of these things criss-cross borders a lot, so thinking about supply chains is essential. The United States has been talking about "friend-shoring", which means that a lot of supply chains come back to the UK or Europe or to nearby friends across the north Atlantic in particular and Europe first and foremost.

The UK is essentially a trade and services superpower. The economic structure of the UK has completely changed. It is now 80%-plus services. Services trade is concentrated in the big cities, so that has big regional implications for Members who are regional MPs as opposed to urban MPs. That is a big issue to think about. Therefore, the issue of regulation is crucial. Duplicate regulation in particular is very costly for UK businesses. Looking forward, we have to think much more about what it means to have institutional back-up of international trade rules and regulations and how the UK can influence that.

Viscount Stansgate: Thank you very much. Can I turn to John Gerson? How has increased global competition undermined UK national security?

John Gerson: First, in the same sense that it has undermined everybody's security. We lived in a world of fantasy before Ukraine was invaded in which we imagined that the challenges of every other century had somehow or other disappeared. Whenever the duvet covering our sleeping form slipped, we would pull it over our heads and go back to sleep. That is what happened after Georgia. It is what happened every time reality broke through. Putin ripped the duvet off.

What then affected our understanding of our national security were the exposures that have just been described: our supply chains. The fact is that on 23 February 2022 globalisation paused. We had depended on it and deluded ourselves that it had become an established fact for ever. We have had to wake up.

Viscount Stansgate: Yes. All right. Thank you very much for that concise answer.

The Chair: Lord Robathan, I apologise; I rather strode on. I think you had a supplementary question on the definition.

Lord Robathan: It is not so much on the definition. May I first apologise? I have meetings to go to, so I shall leave. That is not meant to be rude to yourselves.

The nub of the matter to me is how economic security interacts, intersects and relates to national security and industrial policy. We

covered that to a certain extent, but it seems to me that it is absolutely fundamental. At the same time, perhaps somebody might comment on free trade. I am a great believer in free trade. It lifts people out of poverty, et cetera. China has used that against us to a large extent, in my opinion, on the belt and road initiative, where it is establishing economic hegemony in some areas in the name of free trade. That is a big question. I will let you fight among yourselves about who answers first.

Agathe Demarais: I am happy to try. Thank you. I would go back to the geopolitical events that have had an impact on economic security to answer this question. The Covid-19 pandemic was a realisation that the UK and pretty much every western country was dependent on China for masks and medicines, which of course is a risk not only for economic security but for security; at stake were the lives of people. Then there was the war in Ukraine and the weaponisation of gas supplies from Russia. Again, it affected EU countries much more. That was a realisation that a number of countries would not shy away from weaponising access to critical commodities. Again, it has an impact on national security because economic power is a key determinant of military might and geopolitical might.

Finally, there is the question of China and Taiwan. Taiwan is the country that hosts most of the global capacity to produce advanced semiconductors, so of course Chinese aggression against Taiwan would have severe consequences on the region, on the lives of people as well as on the supply of semiconductors for the United Kingdom and like-minded allies.

Looking at all that, it is clear to us that economic security is intrinsically linked to national security. It is about supply chains. It is about critical goods. It is also about industrial policy, as you mentioned, because industrial policies can have an impact on competitiveness. If we link economic might to geopolitical might, it has an impact on our national security.

Finally, I would add the question of financial developments. China is developing a number of financial mechanisms that could vaccinate it against sanctions and other western economic statecraft. Given the importance of sanctions in foreign policy today, that is a tremendous shift for national security and diplomacy. All in all, taken together, supply chains, industrial policy and financial developments are all linked to economic security as well as to national security and defence.

Professor Dennis Novy: What has changed from the post-war period, especially post 1980s and starting in the 1990s, is that we are now living in a world where we have the big three: the US, the EU and China. When it comes to economic policy, especially international trade policy, those three determine everything. The UK is no longer part of that. It will have to follow the orbit of the EU, and that does not matter whether somebody is in the Conservative Party, the Labour Party, the Lib Dems or any other party. It is a fact that any UK Government in the future will have to deal

with. It is just the gravity of the strength of those three players. They decide what happens. Maybe India at some point will arise, but we are many years from that. I can take you through the numbers of the economic size. That is a fact of life. It is dangerous to try to use narratives that somehow say something different. That is a fact that we have to live with.

The impact on national security is obvious. If we have a lack of economic growth, we cannot pay for national security. Right now, the UK spends about 2.2% or 2.3% of GDP on defence, which is about £50 billion or £60 billion. If the UK economy was much larger and if we did not have abysmal productivity growth since the great financial crisis—the United States, for example, has not had that—it would have meant a very different position for our ability to finance our national security.

In terms of growth, you said that China has used the belt and road initiative against us. I strongly disagree with that. First, the growth of the economy in China has been tremendously positive for the UK from an economic point of view. UK people, UK consumers, have benefited from it enormously. UK businesses have benefited a lot. It is misguided to think of this as some kind of competition when it is win-win.

China's belt and road initiative means that the Chinese have a strategy. They have a strategy of talking to other countries in the world, from their close neighbours to all over the world, including very much Africa; and the UK, the EU and the US do not, or not as much. What has the UK done in terms of its foreign development budget? It has reduced it from 0.7%, and that is the opposite of what China has done. I would not necessarily see that as China doing something against us. I would see it as a wake-up call for a country like the UK to enter that arena and think about its economic security as a function of what happens elsewhere in the world. If there is no economic security in other parts of the world, that means in turn that the UK's economic security is threatened.

Lord Robathan: Why do you think China has entered all these deals with not only sub-Saharan Africa but also Sri Lanka? It seems to me that in sub-Saharan Africa, which I know better than Sri Lanka, it is basically buying up the continent.

Professor Dennis Novy: Yes, it is in its interest.

Lord Robathan: Is it in the interests of our economic security and indeed the economic security of those countries?

Professor Dennis Novy: It is in China's political and economic interest, and that is obviously the reason it is doing it. It is in our interest, in western European and North American countries, to do the same. As you well know, other countries in sub-Saharan Africa do not necessarily believe that our system is superior to the Chinese system, but it is for us to demonstrate that.

Agathe Demarais: China is doing economic security when it enters deals with sub-Saharan African countries because it is trying to secure access to critical raw materials, and China is the world hegemon in the field. It is also about access to critical infrastructure. China is doing everything that we are discussing today. I agree that China has a policy of talking to everyone and essentially defending its interests.

When we go back to the question of the United Kingdom, I agree that the big players in the field are the United States, China and, to a lesser extent, the European Union and Japan. To me, this means that the UK has every interest in collaborating with allies. That is the way the UK can count on the economic security scene from a global perspective. Of course, there is a tension. If economic security is all about sovereignty, collaboration with allies is a bit counterintuitive from that perspective. That is a key tension, a key question and a key challenge for the United Kingdom in economic security strategy.

John Gerson: Perhaps I could illustrate the question by the example of what we did to Germany at the beginning of the First World War. We so dominated undersea cables for communications—we had all the ships that laid them and we manufactured all the materials and so on—that in the first stage of the First World War we simply cut Germany off from the far abroad and left only one cable, the transatlantic, which we happened to be able to listen to. Otherwise, Germany could not communicate properly. Had Germany had a lively sense of its economic security during the previous decades, it would not have allowed itself to get into that position. That is how I see that economic security can have an impact on national security. China is doing the same at the moment as we did in the 19th century with subsea cables.

Q4 Richard Graham: Can I come in with slightly different, brief questions to each of our distinguished panellists? John Gerson, I think you said at the beginning that the key thing about economic security was the sovereignty of the prosperity of our nation. The question to me that leads from that is whether we are pursuing implicitly the wrong track by going for a series of free trade agreements by becoming part of the trans-Pacific partnership and by seeking other agreements with other nations as part of both our prosperity and our global success. Are we therefore wrong in the integrated review refresh to talk about being open and outward-looking? Are you suggesting that we retreat into a little England position, possibly trading a bit with our nearest neighbours and closest allies?

John Gerson: Free trade is not my area. I am startlingly ignorant on the subject of free trade agreements and would not presume to try to answer a very interesting question except to say that, as the questioner is suggesting, it is dotty for a great trading nation like ours to try to shut itself off. All I can say is that, particularly if China was at the root of this question, as it may have been, I imagine, the question is to what extent we should de-risk or disconnect, and that is a difficult and subtle problem. My feeling about it is that the Government are approaching it right, at the moment.

Richard Graham: Chris Patten has said several times that it is too late to decouple. On the other hand, does the speed at which we give export licences, and in fact the speed at which we resolve issues like the sub-postmasters, infrastructure and planning and so on, give an autocracy like China a competitive global advantage against us?

John Gerson: This is a field where I should redirect fire to another sector of this trench.

Richard Graham: Thank you. Shall I swivel the question to Agathe Demarais? You said that there was a tension between security and working with allies. How does the question I asked Mr Gerson fit into that tension?

Agathe Demarais: Absolutely. There is a tension between sovereignty and working with allies. If we agree that the big players in the field of economic security these days would be the US and China, and to a lesser extent the European Union and Japan, that could suggest that an appropriate way to go, or at least a way to go that could be considered, would be to work with the US. Of course, if economic security is all about sovereignty, it calls the concept into question, because I would argue that perhaps the US would have more leverage over the United Kingdom than the United Kingdom would have leverage over the United States.

To go to the question of free trade agreements, being an open economy and forging trade partnerships with other countries, especially in emerging economies, is perhaps one of the best ways to protect economic security. There are three arguments. In the multilateral rules-based order—I am sure that my fellow witness will have more to say about this—free trade agreements can be seen as an insurance policy against hostile behaviour towards the rules-based international order.

The second point is that working hand in hand with emerging countries will be the way to go to secure access to raw materials that will be critical for a green energy transition. I am thinking of lithium, copper, cobalt and manganese. A number of those critical raw materials are found almost exclusively in emerging economies, and at the moment China is the global leader in the field because China has forged mining and processing partnerships with those countries.

There is a related point. There is a global battle for influence in the emerging economies at the moment between on the one hand western like-minded democracies and on the other hand a China-led coalition, and I would include Russia and other rogues there. Forging free trade agreements with emerging economies, not telling them that they must work with us but forging collaboration partnerships, is probably the way to go to score points in the battle for influence.

Richard Graham: Thank you, Madame. Can I swivel then to the professor? That brings into play your comment that there were only three major players in the world, the US, China and the EU, and that therefore we would have to follow one of the three. Is that not dismissing the

whole of the rest of the world rather too easily? Is there not a role for us to have the rather nimble position that we are adopting with the trans-Pacific partnership, in exactly the way that Madame Demarais was suggesting, without having to cut off all our growing business with China and without necessarily having to take a subservient role in a one-sided free trade agreement with the US? Is there not a rather more positive opportunity for us in all this, or do you just see gloom and despair all ahead?

Professor Dennis Novy: No, I am a realist and I look at the data. I am somewhat sceptical of big ideas unless there is evidence for them. That is how I approach it. That does not mean I am pessimistic. I agree that it is about sovereignty to a large extent, but the question is: what is sovereignty? If sovereignty is defined in a narrow-minded way that you can do whatever you like and you can determine your own rules, perhaps North Korea is the model to go for. It is easy to be flippant on that. Sovereignty in the modern economy means that you have to come up with common rules and you have to agree with your trading partners. That is done by the US, the EU and China. They set the standards for international trade. There is no one else in there. That is not to be dismissive of the rest of the world. That is just where the economic might is.

Richard Graham: And the role of the WTO, Professor, in setting the rules?

Professor Dennis Novy: I was going to get to that. This is exactly an example where you become more powerful by pooling your sovereignty. The UK is probably internationally recognised as one of the biggest proponents of an international rules-based order. The UK has a stunning reputation for the rule of law, and that has served it very well. Now that the UK has left the EU, it will be even more important.

I remind the committee of what the United States has done in recent years, which is not out of character. In 2018, the United States imposed tariffs on the UK, among other countries, not just China and Canada. The United States for many years has withdrawn from, in essence, or even undermined the World Trade Organization. This is not President Trump; it goes back to Obama and Bush, and even Bush senior in many ways. That is not something that the UK can pin hope on; the talk about a special relationship is somewhat misleading when it comes to the economy.

Since you mentioned the trade agreements, yes, trade agreements are precisely a way of going about it. The problem for the UK is that the trade agreements that it aspires to, such as the CPTPP or the trade agreements with Australia and New Zealand and so on, cannot compensate for the big loss of the biggest and deepest free trade agreement of all, which is with the European Union. Trade policy is a game of bullies. The big guys tell you what happens. We saw that just last week. You have heard about the Canadian trade deal. The Canadians are very experienced, and they are now no longer grandfathering the privileges that the UK enjoyed through

CETA, the trade agreement that as a member of the EU it enjoyed, and they are now trying to demand other concessions.

You can always have a trade agreement with Australia and New Zealand, but if you look at the details of what the UK has given away in those trade agreements it is quite astounding. I am not sure that is necessarily in the economic interest of the UK. The UK Government's economic assessment is 0.08% of GDP. That is a rounding error. Again, you have to ask yourself: what is the strategy that the UK has here? What is the future long-term strategy that the UK needs to secure its economic position and to work with its allies, especially with the rise of China and other countries that may not be so keen?

Richard Graham: Chairman, I am conscious that I have rather prolonged my opportunity in the questioning role. Can we leave or another session or another question that, of course, it depends on who else joins the TPP in terms of its size and reach?

The Chair: Thank you. Mr Brendan MacNeil, who is on Zoom, had his hand up some time ago. Would you like to come in?

Q5 **Angus Brendan MacNeil:** Yes, thank you. I have a number of observations. On the last point on trade agreements, as a former chair of the trade committee, I know that the trans-Pacific partnership is 62 times smaller in economic gain than what was lost in Brexit. You need about 62 trans-Pacific partnership trade agreements to get what Brexit cost. The problem with free trade, of course—I am coming to a question—is that tariffs are often replaced in free trade agreements with bureaucracy. Quite often, trade agreements such as the trans-Pacific partnership have long supply lines, which then lead into economic security.

There was a point made earlier that I want to pursue. Are we saying, when we talk about economic security, that we sometimes have to make less economical choices? Sometimes the immediate decision that is very economical might start to build patterns that do not build economic security. It is making you reliant on certain partners across the world, and the big fear is that they are outside your trade bloc and they could pull the rug from under your feet.

The second question I want to ask is this. Are we seeing a return to a world of wars of conquest? Something was said about peace, and that we had been misleading ourselves for a number of decades. A number of writers, such as Steven Pinker in *The Better Angels of Our Nature*, would say that wars, violence and genocide, despite what we see in the news, are declining trend-wise. The point might be that Steven Pinker is just making those observations in a blip. On those two points on economics, does a short-term economic decision, whether or not it is economical and makes financial sense, very often undermine economic security and the trend in wars?

The Chair: Professor Novy, would you like to start on those questions?

Professor Dennis Novy: On the issue about de-risking, it is true that in the past a lot of the economic system ignored the politics to a large extent and then might have gotten itself into running some risks that we no longer see as acceptable. Firms might buy from the cheapest supplier, but then if their supplier for some reason is no longer available, perhaps it is rare earths or there is some natural disaster somewhere else, suddenly they might be in trouble. The issue of de-risking and diversifying is crucial. In economics, we call it moving away from static efficiency to dynamic efficiency. I know it is a bit technical. Trying to think about the ability to deal with risk is crucial.

On the issue of violence, it is true that there is a decrease in violence. In terms of economic policy, in the old days it used to be done by gunboat diplomacy; you threatened your trading partners with military conflict. That has become less in principle over the last few decades, but there is a serious risk that it might go in the opposite direction. We see what is happening in eastern Europe and what is happening in Asia with Taiwan in particular. It is something to be taken very seriously.

Angus Brendan MacNeil: I have a second point. I think Agathe Demarais mentioned that China is building up its economic security. Has China taken steps that have been short-term economically painful to do? Has China consciously said, "I'm not doing this. I'm doing that. It might make economic sense to do that today, but overall in the decade it is better to build up economic security"? Do we have examples of that, or is it just the way things have emerged that we now feel that?

Agathe Demarais: I would go back to the original question about whether sometimes the less economical choice is the best choice to make. This is related to the question of how we get the private sector on board for de-risking efforts. Governments can have the best de-risking strategy on paper and in theory, but they will always need the private sector on board to implement it. That is extremely difficult in all western economies at the moment. You can do industrial policy, as the US is doing, but in other areas it begs the question of whether there is fiscal space to have incentives for private firms to buy more expensive products because they come from more reliable suppliers. How do we convince private firms to do that and, essentially, cut their profits? That is extremely difficult. I do not think there is any fiscal space to do it, and I do not think that using sticks is a good option either because it would penalise firms. It is not a great idea. The tension about how to get the private sector on board is critical.

On violence, economic warfare has become a key pillar of foreign policy, and I would include tariffs, sanctions and export controls there. I am not entirely sure that we can make comparisons as to which is more or less violent, but we have to acknowledge the fact that economic statecraft, sanctions in particular, is now the tool of choice for foreign policy, and it comes with implications for economic security.

Finally, on China, it has made some decisions that it knew were not financially sound in the long run, or even the short run, but those

decisions would buy it influence on the ground. For instance, China extended cheap loans to a number of sub-Saharan countries that it probably knew would be very difficult to be repaid, but China still did it. This points to the fact, again, that China probably has a strategy when we are only starting to think about economic security and what we should be doing.

Angus Brendan MacNeil: Thank you.

Dame Margaret Beckett took the Chair.

The Chair: Do you want to come in, Professor Novy?

Professor Dennis Novy: Very quickly. Mr MacNeil, you asked about another China example. One key example would be the entry of China into the World Trade Organization in 2001. That was economically and politically extremely painful for China. There was a big debate within the Chinese leadership whether they should do it at all. The side of the Chinese leadership that was in favour prevailed in the end, and it turned out to be very difficult for them because they were running up against political interests domestically. China has ever since stalled the WTO progress. China is seen as a member of the WTO that does not want the WTO to progress very much further because it feels the system is not on its terms. It was a strategic decision that was costly for China, but it did it.

The Chair: Thank you very much.

Baroness Fall: I have a supplementary to that. We have talked about blocs, in particular regulatory blocs, in our approach to economic security, but we have not mentioned the G7, which we very much focused on in the last few meetings. Do you feel that the G7 is basically becoming a functional western bloc for economic security and, related to that, do you think that the G20 therefore is the opposite and is becoming a more complicated place from the economic security point of view?

Agathe Demarais: Yes, absolutely. In the past, I would not say that the G7 was boring, but not much was coming out of it. The G7 has become the key forum for collaboration between like-minded allies on sanctions. The price cap on Russian oil exports is a G7-EU measure. On measures to tackle China's military rise and ambitions, we see a lot of co-ordination, especially between the United States and Japan, on export controls. The G7 forum is becoming a key place for discussions between like-minded allies. The G20 is extremely important for discussions with emerging economies—everything that we were discussing previously. All in all, these forums are becoming increasingly important and they are key areas for collaboration. Yes, I agree with your assessment.

Q6 **Lord Strasburger:** Welcome to our panel. I have two questions. They are more directed at Professor Novy and Madame Demarais. How effective is the UK's investment screening regime, and how does this compare to other countries' approaches? Perhaps we could go with ladies

first.

Agathe Demarais: Thank you for the question. To be entirely honest, this is not an area where I have a lot of expertise, so I turn to Professor Novy, if he has any thoughts about this topic.

Professor Dennis Novy: What do you mean by screening regime?

Lord Strasburger: Screening incoming investment.

Professor Dennis Novy: Okay. It is an issue of strategic industries where you need to screen very carefully. These are specific areas, such as high-tech areas, where you might be concerned if a company, especially a state-owned company, say from China, buys up essential UK infrastructure. On that, the UK needs to be careful. I cannot speak to the details of that.

I know the committee is interested in statecraft and the institutional back-up for all these issues. The UK Government and the UK Civil Service need to become much more data focused precisely to answer the questions that you raised. We are living in a digital world, but a lot of the data are not available in the UK. If we compare the UK to France or Scandinavian countries, the amount of data that France and Scandinavian countries have about businesses, people, workers and trends in the economy is just unbelievable. The UK either does not have the data or does not make the data available either to researchers or within government. The UK data infrastructure is lagging and it is quite poor, and with that comes the requirement for government and the Civil Service to have the ability and the skills to deal with the data.

We need to move away from the fax machine age. That is a real challenge for all countries and all Governments, but especially the UK. There needs to be some serious strategic investment in data skills and in data availability. I am talking about HMRC and the ONS. They have different datasets. They need to be linked up. I could talk to you about this all day. I see that as absolutely essential, not least regarding the issue of screening.

Lord Strasburger: Could you expand on the “fax machine” approach that you feel that we are particularly bad at?

Professor Dennis Novy: We still talk, almost 19th century-style, about big countries and powers and so on. What we need to talk much more about is what I would call the granular detail of the economy. Which are the big firms? International trade is done by very large firms, the vast majority by multinationals. About half of trade is trade within firms, from one subsidiary to another. Who do those firms employ? What are the skills that those people have? What are the skills that the people in the Civil Service have? They are doing their best. How are the Government thinking about this? How many people do we have sitting in the House of Commons or the House of Lords with a STEM background? How does that compare to Singapore or Japan or China? That is the kind of question that we need to ask. I do not think the UK is at the forefront of that. It really

is not, and we desperately need a national debate on that. How can we become fit for the digital age in terms of statecraft? What is the quality of our information? There is a lot of room for improvement. It is not a party-political point. I wish that all parties would come together on that.

Lord Strasburger: Which countries do you consider to be exemplars of this skill?

Professor Dennis Novy: Scandinavian countries are miles ahead. France has fantastic data that it makes available, and to some extent Canada. There are a few countries that do that.

Lord Strasburger: Please go ahead, Madame Demarais.

Agathe Demarais: Thank you so much. I would like to add one point about the need for robust data. We talk a lot about supply chains. Supply chains are extremely difficult to track; they are extremely opaque. I will give one example on supply chains. If we look at United States trade data, we see that Mexico has become the key supplier of US imports. On the face of it, it could look like the US's de-risking strategy is working and the US is importing less from China than it used to. Actually, when we look at the data, we see that Mexico is importing more from Vietnam or Thailand, south-east Asian economies, and those economies are doing more trade with China. That means that, probably, Vietnam, Thailand and Mexico have become re-export hubs for Chinese goods en route to the US.

With that example, I am trying to highlight the fact that it is extremely difficult to track the reality of supply chains. We would need data on that. We talk a lot about de-risking. Just looking at the data, we see that the US is relying less on China, but the reality is that supply chains have become more complex, more difficult to track and therefore probably less safe and robust. I agree that access to data is extremely important.

Professor Dennis Novy: If I may, I can give you a concrete example. In February 2022 when Russia invaded Ukraine, energy prices went through the roof. You need to understand how precisely that affects the economy. Does it mean that your economy will go down by 10%? Does it mean that your economy will go down by 1%? Which sectors will be affected? Which parts of the country will be affected? Which type of people—low-income, high-income and so on? For that, you need data. We have the data in principle. The UK is sitting on the data. We have VAT receipts. We have tax receipts. We have all sorts of surveys and so on. We just need to harness that data.

We also need to know what to do with the data, and you need skills for that. AI is coming in. We need people who can harness those tools, and that is something that the UK in principle is very well placed to do, because it has the best universities in Europe. That is fair to say—it is a somewhat self-serving point because I work in a UK university. That is a strength that the UK needs to build on, and there is a lot of potential for the UK to do much better.

Lord Strasburger: Thank you very much.

Baroness Fall: I want to come back to the investment screening element of the question in relation to the National Security and Investment Act, which set up a UK-type of CFIUS mechanism at the heart of government, and whether your assessment is that it is working well—it has not been going very long—especially in relation to how CFIUS works. Does anyone want to jump in on that question? No takers. I might come back to that on another point, Chair.

The Chair: Okay.

Q7 **Lord Snape:** You have cast a bit of a pall of gloom over the proceedings, Professor Novy. Arising from what you said, how effective are the UK Government in balancing economic security with supporting a global trading economy? How, in your opinion, do we compare with countries like Japan, the EU and the United States?

Professor Dennis Novy: Again, it is important to look at evidence. In the last few years in particular, not just in the UK but elsewhere, there has been too much focus on the politics, whether it makes sense or not from a realism point of view. The elephant in the room, of course, is Brexit. Brexit is not done. Brexit has barely started. By that, I mean that the divergence between rules in the EU and rules in the UK keeps on growing day by day. There is new regulation that comes out of either Brussels or London day by day, and that is a huge cost to UK businesses because duplicate regulations are the worst thing that happens. It is no longer about tariffs these days. Most businesses would say, "If you give me a 5% tariff but I don't have to do any of the other stuff, the regulation and the red tape," they would take that. Enormous uncertainty is generated through that. That has to be the starting point for UK policy: to be very realistic about this.

I wish the politicians luck. I wish them the art of the possible so that, no matter what colour their political party is, in the future we can move beyond the debates of the past and try to make do with what we have. That means being realistic about being in the orbit of the EU from now. There might be some small things you can do there, but the trans-Pacific story will never, ever make up for it. The numbers are just not there. They are too far away. We have to agree on those facts. We cannot live in a fantasy world. The UK needs a strategy in terms of its economic strengths. That is mainly services: financial services, tourism, chemicals. That is where the UK really needs a strategy. The manufacturing sector is declining. Maybe we can safeguard it to the extent that we can, but we need to think about skilling up the economy for the future.

Richard Graham: Professor, forgive me for coming back, but this is a fairly unmitigated outpouring of gloom and doom. Manufacturing-wise, we have just overtaken France as the world's eighth largest manufacturer. Multinational-wise, there is no country in Europe that can rival us on pharmaceuticals. One could go on. A third of the value of every aeroplane produced by Airbus is manufactured here in the UK. The

idea that we have, by your definition, no cards to play except to sit back and do whatever the EU tells us to do is a rather curious picture to tally with current reality.

Is it not the case that we have had to endure, since leaving the European Union, significant restrictions and burdens on our exports to the EU, which have indeed cost us exports there, although our total exports have grown? The very similar rules on them are only coming in very shortly. At that stage, what do you anticipate will be the reaction of European businesses that may find themselves with similar burdens to those that we face? Is there not an opportunity for both to sit down and say, "We need to do something about this"?

Professor Dennis Novy: Do you want me to respond to that?

Lord Snape: It was aimed at you, Professor.

Richard Graham: It was a question.

Professor Dennis Novy: There are definitely strengths that the UK economy has, and they are concentrated mainly in the services industry. The manufacturing sector is declining. That is not just a UK thing; it is happening pretty much all over the world, especially in western economies. There have been serious problems for cars in particular related to Brexit, as well as in other industries, such as from chemicals regulations. Food prices have gone up. There has been the exchange rate depreciation. It is a difficult picture. We have to be realistic about that. It is not all doom and gloom. The UK has enormous strengths, and we need to build on them, but those strengths are not the strengths of yesteryear; they are the strengths of the future in particular services. That is how I see it.

You mentioned Airbus. Airbus is a classic example of a supply chain type of business that is now getting less commonplace in the UK because of the red tape and the barriers that have come in.

Richard Graham: That is simply not true. I am so sorry, Chair, but there are no restrictions on aerospace—

Professor Dennis Novy: There is red tape.

Richard Graham: —supply chains, which is why the wings, the landing gear, the engines and some of the avionics continue to be manufactured here in the UK. Professor, I am really sorry, but we must try to stick to the facts.

Stephen McPartland: I would like to raise a quick point. My constituency builds 25% of the world's telecommunications satellites. We build complex weapons systems that are being used at the moment to keep the sea lanes open and defend our friends in Ukraine. We are one of the two headquarters for GSK's R&D and pharmaceutical manufacturing in the world. When we talk about manufacturing, there is a big distinction between manufacturing something like a bottle of water and the

production to do with that, and advanced manufacturing and complex engineering. I think my colleague is trying to suggest that the UK has great world-beating industries. Although I appreciate the evidence that you are giving, I feel that we have to focus on economic security and national security, because a lot of the evidence seems to be moving towards Brexit as opposed to economic and national security.

The Chair: If you do not wish to respond to that, there is no need.

Lord Snape: Chair, can I go back to the point rather than getting bogged down in pro or anti-Brexit? How do other countries compare with us, Professor Novy, in balancing the economic security risks with a global trading economy? I come back to the Japanese and the Americans. Let us forget the EU for a moment, otherwise we will bicker about it all afternoon. How do we compare with other countries?

Professor Dennis Novy: One area that probably comes to mind is that some countries have responded with what you might call industrial policy. The Inflation Reduction Act in the US is really about subsidies for certain industries, particularly renewables. China is very active on industrial policy as well. It promotes the export sector. That might be coming through, say, financial regulation that makes it particularly easy for exporting. That has been a response. The EU, of course, struggles with that because it is not a federal state. With the EU, to the extent that that is happening, it is mainly happening at the level of national countries. Europe is not at the forefront of that.

John Gerson: Can I add a small point from my business experience? It applies only to trade policy or export promotion at its most basic, but the Australian Government are extraordinarily effective in support of their trading economic interests, and use methods that I have not noticed any other Government of a democratic sort using. They co-ordinate all national interests in support of their need to sell things to Japan, China or whatever. Their needs are different from ours and, of course, their economy is very different, but in designing machinery to improve our ability to sell abroad we would be very well advised to go and sit at their feet.

Lord Snape: Madame Demarais, do you want to skate on this thin ice with the rest of us?

Agathe Demarais: I am always very happy to skate on thin ice. On the question of competitors or how others are doing, it is interesting to take a look at four blocs of countries: China, Japan, the US and the EU. On economic security, I would argue that China is probably one of the world leaders in the field. It has been doing de-risking and economic security, or decoupling, or however you want to call it, for far longer than we have. When we take a look at technology, China's "Made in China" blueprint for technology self-sufficiency dates back to 2015. China has been trying to have semiconductors since the 1980s, arguably with very low results.

In terms of finance, China, as I mentioned previously, is developing non-western alternative financial mechanisms to shield itself from western financial mechanisms such as SWIFT or currencies such as the US dollar and the euro. China is developing a digital currency that will be completely immune to western sanctions.

Finally, there is trade diversification. When we look at the data, and I share the interest of Professor Novy in looking at the hard data, we see that China's exports to western countries have been gradually dropping over past years, but those to emerging economies are rising. To me, this suggests that China has a strategy of diversifying trade ties, which is exactly also economic security.

The second player is Japan. Japan is often overlooked, but it has been doing economic security for far longer than other western countries, especially in the tech field. Looking at the data, we see that Japan's reliance on China as a trade partner is far below the reliance of western economies on China for trade. There are interesting lessons to look at from the Japanese perspective.

Finally, there is the US. The push is more recent. We could date it back to Trump's election to the White House. It was the start of the trade war. That is the moment when everybody started talking about China. Then there was the Covid pandemic and the war in Ukraine, but the starting point for the discussions, including in Europe, about issues of economic security was when you had Trump in the White House.

The US has a very clear de-risking strategy. In the communications from Jake Sullivan, the US national security adviser, there is a very clear strategy. The US has identified four key sectors: semiconductors, artificial intelligence, biotech and quantum computing. Why those four sectors and not cleantech for instance? It is because all those sectors have clear dual-use military applications.

Then there are the three tools. The first is industrial policy, the IRA, which has an impact on Europe's competitiveness. Then there are export controls. We have seen a revival of such tools that were previously forgotten. They dated back to the Cold War, and then we did not use them any more. We are using them again. Then there is collaboration with allies, as we have seen at the G7 forum.

Finally, there is the EU. It is more recent and nascent. I think there is a lack of consensus among EU member states about a common stance regarding China because there are very hawkish eastern European member states, and more flexible European member states, such as Germany and France, that are more open to doing trade and business with China. That is a key problem for EU strategy, but we see progress; there were communications last week about Europe's new economic security package. That is a picture of how others are doing.

Lord Sarfraz: In your list of blocs, why are you not including India yet? I see that the Indian stock exchange is bigger than that of Hong Kong,

France and the UK. It is the fourth-largest stock exchange in the world, with all types of growth. Why are you not considering it as a major economic security bloc?

Agathe Demarais: Of course, India is an important economy. India is excellent at balancing ties between various diplomatic partners. This may be beyond my knowledge, but I have not seen any strategy for economic security coming from India. I may be wrong on this one, but I have not seen any strong communications and strong views from the Indian Government on the topic.

The Chair: Thank you very much. I am going to move on to another area of questioning.

Q8 **Stephen McPartland:** Madame Demarais, how do you believe Russia's role in the international economy has changed since the invasion of Ukraine?

Agathe Demarais: We are facing a decoupling from Russia. I think that western economies will continue to impose sanctions on Russia for the foreseeable future for two reasons. First, sadly, I see no end to the war in Ukraine in the foreseeable future. Secondly, any rapprochement with Russia seems very difficult even to imagine because I am not entirely sure that even a potential successor to Putin would be inclined to negotiate or work alongside western economies. Sanctions are going to remain in place.

What we see at the moment is a decoupling of western economies from Russia. This is especially clear in the energy field. Russia used to be a major supplier of gas and oil, of course, to western economies. That is no longer the case. When we take a look at data for oil, we see that the three largest buyers of Russian oil by far, absorbing more than 90% of Russian oil exports, are, first, India, secondly, China and, thirdly, Turkey. We see a decoupling, which shows that Russia is completely reorienting towards non-western economies. That will lead to a global bifurcation of trade blocs, which will, of course, have a major impact on the global economy.

John Gerson: Russia's continuation of this war for any great length of time depends on \$60 oil. If oil comes down to \$60—I think it is about \$83 at the moment—or far lower, as it could, Putin will face real trouble before long.

Agathe Demarais: To add to that, it is difficult to have a view about the real state of Russia's fiscal situation at the moment. We know that Russia is probably tapping into the resources of its national sovereign wealth fund, the national welfare fund in Russian, and experts believe that Russia may be able to do that for two or three years. I agree with that view. It is a question of time, which leads to the fact that sanctions will take time to have a major impact on the Russian economy, but gradually they will take a toll on it.

There is a related question, which is relevant also to your previous question. Sanctions are currently depriving Russia of access to top-notch western technology in the energy field. For Russia, that is an existential threat, because a number of Russian energy fields are coming to maturity, which is a diplomatic way of saying that their reserves are fast being depleted. Russia needs to build new oil and gas fields to remain a major power on the global energy scene. Most reserves are located in the Arctic, and without access to American technology—it is mostly American technology—Russia will not be able to do that. At this stage, China does not seem to have that technology.

Gradually, Russia could lose its status as a global energy superpower, and the latest data from the International Energy Agency confirms that. At the moment, about 30% of globally traded oil and gas is from Russia, but that share could fall to 15% by 2030, which is essentially tomorrow. Of course, that is an existential threat for the Russian economic model, which relies on extracting and selling commodities abroad—oil and gas.

Professor Dennis Novy: I agree with everything that has been said. I want to say something quite general. What is important about Russia is that its economy is fairly small. It is about \$2.2 trillion. By comparison, the Italian economy is \$2.7 trillion. Russia is not that large in aggregate, but of course it is very powerful, especially in energy and some other smaller areas of the economy. It is now a war economy; about 40% of the government budget is on warfare. Let us compare that to the UK, where it is just over 2%.

On sanctions, what is important for UK policy in particular is the leakage problem. We are seeing now in the trade data that a lot of the stuff that Russia is not supposed to get, such as high-tech weaponry or high-tech semiconductors and so on, is rerouted through places such as Kazakhstan. It goes the other way for oil. A lot of the oil can be sold to China, and it is just relabelled and then suddenly becomes something like “Chinese oil”. They are building a new pipeline, the trans-Siberian pipeline.

For UK economic policy, it is crucial to stop that leaky pipeline and make sure that the sanctions are adhered to by lots of other countries and therefore not watered down. Economic warfare is slow, but eventually effective. Military warfare can of course be very fast depending on the circumstances. For the economy, it always takes a long time. I agree fully with what Agathe said.

Agathe Demarais: If I may, I have just one more remark. I agree with everything that you said. The Iran JCPOA is a very good example of sanctions working, but it took time. It took several years before Iran got to the negotiating table. That is a good example to keep in mind.

It is extremely important to tackle sanctions evasion, especially for semiconductors and top-notch technology. That being said, it is also important to remind ourselves that this does not mean that export controls are completely ineffective. When we look at the data, we see

that Russia's imports of top-notch technology dropped by about 40% between the first half of 2021 and the first half of 2023, at a time when Russia's needs have probably never been higher. That is a study conducted by the Bank of Finland.

The big picture is that export controls have an impact; it is not black and white, and they are not perfect, but more needs to be done to ensure compliance. In this field, I would argue that more alignment between the UK and the EU sanctions regimes would be a massively positive step. The UK used to be part of EU sanctions regimes. I am a former French Treasury official working on sanctions. I can tell you that the most important partners, the people we were working with on a daily basis, were the British. I would have bet that the UK would remain in EU sanctions regimes, but the UK has left EU sanctions regimes, and it creates loopholes. For instance, there are some Russian hacker groups that are under sanctions in some jurisdictions but not in others. That creates loopholes that illicit actors can take advantage of, and it is an important point to recognise.

Stephen McPartland: I have two quick points. First, how would we get down to \$60 a barrel in the current climate? If Russia continues to mobilise assets and do what it is doing and the European Union and UK continue to respond, that will have a negative impact on our economic activity. How does a state's economic activity and security contribute to its ability to apply effective sanctions if sanctions take so long?

John Gerson: A very quick answer is that it is only by sacrificing our need to care about climate change.

Stephen McPartland: So \$60 a barrel is by sacrificing—

John Gerson: It would not be difficult, given the enormous potential for more shale production from the United States, where President Biden has just suspended 15 potential LNG licences, for example, in the gas field, or by strong-arming Saudi Arabia in ways that people have not tried hitherto; but it would be laying victory in Ukraine on the altar of climate change.

Agathe Demarais: Maybe I can comment on the second part of the question. I do not think that sanctions are the root cause of economic difficulties in Europe at the moment. It is Russia's weaponisation of gas flows that has led to an increase in energy prices, not the other way around. There are no sanctions on gas imports from Russia at the moment. Actually, Russia's LNG still makes up about 14% of total gas imports in western Europe.

When we take a look at sanctions—the G7/EU price cap on Russian oil exports—the price is capped at \$60 per barrel, which has a disinflationary effect. It is a price cap. I would say that it is the other way around. It is Russia's decisions to invade Ukraine and then to weaponise gas flows that have had a detrimental economic impact, not the other way around.

Q9 Richard Graham: That is a really interesting point about the price of oil and the effect that it could have on economic security. John Gerson, do you think that the sanctions on Chinese individuals have had any noticeable effect on China's approach to Xinjiang or any other beneficial result? Since they have made it very clear that any sanctions, or, indeed, further sanctions, would simply give them the button to press for more sanctions against us, is there a benefit to that policy, which is rather different from the one on Russia and economics?

John Gerson: The palpable effect of China's sanctioning Members of Parliament, for example, was that it severely damaged a considerable Chinese interest. It nettled people. The Chinese have a very strong interest in separating European nations from the United States. They were doing okay on that. They have done very badly since the Ukraine invasion and since taking measures such as sanctioning British parliamentarians. It was an act of self-harm.

Richard Graham: I think that you are absolutely right about that, but it does not quite answer the question, what has it achieved for us?

John Gerson: That is all that I know to say.

Richard Graham: Madame Demarais?

Agathe Demarais: I am happy to say a few words about it. My area of expertise on sanctions is mostly linked to Russia. A question that I am often asked is: what is the effectiveness of individual sanctions on Russian oligarchs? I agree that such measures are going to have a huge impact on the individuals but not on the Russian economy. They are mostly symbolic measures, but they matter, for two reasons.

The first reason is the diplomatic message that is being sent, both to Russia and to Ukraine: a message of western resolve. It is the same thing when Chinese individuals fall under sanctions. It would be foolish to expect a change in policy for China because of these sanctions. Still, there is a diplomatic message and I think that it is an important one. Then there is the question of the counterfactual. What would happen if we did not impose sanctions? What message would we be sending? That is a key question and, to me, a key argument in favour of such sanctions.

Richard Graham: Do you think that that argument works equally well for the sanctions on Russian individuals and those on Chinese members of a system that has introduced policies that we intensely dislike?

Agathe Demarais: The example that you used referred to Xinjiang, where there are well-documented human rights abuses. I think that such sanctions are warranted in such cases.

Professor Dennis Novy: On Xinjiang, since you mention it, I fully agree that targeting individuals is not an economic measure. It is still very important, in my view, but it is not an economic point. What is an economic point is the supply chain tracing. There has been some legislation coming in at EU level, which the UK may want to look at,

requiring companies to document whether they get any inputs from Xinjiang. For example, if you produce clothes and get cotton from Xinjiang province, you might no longer be able to do that. That does have an economic impact. The Chinese track that very closely. Of course, it is a potential problem for them.

Richard Graham: Yes. As I understand it, the specific economic sanction on that has moved from being a positive one to having to prove a negative. You have to demonstrate as a shirtmaker that no strand of cotton might have been made by somebody working under pressure in a place that might have such labour working for them. That is a very difficult thing for businesses to deal with.

John Gerson: Can I add a comment? First, I strongly endorse the counterfactual point made by my companion. Also, I make the point that it is a staggering failure of diplomacy that we, the West, have failed to persuade Muslim Governments to take up the cause of Muslims in China. There are Muslim villages on the outskirts of Beijing. It is not just Uighurs. They have been subjected to horrors, and Muslim states, which, in some cases, are reluctant to show sympathy for Palestinians, certainly show none for their coreligionists in China. That is a scandal that we should be scratching all the time, because it is the best hope to effect change there.

Richard Graham: Chair, that is probably something for our next review and discussion, which we were talking about earlier, before you arrived, rather than for this one, on economic security. Anyway, thank you very much.

Q10 **The Chair:** Of late, there has been increasing talk of issues such as economic deterrence. In your judgment, how have UK and EU approaches to economic deterrence changed in recent years?

Professor Dennis Novy: We have covered a bit of that territory already, when talking about sanctions. Sanctions have been around for a long time, of course, but they have become much more front and centre because of what has happened in Ukraine and Russia.

Another issue is the scrutiny or screening of high tech. Huawei was a big topic a few years ago. Security in general, like military alliances, often has an economic sidearm: particular research in science and technology that can be military but is not necessarily military research. The big issue here is AI, which is going to come in. The stories about fake news and how we can undermine the rules-based system and democratic systems of free information are a really important area where countries have to work together.

As was said previously, with all these issues that have to do with the economy, it is essential to work with like-minded countries. No country that is a small or medium-sized economy, or even one that is relatively large, such as the UK, can do it on its own.

Agathe Demarais: I completely agree. It is a question of working with allies. With regard to Russia, probably one of the greatest achievements of like-minded democracies has been to remain on the same page for sanctions. In 2014, there were tensions between the European Union and the United States about sanctions against Russia. At the time, the United States wanted to go for much more stringent sanctions, which the European Union opposed because it relied much more on Russian energy.

It is very difficult to answer your question because, by definition, deterrence is going to be about things that we do not know. If deterrence has worked, something has not happened. It is very difficult to know what has not happened because of economic deterrence. The related point is that I have been asked a number of times why western countries do not go with much more stringent, robust measures against Russia. I would say that it is to keep some powder dry and to keep the deterrent effects if there is an escalation of the war in Ukraine.

Finally, of course, the big question is going to be about Taiwan: economic deterrence against China and Chinese aggression against Taiwan. In this field, I am increasingly worried. I know that I have said it a number of times already, but I see China vaccinating itself against sanctions. I see China doubling down on its ambitions for technology self-sufficiency. I see China decoupling, de-risking and doing economic security, whatever we want to call it. It will give less leverage to western economies to apply pressure on China if China invades Taiwan or has other aggressive behaviour around Taiwan.

- Q11 **Lord Sarfraz:** How can businesses be supported to respond to sanctions? We had a situation in this country where hundreds of thousands of jobs were held by individuals working for businesses owned by a private equity fund of which the primary sponsors were sanctioned Russian individuals. One day, all of a sudden, they do not know whether they will get funding, whether their accounts will be frozen, et cetera. How can they be helped? How can we prepare them for such situations?

Professor Dennis Novy: If a business, or even an entire industry, faces a big shock—their business, for whatever reason, breaks away—it is very tough. There is not much that you can do in the short run. You can just hope that the businesses are diversified and can find their feet and reorient towards other markets. That is what you can do.

You could always throw money at businesses. You could throw subsidies at them, to the extent that that is compatible with legal frameworks, but that probably does not make much sense from an economic policy point of view. It is just part of the problem of living in a volatile world. You want to have your biggest exposure to markets that are reliable and not volatile so that you can deal with shocks.

I mentioned at the very beginning that the definition of economic security can be that you have to be able to deal with and absorb shocks. That is very hard to do when dealing with very volatile countries. Perhaps a point to be made to that industry is that, if you make yourself very vulnerable

by dealing to a large extent with countries that are potentially risky, it is part of the business risk. Obviously, businesses are not free money. They need to understand those risks.

Lord Sarfraz: Madame Demarais, you have worked on sanctions. The professor talked about exposure to markets that might be sanctioned, but what if your investors are sanctioned, or a fund they have invested in or a bank they have invested in that is lending to you are sanctioned? How do you prepare yourself for all that?

Agathe Demarais: I completely agree with this. When you are doing business with countries that show aggressive behaviour, the risk has to be priced in by private firms. It is not as though Russia invaded Ukraine and there were no clues that anything was going to happen. That is the key thing. It is all about identifying the risks, diversifying the risks—having a diverse base of suppliers—and due diligence. I would be very surprised if any person fell under sanctions out of the blue.

Q12 **Baroness Fall:** You have talked about sanctions and the growing strategy to build resilience so that they do not impact in relation to China. What are the other tools in the toolbox, as it were? I am mindful of the fact that, with Ukraine, a lot of businesses helped by divesting from the region. The impact was larger because the private sector acted, under pressure, for reputational and other reasons. Is that something that you see as potentially coming again?

Agathe Demarais: To be clear, on the tools, do you mean tools for China to vaccinate itself?

Baroness Fall: No, tools for us, other than sanctions.

Agathe Demarais: Okay. I do not think that there is an easy fix, sadly. I think that there will be a gradual loss in the effectiveness of sanctions. It is not going to happen from one day to another, but over several decades rogue countries are going to have access to non-western financial mechanisms.

The impact will not only be on foreign policy. For instance, tracking illicit financial flows is a key way to prevent terror attacks or to track nuclear proliferation. If groups involved in illicit activities have access to financial mechanisms we have zero oversight of, tracking their activities will be very difficult. At the same time, I would argue that we are in this situation because we, too, have weaponised access to western financial mechanisms—for instance, when we cut off Iran's access to the SWIFT network in 2012. At the moment, there is a debate about seizing the reserves of the Russian central bank. The moral argument in favour of proceeding is extremely strong. At the same time, we have to recognise that we would have to weaponise Euroclear, a global security depository, to do that.

There is no easy answer to this question. It is not black and white. I think that, over time, there will be a gradual loss in the effectiveness of

sanctions. I am sorry, but I am not sure that I understood your second question.

Baroness Fall: It was about the fact that the second pillar of the financial reaction in Ukraine was a lot of western companies leaving Russia.

Agathe Demarais: Of course.

Baroness Fall: Do you think that something like that would happen in Taiwan, for example?

Agathe Demarais: Absolutely. The reputational risk of doing business with China, if China were to invade Taiwan, would be extremely high. It depends on the jurisdictions and the specific sectors, of course, and there are a lot of technicalities, but most western companies can still do business with Russia. It is very difficult in practice because of banking issues, and it is problematic on a number of accounts, but businesses that have left Russia have done so mostly because of reputational problems and name-and-shame campaigns. Such a thing would likely happen again if China were to invade Taiwan.

John Gerson: You asked what the other tools in the toolbox are. An instant answer is isolation and the law. Mr Putin has been severely damaged, and will feel that he has been severely damaged, by the fact that he is no longer able to turn up at what was the Group of Eight and is now the Group of Seven. Even more, he could not go to represent himself and his country in South Africa for fear of arrest. That is powerful. There are other tools, but those are two that occur straightaway.

The Chair: I move on now to one final area of questioning.

Q13 **Sarah Atherton:** Good evening, all. I want to look at maritime risks, particularly events in the Red Sea. Suez Canal transit is down by 37% and Cape of Good Hope passages are up by 70% since the Houthi attacks. That demonstrates the impact that maritime disruption has on international trade. It is not just military conflict. We saw a blockage of the Suez Canal for six days in 2021. What can the UK Government do to address the increasing risk of disruption to global maritime trade?

John Gerson: Restore the Royal Navy.

Sarah Atherton: I would not disagree.

John Gerson: It takes 200 years, but it works.

Professor Dennis Novy: The UK has to work with other countries to see what can be done on the military side. That has already been happening in the Red Sea, with the Suez Canal. Apart from that, it is about resilience. It is perhaps about absorbing higher costs. If shipping through the Suez Canal becomes more difficult and that is a permanent feature, you have to go to other routes. That will be costly. You just have to be transparent about that. Just because the Suez Canal has been there for a

long time does not mean that it will be there for ever. It is not the first time that there have been such disruptions. I think that a lot of businesses are well placed to deal with that. We had the Evergreen disaster a few years ago, when the canal was blocked. We are now having problems in the Panama Canal because there is not enough water in the canal. Those issues arise.

You have to keep the bigger picture in mind. Yes, some goods come by ship, and they may be essential, especially if they are supply parts for manufacturing businesses, but the future of UK trade is in services. The majority of UK trade is already in services. That is the one area of UK trade that over the last few years has not been damaged as much as goods trade. If we look at the evidence, we see that the UK has not done very well on trade. It has lagged. There has been a bit of a trade boom in Europe and elsewhere, especially since the end of Covid, but the UK seems to be the odd-one-out country that has missed out on that.

One really important question to which we do not yet know the answer—it is open research—is whether the Brexit problems will lead to supply chain issues further down the line. Is the UK damaged in its overall supply chain, even with countries outside the EU? There seems to be some early evidence pointing in that direction. We do not quite know yet. I would say to government, “Stop doing foolish things”. That is a really important implication. Look at the evidence. Look at the data. Talk to businesses. Talk to people who work in businesses. Listen to them, and stop doing things that damage manufacturing industries, in particular. When it comes to the strategy, think about trade in services.

Sarah Atherton: Can I go back to maritime trade, in particular? Despite what you have said, the UK is the fifth-largest exporter of goods and services. Maritime transport accounts for 95% of UK export and import trade by volume, so it is imperative that we have safe transit and resilient supply chains. I do not disagree with that. Is the UK more vulnerable to maritime risks compared with our G7 allies? If so, why?

Professor Dennis Novy: No, I do not think that the UK is more vulnerable than any other country there. If we compare the UK with France, Germany or Spain, we see that they face the same risks on that front. I do not think that the UK is an outlier in any way on that front.

Q14 **Sarah Atherton:** The last question is about critical underwater infrastructure and its security. I think we have mentioned this before. When I say undersea infrastructure, I mean oil, gas and communications. I would like to extend that to offshore wind farms and oil rigs. Recently, we saw the “grey zone” sabotage of the Nord Stream pipeline in the Baltic Sea. A lot of such infrastructure is privately owned. How should the UK respond to such “grey zone” sabotage threats and is it doing enough?

John Gerson: It should be through the mechanisms that have applied for decades for the protection of critical infrastructure: sharpening them, rejuvenating them and maintaining them.

Sarah Atherton: Do you think that the UK has taken a lead in fostering combined science and maritime co-operation with like-minded states and commercial businesses?

John Gerson: I do not know.

Sarah Atherton: That was short and sweet. Thank you, panel.

The Chair: I am very mindful of the fact that Madame Demarais needs to leave very shortly.

Agathe Demarais: I have time for a few more minutes.

The Chair: If you have a few more minutes, Lord Stansgate has a question that he is keen to ask.

Q15 **Viscount Stansgate:** How effective has UK-EU co-operation been on energy security?

Agathe Demarais: To be honest, I do not know. That is outside my area of expertise, so I am not able to respond.

Viscount Stansgate: I understand. In that case, I will move on to ask this question. What would be the security risks of developing a more diverse energy supply and how should those risks be managed? Does any member of the panel want to consider that briefly in the short time left?

Professor Dennis Novy: On UK co-operation on energy security, it is crucial to focus on international trade. The wind does not always blow everywhere, so the trade in electricity from the UK to the continent and the other way around is something worth investing in. It strengthens the UK's economic security, provides insurance for the UK and does the same for France, Norway and other countries. It is a common interest where there is a potential win-win to be had. In terms of—

Viscount Stansgate: Forgive me for interrupting. Are you referring to the interconnectors that exist around Europe?

Professor Dennis Novy: Yes, but also energy pipelines such as the gas pipelines from Norway and so on.

Diversifying the UK's energy supply is a lot about green technology and, perhaps, nuclear. It is vital to the UK interest. Energy is a security issue. You do not want to be vulnerable to someone sitting in the Kremlin cutting off your energy supply. For that reason alone, it is definitely in the UK economic interest to invest in green energy and, perhaps, nuclear and to bring down energy costs. We already know that the per unit energy costs for solar and wind are substantially lower than what coal and gas can offer. It depends a bit on whether the wind is blowing and you need energy storage. The wind is not always blowing, so there needs to be major investment. We have electric cars. This is definitely the future.

The UK has a lot of expertise in that. It made huge progress on wind energy a few years ago. That is something to be very proud of and to continue.

Agathe Demarais: As a general rule, more diverse is always better when it comes to security and safety. I would say that diversification of energy supplies is always a good idea.

John Gerson: Didn't Churchill say that our energy security depended on diversity of supply? I think he did, but I am not 100% sure. It does. I think that the added risks are classic business risks, plus the fact that if we are increasing our supply from traditional sources, fossil fuels and so on, all too often that involves doing business with regimes that themselves carry risk: reputational risk, stability risk and so on. It seems to me that it is a classic question with a conventional answer: diversity, yes.

The Chair: As it has gone past six o'clock, I thank all three of you for coming. I am sorry that I was delayed at the start of the meeting. Clearly, it has been a constructive one. We very much appreciate your willingness to give evidence to us.